Witness CCS-1
Exhibit WDA-1
Exhibit WDA-2
Exhibit WDA-3
Exhibit WDA-4
Exhibit WDA-5

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application for Increase in USF Eligibility for Uintah Basin Telecommunications Association Inc and UBET Telecom Inc	: : : : :	Docket No. 05-053-01

DIRECT TESTIMONY

OF

WILLIAM DUNKEL

ON BEHALF OF THE UTAH COMMITTEE OF CONSUMER SERVICES

SEPTEMBER 9, 2005

PUBLIC VERSION

I. INTRODUCTION AND STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is William Dunkel. My business address is 8625 Farmington Cemetery Road, Pleasant Plains, Illinois 62677.

Q. What is your present occupation?

A. I am the principal of William Dunkel and Associates, which was established in 1980. Since that time, I have provided consulting services in telephone regulatory proceedings throughout the country. I have participated in over 140 state regulatory telephone proceedings before over one-half of the state commissions in the United States. I specialize in the following areas: cost analysis; rate design; jurisdictional separations; and depreciation.

Q. Have you prepared an appendix that describes your qualifications?

A. Yes. My qualifications are shown on Appendix A.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Utah Committee of Consumer Services (CCS).

Q. Have you previously participated in telecommunications proceedings in Utah?

A. Yes. I have participated on behalf of the CCS in many of Qwest's (previously U.S. West Communications or Mountain Bell Telephone Company) proceedings in Utah. I testified on behalf of the CCS in Qwest's petition proceedings for Pricing Flexibility in Utah (Docket No. 03-049-49 (residential services), Docket Nos. 01-2383-01 (residential services) and 02-049-82 (business services)). In addition, I was involved in six Qwest (or its predecessor) general rate cases, Docket Numbers: 84-049-01; 88-049-07; 90-049-06/90-049-03; 92-049-07; 95-049-05; 97-049-08. I was also involved in the Qwest 800 Services case, Docket No. 90-049-05.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the Application of Uintah Basin Telecommunications Association, Inc. (UBTA) and UBET Telecom (UBET and collectively UBTA-UBET or the Company), Inc. for an increase in USF eligibility.

II. THE ACQUISITION PREMIUM

Q. Can you briefly summarize the main issue that you will address in this section?

A. Yes. During the purchase of Qwest's exchanges in April 2001, UBTA signed two documents in which it agreed not to recover the acquisition premium from regulated rates or from the State or Federal Universal Service Fund (USF). However, in this proceeding, UBTA is attempting to recover the acquisition premium from the Utah USF, and its reasons for doing so are neither convincing nor appropriate as will be discussed below.

Q. Which documents are you referring to?

A. I am referring to the Agreement for Purchase and Sale of Telephone Exchanges between UBTA and U S West Communications dated October 22, 1999 (Purchase Agreement), and to the Stipulation between UBTA and the Division of Public Utilities to Approve the Purchase and Sale of Various Exchanges[1] (Acquisition Stipulation) signed on July 6, 2000.

Q. Did UBTA agree, in both documents, that it would not recover the acquisition adjustment in regulated rates or from the Utah USF?

[1] Stipulation to Approve Purchase and Sale of Various Exchanges, Docket No. 99-049-65, July 6, 2000, page 9, item #15. Other rural companies that bought other Qwest exchanges also signed that Stipulation.

A. Yes. In the Purchase Agreement, UBTA agreed to purchase three exchanges (i.e., Duchesne, Roosevelt and Vernal) from U S West Communications (now Qwest). Paragraph 1.7 of that Agreement, signed by UBTA states:

> Buyer will not seek recovery of an acquisition adjustment through its regulated interstate or intrastate rates, including from federal or state universal service funds.[2]

In addition, the Acquisition Stipulation signed by UBTA states:

> 15. Costs incurred directly as a result of the purchase will neither be recovered from the State Universal Service Fund nor in intrastate rates from the customers of either the exchange being purchased or the Buyers' existing service territory. The premium paid to U S WEST in excess of the net book value will not be included in the Buyers' rate base or revenue requirement.[3]

This Stipulation was adopted by the Commission. The Commission's Report and Order states:

> As its finding of fact and conclusions of law in this matter, the Commission adopts the representations and covenants contained in the stipulation, which is annexed hereto and incorporated herein by this reference.[4]

On April 6, 2001, the Purchase Agreement was executed.[5]

Q. Did UBTA pay more than the net book value for the exchanges it bought from Qwest?

A. Yes. UBTA paid Qwest over *** *** the net book value of those exchanges.[6]

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[2] Karl Searle's Direct Testimony, page 4.

[3] Paragraph 15, "Stipulation to Approve Purchase and Sale of Various Exchanges", dated July 6, 2000.

[4] Report and Order, Docket No. 99-049-65, issued September 6, 2000, page 1.

[5] Karl Searle's Direct testimony, page 4.

Q. In spite of the above referenced Agreement, Stipulation and Commission Order, has UBTA-UBET included the acquisition premium in its proposed revenue requirement in this proceeding?

A. Yes. The Company included the intrastate portion of the acquisition premium in its proposed intrastate rate base in this proceeding. The intrastate amount of this rate base adjustment proposed by the Company is *** ***.[7] The Company also included *** *** of expense as the intrastate portion of the amortization expense of the acquisition adjustment.[8]

Q. What was the dollar amount of the acquisition premium in the sale of these exchanges?

A. The dollar amount of the acquisition premium was in excess of *** ***. The net book value of those exchanges was *** ***, but the Company paid Qwest *** ***.[9] Therefore, the price that UBTA-UBET paid Qwest for these exchanges was more than *** *** the net book value.

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[6] UBTA-UBET response to CCS' Data Request 3.4.

[7] Exhibit 1, Column J, of the Company's April 27, 2005 Application For Increase In USF Eligibility.

[8] Exhibit 1, Column J, of the Company's April 27, 2005 Application For Increase In USF Eligibility.

[9] In response to CCS Data Request 3.4, the Company indicated that the purchase price for the three exchanges from Qwest was *** ***, and the net book value of those assets was *** ***. Therefore, the difference between these two amounts, *** ***, is the amount of the "Acquisition Premium" (also called Acquisition Adjustment) that resulted from the Company' purchase of these exchanges from Qwest. These amounts are the "unseparated" amounts.

Q. The Company has included the intrastate portion of the acquisition premium in its revenue requirement based on which it now requests additional Utah USF. Would this be an appropriate use of the Utah USF fund?

A. No. The Utah USF is funded by end-user surcharges on intrastate retail services.[10] Therefore, retail telephone service customers across the entire State financially support the Utah USF. What the Company is asking this Commission to do is to force all customers to shoulder the burden of covering additional purchase costs that resulted from UBTA-UBET's consent to pay Qwest more than the net book value for these three exchanges. The acquisition premium does not include purchasing new or different equipment necessary for the provision telephone service to customers in the Uintah Basin. The acquisition premium reflects only the amount that UBTA-UBET agreed to pay Qwest in excess of net book cost. Thus, if the acquisition premium is accepted by the Commission as an eligible for USF recovery item, the customers [11] would be required to pay *** *** for that investment than they paid for it when it was owned by Qwest.

The acquisition premium should not be eligible for either USF or regulated rate recovery. The purpose of the Utah USF is to preserve and promote universal service, promote equitable cost recovery of basic telephone

[10] Utah Administrative Code Section R746-360-4, "Application of Fund Surcharges to Customer Billings".
[11] Customers would pay through the Utah USF.

service[12], and otherwise ensure that all ratepayers in the State have access to affordable telephone service.

Q. If UBTA-UBET were to receive Utah USF funds to recover the acquisition premium, could that convey an improper economic incentive to other carriers in the state?

A. Yes. If the Commission were to grant UBTA-UBET's request, that would create a precedent other carriers could use to seek Utah USF support in order to recover their acquisition premium. In addition, it may also provide an improper economic incentive encouraging the future transfer of more exchanges from one company to another at prices in excess of the net book value, in part with the intent of recovering the acquisition premium from the Utah USF.

Q. Did other carriers purchase Qwest's exchanges in 2001?

A. Yes. The same Acquisition Stipulation that included the sale of Qwest exchanges to UBTA-UBET included <u>seven</u> independent telephone companies, who purchased a total of twelve (12) exchanges from US WEST (now Qwest). If UBTA-UBET's request to support the acquisition premium using Utah USF funds is approved, that could encourage other carriers to seek similar recovery of purchase prices in excess of net book cost.

[12] 54-8b-15 (6)

Q. Has the Federal Communications Commission (FCC) expressed a similar concern with regards to the distribution of Federal USF?

A. Yes. In 1997, the FCC implemented a rule to prevent carriers from increasing the payment from the Federal USF as a result of transferring exchanges from one company to another. The FCC later explained:

> Section 54.305 of the Commission's rules provides that a carrier acquiring exchanges from an unaffiliated carrier shall receive the same per-line levels of high-cost universal services support for which the acquired exchanges were eligible prior to their transfer. Section 54.305 was adopted in the Universal Service First Report and Order as an interim measure aimed at discouraging carriers from transferring exchanges merely to increase their share of high-cost universal service support. The Commission was concerned that, while support is calculated for carriers based on separate rural and non-rural mechanisms, potential universal service payments may unduly influence a carrier's decision to purchase exchanges from other carriers.[13]

In addition, the FCC found that the possibility of receiving Federal USF funding for the purchased exchanges could also impact the price at which another carrier may be willing to sell its exchanges. The Commission specifically stated the following:

> Section 54.305 is meant to insure that a selling carrier does not artificially inflate the price of an exchange in anticipation of the buyers' receipt of universal service support as a result of the transfer.[14]

Allowing UBTA-UBET to recover the acquisition premium from the Utah USF could encourage other carriers to pursue a similar course of action. This would impose improper pressure on the fund and thus on Utah

[13] Order and Order on Reconsideration, CC Docket No. 96-45, Released January 10, 2005, ¶ 2.

[14] Memorandum Opinion and Order, CC Docket 96-45, Released September 17, 2001, ¶3.

ratepayers, which is contrary to the fundamental goal of the availability of affordable telephone service to all customers.

III. UBTA-UBET'S REASONS FOR SEEKING RECOVERY OF THE ACQUISITION PREMIUM.

Q. In the previous section, you indicated that UBTA signed the Acquisition Stipulation and the Purchase Agreement in which the Company agreed it would not seek to recover the acquisition premium from the USF or in regulated rates. What reasons does UBTA-UBET provide for not adhering to its commitments?

A. The Company provides several reasons why it does not want to abide by the relevant section of the Purchase Agreement and the relevant section of the Acquisition Stipulation. These claims are discussed separately in the following sections of this testimony.

COMPANY REASON #1: UBTA-UBET CLAIMS THAT A NEW FCC ORDER IN 2001 ELIMINATED ITS ABILITY TO RECEIVE FEDERAL HIGH COST LOOP SUPPORT FOR THE ACQUIRED EXCHANGES.

Q. The Company claims that after it purchased the exchanges, in 2001 the FCC allegedly changed its rules rendering UBTA's newly acquired areas ineligible for Federal USF support.

Referring to a 2001 FCC Order, UBTA-UBET alleges that[15]:

> **One FCC order changes the rule to eliminate the prospect of rural telecommunications companies acquiring properties from Bell Operating Companies being eligible to receive Federal Universal Service Funds ("FUSF") for the high cost area purchased."**
>
> **Prior to these Orders, a rural exchange carrier could purchase exchanges and include the new costs in a single study area and be eligible for FUSF."[16]**

Is UBTA-UBET's claim accurate?

A. No. At the time UBTA-UBET agreed to purchase the exchanges, this rule had already been in effect for two years. The rule that made the acquired exchanges ineligible for Federal USF support became effective in 1997. The FCC approved it in its Universal Service Order, adopted on May 7, 1997.[17] Since the Agreement for Purchase and Sale of Telephone Exchanges between UBTA and US West Communications is dated October 22, 1999 [18], the referenced rule had already been in effect for approximately two years *before* UBTA-UBET agreed to acquire Qwest's exchanges.

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[15] In response to CCS Data Request 4.1.1, UBTA-UBET indicated that the FCC Order it is referring to is the FCC's RTF order adopted May 10, 2001.

[16] Searle Direct Testimony, page 4 and 5.

[17] FCC Report and Order in CC Docket No. 96-45, Appendix I - Final Rules, page I-17, Adopted May 7, 1997 and Released May 8, 1997. Hereinafter, this Order will be referred to as the "FCC's Universal Service Order".

[18] Karl Searle's Direct testimony, page 4, lines 5-6.

In response to a discovery request [19], UBTA-UBET acknowledged that the FCC rule that prevents it from receiving Federal USF for the acquired exchanges is:

> A carrier that acquires telephone exchanges from an unaffiliated carrier shall receive universal service support for the acquired exchanges at the same per-line support levels for which those exchanges were eligible prior to the transfer of the exchanges. A carrier that has entered into a binding commitment to buy exchanges prior to May 7, 1997, will receive support for the newly acquired lines based upon the average cost of all of its lines, both those newly acquired and those it had prior to execution of the sales agreement.

As previously discussed, the FCC adopted this rule in 1997. Since Qwest (US West) was receiving no Federal USF for the Vernal, Roosevelt, and Duchesne exchanges, the above rule makes it clear that UBTA-UBET was also ineligible for Federal USF support on those exchanges after the purchase.

The FCC's 2001 Order [20] referred to by UBTA-UBET in its testimony did not change this rule. This Order only changed the paragraph number in which the rule appears. [21]

Q. Can you demonstrate that the wording of this rule has not changed since it was adopted in 1997?

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[19] UBTA-UBET response to CCS Request 4.1.2.

[20] In response to CCS Data Request 4.1.1, UBTA-UBET indicated that the 2001 FCC Order it is referring to is the FCC's RTF order adopted May 10, 2001.

[21] Title 47 of the Code of Federal Regulations (CFR). Section 54.305 changed to Section 54.305(a)

A. Yes. Attached as page 3 of Schedule WDA-1 is a copy of the page from the Final Rules' Appendix of the FCC's 1997 Universal Service Order, that implemented Section 54.305. Also attached, as Schedule WDA-2, is a copy of the page from the CFR published in late 1997, which shows that the rule referenced above was in the published CFR in 1997.

Attached, as page 2 of Schedule WDA-3, is the relevant page from the most recent CFR, which shows that this rule (now Section 54.305(a)) still exists with the same wording it had in 1997.

Q. At the time of the purchase, did UBTA-UBET expect to be able to recover the acquisition adjustment through the federal or state USF?

A. No. Paragraph 1.7 of the Purchase Agreement states:

> Buyer will not seek recovery of an acquisition adjustment through its regulated interstate or intrastate rates, including from federal or state universal service funds.[22]

COMPANY REASON #2: UBTA-UBET CLAIMS THAT THE NEW INTERSTATE ACCESS RATE STRUCTURE IMPLEMENTED BY THE FCC NEGATIVELY IMPACTED THE COMPANY.

Q. In his Direct testimony, Mr. Searle alleges that an FCC Order "changed the support mechanism for rural telephone companies from an implicit support to explicit support, and UBET Telecom was

[22] Karl Searle's Direct Testimony, page 4.

not eligible to receive these explicit support mechanisms".[23] What FCC Order is Mr. Searle referring to in this section of his testimony?

A. In response to a discovery request [24], UBTA-UBET indicated that the FCC Order that Mr. Searle is referring to is the FCC's MAG Order.[25]

Q. Did the FCC's MAG Order reduce the telephone company revenues?

A. No. The MAG Order included an interstate rate restructuring for rate-of-return rural carriers. In general terms, the MAG Order resulted in some of the interstate charges being decreased, and other interstate rates being increased.

The MAG Order was designed to change certain interstate rates in a revenue neutral manner. The total interstate revenues that the carriers receive under the MAG plan would be virtually the same as before the MAG plan. Both the rates before and after the MAG plan were designed to recover the carriers' interstate revenue requirements.

Specifically, Under the MAG Order, per-minute switched access charges were reduced, and the caps on Subscriber Line Charge (SLC) were increased. The SLC charge is a flat monthly charge that is paid by most

[23] Searle Direct, page 5, line 6..

[24] UBTA/UBET response to CCS Data Request 4.2.1.

[25] "Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166", adopted October 11, 2001, Released November 8, 2001. (Hereinafter referred to as "the MAG Order").

end-user telephone customers. It is an interstate rate, which is controlled by the FCC. For example, UBET's interstate residential and single-line business SLC increased from $3.50 to $6.50 as a result of the MAG Order. The multi-line business SLC rate increased from $6.00[26] to $9.20.[27]

Q. What is Mr. Searle referring to when he discusses the "explicit support mechanism"?

A. In response to a discovery request, UBTA-UBET indicated that the "explicit support mechanism" that Mr. Searle is referring to is called the "Interstate Common Line Support".[28]

Q. Please explain the "Interstate Common Line Support" mechanism?

In addition to reducing switched access rates and increasing the caps on the SLCs, the FCC implemented the "Interstate Common Line Support" mechanism for those companies that otherwise would have had a an interstate "common line" revenue deficiency.

To the extent that the MAG restructuring of access charges failed to recover all of a MAG carrier's interstate common line revenue

[26] MAG Order, ¶51 and ¶52.

[27] UBTA/UBET response to CCS Data Request 4.2.6.

[28] UBTA/UBET response to CCS Data Request 4.2.8.

requirement, the "Interstate Common Line Support" mechanism supported the difference. In its MAG Order, the FCC explained:

> In this section, we establish a new universal service support mechanism, Interstate Common Line Support, to replace implicit support in the interstate access rate structure of rate-of return carriers. Specifically, we replace the CCL charge with explicit support that will be available to all eligible telecommunications carriers on an equitable, non-discriminatory, and competitively neutral basis. Like the CCL charge, <u>Interstate Common Line Support will provide support for rate-of-return carriers to the extent that SLC caps do not permit them to recover their common line revenue requirements</u>.[29] (Emphasis added)

As clearly indicated above, the Interstate Common Line Support is provided only to those carriers who need it (i.e. to those carriers whose SLC caps do not allow the company to recover its interstate common line revenue requirement).

Q. Has the Company provided any evidence that its interstate rates that resulted from the MAG Order do not permit it to recover its interstate common line revenue requirement?

A. No. The Company has provided no evidence to that effect.

In addition, even if the Company could provide evidence showing that its interstate rates resulting from the MAG Order do not permit recovery of its interstate common line revenue requirement, that would be an interstate

[29] "Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166", adopted October 11, 2001, Released November 8, 2001.

matter to be decide by the FCC. The Utah Commission does not have jurisdiction over UBTA-UBET's interstate common line revenue requirement.

<u>COMPANY REASON #3: UBTA-UBET CLAIMS THAT A NEW ACCOUNTING RULE (FAS 142) HAD A SIGNIFICANT NEGATIVE IMPACT ON THE COMPANY'S ABILITY TO BORROW FUNDS.</u>

Q. What is the Company's claim with regards to the change in the treatment of the "acquisition adjustment" for financial reporting purposes as a result of FAS 142?

A. Referring to UBTA-UBET's testimony, the Company's witness claims:

> As Mr. Todd testifies, the impairment of that goodwill, and resulting write down, has resulted in a negative equity position.[30]

Q. Would UBET's equity position be negative even without the write down that resulted from FAS 142?[31]

A. *** ***. The FAS 142 write down was *** ***.[32] The equity amount reported in UBET's 2004 Annual Report to the Commission is ***

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[30] Searle Direct Testimony, page 6, lines 18-19.

[31] The statement about negative equity is in reference to UBET. UBTA shows a positive "Patronage Capital" (Cooperative carriers' reports do not show figures for "Stockholders' Equity") and the sum of UBET's "Stockholders' Equity" and UBTA's "Patronage Capital" is a positive number.

[32] Searle Direct testimony, page 5, line 19.

***.[33] Therefore, the Company's equity would have been *** *** even without the FAS 142 write down.

Q. Is there another claim that the Company makes regarding FAS 142?

A. Yes. The company alleges that the asset write down under FAS 142 has "dramatically impacted"[34] its ability to borrow funds, because FAS 142 "resulted in a substantial decrease in the value of the assets carried on the financial statements of UBET Telecom." [35]

Q. Has FAS 142 resulted in a large difference in the value of the acquisition asset carried on the books?

A. No. FAS 142 did not result in a large difference in the value of the acquisition adjustment on UBET's books, as compared to what was planned when the Company purchased the exchanges. First of all, the FAS 142 write down was less than *** *** of the original amount of the acquisition adjustment.[36] Under FAS 142 rules, the value of this "goodwill" investment was reduced by *** *** in 2002.[37] However, a large part of this reduction was offset by the fact that FAS 142 also stopped the *** *** asset reduction that would have

[33] Page 8, Annul Report of UBET Telcom, Inc. to the Public Service Commission of Utah, for year 2004. In addition, by the end of 2004, the net impact of FAS 142 on the value of this asset on the books is far less than *** ***, as discussed in a later section of this testimony.

[34] Searle Direct Testimony, page 7.

[35] Searle Direct Testimony, page 6.

[36] In this 2002 adjustment, the Company wrote off *** *** of the original Acquisition Adjustment. *** *** (Sources: UBTA-UBET Responses to CCS Data Requests 3.3 and 3.4, and page 5 of Mr. Searle's Direct Testimony).

[37] Searle Direct Testimony, pages 5 and 6.

otherwise occurred in 2003 as the planned amortization, and it also stopped the *** *** asset reduction that otherwise would have occurred in 2004 as the planned amortization.[38] As Mr. Searle states on page 3 of his Direct Testimony, FAS 142 “discontinues the amortization of goodwill.”

By the end of year 2004, the value of the acquisition adjustment as a result of FAS 142 should have been within *** *** of what the acquisition adjustment value on the books would have been without FAS 142.[39]

Q. What kind of amortization arrangements were made for the acquisition adjustment before FAS 142 was in implemented?

A. Before FAS 142, UBTA’s business plan was to reduce the value of the acquisition adjustment by almost *** *** **per year**. When asked about the amortization of the acquisition adjustment in UBTA’s business plan developed during the exchange acquisition, UBTA-UBET responded:

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[38] There was also a *** ***amortization of the “customer list” part of the acquisition premium in 2002.

[39] In 2004 the Company is claiming an amortization on the acquisition premium. The FAS 142 number used in this section of my testimony excludes this claimed amortization, since FAS 142 does not allow this amortization. If the claimed amortization in 2004 is considered in the FAS 142 figures, the difference between the FAS 142 financial investment figure and the investment figure expected without FAS 142 is *** . *** by the end of year 2004.

***

[40] ***

A copy of this request and response is attached hereto as Schedule WDA-4.

However, FAS 142 put an end to this *** *** per year amortization.[41] Please note that the numbers used in this and the prior answer are before separations. The “intrastate only” numbers would be lower.

Q. Can you summarize the issue you just discussed?

A**.** Yes. It is correct that in the year 2002 FAS 142 resulted in the Company reducing the value of this asset on its financial books more than the reduction originally planned for the year 2002. On the other hand, the Company’s original business plan would have reduced the value of this asset by a greater amount in the years 2003 and 2004 than occurred under FAS 142 implementation. As a result, at the end of 2004 there is not a large difference between this asset’s value under FAS 142, and what the value would have been, had the planned 15-year amortization simply continued.

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[40] From UBTA/UBET response to DPU Data Request 3.2.

[41] A *** *** annual amortization would effectively reduce the net investment shown for that asset by *** *** each year and show an amortization expense of *** *** each year, until the asset was fully amortized.

Q. Is there another problem with the Company's claim with respect to the FAS 142 issue?

A. Yes. With regards to the impact of FAS 142, the Company's witness testified:

> As Mr. Todd testifies, the impairment of that goodwill, and resulting write down, has resulted in a negative equity position. As such, UBET Telecom no longer complies with its loan covenants with RUS and CoBank and the companies are technically in default of their respective loan covenants. As such, the ability of UBTA-UBET to borrow funds to meet the capital project demands for service required by UBTA-UBET's subscribers has been dramatically impacted.[42]

However, UBTA-UBET's responses to discovery requests in this proceeding indicate that the "write down", "impairment of that goodwill", or "equity position" were **not** *** *** in the lenders' analyses. In response to a data request, UBTA-UBET stated:

> ***
>
> ***[43]

In addition, CCS Data Request 4.4.4 asked the Company for evidence that any of its loan problems were "specifically due to the 'write-down' of the impairment to goodwill which is reflected on the financial statements of the companies as described on page 8 of Mr. Todd's Direct Testimony." In response to that Data Request, the Company provided no evidence that any loan problems were directly related to the FAS 142 requirements.

[42] Searle Direct Testimony, pages 6 and 7.

[43] From UBTA/UBET response to CCS request 4.3.1.

Q. Is there anything else of interest on this issue?

A. Yes. As previously discussed, FAS 142 "discontinues the amortization of goodwill." [44] As a result, the Company *** ***.[45] However, in the test year 2004 the Company is claiming a test year amortization expense of *** ***.[46]

However, there is no real need for us to debate whether the acquisition premium can be amortized under FAS 142, or what amortization rate should apply, because the Acquisition Stipulation specifically states:

> The premium paid to U S WEST in excess of the net book value will not be included in the Buyers' rate base or revenue requirement.[46]

In addition, paragraph 1.7 of the Purchase Agreement states:

> Buyer will not seek recovery of an acquisition adjustment through its regulated interstate or intrastate rates, including from federal or state universal service funds.[47]

Q. Could you please summarize this issue?

A. Yes. This issue is summarized as follows:

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[44] Page 3 of Mr. Searle Direct Testimony.

[45] *** *** (Sources: Company response to CCS request 3.3, and pages 10 and 11, UBET Annual Report to the Commission for year 2004.)

[46] Exhibit 1, column J, UBTA-UBET Application in this proceeding. In year 2004, the Company had placed the acquisition premium in account 2690 "Intangibles."

[46] Report and Order, Docket No. 99-049-65, Issued September 6, 2000, page 9, item #15.

[47] Searle Direct Testimony, page 4.

(1) The Company claimed that UBET's negative equity position "resulted" from the FAS 142 impairment and write down. The fact of the matter is that UBET's equity position *** *** even without the FAS 142 impairment and write down.

(2) The Company claimed that the write down under FAS 142 has "substantially decreased" the value of that asset on the financial statements. However, the value of the asset under FAS 142 is not much different than it would be without FAS 142. The write down in 2002 was less than *** *** of the original amount of the acquisition adjustment.

There was a *** *** write down in 2002 because of FAS 142, but FAS 142 also put an end to the *** *** amortization that would have otherwise occurred in 2003 and also stopped the *** *** amortization that would have otherwise occurred in 2004.

(3) The Company claimed that the "write-down", "impairment of that goodwill", and changes in "equity position" resulting from FAS 142 had "dramatically impacted" the Company's ability to borrow funds. However, the Company responses to discovery requests demonstrates the FAS 142 "write-down", "impairment of that goodwill", or "equity position" changes resulting from FAS 142 were not *** *** in the lender's analyses of the Company financial position.

<u>COMPANY REASON #4; UBTA-UBET HAS SPENT SUBSTANTIAL RESOURCES TO UPGRADE UBET FACILITIES.</u>

Q. Is there another reason that UBET-UBTA provides to justify Utah USF recovery of the acquisition premium?

A. Yes. The Company claims it has "expended substantial resources to upgrade the quality of the facilities in those exchanges."[48]

Q. Are new plant expenditures part of the acquisition premium?

A. No. Any new construction expenditures are not part of the acquisition premium. The acquisition premium is just the amount that UBTA-UBET paid Qwest in excess of the net book cost of the acquired exchanges.

Q. Did the Company invest an unusually large amount in the acquired exchanges during the test year?

A. No. In fact, the new investments it made were less than the depreciation of the existing plant. According to its Annual Report, in 2004 the UBET[49] depreciation expense was *** ***.[50] The investment in new facilities was *** ***. [51] As a result, the net shareholder investment in UBET declined in 2004. In net terms, the Company took

[48] Todd Direct Testimony, page 7.

[49] UBET consists of the acquired exchanges.

[50]***

.***

[51] Page 10, 2004 Annual Report of UBET Telcom, Inc. to the Public Service Commission of Utah

money out of UBET plant in 2004. The net shareholder investment in UBET at the end of 2004 was less than it was at the beginning of 2004. In 2004 the Company did not even reinvest all of the UBET depreciation money into new UBET plant.

Considering a longer period of time, at the end of 2004 the net investment in UBET plant was only *** *** more than what the net investment in plant was when the Company bought these exchanges from Qwest.[52] In fact, at the end of 2004, the net UBET plant investment per line *** *** than it was when Qwest sold the three exchanges.

IV. THE BENEFIT OF TAX-EXEMPT STATUS

Q. What was one of the benefits that UBTA-UBET was touting to the Commission in support of approving its proposed merger?

A. UBTA-UBET claimed that the merger would allow the company to "take advantage of" the fact that it is income tax exempt as a nonprofit cooperative. The November 15, 2004 merger "Stipulation", which was signed by UBTA-UBET, specifically stated:

> The Dissolution will provide greater opportunity to improve the services offered and allow the company to take advantage of

[52] When acquired, the net investment in plant (not including acquisition premium) was *** *** (Response to CCS request 3.4.3) At the end of 2004 the net investment in plant (which does not including acquisition premium) was *** *** ("end of year" column: 2004 UBET Annual Report, pages 10 "Total Telecommunications Plant in Service" less page 10 "Intangibles" less [page 11 "Total Accumulated Depreciation and Amortization"-page 11 "intangibles"]. (The "intangibles" are the acquisition premium)).

> operating efficiencies including tax-exempt status as a nonprofit cooperative telecommunications corporation.[53]

Q. In support of the merger, UBTA-UBET claimed that the merger would allow the company to take advantage of tax-exempt status. Has UBTA-UBET included any income tax in its revenue requirement calculation in this proceeding?

A. Yes. In its revenue requirement calculation shown in Column L of Exhibit 1 of the Application, UBTA-UBET has included ***   *** in Federal and State income taxes.[54]

UBTA-UBET is assuming that it will be required to pay both Federal and State income tax on any State USF funding it would receive. Also, on page 2 of Exhibit 1.1 of the Application, there is a "gross-up" calculation in which the Company assumes that because of its income taxes it must collect ***   *** to produce a one-dollar increase in after-tax revenue.

Q. Why has UBTA-UBET included Federal and State income taxes in its revenue requirement calculations?

A. In response to a discovery request, UBTA-UBET explained:

> At the time the Application for approval of the merger was filed by UBTA-UBET with the Commission, the provision for UBET Telecom subscribers becoming members was that they would become members unless they specifically opted out. Following negotiations

[53] Merger Stipulation, paragraph 9, dated November 15, 2004, in Docket number 04-053-03.
[54] Column L, Exhibit 1 of UBTA-UBET's April 27, 2005 Application of UBTA and UBET for an Increase in USF Eligibility.

> with the CCS and the Division of Public Utilities ("DPU"), that provision was modified to require UBET Telecom members to specifically opt in. As a result of that change, it is anticipated that, upon implementation of the merger, it will take several years, before the majority of the subscribers of UBET Telecom will become members of the cooperative, UBTA-UBET Communications, Inc (the Cooperative). As such, it is anticipated that the Cooperative will not meet the requirements of 85% of the revenue generated from use of services by members until such time and, as such, will be subject to federal income taxes for such period.[55]

"85% of the revenue generated from use of services by members" is a requirement necessary to enjoy tax-exempt status. The Company claims that it would not meet this requirement because the Commission's Order allegedly requires "UBET Telecom members to specifically opt in."

Q. Has UBTA-UBET misrepresented the Commission's Order regarding customer membership in the cooperative?

A. Yes. UBTA-UBET's claim that customers would have to "specifically opt in" to the cooperative is a misrepresentation of the Commission's Order. The Commission's Report and Order approving the UBTA-UBET merger specifically states that all customers of the merged company would be members of the merged cooperative (unless they opt-out). Current UBTA customers would automatically become Class A voting members and

[55] UBTA-UBET's response to CCS Data Request 2.1.5.

current customers of UBET would automatically become Class B non-voting members.[56] The Commission's Order states:

> The Plan also states that all present members of UBTA would become Class A members of the new UBTA-UBET. Current UBET customers would become Class B members of UBTA-UBET until they qualify for Class A membership.
>
> Contrary to the Applicant's original membership plan, Upon Dissolution, current UBET customers will be deemed to be Class B non-voting members and shall not be charged any membership fees until they affirmatively elect to become Class A members or until they have accrued sufficient patronage to pay the membership fee.[57]

Q. In light of your findings what do you recommend?

A. UBTA-UBET's claim that UBET customers would be required to specifically "opt in" to be a member is false, and is a misrepresentation of the Commission's Order. The additional income tax expense that **UBTA**-UBET has included in its revenue requirement calculation should be rejected.

In addition, during the merger docket the Company represented to the Commission that the merged company would have "tax-exempt status as a nonprofit cooperative telecommunications corporation." But in this docket the Company is claiming that the merged Company would **not** have tax-exempt status. These statements contradict each other.

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[56] The IRS rules say that 85% of the revenues must be from "members". These IRS rules don't say anything about 85% of revenues having to be from "voting members" or "Class A members". Attached as Schedule WDA-5 is a copy of the IRS rules that describe the 85% revenue requirement.

[57] PSC Report and Order in Docket No. 04-053-03, November 26, 2004, page 5.

Q. Can you summarize your recommendations?

A. Yes. For the reasons explained in this testimony I recommend the following:

(1) The Company's proposal to include the acquisition adjustment in the revenue requirement to be recovered from the Utah USF should be rejected.

(2) The Company proposal to include alleged additional income tax costs in the revenue requirement to be recovered from the Utah USF should be rejected.

Furthermore, I reserve the right to review, and if appropriate to support, additional adjustments or positions presented by other parties, such as the Division of Public Utilities (DPU).

Q. Does this conclude this testimony?

A. Yes.