BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF MANTI TELEPHONE COMPANY'S APPLICATION FOR USF ELIGIBILITY	)))	**Docket No. 13-046-01**
MANTI TELEPHONE COMPANY, **Applicant**	)))	

REDACTED

DIRECT TESTIMONY

OF

KEVIN J. KELLY

ON BEHALF OF MANTI TELEPHONE COMPANY

(WITHOUT CONFIDENTIAL EXHIBITS)

December 20, 2013

DIRECT TESTIMONY OF KEVIN J. KELLY

Q. What is your name?

A. My name is Kevin J. Kelly.

Q. By whom are you employed and in what capacity?

A. I am the Regulatory Director for TCA, Inc - Telcom Consulting Associates ("TCA"). TCA's business address is 526 Chapel Hills Drive, Suite 100, Colorado Springs, Colorado, 80920. My principal role is directing the TCA Regulatory Team, which analyzes, advocates, and interprets federal and state regulatory actions on behalf of our clients. TCA provides financial, regulatory, marketing and management consulting services to more than 100 small and mid-size rural local exchange carriers ("LECs") and their affiliates throughout the United States.

Q. Briefly describe your educational background and work experience.

A. Prior to joining TCA in 1997, I practiced as Certified Public Accountant ("CPA") for eight years for two regional public accounting firms, Kiesling Associates and Frederick & Warinner. Both of these CPA firms specialized in performing external audits of rural telephone companies - one of the primary aspects of which was to ensure compliance with the Federal Communications Commission's ("FCC") Part 32 accounting rules. I also have been employed by Sprint, in tax and general accounting positions for multiple affiliates; the Kansas Corporation Commission ("KCC"), as a managing auditor; and Overland Consulting, a regulatory consulting firm.

In addition to testifying in previous Utah proceedings, I have also participated in regulatory proceedings in Kansas, Colorado, Nebraska, Wyoming, and New Mexico. Many of these proceedings have involved the determination of the jurisdictional revenue requirement for rate-of-return regulated LECs. Accordingly, I have provided expert testimony during many of these proceedings on the measurement, gathering, and allocation of the costs necessary to provide regulated telecommunications services in compliance with FCC rules contained in Part 32 (Uniform System of Accounts), Part 64 (Subpart I, Allocation of Costs), and Part 36 (Jurisdictional Separations Procedures).

I was recently appointed an advisor to the Industry and Regulatory Policy Committee of NTCA – the Rural Broadband Association. Prior to this, I served for more than a decade as a member the National Exchange Carrier Association's ("NECA")[1] Cost Issue Task Group ("CITG"), a small group of industry experts that assists NECA staff in the analysis of issues that are complex in nature. Qualifications for CITG membership include: 1) the ability to address a wide scope of issues, 2) subject area expertise in most phases of telecommunications accounting and separations, and 3) the ability to support positions when making recommendations.

[1] NECA administers the FCC's access charge regime for more than 1,000 rural LECs. This includes the filing of tariffs, collecting and validating cost and revenue data, ensuring compliance with FCC rules and distributing access charge revenues based on the company's cost of providing interstate access.

I received both a Bachelor of Business Administration, with an accounting major, and a Masters in Business Administration, with an emphasis in finance, from the University of Iowa. I hold the Iowa Board of Accountancy CPA certificate no. 3455.

Q. On whose behalf are you presenting testimony?

A. I am presenting testimony on behalf of Manti Telephone Company ("Manti" or "Company") in support of its application for increased support from the Utah Universal Service Fund ("UUSF").

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide detailed explanations for selected financial and statistical information supporting Manti's Application for increased UUSF eligibility, filed September 11, 2013. Specifically, I will provide testimony that will support Confidential Schedules 1-6 and 12 contained in the Application, which are attached to this Testimony as Exhibits.

Dr. Curt Huttsell, also of TCA, will provide expert testimony addressing the proper authorized return on equity for Manti. The Company's General Manager, Dallas Cox and Accounting Manager, Tami Hansen, will also provide testimony in support of the Application.

Q. Please identify the Exhibits to your testimony.

A. The individual Exhibits include:

- Manti KK 1 - Computation of Earnings Shortfall (Confidential)
- Manti KK 2 – Rate Base Summary (Confidential)
- Manti KK 3 – Rate Base Adjustments (Confidential)
- Manti KK 4 – Income Statement Summary (Confidential)
- Manti KK 5 – Income Statement Adjustments (Confidential)
- Manti KK 6 - Cost of Capital Summary
- Manti KK 7 – Depreciation Rates (Confidential)

Q. Were the Exhibits referred to above and the supporting workpapers prepared by you or someone under your supervision?

A. Yes, they were.

Q. What is the proposed test period specified in the Application and how was it derived?

A. Pursuant to Utah Code Annotated Section 54-5-4(3), Manti proposes to use calendar year 2012 as the test period for the purpose of determining the appropriate amount of UUSF support. Accordingly, the Application and Confidential Schedules are based upon audited financial information for the 12 months ending December 31, 2012. This test period selection is consistent with the Commission's historic treatment of rural LECs in Utah.

This historical “test period” was then adjusted for “known and measurable” changes in operations, which more accurately reflect Manti’s ongoing cost of providing telecommunications services. Additionally, Manti’s operations were carefully scrutinized to ensure that all non-regulated operations – including those pertaining to MTCC, an affiliated non-regulated entity - were removed from the test period operating results. These pro forma adjustments, which are contained in Confidential Schedules 3 and 5, comprise the focus of my testimony.

Confidential Exhibit Manti KK 1- Computation of Earnings Shortfall

Q. Have you calculated Manti’s Revenue Deficiency?

A. Yes. Confidential Exhibit Manti KK 1 reflects a revenue deficiency of $1,559,173.

Q. How was Manti’s revenue deficiency determined?

Manti is a rate-of-return regulated LEC in both federal and state jurisdictions. Accordingly, Manti maintains its accounting records in accordance with the FCC’s Part 32 Uniform System of Accounts (“USOA”), as required by Commission Rules.[2] As a result, the Company’s Application complies with FCC rules guiding the measurement, gathering, and allocation of the costs necessary to provide regulated telecommunications services, including the FCC rules contained in Part 32 and Part 64 (Subpart I, Allocation of Costs).

To determine Manti's revenue deficiency, first the Company's rate base was multiplied by a reasonable rate-of- return to determine the allowable return, which is reflected on Line 3 of Confidential Exhibit Manti KK 1. Next, the allowable return is reduced by the Company's operating income, resulting in the revenue deficiency, which is identified on Line 5 of Confidential Exhibit Manti KK 1. However, because the Company's allowable return is an after-tax amount - the revenue deficiency must also be "grossed up" to a level that will sustain the required return after Manti recognizes the associated federal and state income taxes. The grossed up revenue deficiency is identified on Line 7 of Confidential Exhibit Manti KK 1.

Q. How does Manti propose to recover its revenue deficiency?

A. Manti's local service rates are already at the affordable base rate as determined by the Commission. Therefore, in order to enable the Company to earn a fair return on its investment in facilities to provide service, Manti proposes that its entire revenue deficiency be recovered through UUSF disbursements. This will enable Manti to continue providing service to its customers and to initiate capital projects that have been delayed by the Company's current significant under-earnings.

Confidential Exhibit Manti KK 2 – Summary of Rate Base

Q. Have you calculated Manti's Rate Base for purpose of this proceeding?

[2] PSC R746-340-2

A. Yes. Confidential Exhibit Manti KK 2, attached hereto, provides a calculation of the Company's total rate base. The Confidential Exhibit Manti KK 2 begins with historical book amounts and contains adjustments to produce a pro forma regulated rate base as of December 31, 2012.

Q. When describing Confidential Exhibit Manti KK 2 above, you indicate that it contains adjustments required to produce a pro-forma regulated rate base. Please describe those adjustments.

A. The adjustments to rate base are included in Confidential Exhibit Manti KK 3. I will identify and explain each adjustment to rate base contained in Exhibit 3 below.

Confidential Exhibit Manti KK 3 - Rate Base Adjustments

Q. Please explain Adjustment RB-1.

A. Adjustment RB-1 removes the outdated copper plant that the Company has replaced with fiber from rate base. This adjustment prevents the recovery of the cost of facilities no longer in service. The removal of this fully-depreciated plant also reduces Manti's normalized depreciation expense (see IS-10).

Q. Please explain Adjustment RB-2.

A. Adjustment RB-2 removes the Company's net investment in facilities required to provide voicemail from rate base. Voicemail is a non-regulated service - and as a result the Company is excluding this investment from the calculation of its UUSF revenue deficiency. Manti has also made corresponding adjustments to remove the revenues (IS-4) and expenses (IS-7) associated with providing voicemail services.

Q. Please discuss Adjustment RB-3.

A. Adjustment RB-3 removes COE Radio Equipment. This adjustment is necessary and appropriate because the COE Radio Equipment is no longer in service from rate base. It is my understanding that the Company has made this same retirement entry on its books in 2013.

Q. Please explain Adjustment RB-4.

A. Adjustment RB-4 removes the net acquisition premium associated with the Company's purchase of the Ephraim exchange from rate base. Typically, inclusion of an acquisition premium in rate base requires prior regulatory approval, which the Company has not sought. This adjustment is consistent with the DPU's treatment of this asset in Manti's 2012 proceeding.

Q. Please explain Adjustment RB-5.

A. Adjustment RB-5 removes Rural Telephone Finance Cooperative ("RTFC") stock surrendered during 2013 from rate base. Due to Manti's dire financial situation, RTFC has required that the Company surrender its RFTC stock and apply the proceeds to its outstanding debt. Therefore, it is appropriate that the RTFC be removed from the Company's rate base.

Q. Please discuss Adjustment RB-6.

A. Adjustment RB-6 calculates the Company's cash working capital allowance. Manti has used a 15-day allowance, as prescribed by the FCC for small LECs who opt not to undertake the burden, time and expense of a full lead-lag study.[3]

Confidential Exhibit Manti KK 4 – Test Year and Normalized Income Statement

Q. Have you calculated Manti's normalized earnings for purposes of this proceeding?

A. Yes. Confidential Exhibit Manti KK 4 calculates Manti's normalized earnings as specified in the Total Company Rule, R746-360-8. This Confidential Exhibit Manti KK 4 begins with historical book amounts and identifies and adjusts for fixed known and measurable items necessary to produce a pro-forma, regulated income statement as required and permitted by Utah Code Annotated Section 54-4-4 (3)(b)(ii)(B). The adjustments to Confidential Exhibit Manti KK 4 are identified in detail in Confidential Exhibit Manti KK 5. I will identify and explain each adjustment to normalize the income statement below.

Confidential Exhibit Manti KK 5 - Income Statement Adjustments

Q. Please explain Adjustment IS-1.

[3] 47 CFR §65.820(d)

A. Adjustment IS-1 replaces the transfer price Manti charged to MTCC for access to its customers with the appropriate wholesale DSL transmission rate, as specified in NECA Tariff 5. The Company implemented this change in 2013, to more appropriately compensate Manti's regulated operations for the wholesale service it provides. This change not only brings the Company into compliance with FCC rules on DSL costing, but also will ensure that Manti is treated consistently with virtually every other rural LEC in the state – and even the nation. Manti calculated this "known and measurable" change to the test period, using the 2012 customer counts and applying the January 1, 2013 appropriate NECA rate. Adjustment IS-1 identifies the increase in Manti's regulated pro forma revenues as a result of this known and measurable change.

Q. Please describe Adjustment IS-2.

A. Adjustment IS-2 is a pro forma reduction in test period revenues from the Utah Education Network **("**UEN"). While this adjustment only recognizes the Company's 2013 revenue decrease – the UEN contract is up for renewal. The Company anticipates UEN revenues will be further reduced. Mr. Cox can provide additional information on the status of these negotiations.

Q. Please describe Adjustment IS-3.

A. Adjustment IS-3 recognizes a "known and measurable" reduction of the co-location rent revenue from CenturyLink, effective July 2013. CenturyLink has removed the majority of its facilities located on Manti's premises and has indicated that it will renegotiate the current contract at a reduced rate. Mr. Cox can provide additional information on the status of the new contract negotiations.

Q. Please explain Adjustment IS-4.

A. Adjustment IS-4 removes revenues from providing voicemail service. As I stated earlier, voicemail is a non-regulated service and accordingly, the financial impact must be excluded from the calculation of a regulated revenue deficiency. The impact of voicemail investment was removed in Adjustment RB-2 and expenses have been removed in IS-7.

Q. Please discuss Adjustment IS-5.

A. Adjustment IS-5 recognizes the "known and measurable" impact of the FCC's USF/ICC Transformation Order on the Company's access revenues. The FCC has mandated that LECs reduce all terminating intercarrier compensation rates to zero, which will significantly reduce Manti's regulated revenues. Because the FCC has established different transition periods for the various terminating rates to reach zero and has partially offset some of the revenue reductions with increased federal high-cost support and customer charges - the Company has calculated this revenue lost revenue by simply comparing 2012 total company access revenues with annualized 2013 access revenues. In reality, this method of calculating the lost intercarrier compensation revenues is quite conservative, as it only recognizes the current year losses, and excludes known losses in future years.

Q. Please explain Adjustment IS-6.

A. Adjustment IS-6 replaces the negative balance in uncollectible revenues for the test period with a more appropriate recognition of bad debt expense. IS-6 was calculated by annualizing to date 2013 uncollectible revenues.

Q. Please explain Adjustment IS-7.

A. Adjustment IS-7 removes the non-regulated voicemail depreciation associated with the asset removed in RB-2.

Q. Please explain Adjustment IS-8.

A. Adjustment IS-8 recognizes the current retail broadband rate of MTCC in calculating the amount that Manti compensates MTCC for providing broadband service to its office. Manti adopted this change on its books in 2013, which requires recognition of this "known and measurable" decrease in expenses as identified in IS-8.

Q. Please explain Adjustment IS-9.

A. Adjustment IS-9 removes the lease expense Manti pays MTCC for the lease of the storage yard. This change was recommended by the DPU in the Company's previous Rate Case proceeding. Manti adopted this change on its books in 2013, but the lease expense was recorded during the 2012 test period. Accordingly, the adjustment is necessary to remove the expense from the calculation of the UUSF revenue deficiency in this proceeding.

Q. Please explain Adjustment IS-10.

A. Adjustment IS-10 reduces pro forma depreciation expense as a result of the retirement of copper plant that has been replaced by fiber (see Adjustment RB-1).

Q. Please explain Adjustment IS-11.

A. Adjustment IS-11 normalizes regulated payroll costs at an anticipated, ongoing level of employees. The Company's dire cash flow situation (explained in detail in Ms. Hansen's testimony), has forced it to drastically scale back operations and reduce employees. Adjustment IS-11 normalizes payroll costs at the staffing levels that will be required for continued operations.

Additionally, Adjustment IS-11 replaces actual employee compensation levels (for all but three management employees with changed responsibilities) with the DPU's proposed compensation levels in the 2012 proceeding.[4]

Adjustment IS-11 also increases the allocation of management and customer service compensation costs to non-regulated operations to a more appropriate level. This

[4] The DPU levels were increased to allow for a cost of living increase.

allocation was updated as a result of job responsibility changes and both management and employee personnel changes.

The cumulative impact of these changes to pro forma payroll expense is a reduction in regulated expenses as identified in IS-11.

Q. Please explain Adjustment IS-12.

A. Adjustment IS-12 recognizes the "known and measurable" increase in healthcare and employee benefit costs for 2013.

Q. Please explain Adjustment IS-13.

A. Adjustment IS-13 reflects the standard regulatory practice of normalizing depreciation expense as of the end of the test period. Manti's normalized depreciation expense was determined by applying the prescribed depreciation rates to December 31, 2012 plant in service balances.

In addition to normalizing depreciation expense, Adjustment IS-13 proposes to convert Manti to a group accounting method (commonly referred to as mass asset accounting) for calculating depreciation. This would allow the Company to more closely adhere to FCC Part 32 rules[5] and would increase its comparability with other rural LECs in the state. Mass asset accounting computes deprecation for each category of telecommunications

[5] § 32.2000(g)

plant, rather than individual assets, by applying depreciation rates approved by the Commission to the balance of each category of plant.

Q. Please discuss Adjustment IS-14.

A. Adjustment IS-14 calculates the Company's recoverable procedural costs. The Company's estimated legal and consulting fees associated with this Application have been amortized over a period of two years, which is consistent with the previous Rate Case proceeding. Additionally, Manti has included the unrecovered costs approved by the Commission in the 2012 proceeding. These recoverable procedural costs have been reduced by the procedural costs actually incurred by the Company during the test period.

Q. Please discuss Adjustment IS-15.

A. Adjustment IS-15 calculates the Utah "net to gross multiplier" using both state and federal statutory tax rates. The long-established regulatory principle of "grossing up" revenue increases simply calculates the additional income tax expense Manti – or any other rural LEC in the state - will incur as a result of the increased revenue from the UUSF. By grossing up the revenue deficiency, Manti sustains the required return after calculation of actual taxes. Confidential Schedule 1 contains the Utah "net to gross multiplier."

Exhibit Manti KK 6 - Cost of Capital

Q. What cost of capital has Manti used in this Application?

A. Manti used a composite cost of capital of 9.61% in calculating its UUSF revenue deficiency requirement.

Q. Please explain Manti's Cost of Capital.

A. In accordance with UUSF policy, Manti has calculated a blended cost of capital, which represents the weighted average of an interstate rate of return of 12.97% and a state rate of return of 7.43%. Manti's intrastate cost of capital was derived using the DPU's suggested imputed capital structure of 35% equity and 65% debt. For the individual components of its capital structure, Manti has used a cost of debt of 4.7% and a cost of equity of 12.5%, which results in a composite intrastate rate-of-return of 7.43%. The Company's cost of debt was derived from their actual cost of debt. Dr. Curt Huttsell has provided direct testimony in this proceeding stating that the Company's requested cost of equity in the Application of 12.5% is quite conservative – and that a more appropriate cost of equity under today's economic conditions would be in the range of 14.5%.

Consistent with the DPU's testimony in the Manti's 2012 proceeding, the interstate return of 12.97% is derived from NECA's Form 492 filing with the FCC on September 30, 2012 for calendar year 2011 Carrier Common Line ("CCL") and Traffic Sensitive ("TS") pool participants.

Q. Please explain how the Company's blended Cost of Capital was derived.

A. The Commission's Total Company Rule requires a "blending" of the authorized cost of capital costs in the state and interstate jurisdictions. This weighting of the jurisdictional capital costs is typically done based upon the jurisdictional separation of the LEC's rate base in accordance with the FCC's Part 36 rules. However, Manti is an "average schedule" company in the interstate jurisdiction – and unlike "cost" companies - it does not perform an annual jurisdictional cost separation study.

Accordingly, Manti has used NECA's composite jurisdictional allocation of all rural LECs participating in the NECA cost study process.[6] NECA uses the jurisdictional allocations of "cost" companies as a surrogate for "average schedule" LECs in determining their interstate cost recovery. Accordingly, the allocation of Telephone Plant in Service contained in NECA's report is representative of the appropriate jurisdiction allocation (state or interstate) of the Manti's rate base. The Company's Weighting Percentage is contained on Line 6 of Confidential Exhibit Manti KK 6.

<u>Confidential Exhibit Manti KK 7– Depreciation Rates</u>

Q. Have you provided Manti's Depreciation Rates and Depreciation Lives for purposes of this proceeding?

A. Yes. Confidential Exhibit Manti KK 6, incorporated herein by reference, contains Manti's Depreciation Rates and Lives as required by Utah Code Ann. §54-7-12.1.

Q. **Has Manti calculated depreciation expense in this proceeding using the rates and lives set forth in Confidential Exhibit Manti KK 7?**

A. Yes.

Q. **Has Manti performed a depreciation study?**

A. No. Manti has not completed a depreciation study. Manti is not proposing any depreciation rate changes in this proceeding.

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

A. Yes it does.

[6] See NECA's *2013 Modification of Average Schedules,* filed annually with the FCC (updated March 8, 2013).