Service Date: November 30, 1982

DEPARTMENT OF PUBLIC SERVICE REGULATION
MONTANA PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER of the Application of MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY, INC., GENERAL TELEPHONE OF THE NORTH-WEST, INC., and NORTHWESTERN TELEPHONE SYSTEMS, INC. To Adopt Certain Depreciation Changes And Certain Changes Pertaining to Station Connections and Inside Wiring, AND IN THE MATTER of the Commission's Investigation Into Detariffing Customer Premises Equipment.	)	UTILITY DIVSION DOCKET NO. 82.6.37 ORDER NO. 4951

APPEARANCES

FOR MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY, INC.:

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FOR THE MONTANA CONSUMER COUNSEL:

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DOCKET NO. 82.6.37, ORDER NO. 4951

FOR TELEPHONE ANSWERING SERVICE INTERVENORS:

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FOR THE COMMISSION:

Calvin K. Simshaw, Staff Attorney, 1227 Eleventh Avenue, Helena, Montana 59620

BEFORE:

GORDON E. BOLLINGER, Chairman
JOHN B. DRISCOLL, Commissioner
HOWARD L. ELLIS, Commissioner
CLYDE JARVIS, Commissioner
THOMAS J. SCHNEIDER, Commissioner

FINDINGS OF FACT

PART A

GENERAL

1. On December 5, 1980, the FCC issued its "Report and Order" in Docket No. 20188 which has the effect of accelerating the capital recovery process for the telecommunications industry through the use of Straight Line Remaining Life (SLRL) and Straight Line Equal Life Group (ELG) depreciation methods. Previously all telephone companies were required to use the Straight Line Vintage Group (SLVG) method for calculating depreciation.

2. On April 1, 1982 the FCC adopted its "Memorandum Opinion and Order" CC Docket 79-105 specifying that "state commissions are not precluded from departing from accounting or depreciation rules prescribed by this Commission for purposes of regulating intrastate telecommunication service rates. "

3. On May 11, 1982 General Telephone of the Northwest, Inc. (GTNW) filed its 1982 Capital Recovery Study which was the basis of the Company's

proposal to the FCC and to this Commission for modification of depreciation rates.

4. On June 15, 1982 Mountain States Telephone and Telegraph Company, Inc., hereinafter Mountain Bell (MB), filed its 1982 Depreciation Rate Study. This study was the basis for Mountain Bell's request to the FCC and to this Commission for changes in depreciation rates.

5. Both GTNW and MB presented proposals for new depreciation rates using SLRL and ELG depreciation methods.

6. On May 18, 1982 Northwestern Telephone Systems, Inc. (NWTS) requested permission to amortize its embedded customer premises equipment (CPE) over a three year period beginning no later than December 1, 1982.

7. This Commission's response to the above events was to initiate this docket to consider the three companies' requests for depreciation changes and to investigate other current changes in the telecommunications industry.

8. This order is intended to address only the depreciation matters included in this docket. Subsequent orders will address other issues in this Docket.

9. Pursuant to appropriate Notice of Public Hearing, a hearing on these applications for depreciation rate changes was held on October 26-29, 1982 in the State Capitol in Helena, Montana.

10. The office of the Montana Consumer Counsel has participated in the proceedings of this docket since its inception.

PART B

DEPRECIATION

11. Thomas L. Clark, Mountain Bell Division Staff Manager-Capital Recovery and Separations, presented testimony on SLRL, ELG and the 1982

Depreciation Rate Represcription. William E. Stern, GTNW Vice President Revenue Requirements, and Sterling Sawyer, GTNW Supervising Engineer-Valuation and Depreciation, presented testimony on these same issues on behalf of GTNW. All three of these witnesses recommended that the Commission adopt SLRL and ELG depreciation methodology and approve the asset lives and depreciation rates accepted by the FCC as a result of the 1982 Depreciation Represcription.

12. Mr. Allen G. Buckalew, Economist at J.W. Wilson & Associates, Inc., presented testimony in this docket on behalf of the Montana Consumer Counsel (MCC). Mr. Buckalew recommended that the Commission not implement any depreciation changes at this time.

13. Prior to the FCC decision in Docket No. 20188, telephone utilities were required to use the SLVG method for calculating depreciation. This depreciation method worked well during periods when changes in life estimates were minor and retirements were made as originally scheduled. During recent years substantial changes have occurred in the telecommunications industry and rapid changes are expected to continue. Depreciation practices need to be able to accommodate a continually changing environment.

14. Under the SLVG method, all plant is classified into groups which are basically homogeneous in character, used in the same way and operate under similar conditions. Examples of these kinds of groups include poles, buildings, large PBX's and buried cable. All plant placed in service during a single year is called a vintage group. Average service lives and average net salvage factors are developed for each vintage group. The annual depreciation rate for each category is calculated using the following formula:

$$\text{Depreciation Rate (\%)} = \frac{\text{100\% - Average Net Salvage (\%)}}{\text{Average Service Life}}$$

If five assets costing $100 each and having lives of 1 year, 2 years, 3 years, 4 years and 5 years, are placed in a vintage group, the depreciation rate for the group would be 33.3 percent and the annual depreciation expense would be $166.67 calculated as follows (assuming zero net salvage):

1. 1 + 2 + 3 + 4 + 5 = 15 years

2. 15 ÷ 5 = 3 years = average service life

3. $33.3\% = \frac{\text{100\% - 0\%}}{\text{3.0 years}}$

4. $500 x 33.3% = $166.67

15. The ELG method is a refinement of the SLVG method. Each vintage group is further divided into equal life groups. In the above example, the vintage group with five assets would become five equal life groups of one asset each. The asset with a one year life would be depreciated over one year; the asset with a two year life would be depreciated over two years; and so on. Under the ELG method, depreciation in the first year would be $228.33 calculated as follows:

$100 ÷ 1 year =	$100.00
$100 ÷ 2 years =	50.00
$100 ÷ 3 years =	33.33
$100 ÷ 4 years =	25.00
$100 ÷ 5 years =	20.00
Depreciation in Year 1	$228.33

16. Witnesses for Mountain Bell and GTNW testified that there are two major reasons why SLVG should be considered an inadequate depreciation method. The first reason is that the rate of capital recovery through depreciation expense does not keep pace with the rate of capital consumption. This results in improper matching of consumption and expense recognition because the expense is deferred from early years to later years. A comparison of the two methods using the examples outlined above shows this deferral.

SLVG	ELG

Year 1	$166.67	$228.33
Year 2	133.33	128.33
Year 3	100.00	78.34
Year 4	66.67	45.00
Year 5	33.33	20.00
	$500.00	$500.00

17. Mr. Buckalew, in his direct testimony, testified that he has no quarrel with ELG on theoretical grounds (Exh. MCC-1, p. 7). Under cross-examination by Mr. Simshaw, Mr. Buckalew stated that ELG is simply a refinement of the vintaging process and, if implemented properly, it is an appropriate method to use (TR, p. 127).

18. No witness in this docket rebutted the position that ELG is a superior depreciation method when compared to SLVG because it provides a better matching of capital consumption with capital recovery. This Commission approved the first year phase in of ELG in Docket No. 80.12.100, Order No. 4786b. The Commission recognizes that ELG is a superior depreciation method and approves the phase in of the ELG method ordered by the ECC. MB requested permission to implement ELG depreciation rates on additions to outside plant effective January 1, 1982, and additions to the building accounts, central office equipment accounts, general equipment accounts, motor vehicles, furniture, and computers effective January 1, 1983.

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GTNW requested permission to implement rates based on ELG methodology on future additions in accordance with the following schedule:

COE Accounts	January 1, 1983
Outside Plant Accounts (excluding Aerial Wire)	January 1, 1983
All Other Accounts (excluding: Station Apparatus 231, Station Connection 232 Large PBX 234)	January 1, 1984

19. The second reason witnesses recommended considering SLVG an inadequate depreciation method is that it does not assure 100 percent recovery of capital. Recovery could be greater than or less than 100 percent depending on thc circumstances. Early retirements can strand investment in the rate base. When this occurs, ratepayers continue to pay a return on that investment forever. For example, if an asset costing $1,000 is assumed to have a life of 10 years, it would be depreciated at a rate of 10 percent per year. Assume that the asset is retired at the end of five years. Both MB and GTNW are required by the FCC to use salvage accounting. When salvage accounting is used, no gains or losses are recognized on retirements. Retirements are accomplished by a debit to the accumulated depreciation account in an amount equal to the original cost of the asset less any net salvage. A corresponding credit is made to the plant account for the original cost of the asset. In the example, if we assume zero net salvage, $1,000 would be removed from the plant account and a credit would he made to accumulated depreciation for $1,000, leaving $500 of stranded investment.

20. The SLVG depreciation method does not provide 100 percent capital recovery if life estimates are revised after assets are placed in service.

Under the SLVG method, if the estimated average service life is changed, the depreciation rate is changed to reflect the new life. However, existing assets are treated as if they had always been depreciated at the new rate. This causes the capital recovered to be over or under 100 percent depending on whether the revised life estimates are longer than or shorter than the original estimates. For example, an asset costing $1,000 was estimated to have a 10 year life. At the end of the fifth year the original life estimate was reviewed. The following examples show how capital is recovered if the life estimate is changed.

a. Assume the asset is expected to last 3 more years.

	Capital Recovered
Year 1 through Year 5 ($1,000 x 10%) x 5	$500
Year 6 through Year 8 ($1,000 x 12.5%) x 3	375
Total Capital Recovered	$875

b. Assume the asset is expected to last 7 more years.

	Capital Recovered
Year 1 through Year 5 ($1,000 x 10%) x 5	$500
Year 6 through Year 12 ($1,000 x 8.33%) x 7	583
Total Capital Recovered	$1,083

21. MB and GTNW recommend implementation of the SLRL method to solve this problem. The SLRL method allocates the net book value (original cost less depreciation taken in earlier years) of an asset over the estimated years remaining in the asset's life on a straight line basis. In the above examples, use of remaining life would recover exactly $1,000 as follows:

a. Assume the asset is expected to last 3 more years.

	Capital Recovered
Year 1 through Year 5 ($1,000 x 10%) x 5	$500
Year 6 through Year 8 ($500 x 33.33%) x 3	500
Total Capital Recovered	$1,000

b. Assume the asset is expected to last 7 more years.

	Capital Recovered
Year 1 through Year 5 ($1,000 x 10%) x 5	$500
Year 6 through Year 12 ($500 x 14.29%) x 7	500
Total Capital Recovered	$1,000

22. Mr. Buckalew testified that he had no problems with SLRL on theoretical grounds. No witness rebutted the Companies' testimony in this docket that SLRL is needed to assure 100 percent capital recovery. Both companies have experienced declining reserve percentages. MB's depreciation reserve has declined from 35.5 percent of depreciable plant in 1950 to 22.6 percent in 1981. GTNW's depreciation reserve in 1980 was 16 percent. This further shows that better depreciation practices are needed. The Commission approves both companies' requests to implement the SLRL depreciation method.

23. Under the Communication Act of 1934 the FCC is given the right to prescribe depreciation rates used on the books of telephone companies it regulates. The Act also states that prior to prescribing rates the FCC must give state regulatory commissions an opportunity to express their views on any proposed changes. To comply with the requirements of the Act the FCC

reviews depreciation rates for telephone companies every three years. The company files proposed revisions to depreciation rates based on studies of asset lives. The FCC reviews these studies and sends out its own proposals for revisions in life estimates. A three-way meeting is then held among representatives of the company, the FCC, and the state commissions that regulate the company. Representatives from these organizations attempt to achieve three-way agreement on depreciation rates. The FCC then orders the telephone company to implement the agreed upon rates.

24. On July 19-20, 1982 a three-way depreciation meeting was held in Seattle, Washington for the purpose of reviewing the depreciation rates used by GTNW. A similar three-way meeting was held on August 16-19, 1982 to review depreciation rates used by MB. Thc Montana Public Service Commission staff attended both of these meetings. Three-way agreement was reached on appropriate depreciation rates for all accounts. In this docket GTNW and MB requested that the Commission approve the depreciation rates that were developed in the three-way meetings. When these rates are formally approved by the FCC the companies will use them to calculate depreciation for book purposes. However, pursuant to the "Memorandum Opinion and Order" in CC Docket No. 79-105, state commissions are not precluded from prescribing depreciation rates to be used for purposes of developing intrastate service rates.

25. The Commission has reviewed the depreciation rates developed at the 1982 three-way meeting. With the exception of the specific depreciation rates for MB as discussed below, the Commission finds the depreciation rates requested by the companies to be fair and reasonable. The Commission grants permission to GTNW to establish remaining life depreciation rates as

filed, for its Montana operations and General Plant effective December 1, 1982 and to implement rates based on ELG methodology in accordance with the schedule outlined in Finding No. 18.

26. MCC recommended that the Commission not implement any depreciation changes at this time. Mr. Buckalew testified that competition has had a substantial effect on the determination of depreciation and basic exchange ratepayers should not be asked to pay increased depreciation caused by AT&T's competitive activities. In Mr. Buckalew's direct testimony he explains:

> The current depreciation practices have been substantially effected by competition in the toll, terminal equipment and enhanced services markets. American Bell will probably be the supplier of these services (or some other separate entity). The settlement of the antitrust case can be viewed as dividing Mountain Bell into separate companies, one providing monopoly services and one providing competitive. Many of the reasons for the FCC approval of ELG and RL techniques are directly related to competition. Indeed, the FCC only regulates segments of the telephone companies that are competitive.
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> (Exh. MCC-1, pp. 32-33)

27. Mr. Buckalew also had several problems with methodologies the companies used in their depreciation studies. However, to a large extent these problems were corrected at the three-way meetings. Under cross-examination by Mr. Hyer, Mr. Buckalew stated that, not withstanding divestiture concerns, the results of the three-way meetings are basically reasonable (TR, p. 114).

28. Competition is cited by both companies as a major reason depreciation changes are needed. Mr. Clark, under cross-examination by Mr. Allen, stated that the toll and terminal equipment markets are competitive (TR, pp.

30-31). Mr. Clark also stated that the greatest declines in useful service lives were in the area of terminal equipment (TR, p. 32) and that competition has had an effect on asset lives in the toll area although not as great an effect as it has had on terminal equipment (TR, p. 35).

29. On the date of the AT&T divestiture, currently expected to be January 1, 1984, all embedded customer premises equipment and any plant used predominately for inter-LATA (Local Access and Transport Areas) services will be transferred to AT&T. These assets represent the company's plant that is devoted mostly to competitive operations.

30. The Commission feels that MB has presented adequate information supporting the need for updated depreciation rates. However, the Commission supports Mr. Buckalew's position that Montana ratepayers should not be asked to pay rates which reflect higher depreciation expenses attributable to competitive activities that will be transferred to AT&T. The Commission does not approve any revisions in depreciation rates for plant that will be transferred to AT&T upon divesture and directs Mountain Bell to continue to use existing depreciation rates on these assets for purposes of determining intrastate revenue requirements.

31. With the exception outlined in Finding No. 30, the Commission finds the revised depreciation rates requested by MB to be fat. and reasonable. The Commission grants the request of MB to establish remaining life depreciation rates as filed for all plant accounts excepting those in Finding No. 30 and to implement ELG rates as filed in accordance with the schedule set forth in Finding No. 18.

3-YEAR AMORTIZATION

32. Mr. Vern K. Dunham, Senior Vice President of Northwestern Telephone Systems, Inc., testified in this docket on behalf of NWTS. The purpose of Mr. Dunham's testimony was to demonstrate that a three-year amortization of embedded customer premise equipment (CPE) would be in the best interests of both NWTS and its ratepayers.

33. No witness testified on the record in this docket opposing NWTS's three year amortization proposal for CPE.

34. On February 26, 1982 the FCC released the Decision and Order in CC Docket No. 80-286. The order adopts the Federal-State Joint Board recommendation to remove CPE from the separations process. Pursuant to this order no investment or expenses associated with CPE incurred after January 1, 1983 will be allocated to interstate operations. The amounts in the CPE plant accounts on the company's books as of that date, and the average amounts in related expense accounts for the previous year, will constitute a "base amount" for separations purposes. The base amount will be reduced at the rate of one-sixtieth per month for five years. Depreciation expense associated with CPE for the month of December, 1982 will be expressed as a ratio to the plant balance at December 31, 1982. This ratio will be applied to the phase out of the CPE accounts.

35. Because of this FCC decision it is beneficial to NWTS and to its local ratepayers to have any depreciation revisions in the CPE accounts effective on or before December 1, 1982.

36. This Commission finds that three years is a reasonable time period over which to amortize CPE. The Commission directs NWTS to implement this amortization rate with an effective date of December 1, 1982.

REVENUE REQUIREMENTS

37. Revised depreciation rates will cause a higher level of expenses for MB and GTNW. To cover the additional expenses resulting from this order, the Commission grants MB additional annual revenues of $2,546,000 calculated as follows:

	(000)
Average Rate Base - Excluding CPE	(828)
Rate of Return (Order No. 4948)	11.70
Total Earnings Required	(97)
Available Net Operating Income - Excluding CPE	(1,493)
Additional Earnings Required	1,396
Income to Revenue Multiplier	2.0258
Additional Revenues Required - Excluding CPE	2,828
Less: Additional Revenue Requirement Resulting from Plant to be Divested on January 1, 1984	(282)
Revenue Requirement	$2,546

The rate spread for these revenues will be addressed in Order No. 4948 in Docket No. 82.2.8.

38. Additional revenue requirements for GTNW resulting from this order will be considered as an uncontested issue in that company's current general rate case, Docket No. 82.6.39. The depreciation rate revisions granted for GTNW in this order will decrease the company's test year intrastate net operating income by $41,031 and decrease the test year intrastate average rate base by $70,450.

39. NWTS requested additional annual revenues in the amount of $246,000. This amount represents the Company's expected capital recovery shortfall through 1987 of

$1,230,000 spread evenly over five years. The Commission denies NWTS's request for additional annual revenues in this

docket. The Commission normally requires revenue requirements to be calculated on a test year basis. The Commission also examines the overall financial status of a utility before granting additional revenues. The Commission will consider any revenue requirements resulting from the three year amortization of CPE in NWTS's next general rate case.

CONCLUSIONS OF LAW

1. Mountain States Telephone and Telegraph Company, Inc., General Telephone of the Northwest, Inc., and Northwestern Telephone Systems, Inc. are corporations providing telephone and other communications services within the state of Montana and as such are "public utilities" within the meaning of MCA § 69-3-101.

2. The Montana Public Service Commission properly exercises jurisdiction over these three companies' Montana operations pursuant to Title 69, Chapter 3, MCA.

3. The Commission has the authority to inquire into the management of the business of Mountain Bell, GTNW and NWTS including such areas as depreciation methods and is required to keep itself informed as to the manner and method in which the same is conducted, MCA § 69-3-106(1).

ORDER

THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. The increased annual revenues of $2,546,000 authorized herein for Mountain Bell shall be collected from tariffed services in the manner described in Docket No. 82.2.8, Order No. 4948.

2. The increased rates authorized herein shall be effective upon the filing and approval of revised tariffs consistent with Docket No. 82.2.8, Order No. 4948.

3. The companies are directed to implement new depreciation rates in accordance with the effective dates contained in the Findings of Fact of this order.

4. All motions and objections made by the parties in this docket which were not rules upon by the Commission at the hearing or earlier in this order are hereby denied.

DONE AND DATED this 29th day of November, 1982 by a vote of 5-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

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GORDON E. BOLLINGER, Chairman

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JOHN B. DRISCOLL, Commissioner

_____
HOWARD L. ELLIS, Commissioner

_____
CLYDE JARVIS, Commissioner

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THOMAS J. SCHNEIDER, Commissioner

ATTEST:

Madeline L. Cottrill
Secretary

(SEAL)

NOTE: You may be entitled to judicial review of the final decision in this matter. If no Motion for Reconsideration is filed, judicial review may be obtained by filing a petition for review within thirty (30) days from the service of this order. If a Motion for Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. the Montana Administrative Procedure Act, esp. Sec. 2-4-702, MCA; and Commission Rules of Practice and Procedure, esp. 38.2.4805, ARM.