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and its Members

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH	
In the Matter of the 2019 Utah Universal Service Recommendations	UTAH RURAL TELECOM ASSOCIATION'S COMMENTS DOCKET NO. 18-040-01; 18-043-01; 18-046-01; 18-051-01; 18-052-01; 18-053-02; 18-054-01; 18-576-01; 18-2180-01; 18-2201-01; 18-2302-02; 18-2303-01; 18-2419-01

The Utah Rural Telecom Association ("URTA"), on behalf of itself and URTA members, All West Communications, Inc., Bear Lake Communications, Inc., Beehive Telephone Company, Carbon/Emery Telcom, Inc., Central Utah Telephone, Inc., Direct Communications Cedar Valley, LLC, Emery Telephone, Gunnison Telephone Company, Hanksville Telcom, Inc., Manti Telephone Company, Skyline Telecom, South Central Utah Telephone Association, Inc. and Union Telephone Company ("Members" or "URTA Members") hereby file these Comments related to the Recommendations made on October 4, 2018 by the Division of Public Utilities ("Division") for Utah Universal Public Telecommunications Service Support Fund ("UUSF") disbursements for rate-of-return providers.

BACKGROUND

On July 1, 2017, Senate Bill 130 ("SB 130") went into effect. SB 130 made substantial changes to the UUSF in Utah Code Section 54-8b-15. Specifically, SB 130:

- Provided that a telecommunications provider that established and maintains a network capable of providing access lines, connections, or wholesale broadband Internet access service may qualify for payments from the UUSF;
- Required that each access line or connection provider in the state to contribute to the UUSF;
- Required the Public Service Commission ("Commission") to develop a method for calculating the amount of each contribution charge assessed to an access line or connection provider;
- Combined a surcharge and funding for administering the hearing and speech impaired program with the UUSF surcharge;
- Provided for a depreciation method and rate-of-return for a carrier of last resort that receives UUSF; and
- Provided that a wireless telecommunications provider is eligible for a distribution from the UUSF for providing lifeline service under certain circumstances.[1]

Pursuant to Utah Code Section 54-8b-15(2)(c), the Commission was required to promulgate rules to establish policies and procedures to govern administration of the UUSF. On February 21, 2018, Commission Administrative Rule R746-8-401 ("R746-8-401") took effect. R746-8-401 provides, among other things, that:

> (3) The calculation of a rate-of-return regulated provider's ongoing UUSF distribution shall conform to the following standards:
> (a) The provider's state rate-of-return shall be equal to the weighted average cost of capital rate-of-return prescribed by the FCC for rate-of-return regulated carriers, as of the date of the provider's application for support, and as follows:
> (i) beginning July 1, 2016: 11.0%
> (ii) beginning July 1, 2017: 10.75%;
> (iii) beginning July 1, 2018: 10.5%;
> (iv) beginning July 1, 2019, 10.25%;
> (v) beginning July 1, 2020, 10.0%; and
> (vi) beginning July 1, 2021, 9.75%.
> (b) The provider's depreciation costs shall be calculated as established in Utah Code Section 54-8b-15.

R746-8-401(3)(a) mirrors the Federal rate of return, or weighted average cost of capital ("WACC") and the dates for which the Federal rate of return is applicable. R746-8-401 further provides that:

> (4) Yearly following a change in the FCC rate-of-return, unless the provider files with the

[1] SB 130.

Commission a petition for review of its UUSF disbursement, the Division shall make a recommendation of whether each provider's monthly distribution should be adjusted according to:

(a) the current FCC rate-of-return as set forth in R746-8-401(3)(a); and

(b) the provider's financial information from its last Annual Report filed with the Commission.

Pursuant to R746-8-401(4), annually, the Division is required to review each provider's annual report and the current FCC rate of return and make a recommendation to the Commission as to whether each provider's monthly UUSF distribution should be adjusted. On or about October 4, 2018, the Division filed recommendations for each of the URTA Members with the Commission (the "Recommendations"),[2] based on its review of the annual report for each provider. The Recommendations for each provider were filed publicly, while the particular excel workbooks for each provider were filed as a Confidential Exhibit in each particular docket.[3]

Simultaneously with the filing of the Recommendations, on October 4, 2018, the Division filed Comments ("Division Comments") alerting the Commission to several issues where there is disagreement between the Division and the URTA members. In particular, the Division Comments identify the following issues:

1. <u>Interest Synchronization</u>. The Division has calculated UUSF disbursements using interest synchronization when a provider has no debt in its capital structure.

2. <u>Prospective or Retroactive UUSF Payments</u>. The Division has calculated the 2019 UUSF disbursements using the tax rates that will be in effect during the year of the disbursement (2019).[4]

3. <u>Excess Deferred Income Tax (EDIT)</u>. The change in tax law that went into effect in 2018 has required providers to calculate EDIT. This is the amount that should be refunded to

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[2] Docket Nos: 18-040-01; 18-043-01; 18-046-01; 18-051-01; 18-052-01; 18-053-02; 18-054-01; 18-576-01; 18-2180-01; 18-2201-01; 18-2302-02; 18-2303-01; 18-2419-01.

[3] URTA's Comments will address the publicly filed Recommendations and will not delve into the particular numbers found only in the Confidential excel spreadsheets filed by the Division in each docket.

[4] The Division also uses the blended federal rate of return that the FCC will use for 2019 operations (10.375%) but does not identify this as an issue in the Division Comments. URTA will address this issue below.

the UUSF for past over-collection based on the higher tax rate that no longer applies (34% federal rate vs. 21% federal rate for 2018 forward).

URTA agrees that the issues identified in the Division Comments are issues that should be decided by the Commission because of their global application to the URTA members. URTA also believes that the "prospective/retroactive" issue identified by the Division also affects the rate of return that should be applied by the Division in the calculation of the UUSF disbursements for the providers. Therefore, URTA believes there are three core issues with four separate effects:

1. Historic Cost-Recovery vs. Prospective Analysis
    a. Tax rates to be applied
    b. Rate of return to be applied
2. Interest Synchronization
3. EDIT

URTA, on behalf of its members will address each of these issues in its comments below.

COMMENTS OF URTA

1. Historic Cost Recovery vs. Prospective Analysis

In this case, as required by R746-8-401, the Division has reviewed the providers' annual reports for 2017 to determine the amount of UUSF each provider is entitled to receive based on the costs and revenues reported in the annual report and the rate of return set forth in R746-8-401(3)(a). Historically, as the Commission is aware, when a provider has sought an increase in UUSF disbursements, the provider has filed an Application for UUSF Disbursement with the Commission based on an historical test year, adjusted for known and measurable changes, and the Division and the Office have reviewed the provider's application to determine the provider's reasonable costs and made a recommendation as to the amount of UUSF to which the provider is entitled. The amount of the UUSF disbursement has historically been determined by stipulation of the parties approved by Commission order, or by Commission order after hearing. Prior to SB 130, the provider would continue to receive the ordered UUSF disbursement until it sought an increase, or until the Division recommended a decrease through a request for agency action. Therefore, the UUSF disbursements were typically in place and static for several years.

SB 130 and its changes to Utah Code Ann. Section 54-8b-15 sought to provide regulatory certainty to providers by eliminating several issues that were litigated between the provider, the Division, and the Office of Consumer Services in nearly every UUSF request—capital structure, cost of debt, cost of equity, and depreciation methods. The capital structure, cost of debt, and cost of equity issues were eliminated with the State Legislature's adoption of the federal WACC, or rate of return, for state purposes. Specifically, rather than determine an in-state rate of return for each individual company, the Legislature adopted the federal rate of return for all providers, thus eliminating the capital structure, cost of debt, and cost of equity debates.

As a result of the implementation of SB 130 and R746-8-401, there has been a paradigm shift in the State of Utah for UUSF purposes. SB 130, the changes to Utah Code Section 54-8b-15, and R746-8-401 have eliminated the historical use of test period adjusted for known and measurable changes for UUSF and adopted an historic cost-recovery process similar to the federal high cost loop support (HCLS) program. The HCLS is an historic cost recovery program that reviews reasonable expenses incurred in a past period and determines a revenue requirement based on those reasonable expenses. The revenue requirement is then paid during a future period due to regulatory lag (typically 18-24 months). With the mirroring of the federal rate of return, it makes sense for Utah's review to mirror the federal HCLS review program. The Commission and Division should review the 2017 annual reports and determine the amount of UUSF to be received based on 2017 numbers—with the payments for such disbursements made in 2019 due to regulatory lag. This is the precise approach taken by the FCC, and is the approach contemplated by both SB 130 and R746-8-401. Admittedly, this is a new approach necessitated by the new statute and the new rules. The goal is to apply the new approach, beginning with the review of the 2017 numbers, and annually thereafter.

Moreover, an historic cost-recovery approach at the State level, like the HCLS program at the federal level, is easier to implement and more efficient to administer than the traditional State UUSF application process. Under the historic cost-recovery approach the review begins with the provider's annual report; allows for "prudence" review by the Division, Office, and Commission; and adjusts the provider's UUSF distribution on an annual basis without the resource expenditure and uncertainty associated with a litigated UUSF application. Additionally, the annual review will eliminate any overearning or underearning that may have been permitted with a more periodic review of the UUSF disbursements, which is a more efficient use of the UUSF. The annual historic cost-recovery approach will also eliminate the necessity of the provider including known and measurable changes to costs and revenues because the UUSF will be an annual amount based on actual expenses and revenues for a specific year.

A. Taxes

In the Division's Comments, the Division has indicated that "if the fund is used as a retroactive true-up, the DPU argues the use of hypotheticals and stale projections for various items is inappropriate and a backward-looking prudence review is also warranted." While the Division does not elaborate on the "hypotheticals and stale projections" it refers to in its Comments, URTA understands that the Division may be referring to the practice of using a process of “grossing-up” the revenue requirement for taxes that will be owed based on the tax rate in effect, rather than looking at the actual taxes paid by the provider for the period.

As the Commission is aware, the Division has used a tax gross-up process in its Recommendations. The problem that URTA has with the Division's calculation is not with the method—URTA supports the tax gross-up process. Rather, the problem URTA has with the Division's tax calculation is that the Division used the 2018 tax rate to gross-up the revenue requirement for the 2017 historic cost-recovery period because, according to the Division, these are the “tax rates that will be in effect during the rate effective period.”[5]

URTA disagrees with this approach. URTA believes that the better approach is to use the tax rate that is in effect for the 2017 historic cost-recovery period (34% federal tax rate). To look at this from another perspective, URTA and its members think it is unlikely that if Congress had voted to <u>increase</u> the corporate tax rate to 40% in 2017, with an effective date of January 1, 2018, the Division would be recommending application of a tax gross-up of 40% to the 2017 revenue requirement. The providers need predictability, and utilization of the tax rate for the period of the historic cost-recovery (2017 in this case) is the only way to provide a predictable outcome since tax rates can change at the whim of the legislators. Moreover, because the UUSF review is being done annually, the tax rate for 2018 will be factored in during the Division's review of the providers' 2018 Annual Reports. This ensures consistent treatment year after year, regardless of whether tax rates go up or down.

Additionally, the process of “grossing-up” the revenue requirement for taxes by applying the tax rate for the period of historic cost-recovery is completely consistent with the federal

[5] Division Comments, p. 2.

HCLS process, which also grosses-up the federal HCLS revenue requirement based on the tax rates applicable for the period of historic cost-recovery and applies these rates to allowable revenue and expenses. The FCC adopts this approach because of the differences between USF calculations and federal and state tax return calculations. For example, amortization of acquisition adjustment is excluded from federal and state UUSF calculation but is included for actual federal and state tax return purposes. If the Division were to use "actual taxes paid", they would be utilizing the tax benefits of the excluded items, such as amortization of acquisition adjustment, without allowing the providers to receive recovery on the associated acquisition expense amortization. Just as it would be inappropriate for regulators to include the positive or negative tax impacts of other consolidated entities, it is also inappropriate to include the effects of the entity's excluded revenue or expenses. Similarly, if the Division promulgates rates or methodologies different than the federal rates used by the FCC in their "total company" calculation, the UUSF would be inappropriately subsidized by the results of the federal calculation.

The next question often raised (and evident in the Division inquiries and Comments) is book to tax timing differences. Many of the differences between the gross up tax calculation and actual taxes paid are the result of temporary differences between the book accounting and tax accounting (primarily depreciation or expensing of capital expenditures). It appears that the Division is concerned is that in a year with a large tax deferral, the actual taxes paid are less than the UUSF tax gross-up. However, the point with temp difference is that they are, in fact, "temporary" and the tax gross-up received will eventually be paid in taxes. To account for the timing difference, the amount of deferred tax is deducted from rate base. Thus, the UUSF remains whole with the time value of money rate equal to the applicable rate of return. Correct handling of tax rates, excluded items, and timing differences are critical to ADIT and EDIT as discussed herein. If the Division is going to begin using actual taxes paid in the "historic" review, rather than a gross up for taxes based on the applicable tax rates for the period of historic cost-recovery, the Division cannot reduce the rate base for the associated deferred taxes every year that a temporary difference exists. Any tax deferrals utilized by the providers in 2017 resulted in a corresponding increase in the deferred tax on the providers' balance sheets, which resulted in a corresponding reduction to rate base. If the Division uses actual taxes paid for 2017, then the providers who deferred taxes in 2017 should not be required to decrease their rate base by the 2017 deferral, or any other future year where the 2017 portion of the temporary difference exists.

In summary, to move away from the current state and federal practice of "grossing-up" the revenue requirement for taxes based on the tax rate for the historic cost-recovery period, would create more problems than it would solve. Items excluded for UUSF purposes but included for tax purposes would have to be addressed; and temporary differences between the books and the taxes would have to be addressed. While these issues could be reconciled, the process would be laborious and could easily result in disparate treatment between providers. Additionally, this process would substantially increase the workload for both the providers and the Division, which is not an efficient use of resources when the process of grossing-up the revenue requirement for tax purposes is consistent with past treatment at the State level, and is consistent with current treatment at the federal level for the historic cost-recovery HCLS program.

URTA urges the Commission to continue to utilize the tax gross-up process that the FCC currently uses for HCLS historic cost-recovery in reviewing the annual reports utilizing the tax rates in effect for the period of the annual report being reviewed, applying the taxes to recoverable revenue and expenses (not on excluded revenue and expense), and properly accounting for ADIT and EDIT.

B. Prudence Review

The Division also raised concerns in its Comments that a backward-looking prudence review would be warranted.[6] Contrary to concerns raised by the Division, an historic cost-recovery approach does not eliminate a regulatory "prudence" review. On the contrary, the process, as contemplated by SB 130 and R746-8-401, allows regulators to review the costs and expenses set forth in a provider's annual report for "reasonableness,"[7] and to remove or disallow certain previously incurred expenses if the regulators find them to be "imprudently" incurred or not used and useful for the intended purposes of Utah USF. The disallowances, or "prudence adjustments," if any, would be reflected as an "adjustment" in the Division's excel spreadsheet and would affect the recommended UUSF disbursement.[8] If a provider disagrees with the Division's recommendation based on the ""adjustments" recommended by the Division, the provider should have the opportunity to raise these concerns before the Commission (via hearing) prior to the Division's recommendation being implemented for the following year.

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[6] Division Comments, p.2.
[7] UAC R746-8-401
[8] The Division has made such adjustments for some of the providers which demonstrates that the historic cost-recovery prudence review was completed by the Division. While individual companies may take issue with the "known and measurable" changes recommended by the Division, URTA and these comments do not address such particular "known and measurable" changes.

C. Rate of Return

Similar to the applicable tax rate issue, is the applicable rate of return issue. As the Commission is aware, SB 130 provided that the state rate of return shall mirror the federal rate of return.[9] The Division has applied a 10.375% rate of return in its Recommendations. The 10.375% rate of return was derived from the average of 10.5% (which is the federal rate of return from January 1, 2019 to June 30, 2019) and 10.25% (which is the federal rate of return applicable from July 1, 2019 through December 31, 2019).[10] In essence, the Division has applied the 2019 federal rate of return to the review of the providers' 2017 operations. This is inconsistent with the federal HCLS process. Rather, because the HCLS process is an historic cost recovery program, the FCC applies the rate of return that matches the period of historic cost-recovery, which in this case would be 2017. In other words, under the federal process, the Division, when reviewing the providers' 2017 annual reports, should apply the rate of return for 2017 which is 10.875% —derived from the average of 11.0% (which was the federal weighted average cost of capital from January 1, 2017 through June 30, 2017) and 10.75% (which was the federal weighted average cost of capital from July 1, 2017 through December 31, 2017).

Again, this historic cost recovery process ensures predictability for the providers. Further, application of the rate of return applicable to the historic cost-recovery period is consistent with the federal process and implements the Utah Legislature's directive that the providers shall be entitled to the rate of return as prescribed by the FCC. If the Division's method is employed, the providers will receive 10.375% rate of return from the State based on 2017 operations, while receiving 10.875% from the FCC for the same period.

[9] Utah Code Section 54-8b-15(5)(a).
[10] See UAC R746-8-401(3)(a).

URTA believes that an historic cost-recovery approach, consistent with the federal HCLS program, is appropriate under both Utah Code Section 54-8b-15 and R746-8-401, and as needed, URTA supports a rule change to indicate:

- The review is an historic cost recovery review;
- The taxes should be grossed up using the tax rates applicable to the historic cost-recovery period;
- The rate of return to be applied is the rate of return associated with the year of the operations being reviewed; and
- The timelines and the process for review.

In fact, URTA has been working with the Division to draft a proposed rule change to include more process detail. To the extent the Commission determines the issues raised in this docket and clarifies the process, URTA believes these determinations should be included in a Commission Rule and would support modification of the existing R746-8-401 as needed to reflect the outcome of this docket.

2. Interest Synchronization

Interest synchronization is a term used to describe the application of a hypothetical interest expense against a provider when determining the provider's UUSF disbursement. In the current Recommendations, the Division has applied an "interest synchronization" adjustment to providers who have no debt in their capital structure because the Division believes that imputing some level of interest expense is necessary to reflect prudent operations.[11] As indicated above, URTA acknowledges that SB 130 and Utah Code Annotated Section 54-8b-15 permit the Commission's determination of "reasonable" costs, and permit "prudence adjustments." However, URTA submits that the Division's use of interest synchronization as "prudence adjustment" is in error.

[11] Division Comments, p.2.

In the Division's Recommendations, if an applicant has 100 percent equity, the Division has applied a hypothetical interest expense which has the effect of reducing the "booked taxable income" to a now hypothetical taxable income for the applicant. Replacing the booked taxable income with hypothetical taxable income results in a hypothetical tax liability for the year that is <u>lower</u> than the provider's tax liability for the year (either taxes actually paid or taxes deferred). Consequently, as demonstrated in the example below, this lowers the Utah USF support request and because this "synchronized interest" cannot be realized on the actual tax return, does not provide a reasonable opportunity for the applicant to earn overall rate of return mandated by Utah Code Section 54-8b-15.

As indicated briefly above, the Utah Legislature adopted S.B. 130 which was intended to eliminate controversy surrounding the "appropriate" capital structure and the Commission's previous practice of applying a hypothetical capital structure to various providers. SB 130 accomplished this by adopting the federal prescribed rate of return or weighted average cost of capital ("WACC"). The federal prescribed rate of return consists of two parts: a cost of equity and a cost of debt. In calculating the prescribed rate of return, the FCC took into consideration a prudent level of equity and debt. The FCC notes:

> "We note that the WACC is supposed to compensate equity holders and debtholders who provide the funds used to finance the firm's assets. Given a rate of return set equal to 9.75 percent, an average capital structure based on our estimates of 54.34 percent debt, and a cost of debt based on our estimates of 5.87 percent, the implied cost of equity is 14.37 percent. We find that not only is the WACC of 9.75 percent high enough adequately to compensate the firm's debtholders, but the implied rate of return on equity also provides equity holders with the opportunity to earn a reasonable rate of return on their investment. …" (Federal Communications Commission, Report and Order, Order and Order on Reconsideration, and Further Notice of Proposed Rulemaking, March 30, 2016, FCC 16-33 at 332)

The intent of SB 130 was to mirror what he FCC does for rate of return in the interstate jurisdiction. With the adoption of the federal rate of return for state purposes, capital structure, cost of debt, and cost of equity have become irrelevant to determining the UUSF disbursement. The FCC does not lower a provider's tax liability by reducing taxable income with a hypothetical interest expense. Rather, as demonstrated above, the FCC uses a tax-gross-up calculation using the current corporate tax rate to reflect the tax liability for the year.

In applying an interest synchronization adjustment, the Division goes beyond the FCC's methodology and attempts to take the hypothetical capital structure used by the FCC in the determination of the WACC and use it to determine a hypothetical interest expense, using a hypothetical cost of debt. In effect, the Division's approach takes the mandated 10.875% rate of return for 2017 and effectively reduces it for a provider with no debt. The following example shows the effect of the Division's interest synchronization (excel copy with working formulas attached as Exhibit 1):

Equity: 100 Percent	No Iinterest Synchronization Applied	With Interest Sychronization Applied	2017	2018
Earnings before UUSF, Interest, and Taxes	$ 2,000,000	$ 2,000,000		
Utah USF	$ 601,675	$ 317,038		
Less: Hypothetical Interest Sync Expense (54.34% debt at 5.87%)	$ -	$ 478,464		
Taxable Earnings	$ 2,601,675	$ 1,838,575		
Composite State and Federal Tax Rate	37.30%	37.30%	37.30%	24.9105%
State/Federal Income Tax	$ 970,425	$ 685,788		
After Tax Net Utility Operating Income	$ 1,631,250	$ 1,152,786		
UUSF Operating Income (does not include interest)	$ 1,631,250	$ 1,631,250		
Rate Base	$ 15,000,000	$ 15,000,000		
Rate of Return	10.875%	10.875%	10.875%	10.375%
Return on Rate Base	$ 1,631,250	$ 1,631,250		
Actual Tax Liability	$ 970,425	$ 970,425		
Hypothetical Tax Reduction from Interest Sync (cannot be realized on tax filings)	0.00	$ 284,636		
UUSF adjusted income tax expense	$ 970,425	$ 685,788		
Total Regulated Realized Rate of Return with Interest Sync	10.875%	8.977%		

Because the application of an interest synchronization adjustment effectively lowers the rate of return, it is not appropriate for State purposes. This is further bolstered by the fact that an interest synchronization adjustment is not performed at the federal level and is not appropriate when mirroring the federal WACC.

3. Excess Deferred Income Tax.

Finally, the Division notes that the change in tax law has required companies to calculate EDIT and that the EDIT should be refunded back to the UUSF for "past over-collections based on a higher tax rate that no longer applies" as a result of the tax rate change effective January 1, 2018. URTA does not dispute that the providers should calculate EDIT and the EDIT should be paid back over the life of the asset. As discussed above, however, the EDIT calculation should be based on application of the new tax rate in 2018, as the FCC is doing — not 2017 as the Division suggests.

With regard to the issue of how to deduct the repayment of EDIT where a company is not receiving UUSF for the particular historic cost-recovery period, URTA recommends a technical conference to discuss this issue. URTA does not believe, however, that a reduction in the affordable base rate is appropriate because reduction of the affordable base rate in Utah brings a host of other problems associated with not meeting the federal benchmark rate floor which would further impact the UUSF.

CONCLUSION

URTA appreciates the opportunity to provide these Comments. In short, URTA recommends that the Commission adopt an historic cost recovery approach like the federal HCLS program which looks at operations for a particular year, applies the appropriate rate of return for that same year; and utilizes a tax gross-up based on the tax rates applicable for the same year. URTA further supports the incorporation of these issues into R746-8-401 as needed.

DATED this 30th day of October, 2018.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of URTA's Comments on the Division's Recommendations, Docket 18-040-01, et. al., was served the 30th day of October, 2018 as follows:

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EXHIBIT 1

INTEREST SYNCHRONIZATION EXCEL SAMPLE