Docket No. 15-053-01
DPU Exhibit 2.0 SUR
Paul A. Hicken
November 17, 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 SR**

SUR-REBUTTAL TESTIMONY

OF

PAUL A. HICKEN
STATE OF UTAH
DIVISION OF PUBLIC UTILITIES

November 17, 2015

I. INTRODUCTION

Q: Please state your name for the record.

A: My name is Paul Hicken.

Q: Are you the same Paul Hicken who filed direct testimony previously in this docket?

A: Yes, I am.

Q: Is there anything relative to your employment, education or experience that has changed since the previous testimony?

A: No, nothing has changed.

II. PURPOSE AND SCOPE OF TESTIMONY

Q: What is the purpose of your sur-rebuttal testimony?

A: I will respond to the rebuttal testimonies of Mr. Douglas Meredith, who filed testimony for UBTA-UBET Communications Inc. (STRATA) and the Utah Rural Telecom Association (URTA), and Mr. Karl Searle, who represents UBTA-UBET Communications Inc. (STRATA).

Q: Have you reviewed the rebuttal testimonies of Mr. Meredith and Mr. Searle? Can you respond to their rebuttals?

A: Yes I have. I will respond first to Mr. Meredith's rebuttal, then to Mr. Searle's.

III. SUR-REBUTTAL TO MEREDITH

Q: Mr. Meredith infers that the Division disagrees with the group asset method of depreciation. How do you respond to this notion?

A: The Division disagrees with the group asset depreciation method only when it distorts depreciation expense. The Division believes that straight-line group depreciation as mandated by the FCC (See 47 CFR 32.2000 (g)), should be calculated and recovered throughout the service life of the asset. The straight-line group method of depreciation should be designed and intended to allow recovery of costs through depreciation expense, in equal amounts and at regular intervals. If a group depreciation method is applied to asset groups without proper weighting or without age adjustments, it can distort depreciation expense.

Q: How do you respond to the assertion that DPU is recommending the single asset method of depreciation as the only acceptable method for companies to use?

A: The Division is not recommending that single asset straight-line depreciation method is the only acceptable way to calculate depreciation as asserted by Mr. Meredith (Meredith, lines 522-523, 714). However, DPU uses this method as a preliminary step to compare depreciation expense when companies report their earnings using a group asset method of depreciation. We prefer the single asset straight-line method for comparison purposes because it is simple and unequivocal, and it provides a consistent approach for comparison and treatment of all companies. Every asset has a depreciable life as defined by the Public Service Commission of Utah (Commission), which sets the depreciation

rate for that asset. The asset lives and rates have generally been predetermined and set in prior dockets by the Commission. They are known and approved beforehand, though a company could choose to introduce new evidence of appropriate depreciation lives in a case.

Q: Is the DPU opposed to companies using group asset depreciation?

A: No, DPU does not oppose group asset depreciation so long as it does not distort depreciation expense, which usually requires the asset groups be consistently adjusted for age and properly weighted. As mentioned by Mr. Meredith (Meredith, lines 622-628), the FCC describes a group method where the average service life of the asset group is properly weighted and we believe this is appropriate. The issue in this docket is that STRATA has not applied this adjustment to the average service life of asset groups as required by the FCC. Assets are grouped by type and purpose, but we have found no indication that assets within the group are properly weighted and there is no evidence that average service life was a factor in the calculation of annual depreciation. As mentioned in Mr. Meredith's rebuttal (Meredith lines 530-533), a carrier needs to periodically adjust the properly weighted average service life of the group and apply straight-line depreciation reflecting the estimated average service life. STRATA has not completed these adjustments. If STRATA had made adjustments to average service lives, it would go a long way in addressing the Division's concerns. Because depreciation expense can be distorted by improperly weighted groups, the Division believes its adjustments, or others, are necessary to bring depreciation expense in line with PSC approved rates.

Q: You mentioned several terms in the previous section. Can you explain what you mean by "depreciable life" and "average service life"?

A: Yes, there are several terms which need further explanation. The *depreciable life* of an asset is an estimate of the amount of time over which depreciation expense is calculated and accounted for. In a straight-line method this means the service life divided into equal units of time. Because we don't know what the actual service life will be, the Commission has generally defined and approved depreciable lives for each asset type in prior dockets for each company. The depreciable life is an estimate of what the service life will be. It is necessary to have an estimated service life so that there can be a starting point for calculating depreciation. If the Commission-approved depreciable life varies from the actual service life, then it should be changed to more accurately reflect the actual service life. This is part of the Utah statute (UCA 54-7-12.1) and also required by the federal regulations (47 CFR 32.2000(g) (1) (ii)). The DPU maintains that when an application for state support is submitted, it is the company's responsibility to provide documentation of expenses and revenues that is accurate and representative of the actual costs incurred in the test period. This certainly pertains to depreciation expense. Also, companies receiving federal support are required to adhere to part 32 of the federal code, and this requires periodic adjustments to depreciation lives when they don't match the actual service life. This is especially true when the method of depreciation exacerbates the problem. In a straight-line method, an incorrect depreciable life can distort depreciation expense in either direction. However, a group method creates additional

potential for distortion. An example is instructive. I will use an example Mr. Meredith briefly touched on in his rebuttal (Meredith lines 523-530). Let us look at the same example with more detail as follows:

AVERAGE SERVICE LIFE[1]						
Asset Units	Unit Costs	Group % Value	Years Service	Remaining Useful Life	Total Service Life	Weighted Average Service Life
Unit 1	$20,000	20%	5	1	6	1.2
Unit 2	$20,000	20%	5	1	6	1.2
Unit 3	$20,000	20%	5	2	7	1.4
Unit 4	$20,000	20%	5	3	8	1.6
Unit 5	$20,000	20%	5	4	9	1.8
TOTAL	$100,000	100%	25	11	36	7.2

As shown in the example, the asset group consists of 5 components, each valued at $20,000 and each with a stated depreciable life of 5 years. Suppose the assets are each 5 years old and fully depreciated but they are still in service and used and useful. Note that the assets will be in service longer than the depreciable life, making the actual service life longer for each asset component. Because the assets were in service longer than

1 The *service life* of an individual asset includes the *time in service* plus the estimated *remaining useful life* (SL=TIS+RUL). Time in service is simply the accumulated time from the date the asset was placed in service until the current time. It is a known and measurable amount. The remaining useful life is an estimate of how much life remains for the asset to be used and useful and in service. The total service life of an asset is a best estimate because it is not known how long an asset will remain in service. When to retire an asset from service is a subjective decision, and all assets in a group, even though they might be identical, might have different service lives. The *average service life* is the average life in service for each asset component of the group. When you have a group asset comprised of many individual units used for the same purpose, each component of the group may have a different service life. The way to account for this is to calculate the weighted average service life for the group.

expected, the weighted average service life for the group is 7.2 years and not 5 years, which was the estimated depreciable life. Nevertheless, the asset group was fully depreciated on a 5 year basis even though the actual service life was longer.

Now add another new asset to the group with the same value and the same life. The group asset value is now $120,000 and the stated depreciation rate is 20%. Does this mean you should fully depreciate the new $20,000 addition in only 10 months? ($120,000 x 20% = $24,000 annual depreciation expense or $2,000/month.) This would mean the effective depreciation rate is no longer 20% but 120%. This is accelerated depreciation. This is exactly why individual assets must be properly weighted when applying group asset depreciation, so as to avoid accelerated and distorted depreciation expense. Individual assets within the group must be weighted in terms of cost because in reality, very expensive components within the group might have a very short service life and inexpensive components might have very long service lives, or vice versa. Without weighting the service life, you will have distorted depreciation rates and the depreciation expense will likely be accelerated. The Division has heard anecdotal evidence from individuals in Utah's rural telecommunications industry that group asset depreciation is a way to allow accelerated investment in rural telecommunication infrastructure. While perhaps a laudable goal and useful tool from the FCC's perspective, this is not an appropriate use of state USF monies intended to provide affordable basic telephone services to high cost areas.

Q: Mr. Meredith argues vintage depreciation is not a viable method. Do you consider this a valid method of depreciation and can you explain why it was mentioned in your testimony?

A: Vintage depreciation is one method of group depreciation where assets of similar type and use are grouped together in the year placed in service. The intent is to allow straight-line depreciation to be calculated evenly for the group over the life of asset. The theory is that vintage groups will provide more even and consistent depreciation than groups with many different vintages. DPU is not necessarily advocating vintage depreciation, merely pointing out that there are multiple methods of group depreciation. Part 32 says telecom utilities can, at least for interstate purposes, use group asset depreciation but it does not specify which method to use nor how it should be applied. The DPU mentioned vintage grouping as an option that, when applied consistently and uniformly, could alleviate accelerated depreciation that can occur with other methods of group depreciation. We do acknowledge however, that if depreciation is calculated for a group asset, using a properly weighted average service life, the vintage method would not be necessary. Again, the touchstone is that the method should reasonably match depreciation expense with the actual time the assets are in service.

Q: Mr. Meredith objects to the notion that fully depreciated assets should be removed from the depreciable asset group. How do you respond to this?

A: Again, the DPU is not recommending the removal of assets from a group if they are still used and useful. Mr. Meredith persists in his mistaken belief the DPU is confused

(Meredith line 593). Leaving assets in the group is not the same as failing to make any effort to adjust the depreciation rate for average service life or properly weight the assets. Depreciation based on the net book value rather than the initial book value of the group is another way to apply group asset depreciation. This method makes adjustments for costs that are already recovered. When depreciation expense is recovered and accumulated depreciation is booked, those asset values generally should not continue to be part of the depreciation expense calculation. They can stay in the asset group as long as they are used and useful, but should not be allowed to distort or accelerate depreciation expense on new assets. Any method that significantly accelerates depreciation expense must be adjusted to match expense with Commission approved service life for state USF purposes.

Q: Do you have any further response to Mr. Meredith?

A: No, I have no further response.

IV. SUR-REBUTTAL TO SEARLE

Q: Mr. Searle contends that STRATA's depreciation rates are not 20 years old because they were reviewed in 2003 and approved by the Commission in Docket 03-053-01. What is your response?

A: Yes, that is correct. Depreciation rates were initially set for 22 asset categories in a 1994 docket. Rates were reviewed in 2003 and slight changes were made to rates for 5 asset categories. The point is that depreciation rates are old and out dated. They are not

reflective of the actual service lives of the assets. The most recent changes to rates were made in 2003, more than 12 years ago. Most depreciation rates have not been changed since 1994, more than 20 years ago.

Q: In your testimony you indicated that electric and gas utilities revise their depreciation rates every few years. Mr. Searle does not see how this is relevant to telecom utilities. How do you respond to this?

A: It is relevant because all regulated utilities are required to report depreciation expense to the Commission on an annual basis. It is incumbent on the utilities to report using the most accurate data available. Gas and energy utilities conduct a depreciation study every 5 years in order to adjust rates based on actual service lives. In reference to electric and telephone utilities the statute says "…the commission shall consider all relevant factors, including the alteration of asset lives to better reflect changes in the economic life of plant and equipment used to provide telecommunications services." (UCA 54-7-12.1) Telecom utilities should not be using outdated depreciation rates when other utilities are required to keep their rates current.

The Division realizes the challenges of comprehensive evaluations of depreciation rates in cases involving small telecommunications companies. The Commission may wish to consider a periodic, Commission-administered depreciation study geared toward establishing default depreciation rates that companies could employ. Whether adopted by administrative rule or some other method, this approach could prove more nimble and efficient than the current system.

Q: Your testimony discussed how group asset depreciation can create accelerated depreciation, particularly with the addition of new assets to the group. Mr. Searle disagrees with your assessment. How do you respond to his rebuttal?

A: Group asset depreciation methods can definitely create accelerated depreciation. This frequently occurs when assets within the group are kept in service longer than the depreciable life with a rate that has not been adjusted to reflect the actual average service life. The example I discussed in my sur-rebuttal to Mr. Meredith shows this quite clearly. If you have a group of assets that are fully or nearly depreciated, and a new asset is added to the group without having properly weighted the assets or adjusted the rate for average service life, the new asset will be depreciated very rapidly.

Q: Mr. Searle takes issue with your use of the term "PSC approved life". What is your response to his concern?

A: My use of this term was probably misunderstood, and more accurately stated would be the PSC approved depreciable life. The Commission has generally approved a depreciation rate and a depreciable life for each asset category and for every separate utility. The DPU did not mean to infer that assets should be retired at the end of their "approved life". Rather, it was pointing out that many assets have reached the end of or surpassed their depreciable lives. The expense has been recovered and the accumulated depreciation has been booked. Yet they are still in service and are used and useful and they continue to be a factor in the calculation of any depreciation on new assets added to

the group. Assets that are used and useful should remain in service until it is no longer prudent to use them.

Q: Mr. Searle objects to your depiction of STRATA's depreciable assets being in service longer than their PSC approved depreciable life. What is your response to this concern?

A: I think the depiction is accurate. Many of STRATA's assets are near the end or have surpassed their approved depreciable lives. This is shown in Service Life Comparison chart provided by Mr. Searle in his rebuttal testimony.

Q: Mr. Searle objects to your comparison of STRATA's depreciation rates with the average rates of other ILECs in Utah. How do you respond and what was the purpose of your comparison?

A: The purpose was merely to show that all ILECs in the state do not have the same identical depreciation rates and likewise they do not all follow the same procedures for depreciation. The federal and state laws regarding asset depreciation for telecoms are not specific. Therefore, utilities can and do apply the depreciation procedures according to their own understanding, and to meet the specific needs of their company. So long as the effects are not distortive, there is no problem in doing so for purposes of the UUSF.

Q: Mr. Searle is concerned that the Division is treating this docket as a ratemaking proceeding and that it is the Division's duty to adjust the average service lives of the

assets. How do you respond to these concerns?

A: I think Mr. Searle is confusing the issue. DPU has never considered this a ratemaking proceeding. We have not discussed service rates in this docket, only depreciation rates. In his rebuttal Mr. Searle states, "If there is concern by the Division over average service lives, that is attributable to the Division, not to STRATA."(Searle lines 881-883). I disagree with this statement. It is the company's responsibility to record and keep depreciation records and to record them as accurately as possible. STRATA keeps a Continuous Property Record (CPR) and other asset records showing book cost, date in service, time in service, annual and accumulated depreciation, net asset value and several other facts pertinent to each unit within each asset category. The company can easily calculate average time in service and estimate remaining useful life of each unit. It is the company responsibility to keep the records accurate and updated. The DPU trusts that all utilities will report their operations accurately, but if errors or inaccurate data are found during the course of fieldwork, the DPU will make adjustments in cases that are appropriate.

Further, as the Commission noted in its Order on Motion for Partial Summary Judgement, "the Division has not requested that STRATA be required to make any changes in its accounting. Rather the Division has requested that the Commission adjust STRATA's depreciation calculation…" (Order at page 6) The Division is merely using its own calculations to establish a dollar amount for depreciation expense that it views as representative of the depreciation expense needed to reimburse the company for the actual diminution in the value and useful life of its assets in the test year.

Q: Mr. Searle suggests that a change in accounting method such as depreciation would require retroactive changes to the beginning of the asset record. What is your response?

A: Mr. Searle is incorrect. First of all, DPU is not recommending a change in accounting method from the group asset method to the single asset method. Secondly, if this were to occur, changes would not be retroactive because we consider all previously reported depreciation expense to be already recovered, and whether the company loses some return on rate base because assets were depreciated early is a moot point. That was a business decision the company made. It chose to accelerate the recovery of the expense and thus accumulate depreciation, which decreased rate base.

Q: How do you respond to Mr. Searle's argument that the interstate portion of any expense should be adjusted out?

A: I disagree with this assumption. Assets and rate base are reported with the total company included. Depreciation expense is likewise calculated on the assets of the total company. There is no separation between interstate and intrastate for depreciation and rate base purposes. The DPU uses total company revenue, expense and rate base in calculating UUSF eligibility.

Q: Do you have any further response to Mr. Searle? If no, does this conclude your sur-rebuttal testimony?

A: I have no further response, and this concludes my testimony.