**BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH**

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| **IN THE MATTER OF THE EMERY TELEPHONE'S APPLICATION FOR AN INCREASE IN UTAH UNIVERSAL SERVICE FUND SUPPORT** | ) ) ) ) | DOCKET NO. 15-042-01 |

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# REBUTTAL TESTIMONY OF DOUGLAS DUNCAN MEREDITH

## ON BEHALF OF

## EMERY TELEPHONE

**August 28, 2015**

BLACKBURN & STOLL, LC
Kira M. Slawson
Attorneys for Emery Telephone
257 East 200 South, Suite 800
Salt Lake City, UT 84111
Tel: 801-578-3578
kslawson@blackburn-stoll.com

# Introduction

**Q: Please state your full name, place of employment and position.**

A: My full name is Douglas Duncan Meredith. I am employed by John Staurulakis, Inc. ("JSI") as Director – Economics and Policy. JSI is a telecommunications consulting firm headquartered in Greenbelt, Maryland. My office is located at 547 Oakview Lane, Bountiful, Utah 84010. JSI has provided telecommunications consulting services to local exchange carriers since 1963.

**Q: Please describe your professional experience and educational background.**

A: As the Director of Economics and Policy at JSI, I assist clients with the development of policy pertaining to economics, pricing and regulatory affairs. I have been employed by JSI since 1995. Prior to my work at JSI, I was an independent research economist in the District of Columbia and a graduate student at the University of Maryland – College Park.

In my employment at JSI, I have participated in numerous proceedings for rural and non-rural telephone companies. These activities include, but are not limited to, the creation of forward-looking economic cost studies, the development of policy related to the application of the rural safeguards for qualified local exchange carriers, the determination of Eligible Telecommunications Carriers, the sustainability and application of universal service policy for telecommunications carriers, as well as supporting incumbent local exchange carriers in arbitration proceedings and rural exemption and suspension and/or modification proceedings.

In addition to assisting telecommunications carrier clients, I have served as the economic advisor for the Telecommunications Regulatory Board of Puerto Rico since 1997. In this capacity, I provide economic and policy advice to the Board Commissioners on all telecommunications issues that have either a financial or economic impact on carriers or end-users. I have participated in a number of arbitration panels established by the Board

to arbitrate interconnection issues under Section 252 of the Telecommunications Act of 1996.

I am participating or have participated in numerous national incumbent local exchange carrier and telecommunications groups, including those headed by NTCA, USTelecom, and the Rural Policy Research Institute. My participation in these groups focuses on the development of policy recommendations for advancing universal service and telecommunications capabilities in rural communities and other policy matters.

I have a Bachelor of Arts degree in economics from the University of Utah, and a Masters degree in Economics from the University of Maryland – College Park. While attending the University of Maryland – College Park, I was also a Ph.D. candidate in Economics, having completed all coursework, comprehensive and field examinations for a Doctorate of Economics.

**Q: Have you testified previously in federal and state regulatory proceedings on telecommunications issues?**

A: Yes. I have testified live or in pre-filed regulatory testimony in various states including Utah, Maine, Vermont, New Hampshire, New York, Michigan, Wisconsin, North Dakota, South Dakota, Texas, South Carolina, Tennessee, and Kentucky. I have also participated in regulatory proceedings in many other states that did not require formal testimony, including Florida, Louisiana, Mississippi, Puerto Rico and Virginia. In addition to participation in state regulatory proceedings, I have participated in federal regulatory proceedings through filing of formal comments in various proceedings and submission of economic reports in an enforcement proceeding.

**Q: On whose behalf are you testifying in this proceeding?**

A: I am testifying on behalf of Emery Telephone ("Emery").

**Q: What is the purpose of your testimony?**

A. The purpose of my testimony is to address the various issues discussed in Direct Testimonies offered by the Office of Consumer Services and the Division of Public Utilities. In their testimonies, these parties propose modifications to Emery's Application for Increase in Utah Universal Service Fund ("Utah USF") support.. In this testimony, I recommend that the Commission reject or modify many of these proposed modifications. Specifically, I will address the testimony of:

- Casey Coleman, Division of Public Utilities;
- David Brevitz, Office of Consumer Services;
- Joeseph Hellewell, Division of Public Utilities.

**Q. Have you reviewed the testimony of the individuals you have identified above?**

A. Yes. I have reviewed all of the testimony filed in this docket.

## Rate of Return

**Q: In his testimony on behalf of the Utah Office of Consumer Services (Office), Mr. Brevitz argues that the Utah Public Service Commission should take guidance from a bevy of cases in Kansas regarding the appropriate rate of return to be used by Emery Telephone. Do you agree that the Kansas information is helpful in informing the Commission on this issue?**

A: Not at all. While Mr. Brevitz alludes that his Kansas cases were fully vetted, his testimony actually indicates that only one case (LaHarpe 2012) was fully reviewed and litigated. In all other cases, the cases ended with a stipulation. Furthermore, we have no information from Mr. Brevitz that the LaHarpe case throughly reviewed the various standard methods to determine return on equity. So I discount these citations and urge the Commission to give them little if any weight. We simply don't have any information suggesting that the rate used for the return on equity was fully examined in the cited Kansas cases, especially absent is any reference or citation from the Commission about its evaluation and determination of the rate of equity in the LaHarpe case.

**Q: Please describe what a small company premium is and how it is used.**

A: A small company premium is an adjustment to the calculated rate of equity and is designed to account for the fact that access to equity is more constrained as companies get smaller. Thus, due to various factors, access to capital requires a premium over a return on equity for much larger companies.

**Q: Did Emery propose a small company premium in this proceeding?**

A: No. Emery did not propose a small company premium in this proceeding because it used an overall rate of return that was proposed by the Division last year and was used in Emery's Utah USF request finalized earlier this year. Emery assumed that since the Division was comfortable with its proposed rate of return in January, the same rate of return should be used in this proceeding that was filed a few months later.

**Q: What was the Division's overall rate of return used earlier this year?**

A: The overall rate of return used earlier this year was 10.50 percent. This accounts for the cost of debt and the return on equity weighted by a debt and equity capital structure to develop an overall rate of return.

**Q: Mr. Brevitz argues that a small company adjustment is not necessary or appropriate in this proceeding. What is your opinion of the use of small company adjustments when using a peer group whose members are much larger than the target company?**

A: I disagree with Mr. Brevitz on the application of small company adjustments. A small company adjustment or more specifically a size adjustment is a standard tool in the toolbox when examining small companies. The outright rejection of this tool by Mr. Brevitz appears strident and unreasonably designed to simply produce a low rate of return for Emery. The Morningstar/Ibbotson Annual Yearbook routinely reports an adjustment that would be applied to a company based on market capitalization. Depending on the size of the company, the size premium ranges from a negative adjustment of 38 basis points for very large companies to a positive adjustment of 6.10 percent for the smallest of companies. In a presentation entitled "Telcom Cost of Capital Issues: January 1, 2012",

Dr. Hal. B. Heaton (BYU Professor, Stanford Ph.D.) describes a size premium as a "minimum adjustment" to be used when applying the standard Capital Asset Pricing Model (CAPM). (Rebuttal Testimony of D Meredith Exhibit 1- PDF page 18)

Furthermore, in 2013 Dr. Billingsley (Virginia Polytechnic Institute & State University Associate Professor, Texas A&M Ph.D.) examined a Federal Communications Staff report on rate of return that was proposed for rate-of-return carriers. (This is a report cited by Mr. Brevitz in supporting his position.) Dr. Billingsley recommends using the Duff & Phelps, another established and well respected company specializing in valuation and corporate finance, size adjustment and this process yielded a 5.32 percent increase for mid-sized carriers and a 7.11 percent increase for smaller rate-of-return carriers. Dr. Billingsley summarizes the impact of ignoring the size effect as follows:

> "Using the CAPM, the Staff Report estimates that the average cost of equity for its entire 16-company sample is 7.18 percent, 6.70 percent for the RHC subsample, 7.75% for the mid-sized carrier subsample, and 6.90 percent for the RoR subsample of companies. In contrast, the approach to applying the firm size-adjusted CAPM recommended by Duff & Phelps produces an average cost of equity for the entire Staff Report company sample of 12.74 percent, 9.13 percent for the RHC subsample, 13.07% for the mid-sized carrier subsample, and 14.01 percent for the RoR subsample of companies.
>
> Consistent with the empirical evidence on the size effect, the Staff Report underestimates the equity costs of the smallest firms the most, which are the RoR firms that are the most comparable subsample to the average RLEC. The data used to generate the Duff & Phelps estimates are available by subscription and are relied on by investment professionals. Duff & Phelps consequently provide objective evidence that the Staff Report's failure to adjust for the small firm effect provides significantly understated RLEC equity costs and, by implication, an understated average RLEC WACC." (Rebuttal Testimony of D Meredith Exhibit 2 - PDF page 55-56)

Also included as Rebuttal Testimony of D Meredith Exhibit 3 is the Federal Communications Commission Staff Report that is the subject of this critique. A small company adjustment or premium should be a standard tool used to evaluate the rate of equity for a small rural carrier in Utah.

**Q: Is it your testimony that the 10.50 percent rate of return should be used in this proceeding?**

A: Now that the issue is fully open and witnesses for the Division and Office have argued against the rate of return used last year, it is my recommendation that the Commission take notice that the rate of return for Emery should be higher than the proposed 10.50 percent. There is more than enough evidence to support the 10.50 percent rate of return based on the information in this proceeding and filed at the Federal Communications Commission.

**Q: Please explain the information you reviewed in reaching your recommendation that 10.50 percent is a minimum rate of return that will ensure that equity freely flows to Emery Telephone for its long-term infrastructure projects.**

A: First is the volume of information filed at the FCC and the FCC's actions in a docket to examine the interstate rate of return. As I mentioned earlier, in 2013 the FCC examined whether it should change its prescribed rate of return used for investments assigned to the interstate jurisdiction. Currently the authorized rate of return used by the FCC is 11.25 percent. The FCC staff issued a report (Rebuttal Testimony of D Meredith Exhibit 3) whose conclusion was cited by Mr. Brevitz. In this staff report, the recommended range for a rate of return was 7.39 percent to 8.72 percent. What should inform the Commission in this proceeding is the fact that the FCC did not accept the conclusions of the staff report. The rebuttals of the staff report provided by NTCA, et al. (Rebuttal Testimony of D Meredith Exhibit 2) and the Rural Broadband Alliance (Rebuttal Testimony of D Meredith Exhibit 4) leveled a broadside against the staff findings to the extent that the FCC has let the issue remain dormant for two years and no action has been taken.

The NTCA report showed various errors in the staff report and also recommended an alternative to the DCF method that uses small company data to calculate a rate of return—

these data are from purchases of small carrier's across the country. The NTCA report demonstrates that the 11.25 percent rate of return is in fact too low. (Using other methods, the Rural Broadband Alliance examination demonstrates the same and applies a 6 percent size adjustment on pages 18-23). So, from the FCC's docket we have one staff report that was thoroughly rebutted. The findings of the two industry rebuttals demonstrate that the 11.25 percent rate of return is low for small rural carriers and if any change were to be made, this rate of return should increase. In light of the evidence, the FCC has let the issue remain idle and the authorized prescribed interstate rate of return for rural carriers remains set at 11.25 percent.

**Q: What should the Commission take from the FCC's proceeding examining the same issue raised by the Division and the Office?**

A: First, the Commission should recognize that the FCC's docket has a wealth of information about the procedures and pitfalls in determining a rate of return. (The exhibits I have supplied provide the details needed to adjust CAPM for size and liquidity and in producing a levered beta, etc.)

Second, the Commission should conclude that it should take no action to change the interstate authorized prescribed rate of return after an exhaustive review demonstrates that the 11.25 percent rate of return provides a reasonable incentive for equity to freely flow to carriers, like Emery, whose aim is to invest in long-term infrastructure projects in the provision of telecommunications service regulated by the state. The FCC as an expert agency in regulating telecommunications carriers has examined the issues, pro and con, and has deferred from taking actions to lower its prescribed rate of return. This fact should inform the Commission and provide sufficient support for retaining Emery's 10.50 percent rate of return in this proceeding. However, my recommendation is that the Commission revise upward the 10.50 percent rate used by the Division in prior cases to 11.25 percent in light of this evidence.

Finally, the rebuttals to the FCC's staff report show that calculating a rate of return for carriers that are not publicly traded a stock market challenges the standard financial

models, especially when there are so few companies with public information. Traditional methods of calculating a rate of equity for small companies has a tendency to understate the lack of access to equity markets and the corresponding return that is necessary to attract equity to remote locations in Utah.

Based on this information alone, the Commission can reach the conclusion that a 10.50 percent rate of return is reasonable and properly balanced. If the Commission were to examine the matter to calculate a Utah rate of return for Emery Telephone, it should increase Emery's proposed 10.50 percent value.

**Q: Mr. Coleman provides an update to one traditional method, the Capital Asset Pricing Model (CAPM). What observations have you made concerning Mr. Coleman's application of the CAPM?**

A: First, the CAPM is very sensitive to the selected peer group of publicly traded companies. The CAPM methodology assigns a risk premium based on this peer group to calculate a return on equity. So, the selection of similarly situated companies to be used for comparison is very important. Mr. Coleman uses 13 publicly traded companies in his peer group. Examining this peer group shows serious problems that should give the Commission reservations in using this method. The size of the majority of these companies dwarfs Emery Telephone. Table 1 show the access line counts for the most of peer group companies and includes several that Mr. Coleman excluded from his analysis. The use of large companies would indicate the need to adjust for size using standard small company adjustment methods.

Table 1

| | | | Access Lines as of 6/30/2015 |
|---|---|---|---|
| | Exchange | Ticker | |
| Verizon | NYSE | VZ | 19,079,000 |
| AT&T | NYSE | T | 18,116,000 |
| CenturyLink | NYSE | CTL | 12,100,000 |
| Frontier Communications | NYSE | FTR | 3,476,000 |
| Windstream | NSDQ | WIN | 1,828,900 |
| Fairpoint Communications | NSDQ | FRP | 768,222 |
| Telephone & Data Systems | NYSE | TDS | 510,800 |
| Consolidated Communications | NSDQ | CNSL | 493,540 |
| Cincinnati Bell | NYSE | CBB | 389,000 |
| Alaska Communications | NSDQ | ALSK | 119,432 |
| Lumos Networks | NSDQ | LMOS | 105,298 |
| Otelco | NSDQ | OTEL | 59,506 |
| New Ulm Telecom | OTCBB | NULM | 26,570 |
| Shenandoah Telecommunications | NSDQ | SHEN | 21,615 |

Source: JSI Capital Advisors

Also, as noted by Dr. Billingsley, many of these companies are distressed or are in bankruptcy, thereby affecting their beta value. Mr. Coleman is lukewarm endorsing the CAPM for this proceeding assigning it to a "comfortable" status given that the Division found no other suitable alternative. Without standard adjustments to the CAPM, I suggest the Commission accept the observation of Dr. Heaton and reject the CAPM as unable to "produce credible results" and that the CAPM "must adjust for unusual economic

circumstances" such as size and a highly irregular interest rate market. (Rebuttal Testimony of D Meredith Exhibit 1, PDF page 21)

Another set of pitfalls I see in the update provided by Mr. Coleman is that he uses spot rates for the inputs used in his CAPM. Generally accepted practice is to trend these over a period of time to smooth out normal and expected fluctuations in the market. Additionally, Mr. Coleman does not adjust for the unusual and historic rate anomaly we have had in the 20 year treasury rate since the great recession in 2009. In Graph 1, I report the 20 year yield over time and in this graph, the abnormally low yield since 2009 is clearly illustrated. One procedure, if the Commission is going to use the CAPM, is to adjust for this recognized anomaly by using an historic 4-5 percent value to represent a more "normal" 20-year yield. Dr. Billingsley suggests this in his review as does Dr. Heaton.

Graph 1


Source: Federal Reserve of St. Louis - Federal Reserve Economic Data (FRED) website.

Mr. Coleman fails to adjust his results with a small company adjustment, perhaps because he excluded the two largest carriers in the nation in his peer group. It should be obvious that a small company such as Emery is challenged in the equity markets when compared with much larger companies in the marketplace. As I have explained this omission is a flaw of the standard CAPM.

Another adjustment to CAPM is the recognition of a liquidity premium. This is discussed in some detail by Dr. Heaton and his conclusion is that CAPM "must adjust for differences" between securities [size] and illiquid property." (DDM Exhibit 1, PDF page 21) So there are a number of adjustments that need to be made to a the CAPM in order to be applied correctly.

Lastly, adjusting for the leverage of a company, by adjusting the beta to account for leverage, is another standard tool when using CAPM. Since Emery is using the Division's capital structure of 35 percent debt and 65 percent equity, the levered beta equals the product of the unlevered beta and the expression (1+(1-effective tax rate)x(Debt%/Equity%)), which in this case yields a factor of 1.5385 (zero taxes for Emery as a cooperative). Adjusting for leverage, Mr. Coleman's unlevered beta of 1.23 yields a levered beta of 1.89. Applying this standard adjustment would produce a rate of return in excess of Emery's 10.50 percent.

**Q: Mr. Coleman's rate of return is 9.96 percent and is only 54 basis points below Emery's proposed rate of return. To be clear, if the Commission were to use a small company premium to account for increased risk and constrained access to equity, or adjust for liquidity constraints, or leverage, would it be reasonable to conclude the 10.50 percent rate of return is a minimum rate of equity for any of these adjustments?**

A: Yes. I recognize that Mr. Coleman excluded the largest RBOCs from his peer group and so the adjustment to his CAPM result would need to account for this if a small company premium would be applied. Using the Rural Broadband Alliance estimate of 6 percent for a size premium, a value corroborated by Drs. Billingsley and Heaton, even using all possible peer group companies I expect Mr. Coleman's adjusted result would exceed the 10.50 percent proposed by Emery.

I cannot address in detail the results of Mr. Brevitz because I believe he has failed to indicate the method used to calculate the proposed staff returns on equity in Kansas. But since he argues strongly against a size adjustment, I assume that CAPM was used and that no adjustments were used. Mr. Brevitz argues against a size adjustment but does not

address other standard adjustments, such as using a levered beta or recognizing the current market rate is irregular and instead using of an appropriate treasury rate instead of an abnormally low treasury rate.

**Q: Do you agree that with Mr. Coleman that there is no other practicable way to calculate a rate of equity for rural carriers?**

A: No. There are other approaches in the financial literature that attempt to resolve the knotty issues raised by CAPM and its failure as a predictive tool. NTCA proposes a method that uses actual rate-of-return transactions to calculate a Free Cash Flow rate. This method is a variant of the DCF method and is explained by NTCA (Rebuttal Testimony of D Meredith Exhibit 2 — Appendix B PDF page 81). Using this method, the weighted average cost of capital equals Free Cash Flow divided by Value. NECA calculated the rate of return for rural carriers and the median value was at least 11.75 percent. This alternative method informs the Commission that the 10.50 percent rate of return proposed by Emery is reasonable and should be adopted.

**Q: Let me ask you about the debt/equity structure of Emery. Mr. Brevitz argues that a 50/50 ratio should be used. Please explain how the debt/equity sliding scale is used in Utah.**

A: As discussed by Mr. Coleman, the standard practice in Utah stems from a lengthy series of workshops and technical conferences. To account for and balance the various interests, a sliding scale has been used by the Division for many years and was recommended as a rule but the Commission declined to establish this policy as a rule. Notwithstanding the Commission's reluctance to adopt the sliding scale as a rule, it is a very good approach to balance the state's interest. The sliding scale has endpoints at 35 percent and 65 percent. If a carrier has a debt percentage above 35 percent but below 65 percent, then the actual rate structure is used. Otherwise, if debt is 35 percent or lower a hypothetical 35 percent debt structure is used and similar treatment is on the other side of the scale. Emery does not hold any long-term debt and so the sliding scale approach would apply a hypothetical 35 percent debt structure. These percentages are then used to weight the costs of capital and debt which results in an overall rate of return. Emery uses the approach endorsed by

the Division. Mr. Brevitz takes exception to this long-standing practice and argues for a hypothetical 50 percent debt. I have reviewed his testimony and I find nothing new in Mr. Brevitz's testimony that wasn't thoroughly discussed when the sliding scale was developed. His comparison of large companies is unconvincing. Only SHEN is close to the size of Emery and it has 43 percent debt. Without considering the specific circumstances of SHEN, Mr. Brevitz's own evidence shows that the Divsion's sliding scale approach is reasonable and since 43 percent is relatively close to the 35 percent the Division and Emery use, the Commission should continue to apply the Divsion's sliding scale method to adjust for capital structure.

**Q: What is the appropriate interstate rate of return to be used for interstate services?**

A: The appropriate interstate rate of return is 11.45 percent. Mr. Brevitz is incorrect in proposing another rate. The development of the interstate rate has been developed by Commission rule. Mr. Bretivz argues that even his incorrect rate of 9.40 percent is too high despite the fact that the Commission has established the method of how to apply the interstate rate in Utah. His protest is telling and signals that without regard to even Commission rule, the Office is taking unreasonably biased positions in an attempt to lower the amount of Utah USF disbursed to rural carriers. I recommend the Commission weight its consideration of the Office's testimony accordingly.

**Loop Allocation**

**Q. Are you familiar with the Office's proposed adjustment referred to as BCO-1 in which the Office proposes an allocation of fiber/internet related common costs from Emery to its non-regulated affiliates?**

A. Yes.

**Q. Do you agree with this proposed adjustment?**

A. No.

**Q: Please explain.**

A. The analysis for the proposed adjustment BCO-2 is found in the testimony of Mr. Brevitz. Mr. Brevitz claims that "some allocation or appropriate division of fiber-to-the-home ("FTTH") facilities between regulated basic telephone service and non-regulated services and entities is required."

**Q What is your response to this assertion?**

A: There already is an allocation of cost is performed for the provision of broadband Internet access services over FTTH infrastructure. Mr. Brevitz propounds a theory to remove 50 percent of Emery's loop infrastructure from Emery's Utah USF disbursement request. The Commission should reject this proposal.

**Q: Does the Division raise any concerns it has with how Emery is allocating costs?**

A: No. The Division appears comfortable with the cost allocations Emery makes to its loop plant.

**Q: Please explain how FTTH facilities are used to provide services.**

A: Connections to end-user customers are used for a variety of services. Emery's switched access services, for example, allows a long distance provide to access its end-user customers using Emery's local loop—in this case Emery's FTTH facilities. Long distance providers pay Emery for this access under the interstate or intrastate switched access tariff.

**Q: Is FTTH loop plant any different than traditional or legacy copper loop plant?**

A: No. The decision to use fiber optic cables for loop plant is well supported in the industry. As copper plant ages, replacement to fiber improves service quality, reduces operational expenses, and according to the FCC, fiber optic installation is the forward-looking least cost technology it uses to estimate the cost of delivering telecommunications services. (The FCC uses FTTH in its modeling for price-cap carriers' federal universal service support.)

**Q: Does Emery allow other entities, including but not limited to its affiliates, to have access to FTTH services through which services are offered to end-user customers?**

A: Yes. All rate-of-return incumbent local exchange carriers (ILECs) in the nation who offer wireline broadband Internet access service (WBIAS), including Digital Subscriber Line service (DSL) provide such services under Title II of the Communications Act of 1934, as amended. The process for offering this service is explained in the following FCC Order entitled: "Appropriate Framework for Broadband Access to the Internet over Wireline Facilities et al., CC Docket No. 02-33 et al., Report and Order and Notice of Proposed Rulemaking," 20 FCC Rcd 14853, 14915, para. 138 (2005) (WBIAS Order).

It is important to distinguish for rate-of-return ILECs between the nonregulated retail Internet or Video offerings an ILEC or its affiliate may have and the regulated telecommunications component of the service identified as WBIAS. For the regulated Title II component of the retail nonregulated Internet or Video service, the ILEC or its affiliate must pay the tariffed rate or the permissively detariffed generally available rate to the ILEC under the requirements of the Federal Communications Commission's (FCC's) affiliate transaction rules at Section 32.27. (See 47 CFR § 32.27). Moreover, such rates are available to unaffiliated third party customers such as Internet Service Providers (ISPs). In this respect, the regulated WBIAS is a common carriage service available to the public. It is obvious that the proposal by the Office completely ignores these realities and facts extant in the industry.

**Q: Is WBIAS offered to providers as an intrastate or interstate service?**

A: WBIAS is an interstate service that is regulated by the FCC.

**Q: Do affiliates of Emery order WBIAS from Emery in the provisioning of broadband services?**

A: Yes. Affiliates, and any third-party providers, order WBIAS from Emery and then package this access service with their own services or products to offer to their end-user customers.

**Q: Does Emery allocate costs to the interstate jurisdiction to account for the use of FTTH loop plant when providing interstate services such as WBIAS?**

A: Yes. The FCC requires that Emery and all rate-of-return regulated ILECs assign a portion of their loop costs to the interstate jurisdiction. The allocation of loop costs to the interstate jurisdiction is governed under FCC regulation, specifically Part 36 of the Code of Federal Regulations. ILECs allocate FTTH loop costs to the interstate jurisdiction and thereafter tariffed rates are developed, generally by NECA, and ILECs have the duty to use these rates when providers want WBIAS or other interstate services.

**Q: When Emery affiliates and third-party providers purchase interstate WBIAS from Emery, do they pay rates that recover FTTH loop cost that has been assigned to the interstate jurisdiction?**

A: Yes. In the case where an end-user adds broadband service to an existing local exchange service (such as a bundle of regulated voice service and an unregulated broadband service), Emery assigns 25 percent of the FTTH loop cost to the interstate jurisdiction and receives cost recovery through various interstate mechanisms. Moreover, if an end-user only wants broadband service with no voice component, then 100 percent of the FTTH loop cost is assigned to the interstate jurisdiction where Emery recovers the cost through special access service prices.

**Q: Who establishes the 25 percent loop allocation that shifts or allocates cost to the interstate jurisdiction?**

A: This assignment is under the exclusive jurisdiction of the FCC. There is considerable legal guidance on the separation of costs between interstate and intrastate jurisdictions. The Supreme Court established that this separation is "important not simply as a theoretical allocation of the two branches of the business. It is essential to the appropriate recognition of the competent governmental authority in each field of regulation." (Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930) at 148) The Communications Act of 1934, as amended empowers the FCC to prescribe uniform separations procedures. *Illinois Bell,* 740 F.2d at 567 (cited in *Hawaiian Telephone Company*, 827 F2d 1264 (1986). In *Hawaiian Telephone Company,* the appellate court states "these statues evince a Congressional intent that the

FCC separations order control the state regulatory bodies, because a nationwide telecommunications system with dual intrastate and interstate rates can operate effectively only if one set of separations procedures is employed." *Id.* (Emphasis Supplied) The decision in *Louisiana Public Service*, 106 S. Ct. At 1902 reinforces this view because only after a uniform separations of costs has been applied that a state's independent rules for intrastate ratemaking separations of costs has been applied that a state's independent rules for intrastate ratemaking can be protected from federal preemption. Specifically, the Court in *Louisiana Public Service* states:

> "The Communications Act not only establishes dual state and federal regulation of telephone service; it also recognizes that jurisdictional tensions may arise as a result of the fact that interstate and intrastate service are provided by a single integrated system. Thus, the Act itself establishes a process designed to resolve what is known as "jurisdictional separations" matters, by which process it may be determined what portion of an asset is employed to produce or deliver interstate as opposed to intrastate service. 47 U.S.C. Secs. 221(c), 410(c). Because the separations process literally separates costs such as taxes and operating expenses between interstate and intrastate service, it facilitates the creation or recognition of distinct spheres of regulation. See *Smith v. Illinois Bell Telephone Co.*

**Q: Once a jurisdictional separation of costs has been made by the FCC, can the Commission, or any state Commission for that matter, object and assign more costs to the interstate jurisdiction or to interstate services?**

A: No. For the reasons I identify above, and the clear guidance in 1993 by the U.S. Court of Appeals, District of Columbia Circuit in *Crockett Telephone Company, el al. v. FCC* it states, referencing *Smith,* "Although each state has great freedom to regulate intrastate rates, once the FCC has applied its jurisdictional separation, that part of the cost base deemed to be interstate is outside the jurisdictional reach of the state regulatory agency." (963 F2d 1564)

Consider the consequence of such an act. It would be difficult, if not impossible, for Emery to recover any WBIAS costs deemed interstate by the Utah Commission that exceed WBIAS costs deemed interstate under the FCC's Part 36 Jurisdictional Separations rules and Part 69 Access Charge rules. (See, respectively, 47 CFR Part 36 and 47 CFR Part 69.) There would be no federally regulated service that could absorb the state-driven costs to the interstate jurisdiction. As mentioned above, rate-of-return ILECs may offer WBIAS either pursuant to their interstate access tariff or on a permissively detariffed basis. For ILECs offering WBIAS under tariff, in most cases NECA Tariff FCC No. 5, they have a duty to charge the applicable tariff rate or rates under Title II of the Communications Act. Thus, were the Commission to separate Category 1.3 loops used jointly for voice and data and apply an interstate allocation greater than 25 percent, the incremental allocation above 25 percent would constitute stranded costs bereft of any recovery.

**Q: Does the proposal offered by the Office fall afoul of the regulations you have identified?**

A: Yes. The proposal by the Office is an attempt to shift more costs to the interstate jurisdiction than is currently allowed by the FCC. The Office seems to ignore the fact that Emery offers its affiliates and all third-parties WBIAS that is used for broadband service, including high-capacity broadband services. The Office argues it is allocating cost to a nonregulated affiliate. It believes it can recommend this policy because it is cutting from whole cloth—albeit hypothetical and not grounded in the realities of jurisdictional separations and regulated interstate services. Viewed correctly, the Office proposes to assign more costs to an interstate service, WBIAS, and thought this interstate service seeks recovery of FTTH costs from a nonregulated affiliate through the vehicle of an interstate tariff. This simply is not permitted.

Moreover, were Emery forced to pass along as "interstate" greater costs for WBIAS than allowed under Part 36 and Part 69 to its affiliates, Emery's affiliates would be at a disadvantage in comparison to any unaffiliated third parties who are able to purchase WBIAS from the ILEC at the tariffed-rate. Given the guidance from the courts informing this policy, it does not seem that the Communications Act allows for such a dissymmetry.

**Q: Has the Federal-State Joint Board on Jurisdictional Separations received comment on this issue? After all, isn't the 25 percent loop a bit dated?**

A: Yes and yes. The Federal-State Joint Board on Jurisdictional Separations is the policy recommending body that gives guidance to the FCC when requested. The Joint Board has examined the 25 percent allocator and the state members of the Joint Board have recommended that the 25 percent allocator be increased. However, the Joint Board has never made a recommendation to the FCC on changing the allocator and the FCC appears comfortable with the current allocator.

**Q: Do you know of any state commission that has assigned more costs to the interstate jurisdiction?**

A: No. Moreover, Mr. Brevitz fails to identify any state commission that has accepted his novel theory.

**Q: Please summarize your testimony concerning the Office proposal to allocate FTTH costs to non-regulated affiliates.**

A: The proposal is a clever mechanism to allocate surreptitiously more costs to Emery's WBIAS—an interstate service with the consequence of disadvantaging Emery's affiliates and leaving Emery stranded in its ability to recover costs for this interstate service. The Commission should reject this effort as contrary to long established law and policy on this matter. If the Office wants to address this issue, the proper venue is the Federal State Joint Board on Jurisdictional Separations.

## Depreciation Method

**Q: Have you reviewed the testimony of Mr. Joseph Hellewell offering testimony on behalf of the Division of Public Utilities?**

A: Yes.

**Q: What is the core issue with regards to depreciation raised by Mr. Hellewell?**

A: The Division disagrees with the use of a standard and industry accepted method of depreciation called group asset depreciation. Currently Emery uses the group asset straight-line depreciation method to calculate allowable depreciation expense for infrastructure it puts into service for the provision of regulated telecommunications services.

**Q: Is group asset depreciation required by the FCC?**

A: No. Group asset depreciation is the preferred or default method that carriers may use to calculate depreciation expense. (See 47 C.F.R. §32.200(g))

**Q: Does the Division describe the "questionable results" it believes occur with the group asset depreciation method used by Emery?**

A: Not fully. Mr. Hellewell correctly states that group asset depreciation effectively accelerates the allowed depreciation expense for an asset. The degree of the acceleration depends on the total amount of investments in the particular group. However, Mr. Hellewell incorrectly concludes that this has the effect of inflating the depreciation expense leading to an increase in Utah USF support.

The facts are quite the opposite. The use of group asset depreciation accelerates the recovery of allowed depreciation expense and over the life of the asset REDUCES the amount of Utah USF support that would be generated by this asset. This is because the acceleration of depreciation expense reduces the rate base for which an authorized rate of return is applied. Ultimately, Emery will recover 100 percent of the investment of the asset through depreciation expense, but with group asset depreciation the asset is not earning a rate of return for as long as if Emery were using a single asset straight-line depreciation method. This fact is missed by the Division and consequently leads the Division to incorrectly assume that group asset depreciation yields a "questionable result."

**Q: The Division admits that there are benefits to the group asset depreciation method but argues that everyone needs to be on the same method to assist in reviewing company reports. Do you agree?**

A: I agree there are recognized benefits to group asset depreciation method. However, I disagree that there needs to be a standardized method across all carriers. I think we all can agree that discussing depreciation is almost as exciting as watching paint dry. Nonetheless, having a standard across companies provides no benefit. Contrary to the Division's claim, the regulated companies in Utah do not compete with one another for regulated services, so there is no need to be concerned about competitive issue in this context.

Also, the Division has shown it is capable of examining various systems of accounts, so standardization doesn't improve administrative efficiency. On the contrary, if the Commission were to mandate using single asset depreciation for carriers that are currently using group asset depreciation, there are a host of administrative issues related to keeping track of interstate group asset accounting and whether the asset is correctly accounted for between the interstate and intrastate jurisdictions. This point is very important. Since the allocation of cost between jurisdictions (interstate and intrastate) changes annually, there will always be a gap between the state's single asset method and the interstate group asset method. I cannot think of how the accounting would be able to easily resolve this discrepancy.

Furthermore, if the Commission were to require single asset depreciation for state USF, the annual reports for each company would be less transparent since depreciation expense would need a separate reconciliation schedule. While this added administrative effort can be ordered, I ask to what purpose? It seems that the Division's proposal is based on a misguided belief that something strange is happening and straight-line depreciation will solve the problem. In reality, there is nothing fishy going on and straight-line will create more administrative problems than it will solve. Again, a reconciliation could not easily deal with the gap between the state's single asset method and the interstate group asset method.

I also note that if the Division wanted to standardize the depreciation method for all carriers—for some illusory state purpose, doing so in Utah USF disbursement requests is a strange way to go about establishing a new state policy. To achieve full compliance with its policy, the Division's only hope is that all carriers will eventually request a USF disbursement. And even then, the only effect is an extraordinary adjustment to the Utah USF. No carrier is mandated to move to a single asset depreciation method unless the Commission sets a statewide policy. To set this policy the Commission will have to be convinced that moving from an acceptable group asset method, used for and approved by the FCC, will further the state's interests and hopefully reduce the administrative burden of rural carriers in Utah. We have nothing in this proceeding that supports such a monumental change of policy by the Commission.

**Q: Does Emery manipulate Commission approved depreciation rates?**

A: No. Emery Telephone uses the approved Commission depreciation rates for each asset classification. The only difference between group asset and single asset methods is the calculation of authorized depreciation expense for a given year. Both methods use straight-line depreciation, but under the group asset method, the group account investment balance is multiplied by the approved depreciation rate and this amount becomes the maximum depreciation expense for the group of assets. If there is a sufficient remaining net investment balance, the depreciation expense will equal the maximum depreciation expense. Otherwise, only the remaining portion of undepreciated plant will be depreciated. Consider for example the following: the initial group account investment balance is $1,000,000, the accumulated depreciation for this group is $750,000, the new investment is $200,000 and the depreciation rate is 10 percent. Under group asset method, the allowable deprecation for the group (undepreciated plant and new investment) is 10% x $1,200,000 = $120,000. Under single asset depreciation the allowable depreciation for the group of assets is 10% x ($500,000+$200,000) = $70,000, (assuming that half of the assets are fully depreciated). If the rate of return were 11.25 percent. The group asset method would reduce return by $13,500, while the single asset method would reduce return on rate base by $5,062.50. This example is simplified since no mid-year convention was used. So over time, which method is preferred? If the goal is to minimize total Utah USF over time,

the group asset method will reduce return on rate base since the rate base is being reduced at an accelerated rate. The calculation of group asset accounting and the corresponding continuing property records held by Emery allow for absolute transparency using the group asset method of depreciation.

There is no manipulation of Commission approved depreciation rates. I note that when the Commission established its approved rates in the 1990s, group asset accounting was an approved method of depreciation and was recognized as a method used by carriers. Further, when the Commission set Emery's specific depreciation rates in 2001, Emery was using (and has continuously used) group asset depreciation. Neither the Division, nor the Commission have historically had any concern or issue with group asset depreciation. In fact, they have tacitly approved it for more than 20 years. The group asset methodology is reasonable and well within the "pasture" of the public interest.

The office furniture example cited by Mr. Hellewell shows the effect of both methods. Please excuse the seemingly insignificant numbers in this example, because the illustration clearly shows the error of the Division's thinking. Because the $2,721.50 in new assets was depreciated over two months, and because the amount of allowable depreciation expense was large relative to the undepreciated balance in the group, this $2,721.50 was fully deprecated within two months, Emery did not get any return on this rate base. If the asset were under the single asset depreciation method the rate of return (11.25%) over the life of the asset would be $872.58. Total cost: single asset = $3,594.08 and group asset = $2,721.50. A difference of 32 percent. Mr. Hellewell argues that having a total cost of <u>32 percent higher</u> than group asset depreciation is in the public interest. I disagree and recommend the Commission disabuse the Division of its shortsighted thinking. The use of group asset depreciation certainly allows for accelerated depreciation expense recovery, but on its flip-side, it reduces the rate base at an accelerated rate and saves the Utah USF money in the long run.

**Q: What is your response to the various other methods the Division proposes?**

A: I find it ironic that in on one hand the Division argues for standardization across all carriers and on the other hand says that five other methods would be perfectly acceptable. Such inconsistency in its advocacy of policy should cast serious doubt on the thoughtfulness of the Division's proposal. Further, there is no suggestion that these alternative methods improve or advance the state's interests. I also note that whatever method the Commission adopts in a rule making, a reconciliation for prior treatment, as described by Darren Woolsey, is necessary to ensure that the proper amount of depreciation expense and return is credited to Emery.

**Q: Please summarize your testimony on depreciation methods.**

A: Emery uses a standard and industry approved depreciation method. This method has the effect of accelerating depreciation but also accelerates the decline of the rate base used for ratemaking purposes. The accounting and reporting hazards of using two different methods—one for interstate purposes and the other for state USF purposes has been ignored by the Division. Emery's method is transparent and widely, but not universally used. The Division's position is a change in policy and if it wanted standardized approach across all carriers, it should petition for a rule making to examine the issue. Currently, group asset depreciation minimizes the need for state USF disbursements over the life of the asset since it is removed from the rate base at a faster rate. For these reasons, I recommend the Commission allow Emery to continue to use group asset depreciation in calculating its need for Utah USF support.

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

A. Yes.