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SERVICE DATE

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BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of U S WEST COMMUNICATIONS, INC., for an Order Approving Capital Recovery Methodology and Related Accounting.	))))))))	DOCKET NO. UT-920085 THIRD SUPPLEMENTAL ORDER DENYING U S WEST PETITION TO IMPLEMENT THE EQUAL LIFE GROUP (ELG) METHODOLOGY

NATURE OF PROCEEDING: On January 30, 1992, U S WEST Communications, Inc. (U S WEST or company), filed a petition for an order authorizing use of the equal life group (ELG) methodology in computing intrastate depreciation expenses.

HEARINGS: A prehearing conference was held on June 3, 1992. Hearings were conducted on August 3 and October 19, 1992, before Administrative Law Judge Rosemary Foster of the Office of Administrative Hearings. Briefs were filed by the parties on January 4, 1993.

APPEARANCES: Petitioner was represented by Mark Roellig and Edward T. Shaw, attorneys at law, Seattle. The Commission Staff was represented by Steven W. Smith and Jeffrey Goltz, Assistant Attorneys General, Olympia. The public was represented by Charles F. Adams, Assistant Attorney General, Seattle. Intervenor GTE Northwest Incorporated (GTE) was represented by Timothy Williamson, attorney at law, Everett. Intervenor Telecommunications Ratepayers Association for Cost Effective and Equitable Rates (TRACER) was represented by Arthur Butler, attorney at law, Seattle. Intervenor Washington Independent Telephone Association (WITA) was represented by Richard A. Finnigan, attorney at law, Tacoma.

SUMMARY: The Commission finds that U S WEST has failed to establish that it is in the public interest to authorize the company to use the ELG depreciation methodology. The Commission therefore denies the petition.

MEMORANDUM

1. Background and Procedural History

U S WEST and its predecessor company, Pacific Northwest Bell Telephone Company (PNB), have traditionally used the vintage group (VG) methodology for computing intrastate depreciation expense. In 1981, in Docket No. U-81-41, and again in 1982, in Docket No. U-82-19, PNB petitioned the Commission for authority to use the ELG methodology for computation of intrastate depreciation expense. In both cases, the Commission denied the company's request.

During this same period of time, the Federal Communications Commission (FCC) issued regulations which authorized telecommunications companies to use ELG, and preempted state regulation of depreciation expense rates. In reliance on the FCC ruling, PNB adopted ELG for computing intrastate depreciation for Washington intrastate operations. The U.S. Supreme Court, in Louisiana Public Service Commission v. FCC, 476 US 355 (1986), reversed the FCC's preemption ruling on intrastate depreciation. After this decision, the Commission reopened Docket No. U-85-52 to consider, among other things, the appropriate depreciation method to be used by PNB.

This reopened proceeding was eventually resolved by a stipulated settlement which was approved by the Commission. As part of the settlement, PNB agreed to give up ELG, but retained the right to revisit the issue at a future date. In addition, PNB was directed to refund $73 million of ELG related funds which had been collected since the FCC's attempted preemption. The refund was amortized over a period of 11.36 years beginning in July 1987.

The Commission's Fourth Supplemental order in Docket Nos. U-89-2698-F and U-89-3245-P, entered January 16, 1990, approved an alternative form of regulation (AFOR) for U S WEST pursuant to a settlement agreement filed with the Commission by the parties. Under the AFOR, the company files annually the amount of excess earnings above its authorized rate of return, which revenue is available for sharing with ratepayers according to formulae established in the agreement.

The settlement agreement prohibits adjustments "for other revenues, expenses, or rate base" unless ordered by the Commission in an adjudicative proceeding. The revenue effect of a change in depreciation methodology is an "adjustment" of the type contemplated by paragraph K of the settlement agreement.

On January 30, 1992, U S WEST filed with the Commission a petition for a declaratory order authorizing the company to use ELG for intrastate depreciation. The Commission declined to treat the matter on a declaratory order basis, but accepted the filing as a petition for an accounting order and set the matter for hearing. Hearings were held on August 3 and October 19, 1992. The parties have waived their right to an initial order.

2. Vintage Group and Equal Life Group

Vintage group, or VG, depreciation is a technique which segregates assets according to the year or calendar period the asset was placed into service. Equal life group, or ELG, methodology further segregates those assets within vintages that

are expected to have the same service life. Vintage group depreciation is straight line. ELG allows more recovery during the earlier years than VG, based upon anticipated retirements. This leads to a larger revenue requirement during the early years. If U S WEST converts to ELG, it will create a revenue requirement of $32 million during the first year, with higher revenue requirement than under VG depreciation in each succeeding year as long as ELG is in effect. This additional revenue requirement would not immediately require a corresponding increase in rates, but would decrease the amount of revenue available for sharing under the current AFOR approved by the Commission.

3. Positions of the Parties

a. U S WEST

U S WEST contends that the VG method of depreciation currently used by the company understates expenses during the early years and overstates expenses during later years. It claims ELG, on the other hand, is a proven and long standing depreciation methodology which more closely matches depreciation expenses with the actual service lives of assets. The company asserts that it has experienced increased interexchange competition in recent years and will face increased intraexchange competition in the near future. To remain competitive, U S WEST submits that it must utilize the latest technologies, and to attain this goal the company must be allowed accurate and timely capital recovery.

U S WEST also contends that lack of ELG is one of the major factors which has contributed to substantially lower than nationwide average composite depreciation rates and depreciation reserve ratio levels for the company in the state of Washington. In support of this position, the company sponsored as an exhibit a 1990 depreciation study compiled by the United States Telephone Association (USTA). The study identifies depreciation rates for 15 telephone companies throughout the nation. Based upon the study's data, the company contends that its capital recovery levels are below those of other telecommunications companies. The company also asserts that its capital recovery in Washington is below the U S WEST average in its 14 state service territory.

The company also contends that the situation is aggravated by ever-shortening asset lives caused by competitive and technological pressures, leading to a substantial mismatch between asset consumption and depreciation expense. Finally, the company maintains that use of ELG will be more equitable in that today's customers will be more likely to pay for today's consumption.

b. GTE

GTE supports the use of the ELG methodology. GTE argues that VG depreciation is inherently flawed because under this methodology there is an obligation for an individual, long-lived asset to accrue two-to-three times its original cost. GTE asserts as a virtue of the ELG methodology that the only obligation of the asset in service is to recover its cost, and not to bear costs of any investments already removed from service. With the rapid pace of technological change and competition in the telecommunications marketplace, estimates of useful life will become more unpredictable and historical life trends will offer little guidance for the future, other than to indicate that assets will have generally shorter service lives. Ultimately, according to GTE, long term cost levelization would best be achieved under the ELG methodology.

c. WITA

WITA supports the U S WEST petition to use the ELG methodology. WITA claims that ELG should be available to telephone companies if they choose to use it, but the choice of depreciation methodology should be left to the discretion of each company based on individual needs. WITA maintains that ELG provides a more accurate and reliable method of matching capital consumption to depreciation expense. WITA asserts that depreciation methodologies should be evaluated in terms of how they affect capital recovery, not their impact on rate levels. WITA urges that the choice of depreciation methodology should be based exclusively on capital recovery considerations.

According to WITA, if depreciation methodologies are selected which result in assets with lives which are too long, the ability of a company to compete in a marketplace experiencing rapid changes in technology will be severely hampered. WITA argues that because the Commission has not permitted companies to adequately recover past capital expenditures, depreciation reserve levels have dropped, and current ratepayers now bear the burden of inadequate capital recovery through higher rates.

d. Commission Staff

Commission Staff opposes the petition for several reasons:

1. Granting the petition would impose an additional $32 million revenue requirement during the first year at a time when the company is doing very well financially.

2. Granting the petition would remove the Commission's discretion over the excess revenue available for sharing under the AFOR, to the extent of the cost to the company of adopting ELG.

3. There is no need to increase cash flow above present levels, as the company is currently funding all construction from internally generated funds.

4. The only cogent reason U S WEST advances for granting the petition is premised on the USTA study which purports to show below average capital recovery for U S WEST in Washington as compared with other states. Commission Staff contends the USTA study is flawed for several reasons including the following:

a. The study mixes interstate and intrastate data, which makes comparison with Washington intrastate data inappropriate.

b. The company's USTA comparison fails to take into consideration $10 million in annual depreciation accruals authorized as of January 1, 1991.

c. The study used a financial reporting, or "FR", basis utilized in Securities and Exchange Commission reporting. This method can be inconsistent with the monthly reporting basis, or "MR", used by the Commission for ratemaking purposes and revenue sharing under the AFOR. Thus, a comparison between the USTA study and Washington data is inappropriate.

5. The mix of plant, the $73 million refund, and similar factors, rather than the existence or absence of ELG, have affected the company's composite intrastate depreciation rate and depreciation reserve ratio.

6. Washington is already paying its fair share of U S WEST's intrastate depreciation expense. For 1991, Washington provided approximately 12% of total state revenue, and provided about 12% of total state depreciation accruals.

7. Washington has a lower fill ratio for central office equipment and outside plant relative to other states, indicating greater construction for future growth in revenues.

8. U S WEST's proposal amounts to single issue or "piecemeal" ratemaking. Authorizing ELG would reduce the amount of 1993 revenue available for sharing by $32 million next year, with continuing reductions in shared revenues during subsequent years, without considering the totality of company operations or the relationship between risk and return.

e. Public Counsel

Public Counsel opposes the proposal for many of the same reasons advanced by Commission Staff. In addition, Public Counsel expresses concern that if U S WEST is allowed to use ELG, other telecommunications companies in Washington would also seek ELG, thereby increasing depreciation expenses and rates.

f. TRACER

TRACER asserts that the company has not demonstrated any compelling need for a change in its depreciation methodology. TRACER claims that U S WEST has not shown that it has lower capital recovery because it is not using ELG. TRACER reiterates Commission Staff's excess capacity argument, and states that future ratepayers should pay for growth as it occurs.

TRACER notes that the AFOR allows the Commission to allocate excess revenues to the depreciation reserve, and thereby gives the Commission more flexibility in dealing with any capital recovery problems which may exist. TRACER claims that U S WEST has failed to show that ELG would afford a closer matching of asset consumption with depreciation accrual. Finally, TRACER argues that allowing ELG would be inappropriate in the context of the company's current AFOR and would amount to a "fundamental change of the rules in the middle of the game."

DISCUSSION

1. The Commission has carefully reviewed the evidence in this record both supporting and opposing adoption of the ELG methodology.

2. We believe that adoption of ELG without considering other aspects of the company's rate structure would amount to single issue ratemaking, and would represent a substantial change in the framework within which the current AFOR was approved.

The current VG methodology was in effect at the time the company entered into the settlement argreement adopting the current AFOR. The AFOR is in effect through December 31, 1994. As TRACER noted, a change in depreciation methodology now would amount to a change "of the rules in the middle of the game."

The Commission finds that adoption of ELG at this time is inappropriate under the AFOR currently in effect. We therefore hold that the company's petition is not in the public interest and should be denied.

Having discussed above in detail, the evidence concerning all material matters, and having stated findings and conclusions, the Commission makes the following summary of those findings and conclusions. Portions of the preceding discussion are incorporated by this reference.

FINDINGS OF FACT

1. The Washington Utilities and Transportation Commission is an agency of the state of Washington vested by statute with authority to regulate rates, rules, regulations, practices, accounts, securities, and transfers of public service companies, including telecommunications companies.

2. Petitioner U S WEST Communications, Inc., is a public service company engaged in the business of furnishing telecommunications service to customers within the state of Washington, and, as such, is subject to regulation by the Washington Utilities and Transportation Commission.

3. On January 30, 1992, the company filed a petition for a declaratory ruling that would allow the company to use the ELG methodology for calculating intrastate depreciation.

4. By letter dated April 3, 1992, the Commission declined to accept the petition as one for a declaratory ruling, but accepted the filing as a petition for an accounting order authorizing use of the ELG method. Hearings were held in this matter on June 3, August 3, and October 19, 1992.

5. The parties have waived their right to an initial order in this case.

6. The Commission approved an alternative form of regulation (AFOR) for U S WEST for a five year period ending December 31, 1994.

7. U S WEST currently uses the vintage group depreciation method. Under this method, assets are grouped according to the year they are placed in service, and recovery is on a straight line basis for each year of service life. The equal life group method groups together assets with the same anticipated service life, and allows greater recovery in earlier years than in later years of the asset's estimated life. Consequently, ELG results in a greater revenue requirement during

the early years of recovery. In this case, if ELG were implemented by U S WEST, it would result in an increase in the company's revenue requirement, which could be offset by revenue available for sharing under the AFOR.

8. The ELG petition addresses only one aspect of the company's overall operations, i.e., intrastate depreciation rate recovery levels. As such, it fails to take into consideration all factors which affect company rates.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the parties and the subject matter of this proceeding.

2. The Commission concludes that authorization of the ELG method for computing intrastate depreciation is not in the public interest, as it amounts to single issue ratemaking. Granting the company's petition to use ELG would significantly alter the framework within which the current AFOR was adopted. The petition to adopt the ELG methodology should be denied.

ORDER

IT IS HEREBY ORDERED That the petition of U S WEST for an accounting order authorizing use of the equal life group (ELG) methodology to compute intrastate depreciation is denied.

DATED at Olympia, Washington, and effective this 15th day of April 1993.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Sharon L. Nelson

SHARON L. NELSON, Chairman

Commissioner Casad (specially concurring) - I support the majority's order, but feel compelled by the dissent to make the following additional comments.

I am painfully aware of the pace of technological advancement in the telecommunications industry -- the Commission has and will continue to struggle with the effects on affordable universal service from market forces occasioned by rapid development and deployment of new technologies.

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The Commission's order in this proceeding neither denies the potential reality of stranded telecommunications plant, nor the ability of ELG depreciation to address such realities. The decision is much more narrowly drawn.

The Commission is currently engaged in a review of the company's alternative form of regulation (AFOR). We narrowed the scope of this proceeding in an attempt to forego a major litigious proceeding with only two years remaining until the AFOR's termination.

I did not believe it fair to the company, the parties, or the ratepayers to order a change in depreciation methodology at this point in the AFOR experiment. We have clearly left the door open for the company to include ELG in the issues which must be resolved in fashioning a successor to the current AFOR.

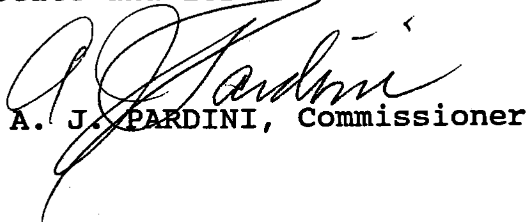
RICHARD D. CASAD, Commissioner

Commissioner Pardini (dissenting) - I dissent. One does not need to be a rocket scientist to be aware of the accelerating rate of technological changes and economic obsolescence in the telecommunications industry. The Governor and the Legislature are committed to the best technological tools available as components of a comprehensive plan for growth management and economic development. Proper depreciation schedules are vital to achieving the best technology.

Under either vintage group (VG) or equal life group (ELG) the amount that the company is able to claim as an expense over the life of the equipment is exactly the same. This amount is the cost of the equipment less the salvage value. Under VG which is favored by the staff and the intervenors, the rate of recovery is slower during the early years than during the later years of the equipment life. Under ELG, the rate of recovery is quicker during the early years than the later years. Under either system the total recovery is the same if the equipment is used and useful for the full life for which it was predicted.

This means that if the equipment is made obsolete for any reason more quickly than the predicted life span, it is likely that replacement will not occur until recovery is made. I believe that continuing the VG methodology could mean that there will be times that we will be disadvantaged by not having the latest equipment or technology. If this Commission knew with

exactness or even near exactness what the effective lives of future technologies and equipment will be, then the choice of VG is appropriate. This Commission is not blessed with this vision. Therefore I am forced to conclude that use of ELG is the appropriate methodology to assist, however minutely, in the long range development of this state and its citizens.



A. J. PARDINI, Commissioner