BOC Depreciation Issues in the States

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BOC Depreciation Issues In the States

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I would like to thank NASUCA for inviting me. The subject of my discussion is BOC Depreciation. I have been involved in several BOC Depreciation proceedings over the past six to seven years. My comments today reflect that experience, however, the primary basis of these comments is a recent Southern Bell of Florida case. That case covered just about all the BOC Depreciation issues of which I am aware. Furthermore, Southern Bell's motivations are no different than any other BOC. Therefore, the information obtained in the Florida case is relevant for all other BOC'S.

The primary issue is money. One BOC Depreciation expert aptly stated - depreciation is money - it is green pieces of paper with pictures of presidents on it. **Where will the money go? It appears that if the BOC'S have their way - it will flow from ratepayers into the companies in the form of regulated rates and from there to shareholders in the form of unregulated profits.**

During the 1980's, most BOC's switched from whole-life to remaining life depreciation; adopted equal life group depreciation, obtained depreciation lives much shorter than are indicated by statistical life analyses, and amortized reserve deficiencies on an accelerated basis (commonly referred to as RDA). Each one of these changes produced higher depreciation expenses. In turn, many BOC's service rates were increased to accommodate the higher depreciation charges. As often, the BOC's avoided reductions that would otherwise have been ordered.

Notwithstanding, the propriety or impropriety of any of these changes, from the ratepayer's standpoint, it was generally assumed that RDA would be the end of the BOC's major depreciation expense increases. A depreciation reserve deficiency is the difference between a so-called theoretical depreciation reserve and the actual book reserve. Theoretical reserves calculated by the BOC's reflected the much shorter lives and equal life group procedures approved in the 1980's and a result were substantially higher than the actual book reserves.

The difference was allowed to be amortized by the FCC over five years and by many state PUC's over periods ranging from three to five years. As indicated, since the RDA's reflected the shorter lives and accelerated procedures, it was reasonable to assume that once the amortization was completed - depreciation expense would decline substantially. It was also reasonable to assume that rates for service would decline correspondingly especially in light of declining unit costs produced by advanced technology.

Such has not been the case - at least not in most of the states with which in I am familiar. BOC's continue to request higher depreciation expenses. But now, they usually attempt to sell the request as package deals at both the FCC level and the state legislative level through intensive lobbying efforts. Typically, the deal is that the BOC will increase its internal cash flow through higher depreciation expense without increasing rates for service and, in the mean time, make greater investments in modern plant. It should be obvious that the higher cash flow is coming from the BOC's monopoly ratepayers - under regulation.

The kicker is an implied threat and a promise. The threat is that if the deal is not accepted the state's infrastructure problems will not be solved. The promise is that if the deal is accepted, the state will singularly draw substantial business from all states and the world in general. Both the threat and the promise are fairly potent rhetoric. If the BOC's are successful, through their lobbying efforts, then the obvious result is that current ratepayers pay higher depreciation expense to the BOC's in the form of higher rates or foregone rate reductions.

PURPOSE OF DEPRECIATION

Depreciation is the process of writing off plant over its service life through non-cash charges to income. The shorter the life the higher the depreciation expense. Depreciation can produce real incremental cash flow for public utilities whose prices are set using rate base/rate of return regulation. If a public utility is allowed to increase its depreciation expense and correspondingly increase its service rates or forego a warranted rate reduction then its internal cash generation from ratepayers is increased. This fundamental arithmetic does not hold for an unregulated business in a truly competitive environment. In that situation, the market determines whether prices will allow recovery of accelerate depreciation associated with obsolete plant.

It is my opinion that a competitive market would not have allowed the RDA described above to be reflected in competitive prices. Nevertheless, it was approved in many states and produced incremental cash flow for many BOC's. As indicated, the quid pro quo was the reasonable anticipation that once completed, both depreciation and rates for service would correspondingly decline.

The BOC's intend to keep the money. In 1988 Southern Bell of Florida filed petitions to freeze local rates at pre-existing levels, reduce certain toll rates and provide a sharing mechanism for excess equity returns earned over the three years ending in 1990. The company filed a projection of its earning which purported to demonstrate it would not over-earn if its plan was approved.

The earning projections included the assumption of substantially increased depreciation expense even though it had just recently obtained substantial depreciation increases for accelerated amortization such as the RDA. These amortizations were scheduled to cease in 1989 and 1990. The sole purpose of the increased depreciation in the Company's earnings projections was to offset the cessation of these amortization schedules which would have decreased depreciation expense substantially and, in turn, would have resulted in greater service reductions. The Florida commission set aside the depreciation increases in anticipation of a depreciation study yet to be filed.

In 1989 Southern Bell filed a depreciation study which matched, almost to the dollar the money set aside by the Commission. It was evident that the underlying rationale of the study was to keep the cash set-aside by the Commission. The following statement was contained in an internal letter obtained from the Company:

...if the Company is successful in negotiating new depreciation rates/amortization sufficient to cover these amounts, it can keep the cash flow as capital recovery. Otherwise, the Commission will return the unsubstantiated portion of these amounts to ratepayers.

Clearly, the impetus was to keep the cash flow rather than return it to ratepayers. I would like to state that in my opinion this was an understandable desire from the Company's standpoint, however, it was undesirable from the standpoint of its monopoly ratepayers. This is one reason why we regulated monopoly prices.

THE STUDY

There are several parameters involved in a traditional depreciation study: Service lives (as indicated earlier), retirement dispersion curves, net salvage ratios, methods, procedures and techniques. Each of these was subject to challenge in Southern Bell's study. However, it was clear upon reading the narrative discussions in the study and other information obtained from the Company that the primary focus was a substantial depreciation and amortization increase resulting from shorter lives as a direct result of an early change-out of plant (network modernization) in anticipation of a broadband integrated services digital network - BISDN.

BISDN

Hear are but a few of the comments contained in Southern Bell's study.

- The next decade information age and intelligence network requirements will rapidly accelerate not only the demise of present analog switches but even existing digital switches that can not evolve to the next general broadband integrated services digital network (BISDN) switch.
- Delivery of high capacity services will require a well planned network with uniform bandwidth capabilities. Completion of the SONET specifications provides the direction of cohesiveness necessary to create compatible equipment required for the future optical network, BISDN.
- Technically, a SONET network is a digital, fiber-optic network whose capabilities far eclipse today's network.
- A 'Pipeline' for HDTV (and all other information services). That new pipeline is fiber-optic.

The study was replete with references to the tremendous future revenues from HDTV and other entertainment service available from BISDN. In fact, the Company acknowledge that "the stage is being set today fro the battleground of the 1990's," with its major opponent being the cable television industry. It is important to note that the battle is for future, highly profitable, revenues (primarily cable TV revenues) and that the anticipation of those revenues is the primary reason for shorter lives of today's plant. It is going to take a substantial investment to purchase the equipment and technology to produce the future revenues. The cheapest source of financing is, of course, cost free cash flow from ratepayers.

At least one person representing Southern Bell anticipated in an internal memorandum that by the time the future revenue streams begin, rate of return regulation will not exist, and that the Company will be able to keep the higher profits despite the low level of incremental cost required to provide the service.

Of course, there will be a low level of future incremental cost to provide BISDN services if a majority of the primary incremental cost, i.e., the initial investment, has been paid for by cash flow derived from substantially increased depreciation and amortization associated with the early charge-out of existing plant.

The important point is that the company itself through internal correspondence provided the linkage between higher depreciation charges today - under regulation - and the retention of the resulting future profits in an unregulated environment. Therefore, notwithstanding the implied threat and promise, I concluded that its request for higher cash flow now was directly attributable to the anticipated future BSIDN revenues. Were it not for the anticipation of those revenues, it is unlikely that lives would be further shortened today relative to the various changes that already took place during the 1980's.

This relationship invoked several accounting, economic, and regulatory concepts. For example, the concepts of matching revenues with cost, cost causation, and incremental costing. Logically each of these concepts would require the matching of higher depreciation expense with the anticipated revenues causing the higher depreciation expense.

OBSTACLES

Logical as they are, however the deck is stacked against consumer advocates and the monopoly ratepayers they represent. The obstacles include but are not limited to:

- Heavy lobbying efforts by the BOC's;
- Complex depreciation studies which, in the final analyses the BOC's essentially disavow;
- Arcane engineering jargon which obfuscates the real issues involved;
- A sense that only BOC employees understand telephone depreciation; and
- A strict adherence to dogmatic accounting rules when it is in the best interest of the BOC to do so.

Having been trained as an accountant, I consider this last obstacle to be extremely disingenuous. There is, or at least used to be, the accounting concept of “substance over form.” Substance over form would, in my opinion, require at a minimum the matching of higher depreciation charges caused by the anticipation of future new revenues with the new revenues. But you can be certain that the BOC's will revert to the accounting principle of depreciation assets over their shortened service lives notwithstanding the fact that the sole reason for the shortened service lives is the anticipation of the new future revenues.

ALTERNATIVES

What alternatives do consumer advocates have? Basically, you can either fight the higher depreciation charges or accept them. If you choose to fight, it is going to be a tough battle.

- Consumer advocates can argue that lives won't get shorter. This may work at the FCC level since they have already been shortened drastically. The BOC's will undoubtedly accuse you of being a dinosaur with absolutely no vision of the future.
- Consumer advocates could argue that the purpose of the BOC's activities is to put the cable television industry out of business at the expense of current monopoly ratepayers. But then you will be accused of striking and unholy alliance.
- Consumer advocates can accept that lives will become shorter as a result of BISDN but argue that the cost of the shorter life ought to be charges to the people who benefit from the BISDN services. Therefore, a mechanism must established to match the cost to these future, probably unregulated, services.

In Florida, I proposed the first and third alternatives, while the cable television industry pursued the second alternative independently. Unfortunately, it appears that the only party to whom the Commission listed was the Company.

We filed a traditional depreciation study which examined all lives, curves, salvage values, etc., but did not accept the added life shortening effect of anticipated BISDN services. Most of the lives in the traditional study were shorter than history would indicate and yet, they resulted in an overall decrease in depreciation expense.

The alternative proposal accepted all of the Company's lives and salvage values but established a BISDN correction mechanism to ensure that the higher deprecation expense would be matched to the BISDN revenues.

Here is how it was done. Each of the Company's Accounts was examined to determine if BISDN was the primary motivation for the requested service life reduction. Therese ere designated as BISDN accounts.

A BISDN depreciation reserve was calculated for each of the BISDN accounts. I have a hand-out which demonstrates how this calculation was performed. This is for the buried cable metallic account which is one of the largest on most companies' books. The current depreciation rate for this was account 5.0 percent. The Company proposed to increase the rate to 7.9 percent. On lives 8 to 11, the current 5 percent rate is held constant, and the Company's remaining life and future net salvage requests were accepted to solve for the BISDN corrected reserve. Finally, the book reserve was subtracted from the BISDN correct reserve. The difference is the BISDN correction.

The BISDN correction is the amount of additional depreciation required in the depreciation reserve to accept the lives shortened by BISDN but not increase depreciation rates. This amount should be matched to the BISDN revenues.

SUMMARY

As I stated, depreciation is money, it is the major source of cash for the BOC's. It is cost free, and comes straight from the BOC's monopoly ratepayers. Given the magnitude of the dollars involved, and the intensive BOC lobbying efforts, depreciation is a tough battle for the ratepayers to win. Apparently, in Florida the Company was the winner, but that does not change the validity of the evidence we obtained directly from the Company itself in that proceeding. That evidence proves that the BOC's intend to use cash flows from the higher depreciation charges today under regulation to finance the investment in equipment and technology to produce new, unregulated future revenue streams in the future.