\- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

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| In the Matter of Emery Telephone's Application for an Increase in Utah Universal Service Fund Support | )<br>)<br>)<br>)<br>)<br>)<br>) | DOCKET NO. 15-042-01<br>DPU Exhibit 3.0<br><br>Direct Testimony of<br>Casey J. Coleman |


DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE


August 14, 2015

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## I. IDENTIFICATION OF WITNESS

**Q. PLEASE STATE YOUR NAME, EMPLOYER, AND BUSINESS ADDRESS.**

A. My name is Casey J. Coleman. I am employed by the Division of Public Utilities ("Division") for the State of Utah. My business address is 160 East 300 South Salt Lake City, UT 84114.

**Q. BRIEFLY OUTLINE YOUR EMPLOYMENT BACKGROUND.**

A. Before working for the Division, I was employed by a telecommunications consulting firm as a Financial Analyst. Then for approximately three years I worked for the Division as a Utility Analyst and now work as a Technical Consultant for the Division.

**Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

A. I received a Bachelor of Science degree from Weber State University in 1996 and a Masters of Business Administration from Utah State University in 2001.

**Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE UTAH PUBLIC SERVICE COMMISSION?**

A. Yes. I testified before the Commission as an expert witness in Docket Nos. 01-2383-01, 02-2266-02, 02-049-82, 03-049-49, 03-049-50, 05-053-01, 05-2302-01, 07-2476-01, 08-2469-01, 10-049-16, 10-2521-01, 10-2526-01, and 08-046-01.

## II. SUMMARY

**Q. PLEASE SUMMARIZE AND DESCRIBE THE PURPOSE OF YOUR TESTIMONY.**

A. An application filed by Emery Telephone ("Emery") on March 27, 2015 requests that the Public Service Commission of Utah ("Commission") grant an increase in support from the Utah Universal Public Telecommunications Service Support Fund ("UUSF"). My testimony will focus on three specific areas of the application submitted by Emery. First, my testimony discusses the appropriate capital structure for Emery to be used in this application. Second, my testimony will outline Utah Admin. Code § R746-360-8 Calculation of Fund Distributions in Rate-of-Return Incumbent Telephone Corporation Territories and its validity in this application. Finally, my testimony discusses the cost of capital used to develop the revenue requirement for Emery

## III. CAPITAL STRUCTURE FOR EMERY

**Q. WHAT CAPITAL STRUCTURE IS THE DIVISION RECOMMENDING FOR EMERY?**

A. The Division recommends using a capital structure of 35 percent debt and 65 percent equity.

**Q. IS THE 35/65 CAPITAL STRUCTURE AN ACTUAL OR HYPOTHETICAL CAPITAL STRUCTURE?**

A. The 35/65 capital structure recommend by the Division is a hypothetical capital structure.

**Q. WILL YOU EXPLAIN WHY THE DIVISION IS RECOMMENDING USING A HYPOTHETICAL CAPITAL STRUCTURE?**

A. Yes. In 2008, by request of the Commission, a Capital Structure Task Force was created to look at the following items:

1. Suggested rule for capital structures for cooperative and non-cooperative rural ILECs;
2. Recommendation to the Commission as to whether there is a necessity for the capital structure rule to be different for cooperatives and non-cooperatives; and
3. Recommendation as to whether a uniform rule is needed or whether the issue of the appropriate capital structure should be determined in individual rate reviews.

The Division and other interested parties participated in this task force where a variety of issues and solutions were discussed.

Eventually, it was agreed by the Task Force to adopt the following general framework when looking at capital structures. If a company was highly leveraged with an equity position less than 35 percent, a hypothetical capital structure of 65 percent debt and 35 percent equity would be used. Conversely, if a company had a capital structure that was mostly equity a hypothetical capital structure of 35 debt and 65 equity would be used.

A proposed rule, with the findings of the Task Force was filed with the Commission. Although the Commission never formally adopted the rule as proposed by the Task Force, since 2008 the Division has followed the general framework developed by the parties. Namely, when a company's capital structure is greater than either 65 percent debt or 65 percent equity a hypothetical capital structure is used in the calculations on rate of return.

**Q. IS EMERY'S CAPITAL STRUCTURE ABOVE THE 65 PERCENT EQUITY THRESHOLD?**

A. Yes. Emery's capital structure has an equity amount greater than 65 percent.

## IV. INTERSTATE / INTRASTATE SEPARATION

**Q. IS UTAH ADMIN. CODE § R746-360-8 APPLICABLE IN EMERY'S REQUEST FOR A RATE INCREASE?**

A. Yes. In December 2009, when Utah Rural Telecom Association ("URTA") petitioned the Commission to amend Utah Admin. Code § R746-360-2 B and R746-360-8 the purpose of the petition was to provide a framework to be used that would enable companies to have the interstate rate of return to be applied to interstate assets and the intrastate rate of return applicable on assets used within the state. After modification and tweaks the current rule was published by the Commission.

**Q. WHAT INFORMATION IS NEEDED TO CALCULATE THE INTERSTATE / INTRASTATE RETURN CALCULATION?**

A. From my interpretation of the rule, there seems to be two different pieces of information required to make this calculation, the first being the interstate rate of return calculated by NECA as reported on the FCC form 492A. The second data point would be the appropriate allocation of rate base for Emery between interstate and intrastate as required by the FCC in Title 47 part 36.

**Q. DOES THE DIVISION AGREE WITH THE SEPARATION FACTOR USED BY MR. WOOLSEY IN EXHIBIT 3 OF HIS TESTIMONY?**

A. Yes.

**Q. WHAT IS THE INTERSTATE RATE OF RETURN REPORTED TO NECA ON THE FCC FORM 492A FOR EMERY?**

A. The interstate rate-of-return as reported on form 492A is 11.45 percent.

**Q. WHY DID THE DIVISION USE THE 11.45 PERCENT INTERSTATE RATE FROM THE NECA FORM 492A?**

A. As outlined in the cover letter from NECA to the FCC explaining the computation of the intrastate rate Ms. Chirico states:

"NECA has provided two Form 492 reports. The first applies to companies that participate in NECA's Common Line pool. The second applies to the smaller subset of companies that participate in both NECA's Common Line and Traffic Sensitive pools. Because all Common Line pool participants receive a uniform return on investment, the Common Line rate of return reported on both forms is identical."

The September 30, 2014 form 492 filed by NECA to the FCC shows a Common Line pool rate of return at 11.45 percent, while the interstate rate of return for the smaller subset of companies at 9.4 percent.

**Q. IF THE FORM 492 SHOWS AN INTERSTATE RATE OF 9.4 PERCENT WHY IS THE DIVISION RECOMMENDING USING THE 11.45 PERCENT AS SHOWN IN MR. WOOLSEY'S EXHIBIT 3?**

A. The question of which rate to use is really a matter of whether Emery participates in the Common Line Pool, or the smaller subset of companies that participate in both NECA's Common Line and Traffic Sensitive pools. In a phone conversation with Mr. Brandon Gardner, NECA Western Region Manager, the Division learned that Emery is a Common Line Pool participant and not in the second subset. As a result, the correct interstate rate to use when calculating the allowed rate of return is the 11.45 percent. This rate is shown in the first 492A report filed by NECA to the FCC.

## V. COST OF CAPITAL (DPU3.1)

**Q. WHAT IS THE ALLOWED RATE OF RETURN THAT THE DIVISION IS RECOMMENDING FOR EMERY?**

A. As exhibit 3.1 illustrates, the Division recommends using an allowed rate-of-return of 9.96 percent.

**Q. EXPLAIN THE DIFFERENCES BETWEEN EMERY'S REQUESTED ALLOWED RATE-OF-RETURN AND THE RATE RECOMMENDED BY THE DIVISION?**

A. The only difference between Emery and the Division on this point is the appropriate intrastate cost of equity. The Division recommends a rate of 10.75 percent instead of the 12.13 percent recommended by Mr. Woolsey.

**Q. HOW DID THE DIVISION DETERMINE A COST OF EQUITY OF 10.75 PERCENT?**

A. The Division used a Capital Asset Pricing Model ("CAPM") which is a model based on the proposition that any stock's required rate of return is equal to the risk-free-rate of return plus a risk premium which reflects only the risk remaining after diversification. Generally, if parties know the risk premium, the risk-free-rate and beta, a rate of return can be calculated. In CAPM terminology, beta is a measure of the extent to which the returns on a given stock move with the stock market. The ideal scenario is to calculate a beta specific to an individual stock or company based on a variety of different financial information. With small rural telephone companies, the information needed is not publicly available, making a specific beta calculation for Emery or any rural phone company challenging. To determine an approximate beta that could apply to Emery, the Division looked at publicly traded telecommunications companies with similar profiles to determine a beta that would be representative. With this calculated beta and following the general guidelines of CAPM the Division was able to calculate, as reflected in Exhibit 3.2 Emery Telephone Return on Equity – Intrastate, the cost of equity for Emery at 10.75 percent.

**Q. IS THE DIVISION COMFORTABLE WITH THE RESULTS?**

A. Comfortable yes, ecstatic no. The Division recognizes that there are some inherent difficulties in using a CAPM model and the Commission's apparent discomfort using a CAPM model. The Division used a CAPM model because there was not any other viable alternative. A Bond-Yield-Plus-Risk-Premium approach is not precise enough to yield a cost of equity that should be used in a rate case. In a Discounted Cash Flow ("DCF") model dividends are necessary to make the model work. It is impossible with small privately held telecommunications companies to determine a dividend yield. Without a dividend yield it is impracticable to calculate a cost of equity using a DCF model.

Because CAPM was the only financial model available to the Division that could produce results that allowed a certain level of comfort the Division used the CAPM model.

## VI. CONCLUSION

**Q. WHAT IS THE DIVISION'S RECOMMENDATION FOR THIS PETITION?**

A. The Division recommends that the Commission use a 35 percent debt and 65 percent equity hypothetical capital structure and an allowed rate-of-return of 9.96 percent.

**Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

A. Yes it does.