

31. We ask parties to explain whether different proxy groups should be used to estimate the cost of capital for different UNEs. Parties should identify these proxy groups and explain in detail why they are appropriate. Alternatively, parties that advocate using a single proxy group and then adjusting that cost of capital according to the relative risk of the particular UNE should explain in detail how to make the relevant adjustments.

32. *Depreciation Expense.* Economic depreciation is a method of reflecting anticipated declines in the net present value of an asset of the course of its useful life. Calculating the appropriate rate of a price decline is complicated because it is based largely on projections about future events. In UNE pricing cases, the task is even more difficult because most models include a levelization function that imposes a constant price schedule over the life of the asset. There are two components of depreciation—the useful life of the asset and the rate at which the asset is depreciated over that useful life. Although the Commission has yet to provide guidance regarding the use of economic depreciation or to mandate a specific set of economic lives, in the *Triennial Review Order*, the Commission clarified that a carrier may accelerate recovery of the initial capital outlay for an asset over its life to reflect any anticipated decline in its value.

33. The useful life of an asset normally is determined by comparing the operating cost of the existing asset with the operating cost plus investment cost of a new asset that performs the same functions (assuming the new equipment will generate the same revenue as the existing equipment). Estimating asset lives is difficult because the estimate depends on the physical life of the existing asset, the expected operating costs of the existing asset, and the expected investment and operating cost of new assets, some of which may not yet have been invented.

34. We seek comment on the guidance that we may provide to the states on the issue of asset lives. For example, is the Commission's past reluctance to rely solely on Generally Accepted Accounting Principles (GAAP) financial reporting lives warranted in the context of UNE ratesetting? We seek comment on the relationship between the financial lives used to develop earnings reported to shareholders and the financial lives those that companies use to plan their future capital expenditures? If those lives differ, we request that parties explain why. We also request that competitive LECs and incumbent LECs submit the lives that

they use to plan their capital expenditures. We further seek comment on whether compliance with GAAP results in any systematic bias.

35. We seek comment on how financial reporting lives are developed and whether they accurately represent the anticipated economic lives of assets. For example, how do financial lives reflect the potential impact of future technologies? What asset lives are appropriate for equipment in the existing incumbent LEC network that is, or soon will be, obsolete? How relevant, if at all, is the actual retirement experience of an incumbent LEC, its depreciation reserves, or its projected investment plans for the near future? Is there other objective evidence the Commission should consider in this regard? We encourage parties to provide studies forecasting the economic lives of the major local exchange carrier assets in support of their proposals.

36. We also ask parties to comment on whether FCC regulatory lives reflect the competition and technology assumptions required under a forward-looking costing methodology. We seek comment on whether these lives, first established a decade ago, are still accurate. We ask parties to explain whether the validity of FCC asset lives depends in part on whether the Commission retains a scorched node approach to network design or instead adopts its tentative conclusion that forward-looking costs should more closely account for the real-world attributes of the routing and topography of an incumbent LEC's network.

37. The second component of depreciation is the depreciation rate. Where equipment prices are expected to decline over time, the value of existing network assets (and therefore prices under a forward-looking methodology) should decline at the same rate. We seek comment on the relationship between the rate of change in equipment prices and the rate of change in final product prices. To what extent do companies in competitive markets consider changes in the economic efficiency of assets (e.g., price changes, technological advances) in deciding how quickly to recover investments? How can we measure anticipated changes in the efficiency of equipment? Must any measure of equipment price also reflect advances in the capabilities of the equipment? What sources of information would be appropriate for use in establishing rates based on a forward-looking costing methodology? We request that parties explain how different sources of data address changing capabilities of equipment over time. We also request that parties

explain whether recent declines in equipment costs, if any, are useful in establishing a general approach, or are they instead extraordinary events caused by the recent sudden decline in markets for telecommunications equipment generally and therefore not reliable indicators of general trends in equipment pricing.

38. We seek comment on whether, if the investment cost of equipment changes from year to year, should UNE prices also similarly change from year to year, all else being equal. We ask parties to comment on the costs and benefits of using a wholesale pricing regime responds to a market where investment costs are changing and facilities-based competition exists or is expected to exist. We also ask parties to address whether adjustments to depreciation expense are the best mechanism for reflecting anticipated equipment price changes in UNE rates.

39. Although carriers continually invest in new assets and depreciate old assets, UNE cost models typically assume that the entire investment in the network is made at a single point in time, and that no additional investment is made in subsequent periods. This same process is repeated each time a state commission sets new rates. Because the return on investment will decline in each period as the base of undepreciated investment declines, even straight-line depreciation will result in rapidly declining prices over time unless recovery is levelized across time periods. Consequently, a "levelization" function is included in most cost models to replicate real-world investment and recovery patterns.

40. The levelization of rates that occurs in most cost models appears to be inconsistent with the concept of adjusting UNE prices to reflect anticipated changes in equipment prices. We ask parties to comment on this statement and to discuss the consequences of running current cost models without the levelization function. Would there be dramatic variation in rates from year to year if rates were not levelized? Does the use of levelization send incorrect signals to the extent that it produces UNE prices that do not vary over time even when input prices are rising or falling? We seek comment on whether a better approach might be to recover through depreciation expense the difference between the current value of the asset and the anticipated value of the asset at the next rate proceeding. We request that parties explain how such an approach would work as a practical matter, including whether and how prices should be adjusted if a state