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Admin. Law Judge	:	W. Anthony Colbert
ORA Project Coordinator.	:	Ana Maria Johnson
	:	

OFFICE OF RATEPAYER ADVOCATES
CALIFORNIA PUBLIC UTILITIES COMMISSION

REPORT INTO THE REVIEW OF THE CALIFORNIA HIGH COST FUND-A PROGRAM

(PUBLIC VERSION)

R.11-11-007

San Francisco, California
July 11, 2014

98302631

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INTRODUCTION

This Report was prepared by the Office of Ratepayer Advocates (ORA) of the California Public Utilities Commission (Commission) in R.11-11-007. In this Rulemaking, the Commission is considering possible changes to how the California High Cost Fund-A (CHCF-A, or A Fund) is structured. ORA does not here address every issue set for evidentiary hearing listed in the March 18, 2014, Amended Scoping Memo And Ruling Of Assigned Commissioner. ORA's testimony focuses on two issues:

- Should the broadband revenues or profits count towards the intrastate revenue requirement?
- Can and should the Commission standardize costs in considering the Small LEC's revenue requirement?

Silence on any issue should be assumed as assent with the positions expressed by other parties.

Ms. Ana Maria Johnson served as ORA's Project Manager in this proceeding. ORA's witnesses' prepared qualifications are contained in Appendix A of this report. ORA's legal counsel for this proceeding is Travis T. Foss.

EXECUTIVE SUMMARY

In R.11-11-007, the Commission began a detailed review of the CHCF-A program in response to "market, regulatory, and technological changes"[1] since the creation of the program back in 1987. On March 18, 2014, the Commission issued an Amended Scoping Memo identifying eight main issues being considered in the review of the CHCF-A program. In this testimony, ORA provides recommendations and analysis on two of the eight issues that advance efficiency and fairness in the program. The two issues include Issue 3.1(A) "Should the Broadband Revenues or Profits Count Towards the Intrastate Revenue Requirement?", and Issue 3.1 (B) "Can and Should the Commission standardize costs in considering the Small LEC's revenue requirement?"

Key Recommendations:

1. Count net broadband revenue received by each Small LEC affiliate against the revenue requirement of a Small LEC as a condition of participating in the CHCF-A Program.

2. Adopt the Federal Communications Commission (FCC) standards to limit a Small LEC's corporate operations expenses to incent these companies to operate more efficiently.

3. Adopt a standard Return on Equity reasonable range of 8.44% - 9.68% for Small LECs and apply it in all of their GRC filings.

[1] Amended Scoping Memo of the Assigned Commissioner, March 18, 2014 (R.11-11-007).

<u>List of ORA Witnesses and Respective Chapters</u>

Chapter Number	Description	Witness
1	Counting Broadband Revenues	Natalie Billingsley
2	Corporate Operations Expenses	Natalie Billingsley
3	Standardizing Return on Equity	Patrick Hoglund

CHAPTER 1: COUNTING BROADBAND REVENUES

A. Introduction

This testimony presents ORA's recommendation and analysis of Issue 3.1 (A) "Should the Broadband Revenues or Profits Count Towards the Intrastate Revenue Requirement?" as identified in the March 18, 2014 Amended Scoping Memo and Ruling of Assigned Commissioner.[2]

B. Summary of Recommendations

ORA recommends that the California Public Utilities Commission (CPUC or the Commission) count the net broadband revenue[3] received by a Small Local Exchange Carrier's (Small LEC's) broadband affiliate against the revenue requirement of the regulated Small LEC when calculating each Small LEC's subsidy from the CHCF-A. Because the Small LECs are allowed to rate base virtually all broadband investments,[4] ORA recommends that the revenue requirement include all the net broadband revenues resulting from those investments. The revenues currently are retained by Small LEC affiliates offering broadband service. It is inappropriate and unfair to those customers who pay into the A Fund to allow it to subsidize the costs of broadband equipment without taking into account the profits generated by those investments. ORA is not proposing that the affiliate's net revenue actually be paid to the Small LEC. Rather, ORA's recommendation is that those affiliate broadband revenues be imputed when calculating the Small LEC's revenue requirement.

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[2] R.11-11-007 Order Instituting Rulemaking into the Review of the California High Cost Fund-A Program, November 18, 2011.

[3] ORA uses the term "net broadband revenues" to describe the broadband *profits* net of costs, rather than gross revenues.

[4] Public Utilities Code Section 276.5 (c) (6).

C. Discussion

ORA advocates for counting affiliate customer net broadband revenues when calculating the regulated company's revenue requirement. This recommendation appropriately balances the use of CHCF-A subsidy funding the Small LECs receive to build and maintain broadband-capable networks with counting the revenues the affiliates receive from use of the Small LEC facilities to serve their broadband customers. The present arrangement loads the majority of the affiliate's costs onto the regulated utility (and the A Fund) while allowing the affiliate to retain the majority of the profits. This is fundamentally unfair to all of the customers who pay the A Fund surcharge. ORA discusses below the CHCF-A legislative history, illustrates the methodology used for counting broadband revenues and how this recommendation would impact each Small LEC's A Fund subsidy draw.

1. Legislative history

Since the passage of Senate Bill 379[5] (SB 379), codified as § 275 of the Public Utilities Code, the Small LECs are explicitly authorized to include in regulated rate base expenditures to build and maintain broadband-capable facilities in their individual service areas. However, the legislative history and Section 275 do not specifically address the treatment of revenues from customers of Small LEC affiliates providing broadband service from facilities subsidized by the CHCF-A.

SB 379 codified additional Legislative policy direction for the CPUC's administration of the CHCF-A to support investment in broadband-capable technology by the Small LECs. The statute is also intended to preserve the availability of federal funding specifically targeted for broadband facilities in rural areas.[6]

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[5] Chaptered by Secretary of State on September 28, 2012, Chapter 729, Statutes of 2012. An act to amend Section 275.6 of the Public Utilities Code, relating to telecommunications.

[6] Bill Analysis of the Senate Energy, Utilities And Communications Committee, Senator Alex Padilla, Chair, August 30, 2012, stated that "SB 379 will help preserve federal funding coming into rural California and enhance the availability of advanced broadband services in rural areas of the state."

ORA's recommendation to impute affiliate net revenues from broadband services does not conflict with SB 379's policy direction. Further, an Assembly Appropriations Committee amendment required A Fund recipients to provide the CPUC with information about revenues from unregulated broadband services.[7]

2. Methodology

To illustrate the impact of counting broadband revenues on a Small LEC's CHCF-A draw, ORA used each Small LEC's 2013 Annual Filing and the Commission's 2014 CHCF-A awards.[8] Though the companies go through the General Rate Case (GRC) process, for years between GRC filings, the companies file seven months (January-July) of revenue and expense data with the Commission each September or October to adjust prior year revenues and expenses, which can impact a company's CHCF-A draw for the following year.

The seven months of data is annualized and the Communications Division (CD) performs a means test calculation that can result in a lower CHCF-A draw for the next year. A means test is performed to determine if the company is earning over its authorized 10% Rate of Return (ROR).[9] CD performs two calculations. First, it calculates the ROR the company is actually making by dividing Net Revenue by Rate Base. If the return is below 10%, the Commission makes no CHCF-A adjustment for the following year. However, if the means test shows that the ROR exceeds 10%, the Commission calculates the 10% return on rate base which the Small LEC is not allowed to exceed. If earnings minus net income multiplied by a "gross-up" for taxes exceed the

[7] PU Code 275.6 (e) "Upon request from the commission, a small independent telephone corporation that receives support from the California High-Cost Fund-A Program shall provide information regarding revenues derived from the provision of unregulated internet access service by that corporation or its affiliate within that corporation's telephone service territory. The commission shall treat as confidential any information provided pursuant to this subdivision."

[8] Resolution T-17427, issued December 20, 2013.

[9] All the Small LECs had GRCs that were resolved in 1997. For the specific cases where there was a full adjudication of cost of capital, see the following decisions, all of which were issued on April 9, 1997. *See* D.97-04-036 (California-Oregon Telephone Co.); D.97-04-034 (Calaveras Telephone Company); D.97-04-035 (Ducor Telephone Company); D.97-04-032 (Sierra Telephone Company, Inc.).

authorized 10% ROR, the CHCF-A draw is adjusted downward so that the company only earns a 10% ROR.

Imputing broadband revenues to regulated revenues would increase net revenues for the Small LECs. If revenue increases, net income would increase and the means test would yield a higher ROR. ORA found that by adding 2013 broadband revenues to other revenues, the net income for most of the Small LECs grew to the point where the ROR exceeded the authorized 10% for 2013.

ORA applied this methodology to calculate revised 2014 CHCF-A draws for each Small LEC as described in Resolution T-17427.[10] Table 1-1 shows the impact of counting broadband revenues for the ten Small LECs that draw from the CHCF-A on both the means test and the 2014 CHCF-A draw.

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[10] Resolution T-17427, issued December 20, 2013.

TABLE 1-1
Impact on 2014 CHCF-A draw from counting 2013 broadband revenues[11], Annual Filings 2013

	Small LEC	2013 DSL Retail Revenues[12] (A)	CHCF-A draw for 2014[13](B)	Means test in 2013 (C)	Revised 2014 CHCF-A award if including DSL revenues (D)	% Decrease in 2014 CHCF-A draw if counting broadband revenues (B-D)/B
1	**Calaveras**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
2	**Cal-Ore**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
3	**Ducor**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
4	**Foresthill**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
5	**Kerman**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
6	**Pinnacles**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
7	**Ponderosa**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
8	**Sierra[14]**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
9	**Siskiyou**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
10	**Volcano[15]**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
	Total	$[redacted]	[redacted]		[redacted]	[redacted]

The CHCF-A draw for each company in 2014 would have ranged from [redacted] lower had the Commission counted 2013 broadband revenues as a revenue source in the

[11] In the Small LEC's responses to Data Requests, the Small LECs characterized the affiliate broadband revenues as DSL (Digital Subscriber Line) broadband revenues.

[12] Small LEC response to TURN Data Request Number 11, Question 36a.

[13] Resolution T-17427, issued December 20, 2013.

[14] Sierra is subject to the 80% waterfall in 2014.

[15] Volcano is subject to the 80% waterfall for 2014.

annual filings. The total CHCF-A draw would have been [redacted] smaller in 2014 than it currently is, had the Commission counted affiliate broadband revenues in the annual filings in 2013.

D. Conclusion

ORA recommends that the Commission impute the net broadband revenue received by a Small LEC's broadband affiliate when calculating the revenue requirement of the regulated Small LEC and the Small LEC's subsidy from the CHCF-A. Because the Small LECs are allowed to rate base virtually all broadband investments,[16] ORA recommends that the revenue requirement include all net broadband revenues resulting from those investments. It is inappropriate and unfair to those customers who pay into the A Fund to allow it to subsidize the costs of broadband equipment without taking into account the profits generated by those investments.

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[16] Public Utilities Code Section 276.5 (c) (6).

CHAPTER 2: CORPORATE OPERATIONS EXPENSES

A. Introduction

This testimony presents the ORA's recommendation and analysis of Issue 3.1 (B) "Can and Should the Commission standardize costs in considering the Small LEC's revenue requirement?" as identified in the March 18, 2014 Amended Scoping Memo and Ruling of Assigned Commissioner.[17] ORA's recommendation and discussion follow.

B. Summary of Recommendations

ORA recommends that the Commission adopt the FCC standards that limit the amount of a Small LEC's corporate operations expenses that are eligible for federal subsidies. One of the FCC's objectives in doing so is to incent these companies to operate more efficiently. The Commission should use the FCC's formulas to calculate the amount of corporate expenses that a Small LEC can include in calculating its revenue requirement. To the extent that a Small LEC's expenses exceed that amount, the CHCF-A should not be subsidizing them.

C. Discussion

Currently, the Commission can examine and reduce a Small LEC's corporate expense projections as part of the company's General Rate Case (GRC) process. However, California has not adopted any clear guidelines for what constitutes a "reasonable" level of corporate operations expense. Those issues are litigated in a GRC or negotiated in a settlement agreement. The FCC provided guidance in its Notice of Proposed Rulemaking (NPRM) 11-161[18] that provides three formulas that limit corporate expenses eligible for subsidy based on loop counts, i.e., company size. ORA describes the FCC methodologies, and illustrates the impact of ORA's recommendation on each

[17] R.11-11-007, Order Instituting Rulemaking into the Review of the California High Cost Fund-A Program, November 18, 2011.

[18] *In the Matter of Connect America Fund,* et al, WC Docket No. 10-90, FCC 11-161, (released November 18, 2011).

Small LEC's CHCF-A draw using 2013 corporate expenses taken from the Small LEC's Annual Reports.

1. Description of a Small LEC's Corporate Operations Expenses

Corporate operations expenses include executive salaries and benefits, planning, legal, research and development, regulatory, accounting and finance, information management, procurement, human resources, and other general and administrative expenses. This list appears on Form M of the Income Statement in each of the Small LEC's Annual Reports.[19] However, not all ten companies submitted this expense breakdown on the Form M, but instead supplied a summed Total Corporate Operations Expenses amount. The FCC's definition of Corporate Operations Expense is similar to what the Small LECs describe in their Income Statement.[20]

2. Explanation of FCC 11-161 Methodology

On November 18, 2011, the FCC released a Report and Order and Further Notice of Proposed Rulemaking to reform and modernize the FCC's universal service and intercarrier compensation systems[21] which contained a proposal to modify the existing limit on corporate operations expenses.[22] A number of parties appealed the FCC's Order. Almost three years later, on May 24, 2014, the 10th Circuit Court denied all the petitioners' claims.[23]

The petitioners asserted that the FCC's refusal to cover interstate costs will "essentially reassign(ed) to the intrastate jurisdiction for possible recovery from other

[19] Form M Schedule I-1 (FCC ARMIS 43-02 Report Format).

[20] **"Corporate Operations Expense.** 227. *Background*. Corporate operations expenses are general and administrative expenses, sometimes referred to as overhead expense. More specifically, corporate operations expense includes expenses for overall administration and management, accounting and financial services, legal services, and public relations." FCC 11-161 at Paragraph 227.

[21] FCC 11-161.

[22] FCC 11-161at Paragraph 232 (page 86).

[23] *Petition For Review Of Orders Of The Federal Communications Commission (FCC Nos. 11-161, 12-47)* Appellate Case 11-9900. (10th Circuit Case)

sources" "[c]osts that were [originally] assigned to the interstate jurisdiction for recovery from the Universal Service Fund."[24]

The FCC responded that:

> "petitioners' assertion that states have been 'left' with the responsibility to recover certain carrier access costs overlooks the Order's explicit holding that 'states will not be required to bear the burden of establishing and funding state recovery mechanisms for intrastate access reductions,'" *Id* at 16 (quoting Order ¶ 795);"[25]

The principle that the FCC articulated above should also be applied to corporate operating expenses. This is particularly important in view of the FCC's stated explanation for standardizing and limiting the amount of subsidy payments.

ORA does not support using the A Fund to make the Small LECs "whole" for any difference in calculated corporate expense amounts employing the FCC's formulas versus the actual or projected corporate expenses that the Small LECs claim on their Annual Filings or in a GRC. ORA recommends that the Commission adopt the FCC formulas for allowable corporate expense.

This Commission's Rulemaking in this proceeding states that under current Commission rules,[26] any reduction in federal high cost support would increase support from the CHCF-A, making a company "whole" and resulting in an increased burden on California ratepayers. The rulemaking recommends addressing these rules now,[27] and solicits comments on whether these implementation rules are still relevant.[28] ORA agrees that these rules need to change, and sets forth how below.

[24] 10th Circuit Case at 122.

[25] 10th Circuit at 124.

[26] Appendix to D.91-09-042, Section B.

[27] R.11-11-007, original rulemaking, at 13.

[28] *Id.* at 24-25.

The FCC proposed three formulas that each correspond to a company's size expressed as the number of loops:

1. For study areas with 6,000 or fewer total working loops the monthly amount per loop shall be

   (a) $42.337-(.00328 x number of total working loops), or (b) $63,000/number of total working loops, whichever is greater;

2. For study areas with more than 6,000, but fewer than 17,887 total working loops, the monthly amount per loop shall be $3.007 + (117,990/number of total working loops); and

3. For study areas with 17,887 or more total working loops, the monthly amount per loop shall be $9.56;

In addition, beginning January 1, 2013, the monthly per-loop limit may be adjusted each year to reflect the annual percentage change in GDP-CPI.

For illustrative purposes, ORA applied the appropriate formula to each Small LEC's 2013 corporate expenses based on its size (number of loops) to understand the impact of using the FCC methodology. Table 2-1 shows the corporate operations expense limit that would have been applied for 2014. In order to make the calculations simple and straightforward, ORA did not adjust the limit to reflect the annual percentage change in GDP-CPI.

3. Application of the FCC Methodology to 2013 Corporate Expenses and Impact on 2014 CHCF-A Draws

The ten Small LECs that draw from the CHCF-A vary in size from 252 loops to 19,377 loops. ORA applied the formula that corresponded to their 2013 reported number of loops to determine the FCC corporate operations expense limit. ORA then calculated the difference in actual 2013 corporate expense and the FCC allowed expense and expressed that difference as a percentage that each Small LEC either exceeded or fell below the allowed expense amount. ORA lists the Small LECs in alphabetical order in Table 2-1 below.

ORA's results found that nine of the ten Small LEC's corporate operations expenses exceeded the FCC limits for 2013, and ranged from [redacted] over the allowed amount. However, one company, Pinnacles, spent [redacted] less than the FCC allowed limit.

For 2013, total corporate operations expense for the Small LECs collectively was [redacted]. By applying the FCC's corporate operating expense limits, the total amount of corporate expense allowed would equal [redacted] less, or [redacted] less, than the reported corporate expenses of [redacted]

Table 2-1
2013 Small LEC Corporate Operations Expense and application of FCC formula

	Small LEC (A)	Number of loops[29] (B)	Actual Corp Ops Exp[30](C)	FCC-Allowed Corp Ops Exp (D)	Difference btwn Actual and FCC-Allowed Corp Ops Exp (E)	% that Actual Corp Ops Exp are greater/less than Allowed Corp Ops Exp (F)
1	Calaveras	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
2	Cal-Ore	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
3	Ducor	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
4	Foresthill	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
5	Kerman	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
6	Pinnacles	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
7	Ponderosa	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
8	Sierra	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
9	Siskiyou	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
10	Volcano	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
	Total		[redacted]	[redacted]	[redacted]	[redacted]

4. The Annual Filing Process Illustrates Methodology and Impact on CHCF-A Draws

To calculate the impact of this methodology for corporate expenses on the companies' CHCF-A draw for 2014, ORA used the 2013 Annual Filings data to illustrate. Every year, the CD calculates each Small LEC's annual CHCF-A draw for the following year based on the expected change in each Small LEC's revenues and expenses for that year.

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29 Form M Schedule S-3, 2013 Annual Reports.

30 Form M Schedule I-1 (FCC ARMIS 43-02 Report Format), 2013 Annual Reports.

The CD determines this draw based on a Small LEC's revenues and expenses in its most recent rate case and any changes requested in their annual CHCF-A advice letter filings in accordance with D.91-09-042.[31] Limiting the allowable amount of corporate operating expenses claimed in the Annual Filing would also impact the means test calculation.

The means test includes total operating expenses, including corporate operating expenses. ORA subtracted from total expenses the difference between reported corporate expenses and the FCC limit (Column E of Table 2-1) which decreased total operating expenses.

This calculation would have increased the rate of return for all of the companies except Pinnacles. If the company's calculated draw exceeded the means test limit of 10% after applying this methodology, the Commission would have decreased that company's CHCF-A draw for 2014 by an amount sufficient to prevent overearning.

Table 2-2 describes the impact to each Small LEC's CHCF-A draw for 2014 with FCC limits applied to corporate operations expense for purposes of the means test.

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[31] Resolution T-17427, issued December 20, 2013, at 3.

Table 2-2

Change in 2014 CHCF-A draw with FCC corporate operations expense limits applied

	Small LECs	Difference btwn Actual and FCC-Allowed Corp Ops Exp (E)	CHCF-A draw for 2014[32](A)	Means test increase in 2013 by excluding corporate excess (B)	Revised 2014 CHCF-A award (C)	% chg in CHCF-A draw (A-C/A)
1	**Calaveras**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
2	**Cal-Ore**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
3	**Ducor**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
4	**Foresthill**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
5	**Kerman**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
6	**Pinnacles**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
7	**Ponderos a**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
8	**Sierra[33]**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
9	**Siskiyou**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
10	**Volcano[35]**	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
	TOTAL	[redacted]	[redacted]		[redacted]	[redacted]

[32] Resolution T-17427, issued December 20, 2013.

[33] Sierra is subject to the 80% waterfall.

[34] [redacted]

[35] Volcano is subject to the 80% waterfall.

Based on ORA's calculation of subtracting the 2013 excess corporate expense from the 2013 total operating expense claimed on the annual filings, nine of the ten Small LECs would have received less CHCF-A subsidy in 2014.

5. GRC application of methodology

If the Commission adopts the FCC's methodology to limit corporate expenses, when a Small LEC files a GRC, the Small LEC would limit the amount of corporate operating expense it could claim in its GRC application to the amount calculated using the appropriate FCC formula. ORA expects that the subsequent annual filings would not yield as dramatic results as those shown here since corporate expense adjustments would occur in the individual Small LEC's GRCs.

D. Conclusion

ORA recommends that the Commission adopt the FCC's methodology to calculate the amount of corporate expenses to be included in the revenue requirement eligible for CHCF-A Fund subsidy. This should be used both in GRCs and in the annual filings. As ORA demonstrated above, the expenses of the ten Small LECs who receive A Fund subsidies are excessive. Using expense limits will help incent these companies to control costs and increase the efficiency of their operations.

CHAPTER 3: STANDARDIZING RETURN ON EQUITY

Q. Please State Your Full Name, Address, And Occupation.

A. My name is Patrick E. Hoglund, P.E., and my business address is 505 Van Ness Avenue, San Francisco, CA, 94102. I am a Senior Utilities Engineer with the Office of Ratepayer Advocates (ORA) Communications and Water Policy Branch.

Q. What Is The Purpose Of Your Testimony In This Proceeding

A. I am providing part of ORA's response to issue 3.1 (B) Can and should the Commission standardize costs in considering the Small LEC's revenue requirement?[36] Specifically, I present ORA's recommendation that the Commission recognize the return on equity (ROE) as a cost and adopt a standard ROE range for the Small LECs. Adopting a standard ROE range for the Small LECs will promote efficiencies in the GRC process by reducing the number of issues each Small LEC and the parties will need to expend resources on in possible evidentiary hearings in Small LEC GRCs.

Q. What Is ROE?

A. ROE is the cost of the equity invested in a company. It is the return earned necessary to attract sufficient investment to maintain the company's financial integrity and attract needed capital on an ongoing basis.

Q. Has The Commission Adopted A Fixed Range Of ROE Before?

A. In GRCs, the Commission regularly determines a reasonable ROE for companies. In the case of the Small LECs, the Commission has chosen to "decline to adopt specific equity return" but instead focus on the Weighted Average Cost of Capital (WACC).[37] In doing so the Commission sought to provide the Small LECs with an "incentive to manage its capital structure efficiently".[38] By adopting a WACC applicable to the Small LECs the Commission indirectly adopted a range of ROEs for the Small LECs.

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[36] March 18, 2014, Amended Scoping Memo and Ruling of Assigned Commissioner, R.11-11-007, at 10.

[37] See e.g., D.97-04-035, D.97-04-032, D.97-04-034, and D.97-04-036.

[38] D.97-04-035, at 10

Once the WACC is set, the ROE can be calculated using each company's debt-to-equity ratio and each company's cost of debt. For example, when the Commission adopted a WACC of 10.00% for Ducor Telephone Company in D.97-04-035, it resulted in a [redacted] ROE.

Q. Is A Single Range Of ROE Reasonable To Apply To All The Small LECS?

A. Yes. The Small LECs share many characteristics, such as size, customer base, and rural service territories, and also face similar business risks. Furthermore, the Commission recognized that the Small LECs risk is mitigated through continued participation in the CHCF-A. This reduced risk, a common trait of the Small LECs, should be reflected in a lower return on equity than would otherwise be appropriate.

Q. How Is ROE Determined?

A. ROE is traditionally determined by developing a Discounted Cash Flow (DCF), Capital Asset Pricing Model (CAPM), and Risk Premium (RP) analyses. These models are used to calculate an estimate of the required ROE. The DCF analysis relies on, in part, stock prices and the expected value of cash flows investors expect to receive. The CAPM analysis assumes that an investor's expected return on equity is proportional to the return the investor expects on a risk free investment. Finally, the RP analysis accounts for differences in the risk and return investors expect in common stocks as compared to bonds.

Typically, in GRCs and Cost of Capital proceedings, all three types of analyses are prepared and a range of reasonableness is determined. Finally, subjective judgments are typically made to narrow the reasonable range and either adopt a specific ROE or a reasonable range for the authorized ROE, which when combined with a company's cost of debt and capital structure, will determine the adopted WACC.

Calculating a ROE for the Small LECs is a challenging task. None of the Small LECs are publicly traded and therefore stock prices and analysts forecasts of stock performance are not available. Therefore, proxy groups,[39] of representative publicly traded firms, are typically used. This allows for reasonably robust analyses. But because the proxy groups can never be an exact match for individual companies, some manner of subjective judgment is still required.

Q. Has ORA Prepared An ROE Analysis In This Case?

A. ORA has prepared a modified RP (incorporating the Small LECs recorded performance from 2009 thru 2013 with "adopted" ROE from 2003 thru 2008), and references the FCC's May 16, 2013 report "Prescribing the Authorized Rate of Return"[40], for estimates derived from DCF and CAPM models. ORA also compares the "average" resulting RORs to those adopted for the Class C and D water companies. The FCC report is particularly informative in that it incorporates a number of analyses utilizing relevant proxy groups and presents recommendations for LECs subject to rate of return regulation. In lieu of developing its own CAPM and DCF models in this case, ORA utilized the FCC's report that had recently developed estimates utilizing the methods ORA would customarily employ. These steps serve to inform ORA's recommended reasonable range for ROE.

Q. What ROE Does ORA Recommend?

A. ORA recommends that the Commission standardize costs in considering the Small LEC's revenue requirement. One key component of costs is standardizing the ROE. Whereas in prior Commission decisions the ROE was not prescribed, but rather left "open" to allow the Small LECs to manage their capital structure, ORA recommends that a range of reasonable ROEs be adopted. This will reduce the burden on the Small LECs, the Commission, and other parties in litigating GRCs without hampering the Small LECs ability to reasonably earn their authorized ROR. In addition to reducing

[39] For example, the FCC models used a proxy group comprised of 16 companies: AT&T, Verizon, CenturyLink, Alaska Communications, Inc., Cincinnati Bell, FairPoint Communications, Frontier Communications, Hawaiian Tel., Lumos, Windstream, Alteva, Consolidated Communications, Hickory Tech, New Ulm Telephone, Shenandoah Telecommunications, and Telephone and Data Systems.

[40] The FCC's report is available on the FCC website here: http://www.fcc.gov/document/bureau-releases-rate-return-represcription-staff-report.

the administrative burden on all parties, adopting a reasonable range of ROEs (or a single ROE from within the recommended range) will incent the Small LECs to efficiently manage their debt and capital structure. Given their access to CHCF-A, which reduces significant portions of risk the Small LECs face, it is reasonable for the Commission to prescribe a reasonable ROE range for the Small LECs. This is somewhat different from authorizing a ROR yet provides comparable results. This approach explicitly attaches a *cost* to the Small LECs equity.

As summarized in the table below, and in recognition of the market decline in 30-year Treasury rates and the average cost of debt since D.97-04-034, ORA recommends the Commission adopt a standardized ROE range for the Small LECs that is an average of the lower and upper range of the estimates from the FCC and ORA's hybrid RP analyses. Calculating the average for the lower and upper ends of the range yields, (6.31% + 8.80%+10.22%)/3 = 8.44%, and (7.18% + 10.77%+11.08%)/3 = 9.68% respectively. This is a very conservative range. The upper end of the range is also coincidentally very close to the average *earned* ROE of 9.64% ORA calculated from the annual reports for the Small LECs for the period 2009 – 2013. Furthermore, adopting ORA's recommended ROE range will result in a lower ROR for the Small LECs that reflects current market conditions compared to the adopted 1997 10.00% ROR. Much has changed in the past seventeen years and the adopted ROE and ROR should reflect those changes. Finally, standardizing the ROE for the Small LECs is fair to the equity investors of the Small LECs that face similar risk profiles.

The table below summarizes elements ORA considered in developing its recommended ROE range for the Small LECs. ORA also notes for reference that the 2014 average ROR for Class A water companies is currently 8.51%.

Existing Small LEC ROE average (implied by fixed 10.00% ROR, 60/40 capital structure and debt at 5.11%)	FCC Report LEC Average CAPM ROE	FCC Report LEC Average DCF ROE	ORA Hybrid RP ROE
13.26%	6.31% - 7.18%	8.88% – 10.77%	10.22% - 11.08%
Adopted Small LEC ROR	**FCC 2013 Report Recommended ROR**	**2014 Class C Water ROR**	**2014 Class D Water ROR**
10.00%	8.06% - 8.72%	10.20% – 11.20%	10.80% - 11.80%
30-year Treasury 1994 – 1997 range		**30-year Treasury 2014 – 2017 range**	
6.88% – 7.37%		3.63% - 4.75%	

Q. How Does Standardizing ROE Costs Enhance Efficiency?

A. Standardizing the Return on Equity for the Small LECs supports regulatory efficiency by reducing the administrative burden on the Commission, Small LECs, ORA, and other parties by eliminating the need for parties to litigate the appropriate cost of capital in each rate case or other proceeding that will determine the revenue requirements for Small LECs. The Commission has previously taken this approach for the Small LECS in the following Decisions: D.88-07-022, D.91-05-016, D.91-09-042, D.94-04-032, D.94-04-034, D.94-04-035, and D.94-04-036. The Commission also has relevant examples of this regulatory efficiency in the water industry rate case plan.[41] The Commission currently has one cost of capital proceeding for the three largest Class A water companies and another proceeding for the six smaller Class A water companies. The Rate of Return and Return on Margin applied to Class C and D water companies is calculated by the Division of Water and Audits on an annual basis. The FCC also prescribes a rate of return for its rate of return regulated communications companies. These processes reduce the need for

[41] See D.07-05-062.

contentious and time consuming litigation. Furthermore, the existence of the CHCF-A reduces risk sufficiently to reassure all parties that the opportunity to earn a reasonable return is preserved.

Q. Can You Summarize ORA'S Recommendation?

A. Yes. To help control costs and promote administrative efficiency, as well as to reflect current market conditions, ORA recommends that the Commission adopt a reasonable range of ROE for the Small LECs between 8.44% and 9.68% to be used in the Small LECs planned 2015 GRC filings. Alternatively, the Commission could adopt a fixed number within this reasonable range that would be used by all of the Small LECs.

Q. Does This Conclude Your Testimony?

A. Yes.

APPENDIX A

QUALIFICATIONS AND PREPARED TESTIMONY
OF
NATALIE L. BILLINGSLEY

Q.1. Please state your name and business address.

A.1. My name is Natalie L. Billingsley. My business address is 505 Van Ness Avenue, San Francisco, California.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission – Office of Ratepayer Advocates in the Communications and Water Policy Branch - as a Program & Project Supervisor.

Q.3. Please briefly describe your educational background and work experience.

A.3. I am a graduate of Georgia State University in Atlanta, Georgia. I have a Bachelor of Arts in German with a minor in international business and economics. I also attended Friederich-Alexander Universitat in Erlangen, Germany.

I have been employed by the California Public Utilities Commission for almost 26 years, and have been a supervisor since 2001. I have provided testimony in a number of energy and communications cases. My focus has been on communications for approximately the last 22 years. Presently I supervise the Customer Programs Section in the Communications and Water Policy Branch.

Q.4. What are your responsibilities in this proceeding?

A.4. I am responsible for Chapters One and Two of this Report regarding counting broadband revenues and corporate operations expenses.

Q.5. Does this conclude your prepared testimony?

A.5. Yes, it does.

QUALIFICATIONS AND PREPARED TESTIMONY
OF
PATRICK E. HOGLUND

Q.1. Please state your name and business address.

A.1. My name is Patrick E. Hoglund. My business address is 505 Van Ness Avenue, San Francisco, California.

Q.2. By whom are you employed and in what capacity?

A.2. I am employed by the California Public Utilities Commission - ORA Communications and Water Policy Branch - as a Senior Utilities Engineer.

Q.3. Please briefly describe your educational background and work experience.

A.3. I am a graduate of the University of California, Berkeley, with a Bachelor of Science Degree in Industrial Engineering and Operations Research. I am also a graduate of the University of Rochester, William E. Simon School of Business with a Master of Business Administration Degree with concentrations in Finance and Corporate Accounting. I am a licensed professional Industrial Engineer.

I have been employed by the California Public Utilities Commission since 2005. My current assignment is within ORA – Communications and Water Policy Branch where I work on Class A General Rate Cases, Cost of Capital proceedings, and Communications and Water Policy related matters. From July 1999 through August 2004, I was a Senior Rates Analyst at Pacific Gas and Electric Company, where I worked on a variety of revenue requirements issues related to natural gas. From 1990 through 1997, I was employed by the California Public Utilities Commission. During this time I worked on small water utility rate cases, large water utility rates cases, and also worked in the Telecommunications and Energy Branches of the former Commission Advisory and Compliance Division, as well as in the Division of Ratepayer Advocates.

Q.4. What are your responsibilities in this proceeding?

A.4. I am responsible for the preparation of Chapter 3 entitled "Standardizing Return on Equity".

Q.5. Does this conclude your prepared testimony?

A.5. Yes, it does.