Witness OCS – 3D Brevitz, Revised

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

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In the Matter of Carbon/Emery Telcom, Inc.'s Application for an Increase in Utah Universal Service Fund Support	)	**Docket No. 15-2302-01**
	)	
	)	**Revised Direct Testimony of David Brevitz For the Office of Consumer Services**
	)	

Revised as Ordered on Oct. 26, 2015

NONCONFIDENTIAL – REDACTED Version

Subject to Rule 746-100-16

Confidential Information Shaded in Gray

August 21, 2015

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INTRODUCTION

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

A. My name is David Brevitz. My business address is Brevitz Consulting Services, 3623 SW Woodvalley Terrace, Topeka, KS, 66614.

Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?

A. I am an independent regulatory consultant serving state regulatory commissions, Attorney's General offices, and consumer organizations. In this proceeding, I am testifying on behalf of the Utah Office of Consumer Services (OCS).

Q. PLEASE STATE YOUR EXPERIENCE AND PROFESSIONAL QUALIFICATIONS.

A. I have thirty-four years of experience in telecommunications and telecommunications regulatory issues and practices including finance, economics and accounting for utilities generally and telecommunications providers specifically, and the evolution of telecommunications markets, technologies and providers. I earned an undergraduate degree in Justice, Morality and Constitutional Democracy from James Madison College (a residential college at Michigan State University) and a Master's degree in Business Administration with an emphasis in Finance, from the School of Business at Michigan State University. I served first as an Economist, and then as Chief of the Telecommunications Division at the Kansas Corporation Commission. While serving in the latter position, I was responsible for all telecommunications matters before the Commission, including addressing matters subsequent to AT&T Divestiture such as implementation of access charges, certification proceedings for new entrants, supervision of numerous telecommunications company rate cases addressing rate of return, rate design and revenue requirements, addressing industry issues on a generic basis, and oversight of quality of service standards and issues. I then served as Director of Regulatory Affairs for a group of 20 or more independent telephone companies in Kansas, working on the many industry issues at that time. In February 1994 I began work as an independent consultant in telecommunications, serving state utility commissions and consumer counsels, as well as international regulatory bodies. As an independent consultant I have addressed numerous cases and issues including competition and deregulation, substitute services and intermodal competition, quality of service, bundled services, access charges, price floors and imputation, jurisdictional cost allocations including direct assignments, and requirements of the Telecommunications Act of 1996 including competition, interconnection requirements, resale, unbundled elements, TELRIC/cost studies, wholesale quality of service standards, price cap/alternative regulation plans and Section 271 applications. As a result of these assignments, I have current expertise regarding state and federal universal service funds, telephone company rate of return and revenue requirements, and evolving telecommunications markets. A complete description of my background, work in prior telecommunications cases and experience in telecommunications and utility regulation is provided as Exhibit OCS 2D-1.

Q. DO YOU HAVE OTHER RELEVANT QUALIFICATIONS?

A. Yes. In 1984 I was designated as a Chartered Financial Analyst by the Institute of Chartered Financial Analysts ("ICFA"), which later became the CFA Institute. The CFA Institute is the organization which has defined and organized a body of knowledge important for all investment professionals. The general areas of knowledge are ethical and professional standards, accounting, statistics and analysis, economics, fixed income securities, equity securities, and portfolio management.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to convey the results of my review and analysis of Carbon/Emery Telcom's ("Carbon/Emery") Application for additional funding from the Utah Universal Service Fund (UUSF). In particular I focused on the areas of Carbon/Emery's proposed rate of return and appropriate cost allocations associated with Carbon/Emery's deployment of Fiber to the Home (FTTH) for deregulated services.

CARBON/EMERY'S PROPOSED RATE OF RETURN

Q. WHAT OVERALL RATE OF RETURN IS PROPOSED BY CARBON/EMERY IN THIS CASE?

A. As stated in the Application at page 3, Carbon/Emery proposes the use of an overall rate of return of 10.50%, using a "theoretical capital structure of 65% equity and 35% debt (calculated on a basis of a state return on equity of 12.13% and a return on debt of 5.636%)." For the interstate return, Carbon/Emery uses a rate of 11.45%, "derived from NECA's Form 492 filing with the FCC on September 30, 2014 for calendar year 2013 pool participants".[1] For the proposed state return, the capital structure and cost of debt and equity above yield a state return of 9.86%. Mr. Woolsey's testimony on behalf of Carbon/Emery states it computes the overall rate of return using the state/interstate weighting process set out in R746-360-8(A)(1), which using the state and interstate costs above yields a proposed overall rate of return of 10.50%. Further information on the computation of the proposed rate of return is contained in Mr. Woolsey's Exhibit 3, which entire exhibit is claimed confidential by Carbon/Emery.

Q. DO THE COMMISSION'S RULES SET OUT ANY PRINCIPLES OR STANDARDS FOR WHAT CONSTITUTES A REASONABLE RATE OF RETURN FOR PURPOSES OF THE UUSF?

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[1] Redacted Direct Testimony of Darren Woolsey, at line 176. ("Woolsey Direct")

A. No. However, a reasonable rate of return for UUSF purposes should balance the interests of Utah's consumers that pay into the UUSF with the interests of investors in the specific company that is requesting UUSF funding. A reasonable rate of return should fairly compensate existing investors, maintain the utility's financial integrity, and permit it to attract capital if needed on reasonable terms related to the utility's risk.

Q. IS THE RATE OF RETURN PROPOSED BY CARBON/EMERY FOR COMPUTATION OF ADDITIONAL FUNDS REQUESTED FROM THE UNIVERSAL SERVICE FUND PROPERLY BALANCED?

A. No. Carbon/Emery's proposed rate of return is imbalanced between the interests of the company and the consumers statewide that pay in to the UUSF to support funding such as this. Carbon/Emery's calculation of the proposed rate of return is flawed in a number of respects, and must be adjusted to provide for a balanced rate of return. In particular, the proposed rate of return does not reflect an optimal "least cost" weighted cost of capital based on reasonable debt leverage that a firm in a competitive marketplace would be required to employ to remain competitive. I recommend on behalf of the Office of Consumer Services that the Commission use an overall rate of return applied to rate base which is no greater than [**BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL**] to compute any universal service fund payment in this case.

The computation of this proposed overall rate of return is show in the tables below, with following analysis and support.

[**BEGIN CONFIDENTIAL**]

[redacted]

[redacted]

[**END CONFIDENTIAL**]

Q. SHOULD THE COMMISSION ADJUST THE STATE/INTERSTATE WEIGHTING FACTORS PROPOSED BY CARBON/EMERY TO ACCOMPLISH THE WEIGHTED AVERAGING OF STATE AND INTERSTATE RETURNS ACCORDING TO R746-360-8(A)(1)?

A. No, the state/interstate weighting factors proposed by Carbon/Emery appear to be reasonable for use in this case.

Q. HAS CARBON/EMERY PROPOSED TO USE A REASONABLE COST OF DEBT?

A. Yes. Carbon/Emery presently has no long term debt, but proposes to use a cost of debt "that existed with CoBank during the 2013 base year. The debt with CoBank carried a stated rate of 5.64% and was paid off in January 2014."[2] Under those circumstances, I consider Carbon/Emery's proposed cost of debt for use in computing the overall rate of return in this case to be reasonable.

Q. SHOULD THE COMMISSION ACCEPT CARBON/EMERY'S PROPOSED HYPOTHETICAL CAPITAL STRUCTURE OF 65% EQUITY AND 35% DEBT?

A. No. The excessive reliance upon more costly equity financing in the hypothetical capital structure is imbalanced in favor of Carbon/Emery, and against the statewide base of consumers that pays in to support the UUSF. Competitive firms seek to optimize capital structure to provide the <u>lowest overall</u> weighted cost of capital. Equity is more costly than debt, so cheaper debt financing is used by competitive firms to reduce the overall weighted cost of capital. This is done within the constraint that at some point greater debt levels lead to greater risk of the firm's inability to meet the fixed debt service requirements (default on payment of interest and principle) and financial covenants (i.e., failure to meet interest coverage ratios and debt leverage ratios as periodically calculated), which in turn leads to higher interest rates to recognize that higher risk. Accordingly there are limits to the amount of debt that can be used in a capital

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[2] Redacted Direct Testimony of Darren Woolsey at line 173.

structure before the interest rate associated with that debt rises to reflect the increased risk of default. A further factor which affects the ability to incur debt under reasonable rates and conditions is the variability in revenues and cash flows. As a public utility Carbon/Emery has substantial and stable revenues and cash flows. This stability of revenues and cash flows reduces the risk of failure to meet fixed debt service requirements and financial covenants, and therefore supports the ability to borrow more at lower interest rates reflecting the lower risk. The higher the variability in revenues and cash flows, the higher the risk of failing to meet fixed debt service requirements and financial covenants, which in turn is reflected in higher interest rates on debt. However, Carbon/Emery's revenues and cash flows are stable, and thus it has ample room to leverage its capital structure and reduce its overall required rate of return. As a public utility, Carbon/Emery is able to borrow at low cost from entities such as CoBank. Assuming only 35% debt in the capital structure unreasonably and artificially raises the overall rate of return requested by Carbon/Emery.

Q. HAS THE COMMISSION ENDORSED THE USE OF A HYPOTHETICAL CAPITAL STRUCTURE INCLUDING AN ASSUMPTION OF 65% EQUITY?

A. No. The Commission squarely rejected a proposed rule to use this hypothetical capital structure by letter dated October 27, 2008. The Commission questioned the need for the proposed rule, and its "potential impact in ratemaking settings". This case is a perfect example of why using such a rule, or 65% equity assumption has an impact in ratemaking settings that are contrary to the public interest.

Q. WHAT LEVERAGE RATIOS EXIST AMONG TELEPHONE COMPANIES THAT ARE CONSIDERED COMPARABLE FOR COST OF CAPITAL ANALYSIS IN RATEMAKING PROCEEDINGS?

A. The following debt ratios for companies often and regularly used as "comparable companies" for purposes of rate of return analysis for rural telephone companies in state universal service fund proceedings are drawn from Value-Line and company SEC Form 10-K reports. The debt ratios are more than double the 35% debt ratio proposed to be used by Carbon/Emery.

% Long Term Debt to total Capital

	2013	2014
Alaska Communications (ALSK)	76.80%	75.60%
CenturyLink (CTL)	54.00%	57.30%
Consolidated Communications (CNSL)	89.00%	81.00%
Frontier Communications (FTR)	66.00%	72.17%
Shenandoah Telecom (SHEN)	48.91%	43.79%
Windstream (WIN)	91.10%	97.25%
Average	70.97%	71.19%

Q. WHAT HYPOTHENTICAL CAPITAL STRUCTURE DO YOU RECOMMEND THAT THE COMMISSION USE IN THIS PROCEEDING?

A. I recommend that a 50% equity and 50% debt capital structure be utilized in this proceeding, and that capital structure is included in my recommendation on rate of return. While the debt ratios of comparable companies would justify use of a 70% debt ratio, to be more conservative I recommend 50%.

Q. DOES USE OF A HYPOTHETICAL CAPITAL STRUCTURE FOR DETERMINATION OF A REASONABLE RATE OF RETURN OBLIGE CARBON/EMERY TO INCUR NEW DEBT?

A. No. Presently Carbon/Emery has no debt, so its actual capital structure cannot be used to determine a reasonable rate of return. Just as Carbon/Emery's proposed use of a hypothetical capital structure including 35% debt financing does not oblige the company to incur debt, neither does the hypothetical capital structure I recommend oblige Carbon/Emery to incur debt. The decision of whether or not Carbon/Emery should incur debt remains the decision of its Board and management.

Q. SHOULD THE COMMISSION ACCEPT AND USE CARBON/EMERY'S PROPOSED 11.45% INTERSTATE RATE OF RETURN?

A. No. Carbon/Emery states this interstate rate of return is "derived from NECA's Form 492 filing with the FCC on September 30, 2014 for calendar year 2013 pool participants".[3] Carbon/Emery provided this Form 492 in response to OCS 2.4, and labeled it as "confidential", but has since indicated this labeling was "inadvertent".[4] The document itself contains no claim of confidentiality from NECA, who files it at the FCC on behalf of the NECA pool participants, and the form is a public record at the FCC. Therefore, I will refer to the document

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[3] Redacted Direct Testimony of Darren Woolsey, at line 176.
[4] This document is attached as OCS Exhibit 2D-2.

directly. Review of NECA's Rate of Return Report on FCC Form 492 indicates there are several calculated rates of return, and that Carbon/Emery has selected the highest rate of return depicted on the Report. The Form contains rate of return for Switched Traffic Sensitive, Special Access, Common Line, and Interstate Access which is a total of Special Access, Common Line and Switched Traffic Sensitive, as displayed in the following table:

	Rate of Return
Switched Traffic Sensitive	10.12%
Special Access	6.05%
Common Line	11.45%
Interstate Access	9.40%

The appropriate rate of return to use is the Interstate Access return – 9.40%, which is the rate of return for all interstate access. This is the full interstate return for all elements, not just one selected rate element (Common Line). The full interstate access rate of return is the appropriate rate of return to use for the interstate jurisdictional component of the weighted rate of return calculation under the Commission's rules. It is the rate of return I have used in my computation of overall rate of return. The Commission should not permit Carbon/Emery to select the highest rate of return that appears on the Form 492, which is for only one subset of the interstate jurisdiction – "Common Line". Carbon/Emery also has Switched Traffic Sensitive and Special Access services in the interstate jurisdiction.

Q. IS EVEN THIS INTERSTATE RATE OF RETURN TOO HIGH FOR USE IN DETERMINATION OF UUSF FUNDING?

A. Yes. Even the overall interstate access rate of return is unreasonably high, as compared to the computation of the state portion of the weighted rate of return. However, it use appears to be required by the Commission's rules. An overall rate of return at the level indicated by the state rate of return computation would be appropriate on a total company basis. In fact the separate development of state and interstate rates of return is inconsistent with the "Total Company" requirement of the Commission's rules. A consistent approach would be to take total company operations – state and interstate – and apply a total company rate of return developed to apply on an overall basis. Carbon/Emery does not have different costs of capital in the marketplace depending on the state or interstate service jurisdiction. Carbon/Emery has a single cost of capital that exists for its combined total company operations. The weighted state/interstate rate of return serves to artificially increase the rate of return for UUSF funding. Calculating the impact of the use of the unreasonably high interstate return proposed by Carbon/Emery in this case under the rule – 10.50% -- versus applying the state rate of return of 7.82% as a total company rate of return, yields a dollar difference of approximately $289,127 versus Carbon/Emery's request of $816,909. Fully 35% of Carbon/Emery's UUSF request can be attributed to use of an unreasonably high rate of return derived from weighting state and interstate, and using 11.45% as the interstate return assumption.

Q. SHOULD THE COMMISSION USE AND ACCEPT CARBON/EMERY'S PROPOSED 12.13% INTRASTATE RETURN ON EQUITY?

A. No. Carbon/Emery's only support for this requested return on equity is in footnote 2 of the Woolsey Direct, which states "Carbon/Emery's requested cost of equity mirrors the cost of equity used and approved by the Commission in other recent UUSF cases." This vague and non-specific assertion leaves out all details including which cases, and how long ago did those cases occur. Carbon/Emery does not state or claim whether these returns on equity were specifically approved by the Commission in a contested proceeding against other alternatives, or if these were requested returns on equity that were not specifically addressed or contested but the case was subject to an overall settlement. Return on equity by its nature changes over time, and the more dated the cases in which this 12.13% return on equity was purportedly determined, the less likely it is to be an appropriate rate of return for use in the current case.

Q. ARE MORE CURRENT RETURN ON EQUITY ESTIMATIONS AVAILABLE FOR RURAL TELEPHONE COMPANIES IN STATE UNIVERSAL SERVICE FUND PROCEEDINGS?

A. Yes. The Kansas Corporation Commission has undertaken regular cost of service audits for the rural telephone companies which draw funds from the Kansas Universal Service Fund, under the statutory mandate that such support be "cost based". The Commission has undertaken these audits since 1997, and the most recent complete list of returns on equity recommended in staff rate of return testimony[5] is:

Testimony Date	Company	Docket	Staff ROE
10/18/2012	Gorham Telephone Co.	12-GRHT-633-KSF	10.50%
12/19/2012	LaHarpe Telephone Co.	12-LHPT-875-AUD	10.00%
3/13/2013	Craw-Kan Telephone Coop	13-CRKT-268-KSF	10.00%
5/17/2013	Zenda Telephone Co.	13-ZENT-065-AUD	10.00%
5/23/2013	JBN Telephone Co.	13-JBNT-437-KSF	9.75%
9/24/2013	Peoples Telecommunications	13-PLTT-678-KSF	9.75%
2/5/2014	Wamego Telecommunications	14-WTCT-142-KSF	9.60%
9/30/2014	S&T Telephone Coop	14-S&TT-525-KSF	9.75%
1/20/2015	Moundridge Telephone Co.	15-MRGT-097-AUD	9.75%

Two of the cases were fully litigated, and in each case the Commission adopted the staff-recommended return on equity, and rate of return. Remaining cases were settled by stipulation, however comparison of the staff recommended KUSF draw versus the stipulated and Commission-ordered KUSF draw[6] shows that the KCC staff-recommended return on equity, and rate of return was utilized in computing the final authorized KUSF draw:

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[5] Each of these testimonies is public record at http://www.kcc.state.ks.us/

[6] Each of the Commission decisions is public record at http://www.kcc.state.ks.us/

Company	Company Requested KUSF	Staff Recommended KUSF	Commission Granted KUSF	Litigated or Stipulated?
Gorham Telephone Co.	$1,073,777	$543,215	$565,000	Stipulated
LaHarpe Telephone Co.	$525,162	$0	$19,293	Litigated
Craw-Kan Telephone Coop	$2,486,822	$1,714,075	$1,714,075	Stipulated
Zenda Telephone Co.	$459,850	$193,148	$311,715	Stipulated
JBN Telephone Co.	$864,942	$559,332	$559,332	Stipulated
Peoples Telecommunications	$806,538	$374,945	$374,945	Stipulated
Wamego Telecommunications	$4,126,619	$1,869,326	$1,869,326	Stipulated
S&T Telephone Coop	$1,620,205	$746,959	$835,923	Stipulated
Moundridge Telephone Co.	$725,818	$0	$0	Litigated, ROE stipulated

Based on this extensive and direct detailed experience with determining rate of return for rural local exchange companies, the KCC has determined returns on equity of approximately 10% are currently appropriate for its state universal service funding draws. In so doing, arguments in favor of artificially increasing the return on equity above that indicated by traditional application of discounted cash flow (DCF) and Capital Asset Pricing Model (CAPM) methods, such as application of "small company premiums" have been considered and rejected. The Commission should use this recent, robust and rigorously determined series of returns on equity to support use of a 10% return on equity for computation of Carbon/Emery's draw from the Utah Universal Service Fund. Carbon/Emery is similarly situated with the rural local exchange companies in Kansas. Rural local exchange companies generally serve rural areas with low population densities, benefit from low cost borrowing through CoBank and RUS, are organized with multiple deregulated affiliates which also provide broadband internet access and cable TV programming, and are deploying Fiber to the Home to support this array of services. Carbon/Emery and the rural local exchange companies in Kansas are in the same businesses and face the same types of risks. It is therefore reasonable for the Commission to utilize a 10% return on equity based on direct and complete analysis that is current – much more so than the dated determinations to which Carbon/Emery points. Carbon/Emery's recommended return on equity of 12.13% is clearly not current or justified.

Q. IS A 10% RETURN ON EQUITY CONSISTENT WITH RECENT COMMISSION DETERMINATIONS IN OTHER RECENT UTILITY CASES?

A. Yes. Returns on equity authorized by the Commission have declined somewhat over recent utility cases, from 10% granted to Rocky Mountain Power in Docket No. 10-035-124, and 9.80% in Docket No. 13-035-184, to 9.85% granted to Questar Gas Company in Docket No. 13-057-05. Also, a 10% return on equity is consistent with "Rate Case Summary" information published by the Edison Electric Institute, which indicates average awarded returns on equity have trended downward to below 10%, as of the 4th quarter of 2014.

Q. DID CARBON/EMERY INCLUDE A "SMALL COMPANY PREMIUM" IN ITS REQUESTED RETURN ON EQUITY?

A. The sparse two lines of support for Carbon/Emery's requested 12.13% return on equity does not indicate inclusion of any "small company premium". In any event, the Commission should not accept or include a “small company premium” on top of an appropriately determined return on equity. There is no basis for such a premium as is sometimes sought to be applied to rate of return regulated rural telephone companies.

Q. IS YOUR RATE OF RETURN RECOMMENDATION CONSISTENT WITH THE MOST RECENT FINDINGS AND ANALYSIS OF THE FEDERAL COMMUNICATIONS COMMISSION STAFF?

A. Yes. The FCC staff recently produced a comprehensive analysis of appropriate rates of return for local exchange carriers.[7] This Report calculates “a zone of reasonable WACC estimates ranging from 7.39 percent to 8.72 percent”. My recommended 8.45% rate of return is toward the upper end of the FCC zone of reasonableness.

Q. IN YOUR OPINION DOES THIS RECOMMENDED RATE OF RETURN MAINTAIN CARBON/EMERY’S FINANCIAL INTEGRITY AND OTHERWISE PROVIDE A REASONABLE RETURN WHICH APPROPRIATELY BALANCES COMPANY CONSIDERATIONS AND CONSUMER INTERESTS?

A. Yes.

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[7] “Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers”; Wireline Competition Bureau Staff Report; WC Docket No. 10-90; May 16, 2013.

Q. DOES THIS COMPLETE YOUR PREFILED DIRECT TESTIMONY?

A. Yes.