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Impaired Assets (SFAS No. 121)

Before

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Hi. My name is Mike Majoros. I would like to thank NASUCA for inviting me here today, it's a pleasure to see all of you. And some of you may know – Depreciation is my life. Today's subject is (surprise) depreciation, SFAS No. 121, and as I will discuss later "earnings headroom."

Under rate base rate-of-return regulation, depreciation is a noncash expense charged to operations and in turn passed on to ratepayers. The expense is normally calculated on a straight line basis, theoretically resulting in equal annual charges which are summarized in the accumulated depreciation account – the famous *depreciation reserve*.

Consequently, as you may have heard, depreciation is a process of allocation – not valuation. SFAS No. 121, on the other hand, deals with valuation. The valuation concept involved is the unspeakable **impairment loss**. Mr. Carver did a good job of providing an overview of SFAS No. 121 so I won't go into that kind of detail. I will say however, that SFAS No. 121 is significant because it codifies the obvious. A non-regulated competitive entity faced with significant changes in the extent or manner in which an asset is used or a significant change in legal factors or business climate, would assess the asset's recoverability and write it down if warranted.

In 1995 US AIR reported a net loss of $322 million. This included a one-time noncash charge of $186.8 million to create a reserve (i.e., increase to accumulated depreciation) for aircraft no longer in use and for obsolete inventory. This was even before SFAS 121 was issued.

Is the airline industry competitive? – Yes.

Are Airline prices competitive? – Yes.

Was US AIR able to earmark that loss and charge it to its most captive customers? – No.

US AIR's prices are set by the market.

Telecommunications Industry

Now I would like to speak a little about the Telecommunications Industry. All of the RBOCs have recorded one-time extraordinary write-downs as a result of discontinuing accounting under SFAS No. 71. With one minor difference these are equivalent to SFAS No. 121 write-downs. The general reason given [by the RBOCs] was that future prices will not be sufficient to recover existing plant. Consequently these firms took the huge write-downs. They measured the write-downs 2 ways – first by using extremely short depreciation lives, and second by performing DCF studies which were used to corroborate the shorter service lives.

In 1995 my firm did a study of these [RBOC] write-downs and one thing we discovered was that in most cases following the write-downs the Companies' stock prices went up, and at a minimum there was no detrimental stock price impact. Furthermore, on the **financial book** side, after the write-down, future prospects were wonderful. First, the one-time write-downs eliminated that much expense from future earnings i.e. future earning will be higher in absolute dollar terms to the extent of the write-downs, second, they reduced equity. Consequently higher earnings applied to lower equity produces yet higher rates of return on equity. The writedoens were a good deal for shareholders and investors.

The linkage of the financial book write-down to regulated service rate is that in most cases in which I have been involved – the Company's proposed the use of vastly shorter service lives implicit in the write-downs to propose either increased service rates or at least to absorb excess earnings in order to avoid reductions to going-in prices in various alternative regulation schemes.

I have a chart which demonstrates generally what the telecommunications industry did. It is based on a recent Bell Atlantic-MD case but it is fairly typical. In that proceeding the Maryland People's Counsel proposed a local rate reduction before entering a new alternative regulation era. The Company basically needed higher depreciation expense to avoid a rate decrease.

The background is that in a 1992 rate case the Company was granted a huge depreciation expense increase. I have prepared a study demonstrating that its depreciation expense, based on actual observed events, was $70 million less than the Company's proposal and was even $40 million less than the expense based on the existing [depreciation] rate. Nevertheless, the MD PSC granted the depreciation along with a lot of other things. In 1994 the Company [Bell Atlantic] recorded a $530 million SFAS 71 write down on its external financial statements based on shorter lives and a DCF study. And in 1995 Maryland People's Counsel filed its case. The Commission has not yet issued a Decision.

The chart summarizes the depreciation issues in the case based on their impacts on depreciation reserve ratios. The red line at bottom shows the appropriate reserve level based on actual observed empirical retirements included in the Company's depreciation filing.

The green line shows the actual and projected reserve based on the depreciation rates allowed in 1992 and being charged currently to ratepayers. The black line shows the impairment loss recorded by the Company in 1994. But notice that if it weren't for the depreciation expense increase allowed in 1992 the impairment loss would have been substantially greater. It would have started at the red line rather than the green line. Also note that at the rates set in 1992, the regulated book reserve depicted by the green line eventually converges with the financial book reserve. Ratepayers will absorb all of the impairment loss at 1992 depreciation rates. The blue line represents the Company's proposal in order to avoid service rate reductions. They want to accelerate the already accelerated recovery.

Here are some interesting facts. First, the cause of the financial book write-down was anticipated competition and the provision of new broadband services. Second, when the Company prepared the DCF which underlies the write-down, it reflected not only loss of market share, but more importantly it specifically anticipated local service price reductions. These price reductions were built into the impairment loss recorded by the Company before MPC even filed its case. Finally, top officials of the Company confirmed in a very high level internal presentation that increased regulatory depreciation provided **earnings headroom**.

Increased earnings headroom means that regulatory depreciation provides additional cash from regulated operations so that competitive prices can be set as low as possible. In addition to service rate impacts, the allowance of more earnings headroom could have competitive implications as well. Commissions should consider this fact.

Referring back to the Depreciation Reserve Chart – What should be done? In my opinion two simple things should be done. First, any increased depreciation expense, beyond the green line should be charged to the competitive side of the business. This provision alone would result in a service rate reduction. Second, the rate base impact of intrastate portion of the $530 impairment loss should be assigned to the competitive side of the business. Both of these assignments are based on the concept of cost causation i.e. Competition caused them, competition should bear the cost.

But just as important compare the green line to the red line – Ratepayers already provide the Company with substantial earnings headroom and will eventually pay all of the impairment loss. Why should they be penalized with an overvalued rate base at the same time? Something doesn't smell right and I think that Commissions should be extremely cautious in allowing these types of accelerated depreciation charges in essentially monopoly service rates.

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Now I will briefly touch on what I observed in an electric depreciation study. The Company wanted a huge increase in Nuclear Depreciation and a huge decrease in T&D depreciation. Overall this netted to a small increase. The Company proposed to book the changes between rate cases giving the appearance of a benefit to ratepayers. In other words, a depreciation increase between rate cases would give the impression that the company was eating a portion of the Nuclear plant. I have another handout which is taken from the company's **1995** 10-K. The company considers its general plant to be stranded and the note provides a warning to investors that a write-down may be coming.

The most significant aspect of the Company's depreciation proposal was the significant shift from the stranded Nuclear Generation to Transmission and Distribution (T&D). The realities are that Generation apparently will be deregulated. Consequently, the Company's proposals would speed-up [accelerate] generation depreciation before deregulation and slow down T&T depreciation between rate cases. Ultimately, the carrying value of generation – passing out of regulation would be lower – but the carrying value of T&D remaining in regulation would be higher – i.e., a higher rate base. But more than that, the T&D will have a higher depreciable base when using remaining life (RL) depreciation. As I indicated, the Company warned of a potential write-down. You should watch for this type of manipulation in which the company attempts to protect itself from the write-down and assure it would be able to charge it to future monopoly customers under the guise of both a higher rate base and higher depreciation.

This leads to one final point – electric T&D lives are getting longer and I think gas and water lives are also lengthening. Furthermore, the cost of removal included in the resulting depreciation rates should be eliminated. In other words T&D depreciation rates are too high and should be reduced, but only do it when you can get the benefit reflected in service rates. I have a final handout which discusses the cost of removal issue but I won’t go into detail at this time. Anyway, thanks for listening.