

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

12-90

In re the application of Southwestern Bell Telephone Company)
for approval of depreciation rates and amortization.) Case No. TO-90-98
)

APPEARANCES: Katherine C. Swaller and Paula J. Fulks, Attorneys, Southwestern Bell Telephone Company, 100 North Tucker Boulevard, Room 630, St. Louis, Missouri 63101-1976, for Southwestern Bell Telephone Company.

Carl J. Lumley, Curtis, Oetting, Brackman & Crossen, P.C., 130 South Bemiston Avenue, Suite 200, Clayton, Missouri 63105, for MCI Telecommunications Corporation.

Janet L. Sievert, Assistant Public Counsel, Office of Public Counsel, Post Office Box 7800, Jefferson City, Missouri 65102, for the Office of Public Counsel and the public.

Linda K. Gardner, Deputy General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the staff of the Missouri Public Service Commission.

REPORT AND ORDER

On November 6, 1989, Southwestern Bell Telephone Company (SWB) filed an application requesting the Commission approve proposed depreciation rates and amortization for intrastate operations. On December 28, 1989, the Office of Public Counsel filed a request for hearing. The Commission granted the motion on January 12, 1990 and established a procedural schedule. By order issued January 30, 1990, the Commission granted MCI Telecommunications Corporation (MCI) intervention in this proceeding.

A hearing was held in this matter on August 20, 1990. Briefs were filed and a motion to strike a portion of SWB's reply brief was filed by Public Counsel. SWB filed a response to Public Counsel's motion. In addition, SWB has requested the opportunity for oral argument. Staff also moved to strike a portion of SWB's initial brief.

Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact.

A regulated public utility such as SWB is authorized, as part of its operating expenses, to recover in rates costs associated with the depreciation of its facilities. The costs to be recovered in rates are developed for each category of depreciable plant, utilizing life expectancy information, observed and graduated life tables, statistics regarding salvage and cost of removal, as well as other historical information and future plans which may influence the life of the plant. A depreciation study is then performed for each category of plant in which parameters and depreciation rates based upon those parameters are developed. Parameters include projected lives, curve lines, salvage and cost of removal.

The depreciation rates are then used to calculate the amount of depreciation expense to be recovered and thus the revenue requirement to be collected through customer rates. Depreciation parameters for SWB have historically been established at meetings between the Federal Communications Commission (FCC), SWB, and state commissions, including Missouri. These meetings have occurred every three years since 1951 and are referred to as "three-way meetings". The process of developing new depreciation parameters at a three-way meeting is called *re prescription*.

Prior to 1986, the three-way meetings would establish depreciation rates for interstate purposes which would then be adopted for intrastate purposes based upon the FCC's preemption in this area. In 1986 the U.S. Supreme Court held that the FCC did not have the authority to preempt the states from establishing depreciation rates for intrastate purposes. *Louisiana Public Service Commission v. FCC*, 476 U.S. 355 (1986). The 1986 three-way meeting between SWB, FCC and the states, including Missouri Commission staff (Staff) had occurred prior to the *Louisiana* decision. The three-way rates established at the 1986 three-way meeting were implemented by this

Commission in Case No. TR-86-84. Re: *Southwestern Bell Telephone Company*,
28 Mo. P.S.C. (N.S.) 510, 514 (1986).

The 1989 three-way meeting was held in early June 1989. As a result of that meeting depreciation rates were established for all categories of SWB's plant. Two sets of parameters were developed for Step-By-Step and Cross Bar accounts to allow for the Commission's decision concerning SWB's modernization program then being decided in Cases No. TC-89-14, et al. Re: *Staff v. Southwestern Bell Telephone Company, et al.*, 29 Mo. P.S.C. (N.S.) 605 (1989). The Report And Order was issued in TC-89-14 et al. on June 20, 1989. SWB filed for approval of the depreciation rates established at the three-way meeting in November 1989.

The development of depreciation parameters and the resulting depreciation rates is an arcane and intricate process. The focus of the dispute in this case, though, is not the parameters or rates developed at the three-way meeting but whether it is appropriate to adopt these new depreciation rates for SWB in this case at this time. Staff and Public Counsel are objecting to the adoption of the 1989 rates and encouraging the Commission to exercise its authority to reject these depreciation rates. Staff proposes two alternatives if the Commission determines it should adopt the rates. The first alternative is that the Commission adopt the annual depreciation accrual rates in Exhibit 6, Schedule 1, and order a corresponding reduction in customer rates. The second alternative is that the Commission adopt the annual accrual depreciation rates in Exhibit 6, Schedule 1, and order SWB to book the difference between currently prescribed rates and the new rates to the depreciation reserve.

SWB has basically one theme upon which it rests its evidence and arguments. The theme is that, historically, the depreciation rates established at the three-way meetings have been adopted by this Commission; that the 1989 three-way rates reflect the proper parameters for depreciation of SWB's intrastate facilities; and that the rates provide adequate recovery of property used to provide service. SWB also asserts that Staff participated in the 1989 three-way meetings; that Staff was

influential in developing the depreciation rates established; and that Staff should not now be allowed to object to the rates agreed to at the meeting. SWB presented evidence that Staff entered the negotiations at the three-way meeting with no reservations based upon the *Louisiana* decision. Staff's representative at the meeting, John O. Richey, was influential in substantially altering SWB's proposal and, in fact, depreciation rates closer to Richey's proposals were established. Richey subsequently sent a memorandum to his supervisor at the Commission indicating that the three-way meeting had established depreciation rates which would reduce SWB's depreciation expense \$15,268,000 annually and that the rates had been established for the period 1990-1992. SWB also cites the Commission's Report And Order in TC-89-14 et al. to support its position. The Commission in that Report And Order stated:

Staff is recommending its depreciation rates be established and made effective the same time as the Report And Order in this case. This would leave approximately six months for the depreciation rates to be in effect until new depreciation rates are set in the three-way meeting held this year. . . . The Commission believes the three-way process should be utilized to attempt to reach agreement between interstate and intrastate rates. Re: SWB, 29 Mo. P.S.C. (N.S.) at 647. (The Commission adopted Staff's depreciation rates in its Report And Order in Cases No. TC-89-14 et al.)

SWB argues that Staff agreed to the new rates and if allowed to renege on that agreement, the three-way meetings are essentially finished as a vehicle for attempting to establish similar rates for interstate and intrastate purposes.

Staff and Public Counsel both oppose the adoption of the new rates. Staff's position is basically that subsequent to the three-way meeting and after the Report And Order in TC-89-14 et al., the Commission and SWB entered into a settlement agreement on September 25, 1989 which substantially changed the circumstances under which the three-way agreement was negotiated. Staff contends that the settlement was entered into based upon the current higher depreciation expense levels, and the lower levels established at the three-way meeting will allow SWB to retain a substantial portion of earnings under the sharing grid established in the settlement agreement.

Staff asserts further that the settlement agreement was not anticipated during the negotiations at the three-way meeting and all participants assumed SWB would continue under traditional rate of return regulation.

Public Counsel opposes the adoption of the proposed depreciation rates on two grounds. First, Public Counsel contends that adoption of the rates outside of a general rate case proceeding violates the prohibition against single issue ratemaking. *State ex rel. Utility Consumers Council of Missouri, et al., v. PSC*, 585 S.W.2d 41 (Mo. banc 1979). Second, Public Counsel asserts that the adoption of the proposed depreciation rates would increase shareholders' earnings at the expense of rate-payers.

There were many hyperbolic and vitriolic assertions made by parties against other parties in this matter. These assertions revolve mainly around whether Staff can, in good faith, oppose the results of the three-way agreement when it had a significant influence on those results, and whether SWB acted in good faith during the settlement negotiations with the Commission when SWB knew that the 1989 three-way depreciation rates would result in a lower revenue requirement than that ordered by the Commission in TC-89-14 et al.

The Commission does not view the issue in this case in this manner. The Commission assumes all parties acted in what they considered their best interests concerning the three-way process and the settlement agreement. The issue to be considered by the Commission in this case is whether SWB should be allowed to implement the new depreciation rates established in the 1989 three-way meeting. In other words, are these the proper depreciation rates for SWB at this time?

The Commission does not feel any obligation to either adopt the 1989 three-way depreciation rates or to not adopt them. Since the decision in the *Louisiana* case, the Commission now has the jurisdiction to review depreciation rates on a case-by-case basis to determine whether those rates established at a three-way meeting should be adopted for Missouri operations. Any proper person, such as Public Counsel, may oppose the adoption of new depreciation rates and thus require the

Commission to conduct a hearing on the matter. The Commission is now required to exercise its discretion on what depreciation rates are proper.

The depreciation rates proposed by SWB in this proceeding are an historical anomaly. These rates are the first depreciation rates since 1951 which reduce depreciation expense. SWB has always proposed depreciation rates calculated using shorter lives and faster depreciation, which would increase depreciation expense. In the 1989 three-way meetings SWB proposed depreciation rates which would have resulted in a \$71 million increase in depreciation expense. The rates established and agreed to by SWB reduced depreciation expense by approximately \$16 million below the rates approved in TC-89-14 et al.

The decision in TC-89-14 et al. was appealed by SWB, as well as other parties. The Commission on September 25, 1989, entered into a settlement agreement which, among other conditions, provided for an experimental incentive regulation plan for SWB. The incentive regulation plan provides for a sharing of revenues above a certain return on equity. The Commission agreed to the incentive regulation plan as part of the settlement to allow SWB to benefit from efficiencies and cost-saving measures which would reduce the overall costs of providing service to Missouri customers, and from the potential growth in earnings resulting from modernization of SWB's network.

Monitoring procedures were established as part of the incentive regulation plan. Paragraph 2.b. of the monitoring procedures states that the depreciation expense as established in TC-89-14 et al. would be used for calculating SWB's net earnings, although new depreciation rates could be proposed. Paragraph 2.b. provides further that if new depreciation rates are approved by the Commission, the expense associated by the new rates would be used in calculating net earnings for the incentive regulation plan. Based upon these provisions of the monitoring plan, SWB could request the Commission adopt the new depreciation rates established at the 1989 three-way meeting. There is no requirement, though, that the Commission approve any proposed depreciation rates.

The Commission finds that it would not be proper or appropriate to implement new depreciation rates during the period of the current incentive regulation plan. This plan is an experiment and the first approved by this Commission. Telecommunications companies, especially SWB, have been proposing new methods of regulation to allow more flexibility in pricing and an opportunity to retain a share of revenue generated by more efficient operations and growth. The Commission agreed, as part of the settlement in TC-89-14 et al., to establish an incentive regulation plan for SWB to see whether the increased flexibility and potential for earnings retention would stimulate efficiencies in SWB's operations. The Commission finds that a decision on depreciation rates is not an efficiency in operations and the approval of the proposed rates would distort the results of the experiment.

Increased earnings caused by a reduction in depreciation expense are not the result of efficiencies or growth. Even if sharing did occur, it would not indicate the success of the experiment since the sharing would have been generated by a manipulation of current expenses rather than cost savings in SWB's operations. Potentially, the Commission will be asked to continue the incentive plan on a permanent basis after 1992. To be able to evaluate the success of the plan, there should be no manipulation of earnings as this would occasion.

In addition, under current conditions technological advances and modernization of SWB's network indicate that depreciation rates should increase or remain constant, not decrease. The Commission cannot approve of rates which are contrary to these conditions. The FCC may find the new rates appropriate but the Commission finds no basis for a decrease in depreciation rates under current circumstances. The continuation of the TC-89-14 et al. rates will be more consistent with the Commission's view of the retirement of SWB plant. Maintaining the 1986 parameters is clearly superior to adopting parameters which are contrary to the historical pressure to increase depreciation rates.

Additionally, if depreciation rates are reduced in this instance, the next parameters established will not only have to adjust for three years of technological

advances but very probably account for the reduction proposed here. The pressure for an abnormally large increase in depreciation expense in any future proceeding will mount, and any sharing that might occur under the incentive plan would not offset those increases. There is also the consideration that the reduction in depreciation expense will not trigger sharing under the incentive plan. This would mean rate-payers would see no benefit from the decrease in expense and would potentially have to pay for that decrease in expense in future rates.

Since the Commission will reject SWB's proposed depreciation rates, Staff's alternatives will not be addressed.

Staff moves the Commission strike Appendix B to SWB's initial brief. Staff asserts that the newspaper articles in Appendix B are extrarecord and hearsay. The Commission has considered Staff's motion and will deny the motion. Reliance on newspaper articles carries little if any weight in reaching a decision in a case before the Commission. If a party, though, wishes to base its arguments on such insubstantial support, the Commission will not deny the party that opportunity.

Public Counsel moves to strike portions of SWB's reply brief on page 6 and page 17. Public Counsel asserts that SWB attributes statements on these pages to Public Counsel witness Trippensee which Trippensee did not make. The Commission has considered Public Counsel's motion and will deny the motion. SWB has indicated in its response that it did not intend to mischaracterize Public Counsel's witness's testimony. Public Counsel has made the Commission aware of the discrepancy and that is sufficient.

The Commission will also deny SWB's request for oral argument. The briefs filed provided the Commission with the positions of the parties. Additional argument would only be repetitive.

Conclusions of Law

The Missouri Public Service Commission has arrived at the following conclusions of law.

The Commission has jurisdiction over the depreciation rates of a public telephone utility pursuant to the provisions of Chapter 392, R.S.Mo. (Cum. Supp. 1989), and specifically, 392.280, R.S.Mo. (Cum. Supp. 1989). Depreciation rates, and therefore depreciation expense, is a factor in determining a utility's revenue requirement for developing customer rates. Section 392.280 requires the Commission to set proper and adequate depreciation rates for SWB.

Public Counsel has raised the issue that adoption of depreciation rates in a proceeding separate from a general rate case violates the prohibition against single issue ratemaking. *State ex rel. Utility Consumers Council of Missouri, et al., v. PSC*, 585 S.W.2d 41 (Mo. banc 1979). The Commission need not reach this issue since it has found that the depreciation rates will not be adopted.

Prior to 1986 the Commission arguably had no discretion concerning the adoption of depreciation rates established for the FCC at the three-way rescription meetings. The FCC had purported to preempt state commissions from establishing separate rates for intrastate purposes. The U.S. Supreme Court ruled in 1986 that the FCC did not have authority to preempt state commissions from establishing different depreciation rates for intrastate purposes. *Louisiana* at 355.

This Commission therefore has clear authority to accept or reject depreciation rates established at the 1989 three-way meeting. In fact, intrastate depreciation rates for SWB in Missouri are currently different from interstate rates because of the treatment of the hypothetical revenue deficiency in TC-89-14 et al. The Commission has exercised its discretion in this case to reject the depreciation rates established at the three-way meeting. The Commission rejected the rates as inconsistent with the incentive plan agreed to in the settlement in TC-89-14 et al. The Commission concludes that the depreciation rates currently in effect should remain in effect throughout the three-year incentive regulation experiment. This will enable the Commission to evaluate whether sharing revenue encourages more efficient operation of SWB's system. The Commission concludes that the current rates are the proper

and adequate rates for SWB as required by Section 392.280. These rates more accurately reflect the current utilization of SWB's facilities.

IT IS THEREFORE ORDERED:

1. That the depreciation rates proposed by Southwestern Bell Telephone Company in this case be hereby rejected.
2. That this Report And Order shall become effective on the 18th day of December, 1990.

BY THE COMMISSION

Brent Stewart

Brent Stewart
Interim Executive Secretary

(S E A L)

Steinmeier, Chm., Mueller, Rauch,
McClure and Letsch-Roderique, CC.,
concur.

Dated at Jefferson City, Missouri,
on this 5th day of December, 1990.