

JIM IRVIN
COMMISSIONER-CHAIRMAN
TONY WEST
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER



0000159872

ARIZONA CORPORATION COMMISSION

DATE: FEBRUARY 3, 1999

DOCKET NO: T-01051B-97-0689

TO ALL PARTIES:

Enclosed please find the recommendation of Hearing Officers Jerry Rudibaugh and Lyn Farmer. The recommendation has been filed in the form of an Opinion and Order on:

U S WEST COMMUNICATIONS, INC.
(DEPRECIATION RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Hearing Officer by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

FEBRUARY 12, 1999

The enclosed is NOT an order of the Commission, but a recommendation of the Hearing Officer to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

FEBRUARY 17, 1999 and FEBRUARY 18, 1999

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.


STUART R. BRACKNEY
ACTING EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 JIM IRVIN
COMMISSIONER-CHAIRMAN
3 TONY WEST
COMMISSIONER
4 CARL J. KUNASEK
COMMISSIONER

5 IN THE MATTER OF THE APPLICATION OF U S
6 WEST COMMUNICATIONS, INC. FOR
7 CHANGES IN ITS DEPRECIATION RATES.

DOCKET NO. T-01051B-97-0689

DECISION NO. _____

8 **OPINION AND ORDER**

9 DATES OF HEARING: November 12 and 13, 1998
10 PLACE OF HEARING: Phoenix, Arizona
11 PRESIDING OFFICERS: Jerry L. Rudibaugh and Lyn Farmer
12 IN ATTENDANCE: Renz D. Jennings, Commissioner
Carl J. Kunasek, Commissioner
13 APPEARANCES: Mr. Thomas Dethlefs, Senior Attorney, and Mr.
14 Timothy Berg, FENNEMORE CRAIG, on behalf of U S
West Communications, Inc.;;
15 Mr. Peter Q. Nyce, Jr., General Attorney, on behalf of
16 the Department of Defense and Federal Executive
Agencies;
17 Ms. Patricia vanMidde, Assistant Vice President, on
18 behalf of AT&T Communications of the Mountain
States, Inc.;;
19 Mr. Michael W. Patten, BROWN & BAIN, P.A., on
20 behalf of Cox Arizona Telcom, Inc. and e-spire™
Communications, Inc.;;
21 Mr. Raymond S. Heyman, ROSHKA, HEYMAN &
22 DeWULF, PLC, on behalf of the Arizona Payphone
Association;
23 Ms. Karen Nally, Staff Attorney, on behalf of the
24 Residential Utility Consumer Office; and
25 Mr. Christopher C. Kempley, Assistant Chief Counsel,
Legal Division, on behalf of the Utilities Division of the
Arizona Corporation Commission.

26 **BY THE COMMISSION:**

27 On October 10, 1995, U S WEST Communications, Inc. ("U S WEST" or "Company")
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1
2 submitted an Application for Changes in its Depreciation Rates ("Application"), and on December 8,
3 1997, the Application was docketed with the Arizona Corporation Commission's ("Commission")
4 Docket Control. On November 12, 1997, U S WEST submitted its Supplement to Application, which
5 was docketed on December 8, 1997.

6 On December 19, 1997, AT&T Communications of the Mountain States, Inc. ("AT&T") filed
7 an Application for Leave to Intervene in the above-captioned matter. AT&T was allowed to
8 intervene and participate in this docket.

9 On January 6, 1998, MCI Telecommunications Corporation and MCImetro Access
10 Transmission Services, Inc. ("MCI") filed its Application for Leave to Intervene. On January 16,
11 1998, U S WEST filed its Response in Opposition to the intervention. On January 26, 1998, MCI
12 filed its Notice of Withdrawal of Application for Leave to Intervene.

13 On January 15, 1998, the Residential Utility Consumer Office ("RUCO") filed its Application
14 to Intervene and Request for Procedural Order, which was granted by Procedural Order issued
15 February 23, 1998.

16 On May 26, 1998, the Commission issued Decision No. 60928, which granted US WEST's
17 request for a waiver of A.A.C. R14-2-102(C)(1), and directed US WEST to file a rate application
18 within 60 days of the effective date of a Commission Order in this docket.¹

19 On May 27, 1998, a Procedural Order was issued establishing a hearing commencing on
20 September 2, 1998, discovery deadlines, and other procedural matters.

21 On June 18, 1998, intervention was granted to the United States Department of Defense and
22 All Other Federal Executive Agencies ("DOD/FEA"), Cox Arizona Telecom, Inc., ("Cox"), e-spire™
23 Communications, Inc. ("e-spire™"), and Arizona Payphone Association ("APA").

24 During the August 28, 1998 pre-hearing conference, U S WEST and Staff requested a
25 continuance of the hearing date for the purpose of discussing settlement. That request and several
26 other requests for continuances were granted.

27
28 ¹ Subsequently, US WEST agreed to file its rate application in January, 1999. The application was submitted for
sufficiency review on January 8, 1999.

1 On October 14, 1998, the Commission's Utilities Division Staff ("Staff") and US WEST filed
2 their Settlement Agreement ("Settlement Agreement") with the Commission. The hearing on the
3 Settlement Agreement was held before a duly authorized Hearing Officer on November 12 and 13,
4 1998. The parties submitted Briefs on December 10 and 11, 1998.

5 DISCUSSION

6 In its Application, US WEST requested changes in its depreciation rates and also requested a
7 three-year amortization of what it termed "the \$236M intrastate depreciation reserve deficiency in
8 Arizona." U S WEST defines a reserve deficiency to be the "difference between the amount of
9 accumulated depreciation actually recorded on the Company's books and the amount that should
10 have been recorded if current estimated lives had been the basis for depreciation entries all along."
11 US WEST requested that it be allowed to accelerate the amortization of its reserve deficiency rather
12 than spreading it out over the remaining lives of its assets, hence, the term "reserve deficiency
13 amortization" ("RDA").

14 Prior to the Settlement Agreement, Staff proposed depreciation rates which would have
15 decreased annual depreciation expense by about \$22.5 million. RUCO proposed two options, one
16 that would allow amortization of a reserve deficiency and reduce annual depreciation by about \$5
17 million, and the other option was to not allow any amortization and increase annual depreciation
18 expense by approximately \$5 million.

19 The Settlement Agreement would result in a total annual increase in depreciation expense of
20 \$59 million. The terms of the Settlement Agreement are as follows:

- 21 • Staff and U S WEST agree to depreciation rates to be applied to intrastate plant investment for the
22 test year ("TY") in U S WEST's rate case. Such rates would increase the overall annual
23 depreciation expense by approximately \$17 million.
- 24 • Additionally, through a three year surcharge that is subject to true-up, U S WEST would recover
25 approximately \$42 million annually of net book investment in equipment contained in Account
26 2423. The investment to be amortized and recovered on an accelerated basis would be designated
27 from the crossbox and distribution and feeder cable portions of the account.

- 1 • U S WEST would remove the total net book value of \$126 million of investment to be amortized
2 from account 2423 and transfer it to a deferred debit account. The \$126 million would be
3 amortized in equal amounts annually over the three-year periods.
- 4 • The \$126 million would not be included in rate base in the pending rate application, or any future
5 rate case. However, U S WEST would be entitled to a return on the \$126 million investment
6 equivalent to the Company's average embedded cost of debt resulting from the pending rate case.
- 7 • U S WEST would reinvest \$126 million in upgraded plant and equipment to enhance the quality
8 of service in accordance with plans to be reviewed and approved by Commission Staff, including
9 accelerating the replacement of all existing analog switches with digital switches. The
10 accelerated replacement of analog switches and crossboxes would take place over the next three
11 consecutive years, and the accelerated replacement of defective feeder and distribution cable
12 would begin at the time the surcharge takes effect and continue for three consecutive years.
- 13 • A plan for each year of the three-year reinvestment periods would be provided to Commission
14 Staff for its prior review and approval.
- 15 • The changes in depreciation expense and the amortizations collected through the surcharge would
16 be reflected as pro forma adjustments to US WEST's income statement.
- 17 • US WEST would file reports demonstrating that it has complied with the accelerated replacement
18 schedules, and reporting year-end balances on an intrastate basis of its depreciation accounts,
19 evidencing the overall impact of the depreciation.
- 20 • The recovery of the surcharge amounts resulting from the accelerated amortization and applicable
21 carrying charges would commence upon implementation of the rates resulting from the Order in
22 the rate case.

23 RUCO argued that the Settlement is against the public interest and recommended that the
24 Commission reject the Settlement and fold the depreciation issue into the U S WEST rate case.
25 RUCO believes that the Settlement goes beyond resolution of the depreciation issue to excuse U S
26 WEST's failure to make timely investments necessary to meet its public service obligation, and that
27 U S WEST is being offered millions of dollars as an incentive to make the investment it was already
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1 obligated to make as a condition of its status as a public service corporation: maintain and improve
2 its service to customers.

3 RUCO further argued that U S WEST and Staff did not establish that the Settlement is in the
4 public interest for the following reasons: Staff did not examine U S WEST's historical depreciation
5 rates; U S WEST and Staff have not performed a cost-benefit analysis to determine whether the
6 investment is economical and will provide real benefits to the consumers in Arizona; Staff did not
7 evaluate the existing quality of service tariff to determine whether the complaints Staff is attempting
8 to mitigate are addressed in the tariff; the new replacement switch schedule causes harm by adversely
9 affecting certain low-income areas with substantial non-white populations; the investment to replace
10 crossboxes and cable will not eradicate consumer complaints because U S WEST could not estimate
11 the percentage of defective cable nor how much of the defective plant is feeder versus distribution,
12 and did not know how much defective cable the \$90 million would replace and further, U S WEST
13 may focus its replacements on feeder cable in areas that are subject to competition, to the detriment of
14 customers whose problems relate to distribution cable; U S WEST has shifted jurisdictional costs
15 from interstate to Arizona intrastate rate; U S WEST may use approval of the Settlement Agreement
16 as a shield against its quality of service problems; and the depreciation rates are too high and will
17 result in an incorrect increase in annual depreciation expense.

18 RUCO recommended that the Commission reject the Settlement Agreement and move the
19 depreciation issue into the rate case, and ultimately adopt RUCO's position that depreciation rates
20 should increase by no more than \$4.7 million based upon RUCO's depreciation rates without an
21 amortization component.

22 The DOD/FEA opposed the Settlement Agreement. The DOD/FEA believed that the
23 proposed amortization/surcharge mechanism would require ratepayers to fully reimburse US WEST
24 over the next three years for plant that will be used for many years in the future. This inter-
25 generational imbalance is compounded by two possibilities: the appropriate allocation of plant
26 between regulated telephone services and nonregulated services (such as cable television) may
27 change over time, resulting in current ratepayers fully paying for plant which will be used to provide
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1 nonregulated services in the future; and secondly, if current telephone ratepayers have fully paid for
2 plant which will be used to provide services in the future, U S WEST will be provided with an unfair
3 competitive advantage, which could be used to reap excessive earnings or to underprice its
4 competitors, and thereby distort the marketplace. The DOD/FEA recommended that the
5 Commission prescribe depreciation rates derived from parameters currently prescribed for U S
6 WEST in Arizona by the Federal Communications Commission because they are forward looking
7 and the lives underlying the rates in the Settlement Agreement are based upon studies sponsored by
8 an industry association of major local exchange companies and are too short.

9 AT&T joined the DOD/FEA Brief and urged the Commission to reject the Settlement
10 Agreement.

11 Cox and e-spire™ opposed the Settlement Agreement. They argued that approval of the \$126
12 million surcharge to be assessed to U S WEST's retail ratepayers constitutes retroactive ratemaking
13 and would violate Scates; that the alleged public benefit underlying the Settlement Agreement of
14 improving U S WEST's service simply duplicates incentives already in place in the Service Quality
15 Plan Tariff; and that changes in the depreciation rates should be considered in the U S WEST rate
16 case.

17 Given that the majority of the parties opposed the Settlement Agreement and requested a full
18 public hearing; the lack of public notice to US WEST's customers concerning the \$126 million
19 surcharge; that no cost/benefit analysis of the terms of the Settlement Agreement has been made and
20 Staff and the Company were unable to quantify the amount of feeder and distribution cable that
21 would be replaced or quantify how service would improve; that Staff did not consider the existing
22 Service Quality Plan Tariff nor the impact of the Settlement Agreement on the Commission's
23 approach or ability to monitor and enforce the Tariff or previous Decisions; the fact that competitive
24 uses of US WEST's intrastate plant investment were not considered and no separation studies were
25 reviewed; and the conflicting testimony as to whether the Settlement Agreement in essence adopts an
26 RDA which may violate the Scates Decision and result in inter-generational inequities; we conclude
27 that the Settlement Agreement should not be approved at this time, and that the depreciation issue
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1 should be consolidated with the pending rate application.

2 Although we granted U S WEST's requested waiver in Decision No. 60928, in order to allow
3 examination of depreciation rates in a timely manner outside of a rate case, this Settlement
4 Agreement goes beyond just the depreciation issue and also raises notice and due process concerns.
5 Further, the settlement negotiations prolonged the process and delayed the hearing, making the
6 depreciation docket overlap with the rate application. Consolidation would have no detrimental
7 financial impact upon U S WEST, as the Settlement Agreement did not (and could not) implement
8 any rate changes to take effect prior to the final Order in the rate case. We believe that the issue of
9 depreciation is important, and deserves a full public hearing where all interested parties can present
10 their positions for our consideration. Accordingly, we will consolidate this depreciation docket with
11 U S WEST's pending rate application.

12 * * * * *

13 Having considered the entire record herein and being fully advised in the premises, the
14 Commission finds, concludes, and orders that:

15 **FINDINGS OF FACT**

16 1. On October 10, 1995, U S WEST submitted an Application for Changes in its
17 Depreciation Rates, and on December 8, 1997, the Application was docketed with the Commission's
18 Docket Control. On November 12, 1997, U S WEST submitted its Supplement to Application, which
19 was docketed on December 8, 1997.

20 2. AT&T, RUCO, DOD/FEA, Cox, e-spire™, and the APA were granted intervention in
21 this docket.

22 3. On May 26, 1998, the Commission issued Decision No. 60928, which granted U S
23 WEST's request for a waiver of A.A.C. R14-2-102(C)(1), and directed US WEST to file a rate
24 application within 60 days of the effective date of a Commission Order in this docket.

25 4. On May 27, 1998, a Procedural Order was issued establishing a hearing commencing
26 on September 2, 1998, discovery deadlines, and other procedural matters.

27 5. During the August 28, 1998 pre-hearing conference, U S WEST and Staff requested a
28

1 continuance of the hearing date for the purpose of discussing settlement. That request and several
2 other requests for continuances were granted.

3 6. On October 14, 1998, Staff and U S WEST filed their Settlement Agreement with the
4 Commission. The hearing on the Settlement Agreement was held on November 12 & 13, 1998, and
5 the parties submitted Briefs on December 10 and 11, 1998.

6 7. The Settlement Agreement proposed: new depreciation rates; a new schedule to
7 replace analog switches for digital switches; and a three year surcharge to accelerate the replacement
8 and upgrade of obsolete and defective plant.

9 8. In testimony filed prior to the Settlement Agreement, Staff proposed depreciation rates
10 which would have decreased depreciation expense by about \$22.5 million. RUCO proposed two
11 options, one that would allow amortization of a reserve deficiency and reduce annual depreciation by
12 approximately \$5 million, and the other option was to not allow any amortization and increase annual
13 depreciation expense by approximately \$5 million.

14 9. RUCO, DOD/FEA, AT&T, Cox, e-spire™, and the APA opposed the Settlement
15 Agreement.

16 10. No cost/benefit analysis of the terms of the Settlement Agreement has been made and
17 Staff and the Company were unable to quantify the amount of feeder and distribution cable that
18 would be replaced.

19 11. Staff did not consider the existing Service Quality Plan Tariff nor the impact of the
20 Settlement Agreement on the Commission's approach or ability to monitor and enforce the Tariff or
21 previous Decisions.

22 12. In determining the appropriate depreciation lives, the competitive uses of U S WEST's
23 intrastate plant investment were not considered, and no separation studies were reviewed.

24 13. Although not expressly stated as such in the Settlement Agreement, the testimony at
25 hearing established that the Settlement Agreement in essence adopts an RDA which may violate the
26 Scates Decision and result in inter-generational inequities.

1 14. U S WEST's customers have not been provided notice of the proposed \$126 million
2 surcharge and other terms included in the Settlement Agreement.

3 15. U S WEST's depreciation rates were last adjusted in 1991.

4 16. Significant changes have occurred in the telecommunications industry during the last
5 decade.

6 17. Determination of the appropriate depreciation lives is an important issue in
7 establishing just and reasonable rates, and testimony on that issue from all parties should be
8 considered after proper notice and a full public hearing.

9 **CONCLUSIONS OF LAW**

10 1. U S WEST is a public service corporation within the meaning of Article XV of the
11 Arizona Constitution and A.R.S. §§ 40-250 and 40-251.

12 2. The Commission has jurisdiction over U S WEST and the subject matter of the
13 application.

14 3. The evidence and testimony presented by U S WEST and Staff failed to establish that
15 the Settlement Agreement is just and reasonable and would promote the public interest.

16 4. The Settlement Agreement should not be approved.

17 5. This depreciation docket should be consolidated with U S WEST's pending rate
18 application.

19 **ORDER**

20 IT IS THEREFORE ORDERED that the Settlement Agreement between the Commission's
21 Staff and U S WEST Communications, Inc. is hereby disapproved.

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1 IT IS FURTHER ORDERED that this docket shall be consolidated with U S WEST
2 Communications, Inc.'s pending rate application.

3 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

4 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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7 COMMISSIONER-CHAIRMAN

COMMISSIONER

COMMISSIONER

8
9 IN WITNESS WHEREOF, I, STUART R. BRACKNEY,
10 Acting Executive Secretary of the Arizona Corporation
11 Commission, have hereunto set my hand and caused the official
12 seal of the Commission to be affixed at the Capitol, in the City
13 of Phoenix, this _____ day of _____, 1999.

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15 _____
16 STUART R. BRACKNEY
17 ACTING EXECUTIVE SECRETARY

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