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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF
CARBON/EMERY TELCOM, INC.'S
APPLICATION FOR AN INCREASE
IN UTAH UNVERSAL SERVICE
FUND SUPPORT

UTAH RURAL TELECOM
ASSOCIATION'S POST-HEARING
BRIEF AND CLOSING ARGUMENT

DOCKET NO. 15-2302-01

The Utah Rural Telecom Association (“URTA”) is an association comprised of 13 members that are incumbent local exchange carriers operating in Utah. URTA members are regulated by the Commission. Carbon/Emery Telcom, Inc. (“Carbon/Emery”) filed an Application for Increase in UUSF, and URTA intervened in the proceeding. On January 26 and 27, 2016, the Public Service Commission (“Commission”) held a hearing on Carbon/Emery’s Application for an Increase in Utah Universal Service Fund (“UUSF”) Support. URTA participated in the hearing. At the conclusion of the hearing the Commission agreed to permit the parties to the proceeding to submit post-hearing closing argument in writing to the Commission. In the post-hearing briefing the Commission also asked all the parties to address two particular issues for submission to the Commission:

1. How should the Commission determine the level of UUSF Support when the conditions at the company may be changing?

Short Answer: The Commission is required to select a test period that accurately reflects the conditions the company will encounter during the period when the UUSF distributions will be in effect. This question is addressed in further detail in Section I below.

2. How should Carbon/Emery’s assets be viewed for purposes of depreciation?

a. Should the assets be viewed in groups with each component in the group being a part of the machine?

b. Or should each component be viewed as an independent asset with its own depreciable life?

Short Answer: When a company selects and employs a particular method of depreciation, in determining the depreciation expense, the Commission shall consider all relevant factors, including the alteration of asset lives to better reflect changes in the economic life of plant and equipment, but the method of depreciation should not be changed in the middle of the life of an asset. Further, any change in depreciation method should be addressed in a rulemaking proceeding and applied prospectively only. This question is addressed in further detail in Section II below.

I. DETERMINATION OF LEVEL OF UUSF SUPPORT

The Commission has asked the parties to address how the Commission should determine the appropriate amount of UUSF when conditions at the company may be changing. Specifically, the Commission has asked the parties whether the Commission should set the UUSF disbursement at a higher level as requested by Carbon/Emery; or whether the Commission should set the UUSF disbursement at a lower level, as suggested by the Division of Public Utilities (“Division”) and the Office of Consumer Services (“Office”).

The question that must be determined by the Commission is whether Carbon/Emery is entitled to UUSF disbursements. The factors to be determined by the Commission in determining the UUSF eligibility and amount are set forth in Utah Code and Commission Rules. Utah Code Section 54-8b-15 establishes the Utah Universal Service Fund. Eligibility for disbursements under the fund for rate of return incumbent telephone corporations such as Carbon/Emery is determined under rules promulgated by the Commission pursuant to Section 54-8b-15(3) and found in Commission Rule R746-360-6(2)(b) which provides:

“Rate of return Incumbent telephone corporations shall complete a Commission review of their revenue requirement and public telecommunications services’ rate structure prior to any change in their USF distribution which differs from a prior USF distribution.”

R746-360-8 provides the method of calculating fund distributions for rate of return incumbent telephone corporations:

Monies from the fund will equal the numerical difference between the Incumbent telephone corporation’s total embedded costs of providing public telecommunications services, for a designated support area, less the product of the Incumbent telephone corporation’s Average Revenue Per Line, for the designated support area, times the Incumbent telephone corporation’s active access lines in the designated support area. “Total embedded costs” shall include a weighted average rate of return on capital of the intrastate and interstate jurisdictions.

In many instances, an Application for UUSF Distribution will be made in conjunction with an application for rate increase made under Utah Code 54-4-4. In this case, however, Carbon/Emery’s rates are already at the Commission approved affordable base rate of \$16.50 and \$26.00 for residential and commercial service.¹ As a result, Carbon/Emery’s Application for UUSF Increase, like many similar applications, is not a rate case application. In order to determine Carbon/Emery’s eligibility for UUSF disbursements, the Commission is required to

¹ Transcript page (“T.”) 16, Lines 9-12.

review Carbon/Emery's revenue requirement, including total embedded costs, average revenue per line, and return on capital, as it would in a rate case. Therefore, the statutes governing the determination of just and reasonable rates are instructive for the calculation of UUSF disbursements.

Utah Code Annotated Section 54-4-4(3)(a) states that in determining just and reasonable rates, the Commission "shall select a test period that, on the basis of the evidence, the commission finds best reflects the conditions that a public utility will encounter during the period when the rates determined by the commission will be in effect." Similarly, in UUSF Applications the applicant selects a proposed test period. In determining the appropriate level of UUSF to be distributed, the Commission is required, under Utah law to select a test period that best reflects the conditions the public utility will encounter during the period when the UUSF disbursement determined by the Commission will be in effect. The Commission then reviews the revenue requirement based on the appropriate test period and determines the amount of UUSF that the Company is eligible for during the test period. It is not necessary, nor is it appropriate under Utah law, for the Commission to consider the UUSF distribution in terms of "going high now" or "going low now" and "truing up" in a future UUSF Application proceedings. Rather, the Commission is required under Utah to select the test period that *on the basis of evidence*, the Commission finds *best reflects the conditions that a public utility will encounter during effective period of the* UUSF distribution. See UCA Section 54-4-4(3)(a).

Consistent with the Commission's existing practice, the Commission's determination of UUSF should not be arbitrary in approach or result, but, rather, should be based an objective and consistently applied standard in conjunction with existing laws and industry practice allowing for

investment decisions to be made with confidence and reasonable certainty. To maintain an objective standard, the Commission should carefully consider the depreciation method and rate of return issues in this proceeding and employ a separate rulemaking proceeding if changes are to be considered.

A. DEPRECIATION METHOD

As indicated in the testimony, URTA is very concerned about the any change of a company's carefully selected depreciation method when evaluating Utah USF disbursements or rate case proceedings.² In this case the Division states it is not advocating a change in depreciation methods, but it has, nevertheless, reviewed Carbon/Emery's proposed depreciation expense using a different method of depreciation than that adopted and used by Carbon/Emery. This proceeding is the first time a change in depreciation method has been presented before the Commission to resolve a dispute between the division and a URTA member.

Carbon/Emery has testified that its depreciation expense for the test period calculated under the group asset method of depreciation (that the company has employed since its inception) is accurately reflected in Exhibit CE-3.1D. Carbon has provided extensive testimony that this depreciation expense number is representative of the depreciation expense the company will experience in the next 5 years. URTA recommends that the commission allow URTA members to use their chosen group asset method, as prescribed by Part 32 of the code of federal regulations. To the extent the Commission determines that any modifications are needed, the Commission should use adjustments to the average service life as described by Utah Code Annotated Section 54-7-12.1. Utah Code Section 54-7-12.1 which provides:

² T. 302, Lines 18-22.

In determining the depreciation expense of a telephone corporation in any proceeding under Section 54-7-12, the commission shall consider all relevant factors, including the alteration of asset lives to better reflect changes in economic life of plant and equipment used to provide telecommunications services. A relevant factor to consider shall be the asset lives of existing and emerging competitive telecommunications providers. Nevertheless, the commission shall retain the authority to determine the depreciation expense of telecommunications corporations for ratemaking purposes.³

The Division's criticism with Carbon/Emery's group depreciation method is that it manipulates Commission approved rates of depreciation and is not consistent with Utah Code Section 54-7-12.1. Specifically, the Division states:

“The effect of the depreciation expense and method resulting from Carbon-Emery's adoption of group asset depreciation is to alter lives and rates established by the Commission and is not reasonable. The DPU's adjustment is to bring Carbon-Emery's depreciation expense into conformity with the Commission's rates and lives. The Division's main goal is to establish a reasonable depreciation expense that matches depletion of the asset's book value with its actual useful life.”⁴

The Division proposes to calculate depreciation expense by use of a single asset straight-line method. However, the evidence is undisputed that the Division's single asset straight-line method does not properly evaluate the alteration of asset lives. Therefore, it does not effectively meet the criteria of Utah Code Section 54-7-12.1 and should not be adopted by the Commission. On the other hand, the group depreciation method does allow for modifications in the asset life of the group to better match the asset's book value with its actual useful remaining life. Particularly with regard to the FCC method as identified in the Direct Testimony of Hellewell. Under the FCC method⁵ component assets are placed into groups and adjustment of the remaining lives in its group asset accounts to properly reflect changes in the economic life of

4 Surrebuttal Testimony of Hellewell, Lines 48-53.

4 Surrebuttal Testimony of Hellewell, Lines 48-53.

5 Hellewell Direct Testimony, Line 223-234.

plant and equipment used to provide telecommunications services as required by Utah Code Section 54-7-12.1.⁶ In the particular case of Carbon/Emery, it is undisputed that the remaining service lives of the asset groups, as determined by Mr. Woolsey in his Sur-Surrebuttal Testimony accurately reflect the average remaining service lives of the asset groups.⁷

Additionally, using the FCC Method, Mr. Woolsey calculated Carbon/Emery's depreciation expense, which resulted in a range for the test period that demonstrated that the depreciation expense identified by Carbon/Emery in the UUSF Application is just, reasonable, and in the public interest. In fact, the calculation of the depreciation expense using the FCC method results in a depreciation expense that is not materially different from the depreciation expense included in Carbon's Application when properly taking into consideration the interstate revenue impact of the depreciation expense adjustment.

It is undisputed that all methods of depreciation are approximations of the diminution of value of the assets. Proper adjustments within Carbon/Emery's chosen depreciation method will yield the best approximation of the actual diminution of value of Carbon/Emery's assets without creating an artificial distortion by changing the depreciation method in the middle of the life of the asset group. The FCC method does a better job of approximating the actual diminution of value of the assets than the single asset method because the FCC method requires the company to consider the actual remaining life of the group asset on a periodic basis. The FCC method addresses both the Division's concerns and the Office's perceived problems with Carbon's group method.

6 T. 228, Line 24.

7 T. 233, Line 11.

If the Commission ultimately decides to move away from a URTA member's chosen depreciation method, the Commission should engage in rulemaking proceeding to provide a uniform policy, and to permit input into the process and the proposed rule from all interested parties. Furthermore, a rulemaking proceeding is required by Utah law and would ensure that the Commission approved rule is applied on a prospective basis. The FCC Method which provides for consideration of average remaining life in the asset groups is consistent with Utah Code Section 54-7-12.1 and addresses the concerns that the Division has about accurate depreciation lives.

II. THE RATE OF RETURN PROPOSED BY CARBON/EMERY IS CONSERVATIVE, JUST, AND REASONABLE.

With regard to the Rate of Return, all parties agree on the cost of debt and the jurisdictional separations between interstate and intrastate jurisdictions.⁸ With regard to capital structure, it is undisputed that Carbon/Emery currently has no debt.⁹ Nevertheless, the Division and Carbon/Emery agree that use of a hypothetical capital structure of 35% debt and 65% equity as has been the practice for several years is appropriate.¹⁰ The Office believes that the capital structure should be a hypothetical capital structure of 50% debt and 50% equity.¹¹ The testimony is undisputed that imputation of a hypothetical capital structure negatively affects Carbon/Emery's rate of return calculation. However, based on the recommendation of a task force that was convened to discuss capital structure, the Division has typically employed a hypothetical capital structure for companies who have less than 35% debt or equity.¹² It is just

8 T. 112, Lines 13-16.

9 T. 29, Line 20.

10 T 23, Line 11; T.111, Lines 11-23.

11 T. 255, Line 12-13.

12 T. 163, Lines 22-24.

and reasonable for the Commission to impute a capital structure of 35% debt in Carbon/Emery's case. It is not, however, just and reasonable, to impute a capital structure of 50% debt for a company that has no debt unless the Commission is adopting an optimal capital structure to be used for all companies going forward. Of course, if the Commission is adopting an optimal capital structure, it is required to do so in a formal rulemaking proceeding under the Utah Administrative Rules Act.

The next issue related to the rate of return in this case is the interstate rate of return that is to be used pursuant to R746-360-8. With regard to the interstate rate of return, the Division and Carbon/Emery have both presented testimony that the correct interstate rate of return should be taken from the NECA form 492 that is applicable to the applicant. It is undisputed that Carbon/Emery participates only in NECA's common line pool, but does not participate in NECA's traffic sensitive and special access pools.¹³ Therefore, the interstate rate or return of 11.45% is the appropriate interstate rate of return based on Carbon/Emery's participation in the NECA cost pools¹⁴ and the interstate rate of return applicable to traffic sensitive and special access pools is not applicable to Carbon/Emery. The Office believes the interstate rate of return should be 9.4%¹⁵. The Office claims it is reasonable that R746-360-8 be interpreted to employ the rate of return on Form 492 which captures all interstate services¹⁶. However, it is not appropriate to use the Form 492 that is not applicable to the applicant.

None of the parties agree on the last element of the rate of return calculation, which is return on equity. Carbon/Emery in its Application proposed a 12.13% return on equity because

13 T. 257, Lines 4-5.

14 T. 112, Lines 1-12.

15 T. 256, Line 16.

16 T. 256, Lines 20-22.

this is the figure that was used by the Division in the Hanksville Telcom UUSF application in May of 2014, approved by the Commission in August of 2014. However, the Direct Testimony of Douglas Meredith shows that 12.13% ROE is conservative in light of appropriate small company premiums which should be used. As identified in the testimony of Douglas Meredith, and unrebutted in this proceeding, well-established research firms such as Ibbotson & Associates or Duff and Phelps publish small company premiums.¹⁷ Small company premium are used by finance practitioners in the construction of forward looking cost of equity estimates.¹⁸ It is appropriate to apply a small company premium to Carbon/Emery because the evidence shows that the CAPM model provided by the Division does not use companies in the model that are comparable to Carbon/Emery.¹⁹ It is not appropriate to treat the cost of equity calculation in this case as an academic exercise. On the contrary, if the Commission uses a CAPM model for determination of the cost of equity, the Commission should look at these issues like practitioners do and apply a small company premium to account for real differences between Carbon/Emery and the companies used in the model. Furthermore, the CAPM model does not apply the governing standard in Utah for return on equity calculations. The Supreme Court has stated that the governing standard in determining the rate of return on equity is the cost of inducing capital markets to invest in the utility—not the cost of inducing the utility to invest in Utah.²⁰ The Division did not analyze the cost of inducing capital markets to invest in Carbon/Emery.²¹

17 T. 113, Lines 5-11.

18 Id.

19 T.180, Lines 7-25; T. 181, Lines 1-16.

20 *Stewart v. Utah Public Service Commission*, 885 P.2d 759 (Utah 1994).

21 T. 185, Lines 2-4.

The Division also presented evidence that because Carbon/Emery has access to the Utah Universal Service Fund to defray the costs of providing service, that it, in fact, is considered a lower risk investment than most industries.²² This position, however, completely overlooks the undisputed evidence that the Division and the Commission can, and do, review UUSF disbursements at any time.²³ The risk associated with UUSF is a regulatory risk that is real, as demonstrated by certain positions taken by the Division in this proceeding. Specifically, the Division in this proceeding is proposing that the Commission reject the prudent business decision of Carbon/Emery to use (continue to use) group asset depreciation, and review the UUSF application using a different method of depreciation to be applied in the middle of the asset lives. The possibility of the Commission agreeing with this position, and failing to fully and properly account for the change in depreciation methods, is a very real regulatory risk that rate of return companies like Carbon/Emery face. The Division's claim that companies who receive disbursements from the UUSF have a decreased risk doesn't consider or acknowledge this regulatory risk associated with regulatory decrease of the UUSF distribution. The combination of small company risk, liquidity risk, and regulatory risk more than offsets any elusive "certainty" derived from state UUSF. As a result, there should be a positive adjustment to the CAPM value before assigning a disparate peer group result to companies like Carbon/Emery.

The evidence presented by the Office on return on equity is also not persuasive. The Office relies primarily on stipulated cases out of Kansas on companies that are not even closely comparable to Carbon/Emery. There is no dispute that the actions of the Kansas Corporations

²² Surrebuttal Testimony of Casey Coleman, Line 334-339.

²³ In fact, the Commission can take judicial notice of the fact while a company is required to prosecute a complete UUSF application to receive an increase in UUSF disbursements, historically, the Division has decreased companies' UUSF distributions by issuing a letter to such companies in a perfunctory manner.

Commission are not controlling on this Commission. However, the Kansas cases cited by the Office do not offer any valuable persuasive effect either since the majority of the cases did not involve a disputed return on equity.

As the testimony of Douglas Meredith proves, the 12.13% return on equity used by Carbon/Emery is consistent with the most recent UUSF cases determined by the Commission, and is conservative when considering the risks associated with small companies such as Carbon/Emery.

III. CONSIDERATION OF CARBON/EMERY'S ASSETS AS INDIVIDUAL ASSETS OR AS COMPONENT PARTS OF A LARGER GROUP.

At the Hearing, the Commission asked the parties to address whether Carbon/Emery's "assets" should be viewed in groups with component parts making up larger "machines;" or if the "assets" should be viewed individually. As discussed above, Carbon/Emery has employed a group asset method of depreciation under FCC Part 32 since its inception as a company. Carbon/Emery assigns asset units into groups based on the specific characteristics and use. Once these units are assigned to a group, the asset group becomes the asset for purposes of calculating depreciation. Carbon/Emery uses approved depreciation rates and utilizes straight-line depreciation applied to each "group asset."²⁴ To use the language in the Commission's inquiry, under the group asset method, it is as if all of the units in the group make up an individual "machine" and the applicable depreciation rate is applied to that one "machine."

As Mr. Woolsey and Mr. Meredith testified, the concept of treating individual units as one "asset" for depreciation purposes evolved in utilities because "individual components of the telecommunications network systems are too numerous to practically track on an individual basis

²⁴ See Sur-Surrebuttal Testimony of Mr. Woolsey, Lines 17-20.

given the small relative value of each individual component asset.” Additionally, utilities have historically used the group method because the telephone networks are comprised of larger assets such as fiber or cable lines which contain numerous component parts which are impractical to track separately. The assets are often so heavily intertwined that separated alone, they are irrelevant.²⁵ For example, a piece of copper that is installed to repair a damaged section of the network may individually have an estimated useful life of 20 years. But when added to the network to replace the damaged section, the “new” copper fiber section becomes a component part of the entire copper network. According to the testimony of Mr. Woolsey, “While this may result in the new copper being depreciated more quickly as part of the group than if it were an individual component depreciated at the unit level, the fact is that the component has no useful life outside of the group of components with which it was installed. In other words, the group should depreciate together, because it will likely be replaced or retired as a group at some point in time. The new additions may serve to prolong such replacement, but will not be useful outside the group.”²⁶

The Division has suggested that treating Carbon/Emery’s assets as individual assets and applying the Commission approved depreciation rate to individual assets, results in a more accurate depreciation expense that is not accelerated.²⁷

URTA disagrees. While there may be adjustments that should be made to the remaining asset lives, or adjustments to the group, the method of depreciation selected by the company, consistent with FCC Part 32, should not be upset during the life of the asset. While ultimately, a

25 Id. at Lines 29-36.

26 Id. at Lines 60-66.

27 T. 215, Lines 4-8.

company can use a variety of depreciations methods to approximate the diminution in value of its assets, the company should be permitted to select the depreciation method, and rely on that method, subject, of course, to just and reasonable adjustments that may be needed to “better reflect changes in the economic life of plant and equipment,” as required by Utah Code. Any change in depreciation method should be addressed in a rulemaking proceeding and applied prospectively only.

Carbon/Emery’s use of the group method of depreciation is permitted by Part 32;²⁸ consideration of assets in terms of groups has historical and current relevance given the nature of telecommunications networks and plant assets; Carbon/Emery has used the group method of depreciation since 2001 without question;²⁹ and Carbon/Emery’s application of the group method results in a depreciation expense that is consistent with the FCC Method³⁰ which the Division has testified is an acceptable method of depreciation.³¹ The prudence of Carbon/Emery’s choice to use the group method must, pursuant to Utah law,³² be judged at the time the action was taken. There simply is no evidence to suggest that Carbon/Emery’s choice of method of depreciation was imprudent when made. In order to preserve Carbon/Emery’s carefully considered choice of depreciation methods, if the Commission is considering abandoning the group method of depreciation and requiring a change in depreciation methods, it should be on a prospective basis for assets added after the change is adopted.

28 T. 24, Lines 21-25; T. 25, Lines 1-4; T. 303, Lines 3-4.

29 T.25, Lines 1-4.

30 See Sur-Surrebuttal Testimony of Mr. Woolsey, Lines 378-402.

31 See Direct Testimony of Joseph Hellewell, Lines 223-234.

32 UCA Section 54-4-4(4).

III. CONCLUSION

URTA urges the Commission to carefully weigh the policy considerations in this case. Any rule or policy changes related to depreciation which may be considered by the Commission should be handled in a statutory rulemaking proceeding under applicable Utah law. Further, the evidence provided by Carbon/Emery and URTA demonstrates that the return on equity proposed by Carbon/Emery is very conservative, and is, therefore, just and reasonable. Finally, the evidence presented by Carbon/Emery, the Division, and URTA demonstrates that the interstate rate of return used by the applicant is the rate required by Commission rule.

Dated this 2nd day of March, 2016.

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CERTIFICATE OF MAILING

I hereby certify that a true and correct copy of the Utah Rural Telecom Association's Post-Hearing Brief and Closing Argument, Docket No. 15-2302-01 was sent to the following individuals by email and/or mailing a copy thereof via first-class mail, postage prepaid (as indicated), this 2nd day of March, 2016:

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