

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

IN THE MATTER OF CARBON/EMERY)
TELCOM, INC. APPLICATION FOR AN) DOCKET NO. 15-2302-01
INCREASE IN UTAH UNIVERSAL)
SERVICE FUND SUPPORT)

REVISED REBUTTAL TESTIMONY OF DOUGLAS DUNCAN MEREDITH

ON BEHALF OF

CARBON/EMERY TELCOM, INC.

September 4, 2015

(Revised Per Commission Order October 26, 2015)

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1 Introduction

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

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

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

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

13
14 In my employment at JSI, I have participated in numerous proceedings for rural and non-
15 rural telephone companies. These activities include, but are not limited to, the creation of
16 forward-looking economic cost studies, the development of policy related to the
17 application of the rural safeguards for qualified local exchange carriers, the determination
18 of Eligible Telecommunications Carriers, the sustainability and application of universal
19 service policy for telecommunications carriers, as well as supporting incumbent local
20 exchange carriers in arbitration proceedings and rural exemption and suspension and/or
21 modification proceedings.

22
23 In addition to assisting telecommunications carrier clients, I have served as the economic
24 advisor for the Telecommunications Regulatory Board of Puerto Rico since 1997. In this
25 capacity, I provide economic and policy advice to the Board Commissioners on all
26 telecommunications issues that have either a financial or economic impact on carriers or
27 end-users. I have participated in a number of arbitration panels established by the Board

28 to arbitrate interconnection issues under Section 252 of the Telecommunications Act of
29 1996.

30
31 I am participating or have participated in numerous national incumbent local exchange
32 carrier and telecommunications groups, including those headed by NTCA, USTelecom,
33 and the Rural Policy Research Institute. My participation in these groups focuses on the
34 development of policy recommendations for advancing universal service and
35 telecommunications capabilities in rural communities and other policy matters.

36
37 I have a Bachelor of Arts degree in economics from the University of Utah, and a Masters
38 degree in Economics from the University of Maryland – College Park. While attending the
39 University of Maryland – College Park, I was also a Ph.D. candidate in Economics, having
40 completed all coursework, comprehensive and field examinations for a Doctorate of
41 Economics.

42
43 **Q: Have you testified previously in federal and state regulatory proceedings on**
44 **telecommunications issues?**

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

53
54 **Q: On whose behalf are you testifying in this proceeding?**

55 A: I am testifying on behalf of Carbon/Emery Telcom, Inc. (“Carbon/Emery”).

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

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

- 66 ○ Casey Coleman, Division of Public Utilities;
- 67 ○ David Brevitz, Office of Consumer Services;
- 68 ○ Joseph Hellewell, Division of Public Utilities.

69

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

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

72

73 **Rate of Return**

74

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

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

89

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

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

95

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

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

102

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

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

107

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

111 A: I disagree with Mr. Brevitz on the application of small company adjustments. A small
112 company adjustment or more specifically a size adjustment is a common adjustment that
113 is used when examining small companies. The outright rejection of this adjustment by Mr.
114 Brevitz appears strident and unreasonably designed to simply produce a low rate of return
115 for Carbon/Emery.

116

117 The Morningstar/Ibbotson Annual Yearbook routinely reports an adjustment that would be
118 applied to a company based on market capitalization. Depending on the size of the
119 company, the size premium ranges from a negative adjustment of 38 basis points for very

120 large companies to a positive adjustment of 6.10 percent for the smallest of companies. In
121 a presentation entitled “Telcom Cost of Capital Issues: January 1, 2012”, Dr. Hal. B.
122 Heaton (BYU Professor, Stanford Ph.D.) describes a size premium as a “minimum
123 adjustment” to be used when applying the standard Capital Asset Pricing Model (CAPM).
124 (Rebuttal Testimony of D Meredith Exhibit 1- PDF page 18)

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

134
135 “Using the CAPM, the Staff Report estimates that the average cost of equity for its
136 entire 16-company sample is 7.18 percent, 6.70 percent for the RHC subsample,
137 7.75 percent for the mid-sized carrier subsample, and 6.90 percent for the RoR
138 subsample of companies. In contrast, the approach to applying the firm size-
139 adjusted CAPM recommended by Duff & Phelps produces an average cost of
140 equity for the entire Staff Report company sample of 12.74 percent, 9.13 percent
141 for the RHC subsample, 13.07 percent for the mid-sized carrier subsample, and
142 14.01 percent for the RoR [Rate of Return] subsample of companies.

143
144 Consistent with the empirical evidence on the size effect, the [FCC’s] Staff Report
145 underestimates the equity costs of the smallest firms the most, which are the RoR
146 firms that are the most comparable subsample to the average RLEC. The data used
147 to generate the Duff & Phelps estimates are available by subscription and are relied
148 on by investment professionals. Duff & Phelps consequently provide objective
149 evidence that the Staff Report’s failure to adjust for the small firm effect provides
150 significantly understated RLEC equity costs and, by implication, an understated

151 average RLEC WACC.” (Rebuttal Testimony of D Meredith Exhibit 2 - PDF page
152 55-56).

153
154 Also included as Rebuttal Testimony of D Meredith Exhibit 3 is the Federal
155 Communications Commission Staff Report that is the subject of this critique. A small
156 company adjustment or premium should be an adjustment adopted by the Commission to
157 evaluate the rate of equity for a small rural carrier in Utah.

158
159 **Q: Is it your testimony that the 10.50 percent rate of return should be used in this**
160 **proceeding?**

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

167
168 **Q: Please explain the information you reviewed in reaching your recommendation that**
169 **10.50 percent is a minimum rate of return that will ensure that equity freely flows to**
170 **Carbon/Emery for its long-term infrastructure projects.**

171 A: First is the volume of information filed at the FCC and the FCC’s actions in a docket to
172 examine the interstate rate of return. As I mentioned earlier, in 2013 the FCC examined
173 whether it should change its prescribed rate of return used for investments assigned to the
174 interstate jurisdiction. Currently the authorized rate of return used by the FCC is 11.25
175 percent. The FCC staff issued a report (Rebuttal Testimony of D Meredith Exhibit 3)
176 whose conclusion was cited by Mr. Brevitz. In this staff report, the recommended range
177 for a rate of return was 7.39 percent to 8.72 percent. What should inform the Commission
178 in this proceeding is the fact that the FCC did not accept the conclusions of the staff report.
179 The rebuttals of the staff report provided by NTCA, et al. (Rebuttal Testimony of D
180 Meredith Exhibit 2) and the Rural Broadband Alliance (Rebuttal Testimony of D Meredith

181 Exhibit 4) leveled a broadside against the staff findings to the extent that the FCC has let
182 the issue remain dormant for two years and no action has been taken.

183
184 The NTCA report showed various errors in the staff report and also recommended an
185 alternative to the DCF method that uses small company data to calculate a rate of return—
186 these data are from purchases of small carriers across the country. The NTCA report
187 demonstrates that the 11.25 percent rate of return is in fact too low. (Using other methods,
188 the Rural Broadband Alliance examination demonstrates the same and applies a 6 percent
189 small company adjustment on pages 18-23). So, from the FCC’s docket we have one staff
190 report that was thoroughly rebutted. The findings of the two industry rebuttals demonstrate
191 that the 11.25 percent rate of return is low for small rural carriers and if any change were
192 to be made, this rate of return should increase. In light of the evidence, the FCC has let the
193 issue remain idle and the authorized prescribed interstate rate of return for rural carriers
194 remains set at 11.25 percent.

195
196 **Q: What should the Commission take from the FCC’s proceeding examining the same**
197 **issue raised by the Division and the Office?**

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

202
203 Second, the Commission should conclude that it should take no action to change the
204 interstate authorized prescribed rate of return after an exhaustive review demonstrates that
205 the 11.25 percent rate of return provides a reasonable incentive for equity to freely flow to
206 carriers, like Carbon/Emery, whose aim is to invest in long-term infrastructure projects in
207 the provision of telecommunications service regulated by the state. The FCC as an expert
208 agency in regulating telecommunications carriers has examined the issues, pro and con,
209 and has deferred from taking actions to lower its prescribed rate of return. This fact should
210 inform the Commission and provide sufficient support for retaining Carbon/Emery’s 10.50
211 percent rate of return in this proceeding.

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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.

Q: Mr. Coleman provides his 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 companies in his peer group. Examining this peer group shows serious problems that should give the Commission reservations in using his peer group.

1. HickoryTech was purchased by Consolidated Communications on October 16, 2014 so this company cannot be in the peer group.
2. Alteva isn’t a reasonable peer since the majority of its revenues is generated from its VoIP operations and wireless partnership (which was sold in 2014), and not its small ILEC operations.
3. Atlantic Tele Network does not have ILEC operations and its primary wireline operations are in Guyana. It also has a good portion of revenues generated from wireless operations.
4. Earthlink is not a good fit since it doesn’t have ILEC operations.
5. IDT is not a good fit since it doesn’t have ILEC operations.

243 Moreover, the size of these companies dwarfs Carbon/Emery and without adjustment the
 244 CAPM results cannot be reasonably applied to Carbon/Emery. In Table 1 I show the access
 245 line counts for the biggest set of operationally similar companies that can create a peer
 246 group. Table 1 includes more companies than what Mr. Coleman used. I presume Mr.
 247 Coleman didn't think that Verizon or AT&T are peers to Carbon/Emery and he excluded
 248 these from his analysis. I include them due to their operations as the largest ILECs in the
 249 nation.

251 Table 1

<u>Company</u>	<u>Exchange</u>	<u>Ticker</u>	<u>Access Lines 6/30/2015</u>
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

252 Source: JSI Capital Advisors

253
 254 Also, as noted by Dr. Billingsley, some of these companies are distressed or are in
 255 bankruptcy, thereby affecting their beta value. FTR, WIN, ALSK, OTEL and NULM all
 256 report negative beta values using September 4, 2015 Yahoo Finance reports (the same
 257 source use by Mr. Coleman). These companies should be removed from the peer group.

258
 259 Mr. Coleman is lukewarm endorsing the CAPM for this proceeding assigning it to a
 260 "comfortable" status given that the Division found no other suitable alternative. Without

261 adjusting the CAPM, I recommend the Commission reject the CAPM as unable to “produce
262 credible results” and that the CAPM “must adjust for unusual economic circumstances”
263 such as size and a highly irregular interest rate market. (Rebuttal Testimony of D Meredith
264 Exhibit 1, PDF page 21, observation of Dr. Heaton on using the CAPM).

265
266 Another set of pitfalls I see in the update provided by Mr. Coleman is that he uses spot
267 rates for the inputs used in his CAPM. A generally accepted practice is to trend these over
268 a period of time to smooth out normal and expected fluctuations in the market. Data from
269 the U.S Department of Treasury reports that the trend for the three-month T-Bill from
270 1990-today is 3.04 percent, and the trend for the twenty-year T-Bond is 5.009 percent.
271 These trends are based on all the data available online at the Department of Treasury and
272 correspond generally to other data analysis I have examined and include in my testimony.

273
274 In Graph 1, I illustrate the 20-year yield over time and in this graph, the abnormally low
275 yield since 2009 is clearly illustrated. I propose the Commission use the Department of
276 Treasury 20-year T-Bond rate of 5.009 percent that was generated over 1990-today. This
277 corresponds to the recommendation of using an historic 4 to 5 percent value to represent a
278 more “normal” 20-year yield. Dr. Billingsley suggests this in his review as does Dr.
279 Heaton.

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Graph 1

20-Year Treasury Constant Maturity Rate

2015-07: 2.77 Percent (+ see more)

Monthly, Not Seasonally Adjusted, GS20, Updated: 2015-08-06 2:21 PM CDT



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

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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 Carbon/Emery is challenged in the equity markets when compared with much larger companies in the marketplace. The fact that there are only 14 publicly traded ILEC peers in the nation and only two whose line counts are comparable to small company line counts—there are 1,101 small company study areas in the nation—demonstrates that small companies do not have easy access to the equity markets.

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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.” (Rebuttal Testimony of D Meredith Exhibit 1, PDF page 21)

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Lastly, adjusting for the leverage of a company, by adjusting the beta to account for leverage, is another standard tool when using CAPM. The levered beta equals the product of the unlevered beta and the expression $(1 + (1 - \text{effective tax rate}) \times (\text{Debt} \% / \text{Equity} \%))$.

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Q: Have you been able to adjust the Division’s CAPM analysis to account for these adjustments?

309

310 A: Yes, except for the liquidity premium. I have used the meaningful peers because some of
 311 the peers have negative betas. I have gathered today's spot beta, effective tax rate and debt
 312 and equity values that are needed to produce a levered beta. I have also used a mid-point
 313 value of 3 percent for the company premium. I also am using the historic T-Bill and T-
 314 Bond rates. The following table reports the results of a cost of equity of 16.83 percent.
 315 The calculation is presented in Table 2. A 16.83 percent intrastate cost of equity yields an
 316 adjusted weighted average cost of capital of 12.34 percent—exceeding the 10.50 percent
 317 value proposed by Carbon Emery in its filing.

318 Table 2

Company	Access Lines 6/30/2015	Today's Spot Beta	CAPM unadjusted	Tax	Debt %/Equity %	Levered Beta	Levered CAPM
Verizon	19,079,000	0.5628	6%	22%	8.9881	4.5234	25.70%
AT&T	18,116,000	0.5521	6%	35%	0.8801	0.8700	7.40%
CenturyLink	12,100,000	1.0013	8%	30%	1.3393	1.9340	12.72%
Fairpoint Communications	768,222	0.5808	6%	0%	1.7500	1.5971	11.04%
Telephone & Data Systems	510,800	0.5557	6%	0%	0.5078	0.8379	7.23%
Consolidated Communications	493,540	0.8226	7%	46%	4.1933	2.6705	16.41%
Cincinnati Bell	389,000	1.4934	11%	43%	1.0000	2.3467	14.79%
Lumos Networks	105,298	0.9233	8%	40%	3.9032	3.0870	18.50%
Shenandoah Telecommunications	21,615	0.9945	8%	39%	0.8682	1.5211	10.66%
Average							13.83%
					Small company (size) premium		3.00%
T-Bill Rate (1990-today)	3.04%						
T-Bond Rate (1990-today)	5.01%					Adjusted CAPM	16.83%

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 321 I recommend the Commission accept these adjustments to the CAPM when examining the
 322 cost of equity for small companies in Utah.

324 **Q: If the Commission were to use a small company premium to account for increased**
 325 **risk and constrained access to equity, or adjust for liquidity constraints, or leverage,**
 326 **would it be reasonable to conclude the 10.50 percent rate of return is a minimum rate**
 327 **of equity for any of these adjustments?**

328 A: Yes. There are a number of adjustments or premiums that are used to assess value and
 329 return. I have used only two. Graph 2 shows the various premia required to calculate
 330 returns across financial instruments.

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Graph 2

Stocks				Small Stocks	Foreign Stocks	
Equity risk premium				Small-stock premium	Foreign stock premium	Foreign Bonds
	Bonds			Equity risk premium	Equity risk premium	Foreign bond premium
Bond horizon premium	Bond horizon premium			Bond horizon premium	Bond horizon premium	Bond horizon premium
		Cash	Real Estate			
Real riskless rate	Real riskless rate	Real riskless rate	Real return on real estate	Real riskless rate	Real riskless rate	Real riskless rate
Inflation	Inflation	Inflation	Inflation	Inflation	Inflation	Inflation

Source: Ibbotson and Siegel (1988).

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(Ibbotson, Roger G., and Laurence B. Siegel. 1988. "How to Forecast Long-Run Asset Returns." Investment Management Review (September/October).)

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It is claimed that "the liquidity premium is perhaps as important as any of the risk premiums." In a paper entitled The Demand for Capital Market Returns: A New Equilibrium Theory (1984), Roger Ibbotson, *et al.* proposed that the three security characteristics that investors most wish to avoid and, therefore, need to be most compensated for in the long run are (1) risk, (2) lack of liquidity, and (3) taxation. (Ibbotson, Roger G., Jeffrey J. Diermeier, and Laurence B. Siegel. 1984. "The Demand for Capital Market Returns: A New Equilibrium Theory." Financial Analysts Journal, vol. 40, no. 1 (January/ February):22–33.) In 2011, Ibbotson extended his research on liquidity and the impact of this risk on small companies. he quantified the liquidity risk associated with small companies. In Table 3 I report these findings.

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Table 3

Size	Liquidity			
	1 (lowest)	2	3	4 (highest)
1 (smallest)	18.17%	17.46%	13.51%	6.16%
2	16.87	15.15	11.68	6.52
3	15.15	14.36	12.87	9.56
4 (largest)	12.49	11.48	11.55	9.87

Source: Ibbotson, Chen, and Hu (2011).

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358 Ibbotson, Roger G., Zhiwu Chen, and Wendy Y. Hu. 2011. "Liquidity as an Investment
359 Style." Working paper, Yale University (April).

360

361 While I have accounted for a conservative size premium in my analysis, I haven't assessed
362 a liquidity premium because without further analysis I cannot separate the liquidity
363 premium from the small company premium. Nevertheless, these data reveal that
364 adjustments are necessary to determine the appropriate return for a small company and that
365 a standard/textbook CAPM approach should be rejected.

366

367 I cannot address in detail the results of Mr. Brevitz because I believe he has failed to
368 indicate the method used to calculate the returns on equity proposed by the staff in Kansas.
369 But since he argues strongly against a size adjustment, I suppose that the CAPM without
370 adjustment was used. My discussion about adjusting the CAPM applies equally to his
371 testimony.

372

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

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

383 is reasonable and should be adopted. I have attached the ILEC Transaction Roster that
384 shows small carrier activity up to 2015. There have not been many closed transactions
385 since NTCA's analysis, so the conclusions in the NTCA submission to the FCC appear to
386 remain valid. (Rebuttal Testimony of D Meredith Exhibit 5).

387

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

391 A: As discussed by Mr. Coleman, the standard practice in Utah stems from a lengthy series of
392 workshops and technical conferences. To account for and balance the various interests, a
393 sliding scale has been used by the Division for many years and was recommended as a rule
394 but the Commission declined to establish this policy as a rule. Notwithstanding the
395 Commission's reluctance to adopt the sliding scale as a rule, it is a very good approach to
396 balance the state's interest. The sliding scale has endpoints at 35 percent and 65 percent.
397 If a carrier has a debt percentage above 35 percent but below 65 percent, then the actual
398 rate structure is used. Otherwise, if debt is 35 percent or lower a hypothetical 35 percent
399 debt structure is used and similar treatment is on the other side of the scale. In this
400 proceeding both Carbon/Emery and the Division recommend the Commission use the
401 sliding scale approach with a hypothetical 35 percent debt structure. These percentages
402 are then used to weight the costs of capital and debt which results in an overall rate of
403 return. Mr. Brevitz takes exception to this long-standing practice and argues for a
404 hypothetical 50 percent debt. I have reviewed his testimony and I find nothing new in Mr.
405 Brevitz's testimony that wasn't thoroughly discussed when the sliding scale was
406 developed. His comparison of large companies is unconvincing. Only SHEN is relatively
407 "close" to the size of Carbon/Emery and it has 43 percent debt. Without considering the
408 specific circumstances of SHEN, Mr. Brevitz's own evidence shows that the Division's
409 sliding scale approach is reasonable and since 43 percent is relatively close to the 35
410 percent the Division and Carbon/Emery use, the Commission should continue to apply the
411 Division's sliding scale method to adjust for capital structure.

412

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

414 A: The appropriate interstate rate of return is 11.45 percent. Mr. Brevitz is incorrect in
415 proposing another rate. The development of the interstate rate has been defined by
416 Commission rule. Mr. Brevitz argues that even his incorrect rate of 9.40 percent is too
417 high despite the fact that the Commission has established the method of how to apply the
418 interstate rate in Utah.

419
420 Mr. Coleman also proposes that the Commission apply 9.40 percent in this proceeding.
421 Mr. Coleman is also incorrect in this recommendation. As explained by Mr. Woolsey,
422 Carbon/Emery participates in the NECA Common Line pool in conjunction with Emery
423 Telecom. For purposes of NECA, only Emery Telecom is listed, but Carbon/Emery and
424 Hanksville are included in the Emery Telecom submissions to NECA. The appropriate
425 interstate rate of return, per Commission rule, is 11.45 percent.

426

427 **Loop Allocation**

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

431 ~~A. Yes.~~

432

433 ~~Q. Do you agree with this proposed adjustment?~~

434 ~~A. No.~~

435

436 ~~Q: Please explain.~~

437 ~~A. The analysis for the proposed adjustment BCO-1 is found in the testimony of Mr. Brevitz.~~
438 ~~Mr. Brevitz on lines 365-367 of his testimony claims that "some allocation or appropriate~~
439 ~~division of fiber-to-the-home ("FTTH") facilities between regulated basic telephone~~
440 ~~service and non-regulated services and entities is required."~~

441

442 ~~Q. What is your response to this assertion?~~

443 ~~A. There already is an allocation of cost is performed for the provision of broadband Internet~~
444 ~~access services over FTTH infrastructure. Mr. Brevitz propounds a theory to remove 50~~

445 percent of Carbon/Emery's loop infrastructure from Carbon/Emery's Utah USF
446 disbursement request. The Commission should reject this proposal.

447
448 **Q: ~~Does the Division raise any concerns it has with how Carbon/Emery is allocating~~**
449 **~~costs?~~**

450 **A: ~~No. The Division appears comfortable with the cost allocations Carbon/Emery makes to~~**
451 **~~its loop plant.~~**

452
453 **Q: ~~Please explain how FTTH facilities are used to provide services.~~**

454 **A: ~~Connections to end-user customers are used for a variety of services. Carbon/Emery's~~**
455 **~~switched access services, for example, allows a long distance provider to access its end-user~~**
456 **~~customers using Carbon/Emery's local loop in this case Carbon/Emery's FTTH and~~**
457 **~~copper facilities. Long distance providers pay Carbon/Emery for this access under the~~**
458 **~~interstate or intrastate switched access tariff.~~**

459
460 **Q: ~~Is FTTH loop plant any different than traditional or legacy copper loop plant?~~**

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

466
467 **Q: ~~Does Carbon/Emery allow other entities, including but not limited to its affiliates, to~~**
468 **~~have access to FTTH services through which services are offered to end-user~~**
469 **~~customers?~~**

470 **A: ~~Yes. All rate-of-return incumbent local exchange carriers (ILECs) in the nation who offer~~**
471 **~~wireline broadband Internet access service (WBIAIS), including Digital Subscriber Line~~**
472 **~~service (DSL) provide such services under Title II of the Communications Act of 1934, as~~**
473 **~~amended. The process for offering this service is explained in the FCC Order entitled:~~**
474 **~~"Appropriate Framework for Broadband Access to the Internet over Wireline Facilities et~~**

475 al., CC Docket No. 02-33 et al., Report and Order and Notice of Proposed Rulemaking,”
476 20 FCC Red 14853, 14915, para. 138 (2005) (WBIAS Order).

477
478 ~~It is important to distinguish for rate-of-return ILECs between the nonregulated retail~~
479 ~~Internet or Video offerings an ILEC or its affiliate may have and the regulated~~
480 ~~telecommunications component of the service identified as WBIAS. For the regulated Title~~
481 ~~II component of the retail nonregulated Internet or Video service, the ILEC or its affiliate~~
482 ~~must pay the tariffed rate or the permissively detariffed generally available rate to the ILEC~~
483 ~~under the requirements of the Federal Communications Commission’s (FCC’s) affiliate~~
484 ~~transaction rules at Section 32.27. (See 47 CFR § 32.27). Moreover, such rates are~~
485 ~~available to unaffiliated third party customers such as Internet Service Providers (ISPs). In~~
486 ~~this respect, the regulated WBIAS is a common carriage service available to the public. It~~
487 ~~appears the proposal by the Office completely ignores these realities and facts extant in the~~
488 ~~industry.~~

489
490 **~~Q: — Is WBIAS offered to providers as an intrastate or interstate service?~~**

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

492
493 **~~Q: — Do affiliates of Carbon/Emery order WBIAS from Carbon/Emery in the provisioning~~**
494 **~~of broadband services?~~**

495 ~~A: — Yes. Affiliates, and any third party providers, order WBIAS from Carbon/Emery and then~~
496 ~~package this access service with their own services or products to offer to their end user~~
497 ~~customers.~~

498
499 **~~Q: — Does Carbon/Emery allocate costs to the interstate jurisdiction to account for the use~~**
500 **~~of FTTH loop plant when providing interstate services such as WBIAS?~~**

501 ~~A: — Yes. The FCC requires that Carbon/Emery and all rate-of-return regulated ILECs assign a~~
502 ~~portion of their loop costs to the interstate jurisdiction. The allocation of loop costs to the~~
503 ~~interstate jurisdiction is governed under FCC regulation, specifically Part 36 of the Code~~
504 ~~of Federal Regulations. ILECs allocate FTTH loop costs to the interstate jurisdiction and~~

505 thereafter tariffed rates are developed, generally by NECA, and ILECs have the duty to use
506 these rates when providers want WBIAS or other interstate services.

507
508 ~~Q: When Carbon/Emery affiliates and third-party providers purchase interstate WBIAS
509 from Carbon/Emery, do they pay rates that recover FTTH loop cost that has been
510 assigned to the interstate jurisdiction?~~

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

518
519 ~~Q: Who establishes the 25 percent loop allocation that shifts or allocates cost to the
520 interstate jurisdiction?~~

521 ~~A: This assignment is under the exclusive jurisdiction of the FCC. There is considerable legal
522 guidance on the separation of costs between interstate and intrastate jurisdictions. The
523 Supreme Court established that this separation is “important not simply as a theoretical
524 allocation of the two branches of the business. It is essential to the appropriate recognition
525 of the competent governmental authority in each field of regulation.” (Smith v. Illinois Bell
526 Telephone Co., 282 U.S. 133 (1930) at 148) The Communications Act of 1934, as amended
527 empowers the FCC to prescribe uniform separations procedures. *Illinois Bell*, 740 F.2d at
528 567 (cited in *Hawaiian Telephone Company*, 827 F.2d 1264 (1986). In *Hawaiian Telephone
529 Company*, the appellate court states “these statutes evince a Congressional intent that the
530 FCC separations order control the state regulatory bodies, because a nationwide
531 telecommunications system with dual intrastate and interstate rates can operate effectively
532 only if one set of separations procedures is employed.” *Id.* (Emphasis Supplied) The
533 decision in *Louisiana Public Service*, 106 S. Ct. At 1902 reinforces this view because only
534 after a uniform separations of costs has been applied that a state’s independent rules for
535 intrastate ratemaking separations of costs has been applied that a state’s independent rules~~

536 for intrastate ratemaking can be protected from federal preemption. Specifically, the Court
537 in *Louisiana Public Service* states:

538
539 “The Communications Act not only establishes dual state and federal regulation of
540 telephone service; it also recognizes that jurisdictional tensions may arise as a result
541 of the fact that interstate and intrastate service are provided by a single integrated
542 system. Thus, the Act itself establishes a process designed to resolve what is known
543 as “jurisdictional separations” matters, by which process it may be determined what
544 portion of an asset is employed to produce or deliver interstate as opposed to
545 intrastate service. 47 U.S.C. Secs. 221(e), 410(e). Because the separations process
546 literally separates costs such as taxes and operating expenses between interstate and
547 intrastate service, it facilitates the creation or recognition of distinct spheres of
548 regulation. See *Smith v. Illinois Bell Telephone Co.*

549
550 ~~Q: Once a jurisdictional separation of costs has been made by the FCC, can the~~
551 ~~Commission, or any state Commission for that matter, object and assign more costs~~
552 ~~to the interstate jurisdiction or to interstate services?~~

553 ~~A: No. For the reasons I identify above, and the clear guidance in 1993 by the U.S. Court~~
554 ~~of Appeals, District of Columbia Circuit in *Crockett Telephone Company, et al. v. FCC* it~~
555 ~~states, referencing *Smith*, “Although each state has great freedom to regulate intrastate~~
556 ~~rates, once the FCC has applied its jurisdictional separation, that part of the cost base~~
557 ~~deemed to be interstate is outside the jurisdictional reach of the state regulatory agency.”~~
558 ~~(963 F2d 1564)~~

559
560 ~~Q: Does the proposal offered by the Office run afoul of the regulations and guidance~~
561 ~~from the courts you identified?~~

562 ~~A: Yes. The proposal by the Office is an attempt to shift more costs to the interstate~~
563 ~~jurisdiction than is currently allowed by the FCC. The Office seems to ignore the fact that~~
564 ~~Carbon/Emery offers its affiliates and all third-parties WBIAS that is used for broadband~~
565 ~~service, including high-capacity broadband services. The Office argues it is allocating cost~~
566 ~~to a nonregulated affiliate. It believes it can recommend this policy because it is cutting~~

567 ~~from whole cloth—albeit hypothetical and not grounded in the realities of jurisdictional~~
568 ~~separations and regulated interstate services. Viewed correctly, the Office proposes to~~
569 ~~assign more costs to an interstate service, WBIAS, and though this interstate service seeks~~
570 ~~recovery of FTTH costs from a nonregulated affiliate through the vehicle of an interstate~~
571 ~~service. This proposal is not permitted and the Commission should reject this cost shift to~~
572 ~~the interstate jurisdiction.~~

573
574 ~~**Q: Has the Federal State Joint Board on Jurisdictional Separations received comment**~~
575 ~~**on this issue? After all, isn't the 25 percent loop a bit dated?**~~

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

582
583 ~~**Q: Do you know of any state commission that has assigned more costs to the interstate**~~
584 ~~**jurisdiction?**~~

585 ~~A: No. Moreover, Mr. Brevitz fails to identify any state commission that has accepted this~~
586 ~~cost allocation.~~

587
588 ~~**Q: Please summarize your testimony concerning the Office proposal to allocate FTTH**~~
589 ~~**costs to non-regulated affiliates.**~~

590 ~~A: The proposal is a clever mechanism to allocate surreptitiously more costs to~~
591 ~~Carbon/Emery's WBIAS—an interstate service. The Commission should reject this effort~~
592 ~~as contrary to long established law and policy on this matter. If the Office wants to address~~
593 ~~this issue, the proper venue is the Federal State Joint Board on Jurisdictional Separations.~~

594
595 **Depreciation Method**
596

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

599 A: Yes.

600

601 **Q: What is depreciation?**

602 A: Depreciation can be defined many ways, perhaps the most important definition is how
603 accountants define the term:

604 “Depreciation accounting is a system of accounting which aims to distribute cost
605 or other basic value of tangible capital assets, less salvage (if any), over the
606 estimated useful life of the unit (which may be a group of assets) in a systematic
607 and rational manner. It a process of allocation, not of valuation.” (American
608 Institute of Certified Public Accountants)

609

610 A good description of depreciation can be found in a book entitled “Telephone Economy,”
611 written by AT&T in 1952. AT&T states:

612 “[t]he cost of telephone plant is charged to an asset account at the time the plant is
613 installed. Then, each year of the plant’s service life, a portion of its cost is charged
614 against that year’s revenues. This charge, called *depreciation*, is designed to
615 provide for the recovery of capital invested in plant as that plant is used up.”

616

617 “In theory, depreciation accruals could actually be repaid to the investors, and in
618 some ventures this is done. However, in a business which requires substantial
619 amounts of money each year for construction, there would be no point in repaying
620 the investors an amount equal to the depreciation accrual and then going to the
621 capital market for that much more in new funds. Instead, depreciation accruals are
622 reinvested in the business, and these accruals provide funds for the purchase of new
623 plant. ... In a sense, the reinvestment of depreciation represents a recycling of
624 capital.” (Telephone Economy, pp 72-73)

625

626 Carbon/Emery's depreciation expense is reinvested into infrastructure that is necessary due
627 to plant that has reached its useful life, plant that has become obsolete due to technological

628 change—including where vendors discontinue support of vital equipment that is required
629 to operate 24x7, or for new plant where demand has exceeded the existing plant or where
630 demand occurs due to economic activity in the area.

631

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

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

638

639 **Q: Does Carbon/Emery use group asset depreciation in the interstate jurisdiction as
640 approved by the FCC?**

641 A: Yes. Carbon/Emery has used group asset depreciation since the transfer of ownership in
642 2001. It uses the FCC approved group asset depreciation method for cost recovery in both
643 the interstate jurisdiction and state jurisdiction. Using two methods of depreciation in the
644 two jurisdictions would be administratively burdensome and would pose intractable
645 problems.

646

647 **Q: Does the Division describe the “questionable results” it believes occur with the group
648 asset depreciation method used by Carbon/Emery?**

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

654

655 The facts are quite the opposite. The use of group asset depreciation accelerates the
656 recovery of allowed depreciation expense and over the life of the asset REDUCES the
657 amount of Utah USF support that would be generated by this asset. This is because the
658 acceleration of depreciation expense reduces the rate base for which an authorized rate of

659 return is applied. Ultimately, Carbon/Emery will recover 100 percent of the investment of
660 the asset through depreciation expense, but with group asset depreciation the asset is not
661 earning a rate of return for as long as if Carbon/Emery were using a single asset straight-
662 line depreciation method. This fact is missed by the Division and consequently leads the
663 Division to incorrectly assume that group asset depreciation yields a “questionable result.”
664

665 **Q: Could one reason for the Division’s unease over group asset depreciation be the**
666 **possibility that Carbon/Emery would view the acceleration of depreciation to the level**
667 **of complete depreciation as a reason to replace prematurely plant or equipment that**
668 **has remaining economic life?**

669 A: Mr. Hellewell does not describe this hypothetical possibility. However, to the extent the
670 Division’s proposal is based in part on this hypothetical, the Division has not identified in
671 the testimony any instances that Carbon/Emery has replaced prematurely plant or
672 equipment. Given the extensive review of Carbon/Emery in this proceeding, if there were
673 an example of this type of activity, I am certain that the Division would have identified it
674 in testimony. The absence of any instances of premature retirement suggests the
675 hypothetical is a canard.

676
677 Moreover, the decision of whether or not to replace plant is not based on past activity.
678 “The decision of whether or not to replace plant must be based on a comparison of future
679 expenditures, and it should not be influenced by the extent depreciation accruals have been
680 realized on the existing plant.” (Telephone Economy, p. 162)

681
682 If the Division is attempting to guard against this type of behavior, it doesn’t have any basis
683 to claim that Carbon/Emery is making retirement decisions that are in any way untoward.
684 Moreover, if an asset has value after retirement the standard method of calculating net
685 salvage accounts for this value and appropriate adjustments to the accounts are made.

686
687 **Q: The Division admits that there are benefits to the group asset depreciation method**
688 **but argues that everyone needs to be on the same method to assist in reviewing**
689 **company reports. Do you agree?**

690 A: I agree there are recognized benefits to group asset depreciation method. However, I
691 disagree that there needs to be a standardized method across all carriers. Having a standard
692 across all companies provides little or no benefit. Contrary to the Division's claim, the
693 regulated companies in Utah do not compete with one another for regulated services, so
694 there is no need to be concerned about competitive issue in this context.

695
696 Also, the Division has shown it is capable of examining various systems of accounts, so
697 standardization doesn't improve administrative efficiency. On the contrary, if the
698 Commission were to mandate using single asset depreciation for carriers that are currently
699 using group asset depreciation, there are a host of administrative issues related to keeping
700 track of interstate group asset accounting and whether the asset is correctly accounted for
701 between the interstate and intrastate jurisdictions. Since the allocation of cost between
702 jurisdictions (interstate and intrastate) changes annually, there will always be a gap
703 between the state's single asset method and the interstate group asset method. I cannot
704 think of how the accounting would be able to resolve easily this discrepancy.

705
706 Furthermore, if the Commission were to require single asset depreciation for state USF,
707 the annual reports for each company would be less transparent since depreciation expense
708 would need a separate reconciliation schedule. While this added administrative effort can
709 be ordered, I ask to what purpose? It seems that the Division's proposal is based on a
710 misguided belief that something strange is happening and the single-asset method of
711 depreciation will solve the problem. In reality, there is nothing fishy going on and the
712 single-asset method will create more administrative problems than it will solve. Again, a
713 reconciliation could not easily deal with the gap between the state's single asset method
714 and the interstate group asset method.

715
716 I also note that if the Division wanted to standardize the depreciation method for all
717 carriers—for some unspecified state purpose, doing so in Utah USF disbursement requests
718 is a strange way to go about establishing a new state policy. To achieve full compliance
719 with its policy, the Division's only hope is that all carriers will eventually request a USF
720 disbursement. And even then, the only effect is an extraordinary adjustment to the Utah

721 USF. No carrier would be mandated to move to a single asset depreciation method unless
722 the Commission sets a statewide policy. To set this policy the Commission will have to be
723 convinced that moving from an acceptable group asset method, used for and approved by
724 the FCC, will further the state's interests and hopefully reduce the administrative burden
725 of rural carriers in Utah. We have nothing in this proceeding that supports such a
726 monumental change of policy by the Commission.

727

728 **Q: If the Commission wanted to move to a single asset depreciation method, how would**
729 **you recommend it implement this policy change?**

730 A: If single asset depreciation were adopted as a policy, I recommend the Commission adopt
731 the policy on a prospective basis for new assets that are purchased and placed into service.
732 The Commission should allow purchases of past plant assets to remain in their group for
733 purposes of the group asset method until the group account has no more depreciation
734 expense to realize. Since the Commission has allowed the use of the group asset
735 depreciation method, the retirement of this method should be orderly and should allow the
736 current depreciation method to be used for existing plant infrastructure.

737

738 The primary reason for this recommendation is to prevent Carbon/Emery from
739 experiencing a sudden and dramatic decline in depreciation expense—funds that are used
740 to reinvest in plant infrastructure. In a well managed company, my experience is that aside
741 from growth or technological change that requires additional investment, the depreciation
742 expense and the additions to replace existing infrastructure generally trend together. The
743 disruption caused by a sudden change to single asset from group asset accounting for
744 existing assets will result in a cash-flow squeeze and should be minimized. Mandating a
745 change on a prospective basis will help minimize this cash flow disruption and allow
746 Carbon/Emery to continue to invest in infrastructure as identified in its planned capital
747 budget.

748

749 **Q: Is Carbon/Emery's test year depreciation expense representative of what it will**
750 **experience in the next five years?**

751 A: Yes. As explained by Mr. Woolsey, Carbon/Emery has a capital plan filed with the FCC.
752 Based on the method I described above, the level of depreciation expense in the test year
753 is representative for the single asset straight-line depreciation of planned investment
754 combined with group asset depreciation for prior investments over the next five years.
755 While the data show that the test year expense is higher than the resulting depreciation
756 expense for planned investment, there will be uncertainties leading to the need to replace
757 infrastructure in the future that Carbon/Emery cannot quantify, so a cushion of an
758 additional 4.3 percent in depreciation expense is reasonable. The depreciation expense in
759 the test year is reasonable estimate of what Carbon/Emery is expected to experience in the
760 next five years.

761

762 **Q: Does Carbon/Emery manipulate Commission approved depreciation rates?**

763 A: No. Carbon/Emery uses the approved Commission depreciation rates for each asset
764 classification. The only difference between group asset and single asset methods is the
765 calculation of authorized depreciation expense for a given year. Both methods use straight-
766 line depreciation, but under the group asset method, the group account investment balance
767 is multiplied by the approved depreciation rate and this amount becomes the maximum
768 depreciation expense for the group of assets. If there is a sufficient remaining net
769 investment balance, the depreciation expense will equal the maximum depreciation
770 expense. Otherwise, only the remaining portion of undepreciated plant will be depreciated.
771 Consider for example the following: the initial group account investment balance is
772 \$1,000,000, the accumulated depreciation for this group is \$750,000, the new investment
773 is \$200,000 and the depreciation rate is 10 percent. Under group asset method, the
774 allowable depreciation for the group (undepreciated plant and new investment) is $10\% \times$
775 $\$1,200,000 = \$120,000$. Under single asset depreciation the allowable depreciation for the
776 group of assets is $10\% \times (\$500,000 + \$200,000) = \$70,000$, (assuming that half of the assets
777 are fully depreciated). If the rate of return were 11.25 percent. The group asset method
778 would reduce return by \$13,500, while the single asset method would reduce return on rate
779 base by \$5,062.50. This example is simplified since no mid-year convention was used. So
780 over time, which method is preferred? If the goal is to minimize total Utah USF over time,
781 the group asset method will reduce return on rate base since the rate base is being reduced

782 at an accelerated rate. The calculation of group asset accounting and the corresponding
783 continuing property records held by Carbon/Emery allow for absolute transparency using
784 the group asset method of depreciation.

785
786 There is no manipulation of Commission approved depreciation rates. When the
787 Commission set Carbon/Emery's specific depreciation rates in 2006, Carbon/Emery was
788 using (and has continuously used) group asset depreciation. Historically, neither the
789 Division, nor the Commission have had any concern or issue with group asset depreciation.
790 In fact, they have tacitly approved it's use since the rates were approved with the
791 knowledge that group asset depreciation was being used.

792
793 The use of group asset depreciation certainly allows for accelerated depreciation expense
794 recovery, but on its flip-side, it reduces the rate base at an accelerated rate and saves the
795 Utah USF money in the long run.

796
797 **Q: What is your response to the various other methods the Division proposes?**

798 A: I find it ironic that in on one hand the Division argues for standardization across all carriers
799 and on the other hand says that five other methods would be perfectly acceptable. Such
800 inconsistency in its advocacy of policy should cast serious doubt on the thoughtfulness of
801 the Division's proposal. Further, there is no suggestion that these alternative methods
802 improve or advance the state's interests.

803
804 **Q: Please summarize your testimony on depreciation methods.**

805 A: Emery uses a standard and industry approved depreciation method. This method has the
806 effect of accelerating depreciation but also accelerates the decline of the rate base used for
807 ratemaking purposes. The accounting and reporting hazards of using two different
808 methods—one for interstate purposes and the other for state USF purposes has been
809 ignored by the Division. Carbon/Emery's method is transparent and widely, but not
810 universally used. The Division's position is a change in policy based on unidentified
811 concerns. If one of these concerns is to guard against the disposal and replacement of plant
812 infrastructure that has a remaining economic life, there is no evidence supporting this

813 concern. Furthermore, Carbon/Emery does not dispose of and replace its plant
814 infrastructure and assets until the asset is no longer useful. Group asset depreciation
815 minimizes the need for state USF disbursements over the life of the asset since it is removed
816 from the rate base at a faster rate. If a change were to be made, single asset straight-line
817 depreciation method should be adopted on a prospective basis. The depreciation expense
818 in the Carbon/Emery test year is representative of plans for future years and changing all
819 assets to single asset method would cause a significant reduction in depreciation expense
820 recovery that will be used for future investment. For these reasons, I recommend the
821 Commission allow Carbon/Emery to continue to use group asset depreciation in calculating
822 its need for Utah USF support.

823

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

825 A. Yes.

826