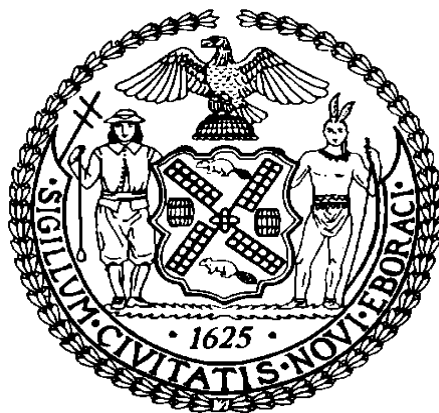


**CITY OF NEW YORK  
OFFICE OF THE COMPTROLLER**

**John C. Liu  
Comptroller**

**BUREAU OF FINANCIAL AUDIT**

**H. Tina Kim  
Deputy Comptroller for Audit**



**Audit on the Payment by  
Empire City Subway of License Fees  
Due the City and Compliance with Certain  
Provisions of Its License Agreement**

*FP08-103A*

**June 2, 2010**



THE CITY OF NEW YORK  
OFFICE OF THE COMPTROLLER  
1 CENTRE STREET  
NEW YORK, N.Y. 10007-2341

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John C. Liu  
COMPTROLLER

June 2, 2010

**To the Residents of the City of New York:**

My office has audited Empire City Subway (ECS) to determine whether it accurately reported its annual profit and paid its franchise tax payments on a timely basis, and whether Department of Information Technology and Telecommunications (DoITT) has ensured that ECS complied with the provisions of the agreement. We audit private concerns that conduct business with the City as a means of ensuring compliance with their agreements.

ECS, a subsidiary of Verizon, is the largest telecommunications conduit provider in New York City. ECS has a franchise from the City of New York to design, construct, and maintain subsurface electrical conduit and manhole infrastructure in Manhattan and the Bronx, which ECS rents to telecommunications and cable television service providers. The franchise agreement is administered by DoITT.

ECS generally adhered to the requirements of the license agreement and paid in a timely manner all franchise tax payments that were due during the audit period. However, ECS financial statements were not certified by an independent public accounting firm. Moreover, ECS did not apply depreciation consistently and overstated gross conduit valuation for the purposes of calculating excess profits that may be due the City by including the costs of unassigned and unidentified conduits. In addition, because the deficits are cumulative, ECS overstated its accumulated deficit, which is used to offset any future excess profit payments due the City.

DoITT has not ensured that ECS effectively manages, constructs, or retires conduits. In a related matter, we believe that DoITT should consider seeking legislative change that would enable the City to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City.

The results of the audit have been discussed with ECS and DoITT officials, and their comments have been considered in preparing this report. Their complete written responses are attached to this report.

If you have any questions concerning this report, please e-mail my audit bureau at [audit@Comptroller.nyc.gov](mailto:audit@Comptroller.nyc.gov).

Sincerely,



John C. Liu

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*The City of New York  
Office of the Comptroller  
Bureau of Financial Audit*

**Audit on the Payment by Empire City Subway of  
License Fees Due the City and Compliance with  
Certain Provisions of Its License Agreement**

**FP08-103A**

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**AUDIT REPORT IN BRIEF**

Empire City Subway (ECS), a subsidiary of Verizon, is the largest telecommunications conduit provider in New York City. ECS has a franchise from the City of New York to design, construct, and maintain subsurface electrical conduit and manhole infrastructure in Manhattan and the Bronx, which ECS rents to telecommunications and cable television service providers. The franchise agreement was executed on May 15, 1891, for perpetuity, and is now administered by Department of Information Technology and Telecommunications (DoITT). ECS maintains an inventory of more than 213,800 conduits under the streets of Manhattan and the Bronx.

We performed an audit to determine whether ECS accurately reported its annual profit and paid its franchise tax payments on a timely basis, and whether DoITT has ensured that ECS complied with the provisions of the agreement.

**Audit Findings and Conclusions**

ECS generally adhered to the requirements of the license agreement and paid all franchise tax payments that were due during the audit period in a timely manner. However, ECS financial statements were not certified by an independent public accounting firm. Moreover, ECS did not apply depreciation consistently and overstated gross conduit valuation for the purposes of calculating excess profits that may be due the City by including the costs of unassigned and unidentified conduits. Therefore, since 1994 ECS annually reported less than 10 percent profit, which resulted in no payments due the City. In addition, because the deficits are cumulative, ECS overstated its accumulated deficit, which is used to offset any future excess profit payments due the City. This minimizes the probability of the City's receiving additional payments under the excess profits contract clause.

DoITT has not ensured that ECS effectively manages, constructs, or retires conduits, which reduces the possibility of additional fees being paid to the City due to ECS excess profits (i.e., greater than 10 percent of gross plant value).

In a related matter, we believe that DoITT should consider seeking legislative change stating that it is just and reasonable to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City. A new rate should take into account the rate of inflation and be comparable to conduit rental rates charged in other cities.

### **Audit Recommendations**

We make eight recommendations to ECS, including the following, that ECS:

- Apply depreciation consistently when calculating annual net profit and accumulated deficits.
- Readjust calculations of net income and associated deficit amounts.
- Maintain accurate and complete financial records as required by the agreement.
- Identify the tenants occupying all the unidentified conduits and bill those tenants. Once the tenants are being billed, the construction associated with those conduits can be added back to gross plant assets.
- Update the Duct Utilization System (ECS's conduit-tracking system) to provide more appropriate information about the status of conduits.

We make two recommendations to DoITT, that it:

- Undertake a more assertive role in overseeing the construction and management of the overall conduit infrastructure system so that the plant valuation is not inflated with unnecessary construction costs for the purposes of calculating excess profits and payments that may be due the City.
- Consider seeking legislative change stating that it is just and reasonable to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City. A new rate should take into account the rate of inflation and be comparable to conduit rental rates charged in other cities.

## INTRODUCTION

### Background

ECS, a subsidiary of Verizon, is the largest telecommunications conduit provider in New York City. ECS has a franchise from the City of New York to design, construct, and maintain subsurface electrical conduit and manhole infrastructure in Manhattan and the Bronx, which ECS rents to telecommunications and cable television service providers. (The two biggest customers are Verizon and the City of New York.) ECS also provides its customers an array of services to facilitate the installation, maintenance, and protection of underground cables in the metropolitan area.

The franchise agreement was executed on May 15, 1891, for perpetuity, between the New York City Board of Electrical Control and ECS. The agreement, previously administered by the Department of General Services, is now administered by DoITT. According to the agreement, ECS provides conduits to the City without charge.

ECS maintains an inventory of more than 213,800 conduits under the streets of Manhattan and the Bronx. According to inventory records dated December 31, 2008, conduits are classified into five categories: those rented to Verizon, those rented to third-party tenants, and those that produce no revenue and are assigned to the City of New York and unidentified tenants, or that are unassigned or vacant conduits. (See Table 1 below.)

**Table 1**  
ECS Conduit Inventory

<b>Category</b>	<b>No. of Conduits</b>	<b>No. of Feet</b>	<b>Rental Billings 2008 (million)</b>	<b>Percent of Billing</b>
Verizon	131,257	40.8 million	\$35.7	78.5
Third Party	35,989	10.9 million	\$9.8	21.5
Unassigned	31,855	9.6 million	NA	NA
City of New York	14,361	3.9 million	NA	NA
Unidentified	339	83,157	NA	NA
Total =	213,801		\$45.5	

ECS pays the New York City Department of Finance (DOF) special franchise tax payments based on an annual assessed value of the conduits. The payments are calculated on the basis of real estate tax rates for Manhattan and the Bronx. For Fiscal Years 2008 and 2009, ECS paid the City \$18.1 million and \$19.3 million in franchise tax payments, respectively.

The agreement also provides for the City to share in any excess profits earned by ECS above a certain threshold. When net annual income exceeds 10 percent of actual cash capital invested in the conduits (i.e., gross plant assets), the excess is payable to the City. However, if the return on invested capital is less than 10 percent, the amount below the 10 percent threshold may be accumulated and used to offset any excess profits earned in future years. According to a 1984 Comptroller's Office audit, #J83-821, entitled *Audit Report on a Contract With Empire City Subway Company, Ltd.*, ECS had never made any excess profit payments since the agreement's inception because the 10 percent threshold had never been exceeded. According to ECS, the financial data for the years prior to 1994 is unavailable; the financial data post-1994 shows that ECS has not exceeded the 10 percent threshold.

### **Objectives**

The objectives of this audit were to determine whether ECS accurately reported its annual profit and paid its franchise tax payments on a timely basis, and whether DoITT has ensured that ECS complied with the provisions of the agreement.

### **Scope and Methodology**

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This audit was conducted in accordance with the audit responsibilities of the City Comptroller as set forth in Chapter 5, §93, of the New York City Charter.

This audit covered the period from January 1, 2007, to June 30, 2009.

To determine whether ECS paid its franchise tax payments on a timely basis, we reviewed the Quarterly Statement of Account for franchise tax payments due that was issued by DOF for the period July 1, 2007, to June 30, 2009. We then compared it to the history of payments made by ECS as recorded in DOF's online Web site "NYC Property, Account History file" and traced these payments to ECS's cancelled checks.

To determine whether ECS accurately reported its annual profit, we obtained and reviewed copies of ECS's financial statements, including internal profit and loss statements from 1994 (the earliest year available) through 2008.

To determine the accuracy of the accumulated profit or deficit amount reported by ECS on December 31, 2008, we requested from ECS and DoITT the financial statements from 1983 through 2008 to continue the analysis presented in the previous audit. We analyzed the statements to determine how ECS calculates its profit or loss and how it reports the cumulative profits or deficits annually. We also reviewed the statements to determine whether consistent

reporting methods were used and whether ECS is reporting all income and expenses in a reasonable manner. We reviewed the conduits listed on the ECS conduit-tracking system known as the Duct Utilization System to ascertain which types of conduits are included as gross plant and, therefore, part of the computation for potential excess profits.

To determine whether DoITT is properly monitoring ECS's compliance with the agreement's provisions, we met with DoITT officials to identify the processes for monitoring the contract. We requested from DoITT the reports it receives from ECS concerning operating profits, balance sheets, and accumulated deficit schedules. We also reviewed memorandums, consultant reports, and other correspondence provided by DoITT and ECS pertaining to the agreement.

ECS requested a rate increase in 2001. We expanded our scope to determine whether such a rate increase for conduit rentals is currently warranted. We analyzed ECS's financial statements, examined its trend of expenses and income, and reviewed the ECS rate request submitted in 2001. We also reviewed the conduit rates charged in three northeastern cities in the United States to determine whether ECS rates are competitive with rates charged in those cities.

### **Discussion of Audit Results**

The matters covered in this report were discussed with DoITT and ECS officials during and at the conclusion of this audit. A preliminary draft report was sent to DoITT and ECS officials and was discussed at an exit conference held on January 8, 2010. On February 8, 2010, we submitted a draft report to DoITT and ECS officials with a request for comments. That report had a new section concerning the rate increase requested by ECS. DoITT contacted us to discuss the new section. On March 12, 2010, we submitted a revised draft report with a request for comments. We received written responses from ECS and DoITT on March 19, 2010.

ECS in its response indicated that it disagreed with the findings and recommendations that pertained to ECS.

DoITT in its response stated, "DoITT generally concurs with the draft audit's recommendations" addressed to ECS. DoITT further stated that it "will consider pursuing a legislative change that would expand the City's discretion in ECS rate-setting, including potential revenue-generation."

The full texts of the responses from ECS and DoITT are included as addenda to this report.



## **FINDINGS AND RECOMMENDATIONS**

ECS generally adhered to the requirements of the license agreement and paid all franchise tax payments that were due during the audit period in a timely manner. However, ECS financial statements were not certified by an independent public accounting firm. Moreover, ECS did not apply depreciation consistently and overstated gross conduit valuation for the purposes of calculating excess profits that may be due the City by including the costs of unassigned and unidentified conduits. Therefore, since 1994 ECS annually reported less than 10 percent profit, which resulted in no payments due the City. In addition, because the deficits are cumulative, ECS overstated its accumulated deficit, which are used to offset any future excess profit payments due the City. This minimizes the probability of the City's ever receiving additional payments under the excess profits contract clause.

DoITT has not ensured that ECS effectively manages, constructs, or retires conduits which reduces the possibility of additional fees being paid to the City due to ECS excess profits (i.e., greater than 10 percent of gross plant value).

In a related matter, we believe that DoITT should consider seeking legislative change stating that it is just and reasonable to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City. A new rate should take into account the rate of inflation and be comparable to conduit rental rates charged in other cities.

These matters are discussed in greater detail below.

### **Financial Statements Not Independently Certified**

ECS financial statements are not certified by an independent public accounting firm, as recommended in Comptroller's Office 1984 audit #J83-821. That audit concluded that ECS "should file its certified financial statements annually with DGS [Department of General Services] and the Comptroller." Moreover, section VI (4) of ECS's agreement with the City of New York states that ECS shall "on the first day of October of each year, make and return a statement to the Comptroller of the City of New York, in such a form and verified as he may require and prescribe for the year ending the next preceding day of September."

ECS officials informed us that ECS does not have its financial statements independently audited and certified because they are included as part of the financial statements of its parent company, Verizon. The officials claimed they were not aware of the requirement to certify separately the financial statements of ECS operations. ECS had gross revenue of \$124.6 million for the year ending December 31, 2008. However, the lack of separate, certified financial statements for ECS prevents DoITT from ensuring the accuracy and integrity of ECS financial activities, and from ascertaining whether the City should be collecting excess profit payments.

## **Recommendation**

1. ECS should immediately employ an independent public accounting firm and issue separate certified financial statements for the year ending December 31, 2008, and in all future years.

**ECS Response:** ECS disagreed with the above recommendation, and stated: “ECS does not believe that certified financials are warranted given the size of its existing deficit, the significant additional cost of obtaining statements certified by a third party on annual basis, and its willingness to have its financial statements certified annually by a member of its senior management.”

**DoITT Response:** DoITT agreed with this recommendation, and stated, “ECS should employ an independent accounting firm and issue certified financial statements for calendar 2008 and future years.”

**Auditor Comment:** The contract requires ECS to “make and return a [financial] statement to the Comptroller of the City of New York, in such a form and verified as he may require.” Therefore, not filing the certified financial statements as recommended in our last report and now in this report, is a violation of this provision of the contract. Having certified financial statements would ensure that ECS is properly recording revenue and expenses and that the “existing deficit,” which ECS referred to, is accurate. A Certified Public Accountant would have noted that the depreciation was not being applied consistently. It is noteworthy that DoITT agreed with this recommendation and should therefore require ECS to comply.

## **Overstated Deficits**

The agreement requires ECS to pay the City excess profits if net annual income exceeds 10 percent of gross assets. Alternatively, net income that is less than the 10 percent threshold may be accumulated as a deficit and used to offset any excess profits earned in future years. Our review indicated that ECS overstated by \$133.3 million (43.7 percent) the value of the accumulated \$305 million deficit for operating years 1994 to 2008.<sup>1</sup> As a result, the amount of the accumulated deficit is inflated and any potential excess profit due the City in future years will be reduced. We attribute this situation to the inconsistent method by which ECS applies depreciation in calculating net income and gross plant assets. ECS is further overstating its gross plant valuation by including \$85 million of non-revenue-producing conduits that are unassigned or are occupied by unidentified tenants.

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<sup>1</sup> We could not ascertain the amount of the accumulated deficit prior to 1994, as required by agreement section VI, because ECS could not provide us with any financial records predating 1994. Therefore, all the calculations of accumulated deficit were based on uncertified financial statements provided by ECS for the period 1994 through 2008.

## Depreciation Applied Inconsistently

Although ECS records the amount of net income after deducting depreciation expenses, the amount of gross plant assets is recorded without similarly deducting depreciation. Consequently, the value of net income is unreasonably low compared to the value of plant assets. Thus, in ascertaining the amount of the excess profit or deficit for the year ending December 31, 2008, we calculated that the deficit should have been \$1,496,652—far lower than the \$12,005,806 amount that was figured by ECS. (See Table 2 below.)

**Table 2**  
Comparative Methodologies for Calculating  
Excess Profit or Deficit Amounts for the Year Ending December 31, 2008

Item	ECS Methodology	Auditors Methodology
Net Income <sup>(a)</sup>	\$35,708,643	\$35,708,643
Less Depreciation	<u>\$10,509,154</u>	<u>\$0</u>
Adjusted Net Income	\$25,199,489	\$35,708,643
Average Gross Plant	\$372,052,953	\$372,052,953
Depreciation	\$0	\$0
10 Percent Threshold	\$37,205,295	\$37,205,295
Less Adjusted Net Income	<u>\$25,199,489</u>	<u>\$35,708,643</u>
Deficit Amount	<b>\$12,005,806</b>	<b>\$1,496,652</b>

(a) It should be noted that in 2008 ECS realized a one-time gain of \$32,787,500 associated with the sale of a building.

The amount of the deficit is significant because if net annual income does not exceed 10 percent of gross plant assets, the deficit can be accumulated and used to reduce any excess profit in future years. Inconsistent application of depreciation overstates the value of the deficit amount.

Section VI of the agreement refers to 10 percent of “net annual profit” as the threshold to be exceeded for determining either when payments should be made to the City or when deficits could accumulate for future years. Although the agreement does not specifically address how ECS should apply depreciation, we believe that ECS should be consistent in its application in order to maintain the integrity of its agreement with the City. When the agreement was executed in 1891, Generally Accepted Accounting Principles (GAAP) had not yet been established, and depreciation was not a method of accounting accepted by industry. It was not until 1909 that the

Supreme Court recognized the legitimacy of depreciation accounting. However, we contend that applying depreciation in a consistent manner would yield the correct and equitable value of the annual and accumulated deficit amounts that mirror the true intent of the franchise agreement.

***ECS Response:*** ECS responded that it calculates the accumulated deficit in accordance with the terms of the 1891 Agreement.

***Auditor Comment:*** Although, ECS stated that “it calculates the accumulated deficit in accordance with the terms of the 1891 Agreement,” ECS did not give any explanation for its not valuing income and gross plant assets consistently. The 1891 agreement, which was executed prior to the establishment of GAAP, could not have envisioned a future time in which “income” could be substantially reduced by “depreciation expense.” Therefore, there could not be a provision in the 1891 agreement that would require consistency in valuing income and gross plants. To ensure that the agreement is equitable for ECS *and* the City, ECS should implement our recommendations and apply depreciation consistently when calculating annual net profit and accumulated deficits.

### **Recommendations**

ECS should, for the purposes of calculating excess profits and payments that may be due the City:

2. Apply depreciation consistently when calculating annual net profit and accumulated deficits.
3. Readjust calculations of net income and associated deficit amounts.
4. Maintain accurate and complete financial records as required by the agreement.

***ECS Response:*** ECS did not respond to these recommendations.

***DoITT Response:*** DoITT agreed with the above recommendations and stated that ECS should apply depreciation consistently when calculating annual net profit and accumulated deficits, readjust calculations of net income and associated deficit amounts and, of course, maintain accurate and complete financial records as required by the agreement.

***Auditor Comment:*** DoITT should require ECS to make the necessary changes so as to comply with the above recommendations.

### **Gross Plant Assets Overstated**

ECS overstated the value of gross plant assets by including in inventory the costs of unassigned conduits. The effect of this is to reduce the possibility of additional fees being paid to the City because of ECS excess profits (i.e., greater than 10 percent of gross plant). Many of

these unused or dormant conduits may be nonoperational or have no marketability. ECS inventory records lists over 16,000 of these conduits as built in the late 1800s and early 1900s. We also found that ECS is also building new conduits when there is no apparent need or request for them (approximately 10,000 unassigned conduits were built in the last nine years). Unused conduits are classified by ECS in their records as unassigned conduits. As of December 31, 2008, the ECS conduit inventory identified 31,855 unassigned conduits at a value of almost \$85 million. When ECS retires a conduit that is deemed unusable, it removes the costs to construct that conduit from the gross plant value.

We found instances in which new conduits were built and then retired a few years later without ever being used. For example, 213 (61 percent) of the 349 unassigned conduits retired in 2007, which were constructed between 2001 and 2004, were never used. In other instances, we found that vacated conduits are added to the list of unassigned conduits and are never reoccupied by another tenant. For example, 590 conduits retired in 2007 had been vacated between 2001 and 2006 and were not reoccupied before being retired.

Some of the conduits were installed despite no apparent need, and, lacking tenants, remained vacant. Thus, of 1,484 conduits added to the conduit inventory in 2007, 1,048 (71 percent) were vacant and lacked tenants as of February 2009. As an example, in 2006, ECS built 48 conduits costing approximately \$300,000 in two sections around Nassau Street and Maiden Lane in lower Manhattan. As of 2009, only one of these 48 conduits has been in use. However, we found that ECS records identified 6 spare conduits built prior to 2006 that were available in the same area. Given the availability of the 6 spare conduits, it appears that there was no need for the construction of the new conduits. Nonetheless, these now dormant conduits were constructed and their cost was added to the value of gross plant assets used to calculate the annual and accumulated deficit against the franchise agreement.

In another example, in 2003, ECS built 8 new conduits at a cost of \$72,760 in an area (Second Avenue in the 70s) where there already existed 13 unassigned conduits.<sup>2</sup> According to ECS, the 13 conduits were built in 1930. ECS explained that they decided to build new conduits in 2003 because at an unknown time the 13 unassigned conduits were deemed inadequate and needed to be replaced but were never retired. According to ECS officials, before they can retire a conduit, they must be sealed. ECS has since retired some of the newly constructed conduits but not the 13 unassigned conduits that ECS deemed inadequate and needed replacement.

### ***Conduits Built as Part of a Municipal Project***

According to ECS there were 19 projects with 55 conduit sections between 2005 and 2008 in which 903 conduits were installed as part of ongoing City projects referred to as “municipal projects.” Municipal projects are instances in which the City hires a private

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<sup>2</sup> It is important to note that four of the eight newly constructed conduits valued at \$36,358 were never used and were retired in 2007. In retiring them, ECS cited low demand for conduits at this site. Of the remaining four conduits, three are still vacant and have yet to be rented since their construction in 2003. In summary, of these eight conduits, only one is occupied (by AT&T Local Services).

contractor to perform various sub-surface construction or road work that will result in the resurfacing of the street. ECS is given the opportunity to place conduits below the street before it is resurfaced. ECS does not do any of the work. Instead, all work is done by the private contractors. ECS officials informed us that conduit installation by private contractor usually costs 20 to 30 percent higher than if ECS had done the work.

Our analysis of the 55 conduit sections revealed that 6 sections used the conduits fully. Thirty-six sections comprising 556 conduits, costing \$3,215,618, have remained vacant since being built. Twelve sections comprised 262 conduits, of which only 28 conduits are being used. Finally, one section comprised 24 conduits built in 2006 at a cost of \$437,200 that were never used and were retired in 2007 (ECS stated at the exit conference that the retirement may have resulted from the expansion of the World Trade Center project.)

In all these cases, by not retiring conduits on a timely basis, ECS continues to include their construction costs in gross plant valuation. As a result, the amount of the annual and accumulated deficits has been overstated. Accordingly, ECS should not include the cost of newly installed and unassigned conduits in the gross plant until the conduits are occupied by a tenant. Furthermore, ECS should ensure that the construction costs associated with newly vacated conduits are removed promptly from gross plant valuation and not wait until the conduit is retired from the inventory. If in the future another tenant occupies the vacated conduit, the construction costs can be added back to the gross plant valuation.

At the exit conference, ECS stated that when building new conduits it was appropriate to build additional unrequested conduits in order not to have to reopen streets in the future if additional conduits might be needed. ECS also indicated that it could not predict in advance how many future conduits might be needed.

However, our analysis of the ECS data indicates that of the 1,026 newly constructed conduits in 2008, 721 are vacant, 277 are occupied by Verizon (the parent company), and only 28 are occupied by other tenants. In 2007, the statistics are even more disturbing. Of the 1,484 newly constructed conduits, 1,048 are vacant, 432 are occupied by Verizon, and only four are occupied by other vendors. In aggregate, for these two years, out of 2,510 newly constructed conduits, only 32 are occupied by vendors other than Verizon, or less than 1.3 percent of the total.

Accordingly, since less than 1.3 percent of the conduits constructed are being used by outside vendors, it appears that ECS should be able to better forecast its future needs. ECS may choose to build an excess of 70 percent of unassigned conduits to have at its disposal for potential future needs without incurring any additional costs in the future. As previously discussed, the costs associated with building the unassigned conduits should not be added to the gross plant valuation until the conduits are actually occupied.

This is further supported by another analysis, which found that 94 percent of the conduits vacant on December 31, 2006, remained vacant or were retired as of March 20, 2009.

### ***Unidentified Conduits***

Another group of conduits that are included in ECS's inventory are those conduits that are in the unidentified category. Unidentified conduits are conduits that according to ECS are being used by tenants that ECS has not identified. Obviously, these unidentified tenants are not charged a rental fee. As long as ECS does not identify these tenants and chooses to forgo the rental fees due, the construction costs associated with these conduits should be excluded from gross plant valuation. Allowing the value of unidentified conduits to be included in gross plant valuation inflates the conduit inventory valuation with non-revenue-producing conduits and diminishes the financial incentive to ensure that ECS identifies and bills the occupant rental fees. As of December 31, 2008, ECS listed 339 unidentified conduits in gross plant inventory at a value of \$308,849.

We partly attribute these problems to ECS's failure to periodically inspect unassigned conduits to determine whether the conduits are still usable or even accessible for inspection. ECS has only one team assigned to do inspections of more than 11,000 manholes. ECS's current inspection process is initiated when a request is made for new conduits. DoITT also contributes to the problem by not undertaking a more assertive role in overseeing the installation and management of the ECS conduit system. (This matter is discussed in the following section.)

### **Recommendations**

ECS should, for the purposes of calculating excess profits and payments that may be due the City:

5. Adjust gross plant assets by reducing the valuation of gross plant assets by \$85 million accounting for the value of the conduits in unassigned and unidentified categories.
6. Identify the tenants occupying all the unidentified conduits and bill those tenants. Once the tenants are being billed, the construction associated with those conduits can be added back to gross plant assets.
7. Implement procedures and employ new technologies to ensure that inspections of unassigned and unidentified conduits are carried out on a timely basis.
8. Update the Duct Utilization System (ECS's conduit-tracking system) to provide more appropriate information about the status of conduits.

***ECS Response:*** ECS stated, the "Report's recommendation that ECS not be permitted to include unassigned conduit in its gross plant assets ignores the reality of the fluctuating and uncertain demand for conduit space, and the significant cost and efficiency considerations driving ECS' build practices. Indeed, if ECS were only permitted to account for conduit that was occupied, it would have no incentive but to build only when

a request is received. This approach would result in substantially higher overall costs to run the business, significant delays in providing conduit space to new tenants (with delays conceivably climbing to as high as a year) and increased disruptions to the City and its residents as streets are more frequently excavated to meet the demand for space.”

In regard to conduits occupied by unidentified tenants ECS responded, “The facilities in these conduits may be part of an active network or simply abandoned. Past efforts have proven to be time-consuming and not cost-effective—the cost of trying to identify and obtain payments from the occupants (assuming an occupant was still in business) outweighed the benefits. Nevertheless, ECS remains open to exploring solutions with DoITT.”

ECS made no reference to recommendations #7 and #8.

**DoITT Response:** DoITT stated that it “generally agrees with the draft report’s finding that the valuation of gross plant assets should not be overvalued based on the value associated with unassigned and unidentified conduits. However, based on the information provided in the draft audit, DoITT is unable to assess whether \$85 million represents the excess value of unassigned and unidentified categories. Further, DoITT believes it can be appropriate, efficient and in the City’s interest for ECS to build conduits in anticipation of future needs, and that it is particularly efficient to do so when City streets are already open due to municipal construction. This recommendation should, therefore, only be implemented in a manner that will not result in disincentivizing ECS from exercising such efficiencies.” DoITT also agreed that ECS should implement procedures and employ new technologies to ensure that inspection of unassigned and unidentified conduits are carried out on a timely basis and that ECS should also update its conduit-tracking system to provide more information about the status of conduits.

**Auditor Comment:** Although it is DoITT’s responsibility to oversee the construction and retirement of conduits, we maintain our position that ECS should not include the costs to construct unassigned conduits until the conduits are actually occupied. The contract does not call for speculative conduit construction based on *potential* future needs. Considering that unassigned conduits represent almost 23 percent of the gross plant value, it is not equitable to include the construction costs of unassigned conduits in gross plant valuation while the conduits remain vacant. If and when these conduits are used in the future, they should be included in the gross plant valuation. In addition, adding the value of conduits constructed as part of a municipal project and which may remain unassigned for years, is not equitable and is certainly not the intent of the contract: “If at any time the space in such subways, conduits ducts shall not be sufficient for all the companies or corporations so applying for the same, or for the city of New York, or any of its departments, the additional space shall be provided by the party of the second part [ECS] at its own cost.”

If ECS wants to stockpile newly-built conduits for future use and thereby reduce its future costs when and if the conduits finally become occupied, then and only then should it add that construction cost to inventory. The contract did not intend for ECS to stockpile numerous vacant conduits. Taking into consideration our analysis that only 1.3 percent of



the conduits built in 2007 and 2008 were used by non-Verizon vendors, 70 percent remained vacant, and 28 percent were occupied by Verizon, its parent company, ECS with the help of Verizon should be better able to predict the future demand for conduits.

Furthermore, ECS's response regarding conduits in the unidentified category does not justify retaining the construction costs of those conduits in inventory year after year. ECS contends that "past efforts have proven to be time-consuming and not cost-effective—the cost of trying to identify and obtain payments from the occupants (assuming an occupant was still in business) outweighed the benefits." While it may be time consuming for ECS to identify those tenants not being billed, it is likewise not cost-effective to the City to include the construction costs of unidentified conduits.

### **Lack of Oversight**

DoITT has not ensured that ECS effectively manages, constructs, or retires conduits as required by Section II and Section IV of the agreement. The effect of this is to reduce the possibility of additional fees being paid to the City because of ECS excess profits (i.e., greater than 10 percent of gross plant). DoITT officials informed us that ECS does not have any involvement with the planning of the construction and retirement of conduits.

Notwithstanding DoITT's position, agreement Section II grants DoITT (the successor to the agreement's original first party) the right to demand necessary changes that will increase the usefulness and efficiency of the system associated with ECS, and Section IV gives DoITT the right to order or direct the building of new conduits. Thus, Section II of the agreement states in part:

Such subways, conduits and ducts as the Empire City Subway Company (Limited) shall be ordered or directed to build, shall be built in accordance with the plans and specifications therefor furnished or to be furnished by the parties of the first part, or their successors [i.e., DoITT] and the same shall be provided, built, equipped, maintained, operated and kept in good repair by and at the cost of the party of the second part [i.e., ECS] who will, upon reasonable demand of the parties of the first part, or their successors, [i.e., DoITT] adopt any and all necessary improvements that will increase the usefulness and efficiency of the system contemplated by this contract and the acts above referred to. The parties of the first part and their successors [i.e., DoITT] shall have the right, at any time, to make such modifications and changes as may be reasonably necessary in said subways, conduits and ducts or any of them, or the construction, plans, material, or any other matter connected with them, or any of them, and the part of the second part [i.e., ECS] shall conform to and carry out any reasonable changes or modifications so made.

Section IV of the agreement states:

If at any time the space in such subways, conduit ducts shall not be sufficient for all the companies or corporations so applying for the same, or for the City of New

York, or any of its departments, the additional space needed shall be provided by the party of the second part [i.e., ECS] at its own cost, by the construction, maintenance, equipment and operation of additional subways, conduits and ducts, sufficient therefore, subject, however, to the same conditions and the same control by the parties of the first part or their successors, [i.e., DoITT] as the original subways, conduits and ducts are by the terms of this contract and by any law.

As stated in Section II above, the City ordered or directed ECS to build the original conduits, and according to Section IV, the same should apply for all subsequent conduit construction.

### **Recommendation**

9. DoITT should undertake a more assertive role in overseeing the construction and management of the overall conduit infrastructure system so that the plant valuation is not inflated with unnecessary construction costs for the purposes of calculating excess profits and payments that may be due the City.

*DoITT Response:* DoITT stated that it “will undertake a greater oversight role with respect to ECS’s construction decisions.”

### **Conduit Rental Rates**

ECS has been charging its customers the same conduit rental rates since 1986. In its last rate increase request to DoITT in 2001, ECS presented documents showing that conduit users in Manhattan and the Bronx were charged one of the lowest conduit rental rates in the United States. DoITT did not address ECS’s request for a rate increase.

ECS’s rental rates are based on the size and length of the conduit. The current annual rental rates are \$0.70 per foot for conduits 2.5 inches or less, \$0.79 per foot for a 3-inch conduit, and \$1.10 per foot for a 4-inch conduit. As of December 31, 2008, ECS’s inventory contained 25,469 conduits that were 2.5 inches or less totaling 6.8 million feet, 127,670 3-inch conduits totaling 37.6 million feet, and 60,662 4-inch conduits totaling 20.9 million feet.

In 2001, ECS conducted a survey of rental rates charged for 4-inch conduits in various cities across the country. The survey revealed that the average conduit rate for the nine jurisdictions surveyed was \$3.43 per foot (only one city charged less than ECS). Four northeastern cities in the survey were charging between \$4.50 and \$5.50 per foot.<sup>3</sup>

During the course of this audit, we verified the current rates charged by three of these four northeastern cities and found that the rates have not changed since the survey. In 2001, ECS requested that its rate be increased from \$1.10 to \$2.60 per foot (a 136 percent increase).

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<sup>3</sup> The four northeastern cities were Newark, Philadelphia, Baltimore, and Washington, DC.

Considering the 92.65 percent cumulative rate of inflation from 1986 to the end of 2008, the current \$1.10 rental fee charged by ECS has the purchasing power of \$0.57 in 1986 dollars. Furthermore, the consumer price index for the northeast area stood at 110.8 in the beginning of 1986 and at 225.1 in December 2008, an increase of 103 percent during the 23-year period that ECS's rate was not adjusted.

Had DoITT approved the 2001 rate increase request of 136 percent for all ECS conduits, by the end of 2002 ECS would have turned a profit in excess of 10 percent of adjusted gross plant assets (after adjusting for depreciation previously discussed) and eliminated the deficit of \$51.9 million that it had accumulated since 1994. Furthermore, had the adjusted gross plant method been in use from 2002 to 2008, the City would have been entitled to additional payments from ECS totaling more than \$262 million.

The City's Law Department contends that a rental rate increase resulting in additional revenue for the City could be successfully challenged in court. The opinion is based on a 1922 Supreme Court ruling (City of New York against Empire City Subway Company) that was later upheld by the Appellate Division.

### **Recommendation**

10. DoITT should consider seeking legislative change stating that it is just and reasonable to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City. A new rate should take into account the rate of inflation and be comparable to conduit rental rates charged in other cities.

**DoITT Response:** DoITT stated that it "will consider pursuing a legislative change that would expand the City's discretion in ECS rate-setting, including potential revenue-generation, but only if such new framework can be implemented compatibly with the City's objectives of protecting City consumers from excessive rates for cable TV, telephone and internet and fostering a competitive communications environment that expands consumer choice."

**Auditor Comment:** In our recommendation, we took into consideration DoITT's concern regarding "protecting City consumers from excessive rates for cable TV, telephone and internet service." First, the rates charged by telecommunication companies for telephone services are regulated by the New York Public Service Commission, which weighs requests for rate increases against a fair rate to be charged to consumers. Second, the rates charged for cable TV and Internet services are established by the outside market, and the rates must be competitive. Last, a single ECS conduit can ultimately service multiple buildings and in turn provide cable TV, telephone, and Internet service to numerous consumers. Therefore, while any increase in the conduit rates charged by ECS could be used as an excuse to raise the rates of those services, the actual costs spread among the multiple services provided to numerous customers should actually result in an insignificant increase to individual customers.

**EMPIRE CITY SUBWAY COMPANY (LIMITED)**

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March 18, 2010

Ms. H. Tina Kim  
Deputy Comptroller  
The City of New York  
Office of the Comptroller  
1 Centre Street  
New York, NY 10007-2341

**Re: Audit on the Payment by Empire City Subway of License Fees Due the City and Compliance with Certain Provisions of Its License Agreement (FP08-103A) – Comments of Empire City Subway Company (Limited)**

Dear Ms Kim:

On March 12, 2010, your office circulated its revised draft audit report, entitled “Audit on the Payment by Empire City Subway of License Fees Due the City and Compliance with Certain Provisions of Its License Agreement” (herein referred to as the “Revised Draft Report” or “RDR”). While we are pleased that the Revised Draft Report concludes that Empire City Subway Company (Limited) (ECS) “generally adhered to the requirements of the license agreement and paid all franchise tax payments that were due during the audit period in a timely manner,” it contains certain findings which ECS disputes and for which ECS submits these comments.

1. ECS Financial Statements Not Independently Certified

ECS does not agree that it has been under an obligation to separately certify its financial statements. The Revised Draft Report correctly notes that a 1984 Comptroller audit report of ECS contains a recommendation that ECS “file its certified financial statements annually with DGS and the Comptroller.” (RDR, p. 7.) The Revised Draft Report reduces this recommendation to a mandate, as reflected in the statement that ECS “officials claimed they were not aware of the requirement to certify separately the financial statements of ECS’ operations.” (RDR, p. 6, emphasis added.) ECS respectfully disagrees that the 1984 recommendation ever became a mandate on two counts. First, as ECS explained during the audit, it has no record of ever receiving any directive to file independently certified financial statements nor was a directive produced by the auditors. As such, the recommendation remained just that – a recommendation. It is also worth noting that in the 20+ years since the 1984 audit, ECS has no record of the Comptroller, DGS (or its successor) ever requesting independently certified financials.

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March 19, 2010  
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Second, the recommendation was made after careful consideration of the circumstances as they existed in 1984. Specifically, the recommendation was made in the context of an audit finding that excess profits under the 10 percent profit provision “will be unlikely in the foreseeable future.”<sup>1</sup> Nevertheless, the auditors concluded that ECS should furnish “full information,” including “its calendar year certified financial statements.”<sup>2</sup> The recommendation, both in wording and context, falls short of constituting a “requirement” that ECS “certify separately the financial statement of [its] operations,” as urged by the Revised Draft Report. (RDR, p. 6.) In this regard, it is revealing that an earlier draft of the 1984 audit report did not use the word “its” in making this recommendation. That report simply stated: “Empire City should file certified financial statements annually with DGS and the Comptroller.”<sup>3</sup> The statement also appears this way in the context of the earlier draft’s discussion. Thus, the inclusion of the word “its” in the final version was not inadvertent and, in ECS’ view, was inserted to remove any suggestion that ECS be required to generate certified financials if it were not already doing so.

ECS also disagrees with the recommendation that it begin obtaining annual independently certified financials, starting with the year ending 2008. (RDR, p. 7.) ECS does not believe that certified financials are warranted given the size of its existing deficit, the significant additional cost of obtaining statements certified by a third party on an annual basis, and its willingness to have its financial statements certified annually by a member of its senior management.

## 2. Overstated Deficits

### a. Depreciation Applied Inconsistently

The Revised Draft Report concludes that ECS’ accumulated deficit is overstated because it does not apply depreciation to its gross plant. (RDR, p. 7.) As ECS explained during the audit, it calculates the accumulated deficit in accordance with the terms of the 1891 Agreement, which provides, in relevant part at Section VI:

Whenever the net annual profits of [ECS], remaining after the payment of the reasonable and necessary expenses of maintaining and operating such subways, conduits and ducts, shall exceed ten per cent. upon the actual cash capital invested by it in providing, constructing and equipping such

<sup>1</sup> See p. 5 of the “Audit Report on a Contract With Empire City Subway Company, Ltd., October 1, 1976 to September 30, 1982, J 83-821,” transmitted from Frank Cannistra, Director, Bureau of Financial Audit to Mr. Alan Snelling, Librarian, dated July 3, 1984 (1984 Report).

<sup>2</sup> 1984 Report, p. 7.

<sup>3</sup> See p. 7 of the Draft Report forwarded to Robert M. Litke, Commissioner, Department of General Services from Frank Cannistra, Director, Bureau of Financial Audit, dated May 4, 1984.

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March 19, 2010  
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subways, conduit and ducts, then the excess of such profit over the ten per cent. shall be paid into the Treasury of the City of New York.

The language is explicit that the calculation is to be based upon “actual cash capital invested.” As noted in the Comptroller’s 1984 audit report of ECS, this calculation is called the “Original Full Cost Method.”<sup>4</sup> That report noted that the Appellate Division of the Supreme Court of New York had ruled that ECS “should report all costs associated with building the conduit systems, including direct labor, materials and overhead, as its investment in conduits. This method, call the “Original Full Cost Method . . . accounts for neither the retirement of obsolete conduits nor depreciation of the assets.”<sup>5</sup>

Thus, ECS’ method of calculating excess profit is entirely consistent with the plain language of the 1891 Agreement and supported by case law interpreting that language.

3. Gross Plant Assets Overstated

a. Unassigned Conduit and Conduits Built as Part of Municipal Projects

The Revised Draft Report concludes that “ECS overstated the value of gross plant assets by including in inventory the costs of unassigned conduits.” It also concludes that ECS builds new conduits “when there is no apparent need or request for them.” (RDR, p. 9) As ECS explained during the audit, the majority of its builds are done in response to a party’s request for conduit space. As part of those builds, ECS typically will include a certain amount of spare conduit for future use. Because the bulk of the construction costs (80%-85%) is made up of labor/equipment/material for the excavation and restoration of the trench, the cost of placing additional spare conduit is minimal. This practice avoids the substantial cost and disruption resulting from excavating the streets of the City every time a party requests space where there is none.

ECS’ participation in municipal projects may be driven by similar considerations; however, in many instances, ECS is required to move its facilities to accommodate City construction, in which case, it typically has no choice but to place new conduit because the integrity of the existing conduit that is to be relocated is lost. It also has been ECS’ experience that the City discourages and, in certain circumstances, may even prohibit ECS from digging up a site that has been recently restored as part of a municipal project.<sup>6</sup> Thus, while it may cost ECS more to have the City’s contractor place its facilities during

<sup>4</sup> 1984 Report at p. 4.

<sup>5</sup> 1984 Report at p. 4, emphasis added.

<sup>6</sup> If conduit is constructed after a municipal project is complete, ECS is required by the New York City Department of Transportation to replace the roadway from curb to curb even though, for example, it may only cut a 3’ wide trench. This requirement adds significantly to the cost of the construction. Also, during planning for such projects, the City consistently expresses its desire to minimize disruption to the community by not having streets excavated multiple times.

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March 19, 2010  
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a municipal project, it is still cheaper and more certain than if ECS had to place the conduit after completion of the municipal project.

The Revised Draft Report's recommendation that ECS not be permitted to include unassigned conduit in its gross plant assets ignores the reality of the fluctuating and uncertain demand for conduit space, and the significant cost and efficiency considerations driving ECS' build practices. Indeed, if ECS were only permitted to account for conduit that was occupied, it would have no incentive but to build only when a request is received. This approach would result in substantially higher overall costs to run the business, significant delays in providing conduit space to new tenants (with delays conceivably climbing to as high as a year) and increased disruptions to the City and its residents as streets are more frequently excavated to meet the demand for space.

As with most businesses that face uncertain future demand for their products or services, ECS cannot be 100% accurate in its forecasts, so it is not hard to second guess build decisions after the fact. For example, no one predicted the telecommunications or dot com booms, both of which resulted in unprecedented demand for conduit space. Similarly, few predicted the subsequent busts for these two sectors. From 1996 to 2001, the telecom boom generated numerous requests for conduit space in multiple locations throughout Manhattan and the Bronx, causing mainline construction delays, some in excess of one year, due to the lack of spare conditions. After the events of September 11, many of these tenants went out of business or paired back their business plans considerably, resulting in the cancellation of existing conduit expansion jobs and a general slow-down in requests for space going forward.

The Revised Draft Report's recommendation appears to be driven by the desire to limit ECS' accumulated deficit as much as possible. (See Recommendation 10.) In this regard, the 1984 Report referenced above noted two other court rulings that touch on this approach. The first is that the excess profits provision "was not intended to produce profits for the City. The excess profits provision was intended to ensure that Empire City did not receive more than a 10 percent return. The only gain contemplated by the City was the removal of poles and wires from the City's streets." The second was that the 1891 Agreement "provided the City with regulatory powers only."<sup>7</sup> As the cited court decision explained, the City "has a remote interest in [ECS'] earnings so long as adequate, efficient service is provided. The excess profits provision merely provides additional assurance that [ECS] will not receive more than a 10 percent profit." Finally, the 1984 Report itself concludes that the excess profits provision had become "unnecessary as a regulatory tool for Empire City's conduit rental rates."<sup>8</sup>

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<sup>7</sup> 1984 Report, p. 5.

<sup>8</sup> 1984 Report, p. 4.

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March 19, 2010  
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These conclusions underscore the tenuous link between the excess profits provision and the current day operation or regulation of ECS' business. As the court noted, by limiting its annual return, this provision was intended to prevent ECS from taking advantage of tenants who were required to rent conduit space from it. As the court noted, it was "a not unusual method of ensuring adequacy of service and reasonableness of rates before the days of governmental supervision and regulation."<sup>9</sup> Nevertheless, the Revised Draft Report's recommendation would take the excess profits provision – a provision in which the City has but a "remote interest" – and make it a significant (albeit inappropriate) driver for how the business should be run. The needs of ECS' business should not be subordinated to the misplaced goal of minimizing or eliminating its accumulated deficit. The focus of regulation should be on ensuring that ECS continues to operate efficiently and fairly. And while the next "boom" or upsurge in demand cannot be predicted with any certainty, ECS can and should be allowed to make investment decisions that ensure that its network of conduits stands ready to meet any spike in demand, whether generated by the next technology boom, natural disaster or act of terrorism.

b. Unidentified Conduits

As noted in the Revised Draft Report, a limited amount of ECS' conduit is occupied by facilities of unidentified parties. (RDR, p. 11.) The facilities in these conduits may be part of an active network or simply abandoned. Past efforts have proven to be time-consuming and not cost-effective - the cost of trying to identify and obtain payments from the occupants (assuming an occupant was still in business) outweighed the benefits. Nevertheless, ECS remains open to exploring solutions with DoITT.

Sincerely,



Robert De Furia

c: David Gudino  
Lawrence Welgrin, Audit Manager

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<sup>9</sup> *City of New York v. Empire City Subway Co Ltd.*, 202 A.D. 494, 498 (1922).





**Information  
Technology &  
Telecommunications**

**Carole Post**  
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March 19, 2010

Ms. Tina Kim  
Deputy Comptroller for Audit  
The New York City Office of the Comptroller  
Audits, Accounts & Contracts  
1 Centre Street, Room 1100  
New York, NY 10007

**Re: Audit of the Payment by  
Empire City Subway of License Fees  
Due the City and Compliance with Certain  
Provisions of Its License Agreement (FP08-103A)**

Dear Deputy Comptroller Kim:

I am writing in response to the above-captioned revised draft audit report ("ECS" draft audit) dated March 12, 2010.

First, on behalf of the Department of Information Technology and Telecommunications ("DoITT"), I would like to recognize the efforts by your audit staff in assessing ECS's compliance with the ECS contract. DoITT has reviewed the draft audit's findings and recommendations and would like to comment on the conclusions that pertain both to ECS's compliance with its contract, and to DoITT's oversight of ECS's conduit construction activities and the agency's potential future role in establishing the rates that ECS may charge occupants of its conduits.

#### **RECOMMENDATIONS PERTAINING TO ECS**

As to the eight findings and recommendations related directly to ECS, DoITT generally concurs with the draft audit's recommendations that ECS should: employ an independent accounting firm and issue certified financial statements for calendar 2008 and future years (recommendation #1); apply depreciation consistently when calculating net profit and accumulated deficits (recommendation #2); readjust calculations of net income and associated deficit amounts (recommendation #3); and, of course, maintain accurate and complete financial records as required by the agreement (recommendation #4).

The remaining four recommendations pertaining to ECS's practices arise from the draft audit's findings that ECS overstated the value of gross plant assets by including in its inventory the costs of unassigned, or dormant, conduits. The draft audit's recommendations associated with unassigned and unidentified conduits, and DoITT's responses and observations regarding these recommendations, are as follows:

Recommendation 5: Adjust gross plant assets by reducing the valuation of gross plant assets by \$85 million accounting for the value of the conduits in unassigned and unidentified categories.

DoITT's Response: DoITT generally agrees with the draft report's finding that the valuation of gross plant assets should not be overvalued based on the value associated with unassigned and unidentified conduits. However, based on the information provided in the draft audit, DoITT is unable to assess whether \$85 million represents the excess value of unassigned and unidentified categories. Further, DoITT believes that it can be appropriate, efficient and in the City's interest for ECS to build conduits in anticipation of future needs, and that it is particularly efficient to do so when City streets are already open due to municipal construction. This recommendation should, therefore, only be implemented in a manner that will not result in disincentivizing ECS from exercising such efficiencies.

Recommendation 6: Identify the tenants occupying all the unidentified conduits and bill those tenants. Once the tenants are being billed, the construction associated with those conduits can be added back to gross plant assets.

DoITT's Response: DoITT agrees, consistent with the above response to Recommendation 5.

Recommendation 7: Implement procedures and employ new technologies to ensure that inspections of unassigned and unidentified conduits are carried out on a timely basis.

DoITT's Response: DoITT agrees.

Recommendation 8: Update the Duct Utilization System (ECS's conduit-tracking system) to provide more appropriate information about the status of conduits.

DoITT's Response: DoITT agrees.

#### **RECOMMENDATIONS PERTAINING TO DoITT**

Recommendation 9: DoITT should undertake a more assertive role in overseeing the construction and management of the overall conduit infrastructure system so that the plant valuation is not inflated with unnecessary construction costs for the purpose of calculating excess profits and payments that may be due the City.

DoITT Response:

DoITT will undertake a greater oversight role with respect to ECS's construction decisions. However, DoITT believes that the final audit report should acknowledge the importance of allowing ECS to build conduits in anticipation of prospective needs, particularly when City streets are already open for other purposes. Building conduits on "spec," helps facilitate the timely deployment of competitive telecommunications and cable TV facilities to serve City

residents and businesses. Undertaking such activity when sub-surface construction is already taking place helps prevent the same streets from being opened repeatedly and minimizes associated traffic congestion and inconvenience to the public. Thus, as part of assuming a greater oversight role, DoITT intends to work closely with ECS to analyze, and if necessary achieve adjustments to, their decision-making processes to ensure a logical and appropriate balancing of interests.

Recommendation 10: DoITT should consider seeking legislative change stating that it is just and reasonable to set the conduit rental rate at a competitive level that permits the contract to generate revenue for the City. A new rate should take into account the rate of inflation and be comparable to conduit rental rates in other cities.

DoITT Response:

DoITT will consider pursuing a legislative change that would expand the City's discretion in ECS rate-setting, including potential revenue-generation, but only if such new framework can be implemented compatibly with the City's objectives of protecting City consumers from excessive rates for cable TV, telephone and internet and fostering a competitive communications environment that expands consumer choice.

In 2001, ECS requested DoITT's approval of a rental rate increase (i.e. an increase in the rate that ECS, a Verizon subsidiary, may charge its conduit-occupying tenants, many of whom are Verizon competitors) of 136%, from \$1.10 to \$2.60 per foot. DoITT did not approve the requested increase, as ECS did not, in DoITT's judgment, sufficiently demonstrate that such an increase was warranted to provide ECS with a reasonable rate of return; which, legally, is the criteria by which such requests must be evaluated.

The draft audit finds (without, however, providing any backup calculations), that if DoITT had approved the 2001 rate increase request for ECS conduits, "by the end of 2002 ECS would have turned a profit in excess of 10 percent of adjusted plant assets ... and eliminated the deficit of \$51.9 million that had accumulated since 1994." The draft audit finding continues, "had the adjusted gross plant method been in use from 2002 to 2008, the City would have been entitled to additional payments from ECS totaling more than \$262 million."

However, the draft audit also acknowledges the New York City Law Department's observation that "a rental rate increase resulting in additional revenue could be successfully challenged in court." Specifically, as noted in the draft report, the New York Supreme Court and Appellate Court have ruled that a rate increase may not be approved for the purpose of raising revenues. (The draft report does not mention that the same legal constraints were also pointed out in the previous audit of the ECS contract by the Comptroller's Office. It is unclear why the draft audit language attributes these legal observations only to the Law Department when they have been shared by the Comptroller's Office itself.)

The draft report claims that ECS has not enjoyed a rate increase since 1986. However, a change in ECS's methodology for calculating rates has led to an effective increase in the amount ECS can charge for occupancy for the same amount of conduit space. In addition, as pointed out above, the appropriate standards for determining maximum ECS rates are based on the ECS contract and applicable law, and the mere passage of time or existence of inflation, or charges in other jurisdictions, do not in themselves provide the legal justification for a rate increase. As noted

above, DoITT previously reviewed ECS's last rate increase request and did not at that time find sufficient justification, within the scope of the contract and applicable law, to grant such request. Also, the nature of conduit services and requirements, and the relationship of conduit rate requirements to other costs of occupying local streets, are highly variable from city to city and from state to state. Without analysis of exactly what conduit occupants of various cities are receiving in return for conduit rental payments (and as well as other relevant conditions), DoITT considers the comparison in the draft audit to conduit rates in other jurisdictions to be of somewhat limited value.

Ultimately, DoITT reviews, on an ongoing basis, a range of possible legislative changes that could have the result of increasing City revenue generated from the occupancy of City street property by communications service providers – consistent with other City goals, including assuring the availability of robustly competitive, and competitively priced, communications services. In particular, DoITT seeks to ensure that any increases to the ECS rates will not simply be passed through to City consumers and businesses in the form of increased cable TV, telephone and internet rates. Because the ECS contract covers only parts of the City, avoiding disproportionate effects on various consumers and businesses would be a relevant consideration. To the extent that changes in the legislative regime that affects Empire City's Subway's activities would be consistent with those goals, DoITT would expect to pursue the recommended changes to law.

Sincerely,



Carole Post

c: Edward Skyler, Deputy Mayor  
George Davis III, Deputy Director/Operations  
Bruce Regal, Senior Counsel/NYC Law Department  
Mitchel Ahlbaum, Deputy Commissioner, General Counsel/DoITT