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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Carbon-Emery : **Docket No. 15-2302-01**
Telephone’s Application for an Increase : **DPU Exhibit 2.0 SSR**
in Utah Universal Service Fund Support : **(REDACTED)**

SUR-SURREBUTTAL TESTIMONY

OF

JOSEPH HELLEWELL
STATE OF UTAH
DIVISION OF PUBLIC UTILITIES

January 15, 2016

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I. INTRODUCTION

Q: Please state your name for the record.

A: My name is Joseph Hellewell.

Q: Are you the same Joseph Hellewell who provided direct and surrebuttal testimony in docket number 15-2302-01?

A: I am.

II. PURPOSE AND SCOPE OF TESTIMONY

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

A: I will respond to the sur-surrebuttal testimony of Mr. Woolsey who is representing Carbon-Emery Telephone.

Q: Is the division selectively applying its single asset straight line depreciation adjustment as suggested by Mr. Woolsey?

A: No. On line 131 of his sur-surrebuttal testimony, Mr. Woolsey laments that the Division is being selective in how it applied its depreciation adjustment. He further states that the Division method fails to establish a correct test year.

When adjusting depreciation expense a counter adjustment must be made to accumulated depreciation. Accumulated depreciation is the culmination of all the prior years' depreciation expense. The depreciation method chosen by a company has lasting effects and must be chosen carefully; if the depreciation method accelerates the expense it will also accelerate the rate at which accumulated depreciation accrues. In prior years Carbon-Emery has chosen to use a depreciation method that accelerates depreciation expense. (Woolsey Surrebuttal Line 60, Rebuttal Line 425, 726, 788, 821 and Meredith rebuttal

60 testimony line 660, 807, and 819) In prior accounting periods Carbon-Emery reaped the
61 reward of accelerated expense and the consequence of an accelerated accumulated
62 depreciation account.

63
64 The depreciation expense adjustment proposed by the Division in its prior testimony did
65 not make the additional correction to account for prior accelerated accumulated
66 depreciation. To adjust the amount of accumulated depreciation to add back depreciable
67 value to assets that had been depreciated by Carbon-Emery in past years to increase rate
68 base would conflict with a basic tenet of utility regulation that the analysis is prospective
69 in nature. To act otherwise would be administratively burdensome as it would require a
70 lookback at all prior periods of revenue and expenses and then an attempt to true-up each
71 time a utility seeks new rates or UUSF distributions. The Division's adjustment is further
72 strengthened by GAAP accounting practices, which label depreciation expense as an
73 estimate. When an accounting estimate is changed there are no retroactive changes, only
74 prospective action is needed. This approach makes the test year more representative
75 because it preserves prior years' account balances and more correctly states the current
76 and prospective financial position of Carbon-Emery.

77
78 The DPU's adjustment to depreciation expense was an adjustment based upon each
79 capitalized asset having depreciated under a single-asset straight line approach since its
80 inception. The Division did not calculate a flash cut to single-asset straight line
81 depreciation using the test year actual net book value of each asset. Because of the highly
82 accelerated depreciation method that has been used by Carbon-Emery in past years many
83 of the assets have already been depreciated further than the result of the more generous
84 Division calculation. The Division's calculation for depreciation expense was calculated
85 this way for the purpose of reaching a reasonable depreciation expense that would match
86 actual diminution in value during the test year without rapidly accelerated depreciation.
87 In order to avoid depreciation of the assets total accumulated depreciation should be

88 applied to the gross book value of its assets to determine which assets still have any
89 remaining depreciable base. If the accumulated depreciation up to the test year is
90 accounted for in the DPU's original straight line example; Carbon-Emery's assets total
91 [REDACTED]; total accumulated depreciation is [REDACTED]. This leaves a net book
92 value of [REDACTED] to be depreciated under the new method. Using the same
93 method in our original adjustment, but accounting for accumulated depreciation results in
94 an annual depreciation expense of [REDACTED]; [REDACTED] lower than the Division's
95 original proposed depreciation adjustment.

96
97 The original adjustment of [REDACTED] to Carbon-Emery's depreciation was simply an
98 adjustment of an unreasonably inflated depreciation expense to a reasonable depreciation
99 expense that better matches actual annual diminution of value for purposes of UUSF
100 distribution calculation. It was not intended as a forced change in Carbon-Emery's
101 internal accounting method. However if the Commission requires Carbon-Emery to adopt
102 a new method going forward it would be appropriate to account for all accumulated
103 depreciation that has been expensed in prior periods. The Division's initial generous
104 adjustment would be increased to ensure proper accounting practices are implemented.

105
106 **Q: In Mr. Woolsey's sur-surrebuttal testimony, line 98, he included examples of why**
107 **Carbon-Emery adds new assets into the larger group pools, stating that they are**
108 **intertwined, and why this is appropriate. Does the addition of new assets into old**
109 **asset groups represent a total asset group that is properly configured?**

110 **A:** No, it does not. Mr. Woolsey uses an oversimplified example of a machine needing new
111 parts in order to function to illustrate his example. While the example he uses illustrates
112 sound accounting practices it fails to capture the gravity and scope of what these
113 additions are doing to Carbon-Emery's depreciation expense, and in turn, Carbon-
114 Emery's UUSF funds request.

115

116 The accounting practice that Mr. Woolsey is referring to is called capitalization. Each
117 company has different guidelines to determine if repairs, betterments, restorations or
118 adaptations qualify for capitalization. Capitalization is the process by which a normal
119 expense would be added to an existing fixed asset and subsequently depreciated instead
120 of instantly being recognized as an expense. This is a very common practice and widely
121 used. When a small part is repaired or added to a larger machine, as illustrated in Mr.
122 Woolsey's testimony (line 98), the entire asset's base is changed to include the cost of the
123 old asset and the new addition. At this time the depreciable life of the asset must be
124 reviewed to determine if the repair or part added extends the service life of the whole
125 asset.

126
127 Using Carbon-Emery's group methodology, when an addition of any kind occurs to a
128 group of intertwined assets, whether it be repairs, betterments, or alterations to current
129 asset groups, no adjustment is currently made to the depreciable life of the group. A
130 properly configured group would have its remaining depreciable life adjusted periodically
131 as new assets are added to the group that extend the group's life.

132
133 **Q: Are Carbon-Emery's group asset accounts as they now stand properly configured as**
134 **stated by Mr. Woolsey on line 104 of his sur-surrebuttal testimony?**

135 **A:** No.

136
137 A properly configured asset group would also have its estimated depreciable life adjusted
138 to meet current market conditions and new information as it becomes available. Currently
139 Carbon-Emery's depreciation rates are over ■ years old. Many of Carbon-Emery's
140 assets are far beyond their depreciable lives; however, Carbon-Emery lists these assets as
141 used and useful. For example in the Buried Cable asset group (#2423) Carbon-Emery
142 currently lists ■ assets. ■ (■%) of those assets are beyond their 20 year depreciable
143 life. Yet the method of calculating annual depreciation used by Carbon-Emery still relies

144 on the original value of these assets to accelerate the depreciation of new assets. If
145 Carbon-Emery was accurately configuring its asset groups, Carbon-Emery would have
146 sought a change in these assets' depreciable lives to reflect current business and market
147 conditions.

148
149 Properly configured asset groups would not distort or misrepresent the amount of annual
150 depreciation expense and would provide a stable, predictable expense that can be used by
151 management for forecasting and planning. Properly configured asset groups within the
152 bounds of UUSF application and setting rates of return would provide an equitable and
153 predictable basis for receiving and calculating UUSF support and revenue requirement,
154 Carbon-Emery would receive UUSF subsidy based upon standards rather than how many
155 fully depreciated assets it has in its group asset accounts.

156

157 **Q: Is the FCC method that Carbon-Emery most recently testified about properly**
158 **applied?**

159 **A:** Given Carbon-Emery's use of a new method at such a late date, the Division was unable
160 to fully review and investigate Mr. Woolsey's implementation of this method. The DPU
161 did notice that Mr. Woolsey's calculations omit several groups of assets currently on
162 Carbon-Emery's books. Asset groups 2122, 2124, 2210, 2231, 2422, 2426 and 2431 all
163 contain assets and depreciation expense, but aren't included in this most recent
164 depreciation expense calculation. In order to give this method the full weight and
165 consideration needed, these groups would need to be included in the calculation.

166

167 As stated in my previous testimony, the Division feels that review of accurate
168 depreciation lives would be necessary prior to implementation of this method, which
169 would warrant investigation and possible Commission clarification. In addition,
170 clarification on the "average remaining life" component of the FCC method would
171 require further review and treatment.

172

173 **Q: Does the Division feel there is a place for companies to use Group depreciation, FCC**
174 **method depreciation, vintage depreciation and single-asset straight line depreciation**
175 **for UUSF calculation purposes with respect to the Commission’s recent Order for**
176 **Motion for Partial Summary Judgment and Order on Petition for Review and**
177 **Clarification?**

178 **A:** Yes as long as each component of the chosen depreciation method is configured properly.
179 As four rounds of testimony conclude, it is clear that this subject is a vital component,
180 and that all involved parties need clear guidelines and practices with which to base their
181 reports and file applications. While incorrect depreciable lives can skew depreciation
182 expense, differing depreciation methods can likewise distort depreciation expense. It is
183 critical that the Commission and companies understand the employed methods and their
184 effects.

185

186 **Q: The Commission mentioned groups that are properly placed in vintages and you**
187 **have mentioned that as a suitable depreciation method. Can vintage depreciation**
188 **work?**

189 **A:** Yes, vintage depreciation would allow for assets capitalized within a certain date range to
190 be grouped and depreciated together, any new assets purchased outside that date range
191 would then be placed in a new group. Groups would then be depreciated using a straight-
192 line method until the group is fully depreciated. Once fully depreciated, if still used and
193 useful the group would remain intact and no further depreciation expense would be
194 generated.

195

196 If an intertwined asset, repair, part, betterment, or alteration needs to occur consistent
197 with Carbon-Emery practice it may be capitalized or placed in a new vintage. If
198 capitalized, the new asset would then need to be reviewed if it should stay within the

199 current vintage or moved to a more current vintage. That decision depends on the effect
200 of the capitalized portion.

201
202 The clear benefit of vintage groups is the significant reduction in the variation between
203 depreciable life and actual asset useful life. In the case of Carbon-Emery's Buried Cable
204 account where half of the assets are beyond the depreciable life but remain in service, the
205 entire gross book value is still contributing to the annual depreciation calculation
206 submitted by Carbon-Emery. Those assets then remain in service without any updates
207 and continue with full weighting in the depreciation calculation for some undefined
208 period until they are taken out of service. When they are taken out of service the group
209 will be recalculated with a significant drop in depreciation expense because of the all or
210 nothing inclusion.

211
212 The result is troubling for a couple of reasons. First, the depreciation cliff looms and
213 drives the incentive to acquire new assets whether prudent or not. Second, the annual
214 depreciation calculation with the older assets, as compared to the calculation after
215 removal, will result in a significant change in annual depreciation calculation in two
216 consecutive years when the real diminution in value of the asset group has been normal.
217 This plainly demonstrates that the group method without vintages or another device to
218 protect against these anomalous results can be unreliable; particularly so when actual
219 asset life does not match depreciable life. This is why the Division does not support
220 group method calculations that do not reliably match actual depreciation. Vintage
221 grouping offers a significant safeguard against such results.

222
223 Determining how large the vintages should be remains a question that will produce varied
224 results. A one year vintage would produce depreciation expense similar to single-asset
225 depreciation; groups with too wide a date range would accelerate depreciation expense on
226 new assets similar to Carbon-Emery's current groups. A possible solution to this would

227 be to adopt either a specific vintage time range for each different asset group, or a flat
228 percentage to be applied against the current depreciable life. For example a 20% vintage
229 rate would allow for vintages of 1 year for vehicles which normally have a 5 year
230 depreciable life, and 4 year vintages for assets like buildings or buried cable that
231 normally have a 20 year life.

232
233 An additional component of vintage group depreciation is how the group lives are
234 determined. If the groups are configured using the first asset placed into the group as the
235 starting point of the group, then at the end of the group's depreciable life there will be a
236 spike in depreciation expense as the group accelerates each asset added afterwards within
237 the vintage date range. For example, buried cable has a depreciable life of 20 years. If the
238 vintage is set to 4 years, and the 20 year group life begins with assets added within the
239 first year, then in the 20th year of this group is the 19th year of depreciation for assets
240 added in the 2nd year. This results in an end of group life acceleration. Assets added
241 within the 2nd, 3rd, and 4th year of the respective vintage are then fully depreciated in the
242 final year. The result is a spike in depreciation expense at the end of each group's
243 depreciable life. The more appropriate method of treatment for vintage groups is to
244 properly configure the groups to allow each asset in its group to reach its depreciable life
245 within the group timeline. This would allow for similar assets to be depreciated together,
246 however the asset added in the first year would begin the 20 year depreciable life, the
247 asset added in the second year would begin its 20 year depreciable life, and so on... This
248 would effectively mean that assets with depreciable lives of 20 years the group
249 depreciates fully over 22-23 years. In this fashion, there would be no spikes in
250 depreciation expense at the end of a group's depreciable life, and no acceleration; each
251 year would be reasonably representative of the future and past years.

252
253 In the DPU's exhibit, JH 2.1 SSR, the DPU calculated depreciation expense for Carbon-
254 Emery using the Group-Vintage method described previously. The DPU selected

255 vintages based on 20% of the PSC approved depreciable life of each asset group and used
256 staggered group starting dates to smooth out depreciation expense. This resulted in a
257 2014 depreciation expense of [REDACTED]. When compared with the DPU's original
258 single asset straight-line proposal of [REDACTED] the difference is [REDACTED].

259
260 However like every other depreciation method described, accurate depreciation lives
261 remain a key driver in determining if a depreciation method and group is properly
262 configured. If depreciable lives are too short even single-asset straight line depreciation
263 will cause acceleration and inflation of depreciation expense.

264

265 **Q: Does this conclude your testimony?**

266 **A:** Yes.