

- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH-

In the Matter of the Application for	:	Docket No. 05-053-01
Increase in USF Eligibility for Uintah	:	Utah Division of Public Utilities
Basin Telecommunications Association, Inc.:	:	Exhibit No. DPU 5.0
and UBET Telecom, Inc.	:	
	:	

Prefiled Direct Testimony of

David T. Thomson

For the Division of Public Utilities

Department of Commerce

State of Utah

September 9, 2005

CONFIDENTIAL PUBLIC VERSION

1 **Q. Please state your name and business address for the record.**

2 A. David T. Thomson. My business address is Heber M. Wells Building 4th Floor,
3 160 East 300 South, Salt Lake City, Utah 84114-6751.

4 **Q. For which party will you be offering testimony in this case?**

5 A. I will be offering testimony on behalf of the Utah Division of Public Utilities
6 (Division).

7 **Q. Please describe your position and duties with the Division of Public Utilities?**

8 A. I am a Utility Analyst II. Among other things, I serve as an in-house consultant
9 on issues concerning the terms, conditions and prices of utility service; industry
10 and utility trends and issues; and regulatory form, compliance and practice
11 relating to public utilities. I examine public utility financial data for
12 determination of rates; review applications for rate increases; conduct research,
13 examine, analyze, organize, document and establish regulatory positions on a
14 variety of regulatory matters; review operations reports and ensure compliance
15 with laws and regulations, etc.; testify in hearings before the Utah Public Service
16 Commission (Commission); assist in analysis of testimony and case preparation;
17 and participate in settlement conferences, etc.

18 **Q. What is the purpose of your testimony?**

19 A. The purpose of my testimony is to explain certain adjustments that I am proposing
20 to be made to the USF eligibility filing (filing) of Uintah Basin
21 Telecommunications Association, Inc. (UBTA) and UBET Telecom, Inc. (UBET)
22 submitted to the Commission on April 27, 2005 under Docket number 05-053-01.

1 **Q. Have you conducted an investigation in regards to the adjustments that you**
2 **are proposing?**

3 A. I have.

4 **Q. Please describe your investigation.**

5 A. I have reviewed the information contained in the filing regarding National
6 Exchange Carriers Association (NECA) revenue, certain operating expenses,
7 year-end adjusting journal entries to revenue and expense accounts, Federal and
8 State income taxes and the corresponding tax returns; deferred taxes and schedule
9 M adjustments. The information reviewed consisted of reading the direct
10 testimony filed by the Company and the exhibits associated with that testimony;
11 onsite meetings and questioning of personnel at the home office in Roosevelt,
12 Utah with review of documentation during the onsite visits. I also reviewed
13 pertinent information provide by UBTA-UBET in response to data requests
14 prepared for the Division and other Interveners in the proceeding.

15 **Q. What conclusions have you reached after conducting your investigation and**
16 **review of the above information?**

17 A. I have concluded that certain UBTA-UBET expense amounts, which I specifically
18 examined during my investigation and review of the filing, should be adjusted.

19 **Non-recurring Expense**

20 **Q. What is your First adjustment?**

21 A. My first adjustment is to normalize the non-recurring expense incurred by the
22 Company to find and label its utility poles.

23 **Q. Please explain this adjustment.**

1 A. UBTA-UBET during 2004 found and labeled the poles that they owned in their
2 service areas. Normally poles would be labeled and their location identified and
3 recorded at the time of installation. This process would require limited onsite
4 labeling effort and limited clerical time if done at the time of installation on an
5 ongoing basis throughout the year. The one-time cost during the test-year period
6 to find and label poles for control purposes was ***** per company batch
7 number *****.

8 I am proposing to amortize this one-time cost by using an annual rate of
9 10%, which is the Commission's ordered annual depreciation rate for UBTA-
10 UBET. Per my exhibit 5.1 the above expense should be reduced by ***** for
11 total Company and by ***** for intrastate using the allocation percentage
12 provided by the Company in its filing. This adjustment normalizes the one-time
13 cost for the test period and provides a yearly amortization expense of ***** for
14 the next 9 years.

15 **Income taxes**

16 **Q. Did UBTA-UBET use the stand-alone method, which is the method most**
17 **commonly used by this Commission to compute its Federal and State tax**
18 **provision in its filing?**

19 A. Yes.

20 **Q. What is the stand-alone or separate-entity concept of ratemaking?**

21 A. The stand-alone concept holds that a utility's cost of service should be determined
22 as if the utility were a separate or stand-alone company so that the utility's
23 ratepayers do not bear the burden of costs or losses attributable to an affiliate.

1 Accordingly, for ratemaking purposes, the utility's cost of service takes into
2 consideration only those expenses incurred by the utility in providing service to
3 its customers. Under this method, regulators have sought to segregate the
4 regulated utility from its affiliates, and to determine the operational and capital
5 cost specifically attributable to the utility's jurisdictional activities.

6 **Q. How does this stand-alone concept apply to income tax expense?**

7 A. Because income tax is a recoverable expense, it is important that the tax reflects
8 the utility's revenues, credits and losses. The income tax becomes more
9 complicated when the utility files a consolidated tax return with its parent and
10 affiliates. Generally, each company participating in the consolidated filing
11 prepares a return that indicates its tax liability, if any. The returns are then
12 compiled or consolidated so that the taxes and losses of the various companies
13 offset one another. The consolidated return, then, indicates the amount of tax due
14 from these companies as a group. The Parent and Subsidiary group that UBTA-
15 UBET is a part of does not prepare separate returns but uses individual balance
16 sheet and income statement amounts and combines the income or losses, after
17 applicable tax adjustments, to arrive at taxable consolidated income and losses.
18 The consolidated return, then, indicates the amount of tax due from these
19 companies as a group.

20 The stand-alone method holds that when a utility's taxes are filed using a
21 consolidated return, the income tax expense paid by the utility ratepayers should
22 be determined as if the utility filed its taxes separately. This approach ensures
23 that any burdens or benefits that result from the utility's operations accrue to its

1 ratepayers and insulates those ratepayers from the burdens, benefits and risks
2 associated with the operations of affiliated companies.

3 **Q. Could there be a situation arise or come about where the stand-alone method**
4 **could become compromised when computing the Federal and State taxes for**
5 **a stand-alone utility?**

6 A. Yes, if you mean by compromised that there can come into question the accuracy
7 of the amount computed due to a violation of the burden / benefit standard.

8 **Q. Could you explain why this is so?**

9 A. Yes. The stand-alone tax method along with what is sometimes called the
10 “burdens / benefit standard” works properly when there is a well defined stand-
11 alone structure that has been set up between the utility and affiliated companies or
12 subsidiaries. This is especially true, if the organization has strong ring-fencing
13 provisions between the regulated utility and the other parties to the consolidated
14 group. See Chuck Peterson’s testimony that discusses ring-fencing and why
15 regulators use it to separate a utility from other members of its consolidated
16 group.

17 If great care and planning through group structure and ring-fencing has not
18 taken place between members of a consolidated tax group; if activity or
19 transactions between the affiliated group members is such that the organizational
20 lines or separate entity delineation between the members of the group becomes
21 blurred or even nonexistent; then a tax burdens/ benefits standard cannot be made
22 clearly and concisely to each member in the tax group. The confusion as to the
23 proper matching of burdens / benefits between tax members clouds the ability to

1 compute the proper stand-alone tax expense between the entities. If this happens,
2 you may need to expand to the next organization level above the separate entities
3 to obtain overall proper matching of burdens and benefits. It can be argued that
4 what I have talked about above has happened within the consolidated group that
5 UBTA-UBET is a member.

6 **Q. Besides making sure that the tax burdens / benefits standard can be clearly**
7 **and concisely applied to regulated and unregulated members in a group, is**
8 **there another reason why ring-fencings is important to the stand-alone**
9 **method?**

10 A. Yes, a well defined stand-alone structure for a public utility is maintained so that
11 cross subsidization between the utility and its affiliated subsidiaries or group
12 members will not take place and if it does it can be quickly determined and then
13 prevented or stopped.

14 Great care and control must be maintained within the Parent and subsidiary
15 group to ensure that intercompany transactions are not causing or are not being
16 used in a manner to cause the regulated utility to subsidized unregulated group
17 members. One control method is to minimize, discourage, or prevent a lot of
18 intercompany transactions, allocations, or journal entries between the regulated
19 utility and other members of the consolidated group.

20 **Q. Would you describe the ownership structure of the Parent / Subsidiary group**
21 **containing UBTA-UBET?**

1 A. *****

2 *****

3 *****

4 Q. What has happened within the combined group of companies that UBTA-
5 UBET is a member of that is causing the compromising of the burdens /
6 benefits method?

7 A. First, the existence of numerous related party transactions. The following are a
8 few of many such transactions as described in the 2003 consolidated audit of
9 UBET Telecom, Inc.

10 *****
11 *****
12 *****
13 *****
14 *****
15 *****

16 *****
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19 *****
20 *****

21 *****
22 *****
23 *****
24 *****

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26 The balance sheet of UBET Telecom, Inc. includes the following amounts
27 advanced to and from affiliates at December 31, 2003 and 2002. *****

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29 *****

30 *****

31 *****

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It should be noted that the above were year-end balance sheet amounts. Many increases and decreases to these accounts would have happened to arrive at the final amount. Also there could have been numerous advances to and from other members of the group during the year that are not shown in the year end amounts because they could have been repaid prior to year end.

Second, a member of the group is guaranteeing debt of another member of the group.

Third, there is management concentration in the consolidated group, which clouds the separation and segregation of the regulated and unregulated entities. Attached is an organization chart of UBTA-UBET as of May 23, 2005 as provided by UBTA-UBET per a Division data request. (DPU Exhibit 5.2).

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Fourth, the churning of cash between all of the entities in the form of inter-company advances calls into question whether the proceeds of loans to each affiliate in the long run really end up being used by that entity exclusively. It also greatly clouds the delineation between the entities as separate stand-alone entities. Attached is an unaudited UBTA-UBET Companies Balance Sheet at December 31, 2004 as provided by the Company per a DPU data request. (DPU Exhibit 5.3). I have put a block around the lines in this balance sheet that show the advances to affiliates and advances from affiliates at the end of December 31, 2004. *****

Fifth, after reading the testimony of others from the Division such as Wesley Huntsman, John Gothard Jr. and based on my own analysis I have concluded that that there is a lot of support going on between the regulated and unregulated entities. This clouds the burdens / benefits method

Q. Due to the above concerns is it your recommendation at this time that the stand-alone method be applied to the combined / consolidated group to compute the tax provision for the filing?

No. But, I would strongly recommend that the Commission require that management be accountable for all inter-company transactions and implement ring-fencing measures as a condition of any additional USF support. Greater care

1 must be taken to ensure that separation between the entities of the consolidated
2 group takes place so that the proper matching of burdens / benefits can take place
3 so that a compromising of the stand-alone method does not continue to be a
4 concern in the future.

5 **Q. Does this conclude your testimony?**

6 A. Yes.