BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Increase of Rates And Charges and Increase in USF Eligibility for Manti Telephone Company	:	Docket No. 08-046-01 DPU Exhibit 3.0 DIRECT – Rev Req **(REDACTED)**

DIRECT TESTIMONY

OF

PAUL A. HICKEN
STATE OF UTAH
DIVISION OF PUBLIC UTILITIES

OCTOBER 18, 2012

1 **I. INTRODUCTION**

2 **Q: Please state your name for the record**.

3 A: My name is Paul Allen Hicken.

4 **Q: By whom are you employed and what is your business address?**

5 A: I am employed by the Utah Department of Commerce, Division of Public Utilities (DPU).

6 My business address is 160 East 300 South, 4th Floor, Salt Lake City, Utah, 84114.

7 **Q: What is your position with the Division?**

8 A: I am employed as an Analyst of Public Utilities.

9 **Q: Please summarize your educational and professional experience.**

10 A: I received a Masters of Business Administration from Utah State University in 1985. I

11 am also a Certified Government Financial Manager. I was employed for nineteen years

12 with the Utah Office of Legislative Auditor General as a Performance Auditor. I have

13 been employed with the Division since June, 2005.

14 **Q: Have you testified before the Commission on prior occasions?**

15 A: Yes on several occasions, most recently in June 2010 as DPU's witness for the hearing on

16 USF Eligibility for Carbon Emery Telecom.

17 **Q: Please describe your participation in the Division's review of Manti Telephone**

18 **Company (MTC).**

19 A: I have been involved with the review of Manti's operations and rate base pertaining to

20 their USF eligibility since the initial application for state USF assistance in April 2008.

21

22 **II. PURPOSE AND SCOPE OF TESTIMONY**

23 **Q: What is the purpose of your testimony in these proceedings?**

24 A: My testimony addresses and summarizes several specific issues and conditions pertaining
25 to rate base, depreciation, expenses and allocations that were identified during the DPU's
26 audit of Manti Telephone Company.

27

28 **III. BACKGROUND**

29 The Division of Public Utilities (DPU) completed an audit of expenses, revenues, rate
30 base, and operations for Manti Telephone Company (MTC), pertaining to the application
31 for increased USF eligibility by the company. The audit was initiated in April 2008 and
32 delayed for several years because of inadequate accounting records. The audit was finally
33 completed to the extent possible in light of the access and records available in August
34 2012.

35

36 **IV. SUMMARY OF ADJUSTMENTS**

37 The adjustments discussed in this testimony are identified in the following section and
38 will be discussed in further detail in the body of the testimony.

39 - DPU 3.1 Rate base adjustments for non regulated activity

40 • DPU 3.2 Expense adjustments for non regulated activity

41 • DPU 3.3 Rate base and depreciation adjustment for residual value

42 • DPU 3.4 Rate base adjustment for 2010 overstated labor

43 • DPU 3.5 Rate base adjustment for 2012 plant additions

44 • DPU 3.6 Rate base adjustments for redundant copper

45 • DPU 3.7 Expense adjustment for equipment lease from MTCC

46 • DPU 3.8 Expense adjustment for non company vehicles

47 • DPU 3.9 Expense adjustment for building leases from P&C Rentals

48 • DPU 3.10 Expense adjustment for yard storage lease from MTCC

49

50 **1. DPU 3.1 Adjustment to rate base for non regulated activity.**

51 **Q: Please explain the nature of this adjustment.**

52 A: This adjustment removes a portion of the assets or plant associated with non regulated

53 activities.

54 **Q: Does MTC apportion a reasonable share of the joint and common costs to its**

55 **affiliates?**

56 A: No, it does not. MTC makes little or no effort to equitably apportion costs to its affiliates

57 such as MTCC.

58 **Q: How does the DPU most commonly evaluate other USF recipients' allocation of**

59 **costs?**

60 A: Most USF recipients keep records on costs as required by the FCC in order to receive
61 funds from the federal program. 47 CFR 64 has various requirements for tracking and
62 allocating costs. The DPU will generally review the records and make a recommendation
63 based in part of the data found therein.

64 **Q: Did the DPU conduct a similar review of MTC's allocation records?**

65 A: No. MTC claims it is exempt from the allocation subsection of Part 64 because it is an
66 Average Schedule company. MTC claims that its sister company, MTCC is a separate
67 corporate entity and technically not an "affiliate" of the MTC organization. Therefore
68 MTC does not track expenses for purposes of allocating costs like other USF recipients.

69 **Q: If this is the case, explain why DPU believes MTC is required to allocate a**
70 **reasonable share of joint and common costs to affiliates.**

71 A: The DPU does not administer the federal program. The rules and requirements of the
72 federal program are set by the FCC. Whether MTC is an Average Schedule company and
73 whether it would therefore be exempt from the federal allocation requirements are beyond
74 the scope of the DPU's evaluation of MTC's request for Utah USF funds. This docket is
75 for the purpose of determining MTC's eligibility for state USF funds – a different
76 program. The DPU, as administrator of the Utah USF program, believes that allocation to
77 affiliates – whether technical or affiliate by practice – is necessary as required by rule and
78 public policy. The Utah USF program requires that the funds be used to provide basic
79 telephone service only and that the funds may not provide a competitive advantage or

80 disadvantage to any provider. The only reasonable application of this standard is to
81 require all telecommunication companies eligible to receive state USF funding to allocate
82 their investment between regulated and non regulated activities.
83 This docket provides an example as to what might happen if the DPU were to simply
84 ignore the reality of the modern telecommunication industry. Today's providers are
85 bandwidth businesses. Their affiliated businesses use the same facilities to provide voice,
86 internet and television services. The voice service uses only a small portion of the
87 bandwidth available on a modern line and provides only a portion of the total revenue
88 generated by selling services utilizing a single wire-line network. As can be seen by
89 MTC's practices, the facilities are built to accommodate the spectrum of services
90 provided and by sharing the costs, the users of the facilities can operate economically.
91 Therefore it is reasonable to expect that the costs of the shared operations be allocated
92 between the various services. To ignore the other services would result in the USF funds
93 subsidizing the competitive activities of unregulated businesses. It would effectively pay
94 for the distribution network used by unregulated businesses and allow them access for
95 free at the cost of the USF. This would be unfair to other competing unregulated service
96 providers in that area, and treat non-allocating companies significantly differently from
97 other USF recipients without a valid justification or public benefit.
98 **Q: How do other regulated companies in the state treat non regulated activity and**
99 **transactions with non regulated affiliates?**

100 A: Most regulated telecommunication companies offer a combination of regulated and non
101 regulated services. They have affiliate organizations that offer different services but share
102 common resources. They routinely make allocations to non regulated activities for the
103 shared resources. They have Cost Allocation Manuals (CAM) that are very detailed and
104 are developed by considering cost causation factors. Typically they have specific
105 allocators that apply to specific parts of operations and general allocators for non specific
106 operations.
107 MTC claims to be a wholly regulated company with no non regulated activity. It is
108 completely separate from MTCC so there is no need for them to make allocations for
109 shared resources, plant and assets. The DPU has thoroughly reviewed the operations of
110 MTC and MTCC and believes that while MTCC may be a separate corporate entity on
111 paper, it is organized like an affiliate and it operates like an affiliate of MTC. There are
112 many shared resources and assets. MTC and MTCC use the same public phone numbers
113 interchangeably for purposes of customer service support. Clearly, the entities are not
114 unrelated and share significant resources. Further, both companies are run by members of
115 the same family. Consequently, all business transactions and operations are not arm's
116 length. The broad sharing of assets, especially in light of close ownership of the two
117 companies, suggests many operational and transactional decisions affecting MTC are
118 influenced by factors relevant to MTCC.
119 **Q: Does Manti have a Cost Allocation Manual?**

120 A: Yes. Manti does have a Cost Allocation Manual which states the company will apportion
121 costs between regulated and non regulated activities using direct assignment for costs
122 incurred exclusively for providing regulated or non regulated services. For indirect costs
123 that cannot be directly assigned, cost causation factors will be used to allocate a share of
124 costs.

125 **Q: Does Manti follow their Cost Allocation Manual?**

126 A: No. The DPU believes that Manti has not followed their CAM in all instances for costs,
127 revenues and assets. For example, we found several legal invoices that were billed to
128 MTCC for services that were clearly identified as non regulated, yet they were paid by
129 MTC. In another example, the central office in Sterling is a divided use facility. The
130 main floor is used to support phone service and the basement area is used for internet and
131 TV transmission. The facility is owned by MTC and it appears in MTC's Continuing
132 Property Records (CPR). The property tax for this facility is paid by MTC. Although the
133 usage appears to be somewhat equally divided, we could find no indication that any
134 portion of this asset or the associated expense was allocated to MTCC. This facility was
135 not mentioned in the lease agreement between MTC and MTCC. However, it does appear
136 that MTCC pays [redacted] to rent the basement of the facility. The DPU did not
137 perform an analysis whether this was a fair and reasonable rate, but the property tax and
138 utilities of this facility would be significantly more than what was collected in rent.
139 Another example is that MTCC uses MTC facilities, employees, and other resources at

140 the main office in Manti for MTCC's non regulated operations. Billing and collections for
141 regulated and non regulated services are conducted as a single operation by MTC
142 employees and from the MTC facility. Breakaway Wireless, an MTCC subsidiary also
143 operates out of the MTC central office. No allocations are made to the non regulated
144 company for the use of these resources. However, MTCC does pay ██████████ for
145 Breakaway Wireless to use the facility. We could not determine if MTCC pays any
146 additional compensation for use of the MTC facilities but nothing else was mentioned in
147 the lease agreement between MTC and MTCC.

148 **Q: Is this rental arrangement a common method of allocating costs?**

149 A: No, most companies in Utah make allocations to non regulated activity for shared assets
150 and costs.

151 **Q: Did the DPU try to formulate a reasonable allocation for Manti's non regulated**
152 **activity?**

153 A: Yes. This was a difficult task because MTC does not have adequate records and the
154 MTCC financial statements provided to the DPU do not appear to be credible for
155 purposes of evaluating apportioned costs for other USF recipients. However, these
156 financial statements offer the best data that was available to the DPU.

157 The DPU considered several factors trying to come up with a reasonable allocation
158 between regulated and non regulated services. Using a composite average of 5 different
159 ratios, the DPU came up with a non regulated cost allocation of █████ There are many

160 different methodologies to help align allocation of costs with causation and the DPU had
161 limited information, but some of the factors considered were: 1) line counts and customer
162 counts, 2) expense ratios, 3) revenue ratios, 4) asset ratios, and 5) payroll ratios. These
163 factors are summarized in DPU Exhibit 3.1. Customer counts were compared between the
164 regulated and non regulated services using the Local Service Detail report from March
165 2012. A comparison of customer counts provides a useful picture of the distribution of
166 services, which should be somewhat correlated to costs. This comparison showed
167 approximately [redacted] of the total customers received non regulated services. The next
168 comparison looked at costs of providing service. Operating expenses of both companies
169 were compared for YE 2011 using the projected MTC expenses from the application and
170 the MTCC financial statement.[1] This comparison between the two companies showed
171 about [redacted] of total expenses resulted from non regulated services. The third
172 comparison looked at the revenues of both companies. Revenue is generated as a result of
173 costs and a revenue comparison gives a look at the proportionate value of the services
174 provided on the whole. The comparison of revenues between the two companies for the
175 same time period using the MTCC financial statement and the MTC application showed
176 about [redacted] of total revenues came from subscriptions to non regulated services. Using
177 another source, the Local Service Detail report showed about [redacted] of total revenue billed
178 was attributed to non regulated service. A fourth comparison looked at assets for both

1 DPU was only provided unaudited MTCC financial statements.

179 companies. This is another indicator of allocation based on distribution of plant assets.
180 The investment required to put plant into service is considered to be a necessary cost to
181 providing service. The comparison of plant assets for the two companies used the same
182 data. This comparison showed the non regulated assets to be about [redacted] of the
183 combined total assets. The last ratio compared payroll between the two companies.
184 Payroll is a result of labor and is a commonly used indicator for cost of service. A payroll
185 comparison shows the percentage of cost of labor to provide services for both companies.
186 This comparison looked at payroll before taxes and benefits at EOY 2011 using the MTC
187 general ledger and the MTCC financial statement. This ratio shows about [redacted] of total
188 payroll was attributed to the non regulated services. To pick one comparison as the best
189 indicator of cost would unfairly skew the allocation, but when 5 indicators of cost are
190 considered collectively, this may provide a reasonable picture for allocation for costs. The
191 adjustment to allocate costs is shown in DPU Exhibit 3.2.

192 **Q: Are there other ways to calculate cost allocations?**

193 A: Yes, there are other valid methods, but this was DPU's best effort based on limited
194 information. Another alternative for the Commission would be to withdraw support under
195 Rule 746-360-3 until the information necessary to more accurately apportion costs can be
196 provided by MTC.

197 **Q: Does the DPU believe it is in the public interest to provide Utah USF funds to**
198 **companies that do not allocate costs to non regulated activities?**

199 A: No. Without proper cost allocations, USF payments would likely be unreasonably high.

200

201 **2. DPU 3.3 Rate Base and depreciation adjustment for salvage value.**

202 **Q: Please explain the adjustment for salvage value.**

203 A: Under Generally Accepted Accounting Principles (GAAP), straight line depreciation is
204 calculated by taking the cost of the asset minus the estimated salvage and dividing by the
205 useful life of the asset. This method of straight line depreciation is again prescribed for
206 utility accounting in 47 CFR 32.2000 which says companies will depreciate on a straight
207 line basis the difference between net book cost and estimated salvage during the
208 remaining service life of the asset. Salvage value is the estimated value of an asset at the
209 end of its useful life. The useful life of each asset type is defined in a docket for each
210 company by the Utah PSC. This is the prescribed method of depreciation unless a
211 company has prior approval to use an alternate method by the Federal Communications
212 Commission. Manti has not followed this method of depreciation as outlined. After
213 reviewing its booked assets and depreciation as shown in the CPR detail, it is apparent
214 that depreciation is calculated at full book cost for the life of the asset. The effect of this
215 is that too much depreciation has been taken on some assets over the years. We estimate
216 that approximately [redacted] in depreciation was overstated. The DPU Exhibit 3.3 shows
217 how this was calculated. We started with the book asset cost and estimated a salvage
218 value then calculated depreciation based on the net value of the asset. For the purposes of

219 this rate case, the adjustment puts the overstated depreciation amount back into rate base.
220 It also reduces the depreciation expense for 2011 by [redacted] because if the depreciated
221 value was restored the expense cannot be taken. A contra entry for this amount was also
222 required to the depreciation reserve account.
223

224 **3. DPU 3.4 Rate Base adjustment for overstatement of 2010 labor in CPR detail.**

225 **Q: Would you please explain this adjustment?**

226 A: Prior to 2010, the company was not keeping accurate timekeeping records for their
227 employees and there was no operational work order system to track work by projects.
228 These accounting weaknesses were pointed out by the Division shortly after the company
229 filed its initial application in 2008. The effect was that labor was listed in the CPR detail
230 without being associated with a specific project. Labor had to be estimated because there
231 were no time records to account for specific labor by employee or by project. In 2009, the
232 DPU reached a stipulation on the rate base which included the estimated labor. During
233 2010, a more accurate timekeeping system was initiated and a work order system was
234 started during the latter part of the year. A review of labor in the CPR detail shows that
235 prior to 2010, labor comprised about [redacted] of the total assets. During 2010, capitalized
236 labor was recorded at above [redacted] of the total assets added during the year. This is shown
237 in the DPU Exhibit 3.4. Labor was still being estimated during 2010 because the work
238 orders were not fully operational.

239 The adjustment brings the estimated labor down to the historical average of [redacted]
240 which is an adjustment that decreases rate base by [redacted]. There is also a corresponding
241 decrease to depreciation expense of [redacted] and a contra entry of the same amount to
242 depreciation reserve.
243
244 **4. DPU 3.5 Rate Base adjustment for plant additions during CY 2012.**
245 **Q: Please explain this adjustment for the 2012 plant additions.**
246 A: In the application, the company proposed to add [redacted] of new assets and remove
247 [redacted] of assets during 2012. This proposed amount is shown in column H, line 38 of
248 revised exhibit 1, filed with the applicant's direct testimony. The net addition to Property
249 Plant and Equipment (PPE) during the year would be [redacted]. The company's
250 proposed adjustment to rate base was [redacted], which is the average of the total
251 additions. These plant additions were presented as 'known and measurable' additions to
252 the rate base, although it was not known when or if the assets would be acquired or
253 placed into operation. The DPU reviewed General Ledger (GL) accounts for the first 6
254 months of 2012 to determine the extent that any of these assets were purchased or put into
255 service. DPU Exhibit 3.5 shows a more realistic figure for known and measurable plant
256 additions for 2012 would be [redacted]. A corresponding adjustment was also made for
257 depreciation expense which was calculated at [redacted] instead of [redacted]. These
258 adjustments were based on MTC's actual figures annualized from 6 months of entries in

259 the 2012 GL.

260

261 **5. DPU 3.6 Rate Base adjustments for redundant copper.**

262 **Q: Please explain "redundant copper" and the details of this adjustment.**

263 A: Manti Telephone is in the process of upgrading its copper network with a fiber network.
264 The copper network includes all the buried and aerial copper wire and cable that provide
265 phone service to the customers. The fiber network replacing the copper provides phone
266 and additional non regulated services with better speed and more capacity. The fiber
267 overlay is a parallel system that follows the existing copper to all the customers. When
268 the fiber overlay is complete, the copper will be disconnected and retired from the rate
269 base. In the meantime, the copper system is connected to some customers and the fiber is
270 connected some customers. Both networks are in service and both systems are part of
271 MTC's rate base. The DPU believes that the fiber network is connected to a majority of
272 customers and consequently, the copper system is redundant and should be taken out of
273 rate base. The details of this adjustment are shown in DPU Exhibit 3.6. The DPU
274 learned that the fiber overlay is about [redacted] complete in Manti and [redacted] complete in
275 Ephraim. The weighted average is about [redacted] of MTC customers are connected to the
276 fiber network. Therefore, this percentage or about [redacted] of the non depreciated
277 copper network should be removed from rate base for purposes of calculating USF. In
278 addition, a corresponding adjustment to depreciation expense during the test year should

279 be taken in the amount of [redacted].

280

281 **6. DPU 3.7 Expense adjustment for equipment leased from MTCC.**

282 **Q: Please explain this adjustment.**

283 A: MTC leases several pieces of equipment from MTCC on a monthly basis. The DPU could
284 not identify these types of equipment nor any terms in any lease agreements. The Cost
285 Allocation Manual simply indicated that MTC would lease heavy equipment from MTCC
286 which included a backhoe, a bucket truck and 2 trenchers. In addition to leasing MTCC's
287 equipment monthly, MTC owns a backhoe, bucket truck and a trencher, which we found
288 included in the CPR detail, although not identified by serial number. During our onsite
289 review, we found invoices paid by MTC to MTCC for monthly leased equipment
290 specified as a backhoe for [redacted] per month, a bucket truck for [redacted] per month and a
291 trencher for [redacted] per month. The monthly payments for leased equipment totaled [redacted]
292 per month or [redacted] per year. We were able to trace this total amount to the MTC
293 general ledger in the vehicle clearing account. In the clearing account we determined
294 that [redacted] of this amount was spread to the plant under construction (PUC) account
295 and the remaining [redacted] was spread to various expense accounts. The amount spread to
296 the PUC account can be traced to specific work orders and theoretically the work order
297 will identify the equipment used. However, the amount spread to the expense accounts
298 could not be traced to any specific piece of equipment.

299 When we inspected the warehouse space, we observed a backhoe with a flat tire which
300 appeared to have been not used for quite some time. We also observed a bucket truck that
301 was in need of repairs. We don't know if these pieces of equipment were the ones leased
302 from MTCC or the ones owned by MTC. We asked for equipment logs or some sort of
303 equipment record to determine how often the equipment is used, but we were told that the
304 company did not keep records of equipment usage. We cannot determine if the owned or
305 leased equipment was used in the work orders but we gave credit for all charges in the
306 PUC account. However as shown in DPU Exhibit 3.7, we adjusted the expense for
307 ███ because there are no invoices from MTCC to MTC to document if the leased
308 equipment was actually used.
309

310 **7. DPU 3.8 Expense adjustment for non company vehicles.**

311 **Q: What are the details of this adjustment?**

312 A: The DPU found invoices during fieldwork showing that MTC paid invoices to the Utah
313 Tax Commission for registration, tax and licensing of █ vehicles. Of these █
314 registrations paid, only █ vehicles were identified in the CPR detail of Manti Telephone
315 and the other █ were not included. The CPR detail lists a total of █ vehicles and we
316 documented registration for █ of those plus another █ vehicles not listed. This equates
317 to roughly █ of the total vehicles identified that did not belong to MTC.
318 Vehicle registrations and other expenses that correspond to each vehicle's use, such as

319 gas, oil, repairs, tires, etc. are all collected to the Vehicle Clearing Account. Once they are
320 grouped to the clearing account, they are spread out to various expense accounts
321 according to the labor spread indicated on the timesheets of the employees using the
322 vehicles. It becomes extremely difficult to identify which expense belongs to a specific
323 vehicle when expenses are grouped in the vehicle clearing account. In the vehicle
324 clearing account there was approximately [redacted] of expense that could not be tied to
325 any specific vehicle. Since the registration expense from all vehicles was collected in the
326 clearing account, we estimated that about [redacted] belonged to the [redacted] vehicles that were not
327 part of MTC. Consequently we made this adjustment out of expense for [redacted]. The
328 details of this adjustment are shown in DPU Exhibit 3.8.
329

330 **8. DPU 3.9 Expense adjustment for leased warehouse space.**

331 **Q: Please explain this adjustment.**

332 A: Manti Telephone leases warehouse space at two locations from P & C Rental. P & C
333 Rental is owned by [redacted], the owners of MTC. The rental agreement is
334 renewable every 5 years and is effective until December 2014. The rental payment is
335 determined to be [redacted] per month or [redacted] per year. This payment is a net lease
336 which covers rent only. In addition, the renter pays for his own utilities and insurance.
337 The rented warehouse space was described in the company's financial statements as
338 [redacted] square feet. The cost works out to be about [redacted] square foot per month.

339 During their fieldwork, the DPU inspected these two warehouses located at
340 . Inside the first warehouse, the center of the building
341 was walled off for personal use of the leaving an approximately U-shaped
342 area that is leased to MTC. The total amount of space utilized by MTC was considerably
343 less than square feet. After the field inspection, DPU received an email note from
344 Manti stating that there had been a mistake in the amount of leased warehouse space
345 stated in the financial statement. The amount of space leased should have been described
346 as square feet of warehouse space. At this rate the cost per square foot is about
347 per square foot per month.
348 In light of the fact that the lease was to a company with common ownership and the
349 square footage had been adjusted yet the lease rate did not change it was apparent that this
350 was not a typical lease arrangement. We investigated the reasonableness of the rate. We
351 contacted several realtors in Sanpete County for comparable prices. The nearest
352 comparable warehouse space was in Utah County and the rate was at per foot per
353 month. Consequently we made an adjustment as indicated in DPU Exhibit 3.9. We felt
354 the rates were excessive, particularly given that one would expect higher rental rates in
355 Utah County than in Sanpete County. Further, there was only feet of leased space
356 that was actually used. We allowed annual expense of to remain
357 and adjusted out of rental expense.
358

359 **9. DPU 3.10 Expense adjustment for yard storage lease.**

360 **Q: Please give the details of this adjustment.**

361 A: During the field audit, the DPU discovered invoices from MTCC billing MTC [redacted] per
362 month for yard storage. There was no yard storage mentioned in the lease agreement
363 between MTCC and MTC. After reviewing records from the Sanpete County recorder's
364 office, we could not find any property owned or registered to MTCC. However, we did
365 find a parcel used for yard storage which was identified as the pole yard. This parcel is
366 actually owned by and registered to MTC. Consequently this expense for yard storage
367 was adjusted for the annual amount of [redacted] as shown in DPU Exhibit 3.10.
368 This concludes my testimony on the above mentioned adjustments. I will be glad to
369 answer any further questions.