SUPREME COURT OF FLORIDA

Case No. SC02-2647

VERIZON FLORIDA INC.,

Appellant,

v.

LILA A. JABER, et al.

Appellees.

INITIAL BRIEF OF VERIZON FLORIDA INC.

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PREFACE

Verizon Florida Inc. appeals the Florida Public Service Commission's Final Order on Rates for Unbundled Network Elements Provided by Verizon Florida, Order number PSC-02-1574-FOF-TP, issued November 15, 2002 (referred to herein as the "*UNE Order*"). Appellant, Verizon Florida Inc., is referred to herein as "Verizon." Appellee, the Florida Public Service Commission, is referred to as the "Commission." The Federal Communications Commission is referred to as the "FCC."

All references to the transcript of the October 14, 2002 special agenda conference at which the Commission established Verizon's unbundled network element rates are designated by "T." followed by the page number within the transcript.

STATEMENT OF THE CASE

Verizon appeals the Commission's *UNE Order* setting rates for Verizon's unbundled network elements ("UNEs"), which are parts of Verizon's local telephone network that may be leased by its competitors.

In May of 1999, the Commission opened a docket to examine the UNE rates of Verizon (then, GTE Florida Incorporated) and the other two large Florida incumbent local exchange carriers, BellSouth Telecommunications, Inc. ("BellSouth") and Sprint-Florida, Incorporated ("Sprint").[1] The Commission held separate evidentiary proceedings and issued separate UNE rate-setting orders for each of these three companies. In Verizon's proceeding (the only one at issue here), Verizon, the Commission Staff, and intervenors submitted written testimony, and the Commission held a hearing on April 29 and 30, 2002.

On September 25, 2002, the Commission Staff issued its Recommendation on each of the issues for resolution in Verizon's UNE rate-setting proceeding.[2] The Commission voted on Staff's recommended decisions in a special

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[1] *See UNE Order* at 13, *citing* FPSC Order No. PSC-99-1078-PCO-TP.

[2] *Investigation into Pricing of Unbundled Network Elements* (Sprint/Verizon Track), Docket No. 990649B, Memorandum from Div. of Competitive Markets & Enforcement, et al. to Director, Div. of the Commission Clerk & Admin. Services, dated Sept. 25, 2002 ("*Staff Recommendation*").

agenda conference held on October 14, 2002.[3] Participation at this agenda conference was limited to the Commissioners and Commission Staff.[4]

The *UNE Order*, issued November 15, 2002, memorializes the Commission's rulings at its agenda conference. The Order significantly reduces Verizon's UNE rates without substantial, competent record evidence. This is not the usual appeal under the substantial competent evidence standard, where the parties disagree on the substance of the evidence and whether it meets that standard. Here, Verizon challenges certain rulings in the UNE Order because they are based on (1) information the Commission knew was outside the record; (2) unsworn statements from Commission Staff who did not testify and whose allegations conflicted with the sworn testimony of Staff and Verizon witnesses; and (3) mistaken calculations.

Verizon timely appealed the *UNE Order*.

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[3] *See generally* Special Agenda Conf. Transcript, October 14, 2002.
[4] *See Staff Recommendation* at 1.

STATEMENT OF FACTS

The federal Telecommunications Act of 1996 ("Act")[5] was intended to promote competition for local telephone services by imposing a series of wholesale obligations on incumbent local exchange carriers ("ILECs"), like Verizon. Among other things, ILECs must lease parts of their networks to alternative local exchange carriers ("ALECs") so that these carriers can provide their own services using these unbundled network elements ("UNEs").[6] The Act provides that, when ILECs and ALECs fail to agree on UNE prices, state commissions may set a "just and reasonable" and "nondiscriminatory rate" for each UNE, based on "the cost of providing the . . . network element," and which "may include a reasonable profit."[7]

The FCC has established the costing standard that states must use in determining the costs upon which UNE rates are based.[8] This standard is called the total element long run incremental cost (or "TELRIC") methodology.

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[5] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56.
[6] 47 U.S.C. § 251(c).
[7] 47 U.S.C. § 251(d)(1).
[8] *See AT&T v. Iowa Utils. Bd.*, 525 U.S. 366, 383-85 (1999).

Under the FCC's TELRIC pricing standard, the cost of a UNE has four components—(1) operating expenses; (2) depreciation; (3) cost of capital; and (4) "a reasonable allocation" of common costs.[9]

In the proceeding below, only Verizon filed studies calculating the cost of each of its UNEs.[10] Although other parties could have presented their own cost studies, they and a Commission Staff witness instead suggested various changes to the assumptions and input values underlying Verizon's cost studies and the proposed UNE rates resulting from those studies.

The *UNE Order* adopted Verizon's cost model ("ICM-FL") and the majority of the assumptions and inputs used in the model.[11] The Commission modified, however, Verizon's inputs for depreciation, cost of capital, and loading factors, as well as Verizon's proposed common cost allocator, among other things. In making these changes, the Commission relied on information outside the evidentiary record and the unsworn, post-hearing speculation of Staff

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[9] *Implementation of the Local Competition Provisions in the Telecomm. Act of 1996, First Report and Order*, 11 FCC Rcd 15499 (rel. Aug. 8, 1996) at ¶¶ 672, 703 ("Local Competition Order").
[10] Hearing Transcript at 640-42 (Trimble Direct).
[11] *See UNE Order*, *passim.*

members who were not witnesses in the proceeding and whose statements conflicted with the sworn testimony of the Staff witness who testified in the proceeding.

STANDARD OF REVIEW

The Court shall reverse agency action that "depends on any finding of fact that is not supported by competent, substantial evidence in the record" or that is otherwise an abuse of discretion.[12] This Court "will not affirm a decision of the Commission if it is arbitrary and unsupported by substantial competent evidence, or in violation of a statute or a constitutionally guaranteed right."[13] Competent, substantial evidence sufficient to sustain a finding of an administrative agency has been defined as such relevant evidence, when considered in its entirety, that a reasonable mind might accept

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[12] FLA. STAT. § 120.68(7) (2000); *Southern Bell Telephone and Telegraph Co. et al. v. Florida Pub. Serv. Comm'n*, 443 So. 2d 92, 95 (Fla. 1983); *United Tel. Co. of Florida v. Mayo*, 345 So. 2d 648, 651 (Fla. 1977); *Bayonet Point Reg'l Med. Ctr. v. Dept. of Heath and Rehabilitative Services*, 516 So. 2d 995, 996-97 (Fla. 1st DCA 1987).

[13] *Shevin v. Yarborough*, 274 So. 2d 505, 509 (Fla. 1973); *see also Citizens of the State of Florida v. Pub. Serv. Comm'n*, 425 So. 2d 534, 538 (Fla. 1982).

as adequate to support a conclusion.[14] Substantial, competent evidence must do more than create a suspicion of the existence of the fact to be established.[15]

[14] *Agrico Chemical Co. v. State Dept. of Envtl. Regulation*, 365 So. 2d 759, 763 (Fla. 1st DCA 1978); *Ammerman v. Florida Bd. of Pharmacy*, 174 So. 2d 425 (Fla. 3d DCA 1965); *Agner v. Smith*, 167 So. 2d 86 (Fla. 1st DCA 1964).
[15] *Tamiami Trail Tours, Inc. v. Bevis*, 299 So. 2d 22, 24 (Fla. 1974).

SUMMARY OF ARGUMENT

Verizon asks this Court to reverse the rulings under review because they are arbitrary and unsupported by competent, substantial evidence. Instead of making decisions based on the evidentiary record in this case, the Commission relied on unsworn remarks of Staff who did not testify in the case; reached outside the record to impose results adopted for a different company and based on a different record; arbitrarily changed Verizon's proposals without any supporting evidence; and inexplicably failed to correct mistakes in its cost calculations. These reversible errors made Verizon's Commission-ordered UNE rates significantly lower than they otherwise would have been.

In making its cost of capital ruling, the Commission relied on unsworn comments of Staff member Lester, who was not a witness in the case. Mr. Lester's remarks contradicted the sworn deposition testimony of Staff witness Draper. Mr. Lester speculated that Mr. Draper "misspoke" when he offered testimony corroborating a key fact in the testimony of Verizon witness Dr. VanderWeide. Mr. Lester's conclusion in this regard was based on his asserted "independent check" of a source that Mr. Draper never consulted or relied upon when determining Verizon's forward-looking cost of equity. It was also contrary to the testimony of Dr. VanderWeide, a recognized expert in the area of

telecommunications finance. In adopting Staff's recommendation, the Commission disregarded the unrebutted testimony of Mr. Draper and Dr. VanderWeide.

For its depreciation ruling, the Commission (on a 3-2 vote) rejected the depreciation lives Verizon actually uses for financial reporting purposes, in favor of the depreciation lives the Commission ordered for BellSouth in another proceeding. The Commission did so even though there was no record evidence about BellSouth's depreciation lives; indeed, the Commission even expressed concern about reaching outside the record to adopt those BellSouth lives.

Similarly the Commission approved Staff's recommendation to slash Verizon's loading factors, even after Staff admitted its proposed reductions were not based on anything in the record. Again, the Commission's expressed objective was to bring Verizon's results "more in line with" BellSouth's, even though there was no record supporting a conclusion that BellSouth's loading factors were appropriate for Verizon.

The Commission's common cost rulings do not account for the Commission's own adjustments to Verizon's cost model inputs and assumptions—although the Commission apparently intended that they should. The Order does not explain these inconsistencies between the Commission's model adjustments and the costs it determined, so Verizon

concluded that they were calculation errors. Verizon sent the Commission a letter identifying the miscalculations and asked that they be corrected before the Commission's vote. The Commission never read the letter.

For its decision setting the UNE platform rate, the Commission again failed to flow through its changes in model inputs and assumptions to its cost results. Both Verizon and Staff advised the Commission that Staff's recommended reduction in the UNE platform rate was not accurate, given Staff's other adjustments. The Commission approved the reduction anyway.

The Commission's abuse of discretion in each of these instances is patent. Because the decisions under review are arbitrary and lack the requisite foundation of competent, substantial evidence, they must be reversed.

ARGUMENT

I. THE COMMISSION IMPROPERLY RELIED ON INFORMATION THAT WAS NOT IN THE RECORD.

A. The Commission's Cost of Capital Determination Must Be Reversed Because It Disregards Undisputed Staff and Verizon Testimony and Relies Instead on the Unsworn Speculation of a Staff Member Who Did Not Testify.

The cost of capital is an essential input to any UNE cost study and significantly affects the resulting costs and rates. Here, the Commission understated Verizon's cost of capital and the resulting UNE rates by disregarding the sworn deposition testimony of Staff witness, Mr. Draper, who conceded that he had made a significant mistake in his cost of capital computation. Instead, the Commission relied upon the unsworn speculation of a Staff member, Mr. Lester, who claimed at the agenda conference that Mr. Draper did not really mean to say what he did in his sworn deposition and that Mr. Draper's original pre-filed written testimony was correct. The Commission ignored Verizon's uncontested testimony describing that same mistake. The Commission, likewise, disregarded the evidence proving that Mr. Draper had made a second mistake in his analysis. Correcting Mr. Draper's mistakes substantially increases Verizon's cost of capital and the ordered UNE rates.

The cost of equity, along with the cost of debt and capital structure, comprise a company's cost of capital, which is the required rate of return on the investment in telecommunications facilities used to provide UNEs.[16] Verizon's appeal of the Commission's cost of capital determination addresses only Staff witness Draper's cost of equity analysis, and the "proxy companies" upon which that analysis is based.[17] Verizon is not challenging Mr. Draper's criteria for selecting proxy companies; rather, it is challenging Mr. Draper's application of his own criteria.

Mr. Draper considered the appropriate proxy group to be all publicly traded telecommunications holding companies, except for companies that received less than 75 percent of their annual revenues from telecommunications services and companies that were the subject of ongoing mergers or acquisitions.[18] The problem is that Mr. Draper's calculations did not follow his stated criteria.

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[16] Hearing Transcript at 391 (VanderWeide Direct).

[17] It is impossible to directly evaluate alternative equity investments of comparable risk in this instance for two reasons. First, Verizon is a wholly owned subsidiary, and its stock is not publicly traded. Second, there are no publicly-traded companies that have built telecommunications networks solely to provide UNEs. Therefore, it is necessary to develop a list of proxy companies whose cost of capital can be used to determine the cost of capital for purposes of setting UNE rates.

[18] Hearing Transcript at 235 (Draper Direct); Draper Depo. at 31-32.

1. Mr. Draper Mistakenly Excluded SBC from His Group of Proxy Companies.

In his pre-filed rebuttal testimony, Dr. VanderWeide demonstrated that Mr. Draper had mistakenly excluded SBC Communications ("SBC") from his proxy group, even though SBC "is a large telecommunications holding company that receives all its revenues from telecommunications operations."[19] Mr. Draper acknowledged this error under oath at his deposition, admitting (subject to check) that SBC did, in fact, receive more than 75 percent of its revenues from telecommunications operations.[20] Mr. Draper *never* changed, supplemented, or clarified this response, although he easily could have done so on numerous occasions. The record on this point is clear and unrebutted: Mr. Draper erred when conducting his cost of capital analysis; SBC should have been included in his group of seven telecommunications holding companies.

The Commission nonetheless overlooked this erroneous omission, choosing instead to rely on the unsworn comments of a Staff member who was not a witness in the proceeding. At the agenda conference where the Commission voted on Verizon's UNE rates, Commissioner Bradley focused on Staff witness Draper's mistaken

[19] Hearing Transcript at 443 (VanderWeide Rebuttal).
[20] Draper Depo. at 56.

exclusion of SBC, asking Staff whether Mr. Draper should be asked to revise his analysis to comport with his own criteria for selecting the proxy companies.[21]

In response, Staff member Lester acknowledged that witness Draper, during his deposition, "did agree, subject to check, that SBC has greater than 75 percent revenue" from telecommunications operations.[22] This admission corrected Mr. Draper's earlier, pre-filed testimony excluding SBC from his proxy group. Nevertheless, Mr. Lester "just chose[] to go with what he [Mr. Draper] put in his direct testimony,"[23] because he speculated that Mr. Draper "misspoke in his deposition."[24] Mr. Lester's unsworn speculation was based on his claim to have "independently check[ed]" and determined that SBC had less than 75 percent of its revenue from telecommunications operations.[25]

This "independent check" was not only contrary to Mr. Draper's deposition testimony, but also the sworn testimony of Verizon witness Dr. VanderWeide, a Professor at Duke University's School of Business with particular

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[21] T. at 61.
[22] T. at 62.
[23] T. at 62.
[24] T. at 63, 71.
[25] T. at 63-64.

expertise in conducting financial analyses of telecommunications companies.[26] Moreover, the source cited by Mr. Lester to support his "independent check," the C.A. Turner Reports, was never relied upon by Mr. Draper when developing his proxy group of telecommunications companies.[27]

Chairman Jaber immediately recognized the problem with Mr. Lester's "independent check:"

> CHAIRMAN JABER: Is that in the record?
>
> MR. LESTER: No.[28]

The discussion continued:

> CHAIRMAN JABER: But the fact—you just said you independently checked and SBC's revenues are 75 percent less. That fact, is that in the record?
>
> MR. LESTER: No, ma'am. I'm not aware that it is.

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[26] Hearing Transcript at 378-80 (VanderWeide Direct).
[27] Draper Depo. at 57.
[28] T. at 64.

> COMMISSIONER BRADLEY: What are you using to—where is the hard data? I mean, what is there that you can show us that indicates that that is true? And what I'm trying to get at is the fact that there appears to me at least to be some inconsistencies, and I'm trying to get at the facts."[29]

After Mr. Lester repeated his belief that Mr. Draper "misspoke" in his deposition, Commissioner Bradley observed:

> [T]hat is a tremendous burden to put on staff in terms of trying to speak for Mr. Draper; this it, to try and interpret or to assume that he misspoke. And, I think it is unfair to put [Staff] in the position of trying to answer maybe what was going on in Mr. Draper's mind. . . .[30]

Despite the obvious concerns about Mr. Lester's extra-record speculation, which conflicted with Dr. VanderWeide's sworn testimony, the majority voted to accept Mr. Draper's original, incorrect cost of equity recommendation.

As Commissioner Bradley (who voted against Staff's recommendation) suggested, interpreting "what was going on" in a *sworn witness's* mind is not Staff's job, nor is it a task Staff can properly undertake, in any event. The Commission may not properly rely on such unfounded guesswork.

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[29] T. at 64.
[30] T. at 72.

Mr. Lester's unsworn, untested comments, offered to support his recommendation disregarding Mr. Draper's deposition testimony, are not evidence at all, let alone the competent and substantial evidence necessary to support a Commission decision. Florida law requires the Commission's findings of facts to be "based exclusively on the evidence of record and on matters officially recognized."[31] "Governmental bodies authorized by law to pass upon utility rates must base their decisions upon evidence and not upon some undisclosed factor or factors."[32] Administrative due process contemplates "that the order be entered will be based on competent and substantial evidence adduced by the parties consisting of sworn testimony of witnesses and properly authenticated documents bearing the required indicia of credibility."[33] A party must be "given an opportunity to test, explain, or refute" all evidence.[34]

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[31] FLA. STAT. § 120.57(1)(j).
[32] *Marco Island Util., et al. v. Florida Pub. Serv. Comm'n*, 566 So. 2d 1325, 1329 (Fla. 1st DCA 1990), *quoting North Florida Water Co. v. City of Marianna*, 235 So. 2d 487, 489 (Fla. 1970).
[33] *Deel Motors, Inc. v. Dep't of Commerce, et al.*, 252 So. 2d 389 (Fla. 1st DCA 1971) (reversing agency order because it was based on unsworn oral presentation, including statements unsupported by any documentary proof).
[34] *Thorn v. Florida Real Estate Comm'n*, 146 So. 2d 907, 910 (Fla. 2d DCA 1962).

Verizon had no ability to test, explain, or refute Mr. Lester's off-the-record, incorrect speculation about the percentage of SBC's revenues derived from telecommunications services—a factual matter critical to the correct decision on the cost of equity.

The Commission abused its discretion in considering Mr. Lester's unsworn testimony, unsupported by any documentary proof, instead of accepting the uncontroverted record evidence on this issue. The Commission's ruling on the cost of equity must be reversed and remanded with instructions to accept Dr. VanderWeide's recalculation of Mr. Draper's cost of equity analysis, this time including SBC.[35] This is the only approach consistent with due process requirements and the evidence in this case.

2. Mr. Draper Mistakenly Included AT&T and CenturyTel in His Proxy Group of Telecommunications Companies.

[35] Hearing Exhibit 40 (VanderWeide Rebuttal at Exhibit JVW-1).

Mr. Draper's second criterion for his proxy group was the exclusion of telecommunications companies subject to ongoing mergers or acquisitions. But Mr. Draper's pre-filed testimony provided no information on which companies were eliminated because they were allegedly "the subject of an ongoing merger or acquisition."[36] As Dr. VanderWeide testified, Mr. Draper did not correctly apply this criterion because he included in his proxy group AT&T and CenturyTel, which were involved in mergers at the time.[37]

Commissioner Bradley also specifically asked about Mr. Draper's failure to adhere to his own selection criteria. As Commissioner Bradley explained:

> The exclusion of companies involved in a merger or acquisition is important because mergers and acquisitions cause abnormal fluctuations in a company's stock price. Since stock prices are a key driver in any cost of equity analysis, the exclusion of companies that are subject to a merger or exclusion . . . will help prevent skewed results. While Witness Draper requires the elimination of companies that are subject to an on-going merger or an acquisition, when calculating the cost of capital for Verizon, he did not follow this criterion and includes such companies in his proxy group . . . . For example, Draper included AT&T which was merging

[36] Hearing Transcript at 235 (Draper Direct); Hearing Transcript at 442-43 (VanderWeide Rebuttal).
[37] Hearing Transcript at 442 (VanderWeide Rebuttal).

> with Comcast. He also included CenturyTel which had an agreement to merge with ALLTEL.[38]

Commissioner Bradley pointed out that Staff's Recommendation did not explain why Staff accepted Mr. Draper's analysis despite this flaw, and asked whether Mr. Draper should be asked to revise his analysis to correct it.[39]

Mr. Lester responded that "the Staff witness had to make a judgment call and he chose to include AT&T and CenturyTel because, like I say, AT&T was not a complete company merger and in CenturyTel it was apparently a dying or nonexistent merger."[40]

Mr. Lester, and apparently Mr. Draper, disregarded the basis for Mr. Draper's own criterion for exclusion of companies from the proxy group—which is not whether the companies actually completed a merger or acquisition, but whether they were "subject to" a merger or acquisition. That is, the *announcement* of the merger or acquisition, rather than the completion thereof, is the relevant consideration, because that is the event that causes the "abnormal

[38] T. at 60-61.
[39] T. at 61.
[40] T. at 62.

fluctuations in a company's stock price," to which Commissioner Bradley referred.[41] Because there was no dispute that AT&T and CenturyTel had made such announcements, Mr. Draper should not have included them, according to his own, plainly stated "subject to merger or acquisition" criterion.

Inclusion of these companies substantially reduced the cost of equity included in the cost of capital the Commission used to set UNE rates. Although the Commission's *UNE Order* twice points out that Dr. VanderWeide challenged Mr. Draper's analysis because of its mistaken inclusion of AT&T and CenturyTel,[42] it does not resolve or otherwise address this objection, simply concluding summarily, "Witness Draper's index of companies is a reasonable proxy group for determining the cost of equity related to UNEs."[43] Based on the testimony of both Dr. VanderWeide and Mr. Draper, it was undisputed that AT&T and CenturyTel had made agreements to merge with or acquire other companies. They were thus "subject to" mergers or acquisitions that would cause fluctuations in their stock prices.

[41] T. at 60.
[42] *UNE Order* at 83.
[43] *Id.*

Mr. Draper's failure to exclude AT&T and CenturyTel from his proxy group violated his own selection criterion. The Commission's approval of his recommendation was thus arbitrary and not based on the record evidence.

B. The Commission's Depreciation Ruling Must Be Reversed Because It Is Based on Information Outside the Record.

As in the case of the cost of capital, the Commission ignored the record evidence in adopting the depreciation inputs for use in Verizon's cost model. Instead, by a 3-2 vote, the majority relied on the extra-record opinions and speculation of its non-testifying Staff. The Commission's depreciation ruling must be reversed for the same reasons.

A key factor in assessing the forward-looking cost of UNEs is an estimation of the depreciation lives of the facilities required to provide UNEs.[44] The Commission recognized that its choice of depreciation inputs in this case would have a very significant impact on UNE rates.[45]

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[44] 47 C.F.R. § 51.505(b).
[45] *See* T. at 29-30.

In its UNE cost study, Verizon used the same depreciation lives it uses for financial reporting purposes.[46] These lives conform to Generally Accepted Accounting Principles ("GAAP") and are commonly called "GAAP lives." GAAP lives are required to be reliable and unbiased.

Nonetheless, the Commission's split decision disregarded the inherent reasonableness of Verizon's GAAP lives, as well as the additional evidence Verizon offered to support those lives, in favor of depreciation lives the Commission had determined for BellSouth in BellSouth's UNE rate setting case. As the transcript of the discussion at the agenda conference and the *UNE Order* itself amply demonstrate, the Commission had no evidentiary basis whatsoever for replacing Verizon's GAAP lives with BellSouth's lives. The Commission's depreciation ruling is thus arbitrary, lacks the requisite foundation of competent and substantial evidence, and must be reversed.

The Commission knew there was no evidence supporting its adoption of BellSouth's depreciation lives. When Commissioner Deason pressed Staff to explain why the Commission should adopt BellSouth's depreciation lives, rather than Verizon's own GAAP lives, Staff member Lee responded: "All I can say is that the lives that you approved for

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[46] *UNE Order* at 45; *see also* T. at 33-34.

BellSouth were based on an in-depth study and analysis that BellSouth provided" and that Staff believed the factors underlying BellSouth's analysis "would be as applicable to Verizon as they are to BellSouth."[47] Commissioner Deason then asked "how are those factors part of the record in this proceeding?" Ms. Lee answered, "*they are not, quote, part of the record*."[48]

Commissioner Baez was "concerned as well about our lack of record in order to just say, all right, these are the numbers that we are going to take."[49]

Chairman Jaber was also troubled about the lack of record evidence to support adoption of BellSouth's lives,[50] and she and the other Commissioners discussed options for developing an adequate evidentiary record.[51] But the majority's perceived "need to make a decision today"[52] ultimately outweighed its concerns about the absence of evidence to support its vote accepting Staff's depreciation recommendation.

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[47] T. at 41.
[48] T. at 41 (emphasis added).
[49] T. at 52.
[50] T. at 42, 45.
[51] T. at 50-52.
[52] T. at 54.

The Order itself merely states "[w]e find it is reasonable to assume that similar plants exposed to similar factors of obsolescence such as technology, market competition, and physical wear and tear would exhibit similar depreciation lives and salvage values."[53] No record evidence supports this assumption.

The Commission's assumption might be reasonable *if* it were based on factual findings that Verizon's plant *is* similar to BellSouth's, and that Verizon's plant *is* exposed to similar wear and tear, market competition, and technological changes. No such evidence, however, was introduced in this case. To the contrary, and as just one example, it is well known that Tampa is the lightning capital of the United States, which wreaks havoc on Verizon's plant. By contrast, Miami is not, and thus BellSouth's plant would not be subject to the same wear and tear.

The BellSouth-specific depreciation study used to set BellSouth's depreciation lives is not a part of the Verizon record. The BellSouth witness who sponsored BellSouth's study did not testify in Verizon's case. There is, in fact, *nothing* in Verizon's record about BellSouth's plant, let alone the factors affecting the lives of BellSouth's plant. So there is no basis for assuming that BellSouth's depreciation lives are more appropriate for Verizon than Verizon's own

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[53] *UNE Order* at 75 (emphasis added).

GAAP lives. To the contrary, the depreciation rates prescribed by the FCC for Verizon and BellSouth in Florida have been different for decades.[54]

The Commission's use of BellSouth's depreciation rates to set Verizon's UNE rates is all the more astounding, given its repeated admonition that "comparing rates of similarly situated companies in the same state" is permissible only if "caution [is] exercised to make sure the rates include similar factors."[55] In its BellSouth UNE Order, the Commission warned against comparing companies' depreciation lives without an understanding of the factors underlying those respective lives:

> [I]t is important to understand the underlying assumptions and the basis for those lives, including whether technological obsolescence, wear and tear, or tax considerations are the driving forces for those lives. We believe that without a complete understanding of how competitors determine their life projections, as well as understanding of each company's equipment and how that equipment is used, an apples-to-apples comparison cannot be

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[54] *See e.g., Prescription of Revised Percentages of Depreciation Pursuant to the Comm. Act of 1934, as Amended for: Alascom, Inc., et al, Memorandum Opinion & Order*, 11 FCC Rcd 12312 (1996) (prescribing depreciation rates for GTE-Florida and BellSouth-Florida); *Prescription of Revised Percentages of Depreciation Pursuant to the Comm. Act of 1934, as Amended for: The Bell Tel. Co. of Penn., et al., Memorandum Opinion & Order*, 8 FCC Rcd 816 (1993) (prescribing depreciation rates for GTE-Florida and BellSouth-Florida).

[55] *UNE Order* at 18.

> made….There is no record evidence regarding the basis for the competitors' lives that BellSouth asserts the Commission should consider as a benchmark for its lives. For this reason, we believe that using these lives as a benchmark is dangerous and incorrect.[56]

There was *no* record evidence in this case regarding the basis for the BellSouth lives, let alone evidence that would provide a "complete understanding" of how BellSouth determines its life projections, what equipment it has, and how it is used. Yet here the Commission did not just benchmark BellSouth's lives against Verizon's, it adopted those very same lives for Verizon. If it is "dangerous and incorrect" to benchmark companies' depreciation lives without a complete understanding of their underlying factors, then it must be arbitrary and capricious agency action to take the more extreme step of actually adopting one company's lives for another.

This Court has defined competent and substantial evidence as "such evidence as will establish a substantial basis of fact from which the fact at issue can reasonably be inferred."[57] There is no evidence to establish the "substantial basis of fact" (or any basis in fact) from which the Commission reasonably could infer that BellSouth's lives were

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[56] *Investigation into Pricing of Unbundled Network Elements*, Docket No. 990649A-TP, Final Order on Rates for Unbundled Network Elements Provided by BellSouth, Order No. PSC-01-1181-FOF-TP ("*BellSouth Order*") at 171 (May 25, 2001).

[57] *Duval Utility Co. v. Pub. Serv. Comm'n*, 380 So. 2d 1028, 1031 (Fla. 1980).

appropriate for Verizon. Indeed, this Court has specifically told the Commission that it cannot set a company's rates based on information about other companies that is outside the record.[58] "[T]he issue must be determined by correctly applying the relevant principles of law to the actual facts, and not on the basis of assumed facts by treating established facts as if they did not exist."[59] "[T]here is no hearing where a party cannot know what evidence is offered or considered, and is not given an opportunity to test, explain, or refute. It is improper for…an agency to base its decision or findings upon facts gathered from its own records without introducing the records into evidence."[60] Because the Commission did exactly that, its depreciation ruling must be reversed.

II. THE COMMISSION ARBITRARILY ADJUSTED VERIZON'S LOADING FACTORS ON THE BASIS OF ASSUMPTIONS AND INFORMATION OUTSIDE THE RECORD.

Verizon's cost model contained two types of loading factors: material and engineering. These loading factors augment the base price of materials, to account for the associated material and engineering costs not included in those

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[58] *General Development Utils., Inc. v. Hawkins, et al.*, 357 So. 2d 408, 409 (Fla. 1978).
[59] *Marco Island Pub. Utils. v. Pub. Serv. Comm'n*, 566 So. 2d 1325, 1328 (Fla. 1st DCA 1990).
[60] *Thorn v. Fla. Real Estate Comm'n*, 146 So. 2d 907, 910 (Fla. 2d DCA 1962).

base prices.[61] The material loading factor accounts for freight, sales tax, provisioning expense and minor materials.[62] The engineering loading factor accounts for the costs of planning, engineering, and ordering equipment additions.[63] Verizon's cost witness, Mr. Tucek, described how these factors were derived and used in Verizon's cost model.[64] No other party addressed the issue in any way, leaving Verizon's evidence uncontested.[65]

Even though no party challenged Verizon's evidence, the Commission adjusted Verizon's loading factors because they were "linear"—that is, they are directly proportionate to the base material prices, regardless of volume.[66] The Commissioners raised the linear loadings issue, not because of any testimony in Verizon's case, but because the Commission had determined in BellSouth's UNE rate proceeding that BellSouth's use of linear loadings created cost

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[61] *UNE Order* at 171.
[62] *UNE Order* at 171.
[63] *UNE Order* at 174.
[64] *See Investigation into Pricing of Unbundled Network Elements*, Docket No. 990649B-TP, Verizon Response to Staff's First Set of Data Requests, Nos. 31-32; *UNE Order* at 170-73.
[65] *UNE Order* at 170.
[66] To use the Commission's example, this means that Verizon's engineering loading factor applied to aerial cable (the base material in this example) will always be 50 percent, whether it is applied to the smallest or largest size aerial cable. *UNE Order* at 176.

distortions as between its rural and urban areas.[67] The Commission's remedy to the perceived linear loadings problem in the BellSouth case was to require BellSouth to submit a filing removing the linear loading factors,[68] because the record did not support any other action.[69]

In Verizon's case, however, rather than requiring additional analysis or evidence, the Commission simply made up adjustments to each of Verizon's factors. For example, the Commission reduced Verizon's provisioning factors by 50 percent, even though Staff candidly admitted that its reductions to Verizon's factors were not based on anything in the record. Instead, Staff relied on its subjective view that Verizon's (uncontested) evidence was not sufficient to support Verizon's factors:

> Because there was no competent evidence in the record, we just reduced them by 50 percent. Could you have done 80 percent? Yes. Could you have reduced them by 20 percent? Yes. It was a judgment call.[70]

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[67] T. at 95.
[68] T. at 95.
[69] *BellSouth Order* at 284.
[70] T. at 98-99.

In the absence of any evidence to support a reduction, simply picking an amount is nothing more than an arbitrary guess. Without substantial, competent evidence to support this finding, it cannot stand.

The Commission similarly adopted all of Staff's other arbitrary adjustments to Verizon's loading factors, resulting in reductions ranging from 15 percent to 40 percent.[71] These other adjustments were made to bring Verizon's factors "more in line" with those of BellSouth.[72] Arbitrarily reducing Verizon's loading factors to move them closer to BellSouth's—without any evidence of how Verizon's loading factors differ from BellSouth's—contradicts the Commission's repeated admonitions that comparisons between companies' rates are useful only if the rates include similar factors and "have been calculated in a similar fashion."[73]

There is nothing in the record showing that BellSouth and Verizon calculated their loading factors in a comparable manner. Indeed, the Commission itself acknowledged, "BellSouth may have calculated different material loadings as a result of differences in the accounting system."[74]

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[71] *UNE Order* at 178.
[72] T. at 99; *UNE Order* at 178.
[73] *UNE Order* at 18.
[74] *UNE Order* at 107.

In fact, Staff itself pointed out a "key difference" between Verizon's and BellSouth's cost studies that justified a much lesser degree of concern about linearity in Verizon's case. Specifically, BellSouth relied much more on loading factors to derive its costs than did Verizon.[75] The Commission criticized BellSouth for using this "loading factor approach as opposed to a 'bottoms up' approach," which more explicitly measures costs.[76]

Verizon's cost model employed the very "bottoms up" methodology the Commission favored in the BellSouth case, and thus relied much less on loading factors than BellSouth did, as Staff member Dowds pointed out at the agenda conference.[77] Given Verizon's minimal reliance on loading factors, there was no basis for concluding that the purportedly serious linearity concerns raised in the BellSouth case also existed in Verizon's case—none of Verizon's opponents complained about *any* linearity problems (while at least three witnesses testified about linearity distortions in BellSouth's case).[78] In fact, as the Commission recognized in its Order, no party other than Verizon provided any

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[75] *See* T. at 96.
[76] *BellSouth Order* at 284.
[77] T. at 96.
[78] *BellSouth Order* at 267, 271.

testimony at all addressing loading factors.[79] Nevertheless, the Commission ordered deep reductions in Verizon's loadings factors because it *assumed* that a linearity problem existed to the same degree it allegedly did in the BellSouth case.

If the Commission was concerned about linear loadings, it should have required Verizon to file a study identifying and removing the effect of linear loadings, as it did in BellSouth's case. The Commission considered doing so,[80] but ultimately opted to approve Staff's arbitrary adjustments in the interest of "getting done at the end of the day and establishing UNE rates."[81]

Administrative expediency is "rarely fruitful as [a] government polic[y],"[82] and it cannot justify reducing Verizon's loading factors by arbitrary percentages that lack any logical or factual support in the record. The Commission's "mere opinion" as to proper loading factors for Verizon is not a valid substitute for evidence. [83]

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[79] *UNE Order* at 170.
[80] T. at 95, 102.
[81] T. at 102.
[82] *Couch Construction Co., Inc. v. Dep't of Transportation*, 361 So. 2d 172, 175 (Fla. 1st DCA 1978).
[83] *See North Florida Water Co. v. City of Marianna*, 235 So. 2d 487, 489 (Fla. 1970).

This Court's decision in *General Development Utilities, Inc.*, provides particularly apt guidance here. In setting General Development's rate of return,

> The Commission selected a ratio [of equity to debt] which nowhere appears in the record, apparently fabricating one for the company based on information it has compiled for water companies generally. [Footnote omitted.] The arbitrary selection of this ratio as a "fact" comes from outside the record of the proceeding and plainly violates the notions of agency due process which are embodied in the administrative procedure act.[84]

Here, the Commission fabricated loading factors for Verizon based on information about BellSouth's loading factors that appears nowhere in the record. This fabrication of factors to be used in rate-setting is just as unlawful here as it was in the *General Development Utilities* case, and the Court should reverse the Commission in this case, as well.

III. THE COMMISSION IGNORED KNOWN CALCULATION ERRORS THAT SUBSTANTIALLY UNDERSTATE VERIZON'S UNE RATES.

After reviewing Staff's Recommendation that would be the basis for the Commission's rulings in this case, Verizon discovered several calculation errors that caused Staff's proposed UNE cost estimates to be substantially

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[84] *General Development Utils*, 357 So. 2d at 409.

understated. Verizon detailed these errors in an October 9, 2002 letter to the Executive Director of the Commission.[85] The competing carriers' coalition filed a Motion to Strike Verizon's letter, claiming it was improper comment on Staff's Recommendation.[86]

Staff advised the Commission to grant the Motion, asserting that the letter constituted argument against Staff's Recommendation, rather than identification of errors.[87] The Commission granted the Motion to Strike on the basis that it was improper argument, *even though none of the Commissioners had ever seen Verizon's letter*,[88] and so could not have determined whether it did, in fact, engage in argument or simply called attention to calculation errors. Most of these errors were consequently incorporated into the Commission's final order. Because there is no record evidence to justify these errors, the Court should order the Commission to correct them.

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[85] Letter from K. Caswell, General Counsel for Verizon, to Dr. M. Bane, Executive Director, Florida Public Service Commission, dated October 9, 2002, located at p. 2620 in the Docket Index.

[86] *Investigation into Pricing of Unbundled Network Elements*, Docket No. 990649A-TP, ALEC Coalition's Motion to Strike Verizon Comments on Staff Recommendation (Oct. 11, 2002) at 1-2.

[87] T. at 4.

[88] *See* T. at 4-7. Striking Verizon's letter as improper argument without having seen the letter plainly violated Verizon's due process rights.

A. The Commission Incorrectly Calculated the Common Cost Allocator.

Under the FCC's pricing rules, the total cost of a UNE includes a reasonable share of the company's common costs.[89] Common costs are overhead and general corporate expenses that cannot be directly attributed to specific UNEs. It is thus necessary to determine how to allocate a share of these common costs to a particular UNE, in order to calculate the total cost of the UNE.

Verizon allocated common costs by applying a uniform percentage mark-up to each UNE. Verizon determined that mark-up by dividing its total wholesale-related common costs for all UNEs by its total direct costs for all UNEs.[90] Based on the common and direct cost figures proposed in Verizon's cost study, Verizon calculated a 14.09 percent common cost mark-up.[91]

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[89] *UNE Order* at 184; 47 C.F.R. § 51.505(c)(2)(B); Hearing Transcript at 557, 640 (Trimble Direct).
[90] Hearing Transcript at 630 (Trimble Direct).
[91] *See UNE Order* at 186-87.

The Commission accepted Verizon's methodology for computing common costs.[92] It correctly recognized, however, that "the factor will change, based on other changes to the model."[93] In other words, Verizon's 14.09 percent factor would change, based on the Commission's changes in the model assumptions and inputs (*e.g.*, changes to depreciation lives and cost of capital).

It appears, however, that the Commission's common cost allocator did not, in fact, account for all the changes the Commission made in the model inputs and assumptions. It is impossible to be certain because the Order does not identify the numbers (or the source of the numbers) the Commission used in recalculating this common cost allocator (which is, itself, never identified in the Order).

However, in reviewing the cost results and Staff's workpapers Verizon requested after the decision, it appears that the Commission's common cost allocations assume an investment amount 60 percent higher than the amount reflected in Verizon's filing, and more than 80 percent higher than the investment that results when all of Staff's changes are incorporated.

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[92] *UNE Order* at 188.
[93] *Id.*

The *UNE Order* does not identify any source for, or process whereby, the Commission arrived at the apparently increased amount of investment, which is not identified anywhere in the *UNE Order*. Using the Commission's erroneously inflated amount of investment in the common cost calculation results in a substantial under-recovery of Verizon's common costs.[94]

There is no indication in the *UNE Order* that the Commission intended to improperly inflate the investment figure in calculating common cost allocations, so it must be a mistake, which must be corrected.

The Commission's calculation of the common cost allocator also fails to account for the fact that Staff disabled the calibration option when it ran Verizon's cost model. Use of the calibration option is intended to ensure that the investments in the expense-to-investment ratios (used to calculate expenses underlying UNE costs) are consistent with

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[94] Specifically, an overstated investment figure will overstate the capital costs and property taxes associated with that investment. Capital costs and property taxes are included in the direct costs that are in the denominator of the ratio that is the common cost allocator. Using overstated capital costs and property tax figures in the denominator of the common to direct cost ratio will produce a lower common cost allocator. To use a simple illustration, if the common costs in the numerator are 100 and the direct costs in the denominator are 500, the common cost allocator will be 20 percent; if the common costs in the numerator are 100, but direct costs in the denominator are 800, the common cost allocator will be only 12.5 percent. A lower common cost allocator means lower UNE rates.

the investments to which they will be applied in the cost model. The Commission decided to turn off the cost model's calibration option when it calculated Verizon's direct costs, because it felt that Verizon used inconsistent data in the expense-to-investment ratios.[95]

Although Verizon disagrees with the Commission's decision not to use the model's calibration function in calculating direct expenses, Verizon does not challenge that decision here. Verizon does, however, challenge the Commission's failure to account for disabling the calibration option when it calculated the common cost allocator. As Mr. Tucek testified, disabling the calibration option (while retaining Verizon's inputs) results in a shortfall in expenses of $79.1 million.[96] The only way to recover this shortfall in the UNE cost results is to modify the common cost allocator by adding the amount of the shortfall (*i.e.*, $79.1 million) to the allocator's numerator (common costs) and subtracting it from the denominator (total direct costs).[97] No one disputed the amount of the shortfall or the remedy Mr. Tucek presented for recovering it in the cost results.

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[95] *UNE Order* at 183-84.
[96] Hearing Transcript at 816 (Tucek Surrebuttal).
[97] *UNE Order* at 183.

The *UNE Order* makes clear that the Commission knew about the expense shortfall and its resulting effect on the common cost allocator when the calibration option was disabled.[98] Nevertheless, the Commission failed to address this expense shortfall. It never performed the requisite offsetting calculation and never gave any reason why it did not. The result was, again, an incorrect reduction in the common cost allocator and Verizon's UNE rates.[99]

There is no dispute that when the cost model assumptions and inputs are changed, the cost results must reflect those changes. The cost results reflected in the *UNE Order* are inconsistent with the Commission's own changes to Verizon's proposed model inputs and assumptions. The discrepancies between the Commission's inputs and assumptions and its cost results are not explained anywhere in the Order or elsewhere in the record, so they must be mistakes. The Commission should be ordered to correct them and to revise Verizon's UNE rates accordingly.

B. <u>The Commission's Computation of Verizon's UNE-P Rates Is Wrong</u>.

In its *UNE Order*, the Commission incorrectly calculated the rates for Verizon's UNE platform ("UNE-P"). The UNE-P is a combination of certain UNEs that permits a competitor to provide local telephone service and discretionary

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[98] *UNE Order* at 183.
[99] Hearing Transcript at 816-17 (Tucek Surrebuttal).

services like Call Waiting.[100] Verizon's proposed UNE-P costs equaled the sum of the individual UNEs that make up the UNE-P combination.[101]

The Commission reduced Verizon's UNE-P cost estimate based on its belief that Verizon could provide the UNE-P using a type of technology (integrated digital loop carrier ("IDLC")) that was more cost-effective than the technology Verizon had assumed (universal digital loop carrier ("UDLC")).

Although Verizon disagrees with the Commission's IDLC technology assumption used in deriving Verizon's UNE-P costs, Verizon does not challenge that decision here. Rather, Verizon challenges only the Commission's calculation of the impact of using IDLC technology to calculate Verizon's UNE-P costs. This error arbitrarily reduced the ordered UNE-P rates.

As Verizon witness Tucek explained, the impact of using IDLC technology on Verizon's proposed UNE-P rates, assuming no other changes to Verizon's model inputs and assumptions, caused the UNE-P rate to fall by $1.39 per

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[100] *See* Hearing Transcript at 602 -03 (Trimble Direct); *UNE Order* at 277-78.
[101] *UNE Order* at 277.

month.[102] But, as discussed above, the Commission did, in fact, make a number of changes to Verizon's cost model inputs and assumptions. These adjustments necessarily changed the IDLC cost savings Verizon had calculated using its own inputs. The Commission knew the $1.39 figure was not accurate, given Staff's input changes, but approved it anyway.

At the agenda conference, Commissioner Deason specifically asked if Mr. Tucek's $1.39 figure would change, given the adjustments Staff had made in the model inputs: "Now, would this amount change any based upon other Staff adjustments in the recommendation?" Staff member King replied: "Yes, sir."[103] Ms. King then informed the Commission that Verizon had, in an interrogatory response, given Staff instructions that would have allowed it to recalculate the UNE-P rate using IDLC technology and Staff's own inputs.[104] However, Staff said it "got a blank result" when it followed the steps on the computer disk Verizon had given Staff.[105] Staff never contacted Verizon to discern how it had obtained the asserted "blank result." So, unable to perform the correct calculation, Staff simply advised

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[102] Hearing Transcript at 786-87 (Tucek Surrebuttal); *UNE Order* at 280.
[103] T. at 118.
[104] T. at 118.
[105] T. at 118.

the Commission to approve the $1.39 figure. The Commission did so, even though it knew this figure was not accurate.[106]

The failure to correctly calculate the IDLC savings reduced the Commission-ordered UNE-P rate. It is plainly arbitrary for the Commission to approve a result it knows is wrong, especially when it easily could have been corrected. This action is even more egregious because Verizon specifically asked the Commission to correct the error (and gave the Commission the corrected figure) in its October 9, 2002 letter. Verizon also offered to make its subject matter experts available to discuss the necessary corrections to Staff's Recommendation. But, as noted, the Commission did not read the letter.

Because the Commission's $1.39 reduction is arbitrary and not supported by the evidence, it must be reversed and remanded. Verizon's UNE-P costs must be recalculated with the inputs the Commission has adopted (as modified by any changes in those inputs as a result of this appeal).

CONCLUSION

[106] T. at 118.

For all the reasons discussed here, the Commission's *UNE Order* must be reversed because it is arbitrary and capricious, and is not supported by substantial, competent evidence.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing **Initial Brief of Verizon Florida Inc.** has been furnished, by U.S. Mail, on _____, 2003 to the parties on the attached list.

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with the font requirements of Florida Rule of Appellate Procedure 9.210(a)(2).

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