BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

)
In the Matter of the Application for) DOCKET NO. 05-053-01
Increase in the USF Eligibility for Uintah) Exhibit No. DPU 1.0
Basin Telecommunications Association,)
Inc., and UBET Telecom, Inc.) Direct Testimony Of
) WESLEY D. HUNTSMAN
)

FOR THE DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE
STATE OF UTAH

CONFIDENTIAL PUBLIC VERSION

September 9, 2005

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EXHIBITS

Exhibit DPU 1.1 - Resume of Wesley D. Huntsman

Confidential Exhibit DPU 1.2 - Division Adjustments to UBTA-UBET Revenue Requirement

Confidential Exhibit DPU 1.3 - Four Year Net Income / Loss Analysis

Confidential Exhibit DPU 1.4 - Exchange Sale Business Plan Compared to Actual Results

Confidential Exhibit DPU 1.5 - CoBank Letter to UBTA dated September 17, 2004

Confidential Exhibit DPU 1.6 - Excerpt from 2003 Independent Auditor's Report for NC Telecom, Inc.

Confidential Exhibit DPU 1.7 - Excerpt from 2004 UBET Goodwill Impairment Review

Testimony of Wesley D. Huntsman

Introduction:

Q. Please state your name and business affiliation.

A. Wesley D. Huntsman. I am employed by the Utah Division of Public Utilities (Division) as Manager of the Telecommunications Section. My business address is 160 East 300 South, Salt Lake City, Utah 84114.

Q. How long have you been employed by the Division of Public Utilities?

A. Since February 22, 1982.

Q. What are your current responsibilities?

A. Since November 2004, I have supervised the Division staff responsible for providing analysis and recommendations relating to telecommunications utilities regulated by the Commission. For the prior seven years, I supervised the Division staff which provided internal and external customer service. Those responsibilities included processing inquiries and complaints filed with the Division, consulting on technical and management issues within the Division, and coordinating administrative support. Also, in March 2000, I assumed responsibility for supervising water and sewer utility regulation on behalf of the Division. Prior to that time, for 15 years, I performed and supervised management, cost, financial and economic analyses on behalf of the Division. In these capacities, I have participated in numerous evaluations of utility functions and have testified in many proceedings before the Utah Public Service Commission (Commission).

Q. What is your educational background, expertise and experience?

A. I have a Bachelor of Science degree with emphasis in Accounting, and I am a licensed Certified Public Accountant. Over the last 33 years I have participated in audits and investigations ranging from small rural government facilities to nationwide programs. I have participated in many utility rate cases and directed major investigations into utility practices and management. I have presented papers, evaluation results, investigation reports, and appeared as an expert witness on utility matters for more than 23 years. I have attached my professional resume as Exhibit DPU 1.1.

Q. What is the purpose of your testimony in this case?

A. First, I will summerize the Division's analysis and recommendations in response to the Uintah Basin Telecommunications Association Inc. (UBTA), and UBET Telecom, Inc. (UBET) (collectively referred to as the Companies or UBTA-UBET) request for State Universal Service Fund (USF) support resulting from the Intrastate and Total Company revenue deficiencies in their application totaling $7.2 million and 10.3 million respectively. I will discuss the overall concerns the Division has with the Companies' application, highlight positions that Division witnesses are taking in this case, and summarize the Division's recommendations in this case. Finally, I will address the Companies' inclusion in their application of costs associated with the "Acquisition Adjustment" that was created when UBET purchased the US WEST Vernal, Duchesne, and Roosevelt exchanges in 2001.

Summary:

Q. Please Summarize your testimony.

A. The Division has examined the UBTA-UBET application for additional support from the State USF high cost fund. Our review identified numerous accounting adjustments which are appropriate in computing the revenues, expenses and rate base used to compute the revenue requirement in support of any additional cost recovery authorized from the State USF.

The Division recommends that the Commission reject two major accounting adjustments proposed in the application to recover costs associated with a redundant route and to recover costs associated with including the amounts paid in excess of book value for the three exchanges purchased from US WEST in 2001.

The Division re-examined our past assumptions and practices regarding USF support payments to assure that our recommendations were consistent with the purposes and policies expressed in both the federal and state guidelines. To cover a portion of the computed revenue requirement, the Division is recommending that the Commission authorize increases in the allowable rates which UBTA-UBET may charge customers for telephone service and an increase in the Extended Area Service (EAS) rate for the Vernal exchange. Additionally, the Division provides alternatives to the current rate-of-return model used for most rural ILECs in response to the Commission's request to address concerns about patronage credits associated with USF support payments when an ILEC is a cooperative. Based upon the Division's evaluation of the application and the current circumstances relating to the telecommunications industry in Utah, the Division recommends that the Commission approve an increase in the annual State USF support to UBTA-UBET of $746,516. Finally, the Division is concerned about the financial impact and additional risk to the regulated telephone companies from unregulated operations and recommends ring-fencing steps be taken to protect ratepayers from further harm.

History:

B. Has the Commission previously encountered a case similar to the one the Companies have filed in this case?

A. Not in recent history, to my knowledge; however, I believe that many of the same issues and problems embodied in this case were addressed by the Commission almost forty years ago. In 1963, Central Utah Telephone, Inc. was authorized to purchase the telephone system serving the town of Fountain Green in Docket No. 5252. Over the following two years, a new central office was built in Fairview. Almost the entire outside plant was replaced with new facilities, and line extensions were constructed to the town of Thistle, where a new exchange was established. In late 1965, the Company applied for a rate increase in Docket No. 5628 because revenues were not sufficient to cover expenses and provide any return on investments. The Commission noted in its Order that the construction program had been financed almost entirely with funds obtained from the Rural Electrification Administration. Analogously, this example is representative of what has happened at UBTA-UBET. In its Order dated February 15, 1966, the Commission noted that:

> "The evidence indicates to the Commission that the rates which appear to be necessary to support the investment in the new telephone plant of Central Utah may be beyond the ability of many subscribers to pay. . . . It appears to the Commission that the lending agency from which Central Utah secures funds for plant construction may be too liberal with its loans and that estimates made of future growth in the area served by Central Utah have been and may now be overoptimistic."

In rejecting much of the rate increase requested by the Company in that case, the Commission admonished Company management, stating:

> "The Commission believes that the ratepayers should not be called upon to underwrite every excursion of a public utility into the realm of debt financing, even though the monies there obtained are at a low interest rate. This Commission cannot inject itself into the functions of management of a public utility. The Commission and the ratepayers can expect, however, that management will exercise diligence and caution in borrowing money for plant modernization. Management should be highly concerned over the question of the ability of the customers served to pay the price necessary to support the latest innovations in the art of telephony."

In this case, the nature of the "latest innovations in the art of telephony" have changed to wireless, cable TV, broadband, Internet, and DSL service; however, I believe that the Commission's expressed concerns about ratepayers' ability to afford such "excursions" are still valid. The concern is even greater because not only are UBTA- UBET customers likely to experience a rate increase due to the Companies' application, but all Utah customers are being asked to contribute to such "excursions" via the requested support from the State USF. In its Order, the Commission made it clear that it was not going to bail Central Utah management out of its financial bind, and the Commission prohibited the Company from paying dividends on its capital stock until the debt/equity ratio was reduced. In the referenced Central Utah case, the Commission cautioned Company management that better management would be required to effectively operate the utility given the level of rate relief awarded:

> ". . . management will have to handle the affairs of Central Utah in an extremely careful manner under these new rates to meet the necessary expenses and obligations."

Division Computed Revenue Requirement and USF Support Recommendation:

Q. Are there any unique or unusual circumstances associated with the Division's evaluation of the UBTA-UBET request for USF support in this case?

A. Yes. Prior to the Companies' filing, the Commission held a Technical Conference in October, 2004 to discuss its concerns about the way equity costs and return on equity had previously been handled in rate cases and requests for USF support by rate of return regulated Independent Local Exchange Carriers (ILECs). The Commission specifically expressed concern about the cooperative ILECs in situations where retained margins partially or wholly achieved from USF support payments may be returned to ratepayers/owners through capital credits and patronage refunds. Division witness John Gothard will discuss the Division's perspective on this issue. He will also discuss the need for the Company to retain capital credits to improve the Company's equity to debt ratio and comply with loan covenants, possibly necessitating a Commission restriction on downstream loans and equity infusions to affiliates and payment of patronage refunds.

Dr. George Compton will address how a cooperative ILEC's excess margins resulting from USF support should be handled for rate-making purposes. At the Technical Conference, the Division expressed the view that the appropriate rate of return for cooperative ILECs and whether actual or hypothetical capital structure was appropriate for rate-making would be more appropriately evaluated in individual cases where actual facts and circumstances were available. Given the Commission's stated desire to address these issues, Dr. Compton has developed several revenue requirement scenario alternatives using "rate of return" (ROR), "times interest earned" (TIER) and "debt to operating cash flow" methodologies to compute revenue requirement. He will also address the policy issue of regulated companies requesting that rates be set using a hypothetical 50/50 capital structure, in lieu of their actual capital structure, in computing their revenue requirement and State USF support requirements.**Q.Does the Companies' application contain assumptions or known and measurable adjustments with which the Division has concerns?**

A. Yes. UBTA-UBET filed the application for USF support as a combined entity. The Companies received Commission authorization to merge their operations in an Order dated November 26, 2004 in Docket No. 04-053-03. However, to date the merger has not been closed. When asked why there has been considerable delay in merging the two company operations, Company representatives would merely state that they are awaiting approval from their primary lender, CoBank. The filed application resulted from simply combining the separate financial results of operations for the two companies, and I believe that separate applications for the two companies would probably approximate the same revenue requirement result. However, absent the merger, the parent cooperative company, UBTA, would not be subject to income taxes while the combined or merged company operations may be. The income tax issues in this case will be addressed in greater detail by Division witnesses David Thompson and Dr. Compton.

Second, the 10.05% weighted return on rate base in the Company's application assumes a 7.6% cost on debt. Note (g) to Exhibit 1.1 filed by the Company supporting its application indicates that the rate represents "the maximum allowable cost of debt" under the variable interest rate provision which CoBank can charge UBTA-UBET under their loan agreements. Division witness Chris Luras will discuss this issue in more detail and explain why the Commission should base rates upon the most recent known and measurable actual cost of debt in 2005.

Division witness Casey Coleman will discuss the historical basis for providing USF support to high cost ILECs and the underlying policies expressed in the Commission rules and Federal guidelines. He will also examine the current affordable rate being charged by the Applicants and provide his justification for the recommended increase in the affordable rate.

Division witness Peggy Egbert will address the Companies' request to recover costs associated with a redundant route from their service territory to the Qwest tandem switch in Salt Lake City. She will outline her concerns about the policy issues and the reasonableness of projected costs associated with the redundant route in the Companies' application. She will also address the need for EAS rate rebalancing and recommend an increase in the EAS rates due to the significant increase in traffic in the Vernal exchange.

Division witnesses Mary Cleveland, Bart Croxford, Bruce Moio, David Thompson and John Gothard will each discuss revenue, expense and rate base adjustments to the test year intrastate and total company results of operations and the Companies' assumptions and adjustments in the application. Charles Peterson will discuss the necessity for regulators to assure that the operating results of unregulated affiliated entities do not negatively impact utility ratepayers and "ring-fencing" measures regulators can employ to minimize such negative impacts. Dr. Joni Zenger will discuss price elasticity and whether customers will seek alternatives to UBTA-UBET telephone service due to the Division's recommended increases in customers' affordable rates.

Q. Assuming that the Commission adopts the adjustments and modifications the Division has recommended in this case, what are the revenue, expense and rate base amounts for the test period?

A. The Commission has historically based USF support payments to ILECs upon the lower revenue requirement computed using either Intrastate or Total Company operations. In this case, the Division used the adjusted Intrastate results of operations in calculating its recommendations in lieu of the Total Company revenue requirement because adjusted Intrastate operations resulted in a lower revenue requirement recommendation. I have attached Confidential Exhibit DPU 1.2, which details the revenue, expense and rate base adjustments recommended by Division witnesses to both Intrastate and Total Company models.

Additionally, the Division identified two errors in the revenue requirement models filed by the Applicants. First, the models filed by UBTA-UBET in Exhibit 1.1 applied an uncollectible or bad debt factor to the additional USF support revenue requirement computed by the model. The Division believes that no uncollectible gross-up is appropriate for any revenue deficiency because the Companies will receive the ordered amount from the State USF fund and incur no additional bad debt expense. Second, the manner in which the Applicants' model computes the income tax expense associated with their net income both before and after the required additional USF support is faulty. The gross-up factor the Applicants used to compute the revenue requirement does not account for the fact that interest expenses are deductible for income tax computation purposes. The models filed in Exhibit DPU1.2 eliminates the application of the uncollectible expense associated with any USF support payment and uses the corporate income tax brackets and rates to compute income tax expenses in the models. Dr. Compton used the resulting Division recommended Intrastate revenue, expense and rate base amounts in computing the revenue requirement and associated USF support amount for each of the return scenario alternatives shown in his exhibits.

Acquisition Adjustment Issue in Rate-Making:

Q. What is an acquisition adjustment?

A. For utility rate making purposes, an acquisition adjustment represents the premium paid in excess of net book value for utility plant previously dedicated to public service by a utility. The general rule related to the acquisition of utility plant previously used in the utility function is that the rate base component for the plant includes only the original cost of the property to the first owner devoting the property to public service less depreciation.

The rationale for exclusion of the acquisition adjustment from a purchaser's rate base lies in the value generated for the company and its shareholders that induced the purchaser to pay a premium (sale value) to acquire utility property already serving the public. The premium is considered an investment risk assumed by the utilities' shareholders which should not be shouldered by ratepayers. The necessity of this accounting treatment for premiums paid over depreciated cost (book value) for utility assets is largely a consequence of abuses in the utility industry during the acquisition and merger period of the 1920s and 1930s. Through the process of acquiring utility assets or entire utility companies at prices in excess of book value, purchasing utilities were able to write up their basis in plant assets and inflate their rate base artificially. The outgrowth of this situation was a general consensus among utility regulators that utility customers should not pay on an amount in excess of the cost when property was originally devoted to public service less depreciation, since any excess premium does not represent an increase in the service function of the assets to utility ratepayers.

Q. Has the Commission adopted the general rule that acquisition adjustments should be excluded for rate making purposes?

A. Yes. The general rule was applied by the Commission when Utah Wyoming Telephone Company purchased Kamas-Woodland Telephone:

> "The Commission observes and cautions, and Applicant acknowledges, that the excess of purchase price over book value cannot be hereafter considered for rate making purposes, whether arising out of the instant acquisition, or a future merger of Applicant and Kamas-Woodland, in the determination of an appropriate revenue requirement or rate structure."

In 1983 the Commission again expressed its regulatory policy in a Utah Power docket in which the Commission Order stated:

> "The Division asserted that investors are compensated only for capital contributed for the provision of public service and that amounts paid in excess of net book value for the CPN System did not represent capital which was invested in the provision of public service.
>
> The Commission agrees that in the context of acquiring assets already dedicated to the providing of public service the general rule for determining the value of such acquired property for ratemaking purposes is depreciated book value."

The Commission has also admitted that exceptions to the general rule may also be appropriate, stating that:

> "The Commission has recognized in past cases that an acquisition adjustment should not be disallowed for ratemaking purposes simply because it is an acquisition adjustment. . . . The costs of the assets to be acquired from Colorado-Ute, including the amounts recorded as acquisition adjustments, will be included in rate base if and to the extent the commission finds, in accordance with the applicable Utah statutes, rules and Commission precedent, the asset purchase to be in the public interest."

However, the Commission has noted that: "such exceptions to the general rule would be an unusual circumstance and would be evaluated on a case by case basis." Additionally, the utility proposing inclusion of the acquisition adjustment for rate-making purposes, "must carry the burden of demonstrating that substantial benefits which would not have occurred absent this sale exceed any requested acquisition adjustment." Finally, the Commission has found that exceptions to the general rule are not allowed subsequently, when it has been stipulated during an acquisition proceeding that the acquisition adjustment shall not be included in the purchaser's rate base or operating expenses for rate making.

The Exchange Sale Case:

Q. Did the Company request rate recovery for costs associated with the Acquisition Adjustment when it requested approval to acquire the US WEST Exchanges?

A. No. The financial projections supporting UBET's business plan to acquire the US WEST exchanges, which were provided to the Division dated July 28, 1999 and July 21, 1999 respectively, both reflect returns of rate base which excluded the acquisition adjustment amount. Additionally, one of the issues stipulated in the Settlement Agreement signed by the parties in that case and approved by the Commission by Order dated September 6, 2000 provided:

> "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 US WEST in excess of the net book value will not be included in the Buyers' rate base or revenue requirement."

Q. Absent the Companies' agreement not to request rate recovery of the premium paid for the purchased exchanges, would the Division have recommended Commission approval of the exchange purchase by UBET?

A. No. Prior to entering the Settlement Agreement, the Division filed testimony with the Commission stating:

> "The Division recommends the Commission approve the sale of exchanges with conditions placed on the Buyers as discussed below. The Division believes that absent these conditions the sale of exchanges would not be in the public interest. A summary of these conditions are as follows:
> 1. Rates, Charges, and the State's Universal Service Fund:
> a. Cost incurred solely as a result of the purchase will neither be recovered from the State's Universal Service Fund (USF) nor the customers of either the exchange being purchased or the Buyers' existing service territory.
> b. The premium paid to USWC in excess of the net book value will not be included in the Buyer's rate base or revenue requirement. . . .
>
> The Division, in this case, reiterates the position that except under very extraordinary circumstances, no acquisition adjustment for the price paid for utility property in excess of the net book value, should be allowed for revenue requirement purposes. Accordingly, the cost basis of the telephone plant being transferred will not change as a result of the transfer. This position is consistent with the Commission's treatment of premium (acquisition adjustment) in prior exchange sales. The Commission has previously ordered purchasing companies to treat the premium in a below-the-line account, and has not included this premium in the purchaser's rate base or revenue requirement.
>
> For this exchange sale, the purchase price of each exchange is above net book value. Specifically, the purchase price of East Carbon, Helper and Price (Carbon/Emery as purchaser), and Duchesne, Roosevelt and Vernal (UBET as purchaser) are substantially above net book value. Ratepayers are currently paying rates that cover the net book value of assets being sold. The addition of a premium, or acquisition adjustment, will require customers to pay higher rates for the exact same equipment. The Division believes that the exclusion of the premium in this sale will cause no harm to customers or the financial integrity of the Buyers."

At a hearing on July 6, 2000, Ingo Henningsen testified on behalf of the Division in support of the Settlement Agreement. He testified that the Division supported the Stipulation, and he addressed each paragraph. Regarding paragraph 15 of the Settlement Agreement, quoted earlier, he stated:

> "The important part here is that the premium paid to US WEST in excess of the net book value will not be included in the buyer's rate base or revenue requirement. . . ."

The Companies' Request:

Q. Why is UBTA-UBET asking for rate recovery for costs associated with the Acquisition Adjustment in this case?

A. **

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Q. What is the impact on the revenue requirement of the Companies including costs associated with the acquisition adjustment in their application in this Docket?

A. Paragraph 12 of the Companies' application states that the Exhibits filed in support of their application "include a Plant Acquisition and Amortization Adjustment related to the purchase of the Vernal, Duchesne and Roosevelt exchanges in April, 2001." The Applicants further stated in their application that: "under the circumstances, they are entitled to the Plant Acquisition and Amortization Adjustment." Exhibit 1 submitted in support of the application reflects the net income and rate base amounts of the adjustment proposed by the Company in Column (J). The adjustments in Column (J) include a $10,210,213 rate base addition and a $475,443 amortization expense increase for the test period. These adjustments increase the Company's Intrastate revenue requirement in the application by **********

Q. What justification have the Companies given for their argument that the Commission should allow recovery of the premium they paid for the US WEST exchanges over book value through local rates and State USF support?

A. ______UBTA-UBET representatives have indicated that the problem originates with the accounting profession adopting new financial reporting requirements, associated with intangible assets, shortly after the Commission approved the exchange sale. Karl Searle expressed the belief on pages 3 and 4 of his Prefiled Direct Testimony that those new financial reporting requirements were not foreseeable at the time UBET requested approval to purchase the exchanges.

The Change in Accounting Standards:

Q. Please explain what changed in how the "acquisition adjustment" intangible asset was accounted for in the Company's annual financial statements.

A. In June, 2001, nine months after the Commission approved the purchase of the US WEST exchanges by UBET Telecom and two months after the transaction was closed in April, 2001, the Financial Accounting Standards Board (FASB) adopted Statement of Financial Accounting Standards No. 142 (FAS 142). The new accounting standard addressed how goodwill and other intangible assets should be accounted for in financial statements. According to FAS 142, companies could no longer amortize goodwill annually as they had done previously pursuant to the Accounting Principles Board Opinion No. 17. Instead, intangible asset values were required to be tested for impairment at the reporting unit level on an annual basis. The Statement defines "impairment" simply as the extent to which the carrying amount of the goodwill or an intangible asset on the Company's books exceeds its fair value. For financial statements reflecting reporting periods after December 15, 2001, FAS 142 requires that any and all of the "impairment" be recognized as an impairment loss against income in the reporting period.

To assure that their financial statements were in conformance with Generally Accepted Accounting Principles, and to avoid the necessity for their independent auditors to negatively opine on their financial statements, UBET retained an independent firm to perform goodwill "impairment analysis" for each accounting year since 2002. Whenever the book value of the Company's assets exceeded the fair market value, any intangible asset, i.e., goodwill or acquisition adjustment, on the Company's books was considered to be "impaired" under the financial reporting rules. Further, the excess "impaired" value was written off as a loss against current year earnings. Those losses ultimately reduced the amount of stockholder's equity reflected in UBET's financial statements.

Q. On page four of his Direct Testimony, Karl Searle indicated that the impact of FAS 142 was unknown and unforeseeable at the time the stipulation in the Exchange Sale case was signed. Do you agree?

A. ______No. Even though FAS 142 had not been issued when the Stipulation was signed by the parties to the Exchange Sale case on July 6, 2000, the accounting community was well aware that something similar was on the horizon. Obviously, the FASB did not issue FAS 142 until June, 2001, well after the Stipulation in the Exchange Sale case was executed. Also, tentative decisions of the FASB regarding accounting for goodwill in connection with business combinations were not known until late 2000. However, as early as April, 1999, the FASB in response to concerns about merger accounting abuses, was examining accounting methods for business combinations and specifically, highlighting the need to address concerns about purchased goodwill and other intangible assets. In September, 1999, the FASB issued an Exposure Draft on a proposed statement related to Business Combinations and Intangible Assets, which among other changes, proposed a goodwill impairment approach for recognizing and measuring impairment losses. Therefore, I would not agree with Mr. Searle that the impacts of the changes in accounting standards under FAS 142 were totally unknown and unforeseeable at the time the Stipulation was signed in the Exchange Sale case.

Q. Have the independent goodwill "impairment reviews" performed to date by UBET resulted in significantly more "impairment losses" being booked against the utility's results of operations than would have been under the old goodwill amortization methodology?

A. No. Undoubtedly, the impairment losses booked to date have contributed to UBET losses and the financial problems of the Company; however, in my opinion those losses have not been the predominant problem. UBTA-UBET retained the Yeanoplos Drysdale Group, PLLC to perform annual impairment reviews of the intangible assets on the books for the years ended December 31, 2002, 2003, and 2004. The 2002 impairment study concluded **

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************************. The 2003 and 2004 impairment reviews both concluded **

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In response to Division Data Request No. 3.1, the Companies provided all the entries relating to the acquisition adjustment. ********************************

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*********************************** In response to Data Request No. 3.2, the Companies indicated that the business plan developed in support of the exchange purchase assumed a **********annual amortization of the acquisition adjustment to below-the-line expenses. Consequently, the acquisition adjustment amortization costs under the old method would have totaled ********* at the end of 2004 compared with the ********** goodwill impairment losses written-off under the new method. I don't know how UBTA-UBET can claim that the required accounting change has contributed to the need for increased USF support when the Companies are $2 million better off financially under the new accounting method than they would have been amortizing the acquisition adjustment under the old accounting method. The Division believes that the goodwill impairment losses written-off by UBET to date have been far less detrimental to UBTA-UBET's financial position than the financial losses incurred by Applicants' unregulated activities.

Financial Results from Regulated & Unregulated Activities:

Q. What financial impact has the unregulated activities of UBTA-UBET had on the Companies' financial results of operations for the last four years?

A. I have summarized the net income and loss from each Corporate entity within the UBTA-UBET organization for the period 2001 through 2004 in Confidential Exhibit DPU 1.3. The financial data was obtained from financial statements provided in response to DPU Data Request No. 1.43. The summary shows, **************************

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** (Refer to line 6 columns 2 & 5). The discrepancy becomes even more pronounced when one-time events are eliminated from operating results in an attempt to normalize the results of operations. ** **

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***************** (Refer to line 8 columns 2 & 5). These financial results illustrate why the Division believes that the Applicants' financial problems are much more attributable to losses associated with unregulated activities and not the result of regulated telecommunications operations.

The operating losses experienced by the unregulated affiliates have had material affects on the financial viability of the regulated utilities. As mentioned earlier, Exhibit DPU 1.3 shows that much of UBTA-UBET's financial hardship has been caused by the operations of their unregulated affiliate NC Telecom, Inc. (NCT) which provides broadband and DSL service to communities in Northwestern Colorado. ************

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*** Referenced pages Attached in Confidential Exhibit DPU - 1.6)

The UBTA Board meeting minutes for October 21, 2004 indicate that the Company had qualified for RUS, RTB and FFB loans totaling ******************** **

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*** ** Through discussions with UBTA officials in June, 2004 and response to DPU Data Request No 3.6, the Division determined that *** **

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Q. Has UBTA-UBET management used regulated utility assets to secure loans for unregulated operations?

A. In two instances, it appears that they have. ***************************

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Additionally, *** **

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*** ** ** This problem highlights the need for ring-fencing efforts by utility regulators to avoid utility ratepayers bearing the risk associated with unregulated enterprises. As previously mentioned, Charles Peterson will address this issue on behalf of the Division.

Q. Have the Companies effectively implemented cost and allocation controls to assure that expenses are properly assigned between regulated and unregulated operations?

A. No. The Companies have adopted a Cost Allocation Manual; however, the Division's audit indicated that they have not always complied with its requirements. As more fully discussed in testimony filed by Mary Cleveland and Bruce Moio, it appears that many expenses and capital costs during the test period were not properly charged. Our examination disclosed that expenses and capital costs which should have been directly assigned to unregulated operations were identified as common costs or joint costs and allocated between regulated and unregulated operations. Other expenses and capital costs which should have been identified as common or joint costs and allocated between regulated and unregulated operations were booked as costs of regulated operations.

Q. Are such subsidies from regulated operations to unregulated operations prohibited?

A. Yes. Federal guidelines for Universal Service prohibit such subsidies, stating:

> "Subsidy of Competitive Services Prohibited: A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

In addition, UCA Title 54-8b-6 similarly prohibits subsidization of unregulated Intrastate public telecommunications services by regulated Intrastate telecommunications services.

Q. Have UBTA-UBET earnings from regulated telecommunications services over the last four years been consistent with the projections in the business plans provided to the Division when UBTA-UBET requested Commission approval to purchase the Vernal, Roosevelt and Duchesne exchanges from US WEST?

A. Yes. In Confidential Exhibit DPU 1.4, I compared the actual and normalized financial results of operations for the regulated telecommunications services for the period 2001 through 2004 with the net income projections in the business plans provided to the Division in the Exchange Sale case. At the time UBTA asked the Commission to approve the purchase of the US WEST exchanges, the Company projected operating losses totaling ********** for the first four years without any USF support and operating profits totaling ********** for the same period assuming both Federal and State USF support was obtained. By comparison, actual regulated telecommunications operating results for the period 2001 through 2004 adjusted to remove the goodwill impairment losses in 2002 resulted in operating margins totaling **********. Therefore, it appears that the actual operating results of regulated operations have approximated what UBTA-UBET anticipated when the Companies requested approval to purchase the exchanges from US WEST.

The Companies' Financial Dilemma: Q.Please briefly describe the Applicants' financial situation that prompted their request for additional State USF support.

A. The financial predicament the Companies currently faces is the erosion of their owner's equity on a consolidated basis **

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Q. **What action has CoBank taken** ***

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A. *** ** **********************. I have attached a copy of the letter (without attachments) as Confidential Exhibit DPU 1.5. ** ** **

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Q. Have the Companies implemented cost controls to reduce expenses in view of their lender's dictates?

A. It appears that they have made efforts to do so. The total operating expenses of UBTA and its affiliates from consolidated financial statements increased from ********** in 2001 to ********** in 2002 and ********** in 2003 respectively; while unaudited 2004 financial statements show total operating expenses of ********** – a reduction of ********** from 2003. However, the reduction in operating expenses in 2004 was accompanied by a ********** reduction in total operating revenue from ********** in 2003 to ********** in 2004. Therefore, it could be argued that the Companies did not do enough cost control to mitigate the losses from operations.

As part of their goodwill impairment review for UBET, ****************** ** ** ** ** ************************************ (Refer to Confidential Exhibit DPU-1.7).

Q. What do you believe primarily caused the Applicants' financial problems?

A. The Division's analysis indicates that financial losses from "excursions" into unregulated activities by UBTA-UBET are the primary reason that the owner's equity on the Companies' financial statements has been reduced to unacceptable levels. In his Direct Testimony, Ray Hendershot admits that the Applicants' combined 2004 end-of-the-year capital structure was 98% debt and 2% equity (page 10). Lenders typically insist on certain minimum equity ratio percentages in their loan covenants as a precaution against the risk of default on loan payments and possible insolvency of the borrower. ** *** ** ** ** ** ** This problem highlights the need for the Commission to impose ring-fencing safeguards to avoid utility ratepayers bearing the risk of unregulated enterprises.

Conclusion & Recommendations:

Q. **What conclusions have you reached regarding the Applicants' request for rate-making consideration for the acquisition adjustment related to the exchange purchases from US WEST?**

A. Without any doubt, the Applicants knew that this Commission had a long history of excluding acquisition adjustments from cost and investment considerations in evaluating the need for rate changes when they requested authorization to purchase the exchanges from US WEST. The Applicants willingly agreed not to ask for rate recovery or State USF support based on the acquisition adjustment in a settlement agreement to assure that state regulators would not oppose the purchase as not being in the public interest. The application includes costs associated with the acquisition adjustment, even though the Companies are $2 million better off financially under the new accounting rules than those which existed when they requested approval to purchase the US WEST exchanges. The Commission should exclude all costs associated with the acquisition adjustment in computing the Applicants' allowable revenue requirement consistent with its stated policy and prior decisions.

Q. What additional conclusions have you reached following the Division's audit of the Applicants' operations?

A. I believe that the Statute that dictates that utility rates be just and reasonable obligates State regulators to assure that requests for State USF support from high cost ILECs are based upon prudently incurred costs and investments. Additionally, I believe that the Commission has the right to expect utility management to exercise diligence and prudence in assuring that costs supporting requests for USF support are reasonable and that ratepayers are not exposed to risks from "excursions" in unregulated activities.

The Division's investigation into UBTA-UBET's operations and financial records for the test year identified substantial losses from unregulated operations which eroded the owner's equity on the Companies' financial statements. Additionally, the Division identified costs, and recommended rate-making adjustments for expenses and capital investments which were: (1) booked or allocated to regulated operations during the test period which evidence a lack of cost control; (2) more properly charged or allocated to unregulated operations; and (3) possibly imprudent expenditures in view of their lender's previously mentioned cost control demands and their financial situation.

Historically, utility regulators have used rate of return on equity as a means to reward shareholders of well-run utilities and motivate management improvements for inefficient or imprudent utility operations. In 1993, the Utah Supreme Court held that the legislature had granted the Commission discretion to set a utility's rate of return so long as it was within a range of reasonableness. Additionally, the Supreme Court stated:

> "We think, however, that the Commission may reduce the rate of return as a method to prompt the utility to correct mismanagement and inefficiency without running afoul of this rule or any other restrictions that have been brought to our attention. . . . We therefore hold that when determining a utility's 'just and reasonable' rate of return on equity, the Commission has the authority to consider the utility's affiliate relationships and how they affect the quality of service. . . . We find that there is substantial evidence to support the Commission's decision to decrease the rate of return as a means to encourage Mt. Fuel to modify its affiliate relationships. There was ample evidence before the Commission to suggest that Mt. Fuel's relationships with Questar and various affiliates carried the potential for costs and risks to Mt. Fuel customers that they would not incur in a true market setting."

Dr. Compton's recommendation in this case was made with the understanding that the Commission may wish to encourage UBTA-UBET stockholders/ratepayers to hold management more accountable for its actions, to reduce the financial risks associated with unregulated operations, and to operate more efficiently. I believe his recommendation results in just and reasonable modifications to existing "affordable base rates" and the annual amount of State USF support to UBTA-UBET.

Q. **Do you recommend any additional Commission actions regarding the financial drain of unregulated operations to help assure the financial viability of the Applicants?**

A. Yes. Consistent with Mr. Gothard's recommendations, the Commission should impose a prohibition against any further patronage refunds until the Companies' debt to equity position is in compliance with their loan covenants. The regulated Companies should be required to obtain Commission approval before downstream funding is provided to unregulated operations and before significant business transactions are entered into with unregulated affiliates. Additionally, the Commission should consider implementing other ring-fencing measures discussed by Mr. Peterson as may be appropriate..

Q. Should the Commission authorize UBTA-UBET to increase local service rates to its telephone customers?

A. Yes. Consistent with the testimony of Division witness Casey Coleman, the Commission should authorize UBTA-UBET to increase the "affordable base rate" for both residential and business customers. Also, consistent with the testimony of Peggy Egbert, the Commission should authorize an increase in the EAS rate for the Vernal exchange to reflect the impact of the increased traffic shown in the most recent traffic studies.

Q. What amount of annual State USF support should the Commission authorize for UBTA-UBET?

A. The Division believes that the Applicant's have demonstrated the need for increased support from the State USF. However, the Division has identified significant adjustments to the revenue requirement computed in the Companies' application. Additionally, in response to concerns previously expressed by the Commission, the Division revisited its recommended policy on how the cost of capital and rate of return should be considered in setting ILEC rates. I believe that Dr. Compton's proposed alternatives provide a framework for the Commission to consider. In the end, I believe Dr. Compton's recommended methodology is an equitable solution to the Commission's expressed concerns. Therefore, I believe that the Commission should authorize UBTA-UBET to receive an annual State USF support payment of $827,669.

Q. **Does that conclude your testimony?**

A. Yes.