

- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

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	)	DOCKET NO. 15-2302-01
	)	DPU Exhibit 3.0
In the Matter of Carbon/Emery Telecom	)	
Inc.'s Application for an Increase in	)	Direct Testimony of
Utah Universal Service Fund Support	)	Casey J. Coleman
	)	
	)	

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DIVISION OF PUBLIC UTILITIES  
DEPARTMENT OF COMMERCE

August 21, 2015

**CONTENTS**

I. IDENTIFICATION OF WITNESS .....1

II. SUMMARY .....2

III. CAPITAL STRUCTURE FOR MTC .....2

IV. INTERSTATE / INTRASTATE SEPARATION (DPU 3.1) .....4

V. COST OF CAPITAL (DPU 3.2).....7

VI. CONCLUSION .....9

1                                   **I. IDENTIFICATION OF WITNESS**

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

4 A. My name is Casey J. Coleman. I am employed by the Division of Public  
5 Utilities (“Division”) for the State of Utah. My business address is 160 East  
6 300 South Salt Lake City, UT 84114.

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

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

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

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

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

17 A. Yes. I testified before the Commission as an expert witness in Docket Nos. 02-  
18 2266-02, 02-049-82, 03-049-49, 03-049-50, 05-053-01, 05-2302-01, 07-2476-01,  
19 08-2469-01, 10-049-16, 10-2521-01, 10-2526-01, 08-046-01 and 15-042-01.

20

## II. SUMMARY

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

23 A. An application filed by Carbon/Emery Telecom Inc. (“Carbon”) on March 27,  
24 2015 requests that the Public Service Commission of Utah (“Commission”)  
25 grant an increase in support from the Utah Universal Public  
26 Telecommunications Service Support Fund (“UUSF”). My testimony will  
27 focus on three specific areas of the application submitted by Carbon. First,  
28 my testimony discusses the appropriate capital structure for Carbon to be  
29 used in this application. Second, my testimony will outline Utah Admin.  
30 Code § R746-360-8 Calculation of Fund Distributions in Rate-of-Return  
31 Incumbent Telephone Corporation Territories and its validity in this  
32 application. Finally, my testimony discusses the cost of capital used to  
33 develop the revenue requirement for Carbon

34

## III. CAPITAL STRUCTURE FOR CARBON

35 **Q. WHAT CAPITAL STRUCTURE IS THE DIVISION RECOMMENDING**  
36 **FOR CARBON?**

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

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

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

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

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

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

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

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

61 Conversely, if a company had a capital structure that was mostly equity a  
62 hypothetical capital structure of 35 debt and 65 equity would be used.

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

69 **Q. IS CARBON'S CAPITAL STRUCTURE ABOVE THE 65 PERCENT**  
70 **EQUITY THRESHOLD?**

71 A. Yes. Carbon's capital structure has an equity amount greater than 65  
72 percent.

73 **IV. INTERSTATE / INTRASTATE SEPARATION**

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

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

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

85 A. From my interpretation of the rule, there seems to be two different pieces of  
86 information required to make this calculation, the first being the interstate  
87 rate of return calculated by NECA as reported on the FCC form 492A. The  
88 second data point would be the appropriate allocation of rate base for  
89 Carbon between interstate and intrastate as required by the FCC in Title  
90 47 part 36.

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

93 A. Yes.

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

96 A. The interstate rate-of-return as reported on form 492A is 9.40 percent.

97 **Q. WHY DID THE DIVISION USE THE 9.4 PERCENT INTERSTATE**  
98 **RATE FROM THE NECA FORM 492A?**

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

101 “NECA has provided two Form 492 reports. The first applies to companies  
102 that participate in NECA’s Common Line pool. The second applies to the

103 smaller subset of companies that participate in both NECA's Common Line  
104 and Traffic Sensitive pools. Because all Common Line pool participants  
105 receive a uniform return on investment, the Common Line rate of return  
106 reported on both forms is identical."

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

110 **Q. WHY IS THE DIVISION RECOMMENDING THE INTERSTATE**  
111 **RATE OF 9.4 PERCENT INSTEAD USING THE 11.45 PERCENT AS**  
112 **SHOWN IN MR. WOOLSEY'S EXHIBIT 3?**

113 A. The question of which rate to use is really a matter of whether Carbon  
114 participates in the Common Line Pool, or the smaller subset of companies  
115 that participate in both NECA's Common Line and Traffic Sensitive pools.  
116 In a phone conversation with Mr. Brandon Gardner, NECA Western Region  
117 Manager, the Division learned that Carbon is a not Common Line Pool  
118 participant and as a result would be included in the second subset of  
119 companies. As a result, the correct interstate rate to use when calculating  
120 the allowed rate of return is the 9.4 percent which blends Common Line,  
121 Switched Traffic Sensitive and Special Access pools. This rate is shown in  
122 the second 492A report filed by NECA to the FCC.



123 **V. COST OF CAPITAL (DPU3.1)**

124 **Q. WHAT IS THE ALLOWED RATE OF RETURN THAT THE DIVISION**  
125 **IS RECOMMENDING FOR CARBON?**

126 A. As exhibit 3.1 illustrates, the Division recommends using an allowed rate-of-  
127 return of 9.12 percent.

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

131 A. The only differences between Carbon and the Division on this point is the  
132 interstate rate as discussed above and the appropriate intrastate cost of  
133 equity. The Division recommends a rate of 10.75 percent instead of the 12.13  
134 percent recommended by Mr. Woolsey.

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

137 A. The Division used a Capital Asset Pricing Model ("CAPM") which is a model  
138 based on the proposition that any stock's required rate of return is equal to the  
139 risk-free-rate of return plus a risk premium which reflects only the risk  
140 remaining after diversification. Generally, if parties know the risk premium,  
141 the risk-free-rate and beta, a rate of return can be calculated. In CAPM  
142 terminology, beta is a measure of the extent to which the returns on a given  
143 stock move with the stock market. The ideal scenario is to calculate a beta

144 specific to an individual stock or company based on a variety of different  
145 financial information. With small rural telephone companies, the information  
146 needed is not publicly available, making a specific beta calculation for Carbon  
147 or any rural phone company challenging. To determine an approximate beta  
148 that could apply to Carbon, the Division looked at publicly traded  
149 telecommunications companies with similar profiles to determine a beta that  
150 would be representative. With this calculated beta and following the general  
151 guidelines of CAPM the Division was able to calculate, as reflected in Exhibit  
152 3.2 Carbon Telephone Return on Equity – Intrastate, the cost of equity for  
153 Carbon at 10.75 percent.

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

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

163 dividend yield it is impracticable to calculate a cost of equity using a DCF  
164 model.

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

168 **VI. CONCLUSION**

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

171 A. The Division recommends that the Commission use a 35 percent debt and 65  
172 percent equity hypothetical capital structure and an allowed rate-of-return of  
173 9.12 percent.

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

175 A. Yes it does.