DECISION MEMORANDUM

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FROM:BRAD PURDY

DATE:OCTOBER 10, 1997

RE:CASE NO. GTE-T-97-5; APPLICATION OF GTE NORTHWEST TO REVISE DEPRECIATION RATES

On March 10, 1997, GTE Northwest, Inc. (GTE; Company) filed an Application requesting authority to revise certain depreciation rates.  The Company seeks to accelerate the asset lives or depreciation rates for those accounts most affected by advances in technology and subject to competition.  GTE asserts that it is not seeking an increase in rates to compensate for the proposed increase in depreciation expense and the resultant decrease in intrastate earnings.  The Company also contends that it does not expect to receive full recognition of any approved change in its depreciation rates for purposes of calculating its cost of service in future proceedings before the Commission (e.g., earnings, investigations, cost study reviews, and universal service cost analysis).

On August 1, 1997, the Commission issued a Notice of Modified Procedure soliciting comments in response to GTE’s Application.  The Commission Staff filed comments and GTE filed a reply.

Commission Staff

GTE’s Application requests an increase in depreciation rates for eight accounts to be effective beginning January 1, 1997.  The depreciation for the remainder of the accounts would be the rates as established by the Commission in 1994.  The eight accounts involved in this Application are set forth in Attachment “1" to this memorandum.  The proposed changes in rates are listed in columns C and D.

The effect of the foregoing changes would be to increase GTE’s overall average depreciation rate from 5.9% to 12.1%.  This would increase depreciation expense from approximately $20.285 million to $42.033 million annually.  In an exhibit attached to the Commission Staff’s comments, Staff notes that GTE’s proposed average depreciation rate of 12.1% is higher than for any of GTE’s other regions presented for comparison.  Moreover, U S WEST agreed to an 8.6% composite rate in a stipulation with the Commission Staff in U S WEST’s most recent rate case (Case No. USW-S-96-5).  For purposes of comparison, the comparable U S WEST stipulated depreciation rates are shown in column F of Attachment 1.

In analyzing GTE’s Application in this case, Staff met with Company personnel to discuss the reasons for the proposed changes.  In addition, Staff audited the records of GTE’s plant-in-service accounts at San Angelo, Texas.  Finally, Staff compared the plant-in-service records to actual plant-in-service by physical inventory of 12 central offices located in Idaho.  In analyzing GTE’s plant-in-service accounts, Staff discovered four distinct errors.  These errors will be reflected in the Company’s next general rate case but will not change the depreciation rates which are at issue in this proceeding.

Staff has identified three significant problems with the Company’s proposed change in depreciation rates and estimated useful lives of its assets.  First, the Company’s foundation for the proposal is a specific Technology Futures Inc.  (TFI) study already seriously questioned by Staff in a recent U S WEST case before this Commission.  In addition, the change in depreciation lives sought by GTE is even more radical than U S WEST sought to justify with the same studies.  Staff’s witness in the U S WEST proceeding noted two specific problems with the TFI studies.

First, the studies ignore the actual empirical life of the assets involved and rely on a non-standard methodology.  Second, the studies were conducted at an industry-wide level and contained nothing Idaho-specific about the actual state of competition and the real need for technological replacement.  Second, Staff contends that the Company’s case for the inappropriateness of historical analysis is based on mere assertion and is without foundation.  Finally, Staff argues that the Company’s comparison to other providers does not show the essential reasonableness of the proposal.  As a matter of fact, GTE’s proposed composite rate of 12.1% is appreciably higher than six of the seven competitors composite rates cited on page 18 of GTE witness Allen Sovereign’s direct testimony.  Moreover, the composite rate is significantly higher than the 8.6% stipulated to in the most recent U S WEST case.

Staff argues that GTE’s proposed revisions are not reasonable based on its own suggested standard of comparison with other rates.  Staff believes that it is critical to distinguish between what is necessary for regulated services from separate impacts on future deregulated services.  Allowing GTE’s proposed rates to be included in future calculations for cost of service and universal service obligations, Staff suggests, would have serious consequences.  Staff believes that the Company’s proposal will create an overhang of “legacy costs” that will be used to artificially inflate cost of service in current interconnection proceedings and that will be difficult to reverse when the time comes to formally consider their possible inclusion in rates.

Staff believes that there is justification for some increase in depreciation rates but contends that it should be based on the “three-way meetings” conducted in 1996 and in which GTE was a participant.  The FCC order (Order No. 896-485) establishing those depreciation rates was issued December 19, 1996.  Staff’s Exhibit No. 103 (included here as Attachment “2") to its Comments shows the depreciation rates established by that order for the eight accounts in dispute and the average of those rates for the eight states involved in the three-way meetings in 1996.  Staff recommends, therefore, that the average of the depreciation rates established in 1996 be the depreciation rates approved by the Commission in this proceeding.  The result is an increase of deprecation expense of $3.4 million as compared to the increase of $21.7 million requested by GTE.  Staff agrees that this change should be made effective January 1, 1997.  Because the changes will not effect the Company’s rates, there is no concern regarding retroactive ratemaking.

GTE Reply

On August 25, 1997, GTE filed a reply to Staff’s comments.  GTE argues that using rates established by the FCC would perpetuate a system that is “archaic, outdated and assures that investment made under regulation will not be recovered under regulation.”  Reply Comments at p. 2.  GTE notes that House Bill No. 313, which repealed Idaho Code § 62-622 provides:

. . . (a) At the request of the incumbent telephone corporation, the Commission shall establish maximum just and reasonable rates for basic local exchange service.  Maximum basic local exchange rates shall be sufficient to recover the cost incurred to provide the services.  Costs shall include authorized depreciation, a reasonable portion of shared and common costs, and a reasonable profit.  Authorized depreciation lives shall use forward-looking competitive market lives.  Authorized depreciation lives shall be applied prospectively and to undepreciated balances.  (Emphasis added.)

GTE argues that regardless of the fact that its proposed depreciation rates may be high in relation to those approved by the Commission for U S WEST, the only relevant criterion is whether they are “reasonable.”  Moreover, GTE argues that rates should be set at the state level as opposed to being dictated from the federal level by the FCC.  GTE contends that the application of the average rates prescribed by the FCC completely ignores the Idaho reserves and the Idaho Commission prescribed future net salvage (FNS).   GTE asserts that it would have been more appropriate for the Staff to have averaged the remaining lives which were provided by the FCC along with the rates as set forth in the FCC order.  In doing so, the average remaining lives could be applied to Idaho-specific reserves and the Idaho FNS.

GTE acknowledges that its proposed average depreciation rate of 12.1% is higher than most other companies.  The reason for this, GTE explains, is that the rate is a direct function of the low Idaho depreciation reserve level of 31% resulting from years of inadequate depreciation rates.  According to GTE, Idaho has the dubious distinction of having the lowest depreciation reserve of any of GTE’s operating companies, which are generally in the 45 to 50% range.  GTE concludes that low historical rates and correspondingly low reserves ultimately lead to higher depreciation rates to correct past actions.  GTE notes that the estimated economic life of the assets in the accounts subject to this proceeding for AT&T are significantly lower than for GTE.  Yet AT&T’s composite depreciation rate of 8.69% is significantly lower than the 12.1% proposed by GTE.  GTE explains that AT&T has had and continues to have the freedom to set whatever rates it desires without regard to any state regulatory Commission intervention.  The result is lower depreciation rates in place as the market for communications becomes more competitive.

GTE contends that the relatively high average rate it requests now is the result of past Commission actions in refusing to raise GTE’s average rate in spite of repeated requests by GTE to do.  GTE argues that the timing and recovery of its investment in telecommunications infrastructure in Idaho has been delayed by inadequate depreciation rates and lives.

GTE disputes Staff’s contention that the TFI analysis is inapplicable to this proceeding.  According to GTE, the communications revolution that is sweeping the country will affect the consumers of Idaho.  Creating a modern communication system for Idaho consumers is not advanced by the utilization of the historical mortality approach and the archaic FCC depreciation methods.  GTE asserts that as the telecommunications market in Idaho is being open to competition, the Company needs the freedom to set its own rates in the same fashion as its competitors do.  To do otherwise, would be to deny GTE an even playing field and the opportunity to recover its investment made under regulation, while at the same time, allowing its competitors to set their rates unincumbered by regulation.

GTE notes that the rates it proposes in this case are comparable to or lower than the rates approved by the Commission for the independent telephone companies in Case No. GNR-T-97-1.  In addition, a comparison of the Staff recommended rates for GTE with the rates stipulated to with U S WEST in Case No. USW-S-96-5 reveals that in seven of the eight major accounts, the Staff recommended rates for GTE are significantly lower than those approved for U S WEST.  Furthermore, the Staff stipulated to an 8.6% composite rate with U S WEST in comparison to the 6.8% composite rate recommended by the Staff for GTE in this case.

Commission Decision

What useful lives and depreciation rates does the Commission wish to approve for GTE?  A.  GTE’s proposed rates (Column D)

B.  Staff’s recommended rates (Column E)

C.  U S WEST’s approved rates (Column F)

D.  Something else

Is the effective date of January 1, 1997 acceptable?

Brad Purdy

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Attachments