Docket No. 15-053-01
DPU Exhibit 2.0D
Paul A. Hicken
September 25, 2015

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of UBTA-UBET Communication Inc.'s Application for Utah Universal Service Fund Support	Docket No. 15-053-01 DPU Exhibit 2.0 DIRECT **(REDACTED)**

DIRECT TESTIMONY

OF

PAUL A. HICKEN
STATE OF UTAH
DIVISION OF PUBLIC UTILITIES

September 25, 2015

I. INTRODUCTION

Q: Please state your name for the record.

A: My name is Paul Hicken.

Q: By whom are you employed and what is your business address?

A: I am employed by the Utah Department of Commerce, Division of Public Utilities (DPU). My business address is 160 East 300 South, 4th Floor, Salt Lake City, Utah, 84114.

Q: What is your position with the Division?

A: I am employed as a Utility Analyst.

Q: Please summarize your educational and professional experience.

A: I received a Masters of Business Administration from Utah State University in 1985. I am also a Certified Government Financial Manager. I was employed for nineteen years with the Utah Office of Legislative Auditor General as a Performance Auditor. I have been employed with the Division since June, 2005.

Q: Have you testified before the Commission on prior occasions?

A: Yes on several occasions, most recently in February 2014 as witness for DPU in the Manti Telephone docket #13-046-01.

Q: Please describe your participation in the Division's review of UBTA-UBET Communications' (DBA-Strata Networks) application for Utah USF assistance.

A: I have been involved with the review of Strata's operations and request for increased distribution of Utah Universal Service Fund (UUSF) since the application was formally filed in April 2015.

II. PURPOSE AND SCOPE OF TESTIMONY

Q: What is the purpose of your testimony in these proceedings?

A: My testimony addresses adjustments for depreciation expense and accumulated depreciation in rate base as proposed in the application by Strata for the 2014 test year.

III. ADJUSTMENTS AND ISSUES

Q: Can you identify and describe your concerns with depreciation in Strata's application for Utah USF?

A: Yes, there a couple of concerns with the depreciation as proposed in the application. I will list and describe them as follows:

- Depreciation rates that were set over 20 years ago that do not reflect the actual lives of the assets.
- Group asset depreciation method used in the application.

I will address each of these issues individually and explain the concerns with them.

Q: Please explain your concerns regarding the depreciation rates used by Strata.

A: Most of the depreciation rates for Strata's assets were set by the Commission in Docket #94-053-01, over 20 years ago. There are about 5 assets with revised depreciation rates that were set in a Commission order for Docket #03-053-01. These rates are still about 12 years old. The Commission generally revises electric and gas utility companies' depreciation rates frequently to account for variations in use that may extend or shorten the life of the asset. This is required in order to keep the depreciation expense in line with the rate of expiration of the asset.

While companies may revise selected depreciation rates annually, full and comprehensive

depreciation studies of company plant and equipment are required every few years. For example, the Commission ordered depreciation studies for Questar Corporation in Dockets #02-057-02, #05-057-T01, and #09-057-16. In addition, Rocky Mountain Power was recently ordered to have a full depreciation study in Docket #07-035-13. In Utah, telephone companies have not been required to use periodic depreciation studies to align their rates with the actual service lives of the assets. Consequently, there may be some assets with a PSC depreciable life of 5 years that remain in service for 10 years or more. It is not unusual to see assets in service for 2-3 times the asset life recommended by the Commission.

Q: Why is this a problem to have assets in service longer than their recommended service life?

A: It is a problem because when the recommended service life is shorter than the actual life, the assets are depreciated at an accelerated rate -- a rate that is not representative of the actual depreciable life of the asset. The intent of depreciation is to recover the cost of the asset at the rate it is used up or expended. Accelerated depreciation while it may be useful for tax purposes or future investment, does not represent the true replacement rate of the depreciated assets.

Q: Can you give an example of some assets that have been in service longer than their recommended life?

A: Yes, there are many examples available from Strata's own Continuous Property Records (CPR) as of 12/31/2014. Buildings are a group of assets that remain in service much longer than their PSC approved life of 20 years. Of the building assets listed in the CPR

detail, more than [redacted] are in service longer than 20 years and many as long as 40-50 years. Buried cable is another asset that remains in service long after the approved depreciable life. The Commission approved a depreciable life of 20 years, but Strata has buried cable in service 50-60 years and even longer. There are thousands of single asset units in the asset group, but by dollar value [redacted] of the total buried cable asset group is in service longer than 20 years. The DPU Exhibit 2.1 shows a selected summary of Strata's asset categories and actual lives. Poles for example, are in service well beyond their approved life.

Q: Are depreciation rates and asset lives consistent with all Utah PSC regulated telecom utilities? Don't all companies follow the same set of rules for depreciation?

A: No, depreciation rates and asset lives are neither consistent nor universal with all regulated telecom companies. Rates and lives for each asset category are set by the Commission in a docket for each individual telecom utility. Each company has its own individual rates and asset lives that are independent from one another. This is shown in DPU Exhibit 2.2. The table shows and compares Stata's asset depreciation rates with the average of 15 other Utah telecom companies. The rates are similar but not universal. As for depreciation rules or method, not all regulated telecom utilities use the same methods, and the rules can be applied differently according to a company's own interpretation. For example, some phone utilities in Utah use the individual asset method with straight-line depreciation and others use the group asset method with straight-line depreciation. In fact, Strata uses a combination of both methods -- individual asset depreciation for vehicles and group depreciation for all other assets. There is no prescribed method and

companies employ whichever method works best for them. It appears most companies prefer the group method, but there is no guarantee that those companies are following the same procedures. According to Utah law [UCA 54-7-12.1], the Utah Commission has authority to determine depreciation expense for ratemaking purposes. When the Commission sets a depreciation rate by docket, the rate should mean an allowable percentage of the book cost per year for the determined life of the asset, or straight line depreciation. No other instructions are given on how to apply the depreciation, whether it be to a single unit or a group of assets. The depreciation rate set in a docket by the Commission implies only that the asset be depreciated on a straight line basis. Most companies are free to interpret and apply the rules to an individual asset or to a group of assets, however they deem appropriate.

Q: Please explain Group Asset depreciation and explain your concerns with its use in the application.

A: Group asset depreciation is an accounting method that allows assets to be grouped together for purposes of depreciation if they are homogeneous in nature. They are grouped because they are of the same construction, they are used for the same purpose, and they have the same depreciable life and salvage factors. Rather than depreciating each asset by itself (single asset depreciation), the homogeneous assets are grouped in a subaccount for purposes of depreciation. Important information such as book value, date in service, location and retirements should be noted and periodic adjustments to the group are necessary so that assets don't remain in the group longer than their intended life and inflate the depreciable value of the group. Group asset depreciation may not be widely

known in the general accounting world, but it is sometimes used for telephone utility accounting.

Q: What is your concern with group asset depreciation?

A: Our concern with the group asset method is that it can accelerate the depreciation rate for new assets added to the group, and may inflate the depreciation expense in any given year, a test year for example. With single asset depreciation, the rules are simple and unequivocal. It is hard to manipulate the rate of depreciation or the periodic depreciation expense. With group depreciation, a company can manipulate the value of the group in order to maximize and accelerate the depreciation expense and thus receive a greater USF subsidy. Not all phone companies use the group depreciation method and it may provide an unfair advantage for those that are using group depreciation. There are many variations of group depreciation and different ways it can be applied. Not all companies follow the same procedures. For example, one company may leave assets in the group and they are part of the depreciation calculation as long as they are used and useful, while another company may follow a schedule for asset retirement. If all companies are not following the same rules, then the group method has created inequity. Further, the acceleration of depreciation can create an incentive for overinvestment as items move out of rate base leaving less capital on which to earn a return.

Q: Does Strata retire assets at the end of their approved life?

A: No. Strata does not retire assets at the end of their depreciable life. As we have already seen, many assets remain in service long after the depreciable life. Strata's asset retirement policy has been to keep the asset in service as long as it is used and useful, and

retire the asset when it is taken out of service. Assets that are used and useful will continue to be part of the asset group for calculating depreciation expense

Q: When using group depreciation, how does having assets in a group beyond the depreciable life, impact depreciation expense?

A: When a depreciation rate is applied to an asset group that contains individual assets that are in service beyond their expected life, the effective rate of depreciation has changed, and the depreciation expense is accelerated on the new assets.

Q: Does the Division believe useful assets should be retired?

A: No. The Division believes assets with useful life should generally continue in service. The problem with group depreciation as used by Strata is not that assets remain in service after they are fully depreciated but that they are fully depreciated much too early. As noted, this can create an incentive and opportunity for overinvestment as well as distorting depreciation expense in any given year. These distortions might make depreciation expense higher or lower than is actually required to compensate a company for the depletion of its assets over the assets' actual useful lives.

Q: Has Strata used group asset depreciation to accelerate depreciation expense and what is the impact on its application for Utah USF?

A: Strata used group asset depreciation during the 2014 test year to calculate depreciation expense and accumulated depreciation. Depreciation is the largest expense category in the application, totaling [redacted] for the test year. It accounts for [redacted] of the total expenses in the test year. Of this amount, [redacted] was depreciation on vehicles and special equipment using the single asset straight-line method. The remaining

[redacted] was calculated using the group asset method. In DPU's opinion, this includes a significant amount of accelerated depreciation caused because a large percentage of each group of assets is in service beyond the prescribed asset life. Any new assets added to the group may be expensed in a relatively short time. Proponents of this group method argue that depreciation expense never exceeds the capitalized value of the group and accumulated depreciation is deducted from rate base so it offsets any depreciation expense taken. This method is popular among proponents because assets are depreciated more rapidly and cost recovery happens quickly. The DPU's concern with this method is that a company may add new assets and /or costs to a group that is fully or nearly depreciated in order to take advantage of the large amount of rapid depreciation expense that occurs. It misrepresents the true rate of depreciation. For example, poles was a fully depreciated asset group at the start of 2014. No depreciation expense was booked during the first three months of the year. In April, a number of poles were retired and removed from service at the cost of approximately [redacted]. Although the retirement reduced the capitalized value of the group, the removal cost increased the capitalized value of the asset. Thus, depreciation expense of [redacted] was booked in April thru October, and [redacted] in November and December. The total depreciation expense of [redacted] for the test year was mostly generated from the cost of removal, which occurred during the test year in April. The DPU believes it is inappropriate to accelerate expense because it does not represent the true rate of depreciation based on the useful asset lives. It is not in the public interest of the state USF to distribute funding based on accelerated depreciation expense.

Q: Have you made any adjustments to the depreciation and can you explain how the adjustments were made?

A: We calculated the depreciation expense for all of Strata's assets, including the vehicles and special equipment. We used the single asset straight-line method and the PSC approved rates and lives for each asset category. We used this method for our adjustment because it is straight forward and not easy to manipulate. It is also consistent with how we have treated other companies in the matter of depreciation. The results are shown in DPU Exhibit 2.3. As shown in this exhibit, the single asset method shows depreciation for the test year to be a total of [redacted]. The amount stated in the application by Strata was [redacted], a difference of [redacted]. Consequently, we have made an adjustment to decrease depreciation expense by the amount of [redacted]. We have also made a positive adjustment to the rate base by adding back the same amount.

Q: Are there any other adjustments to depreciation?

A: Yes, there are a few adjustments that are explained in further detail in the DPU Testimony 3.0 and shown in DPU Exhibit 3.1. Briefly, one adjustment was for known and measurable depreciation expense of [redacted] which was inadvertently listed as corporate operations expense. There was also some known and measurable rate case expense of [redacted] that was listed as depreciation expense and it should have been listed under corporate operations expense. These adjustments are discussed in detail in the testimony of Shauna Springer, DPU 3.0.

Q: Does this conclude your testimony?

A: Yes, it does.