<u>BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH</u>

IN THE MATTER OF ALL WEST COMMUNICATIONS, INC.'s APPLICATION FOR USF ELIGIBILITY	)))	**Docket No. 11-2180-01**
ALL WEST COMMUNICATIONS, INC., **Applicant**	)))	

REDACTED
REBUTTAL TESTIMONY
OF

KEVIN J. KELLY

ON BEHALF OF ALL WEST COMMUNICATIONS, INC.

OCTOBER 24, 2011

REBUTTAL TESTIMONY OF KEVIN J. KELLY

Q. What is your name?

A. My name is Kevin J. Kelly.

Q. Are you the same Kevin J. Kelly who filed direct testimony on behalf of All West Communications, Inc. ("All West") in this docket?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to address the direct testimony of Mr. Clair Oman, filed on behalf the Division of Public Utilities ("Division"), regarding his proposed reduction in All West's normalized depreciation expense.

Q. Please elaborate.

A. Prior to the parties filing direct testimony, All West and the Division entered into a Stipulation to resolve the vast majority of issues surrounding the Company's application for increased funding from the Utah Universal Service Fund ("UUSF"). The only unresolved issue in the case was appropriate level of depreciation expense. Specifically, the parties disagree on two issues: 1) the appropriate application of approved depreciation rates under group asset depreciation accounting to include treatment of fully depreciated accounts; and 2) the normalization of depreciation. The Stipulation specifically reserved these two issues for hearing before the Commission.

Q. Has the amount of the difference in depreciation between the parties changed since the Stipulation?

A. It appears that it has. The Stipulation identifies the difference in depreciation between the parties as BEGIN CONFIDENTIAL *** END CONFIDENTIAL. This was based on All West's proposed normalized depreciation expense of BEGIN CONFIDENTIAL *** END CONFIDENTIAL versus the Division's depreciation of BEGIN CONFIDENTIAL *** END CONFIDENTIAL. However, in the Division's response to Data Request No. 2.4, it acknowledged some errors in its previous depreciation worksheets and appears to have increased its normalized depreciation by BEGIN CONFIDENTIAL *** END CONFIDENTIAL to BEGIN CONFIDENTIAL *** END CONFIDENTIAL.

Q. What is the impact of the DPU's increased depreciation upon All West's UUSF eligibility?

A. The DPU's increase in depreciation would produce a corresponding identical increase in UUSF of BEGIN CONFIDENTIAL *** END CONFIDENTIAL above the BEGIN CONFIDENTIAL *** END CONFIDENTIAL provided for in the Stipulation.[1] Unfortunately, Mr. Oman failed to acknowledge the DPU's increased depreciation in his direct testimony – or the rationale for the increase.

<u>Issue 1</u>

[1] In addition the errors acknowledged in the DPU's discovery response, it appears that Mr. Oman's has double-counted the agreed upon depreciation reductions of BEGIN CONFIDENTIAL *** END CONFIDENTIAL contained in the Stipulation. Correcting this error would have an identical impact, increasing All West's UUSF by BEGIN CONFIDENTIAL *** END CONFIDENTIAL.

Q. Do you agree with Mr. Oman's contention that All West's depreciation approaches do not fully comply with the intent of the Uniform System of Accounts under Part 32?[2]

A. Absolutely not. All West calculates depreciation in accordance with FCC rules and established industry practices, using depreciation rates approved by this Commission. As I indicated in my direct testimony, the company's CPAs, federal regulators (the FCC, USAC and NECA), every state commission and rural LEC industry expert with which I am familiar agree with All West's depreciation calculation methods. Mr. Oman's contention that All West's depreciation methods "accelerate" depreciation is an isolated opinion.

Q. Would there be unintended consequences of requiring All West to comply with Mr. Oman's perceived intent of Part 32 depreciation rules?

A. Yes. Requiring All West – and by extension all Utah rural LECs - to calculate depreciation differently from the rest of the industry would disadvantage the state in the receipt of federal USF.

Q. Please explain.

A. All West currently receives almost 10% of its total regulated revenues from High Cost Loop Support ("HCLS"), one of the support mechanisms comprising the federal USF. HCLS is a "capped" fund and distributes support based on the extent to which the rural LEC exceeds a nationwide average cost. In essence, rural LECs "compete" for HCLS

[2] Oman Direct, line 77

funds based upon their cost of providing service. Requiring Utah rural LECs to calculate depreciation differently from the rest of the industry would result in a decrease of HCLS for the state. Because HCLS directly reduces All West's cost of providing service, the loss of these revenues would directly increase the burden on the UUSF.

Q. Do you agree with either of Mr. Oman's proposals to reduce All West's 2010 depreciation expense?

A. No. Mr. Oman claims that All West's 2010 depreciation expense should be reduced by BEGIN CONFIDENTIAL *** END CONFIDENTIAL.[3] However, his direct testimony includes no supporting documentation that reflects an adjustment of this magnitude. Indeed Exhibit 2.1 attached to his testimony does not reflect the BEGIN CONFIDENTIAL *** END CONFIDENTIAL number suggested in testimony.

Instead, Mr. Oman identifies two proposals, which he characterizes as the "DPU Method" and the "FCC Method," in support of his proposal to reduce All West's 2010 depreciation expense. These two proposals are also identified in Exhibit 2.1, which Mr. Oman describes as a theoretical application of his two proposed methods on the impact on depreciation expense to a single category of asset, COE - Digital Switching (account 2212).[4] According to Mr. Oman's Exhibit 2.1, both of his proposed methods would produce a reduction in depreciation of approximately BEGIN CONFIDENTIAL ***

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[3] Oman Direct, line 166

[4] Oman Direct, line 154

END CONFIDENTIAL for this category of assets.[5] Because both the DPU Method and the FCC Method, as calculated by Mr. Oman, appear to produce similar lower depreciation levels for this category of assets than All West's method, he concludes that the Commission-approved depreciation rates do not accurately reflect the useful lives of the asset accounts. Accordingly, Mr. Oman claims that it is urgent that the Commission order All West to perform a depreciation study[6]

Q. Do you agree with Mr. Oman that a depreciation study is needed?

A. No, I do not. Mr. Oman has both incorrectly and selectively applied the FCC formula for revising depreciation rates, when the existing rates are no longer applicable. He then relies upon this "analysis" to advocate for his "DPU Method," which does not comply with any FCC rule for calculating depreciation. As I will explain in my testimony, I disagree with the premise that All West's existing Commission-approved depreciation rates require modification.

Q. Please explain your concerns with Mr. Oman's "FCC Method" for calculating 2010 depreciation expense for All West.

A. First of all, Mr. Oman's characterization of the "FCC Method" is not accurate. All West follows the actual FCC method, as depicted in Part 32 rules. Second, while Mr. Oman's testimony correctly references the appropriate FCC formula for revising depreciation

[5] Exhibit 2.1 calculates depreciation expense for COE-Digital Switching of BEGIN CONFIDENTIAL *** END CONFIDENTIAL under the "DPU Method" and BEGIN CONFIDENTIAL *** END CONFIDENTIAL under the "FCC Method" versus BEGIN CONFIDENTIAL *** END CONFIDENTIAL under the "All West Method."

[6] Oman Direct, lines 121-125

rates;[7] he fails to apply the formula correctly. The result is his proposed revised depreciation rate is incorrect.

Q. Please explain.

A. The FCC's formula for adjusting depreciation rates requires the use of the "average remaining life." Mr. Oman's calculation incorrectly uses All West's approved depreciation life rather than using the average remaining life of the assets in the plant account. In other words, Mr. Oman assumes that the entire balance of All West's COE-Digital Switching account - even assets that are more than a decade old - have a ***remaining*** life of BEGIN CONFIDENTIAL *** END CONFIDENTIAL years. This is not accurate. The average remaining life of the assets in the COE-Digital Switching Account is BEGIN CONFIDENTIAL *** END CONFIDENTIAL years as set forth in Confidential Exhibit KJK-2 to my testimony. Appropriately using BEGIN CONFIDENTIAL *** END CONFIDENTIAL as the average remaining life in the FCC formula results in a revised depreciation rate for the COE-Digital Switching account of BEGIN CONFIDENTIAL *** END CONFIDENTIAL, not the BEGIN CONFIDENTIAL *** END CONFIDENTIAL calculated by Mr. Oman.[8] Thus, even if the Commission were to require All West to revise the depreciation rate for COE-Digital Switching using the FCC formula the revised depreciation rate would result in an approximate depreciation reduction of BEGIN CONFIDENTIAL *** END CONFIDENTIAL, rather than Mr. Oman's theoretical reduction of BEGIN

[7] Oman Direct, lines 111-113. The FCC formula for revising depreciation rates is Depreciation rate = 100% - accumulated depreciation % - future net salvage % / average remaining life.

CONFIDENTIAL *** END CONFIDENTIAL. In other words, the FCC formula would entitle All West to approximately BEGIN CONFIDENTIAL *** END CONFIDENTIAL more depreciation expense than suggested by Mr. Oman.

Q. Do you have any other concerns with Mr. Oman's proposal for changing All West's depreciation rates using the FCC formula?

A. Yes. It appears Mr. Oman has selectively applied the formula only to asset groups that would result in lower depreciation rates. For example, All West has obtained financing from the Rural Utilities Service ("RUS"), which will be used to replace much of the company's existing copper plant with fiber over the next two years. Had Mr. Oman used the FCC formula to revise depreciation rates for copper plant, he would have calculated a deprecation rate in excess of BEGIN CONFIDENTIAL *** END CONFIDENTIAL.[9] Clearly, this far exceeds the depreciation rate increase to BEGIN CONFIDENTIAL *** END CONFIDENTIAL the parties agreed to in the Stipulation.

Q. Please explain Mr. Oman's proposed "DPU Method" for calculating 2010 depreciation for All West.

A. In addition to his "FCC Method," Mr. Oman has developed a second proposal, which he identifies as the "DPU Method." Although there was no supporting documentation or calculations contained in Mr. Oman's Direct Testimony, it appears he relies upon this method, to arrive at his BEGIN CONFIDENTIAL *** END CONFIDENTIAL reduction

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[8] 100% -74.12%/4.69 =5.523%

in All West's 2010 depreciation expense.[10] Mr. Oman's DPU Method appears to use a different calculation for depreciation for seven groups of assets. Apparently, he identified seven groups of plant that became fully-depreciated at some point in time and then switched to calculating depreciation only on the new additions, not the entire plant balance.

Q. Please explain your concerns with Mr. Oman's proposed depreciation expense reduction using his proposed "DPU Method."

A. My primary concern is that Mr. Oman's proposed depreciation expense calculation directly conflicts with FCC rules and universally accepted industry practice.[11] According to FCC rules,[12] approved depreciation rates are applied to the whole category of the plant, not some subset of the balance. In essence, Mr. Oman is simply retiring entire categories of plant once they become fully-depreciated, regardless of whether the assets remain in service or not. Mr. Oman apparently justifies the "DPU Method" by claiming that it approximates depreciation expense using the FCC formula for revising depreciation rates.[13] However, as I indicated previously, Mr. Oman's comparison is no longer valid when the FCC formula is used correctly.

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[9] BEGIN CONFIDENTIAL *** END CONFIDENTIAL This would have resulted in more than BEGIN CONFIDENTIAL *** END CONFIDENTIAL of additional depreciation for this category of asset, which more than offsets Mr. Oman's theoretical adjustment for COE – digital switching.

[10] Oman Direct, lines 150-153

[11] Mr. Oman correctly observes on lines 48-50 of his Direct Testimony that the Commission requires rural LECs to comply with FCC Part 32 accounting rules.

[12] §32.2000(g)(2)(iii)

[13] Oman Direct, lines 162-165

Q. Has Mr. Oman correctly quantified the impact on All West's UUSF eligibility of his proposed reduction to All West's 2010 depreciation expense?

A. No. Mr. Oman has overstated the impact of his proposed reduction to 2010 depreciation expense on All West's UUSF eligibility by BEGIN CONFIDENTIAL *** END CONFIDENTIAL. While Mr. Oman has proposed a BEGIN CONFIDENTIAL *** END CONFIDENTIAL reduction to All West's recorded 2010 depreciation expense, he has not removed this amount from the company's accumulated depreciation. Correcting his omission would increase All West's pro forma rate base by BEGIN CONFIDENTIAL *** END CONFIDENTIAL, which results in an increase in the Company's revenue deficiency under the Division's calculations by BEGIN CONFIDENTIAL *** END CONFIDENTIAL.

Q. Please summarize your recommendation for the Commission regarding All West's calculation of 2010 depreciation expense.

A. All West has calculated its 2010 depreciation in accordance with FCC rules, which has been confirmed by the company's CPAs. Accordingly, the Commission should reject Mr. Oman's proposal to retroactively reduce All West's 2010 depreciation expense by BEGIN CONFIDENTIAL *** END CONFIDENTIAL.

<u>Issue 2</u>

Q. Please describe how All West normalized depreciation for the test period.

A. As I stated in my direct testimony, All West normalized depreciation expense by simply applying its Commission-approved depreciation rates to its December 31, 2010, plant balances. The Company's actual depreciation for the test period was then increased to this "normalized" amount in order to reflect the known and measurable level of depreciation that All West will incur on a going-forward basis. This is the generally accepted method for normalizing depreciation expense and is used by every state commission with which I am familiar.

Q. Please explain Mr. Oman's adjustment to reduce your depreciation normalization adjustment.

A. Mr. Oman has proposed a BEGIN CONFIDENTIAL *** END CONFIDENTIAL reduction to All West's depreciation normalization calculation of BEGIN CONFIDENTIAL *** END CONFIDENTIAL. Mr. Oman arrives at his much lower proposed depreciation normalization increase of BEGIN CONFIDENTIAL *** END CONFIDENTIAL by discontinuing depreciation on any class of asset that would be fully-depreciated as a result of normalization.

Q. What is the impact of Mr. Oman's proposed reduced level of normalized depreciation?

A. The vast majority of Mr. Oman's reduced depreciation normalization adjustment can be attributed to vehicles, work equipment and furniture. He has reduced All West's ongoing deprecation in these three categories of assets to a composite total of approximately BEGIN CONFIDENTIAL *** END CONFIDENTIAL. This is in contrast to BEGIN

CONFIDENTIAL *** END CONFIDENTIAL in depreciation that All West recorded in 2010 and the more than BEGIN CONFIDENTIAL *** END CONFIDENTIAL that the Company averaged of the three-year period 2008-2010 for these three accounts.

Q. What assumption is implicit in Mr. Oman's extremely low level of depreciation for these three groups of assets?

A. Mr. Oman has implicitly assumed that All West will make virtually no additions to these three categories of assets for the foreseeable future. This is a rather dubious assumption considering that All West has continued to add to these three asset groups and currently has more than BEGIN CONFIDENTIAL *** END CONFIDENTIAL combined in these three asset groups.

Depreciation Study

Q. Do you agree with Mr. Oman's recommendation that the Commission order All West to perform a depreciation study?

A. No. Depreciation studies would be costly and time-consuming for both the DPU and All West. More importantly, I question whether a depreciation study will produce significantly different depreciation rates for All West. For example, **w**hile All West's COE-Digital Switch deprecation rate would decrease from BEGIN CONFIDENTIAL *** END CONFIDENTIAL to BEGIN CONFIDENTIAL *** END CONFIDENTIAL, this decrease would only be temporary. Once All West retires the digital switch, it would then be required to significantly increase the depreciation rate.[14] These repeated

[14] The useful life of a soft switch is about 6-7 years, which translates to depreciation rate of approximately 15%.

depreciation rate changes would all require DPU involvement and Commission approval. In order to recover the varying expense levels resulting from fluctuating deprecation rates, All West would have to file repeated UUSF applications. All West contends that simply leaving the depreciation at BEGIN CONFIDENTIAL *** END CONFIDENTIAL produces a comparable result without the regulatory burden. Furthermore, one of the benefits of mass asset accounting is the use of a composite rate for plant accounts that smoothes out fluctuations in depreciation rates that would otherwise result from the addition and retirement of assets.

Finally, All West's composite depreciation rate of BEGIN CONFIDENTIAL *** END CONFIDENTIAL for 2010 provides more evidence that the Company's current depreciation rates perhaps should be increased instead of decreased.[15] This composite deprecation rate – which reflects that the Company takes more than BEGIN CONFIDENTIAL *** END CONFIDENTIAL years to recover the cost of its regulated plant - is rather low by industry standards. This also certainly refutes any suggestion that All West has inappropriately accelerated its depreciation on regulated plant.

Q. How do most state commissions approve depreciation rates for rural LECs?

A. As competition has increased in the telecommunications industry and technology has rapidly evolved, state commissions have replaced depreciation studies with pre-approved

[15] See Schedule W/P IS 7, BEGIN CONFIDENTIAL *** END CONFIDENTIAL

depreciation "ranges" for each group of assets.[16] Rural LECs can select a company-specific depreciation rate for each category of plant that is applicable for their specific stage of construction. Only when a rural LEC requests a depreciation rate outside the range does the state commission require justification. I would strongly recommend that Utah adopt a similar policy, which allows rural LECs to devote their scarce resources to providing customer service, and preparing for an uncertain future given the matters pending at the FCC, rather than complying with outdated regulatory practices.

Q. Does that conclude your rebuttal testimony?

A. Yes it does.

[16] Both Kansas and Colorado have adopted this approach.