\- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

In the Matter of Manti Telephone Company's Second Amended Application for USF Eligibility	)))))))	DOCKET NO. 08-046-01 DPU Exhibit 2.0 Direct Testimony of Casey J. Coleman

DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE

October 18, 2012

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I. IDENTIFICATION OF WITNESS

Q. PLEASE STATE YOUR NAME, EMPLOYER, AND BUSINESS ADDRESS.

A. My name is Casey J. Coleman. I am employed by the Division of Public Utilities ("Division") for the State of Utah. My business address is 160 East 300 South Salt Lake City, UT 84114.

Q. BRIEFLY OUTLINE YOUR EMPLOYMENT BACKGROUND.

A. Before working for the Division, I was employed by a telecommunications consulting firm as a Financial Analyst. Then for approximately three years I worked for the Division as a Utility Analyst and now work as a Technical Consultant for the Division.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I received a Bachelor of Science degree from Weber State University in 1996 and a Masters of Business Administration from Utah State University in 2001.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE UTAH PUBLIC SERVICE COMMISSION?

A. Yes. I testified before the Commission as an expert witness in Docket Nos. 01-

2383-01, 02-2266-02, 02-049-82, 03-049-49, 03-049-50, 05-053-01, 05-2302-01, 07-2476-01, 08-2469-01, 10-049-16, 10-2521-01 and 10-2526-01.

II. SUMMARY

Q. PLEASE SUMMARIZE AND DESCRIBE THE PURPOSE OF YOUR TESTIMONY.

A. An application filed by Manti Telephone Company ("MTC") on April 24, 2012 requests that the Utah Public Service Commission ("Commission") grant a general rate increase which would increase the funds received by MTC from the Utah Universal Public Telecommunications Service Support Fund ("USF").

My testimony will focus on three specific areas of the application submitted by MTC. First, my testimony discusses the appropriate capital structure for MTC to be used in this application. Second, my testimony will outline Utah Admin. Code § R746-360-8 Calculation of Fund Distributions in Rate-of-Return Incumbent Telephone Corporation Territories and its validity in this application. Finally, my testimony discusses the cost of capital used to develop the revenue requirement for MTC

III. CAPITAL STRUCTURE FOR MTC

Q. WHAT CAPITAL STRUCTURE IS THE DIVISION RECOMMENDING FOR MTC?

A. The Division recommends using a capital structure of 65 percent debt and 35 percent equity.

Q. IS THE 65/35 CAPITAL STRUCTURE AN ACTUAL OR HYPOTHETICAL CAPITAL STRUCTURE?

A. The 65/35 capital structure recommend by the Division is a hypothetical capital structure.

Q. WILL YOU EXPLAIN WHY THE DIVISION IS RECOMMENDING USING A HYPOTHETICAL CAPITAL STRUCTURE?

A. Yes. In 2008, by request of the Commission, a Capital Structure Task Force was created to look at the following items:

1. Suggested rule for capital structures for cooperative and non-cooperative rural ILECs;
2. Recommendation to the Commission as to whether there is a necessity for the capital structure rule to be different for cooperatives and non-cooperatives; and
3. Recommendation as to whether a uniform rule is needed or whether the issue of the appropriate capital structure should be determined in individual rate reviews.

The Division and other interested parties participated in this task force where a variety of issues and solutions were discussed.

Eventually, it was agreed by the Task Force to adopt the following general framework when looking at capital structures. If a company was highly leveraged with an equity position less than 35 percent than a hypothetical capital structure of 65 debt and 35 equity would be used. Conversely, if a company had a capital structure that was mostly equity a hypothetical capital structure of 35 debt and 65 equity would be used.

A proposed rule, with the findings of the Task Force was filed with the Commission. Although the Commission never formally adopted the rule as proposed by the Task Force, since 2008 the Division has followed the general framework developed by the parties. Namely, when a company's capital structure is greater than either 65 percent debt or 65 percent equity a hypothetical capital structure is used in the calculations on rate of return.

Q. IS MTC'S CAPITAL STRUCTURE BELOW THE 35 PERCENT EQUITY THRESHOLD?

A. Yes. MTC's capital structure has an equity amount lower than 35 percent.

IV. INTERSTATE / INTRASTATE SEPARATION (DPU 2.1)

Q. IS UTAH ADMIN. CODE § R746-360-8 APPLICABLE IN MTC'S REQUEST FOR A RATE INCREASE?

A. Yes, absolutely. In December 2009, when Utah Rural Telecom Association ("URTA") petitioned the Commission to amend Utah Admin. Code § R746-360-2 B and R746-360-8 the purpose of the petition was to provide a framework to be used that would enable companies to have the interstate rate of return to be applied to interstate assets and the intrastate rate of return applicable on assets used within the state. After modification and tweaks the current rule was published by the Commission.

Q. FROM YOUR READING OF UTAH ADMIN. CODE § R746-360-8, WHAT INFORMATION IS NEEDED TO CALCULATE THE INTERSTATE / INTRASTATE CALCULATION FOR AN AVERAGE SCHEDULE COMPANY?

A. From my interpretation of the rule, there seems to be two different pieces of information required to make this calculation, the first being the interstate rate of return calculated by NECA as reported on the FCC form 492A. The second data point would be NECA's most recent interstate allocation computation filed at the FCC under 47 CFR Part 69.606.

Q. WHAT IS THE INTERSTATE RATE OF RETURN REPORTED TO NECA ON THE FCC FORM 492A FOR MANTI?

A. The interstate rate-of-return as reported on form 492A is 12.97 percent.

Q. WHAT IS NECA'S MOST RECENT INTERSTATE ALLOCATION COMPUTATION FILED AT THE FCC UNDER 47 CFR PART 69.606 CALCULATED BY THE DIVISION FOR MANTI?

A. The interstate allocation computation calculated by the Division is .21.98%.

Q. WHEN RESEARCHING THE ALLOCATION COMPUTATION FILED AT THE FCC WERE THERE ANY CHALLENGES FACED BY THE DIVISION?

A. Yes. The first challenge was that the factor model filed by NECA does not have one number for an average schedule company. When applying Utah Admin Code § R746-360-8 the Division anticipated that there would be one data point that could be used in the calculation. Unfortunately, that was not the case. Instead the Part 36 Separation Factor Models developed by NECA generally have a minimum and maximum factor for different categories of assets. This presented the Division with the daunting task of trying to determine the category of assets that would fit into the NECA asset descriptions and then estimating appropriate factors. In an effort to be balanced, the Division opted to use a midpoint of the high and low points for the appropriate asset categories. Exhibit 2.1 Interstate / Intrastate Separation shows the calculations developed by the Division and the .2198 interstate factor.

Q. WHAT OTHER OBSERVATIONS ARE IMPORTANT IN DETERMINING THE APPROPRIATE ALLOCATION FACTOR FOR MTC?

A. As Exhibit 2.1 Interstate / Intrastate Separation shows the Division calculated a factor using the low range of the data filed by NECA as well as a high range. Doing this calculation the interstate factor for the lowest and highest amounts would be .0650 or .3746 respectively. Additionally, some asset categories such as land and motor vehicles did not have factors that could be calculated by the Division. In an effort to be as equitable as possible a general allocation factor was developed when no factor was given.

Q. WHY IS IT HELPFUL TO HAVE THE TOP AND BOTTOM FACTORS THAT WERE FILED BY NECA?

A. Having the top and bottom range is helpful for the Commission to be able to see the upper and lower levels that could be applicable when following Utah Admin. Code § R746-360-8. While the Division feels using the median between the high and low point is an equitable alternative for following the rule, the lowest any party could argue for an interstate factor would be the .0650 and the highest would be .3746. Unless another methodology was followed, which would be contrary to Commission rules, the highest factor would be .3746.

Q. IN THE APPLICATION FILED BY MTC, DID THE COMPANY FOLLOW UTAH ADMIN. CODE § R746-360-8 TO DEVELOP THE INTERSTATE FACTOR?

A. No. Mr. Hendershot in line 53 of his Direct Testimony discusses a proxy model used to develop the interstate factor. The proxy model was developed using an average of three cost companies in the State of Utah. Using this average Mr. Hendershot determined the interstate factor to be .5072.

Q. IS THE DIVISION COMFORTABLE WITH THE USE OF A PROXY MODEL TO CALCULATE AN INTERSTATE FACTOR?

A. No. The Division believes that Utah Admin Code § R746-360-8 is very clear about how an interstate factor should be developed. The rule does not suggest the use of any proxy models, but instead outlines how to calculate the appropriate factor for average schedule companies. Using a proxy model simply is not allowed by rule.

Even if the Commission were to consider using a proxy model there would be a variety of challenges. The biggest challenge when developing proxy models is the reliance of those models on confidential information of other companies. Because of the confidential nature of the data, it is almost impossible for interested parties to verify and vet the inputs of the model.

Q. WHAT OTHER WAYS IS THE DIVISION UNCOMFORTABLE WITH THE INTERSTATE FACTOR CALCULATED BY MTC?

A. Using the Separation Factors filed by NECA and discussed earlier in my testimony, the highest factor possible for MTC would be .3746. Any factor higher than the .3746 would seem to be outside the band allowed by the NECA filing. Additionally, the Division reviewed the proxy model used by MTC and determined that more than 75 percent of the cost companies used by MTC had interstate factors that were higher than the top ranges calculated by NECA for each specific asset classification. Using an average of cost companies as a proxy for average schedule companies, does not provide an accurate portrayal of MTC's assets as contemplated by the Commission rules. Therefore the Division recommends that the Commission disregard the proxy model developed by MTC and uses the interstate factor of .2198.

V. COST OF CAPITAL (DPU2.2)

Q. WHAT IS THE ALLOWED RATE OF RETURN THAT THE DIVISION IS RECOMMENDING FOR MTC?

A. As exhibit 2.3 illustrates, the Division recommends using an allowed rate-of-return of 8.16 percent.

Q. EXPLAIN THE DIFFERENCES BETWEEN MTC'S REQUESTED ALLOWED RATE-OF-RETURN AND THE RATE RECOMMENDED BY THE DIVISION?

A. In reviewing the calculations performed by MTC and the Division the encouraging part of the analysis is that there is considerable agreement with the calculations done by both parties. The direct testimony of Mr. Hendershot reflected some adjustments made by the company after meeting with the Division and Office of Consumer Services in a settlement conference. The adjustments in Mr. Hendershot's direct testimony which differ from the second amended application of MTC, that the Division supports are:

1. A hypothetical capital structure of 65 percent debt and 35 percent equity instead of the 50 percent equity and 50 percent debt as originally filed.

2. A weighted average cost of debt of 4.94 percent instead of the 8.4 percent originally filed.

The differences between MTC and the Division are the appropriate interstate factor that should be applied and the appropriate intrastate cost of equity for MTC. As discussed previously, the Division recommends the Commission use an interstate factor of .2198 when calculating the portion of assets eligible for the 12.97 percent rate allowed by the Federal Government. The Division also argues that the appropriate intrastate cost of equity for MTC should be 10.26 percent instead of the 12.5 percent recommended by MTC.

Q. HOW DID THE DIVISION DETERMINE A COST OF EQUITY OF 10.26 PERCENT?

A. The Division used a Capital Asset Pricing Model ("CAPM") looking at similar publicly traded telecommunications companies to determine a beta that would be representative of MTC. With this calculated beta and following the general guidelines of CAPM the Division was able to calculate as reflected in Exhibit 2.2 Return on Equity – Intrastate the cost of equity for MTC at 10.26 percent.

Q. IS THE DIVISION COMFORTABLE WITH THE RESULTS?

A. Comfortable yes, ecstatic no. The Division recognizes that there are some inherent difficulties in using a CAPM model and the Commission's apparent discomfort using a CAPM model. The Division used a CAPM model because there was not any other viable alternative. A Bond-Yield-Plus-Risk-Premium approach is not precise enough to yield a cost of equity that should be used in a rate case. In a Discounted Cash Flow ("DCF") model dividends are necessary to make the model work. It is impossible with small privately held telecommunications companies to determine a dividend yield. Without a dividend yield it is impracticable to calculate a cost of equity using a DCF model.

Because CAPM was the only financial model available to the Division that could produce results that allowed a certain level of comfort the Division used the CAPM model.

VI. CONCLUSION

Q. WHAT IS THE DIVISION'S RECOMMENDATION FOR THIS PETITION?

A. The Division recommends that the Commission use a 65 percent debt and 35 percent equity hypothetical capital structure, use an interstate factor of .2198 and an allowed rate-of-return of 8.16 percent.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.