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BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF THE APPLICATION OF CARBON/EMERY TELCOM FOR AN INCREASE IN UTAH UNIVERSAL SERVICE FUND SUPPORT	DOCKET NO. 15-2302-01 **DIVISION POST HEARING BRIEF**

Pursuant to Utah Code Ann. § 54-4a-1 and Utah Admin. Code r746-100 the Utah Division of Public Utilities ("Division"), hereby submits this Post Hearing Brief. The Commission should find that the Division's proposed return on equity calculation of 10.75% and the resulting cost of equity of 9.97% is just and reasonable. The Commission should further find that the Division's depreciation adjustment using the single asset straight line method is just and reasonable in result. The Commission should increase the Utah Universal Service Fund ("UUSF") for Carbon/Emery $6,833 to a total annual disbursement of $1,045,547.

INTRODUCTION

On March 27, 2015 Carbon/Emery Telcom ("Carbon/Emery") filed an Application for increased UUSF support. A scheduling conference was held and a schedule set. Parties to this

docket filed multiple rounds of testimony. The Division filed direct, rebuttal, surrebuttal, and sur-surrebuttal testimony. A hearing was held on January 26, 2016. During the January 26, 2016 Hearing it was agreed by the parties that post hearing briefs would be permitted. On February 10, 2016 the Commission issued a Scheduling Order setting March 2, 2016 as the deadline to file post hearing briefs.

The Division thoroughly investigated the Application for increased UUSF. The Division submitted multiple Data Requests to Carbon/Emery and testified to the adjustments the Division proposes. The Division recommends two adjustments that remain in dispute with Carbon/Emery and one issue that is disputed between the Division and the Office of Consumer Services ("Office"). The two issues remaining in dispute with Carbon/Emery are return on equity and depreciation expense. The Division recommends that the Commission use a 10.75% return on equity and a 9.97% weighted cost of capital. The Division further recommends that the Commission adjust the depreciation expense as proposed by the Division using the single asset straight line method. The Division remains in disagreement with the Office regarding the hypothetical capital structure. The Division recommends that the Commission calculate the cost of capital based on a hypothetical capital structure of 65% equity and 35% debt. Based on these recommendations the Division recommends the Commission increase the UUSF to Carbon/Emery by $6,833. After the increase Division recommends a the total UUSF distribution of $1,045,547 on an annual basis. There are remaining issues in dispute between the Office and Carbon/Emery that have not been addressed by the Division.

ARGUMENT

Pursuant to Utah Code Ann. §54-8b-15 Carbon/Emery may receive UUSF to defray the costs not covered by other sources of revenue for providing basic telephone service. As a rate of return Incumbent Local Exchange Carrier ("ILEC") the calculation of UUSF support is set forth in Utah Admin. Code r.746-360-8. In order to receive an increase in UUSF support, rate of return ILECs must "complete a Commission review of their revenue requirement and public telecommunications services rate structure prior to any change in their [U]USF distribution."[1] If the ILEC's revenue is deficient, the fund provides support in the amount of the difference between the revenue and costs of providing service. The UUSF "shall provide a mechanism for specific, predictable, and sufficient funds in addition to those provided under the federal universal service fund."[2]

The Division continues to recommend two adjustments. The first that will be discussed is the appropriate cost of capital. The cost of capital adjustment and recommendation by the Division is disputed as to the return on equity by Carbon/Emery and disputed as to the hypothetical structure by the Office. The second issue is the depreciation method. The two questions posed by the hearing officer will be discussed as they are directly related to depreciation.

I. Rate of Return

The Rate of Return proposed by the Division is reasonable, rational, well supported, and should be accepted by the Commission. Carbon/Emery requests a state return on equity of 10.42% relying on a hypothetical capital structure of 65% equity and 35% debt. This value is the result of a proposed return on equity of 12.13% and debt rate of 5.636%. The Division and

[1] Utah Admin. Code. r.746-360-6(2)(b).
[2] Utah Code Ann. § 54-8b-15(9).

Carbon/Emery both agree on the debt rate. The Division's adjustment is a reduction of the intrastate rate of return to 10.75%. The Division disagrees with the Office on the appropriate hypothetical capital structure. The Division remains in support of the ROE adjustment presented by Casey J. Coleman as well as the hypothetical capital structure.

a. 10.75% Return on Equity is Just, Reasonable and Supported by the Facts.

The Commission should accept the 10.75% ROE calculated and supported by Division witness Casey J. Coleman because it is the most reliable and representative ROE value that best matches what market investors would require for a comparable investment of similar risk. While the Division has recognized that the Capital Asset Pricing Model ("CAPM") is imperfect, it provides the best objective calculation of ROE for companies like Carbon/Emery.[3]

The Division has consistently used the CAPM for small telephone utilities like Carbon/Emery. The CAPM model is an industry standard method and other methods such as the discounted cash flow method are practically impossible to apply to small privately held companies. The Commission in a recent docket agreed, stating in relevant part that "[c]onsidering the evidence presented regarding a reasonable return on equity, ie. The Division's use of the capital asset pricing model, the Commission is persuaded the Division's analysis produces a fair and reasonable result."[4]

The premise behind the use of CAPM is to take the current risk free rate of return and adjust it for the risk of the investment. Greater risk is rewarded with greater return. Carbon/Emery witness Douglas Duncan Meredith in prefiled and live testimony suggests that to accurately calculate the ROE for Carbon/Emery the CAPM model should be adjusted for a

[3] DPU Exhibit No. 3.0D, Prefiled Direct Testimony of Casey J. Coleman, line 154.
[4] *In the Matter of: the Application for the Increase of Rates and Charges by Manti Telephone Company*, December 28, 2012 Confidential Report and Order, Docket No. 08-046-01.

liquidity premium, a small company premium, and normalization of the risk free rate because of abnormal treasury rates.[5] The Commission should reject these adjustments to the CAPM model.

As explained by Division witness Casey J. Coleman in prefiled testimony, the most critical adjustment in risk that differentiates Carbon/Emery from nearly all other comparable companies is a state subsidy program that provides a dollar for dollar reimbursement when revenue from operations is insufficient. The adjustment to the risk profile of Carbon/Emery as compared other market participants without this type of safety net is difficult to measure, but easy to identify as being significant. For this reason Carbon/Emery's risk profile is not similar to other small companies that might in other circumstances be adjusted for small company premium or a liquidity premium.

UUSF support reduces risk. Investment decisions are made based on the reduced risk. For example Carbon/Emery witness Darren Woolsey testified that operational decisions are made based upon reliance on the certainty provided by these programs.[6] The fact that Carbon/Emery itself recognizes that the UUSF provides certainty and it chooses to invest based on that certainty is indicative of the value in risk reduction. UUSF risk reduction is not accounted for in Carbon/Emery's proposed CAPM adjustments to ROE. To apply the CAPM model in its traditional way and adjust upward the reward for the higher risk of small size without also adjusting downward for the reduced risk of a safety net as proposed by Carbon/Emery would result in overstating the risk and overstating the resulting ROE necessary to attract investment.

[5] *See* Revised Rebuttal Testimony of Douglas Duncan Meredith pp. 8-14.

[6] Hearing Transcript January 26, 2016 at p. 107 lines 18-25 ("A lot of our decisions with respect to how we manage our books are based upon the certainty that's provided by the FCC and by the state. So if those things change it would change the decisions that we would make regarding the timing of the investments or how we – I guess how we would make decisions based upon rate of return and weigh those decisions against similar decisions that we're making on our nonregulated plant.")

The relatively low rate at which Carbon/Emery can borrow similarly illustrates the reduction in risk provided by the UUSF. Carbon/Emery witness Mr. Meredith testified at hearing that the liquidity risk is a concern for lenders.

> As far as borrowing goes, yes. Small companies are constrained. There are actual boutique lending firms that cater to small rural telephone companies. If you go to ABC bank down on Main Street, it's not likely that they're going to want to lend you money because of the – because of all of these associated risks and the unmentioned risks that we haven't talked about. Liquidity in small companies are definitely considerations for a bank.

While it might seem like this would result in significantly higher borrowing rates for such a risky company as described by Mr. Meredith, the actual lending rates have not reflected this. Rather Carbon/Emery's most recent cost of debt was only 5.64%. If it were the case that the risk were as great as claimed by Carbon/Emery it would be expected that the lending rate would reflect the high risk as well.

The CAPM model should use current interest rates as the risk free rate. Calculating the ROE for purposes of utility rate of return is an attempt to estimate what investors would require today to invest in a company like Carbon/Emery today. "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[7]

An investor considering Carbon/Emery in 1991 would have a 1991 treasury bill as an alternative investment. At that time it would provide a risk free rate. An investor today would not

[7] *Utah Power & Light Co. v. Public Service Commission*, 152 P.2d 542, 568 (Utah 1944) (quoting *Bluefield Water Works*, 262 U.S. at 692, 43 S.Ct. at 679).

rely on the return of a 1991 treasury bill. It is not an alternative investment nor does it provide meaningful information as to the current value of Carbon/Emery as an investment.

The inverse scenario provides is demonstrative of the irrational results of using normalized risk free rates. If the current risk free rate were 10% yet the historical average were only 2%, it would be possible to calculate a current return using CAPM that is lower than the current risk free rate. No reasonable investor would choose the riskier equity investment if the return was lower than the current risk free alternative due to the use of a normalized risk free rate; it would be inadequate to compensate for the risk. The Commission should not rely on stale information that provides little to no value in evaluating what a fair rate of return is for current equity investors. The Commission should reject the use of a long term weighted average for the risk free rate.

Further supporting the Division's position on ROE is Carbon/Emery's own CAPM model. If Carbon/Emery's CAPM model found on page 12 of Mr. Meredith's rebuttal testimony is adjusted to correct for a current risk free rate, the result is an average unadjusted CAPM of 7.33%. Adding Mr. Meredith's proposed 3% size premium equals 10.33%.[8] Moreover, if investors were in fact concerned that the ROE were too low for Carbon/Emery relative to its current risk, it would be an unusual paradox to also be 100% equity when the current cost of debt is under 6% and there are boutique firms that lend to rural telephone companies.[9] The actual rate of return on equity received by investors when adjusted for the hypothetical capital structure is significantly lower than 10.75% and yet Carbon/Emery has attracted 100% equity capital.

The Rate of Return proposed by the Division is reasonable, rational, well supported, and should be relied upon by the Commission. Calculating an ROE for a small privately held

[8] *See* Meredith Revised Rebuttal p. 12 Table 2.
[9] Transcript at p. 120, lines 4-5.

company such as Carbon/Emery is an imprecise exercise. The calculation using a standard CAPM model with current risk free rates provides the best estimate of what investors would actually require today if they were choosing to invest in Carbon/Emery. The comparable set of companies used by Division witness Casey J. Coleman is well founded and reasonably chosen. The outcome of 10.75% is a fair and just ROE.

b. A Hypothetical Capital Structure of 65% Equity and 35% Debt is Reasonable

The Division and Office disagree with respect to the hypothetical capital structure. The Division and Carbon/Emery have both proposed a hypothetical capital structure of 65% equity 35% debt. The Office proposes a capital structure of 50% equity 50% debt. In objecting to the use of the 65%/35% split the Office relies upon a letter from the Commission denying the Division's request to enact an administrative rule.[10] While the letter does not enact the rule it certainly does not reject the idea of the use of a hypothetical capital structure with a range of reasonable ratios. Rather it provides something less than a formal rule, but remains a nod of approval toward the Division using the 65%/35% split. Specifically it states that "[t]he general parameters of the rule accompanied by the variability attempted to be included in the rule proposed may be applied by the Division itself in its interactions with companies."[11]

The Division is doing that very thing. It is applying the general parameters of the proposed rule to its recommendation that the Commission use a 65%/35% hypothetical capital structure. The Division does not disagree with the Office that a 50%/50% capital structure might also be within the range of prudent capital structures. However, the Division has consistently supported the use of a range of capital structures between 35% and 65% equity so long as it has remained reasonable rather than a fixed point. The approach was the result of Docket No. 07-

[10] Letter to Phil Powlick October 27, 2008 Docket No. 07-999-09.
[11] *Id*.

999-09 and, while not a rule, it provides a reasonable guide to use for hypothetical capital structure. The Commission should apply the Division's proposed capital structure based on the merits of the reasoning behind it. It should not reject the structure because it chose not to promulgate it as a formal administrative rule.

II. DEPRECIATION

At the close of the January 26, 2016 hearing Administrative Law Judge Jonsson requested that the parties address two issues relating to depreciation. First, whether the Commission should set UUSF at a relatively "higher level based on a high depreciation expense and high materials and supplies right now, then we might need to have a rate case maybe within three years, five years, whatever to correct for that, if at that point it's over-recovering."[12] Or whether the UUSF should be "a more normalized value" and Carbon/Emery may request more at a future time if it feels it's under-recovering. Second, whether assets of Carbon/Emery should be depreciated as a group like a single machine or depreciated individually as new separate assets. In response to both questions, the ultimate answer is that the Commission should base UUSF distributions on a method of depreciation that does not unreasonably accelerate the depreciation. Setting a high UUSF support level to compensate more quickly for new investment would be contrary to long standing Utah policy. Considering assets individually or as groups can both result in reasonable depreciation expense so long as the groups are properly configured and an appropriate method is chosen.

a. The UUSF Distribution Should be Set at a Level that Reflects Actual Diminution in Value Over Time.

The Commission's first question for parties to address is whether the UUSF should be set at a high rate given the higher level of capital improvements that are currently being made by

[12] Corrected transcript at p. 314 Line 24.

Carbon/Emery to install fiber or whether it should be set at a more normalized rate. The Commission should choose the normalized rate. Setting a high UUSF support level for a period of time for the purpose of or resulting in the expedited recovery of the capital costs is contrary to long standing Utah policy. The normalized rate matches basic accounting principles of cost being matched with revenues, avoids unnecessary intergenerational inequity, and provides revenue stability as required by Utah Code Ann. Section 54-8b-15(9) while also stabilizing UUSF surcharge costs.

Normalization of depreciation expense is a bit of an unusual concept. The distribution of the cost of a capital asset over its useful life is the foundational purpose of depreciation in an accrual based accounting system. The function of any straight line depreciation method should be to normalize the costs in each period by recording the same depreciation expense each year in service. While it is almost always going to be slightly in error, the goal remains the same.

To set a high UUSF now would effectively be funding accelerated depreciation of the new capital assets that Carbon/Emery is currently installing. These are assets that should have a substantial useful life beyond the next couple years. Paying for these assets through a rapidly accelerated depreciation expense would create a mismatch between the cost of the asset and the revenue derived therefrom. The depreciation reserve account grows faster than assets are replaced and the cost is recovered long before the end of the asset's useful life. The result is further reducing any investment risk and providing a substantial benefit to the utility at the expense of the UUSF contributing ratepayers. This issue has been disputed for nearly as long as telephone companies have operated.

> If the predictions of service life were entirely accurate and retirements were made when and as these predictions were precisely fulfilled, the depreciation reserve would represent the consumption of capital, on a cost basis, according to the method

> which spreads that loss over the respective service periods. But if the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers for the telephone service are required to provide, in effect, capital contributions, not to make good losses incurred by the utility in the service rendered and thus to keep its investment unimpaired, but to secure additional plant and equipment upon which the utility expects a return.[13]

Similarly the Utah Supreme Court has recognized that "[u]njustifiable accelerated depreciation rates translate into unjustifiable charges against ratepayers that inure to the benefit of the shareholders."[14]

In addition to the unreasonable benefit to the utility, accelerated depreciation is an unreasonable and unnecessary intergenerational transfer. By accelerating depreciation through the method proposed by Carbon/Emery and having a high level of UUSF now to compensate Carbon/Emery in the short run for its long term capital investments, current UUSF contributors are effectively being overcharged now to subsidize future UUSF paying customers. This runs afoul of the principle of fair distribution of costs among customers over time. And it does so unnecessarily.

Using a method that estimates the useful life of each capital asset and distributes the cost recovery over that life in a straight line method provides stability in rates for customers and adequate revenue for the utility. For UUSF contributing customers a high UUSF now would result in increased UUSF surcharge in the near term and reduced surcharge in future periods. Normalization of the distributions further advances the goal of providing Carbon/Emery stable cash flow and revenues from year to year. High UUSF payments based on accelerated

[13] *Lindheimer v. Illinois Bell Tel. Co*., 292 U.S. 151, 168-69 (1934).
[14] *Stewart v. Utah Public Service Com'n*, 885 P.2d 759, 781 (Utah 1994).

depreciation will result in significant future reductions in depreciation expense and the matching revenues.

Finally, relying on Carbon/Emery to request an increase at a future date is the better policy choice than relying on the Division to continually monitor Carbon/Emery to assess when it is over-earning and file for a reduction in UUSF, particularly given regulatory lag and workload. Carbon/Emery is in the best position to evaluate its current financial state as well as in the best position to manage its operations and expenses. While there may be some level of regulatory lag in either direction, the regulatory lag that would result from the Division being tasked with reviewing year end financial data and preparing and filling the next case is likely to be greater than the lag associated with Carbon/Emery seeking an increase as soon as it believes it is entitled to one.

Additionally incentives are important. If Carbon/Emery is receiving an unreasonably high UUSF it has every incentive to maintain high levels of expense to retain the continued UUSF payments. In the alternative scenario Carbon/Emery will be incented to operate in a cost effective manner as higher UUSF payments are not assured. For these reasons it is the better choice to provide a lower normalized UUSF payment and allow Carbon/Emery to request an increase if necessary.

b. Whether Assets are Viewed as a Group or Individually Should Not Have a Material Effect on Depreciation if Depreciation Lives are Accurate and the Method is Reasonable.

The second question is whether assets of Carbon/Emery should be depreciated as a group like a single machine or depreciated individually as new separate assets. The answer to this question is that there is not a universal answer that would be easily applied to all types of capital assets. For example a repair or upgrade to an existing buried copper wire may be reasonably and

appropriately viewed as part of the greater system of buried copper wire. Similarly a new roof added to a building that would extend the life of that building might be properly capitalized and considered part of the building asset.

What is critical to these capitalizations is the recalculation of the remaining life of the asset. If the building has 5 years remaining in its useful life and the new roof will extend the remaining life of that building for 20 more years, the capitalization of the new roof should be accompanied by a recalculation of the remaining book value of the building and the cost of the roof and the sum depreciated over the next 20 year period. Using Carbon/Emery's method, by which the calculation would use the original cost of the building plus the roof and calculate the per-year depreciation value based on that actually shortens the depreciation life of new betterment while it should be extending the depreciation life of the building. The result is unreasonable.

For other types of capital assets it would be more reasonable to view them as individual assets. For example the multi-protocol packet labeling switch that was discussed by Mr. Johansen at hearing would be appropriately depreciated as an individual asset. While it may be an important part of the network, it is a discrete component that will be retired or replaced individually. Similarly an individual or a set of network interface devices that are installed in customer locations may be reasonably viewed either as a vintage group or individually.

Whether viewed as groups or individually, the most important considerations for depreciation calculation are whether the depreciation rates are reasonably accurate and whether the method of distributing the costs reliably distributes the costs over the useful life. If the network interface devices were viewed as a group it still would not be reasonable to view the devices placed in service in 2016 as the same asset as devices placed in service in 2020. The

original book value of the 2016 group of devices has no influence on the cost of the 2020 devices and should not change the depreciation rate for the 2020 devices based on whether the 2016 devices were more expensive or less.

In order to guard against the pitfalls of some group methods the Division has presented its depreciation calculation based on single asset straight line method. In doing so the Division depreciated individual assets based on the Commission approved depreciation rates. The single asset method is simple, reliable, and has been calculated and relied upon by the Division in previous UUSF cases. The Division has also presented testimony that other methods including vintage group depreciation and the FCC method may also provide reliable and reasonable depreciation calculations.

The fundamental flaw in the method Carbon/Emery proposes is that it not only groups assets together that may be largely unrelated to each other and not part of a larger machine, it also changes the actual depreciation rate based on factors that are entirely irrelevant to the life or cost of new capital assets. It is undisputed that the method used by Carbon/Emery accelerates depreciation.[15] The method used by Carbon/Emery is further troubling because it compounds errors in service life estimates rather than shielding against or minimizing such errors. With any underestimate of service life each further generation of assets in the group with an error in service life estimates causes ever greater acceleration of depreciation. This was plainly demonstrated by the hypothetical depreciation questions answered by Division witness Joseph Hellewell.[16]

This type of error compounding is not inherent in all group methods of depreciation. It is merely a result of the method used by Carbon/Emery. Grouping assets by vintage would offer

[15] Woolsey testimony Transcript at p31.
[16] Transcript p. 236-239.

many of the same protections against compounding service life error that single asset method does. Whether the Commission views assets as groups or individually should not result in a significant difference in annual depreciation so long as grouping is reasonable and an appropriate method is chosen. Single asset method eliminates the grouping issues as well as the potential to compound errors in useful life estimates.

CONCLUSION

The Commission should find that the 10.75% rate of return is just and reasonable. The Division's unadjusted CAPM model produces a fair return on equity. The Commission should reject the higher return requested by Carbon/Emery because it is inconsistent with the evidence. The current risk free rate should be used. Carbon/Emery's proposed rate of return further fails to account for the significant reduction in risk that is provided by the UUSF. The result is an unreasonably high return on equity compared to similar risk investments.

The Commission should not set a high UUSF payment now and rely on the Division to file a request at some future time to reduce the UUSF payments when Carbon/Emery's depreciation expense drops. Public policy strongly supports setting UUSF payments at the cost during the current period of providing basic telephone service. The current cost includes a depreciation level that spreads the asset cost uniformly over the life of the asset and reflects actual diminution in value. Moreover, Carbon/Emery is in the best position to request additional UUSF funds if it is entitled to them at some future time.

The Division's proposed adjustment to depreciation based on use of the single asset straight line method is reasonable and reliable. The Division is not opposed to the idea of group asset depreciation so long as it is performed correctly. The Division supports single asset straight line because it does a better job of providing simplicity, accuracy, and objectivity.

Moreover it does not comingle unrelated assets from different generations or compound errors in service life. The Commission should reject group depreciation as proposed by Carbon/Emery and provide UUSF funding based on the Division's depreciation calculation.

The Commission should find that Carbon/Emery is eligible for an increase in UUSF support in the amount of $6,833 for a total annual support amount of $1,045,547.

Respectfully Submitted this 2nd day of March, 2016

_____/s/ Justin C. Jetter_____

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