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BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of Application of Kerman Telephone Co. (U1012C) d/b/a Sebastian, to Review Intrastate Rates and Charges and Rate of Return for Telephone Service Furnished within the State of California, and to Modify Selected Rates.	Application 11-12-011 (Filed December 28, 2011)

OPENING BRIEF OF THE OFFICE OF RATEPAYER ADVOCATES

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The Office of Ratepayer Advocates (ORA) submits this Opening Brief in the General Rate Case Application (A.) 11-12-011 of Kerman Telephone Company (U1012C) doing business as Sebastian (KTC). ORA's recommendations regarding KTC's corporate structure, expenses, revenues, plant in service, depreciation, ratebase, return on equity, service quality, and other matters are described herein.

I. INTRODUCTION

The California High Cost Fund-A (CHCF-A) was established in 1987 for the purpose of minimizing basic telephone service rate disparities between rural and metropolitan areas.[1] The Commission administers the CHCF-A to ensure that small independent telephone corporations receive rate support through rate-of-return regulation, while providing affordable, safe, and reliable high-quality communications services in rural areas of the state.[2] Kerman Telephone Company (KTC) participates in the CHCF-A program, receiving state subsidies through rate-of-return regulation.[3]

On January 30, 2015, KTC updated its rate proposals in response to new ratemaking rules adopted in R.11-11-007. KTC updated its previously submitted revenue and expense estimates, forecasting intrastate revenue requirements of $10,311,373 for the 2016 test year, a 28% increase over the past 5-year average. KTC proposes an increased subsidy amount of $6,011,945, which is 70% greater than the 2015 authorized amount.[4]

After examining the books and records of KTC and testing for reasonableness and prudency, ORA recommends the Commission authorize intrastate revenue requirements totaling $6,602,548 for the 2016 test year.[5] When combined with its forecast of other

[1] Additional information pertaining to the CHCF-A can be found at: http://www.cpuc.ca.gov/puc/telco/public+programs/chcfa.htm

[2] Public Utilities Code Section 275.6. Hereinafter all statutory references are to the Public Utilities Code.

[3] Section 275.6(d)(4). KTC qualifies as a rural telephone company under federal law pursuant to 47 U.S.C. Sec. 153(44).

[4] Exhibit ORA-1, ORA's Report and Recommendations on the Application of Kerman Telephone Company to Review Intrastate Rates and Charges for Telephone Service within the State of California (Test Year 2016), CORRECTED VERSION. Hereinafter referred to as "ORA Report".

[5] ORA Report at 1.

revenues, ORA calculates a total subsidy need of $1,938,638 from the CHCF-A in test year 2016. A comparison of the components that comprise ORA and KTC's estimates of revenue requirements is presented in Attachment ES-1 to the ORA Report.

The Commission is required to ensure that KTC has sufficient revenues "to deliver safe, reliable, high-quality voice communication service and fulfill its obligations as a carrier of last resort in its service territory, and to afford the telephone corporation a fair opportunity to earn a reasonable return on its investments, attract capital for investment on reasonable terms, and ensure the financial integrity of the telephone corporation."[6] However, the Commission must also ensure that rates "are just and reasonable and are reasonably comparable to rates charged to customers of urban telephone corporations."[7] In addition the Commission is required to "ensure that support is not excessive so that the burden on all contributors to the CHCF-A program is limited."[8]

KTC's subsidy request is "excessive" when it includes undue, unreasonable and imprudent costs and expenses. Several areas of KTC's rate proposals do not comply with the statutory requirements against excessive burdens on ratepayers, described in more detail herein. Briefly, KTC's business name and organizational structure within the parent company Sebastian Enterprises, Inc. (SEI) facilitate the loading of costs that benefit its unregulated affiliates at the expense of ratepayers. KTC's corporate expenses have been inflated by improper ratemaking expenses including KTC's sponsorship of golf tournaments, polo festivals, guest apartments, and holiday parties. KTC charges below-market rates for custom calling features, which results in excessive subsidies to cover the lack of revenue. Finally, KTC seeks investor returns over 16%, which results in a rate of return that far exceeds utility averages or historical norms. ORA's detailed recommendations to address these issues are described below.[9]

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[6] Section 275.6(c)(2).

[7] Section 275.6(c)(3).

[8] Section 275.6(c)(7).

[9] Items not addressed in ORA's testimony or herein or are not opposed by ORA.

II. PROCEDURAL BACKGROUND

KTC's application for a general rate case (GRC) was first submitted in November of 2011. Also in November of 2011, the Commission issued R.11-11-007, a rulemaking to review the CHCF-A to determine how to "more efficiently and effectively meet its stated goals."[10] In February 2012, ORA (then called DRA) filed a timely protest, noting among other things that KTC's application should be stayed during the pendency of the R.11-11-007 proceeding. At a Prehearing Conference in March 2012, the ALJ urged KTC and ORA to engage in settlement discussions.[11] KTC and ORA negotiated a settlement agreement, and on June 29, 2012, submitted a Joint Motion for Adoption of All-Party Settlement Agreement to which the settlement agreement was attached. However, the Commission rejected the settlement agreement, stating "Given the pending CHCF-A Rulemaking and outstanding motions in that docket to freeze CHCF-A draws at existing levels and stay rate case applications until December 2013, we find it premature to allow an increase in the CHCF-A draw for Kerman at this time."[12]

On January 9, 2013, KTC filed a motion in this proceeding requesting that the Commission grant it immediate interim rate relief in the form of additional CHCF-A funds for calendar year 2013. In D.13-10-051, as modified by D.14-02-044, the Commission rejected the request for rate relief and further ordered the rate proceeding to be adjudicated as soon as possible following the conclusion of R.11-11-007.

With the expectation that R.11-11-007 would conclude in December 2014, the Assigned Commissioner and Administrative Law Judge issued a Scoping Memo that ordered KTC to submit an update to its GRC application by November 1, 2014. KTC complied and filed an updated application reflecting annualized 2014 data.

In December 2014, the Commission issued D.14-12-084 which revised and updated the CHCF-A rules in many ways. Notably, D.14-12-084 adopted the Federal

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[10] R.11-11-007.

[11] D.12-12-003 at 4.

[12] D.12-12-003 at 9.

Communications Commission's (FCC) corporate expense cap, and rejected ORA's recommendation to impute the revenues obtained by the CHCF-A carriers through their provision of broadband service.[13] On January 30, 2015, KTC submitted another supplement to its application to address the corporate expense cap implemented in D.14-12-084. Four days of evidentiary hearings were held beginning on April 28 and ending on May 10, 2015.

III. APPLICANT'S CORPORATE STRUCTURE

Kerman Telephone Company (KTC) does business under the name "Sebastian". KTC is wholly owned and controlled by Sebastian Enterprises, Inc. (SEI), which is in turn owned by the descendants of the Sebastian family.[14] SEI owns three other companies: Foresthill Telephone Company (FTC), which is a regulated telecommunications carrier that receives CHCF-A subsidies; Kertel, which provides information services and construction services to KTC; and Audeamus, which provides broadband services in KTC's service area. The president of KTC is William Barcus (one of the owners of SEI), who also serves as the president of FTC, Kertel, and Audeamus.[15] SEI, KTC, FTC, Kertel and Audeamus share many of their resources and facilities, such as the Central Office Building in Kerman, California; the adjoining warehouse; the work yard; vehicles; employees; marketing; and other things.

KTC, as well as the three affiliates (FTC, Kertel, Audeamus), do business using the name "Sebastian". The Central Office Building is branded with the name Sebastian on the exterior, as is Sebastian's other office building located in Fresno.[16] The telephone bills, vehicles, uniforms, letterhead, etc. all have the name Sebastian. KTC does not maintain separate offices from its affiliates, or employees, vehicles, or marketing.

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[13] The CHCF-A carriers are permitted to include "all reasonable investments necessary to provide for … the deployment of broadband-capable facilities in the rate base." Section 275.6(c)(6).

[14] Hearing Transcript (HT) pp. 51-54; Ruth Barcus, Susan Moran, Barbara Douglas, William Barcus, Brian Barcus, Amanda Moran, Evan Moran, and Christopher Moran.

[15] KTC-35 and KTC-36, organization charts for Kertel and Audeamus.

[16] ORA-11.

This corporate structure results in a “tangle of business records that are difficult to segregate.”[17] The business name and organizational structure of KTC within the parent company SEI facilitate the loading of costs to the regulated entity while the unregulated affiliates reap the benefits and rewards.[18]

ORA documented numerous examples where KTC failed to demonstrate that its transactions with its affiliates were conducted on an arms-length basis to protect ratepayers and avoid excessive costs. One example is the regulated account “Other Work Equipment.”[19] Within this account are the costs of construction equipment that is not primarily used by the regulated entity but is nevertheless included in the regulated rate base. Instead, KTC leases the equipment in this account to unregulated affiliates that reimburse KTC at often just 1/10 of the competitive market rate. Another example is Kertel’s maintenance and construction for KTC. The majority of KTC’s actual construction (65% in 2014) is procured through Kertel.[20] Kertel provides IT services to KTC with no contract and basically no documentation. Another example is image marketing. KTC pays the majority of the marketing expenses for Sebastian, although these marketing expenses are not necessarily related to the services that KTC provides.[21]

Thus, the CHCF-A is in effect subsidizing the expenses and operations of unregulated non-telephone companies. The Commission should take steps to separate the operations of KTC from its parent company and its affiliates, and require that KTC and its affiliates do the following:

1. Be held in separate legal entities.
2. Maintain separate books for all transactions.
3. Maintain separate bank accounts for all transactions.
4. Have no joint advertising or marketing.

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[17] ORA Report at 3.

[18] *Ibid*.

[19] ORA Report at 60.

[20] ORA Report at 3.

[21] ORA Report at 46.

5. Have no overlapping of employees or responsibilities.
6. Have no joint events, sponsorships, fundraisers, or charitable donations.
7. Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
8. Conduct financial transactions with each other at "arms-length".
9. Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to KTC from unaffiliated third parties for similar transactions.

These recommendations, or some combination of these and others, should untangle KTC's complicated and overlapping corporate structure, and facilitate the Commission's jurisdiction and review of operations in the future. While these recommendations were not specifically described in ORA's testimony, ORA made a note of the tangled business records in its testimony,[22] and the true extent and severity of the problem became apparent during the hearings under cross-examination.

IV. SUMMARY OF RECOMMENDATIONS

As described in the Executive Summary in ORA's Report and detailed in Attachment ES-1 "Separated Results of Operations Proposed Test Year 2016", ORA recommends total intrastate operating revenues in the amount of $6,602,548, which includes CHCF-A subsidies in the amount of $1,938,638. This result is achieved by adopting ORA's recommendations and adjustments, summarized below:

A. Revenues

1. In Tariff A-1, correct the business flat service rate to be $36.30. KTC requests $30 for the business flat rate which does not take into account the elimination of ARC and EAS charges.
2. In Tariff A-22, eliminate the 50% employee discount.
3. In Tariff A-28, increase charges for custom calling features:
    a) Caller ID – $9.99

[22] ORA Report at 3.

b) Call waiting – $8.50

c) Call forward – $6.50

d) Three-way call – $7.00

e) Anonymous call rejection – $6.50

f) Residential call waiting ID – $8.00

g) Foreign Exchange (FX) call waiting – $8.50

h) FX caller ID – $9.99

i) Business call waiting ID – $8.00

j) Remote call forwarding – $4.00

4. In Tariff A-32, increase monthly charges to $7.50 for residential inside wire maintenance, and $8.00 for business wire maintenance.
5. In Tariff A-40, capture the revenues from directory assistance ($2,200).
6. In Tariff V-1, allow at least one visit charge receipt ($95).
7. Offset CHCF-A draw by imputing Customer Premises Equipment revenues ($6,284).
8. Utilize growth adjustments based on 5-year growth average for Tariff A-28 call wait/call ID service.
9. Order KTC to assess Late Charges to overdue amounts as specified in its tariffs.
10. Order KTC to report Directory Assistance revenues on the appropriate line in their workpapers in revenue tabs.
11. Order KTC to report the amounts collected for CPE on the designated line in its workpapers.

B. Expenses

1. Apply the FCC Corporate Caps as adopted in D.14-12-084 in the amount of $1,692,783, which reduces KTC's requested intrastate corporate expenses by $1,148,933.
2. Reduce the annual rent of KTC's Central Office Building from $760,800 to $570,941, before applying the inflation rate for 2015 and 2016 to reflect a reasonable rent expense.
3. Eliminate the $429,254 rent expense per year for the company warehouse at 15061 W. C. Street; or alternatively, either reduce the warehouse rent to be commensurate with comparable warehouses

with respect to square footage and location, or reduce the warehouse expense to the amount in the current lease ($382,577 per year).

4. Reduce KTC's non-corporate expenses under the category of "Plant Specific" by $696,124 per year for the Kertel IT services contract, because without a written contract or supporting documentation for the work, the scope of work and resources required to meet KTC's needs cannot be determined.

5. $248,302 ($331,069 – ($331,069/4)) in marketing expenses should be removed from KTC's total reported non-corporate expenses because SEI's advertising is unrelated to the products and services offered by KTC.

6. KTC's "Customer Operations" expenses should be reduced by $42,000, the amount KTC pays to its affiliate Audeamus for customer retention fees.

7. KTC's "Customer Operations" expenses category should be reduced by $7,050, to eliminate the unnecessary corporate rental apartment.

C. Plant, Depreciation, and Ratebase

1. If ORA's recommendation to eliminate accelerated depreciation of underground wire is adopted, the Commission should support the approval of KTC's Five Year Plan projects including the Fiber to the Home project, consisting of $7,811,197.

2. The Commission should require a Tier 3 Advice letter 6 months after a final decision is issued, to mitigate potential safety concerns relating to the Five Year Plan projects.

3. Reduce KTC's proposed depreciation expense related to the Underground Metallic Cable and Wire facilities and the Buried Metallic Cable and Wire Facilities by $350,031 as a fair and balanced approach to approving the entire FTTH project.

4. The "Other Work Equipment" account should be reduced to $0. KTC should be credited $17,154 in rents paid to KTC by Kertel for the lease of the equipment.

D. Cost of Capital

1. The Commission should not select a rate of return before determining a reasonable capital structure, reasonable cost of debt, and a reasonable cost of equity.

2. Adopt a return on equity of 8.79%, which recognizes that the risk free rate and utility financing costs have declined significantly since

1997 when the 10.00% ROR was adopted. This ROE reflects recent U.S. Treasury rates, and a reasonable equity risk premium.

3. Adopt a capital structure of 60% debt and 40% equity, which is Sebastian's target capital structure for its regulated businesses (including KTC); in the alternative, the Commission could adopt KTC's actual 2014 capital structure of 49.1% debt and 50.9% equity.

4. Adopt Kerman's actual cost of debt, as reported in its supplemental testimony, of 3.20%.

5. The Commission should reject KTC's proposed size premium of 5.99%.

E. Other Issues

1. Order contact information for the American Red Cross, and animal protective services such as the SPCA to be included in Community Organizations section of the Disaster/Service Outage Communication Plan.

2. Order KTC to make a compliance filing within 90 days that describes in detail its internal standards, methods, and procedures for ensuring that an adequate and readily accessible supply of fuel is available for maintaining services during disasters and prolonged power outages.

3. Order KTC to file a report with the Commission within 90 days which provides an analysis of the net benefits gained from adding redundancy to its alarm notification protocol such that a call is made automatically to designated managers off-site when temperature, moisture, and sprinkler activation occurs.

4. Order KTC to have tariffs readily available in searchable electronic form at Kerman's website.

V. REVENUES

As described in ORA's Report, KTC earns operating revenues from the provision of various telecommunication services, supplemented by federal and state subsidies.[23] KTC's federal and state subsidies are authorized by FCC regulations and Public Utilities

[23] ORA Report at 4.

Code Section 275.6.[24] Rural telephone companies in "high cost" areas are authorized to receive subsidies to make up the difference between prices for basic service (which are set at a fixed amount) and the actual cost to provide the service to the rural area, which would otherwise be largely unaffordable to rural customers.[25]

KTC's revenues generally fall into two categories: discretionary and non-discretionary. Non-discretionary revenues are the revenues generated by providing basic service, for which the Commission sets the rates. They are non-discretionary in the sense that KTC as the Carrier of Last Resort (COLR) is required to provide basic telephone service at prices set by the Commission. Discretionary revenues are the revenues generated by services that are not part of basic service, which customers do not necessarily need. They are discretionary in the sense that KTC is not required to offer them, and customers do not need them for basic service.[26]

Since 2010, KTC's total operating revenue has averaged $12.795 million per year.[27] The total operating revenue includes federal and state subsidies. In its application, KTC seeks 2016 total company (inter and intrastate) revenue of $15,705,233[28], a 23%

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[24] Section 275.6(c)(2) provides that the Commission should ensure "revenues and earnings sufficient to allow the telephone corporation to deliver safe, reliable, high-quality voice communication service and fulfill its obligations as a carrier of last resort in its service territory."

[25] Section 275.6(c)(4) provides that state subsidies must be provided "in an amount sufficient to supply the portion of the revenue requirement that cannot reasonably be provided by the customers of each small independent telephone corporation."

[26] All four large ILECs (AT&T, Verizon, Frontier, and SureWest) list these features separately from basic service, describing them as "custom calling features". See ORA Report, Attachment 1-7.

[27] $12.795 million is the average of total company revenues from 2010 – 2014 (including the dollars from out of period revenues). ORA Report at 4.

[28] *Ibid*. KTC takes issue with ORA's use of annualized numbers rather than end of year 2014 actual numbers. However, the Commission has noted that there must be some cut-off date for updated numbers, so that the Commission and ORA can proceed with its analysis. Otherwise, ORA would be required to use updated data its testimony, then again for the hearings, and then new updated data for its brief, and then the ALJ would be required to use updated numbers for the proposed decision, *ad infinitum*. In D.04-06-018, the Commission stated:

> "The temptation to wait for additional historical data, i.e., updates, upon which to base a forecasted test year cannot be indulged when we face a statutory requirement for getting rates in place by a specific date. Any rate case plan requires a data

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increase over the past 5-year average. The increase is due to KTC's increased CHCF-A subsidy request of $6,011,945, as compared to $3,545,172 for 2013 (a 72% increase).[29]

KTC's revenue is derived from seven categories: local network services, intrastate access revenue, interstate USF, interstate access charges, CHCF-A, uncollectibles, and other miscellaneous services.[30] The Commission has jurisdiction over the intrastate portion of the revenues from services and the CHCF-A as well as other things, but excluding interstate revenues.

For the 2016 Test Year, KTC projects total intrastate revenues of $10,311,373,[31] a 28% increase over the past 5-year average. This includes $6,011,945 in state subsidies. KTC's revenues from services have decreased somewhat in the past 5 years, from $4,820,852 in 2010 to $4,098,623 in 2014.[32] KTC proposes revenues from services of $4,299,428 for Test Year 2016.[33]

In this section, ORA addresses the revenue from services portion of KTC's intrastate revenues request. Generally, if KTC collects higher revenues, the resulting state subsidies are lower – and vice versa. However, this assumes that KTC's costs and expenses are constant, which they are not. ORA addresses costs and expenses in a different section.

ORA recommends that a slightly larger portion of revenues should be derived from provision of services than those proposed by KTC. ORA proposes Test Year service revenues of $2,118,030 as opposed to $1,759,865, a difference of $358,165.[34] The higher

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> collection termination date; otherwise, no rate case with a forecasted test year would ever be completed."

[29] Attachment 1-2 to ORA Report: Resolution T-17461 Appendix A page A-7 line 6.

[30] ORA Report at 12.

[31] ORA Report at 5.

[32] ORA Report at 6.

[33] ORA Report at 6.

[34] ORA Report at 14.

revenue projections by ORA result in a lower overall state subsidy amount, which complies with the legislature's directive to ensure that the subsidies are not excessive.

The majority of the increased revenues consists of upwards adjustments to the following:

- Tariff A-1, KTC's business rate flat service ($78,361);
- Tariff A-28, KTC's provision of custom calling features ($121,410);
- Tariff A-32, KTC's provision of inside wire maintenance service ($151,073); and
- Differences in growth projections for these services.

The differing projections for future growth are explained below. Other adjustments include reducing employee discounts, increased directory assistance charges, and recognition of Customer Premise Equipment charges.[35]

A. Non-Discretionary Revenue

Most of KTC's revenue is derived from local network service, which is generally business and residential basic telephone service. KTC's local network revenue has been approximately $2.078 million per year for 2010 to 2014.[36]

Historically, the Commission had determined that rates for basic service shall not exceed the target level of 150% of comparable California urban rates, and AT&T's[37] rates for basic service were used as the benchmark.[38] However, the Small ILECs' basic service rates have been decoupled from AT&T's basic rates by the Commission. In a separate proceeding, after hearings and briefs by parties that included ORA and the rural carriers, the Commission determined that it is reasonable to set a new basic rate floor and basic rate ceiling for the basic service rates for the Small ILECs.[39] In D.14-12-084, the

[35] *Ibid*.

[36] ORA Report at 12.

[37] The formal legal name for the ILEC in California remains Pacific Bell Telephone Company, doing business as AT&T California or AT&T.

[38] D.91-09-042, and D.14-12-084 at 64.

[39] D.14-12-084 at 64.

Commission determined that a basic rate floor of $30.00 inclusive of additional charges, and a basic rate ceiling $37.00 inclusive of additional charges, is reasonable.

1. Rates for Basic Residential Service

In order to comply with D.14-12-084, KTC has proposed to increase basic residential service rates to $22.58.[40] ORA agrees with this proposal. If additional fees and surcharges were to stay the same on each bill, this would bring KTC's basic residential rate within the non-discretionary $30-37 range mandated by the Commission.[41]

KTC proposes to eliminate the Extended Area Service (EAS) and Access Recovery Charge (ARC) fees, which are currently included in basic residential rates. The decrease would result in rates that fall below the $30 floor, but KTC proposes to increase basic service rates to cover the amount of decrease. ORA agrees with this proposal.[42]

As discussed in KTC's testimony, the EAS charge is outdated and should be eliminated. As described in the November 14, 2014 testimony of Dave Clark (Exhibit KTC-1 at 22), EAS allows customers in Kerman to make a local call to Fresno. However, the FCC's transition away from access/reciprocal compensation to bill-and-keep for terminating minutes makes EAS rates outdated. ORA agrees with the elimination of this charge.

KTC also seeks to eliminate the collection of the interstate ARC[43] charge from customer bills, and to "neutralize the ARC charge by increasing support for intrastate revenue requirement".[44] According to KTC's testimony, the ARC was established by the FCC's 2011 *USF/ICC Transformation Order*, and it is required to be applied to the extent that a company's local service rate does not exceed $30. If the local service rate,

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[40] ORA Report at 10.

[41] *Ibid*. KTC's rate would be $22.58 + $6.50 (subscriber line charge) + Misc taxes ($0.92) = $30, eliminating $0.63 for EAS and $1.50 for ARC.

[42] ORA Report at pp. 8-10.

[43] ARC stands for access recovery charge, the charge that is collected in account 5081.2. ORA Report at 9.

[44] KTC-10 at 10.

inclusive of additional charges, equals or exceeds $30, the ARC charge cannot be assessed.[45] Without the ARC, KTC's rate would be below $30. However, if KTC's basic residential rates are increased to $30, the ARC may no longer be assessed. Therefore, the all-inclusive basic rate should be raised to $30 to account for eliminating the ARC.

2. Rates for Basic Business Service

In its direct testimony KTC recommends the same rate of $30 for its business customers; however, the EAS per business customer is $4.60 not $0.63 (as it is for residential customers).[46] Thus, eliminating the EAS for business customers means that KTC's business rate inclusive of additional charges would fall below $30. To account for this, ORA recommends a business rate of $36.30 inclusive of additional charges, and eliminating the EAS for business customers.[47] This amount is within the permissible range.

In its rebuttal testimony, KTC states: "ORA's proposal to increase business rates in the amount of the Extended Area Service ("EAS") increment that I propose to eliminate is sensible."[48] KTC states that it was not their intent to have business customers pay less than they pay today. As a result, KTC agrees that "it would be appropriate to increase the basic business service rate to offset the $4.60 EAS charge currently imposed ($59,092) and roll it into the basic service rate."[49] ORA and KTC agree that this adjustment results in an additional $59,092 in revenue.[50] However, KTC does not address the shortfall from the lost ARC charges of $1.50 (a revenue loss of $19,269), which accounts for the difference with ORA's recommended adjustment ($78,361).

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[45] KTC-10 at 30.

[46] ORA Report at 11.

[47] ORA Report at 11.

[48] KTC-12 at 3.

[49] *Id.* at 24.

[50] ORA Report at 9, KTC-12 at 24. The figure of $59,092 is for the EAS alone, combined with the ARC the total is $78,361.

3. Other Non-Discretionary Revenues

ORA confirmed KTC's representations with regards to mandatory Universal Service Fee (USF) charges compared to those in the 2015 NECA calculation.[51] While Interstate USF revenue fluctuated between 2010 and 2014, it averaged $1.95 million per year. KTC projects an increase in 2015 to $2 million which is forecasted to continue in 2016.[52] ORA does not recommend a change to this forecast at this time.

ORA also reviewed KTC's projections for Intrastate Access revenues, which were derived by applying growth rates to an estimated 2014 annual total.[53] KTC used a 2012-2013 growth rate for the special access volume changes, but utilized unique judgment-based growth rates for switching, originating and terminating volume changes. ORA does not recommend changes to KTC's forecast of Intrastate Access Revenues at this time.

B. Discretionary Revenue

KTC also offers telecommunications services which are not part of basic telephone service, which customers do not necessarily need. For example, KTC offers inside wire maintenance service, caller ID, and rental telephone equipment (Customer Premises Equipment – "CPE"). These services are discretionary in that KTC is not required to provide them. KTC projects a relatively small amount of additional revenues derived from these sources, at certain projected growth rates.[54]

Public Utilities Section 275.6 requires that rates charged by KTC must be just and reasonable[55] and also "reasonably comparable to rates charged to customers of urban telephone corporations."[56] Thus, KTC's rates must not be unreasonably low compared to urban carriers' rates. The Commission is required to ensure that KTC does not

[51] ORA Report at 22.

[52] *Ibid*.

[53] *Ibid*.

[54] ORA Report at 12.

[55] Mandated by Section 451.

[56] Section 275.6(c)(3).

undercharge its customers compared to urban customers, which would cause state subsidies to be excessively high. Raising rates for discretionary services helps lessen the state subsidies to cover the gap in non-discretionary basic telephone rates, while ensuring that KTC's rates for discretionary services are brought closer to what urban customers pay for the same discretionary services.

While state subsidies are intended to ensure that rural rates are "reasonably comparable to urban rates", it is not the intent of the legislature to provide "free" telephone service, or service that is unreasonably low cost compared to other California ratepayers.

ORA finds that KTC's discretionary services are being priced unreasonably low. ORA therefore recommends that the Commission set a reasonable price for these services.

KTC's revenue projections for local network services for Test Year 2016 are $1,759,865.[57] As a result of its analysis, ORA estimates that KTC should earn $2,118,030 in revenues from local services. As described above, the difference of $358,165 is largely attributable to price differences in provision of discretionary services.[58] The difference is also attributable to different methodologies for estimating growth rates, which is discussed below.

1. Tariff A-22 – Employee Discounts

KTC offers its employees a 50% discount for phone service.[59] The Commission does not require KTC to provide employee discounts.

In its application, KTC fails to adjust its employee discount to reflect the elimination of the EAS and ARC charges. In addition to the discount, eliminating these charges would mean KTC's employees rates go down even further.

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[57] ORA Report at 7.

[58] A small portion ($78,361) is attributable to business basic rate differences.

[59] ORA Report at 18.

However, ORA recommends that the Commission entirely eliminate employee discounts. KTC's basic service rates are already heavily discounted due to state subsidies. As described below in this brief, KTC's employees already make substantially more income than the local residents of Kerman, California, so the large discount is not warranted. In addition, Section 275.6 requires that KTC's rates be "reasonably comparable" to urban rates, and 50% discounts result in rates far below any other carriers' rates. Finally, it is important to note that only 6 of KTC's employees work 100% for KTC (most of KTC's 35 employees spend a portion of their time working for one of KTC's affiliates).[60] The employee discount is therefore not reasonable, necessary, or warranted. Eliminating the employee discount would increase revenues by $5,026.[61]

2. Tariff A-28 – Custom Calling Features

Tariff A-28 describes the rates for custom calling features, which are not part of KTC's basic service.[62] These services include caller ID, call waiting, call forwarding, three-way calling, and anonymous call rejection. Pursuant to Section 275.6(c)(3) these rates must be "reasonably comparable" to the rates that urban customers pay. However, KTC charges below-market rates. ORA recommends the following adjustments to KTC's custom calling feature pricing, in order to bring the pricing for these features into compliance with Section 275.6:

- Caller ID – KTC currently charges $6.17. ORA recommends $9.99 for residential and business customers, based on AT&T's 2013 rate of $9.99 for the same service;[63]

[60] ORA Report at 18.

[61] *Ibid*.

[62] ORA Report at 19.

[63] ORA Report, see Attachment 1-7: Summary of URF ILEC Residential Service Rate Charges. These rates, from 2013, are the most current rates ORA could locate. Rates may be higher in 2015. It should also be noted that KTC charges its foreign exchange (FX) customers $9.99 for Caller ID and $8.50 for Call Waiting.

- Call waiting – KTC currently charges $3.23. ORA recommends $8.50 for residential and business customers, based on AT&T's 2013 rate of $9.00;
- Call forwarding – KTC's current rate is $3.23. ORA recommends $6.50 for residential and business customers. AT&T's 2013 rate was $7.50;
- Three-way calling – KTC charges $3.23 for residential and $5.00 for business. ORA recommends $7.00 for both residential and business customer. This feature was $8.00 in 2013 for AT&T;
- Anonymous call rejection – KTC charges $3.00 for residential and $5.00 for business customers. ORA recommends $6.50 for both residential and business customers. AT&T charged $7.50 in 2013.

Inclusion of these revenue adjustments to Tariff A-28 services, including the missing Tariff A-28 revenues described below, would add $121,410 to the local network revenue projections provided by KTC in its supplemental testimony.[64]

3. Tariff A-32 – Inside Wire Maintenance

Tariff A-32 addresses inside wire maintenance, both the installation of the service and the monthly maintenance charges.[65] Again, pursuant to Section 275.6(c)(3) these rates must be "reasonably comparable" to the rates that urban customers pay. However, compared to AT&T and Verizon, KTC's rates for inside wire maintenance are below market value. As of 2013, AT&T charged $8.00 per month and Verizon charged $7.99 per month.[66] Therefore, ORA proposes increasing the rate from $1.10 per month to a $7.50 monthly service rate for residential customers and from $1.50 to $8.00 per month for business customers. Raising these rates would generate an additional $151,073 in 2016 revenues.[67]

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[64] ORA Report at 14.

[65] ORA Report at 19.

[66] ORA Report, see Attachment 1-7.

[67] ORA report at 14, and 20.

4. Differences in Future Usage Projections

In addition to the differences created by KTC's below-market rates for the above discretionary services, the revenue projections are also different as a result of differences in "growth rate" projections.[68] This is because KTC has "cherry-picked" the years it used for "growth rate" projections by using only 2012-2013.[69] As a result, KTC makes growth rate projections of 87% for its custom calling features (which means a 13% decline in customers who subscribe to the custom calling features). However, ORA rejects the use of 2012-2013 for the projection. Usage rates have in fact remained fairly steady over time. For custom calling features such as caller ID and call waiting, ORA used the 3-year average service usage rate in 2012-2014 of 97%, and the 5-year average in 2010-2014 of 100%.[70] This results in projected revenue for 2016 of $100,674 from residential caller ID and call waiting, an increase of $17,766 above KTC's projections.[71]

5. Additional Services For Which KTC Collects No Apparent Revenue

ORA's revenue projections also differ from KTC's with regards to services that are offered at no apparent charge. ORA recommends that revenues be imputed for certain services for which charges are either missing or appear to be offered for free.[72]

a) Directory Assistance and Customer Premises Equipment (CPE)

Apparently, KTC's application estimated zero 411 Directory Assistance calls.[73] However, ORA noted the discrepancy between KTC's zero projected amount and 2008, when KTC reported $12,915 in local revenues for directory assistance.[74] In response,

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[68] Oddly, KTC's "growth rate" nomenclature describes changes over a period of time, usually an annual change, even if such growth rate results in a decrease in subscribers.

[69] ORA Report at 15.

[70] *Ibid*. DC-3.

[71] KTC accepts this adjustment in the Rebuttal Testimony of Dave Clark, see KTC-12 at 18.

[72] ORA Report at pp. 15-20.

[73] ORA Report at 21.

[74] Resolution T-17081.

KTC stated that it made an error and that its "2014 revenue should be approximately $2,200 for this service."[75] KTC's rebuttal testimony agrees with this adjustment.[76]

Therefore, ORA recommends that $2,200 in revenues be reflected in 2016 for Directory Assistance. This reflects an estimated 4,783 directory assistance calls at the $0.46 per call charge.[77]

With regards to CPE, KTC reported no revenues because it claims that CPE is outside the Commission's jurisdiction.[78] CPE is the telephone equipment that KTC rents to its customers.[79] However, while it is true that the Commission does not regulate the manufacture or sale of CPE, the Commission is not prevented from considering the revenue generated by CPE. This is no different than a company truck, the manufacture and sale of which is not regulated by the Commission, but the Commission regulates the costs and expenses associated with such vehicles. The same is true for broadband equipment, or work equipment such as trenchers, for example. The Commission does not regulate the manufacture or distribution of such items, but nevertheless must determine the reasonable level of associated costs to include in customer rates.[80]

ORA found 5 instances in a sample of 71 customer bills where KTC charged $2 for CPE.[81] ORA thus projects 262 instances in 2016 where a $2 CPE charge will be collected from the residential customers as unregulated revenues, for a total of $6,288.[82] Recognizing this revenue will result in reducing the CHCF-A subsidy by an equal amount.

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[75] ORA Report at 16.

[76] KTC-12 at 24.

[77] ORA Report at 16.

[78] KTC-12 at 19.

[79] HT 204:5.

[80] D.13-09-038 holds that "states have no role whatsoever in overseeing CPE manufacture or distribution" but does not address the costs or revenues associated with CPE.

[81] ORA Report at 16.

[82] ORA Report at 17.

b) Call Waiting ID and Remote Call Forwarding

KTC appears to offer business and residential call waiting ID and remote call forwarding, and other custom calling features, for no apparent charge.[83] ORA found that KTC's workpapers reported no income for these services. ORA recommends adjusting a total of $9,179 in missing revenues for these services. Below are the missing revenues that should be reported pursuant to Tariff A-28:

- Residential Call Waiting ID – $7008. While KTC's workpapers contain no rate in cell AE 85, ORA recommends $8 a month for the 73 customers, to yield the revenue in cell AE 85;
- FX Call Waiting – $408. While the cells are hidden from view, ORA recommends an $8.50 monthly charge for the 4 customers, to yield the appropriate revenue in cell AE 90;
- FX Caller ID – $1379. While the cells are hidden from view, ORA recommends a $9.99 monthly charge for the 12 customers, to yield the appropriate revenue in cell AE 91;
- Business Call Waiting ID – $288. While KTC workpapers show no rate in cell AD 111, ORA recommends an $8 monthly charge for the 3 customers, to yield the appropriate revenue in cell AE 111;
- Remote Call Forward – $96. While KTC workpapers show no rate in cell AD 128, ORA recommends a $4 monthly charge on the 2 customers, to yield the appropriate revenue in cell AE 128.[84]

6. Late Payment Charges

KTC did not bill any late payments for 7 of 12 months in 2014.[85] As a result, the 8 months of recorded 2014 data underreport the late payment incidences and resultant revenues expected for a full year of results. Therefore, KTC's estimate of $9,294 in 2014 is too low. ORA utilizes the 3-year average from 2011-2013 to project $15,600 in late

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[83] KTC claims that it charges a fee for call waiting and a fee for caller ID, so that a fee for call waiting ID is unnecessary. KTC-12 at 17. ORA disagrees because call waiting ID is a unique, separately tariffed service from caller ID and call waiting.

[84] ORA Report at 21. ORA calculated these amounts by multiplying an appropriate price by the number of lines reported by KTC that use the service.

[85] ORA Report at 22. See also ORA Report Chapter 6: Analysis of Kerman Phone Bills.

payment revenue in 2016. KTC's rebuttal testimony agrees with ORA and notes that it made an error in calculation of late payment charges. KTC agrees that an adjustment is appropriate in this instance.[86]

C. Conclusion – Revenue Adjustments

As a result of ORA's upwards revenue adjustments listed above, revenues from local network services should be set at $2,118,030.[87] This number is used in ORA's calculation of KTC's Results of Operations model, Attachment ES-1 to the ORA Report. It should be noted that in its rebuttal testimony KTC has adopted some of ORA's adjustments, such as the directory services revenues and late payment charges adjustments, therefore some of the reported differences between ORA's projections and KTC's application have changed. While these adjustments change some of ORA's analysis of the differences, they do not change ORA's Results of Operations model. ORA has made no additional changes to its recommendations as a result of KTC's rebuttal arguments.

VI. CORPORATE EXPENSES

In an update to its application filed November 3, 2014, KTC estimated test year 2016 total corporate expenses of $3,541,020.[88] This section addresses KTC's corporate expenses and the application of the FCC corporate expense cap in this proceeding.

In D.14-12-084, the Commission found that it was necessary to adopt a uniform standard for determining a reasonable level of corporate operations expenses for carriers that receive subsidies pursuant to the CHCF-A program. Adopting a reasonable standard enables the program to meet the goal of providing support for carriers in rural, high-cost areas while "ensuring that the level of support is not excessive or widely disparate" among the A-Fund carriers.[89] Imposing the cap avoids imposing an undue burden of

[86] KTC-12 at 24.

[87] ORA Report at 13.

[88] ORA Report at 24.

[89] D.14-12-084 at 28.

excessive subsidies on California ratepayers who contribute to the fund.[90] The Commission held that imposing the cap is an efficient and effective way to meet the CHCF-A's stated goals of providing affordable, widely available, safe and reliable service to rural, high-cost areas. Finally, the Commission found that the cap is "a rational mechanism for calculating and determining a reasonable level of corporate expenses" for the A-Fund carriers.[91]

Application of the FCC corporate expense cap formula is relatively straightforward, as follows:

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.[92]

KTC has 4,848 loops; thus KTC calculates that application of the cap without any modification results in $1,692,783 of allowable test year corporate expense ($1,537,917 of allowable corporate expense plus a $154,865 CPI growth allowance).[93] Without the cap, KTC's request for corporate expenses is $3,365,417 (after excluding $175,603 in legal expenses related to the general rate case). ORA recommends applying the cap in this case because pursuant to D.14-12-084 all corporate expenses above the cap amount

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[90] *Ibid*.

[91] *Ibid*.

[92] FCC *Report And Order And Further Notice Of Proposed Rulemaking*, FCC 11-161, rel. November 18, 2011, ¶ 232.

[93] KTC-8, see attachment DC 0111, "Calculation of Corporate Expense Limitation". The calculation was done correctly.

are deemed to be unreasonable, and KTC has not presented a compelling rebuttal argument as to why its corporate expenses above the cap are reasonable.

A. Rebuttable Presumption that Expenses Above the Cap are Unreasonable

In D.14-12-084, the Commission determined that that there is a "rebuttable presumption" that any amount above the cap is *per se* unreasonable.[94] The Commission explained that a rebuttable presumption means "a presumption of unreasonableness and carriers would have the opportunity to rebut the presumed level of expenses imposed under the cap by demonstrating that a different level of corporate expenses is reasonable."[95] The Commission also provided that "If a Small Incumbent Local Exchange Carrier's actual corporate expense amounts exceed the Federal Communications Commission's corporate expenses cap, that carrier has the opportunity in the General Rate Case application to rebut the presumption of unreasonableness to seek additional support from the California High Cost Fund-A Program."[96] Thus, the appropriate forum for KTC to rebut the presumption that its corporate expenses above the cap are unreasonable is in this GRC proceeding.

However, KTC has failed to address specific corporate expenses and explain how those expenses are reasonable. For example, KTC requests $138,480 for a mid-level corporate salary for its Information Systems (IS) Manager.[97] Yet KTC makes no effort to explain why its IS Manager's salary should exceed the average Kerman-area corporate salary by almost double ($76,548 is the average corporate wage in the Kerman area[98]). Nor does KTC explain why this mid-level corporate position should outpace the California statewide corporate average of $93,956.[99]

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[94] D.14-12-084 at 29.

[95] *Ibid*.

[96] D.14-12-084, Ordering Paragraph No. 3.

[97] ORA Report at 30.

[98] KTC-22 at 22.

[99] KTC-22 at 23.

Other examples include Sebastian's sponsorship of a polo festival ($6,667) that KTC attempts to include in its expenses; or Fresno State Bulldog sporting events ($70,560 per year) and tailgate parties ($16,830); or the Sebastian holiday party ($33,863); or its membership in Calcom, a broadband industry group ($14,857).[100] KTC provides no explanation why these expenses are necessary, or even reasonable.

Instead, KTC attacks the cap in three ways. First, KTC argues that application of the cap "would seriously compromise its ability to perform necessary functions and continue to operate in an efficient and reliable manner."[101] Second, KTC argues that application of the cap as it is applied to KTC is *per se* unreasonable because KTC is in a high-cost regulatory environment, which the FCC cap did not account for.[102] Third, KTC argues that the cost of living and other expenses are generally higher in California.[103] ORA addresses these arguments in turn.

First, KTC argues that the cap "would seriously compromise its ability to perform necessary functions and continue to operate in an efficient and reliable manner" because doing so would mean eliminating "almost the entire company labor costs for corporate functions" thus "eliminating this cost would mean eliminating all corporate employees."[104] KTC argues that alternatively, it would eliminate "almost the entirety of Kerman's non-labor related costs."[105] However, as described below there are many other options for KTC to reduce corporate expenses without eliminating their entire corporate staff. The multitude of ways in which KTC could lower its expenses without eliminating positions or functions is described in more detail below.

Second, KTC has not established that the Kerman area is a higher-than-average regulatory cost environment. Mr. Lehman states that California is an "intense regulatory

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[100] ORA Report at 30-31.

[101] KTC-10 at 29.

[102] KTC-10 at 16; KTC-22 at 7.

[103] *Ibid*.

[104] KTC-10 at 18.

[105] *Ibid*.

activity" environment without explaining what that means.[106] Instead, he cites to a Forbes article that purportedly shows "Forbes Ranking of Business Costs and Regulatory Environment across States"; however, this ranking system ranks seven states higher than California. By definition, the FCC used state averages in its calculation of the national corporate expense cap formula – thus it is not surprising that some states are below California, and some states are above. This does not establish that the cap is unreasonable as applied to Kerman. Moreover, if the Commission determines in this proceeding that the cap is *per se* unreasonable in California, the concern is that the cap would be unreasonable for every other A-Fund carrier as well, because they are all in California. This would mean in effect that the cap can never be applied, because it would be *per se* unreasonable to apply it anywhere in California.

Mr. Lehman also states that the number of regulatory proceedings is higher in California than other states.[107] However, the high average number (if true) of regulatory proceedings in California does not apply to KTC, which has only had one GRC since 2008 and only participated in one rulemaking (that ORA is aware of, R.11-11-007 – which was not mandatory). KTC does not specifically address or support the claim that its regulatory costs have been higher than the national average, nor does KTC describe the high regulatory costs spent by KTC. Mr. Lehman acknowledges that his data applies to generic regulatory proceedings, not to KTC specifically.[108] KTC cannot establish that the regulatory environment for KTC is more burdensome than other states, such that applying the cap is *per se* unreasonable.

Third, KTC argues that it is located in a high cost area in general, which makes the cap unreasonable as applied to KTC.[109] To support this argument, Mr. Lehman presents evidence from the U.S. Bureau of Labor Statistics that purports to show that the Kerman

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[106] KTC-22 at 7.

[107] KTC-22 at 18.

[108] *Ibid*.

[109] KTC-22 at 19.

area has high labor costs.[110] Mr. Lehman shows that the Kerman area's average corporate wage is $76,548.[111] He shows that the California average corporate wage is $93,956.[112] Mr. Lehman further shows that there are four states with higher rural corporate occupational wages.[113] KTC uses this data to argue that KTC's corporate should be higher than other states. However, the comparison must fail because KTC's corporate wages are already substantially above the Kerman-area and California averages. Above ORA notes that KTC's IS manager earns $138,480, far above the statewide average.[114] KTC's president earns $236,202 per year.[115] KTC's wages and benefits are generally far above the state average. Thus, KTC has not shown that application of the cap would reduce wages to a point below the Kerman-area average, or even the California statewide average, such that harm might occur to its operations.

Moreover, KTC argues at length against adopting ORA's recommended increase in rates for custom calling features, arguing that its residents cannot afford rate increases. Mr. Clark claims that KTC is in a "low-income area, and an increase of this magnitude would constitute a hardship for many customers."[116] But Mr. Lehman shows that over half of Kerman's households make less than $25,000 per year, which makes Kerman an "extremely low income" area.[117] It cannot be simultaneously true that Kerman is both a high-labor-cost area and a low income level area. KTC merely presents the facts as it suits them, despite the inherent contradictions.

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[110] *Ibid*.

[111] KTC-22 at 22.

[112] *Id.* at 23.

[113] KTC-22 at 22.

[114] ORA Report at 30.

[115] ORA-10, CC3001 Q17 – employee compensation chart.

[116] KTC-12 at 14.

[117] KTC-22 at 31.

1. KTC Has Failed to Show That Its Corporate Expenses Above the Cap are Reasonable

KTC has failed to rebut the presumption that KTC's corporate expenses above the cap are *per se* unreasonable. KTC presents no compelling rationale as to why the cap is unreasonable as applied to KTC. ORA has shown that KTC's alleged fears of eliminating its entire corporate staff are hyperbole, because there are many other reasonable options for KTC to reduce expenses. Further, KTC has not shown that its regulatory expenses are in fact higher than the average costs for other states. In fact, that data shows that KTC's corporate wages are already higher than the rest of the state. Finally, KTC has not shown that it has such high labor costs that it cannot reduce wages without suffering unreasonable hardships.

B. Examples of Unreasonable Corporate Expenses That Could Be Eliminated or Reduced

ORA used KTC's estimates for 2016 operating expenses, which were derived by annualizing the eight months (January to August) of actual 2014 expenses known at the time of its application update.[118] KTC's 2014 annualized total corporate expenses totaled $3,104,451.[119] In response to ORA's data requests, KTC provided data that indicated that its total actual corporate expenses as of December 31, 2014 totaled $3,085,840.[120]

As detailed below, ORA has identified areas where KTC's forecasted corporate expenses could be lowered for ratemaking purposes. ORA analyzed just 3% of KTC's 2014 expense transactions to find these examples, which suggests that additional opportunities likely exist to reduce or eliminate other unreasonable expense in order to meet the cap.[121] If followed, these recommendations alone would reduce expenses by

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[118] ORA Report at 27.

[119] *Ibid*.

[120] *Ibid*. KTC criticizes ORA for its use of annualized data, and ORA accepts KTC's updates for actual data. However, ORA cautions against any policy against using annualized data. The Commission has recognized that if it were to always require actual data, no proceeding would ever finish. (D.04-06-018.)

[121] ORA Report at 27.

$847,971, which demonstrates that application of the cap is reasonable and does not present a hardship for KTC.

1. Reduce Executive Bonuses and Benefits

KTC pays bonuses, board meeting fees, and a quarterly retainer, in the total amount of $294,705.[122] ORA believes these amounts should be eliminated or reduced to meet the cap. KTC has not shown that these amounts are reasonable, or necessary to retain employees. For example, KTC's president is William Barcus, who is also a shareholder. It is not apparent why KTC must pay him a bonus to retain him.

Moreover, most of the board members are family members who own a portion of the company, and thus have an incentive to actively participate, and would likely do so without remuneration.[123]

2. Eliminate Unnecessary Temporary and Regulatory Positions

KTC could eliminate temporary positions and regulatory positions that do not appear to be necessary for its ongoing functions.[124] For example, Mr. Clark testified that he is the only regulatory person at KTC, and he only spends a little over half his time working for KTC (1387 hours – the rest is spent working for Foresthill).[125] Mr. Clark's hours have remained consistent for 2010-2014.[126] KTC requests an additional regulatory position at $120,000 per year, which KTC could save by having Mr. Clark devote his full time to KTC.

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[122] ORA Report at 29.

[123] KTC-12 at 67. Cite to hearing transcript.

[124] ORA Report at 30 and 38.

[125] ORA Report at 38. ORA-10, CC3001 Q17 – employee compensation chart.

[126] *Ibid*.

3. Reduce Salaries And Benefits For Mid-Level Corporate Positions

As discussed above, KTC could reduce the salaries of its mid-level managers such as its IS Manager to be more consistent with Kerman area and California statewide averages.

4. Eliminate Affiliate Memberships In Industry Groups

KTC pays the membership fees in a broadband industry group called Calcom for its parent company Sebastian.[127] According to its website, Calcom's mission is to accelerate broadband deployment.[128] However, KTC provides no retail broadband service. Audeamus is KTC's broadband affiliate, and KTC has not explained why Audeamus or SEI cannot pay the membership fees. Elimination of this corporate expense would reduce expenses by $14,857.

5. Eliminate Charitable Donations, Contributions And Sponsorships

KTC could save $246,465 by eliminating donations, contributions, and corporate sponsorships for events that are intended solely to burnish the "brand image of Sebastian".[129] For example, state subsidies are used by KTC to fund $70,560 per year of Fresno State Bulldog sporting events.[130] KTC sponsors a Polo Festival in Sebastian's name in the amount of $6,667.[131] KTC also sponsors the Kerman Christian School ($400), a golf tournament ($5,100), a Fresno State tailgate party ($16,830), and the California Independent Telephone Political Action Committee ($6,800). Donations, contributions and sponsorships are not typically paid for by ratepayers, because such

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[127] ORA Report at 31.

[128] See http://calcomassn.org/wp-content/uploads/2014CalComDirectoryWeb-FINAL.pdf. This document is attached to ORA's Report, attachment 2-5.

[129] KTC-12 at 37.

[130] ORA Report at 32.

[131] *Ibid*.

expenses do little to increase safety and reliability.[132] In addition, these donations and sponsorships are done in the name of "Sebastian", which includes KTC's parent company and affiliates and thus benefits their brand image, not necessarily KTC.

6. Eliminate Expensive Employee Parties and Retreats

KTC's parent company Sebastian hosts parties and retreats for the employees of KTC and the other affiliates, Foresthill, Audeamus, and Kertel.[133] Yet KTC pays 75% of the costs of the holiday party, 45% of the annual retreat, and 40% of the annual banquet.[134] Eliminating these events would reduce KTC's expenses by $55,716. KTC has not rebutted the presumption that these expenses are unreasonable.

7. Reduce Corporate Travel Expenses

KTC's employees pay exorbitant amounts for travel expenses.[135] For example, an employee paid $509 per night to stay in San Francisco to attend a Commission hearing. KTC has not explained why it would be unreasonable to limit KTC's business travel expenses to the rates authorized by the State of California for Commission employees and external consultants used by the CPUC and other state agencies.

8. Eliminate Corporate Rental Apartment

KTC maintains a corporate rental apartment for business visitors.[136] KTC records half of the rental apartment expense as a KTC corporate expense. Apparently, KTC employees who live in or near Foresthill (4 hours away) must often travel to Kerman on business.[137] Thus, KTC claims that use of the apartment saves money because otherwise its employees who use the apartment would have to rent a hotel room. However, KTC fails to demonstrate that there are not other more reasonable alternatives, such as

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[132] Pacific Telephone and Telegraph v. CPUC, 62 Cal. 2nd 634.

[133] ORA Report at 33.

[134] *Ibid*.

[135] *Id.* at 34.

[136] *Id.* at 35.

[137] KTC-12 at 36.

teleworking.[138] An apartment rental is clearly unnecessary to the provision of safe and reliable telephone service, thus it is unreasonable to expect ratepayers and state subsidies to cover this expense.

9. Eliminate Undocumented Affiliate Maintenance Contracts

KTC's affiliate Kertel purportedly provides network service to KTC, in the amount of $793,100 per year.[139] However, despite ORA's data requests to KTC, it could not provide a copy of the contract between KTC and Kertel, nor could it provide any detailed invoices. Attachment 2-10 to ORA's Report is the only invoice provided by KTC. It is impossible for ORA to evaluate why $96,975 of this contract is allocated to KTC's corporate expenses based on this invoice.[140] The invoice shows no labor, no materials, and provides no description of the work done. As the applicant, KTC maintains the burden to show that its expenses were actually incurred. Moreover, if KTC wishes to show that its corporate expenses are reasonable to exempt from the cap, it must provide more detailed documentation.

10. Reduce Expensive Litigation Expenses

KTC projected its legal expenses for 2015 to be an astronomical $525,475 – or about 4% of its entire operating expense.[141] When ORA requested supporting documentation, KTC used "attorney client privilege" to shield its invoices from discovery.[142] This example demonstrates the necessity and utility of the expense cap. If the expense cap is applied, KTC is incentivized to reduce its legal expenditures on its own, and the Commission is not required to expend resources attempting to obtain invoices and reviewing them.

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[138] HT 67: 21 – 25.

[139] ORA Report at 36.

[140] *Ibid*.

[141] ORA Report at 36.

[142] *Id.* at 37.

In addition, it should be noted that KTC used the legal expenses for the calendar year 2014 to project the Test Year 2016.[143] However, ORA's review of some legal invoices used by KTC to project Test Year legal expenses revealed that some of the invoices were from December 2013. In other words, KTC used 13 months of legal expenses to project 12 months of Test Year legal expenses. The effect is that KTC's projected legal expenses are artificially inflated by the amount of the December 2013 invoices, which totaled $35,095.

11. Conclusion – KTC Has Many Items That Can Be Reduced Or Eliminated To Meet The Cap

These examples, taken from just 3% of KTC's recorded line-item expenses, revealed more than $847,000 in inappropriate corporate expenses for ratemaking purposes. The examples above of improper ratemaking expenses are egregious, including KTC's sponsorship of golf tournaments, polo festivals, guest apartments, and holiday parties costing nearly $500 per employee. ORA's recommendation to apply the FCC's Corporate Expense Caps without modification would reduce estimated intrastate revenue requirements.

VII. NON-CORPORATE EXPENSES

The Commission has jurisdiction to consider the reasonableness of KTC's other operating expenses that are not recorded as corporate expenses.[144] ORA has found that certain non-corporate expenses are not reasonable or justified, and should be adjusted downwards. This section addresses ORA's review of KTC's non-corporate expenses and its recommended adjustments.

In KTC's supplemental testimony filed in November 2014, KTC requested test year 2016 operating expenses of $12,612,841.[145] ORA recommends downward adjustments to KTC's plant specific expenses and customer operations expenses, totaling

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[143] ORA Report at 37.

[144] Public Utilities Code section 275.6.

[145] KTC has subsequently revised their operating expenses downward to reflect a lower level of corporate expenses.

$1,612,589.[146] After applying the intrastate factor for these reductions, the total intrastate reduction is $1,084,673.[147]

The reduction in plant specific expense and customer operation expenses includes adjustments for rent paid for use of the Central Office Building and company warehouse, a maintenance contract with its affiliate Kertel for which no written contract was provided, KTC marketing expenses for Sebastian, customer retention fees paid to its affiliate Audeamus, and the company rental apartment. ORA's rationale for these adjustments is below.

A. Central Office Building Rent

KTC's central office building (COB) is located at 811 S. Madera Avenue in Kerman, California. It is owned by KTC's parent company SEI and leased to KTC (the only tenant).[148] KTC paid rent to SEI in the amount of $760,800 per year, or $63,400 per month, in addition to taxes and insurance in 2014.[149] However, the total rent approved in Resolution T-17081 was $570,941. KTC has presented no evidence that conditions in Kerman have changed since 2008. Therefore, ORA recommends a reduction of $189,859 ($760,800 - $570,941) under the category "Plant Specific" expenses.

B. Company Warehouse Rent

KTC leases a warehouse facility located at 15061 W. C Street in Kerman, California from its affiliated entities, the Barcus Family Partnership and the S&K Moran Partnership.[150] KTC pays rent for this warehouse in the amount of $17,885.59 to the Barcus Family Partnership and $17,885.59 to the S&K Moran Family Limited

[146] ORA Report at 49, see Table 2-10.

[147] ORA Report at 50.

[148] ORA Report at 41. An executed copy of the lease was produced at the hearings, which shows "Base Rent" of $592,800. See KTC-38.

[149] *Ibid.*

[150] ORA Report at 44. The Barcus Family Partnership and The S&K Moran Partnership own SEI, which owns KTC.

Partnership for a total of $35,771.18 per month or $429,254 per year.[151] In preparing its testimony, ORA was told by KTC that an executed lease agreement could not be located, and ORA was informed by the City of Kerman and the County of Fresno that KTC actually owned the warehouse.[152] Therefore, ORA concluded that KTC had not established separate ownership of the warehouse, and recommended that the entire rent expense should be disallowed because it would be illogical for KTC to pay rent to itself.

Subsequently, ORA was informed that KTC does not own the property but in fact the family partnerships own the warehouse, and that KTC had located a signed lease agreement for the property.[153] A copy of the lease was provided to ORA on the first day of hearings. The lease (exhibit ORA-7) provided to ORA was executed in April 2015 (a few days before the hearings), signed by Ruth Barcus and Susan Moran (on behalf of the family partnerships), and William Barcus (on behalf of KTC – his mother is Ruth Barcus). The owners are listed as the "Barcus Family Limited Partnership" and the "S&K Moran Family Limited Partnership". The Base Rent is listed as $382,577.04 per year, to be paid in quarterly installments.

The square footage of the warehouse is 14,058, which equates to $2.27 per square foot per month. This is well above market prices. For example, Sebastian's corporate building leases office space in Fresno for $1.95 per square foot per month.[154] In order to determine if the warehouse lease price is consistent with local market prices, ORA researched additional comparable properties in the area. Exhibit ORA-12 shows a comparable warehouse for $0.31 per square foot per month. Exhibit ORA-13 shows another comparable warehouse for $0.75 per square foot per month. Exhibit ORA-14 shows yet another comparable warehouse for $0.50 per square foot per month.

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[151] *Ibid*.

[152] ORA Report at 45.

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[154] ORA-11.

Therefore, ORA recommends that the entire lease amount be eliminated. Alternatively, ORA recommends that the Commission take into account that the warehouse lease price is far above market value and was negotiated between William Barcus and his mother Ruth Barcus, and therefore was not an arms-length transaction, and reduce the price of the lease. As a second alternative, the Commission should reduce the price of the lease because Base Rent is listed in the current lease is $382,577.04 per year.[155]

C. KTC's Maintenance Contract With Its Affiliate Kertel

KTC's unregulated affiliate, Kertel, provides NOC (Network Operating Center) and IT (Information Technology) Technician Labor to support KTC's operations and customers.[156] As described above, a portion of this IT maintenance expense is reported as a corporate expense. SEI bills KTC for this maintenance service at a price of $66,091.67 per month or $793,100 per year. Of this amount, $58,010 per month or $696,123 per year is allocated to KTC's total non-corporate expenses. KTC has been unable to produce a copy of the Kertel contract despite ORA's repeated requests.[157]

Without a maintenance contract between KTC and Kertel, ORA cannot determine the scope of work and resources required to meet KTC's needs. The sole documentation provided by KTC is a monthly invoice provided in Attachment 2-10 to ORA's Report. The invoice contains no description of the materials provided, the hours worked, or a description of the work performed.

KTC provided a very general description of Kertel's IT maintenance services in its rebuttal testimony.[158] However, KTC has not provided the Commission with sufficient documentation or information to justify the Kertel expenses. Because this is KTC's

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[155] ORA-7.

[156] ORA Report at 43.

[157] *Ibid*.

[158] KTC-12 at 28. KTC describes the services in the most general terms; i.e., "maintenance and programming", "configuration", "monitoring", "program solutions", etc. No details of any actual work were provided.

application, it remains KTC's burden to adequately justify and explain its requests in its application. By providing the explanation for this contract in its rebuttal testimony (which ORA finds to be inadequate nevertheless), KTC has deprived ORA and the Commission of the ability to perform a review of this expense.

Furthermore, KTC also pays for network IT services from Neo Nova Network Services, a company that provides managed IP services for telecommunication companies, municipal organizations and cable companies.[159] KTC fails to explain why the apparently redundant Kertel IT services contract is necessary or reasonable.

Without any supporting documentation, it is simply impossible for ORA to provide a meaningful review of the Kertel services to determine whether the work was actually performed or was necessary and reasonable. The Commission should be especially concerned in light of the fact that Kertel is an affiliate of KTC, and it appears the contract was not executed at "arms-length", in that Mr. William Barcus is the president of both companies, and the contract was entered into without anything in writing and no description of the labor, materials, or work to be done. The Commission should apply strict scrutiny to such deals to determine if they were done at "arms-length". The Kertel contract is for a substantial amount, and it is quite possible that KTC is overpaying for services that were not actually rendered, or are unnecessary. Without any documentation, it is simply impossible to tell. Therefore, KTC's non-corporate expenses should be reduced by the full $696,124 under the category of "Plant Specific."

D. Marketing Expenses For Sebastian

KTC reported that its total actual marketing expenses as of December 31, 2014 were $373,069.[160] As discussed above, KTC does business under the name "Sebastian", as do all of its affiliates. Thus, all of KTC's marketing is under the name "Sebastian", which benefits the parent company and the affiliates to the same extent as KTC.

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[159] *Id.* at 44.

[160] ORA Report at 46.

ORA reviewed a sample of KTC's marketing expense transactions, which revealed that some of its marketing expenses are charged 100% to KTC, while others are allocated between the four affiliated entities doing business as "Sebastian": KTC, Foresthill, Audeamus and Kertel. However, the split between the four entities was not evenly divided 25% to each affiliate. Instead, most were allocated 66.66% to regulated entities (33.33% each to Foresthill and KTC) with the remaining 33.33% split between unregulated affiliates Kertel and Audeamus).[161]

The Commission should question whether marketing expenses for a regulated monopoly are necessary or reasonable, because marketing for KTC's basic telephone service cannot gain more customers or prevent line loss to its competitors – because KTC experiences no competition for basic landline telephone service. In addition, some of the items included in this category as "marketing" expenses were actually for hotel stays and restaurant meals.[162]

Although the Commission could rightly determine that no advertising or marketing expense in rates is reasonable for a regulated monopoly, at a minimum, ORA believes a more reasonable allocation of marketing expense is required. Since SEI operates as KTC, Foresthill, Kertel and Audeamus, the $373,069 (reduced by $42,000 in fees to Audeamus – discussed below) should be allocated using a 25% split to reflect KTC's fair share of the total advertising expenses. Accordingly $248,302 ($331,069 – ($331,069/4)) in marketing expenses should be removed from KTC's total reported non-corporate expenses for ratemaking purposes.

E. Customer Retention Fees Paid To Affiliate Audeamus

KTC's operating expenses include a yearly $42,000 expense for "customer retention fees."[163] KTC pays these fees to its affiliate, Audeamus, on a monthly basis. As described above, Audeamus sells retail broadband services, and charges KTC a

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[161] *Ibid*.

[162] *Ibid*.

[163] ORA Report at 47.

"customer retention fee" for each customer it acquires where the customer also retains telephone service from KTC.[164] This expense is unreasonable, in large part due to the corporate structure of SEI, the parent company of both KTC and Audeamus.

Audeamus purchases wholesale access to KTC's local loop in order to sell retail broadband services to customers in KTC's service territory.[165] The fees that KTC charges Audeamus for wholesale access to its network are assessed according to the NECA Tariff No. 5.[166] However, the "customer retention fees" that Audeamus charges KTC are not established by the NECA tariff, nor any other tariff, even though these fees effectively offset a portion of the wholesale network access fees.

Furthermore, the basis for the "customer retention fees" is questionable. KTC's total working lines have steadily declined since 2010, despite the theoretical "added value" that Audeamus' services contribute.[167] Although it is possible to argue that KTC might have lost even more customers if it were not for the "added value" of Audeamus' broadband services, KTC did not sufficiently demonstrate or quantify the benefits of the "customer retention fees".

KTC and Audeamus are affiliates under the parent company, SEI. These companies are closely intertwined and share common ownership, executive management, and corporate branding.[168] Indeed, both KTC and Audeamus do business as "Sebastian", issuing a single combined "Sebastian" bill to customers who receive both basic telephone service and broadband. KTC's and Audeamus' expenses, revenues and profits are all considered part of SEI's business ventures.[169] Essentially, KTC inflates its regulated expenses with payments to its affiliate for services that have essentially a zero net effect

[164] *Ibid*.

[165] ORA-Report at 47.

[166] *Ibid*.

[167] *Id.* at 48.

[168] *Ibid*.

[169] *Ibid*.

to SEI's bottom line. The $42,000 paid by KTC, doing business as SEI, to Audeamus, also doing business as SEI, is not a reasonable expense for ratemaking purposes. These fees are essentially SEI paying itself to retain its own customers, with ratepayers footing the bill. Accordingly, KTC's total 2014 non-corporate expenses should be reduced by $42,000 under the category of "Customer Operations."

F. Company Rental Apartment

As discussed above, KTC's 2014 expenses used to project 2016 Test Year expenses include the costs of a corporate rental apartment for $1,175 per month or $14,100 per year in Kerman, California. KTC recorded half of this lease expense as a KTC corporate expense and half as a KTC customer operations expense. As explained above, this expense does not appear to be necessary for provision of safe and reliable utility service. Consequently, KTC's total "customer operations" expense category should be reduced by $7,050.

VIII. PLANT, DEPRECIATION AND RATEBASE

The Commission also has jurisdiction to review KTC's Plant in Service, Depreciation, and Ratebase for test year 2016. ORA examined the reasonableness and prudency of those items. In this section, ORA makes certain recommended adjustments, described below. In general, ORA approves of KTC's "Five Year Plan" for additions to plant with one minor adjustment for depreciation of copper assets and another adjustment for "Other Work Equipment". Otherwise, the elements of the Five Year Plan are prudent and reasonably priced, contribute to safety and reliability, and provide greater speeds for broadband services.

KTC's total estimated average balance for Plant in Service for test year 2016 is $49,698,009; with a corresponding average balance for Accumulated Depreciation Reserves of $28,871,342.[170] The intrastate portions of these balances for test year 2016 are $32,237,111 and $18,425,546, respectively.[171] KTC's proposed Test Year Ratebase of

[170] ORA Report at 51.

[171] *Id.*

$12,815,660 is calculated by subtracting the 2016 average Accumulated Depreciation Reserve balance from the average Plant in Service Balance and adding the other components of intrastate Ratebase.[172]

A. KTC's Five Year Plan and Fiber to the Home Project

KTC's "Five Year Plan" consists of projects for the development of Fiber to the Home (FTTH) infrastructure throughout downtown Kerman and eventually to customers outside of the downtown area.[173] KTC states that these projects are necessary because current plant is forty or more years old, and current trends will lead to technological obsolescence of its current copper plant.[174] KTC also states that continued use of existing facilities will necessarily decrease service quality due to increased interference noise and susceptibility to service troubles triggered by environmental issues.[175]

ORA has reviewed the Five Year Plan and finds the projects contained in KTC's Five Year Plan to be prudent and reasonable. ORA concludes that the projects: (1) have comparable costs to projects approved under the California Advanced Services Fund (CASF); (2) align with the Commission's goal of "bridging the gap" between rural and urban broadband development; and (3) support the Commission's focus and advancement of safety.[176]

KTC's estimated total for all of the projects over the three year considered in this rate case (2014-2016) is $7,811,197, which would be added to KTC's ratebase.[177] KTC's proposed projects will affect roughly 5,400 households, for a cost-per-household of $1,447.[178] This estimated cost-per-household falls well within the average of all CASF

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[172] KTC proposes Construction Work in Progress of $1,025,652; Materials & Supplies of $198,257; and Working Cash of $433,000. ORA Report at 51.

[173] KTC-4 at 7.

[174] KTC-4 at 4-5.

[175] KTC-4 at 3.

[176] ORA Report at 53.

[177] KTC-4, Exhibit EK-1.

[178] ORA Report at 54.

approved projects. In 2007, the Commission established the CASF in order to fund new broadband infrastructure to unserved and underserved areas.[179]

According to the FCC, 17% of all Americans, or 55 million people, lack access to the newly established minimum broadband benchmark speeds of 25 Mbps download / 3 Mbps upload.[180] The FCC also found that 53% of individuals who live in rural areas lack access to these speeds, whereas only 8% of people living in urban areas lack access.[181] There is generally wide support for closing the digital divide between urban and rural areas.[182] KTC states that a fiber network based on FTTH technology is necessary to provide high speed service to its unserved or underserved customers.[183] KTC's unregulated affiliate Audeamus currently advertises that it can only provide service up to 20 Mbps download and 2 Mbps upload, which is below the FCC's recently updated broadband benchmark speeds.[184] By completing the proposed projects, KTC's unregulated affiliate would be able to deliver broadband speeds to the KTC service area that match the capabilities of the systems found in urban areas.[185] This advances the Commission's goal of closing the gap in service between urban and rural broadband availability.

ORA finds safety benefits to the FTTH projects as well. During emergency situations without extended periods of power loss, fiber systems allow for rapid communication between hospitals, first responders, and other anchor institutions that can

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[179] Interim Opinion Implementing California Advanced Services Fund, D. 07-12-054.

[180] FCC Finds US Broadband Deployment Not Keeping Pace, Jan. 29, 2015, *available at* http://www.fcc.gov/document/fcc-finds-us-broadband-deployment-not-keeping-pace .

[181] *Ibid*.

[182] Mark Baldassare, Dean Bonner, Sonja Petek, Jui Shrestha, California's Digital Divide, Public Policy Institute of California, available at: http://www.ppic.org/main/publication_show.asp?i=263

[183] Direct Testimony of Eric Kehler, Nov. 3, 2014, pg. 7.

[184] Sebastian Price List For Kerman CA, *available at* http://sebastiancorp.wpengine.com/wp-content/uploads/2013/04/Sebastian-Price-List-Kerman-CA-2.10.15.pdf .

[185] KTC-4 at 3.

enable better responses to situations as they arise.[186] Furthermore, many new medical and educational applications, such as Common Core online modules and telemedicine, require higher speed broadband than KTC's current copper based system can provide.[187] Even in times of emergencies, a study by the FTTH Council found that less than 1% of households currently rely on a corded phone powered by copper lines during electrical outages.[188]

However, two major safety concerns identified by the Commission are the lack of requirements governing back-up power and consumer notification and education about the impact of the transition.[189] In the event of an emergency, copper has proven to be a valuable resource since it works regardless of whether or not there is power in the affected area.[190] FTTH only lasts as long as back-up power sources allow. The current life of most back-up power sources, which are generally battery back-ups, is only 4-8 hours.[191] Also, the use of backup power changes the expectations of how telephone service is provided. The current expectation is everything outside the customer premises is provided by the telecommunications provider, while the inside wiring and phone itself

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[186] *See, e.g.* Reply Comments of the Schools, Health and Libraries Broadband Coalition, In the Matter of A National Broadband Plan for Our Future, GN Docket No. 09-51.

[187] *See, e.g.* Reply Comments of the Schools, Health and Libraries Broadband Coalition, In the Matter of A National Broadband Plan for Our Future, GN Docket No. 09-51.

[188] Reply Comments of Fiber to the Home Council Americas on the Technology Transitions NPRM, In The Matter of Technology Transitions, GN Docket No. 13-5, March 9, 2015.

[189] Comments of the California Public Utilities Commission, In The Matter of Ensuring Customer Premises Equipment Backup Power for Continuity of Communications, PS Docket No. 14-174, Feb. 26, 2015, pg. 3-7.

[190] ORA Report at 56. In the event of a power outage, copper based telephone systems are able to maintain service. Copper wires maintain an electric current provided by a central office and do not require any outside power. These central offices maintain multiple forms of backup power generation, from battery storage systems to diesel generators, allowing all phones in an area that are directly connected to the line (that is, excluding cordless / wireless phone systems) to remain viable methods of communication.

[191] ORA Report, Attachment 3-6: "Typically, any type of battery power will only last for four hours or less under constant use." Kerman Telephone Company Directory– What To Do To Make Sure You Have Phone Service In The Event Of A Power Outage; 5.1 U-Verse Equipment, Battery Backup Info, Broadband DSL Reports, http://www.dslreports.com/faq/17756 .

is provided by the customer. In this instance, consumers are left with the additional burden of determining who is responsible for continued maintenance of the back-up battery.[192]

Some of these concerns have been addressed by Mr. Kehler in his rebuttal testimony, which contains a sample handout to customers that explains these battery backup power issues. [193] Nevertheless, to ensure ongoing safety ORA recommends KTC be required to submit a Tier 3 Advice Letter six months after a final decision in this proceeding proposing a plan to mitigate potential safety concerns and to educate customers about the impact of the transition (including new responsibilities that customers must assume).

B. Disallowance of Accelerated Copper Depreciation

KTC is proposing to replace its current copper based services with FTTH technology at a cost of $7,811,197 added to ratebase. As part of this proposal, KTC is requesting accelerated depreciation of its Underground Metallic and Buried Metallic Cable and Wire Facilities,[194] which are the associated accounts of the copper wire infrastructure as noted in Table 3-1 of ORA's Report. Mr. Kehler testified that the copper depreciation is necessary because metallic cable facilities are "not capable of providing the services customers will need and are demanding. As such, these facilities will likely need to be replaced long before they become fully depreciated under the existing lives."[195] In other words, copper wires cannot currently deliver broadband at necessary speeds, and KTC wants to remove them immediately.

However, unlike many utility replacement projects that occur when the plant involved is in disrepair or can no longer provide useful service, KTC's current copper

[192] *Id.*

[193] KTC-5, Attachment EK-2.

[194] KTC-4 at 10-11.

[195] KTC-4 at 11.

plant is still useful and in good repair.[196] Furthermore, KTC's current plant has the capacity to exceed current CPUC and FCC minimum standards for broadband services in rural areas.[197]

In addition, under the current CASF guidelines, KTC's FTTH project would probably not qualify because KTC's service area is already deemed "served" as it exceeds the minimum threshold for broadband service in rural areas. Moreover, Comcast already serves over 70% of the Kerman area.[198] Essentially, KTC is requesting that used and useful copper be removed and depreciated at an accelerated rate so that it can advance its Five Year Plan. Thus, to ensure fairness to ratepayers and contributors to the CHCF-A, ORA recommends disallowing the accelerated copper depreciation in order to more equitably distribute the costs of building the fiber networks immediately. As Mr. Goldman stated at the hearing, ORA seeks to "strike a balance that is fair to California ratepayers with allowing some of that cost to be absorbed by Sebastian while they still receive the full 7 million roughly cost of the projects for development."[199]

Therefore, ORA recommends that Sebastian's shareholders bear the total cost of the $350,031 in estimated accelerated depreciation expense related to existing underground copper wire facilities for Test Year 2016, to offset the $7,811,197 in new FTTH projects that would be added to KTC's ratebase.

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[196] "Kerman has not had any significant service quality issues… [and] the standards established by the Commission for service quality have all been met." Direct Testimony of Eric Kehler, Nov. 3, 2014, pg. 11; ORA Report, Chapter 5: Service Quality and Reliability Performance.

[197] In The Matter of Connect America Fund, WC Docket No. 10-90, FCC 14-190, Dec. 18, 2014, pg. 6, ¶ 15; Order Instituting Rulemaking to Consider Modifications to the California Advanced Services Fund Including Those Necessary to Implement Loan Program and Other Provisions of Recent Legislation, Decision Implementing Broadband Grant and Revolving Loan Program Provisions, CPUC D. 12-02-015, Feb. 1, 2012, pg. 17; Sebastian – Kerman Price List as of 2/10/2015, *available at* http://sebastiancorp.wpengine.com/wp-content/uploads/2013/04/Sebastian-Price-List-Kerman-CA-2.10.15.pdf; Attachment 3-7: Xfinity Advertised Speed for Extreme 150 Product as of 3/13/15 for Kerman, CA.

[198] ORA Report at 59.

[199] HT, 641:12-17.

C. Adjustment For Other Work Equipment that KTC Leases to its Affiliates

ORA recommends one additional adjustment to ratebase. KTC's proposal for plant in service during the Test Year 2016 includes an account for "Other Work Equipment." During Test Year 2016, KTC projects the "Other Work Equipment" account to have an average balance of $1,249,638, with related accumulated depreciation of $566,870 for a net total of $682,768 in ratebase.[200] This account consists of construction equipment such as: cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment, and concrete saws.[201]

ORA recommends that KTC's ratebase for the Test Year 2016 should exclude the entire plant balance recorded in the account "Other Work Equipment" and any related accumulated depreciation for this account. KTC does not use the equipment that has been recorded to this account to provide services to customers.[202] KTC maintains few employees who are qualified to use this equipment, because the majority of its construction personnel have been transferred to its affiliate Kertel.[203]

Instead, KTC rents or leases the construction equipment solely to its unregulated construction affiliate, Kertel.[204] KTC outsources its construction to Kertel and provides Kertel with the equipment necessary to perform Kertel's construction services on a time-leased basis.[205] However, KTC is a telephone company, not an equipment rental company, and its Ratebase should not include unnecessary plant in service that does not directly support KTC's provision of services.

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[200] ORA Report at 60.

[201] KTC-4 at 9.

[202] ORA Report at 60.

[203] Hearing transcripts at 266.

[204] ORA Report at 61.

[205] *Ibid*.

In addition, the hourly lease rates that KTC charges its unregulated affiliate Kertel are below the market prices for other construction equipment rental companies.[206] KTC purports to use a "GE-100 model", which is an outdated and unused cost standard that, in this particular situation, produces unreasonable lease rates for the construction equipment.[207] Table 3-3 in ORA's Report provides a comparison of similar equipment for the rates KTC charges Kertel versus the market rates of unaffiliated equipment rental companies that ORA researched.[208] At a minimum, the Commission should impute fair market rates for this lease equipment into KTC's revenues.

IX. COST OF CAPITAL

"Cost of Capital" (also referred to as Rate of Return) is the amount of money that the utility has the opportunity to earn on its ratebase.[209] Calculating the cost of capital (COC) requires consideration of three components: cost of equity, cost of debt, and capital structure, each of which are important and will affect the final cost of capital.[210] Once calculated, the cost of capital is applied to the amount of ratebase and is incorporated into the utility's revenue requirement.[211]

This section describes ORA's recommendation for KTC's COC, with an explanation of the three important components of the calculation. This section then demonstrates that KTC's requested COC is unreasonably high and based on faulty assumptions.

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[206] ORA Report, Attachment 3-8. Mr. Clark stated "I would oppose using it [the current market value rates] in terms of calculating any of our revenue requirement, primarily because at a market level lease I don't believe Kertel would lease our equipment." Hearing Transcripts at 267-268.

[207] "A GE-100 analysis form or its equivalent was in general use by the and the LECs from the early 1960s to the late 1970s to establish rates and charges based on fully allocated costs for customer premised telephone equipment and specialized telecommunications services." *See* Decision 90-11-029, Finding of Fact #13.

[208] ORA Report at 62.

[209] ORA Report at 64.

[210] *Ibid*.

[211] *Ibid*.

A. Recommendation

ORA recommends the Commission adopt a return on equity of 8.79%, a 3.2% cost of debt, and a capital structure of 60% debt to 40% equity, which yields an overall 5.44% rate of return. The differences between Kerman's and ORA's positions are shown below in Table 4-1 of the ORA Report and discussed in the following sections.

Table 4-1: Comparison of Kerman and ORA Positions			
		Kerman	ORA
Capital Structure	Debt %	20%	60%
	Equity %	80%	40%
Cost of Debt		3.2%	3.2%
Return on Equity		16.24%	8.79%
	Cost of Capital	**13.63%**	**5.44%**

The Commission's formula for cost of capital involves the capital structure of the company, the cost of debt incurred to borrow money, and the cost of equity.[212] The total weighted cost of capital will vary as any one of the three variables changes. Alternatively, if the cost of capital is fixed and any two of the three variables are also fixed, the third variable can be found.[213]

1. Capital Structure

The Commission has held that a utilities' capital structure "should reflect their collective efforts to finance themselves so as to minimize capital costs while preserving their financial integrity and ability to attract capital."[214] Debt is fairly inexpensive compared to equity, therefore it is not in the financial interest of ratepayers to have a high

[212] The formula is [(rate of return)-(debt)*(cost of debt)]/(equity).

[213] ORA Report at 68.

[214] D.97-04-032 at 5.

equity-to-debt ratio; conversely, an unreasonably high debt level may present risks to the company's financial well-being.

The Commission typically adopts a capital structure that is in a reasonable range. In D.97-04-032, the Commission stated "a reasonable range of common equity for small telephone companies, such as applicant, is between 60% and 80%." The Commission held that "Such an equity range provides applicant the opportunity to preserve its borrowing capacity so that it will have ready and continuous access to adequate capital to meet its service requirements to customers."[215] Thus, ORA finds KTC's current actual capital structure of 49.1% debt to 50.9% equity to be very reasonable, in that it is not above 80% and KTC has maintained adequate borrowing capacity at its actual capital structure at reasonable borrowing rates.

In the 2015 Sebastian Strategic Plan that ORA obtained, KTC identified a target capital structure of 60% debt and 40% equity for its regulated operations.[216] ORA accepts this target goal for purposes of calculating the rate of return, because it represents a reasonable expectation of what KTC will do in the future with regards to its capital structure. Using this ratio produces a result that is more indicative of what will actually occur in the future with regards to KTC's rate of return.

a) KTC's Imputed Capital Structure Should Be Rejected

ORA has significant concerns with Kerman's hypothetical capital structure of 20% debt and 80% equity being used to calculate an overall rate of return.[217] This ratio does not reflect KTC's reality or its projections for the test year. KTC attempts to justify imputing this artificial ratio due to "increased uncertainty surrounding the future revenue streams for small local telephone companies", which it claims justifies the high equity amount. However, ORA's major concerns with KTC's 20/80 ratio are: first, ORA finds

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[215] D.97-04-032.

[216] ORA Report at 68. See also ORA-4, which is the relevant page of Sebastian's Strategic Plan 2015 for its regulated entities.

[217] ORA Report at 68.

KTC's fears of uncertain revenue streams to be not credible; second, that KTC's strategic plan and actual capital structure indicate that KTC has no intention of achieving a 20/80 ratio; and third, that KTC uses this amount for the sole purpose of conveying a false appearance that its return on equity is in a reasonable range, when in fact it is not.

KTC's fears of "uncertainty" are misplaced because substantial regulatory mechanisms are in place at the state and federal level that help to ensure the recovery of authorized revenue requirements and the viability of small local telephone companies. The CHCF-A and the federal Universal Service Fund (USF) are two mechanisms that ensure consistent and reliable revenue streams. There is no basis for incorporating an artificially high equity ratio into the cost of capital to account for perceived risks that do not exist.

Moreover, KTC's Strategic Plan has a 60/40 target ratio, which shows that KTC does not actually fear uncertainty as much as it claims. If KTC's fears were real, its strategic plan would call for higher equity ratio.

Furthermore, the Commission's concern where "a utility's actual equity ratio is too high or too low" indicates a concern over extremely high or extremely low equity ratios, not ratios in the mid-range.[218] The Commission stated "This is because a utility's capital ratio affects its equity return, the more equity in the capital structure, the lower the return."[219] Essentially, the Commission found that extreme ratios, either too high or too low, were not financially sound. In other words, the 60% to 80% zone of reasonableness is like a ceiling, in that companies should not go above the 80% threshold.

This concept was acknowledged by Mr. Burke. He stated:

> Regulatory bodies may use a hypothetical capital structure that differs from the historical or expected capital structure of the utility if that actual capital structure leads to an unreasonable result for determining the overall cost of capital. For example, a capital structure that is 100% equity funded

[218] D.97-04-032 at 5.

[219] D.97-04-032 at 5.

> may be deemed unreasonable or inefficient, leading to an inflated rate of return. Likewise, if the level of debt capitalization is too high, it may subject the utility to unreasonable risks or impairment of capital.[220]

Thus, if the Commission found that a utilities' capital structure is too extreme, it might impute a number more towards the middle in order to ensure a reasonable and financially sound outcome when applying the COC formula. Equity ratios in the mid-range, such as KTC's actual levels, are not a cause for concern.

However, KTC treats the 60% to 80% range as a *floor*. KTC recommends that the Commission grant it *no less than* a 20/80 ratio which turns the equity ceiling concept on its head. But this is directly contrary to the Commission decisions and the testimony of its own witness. Clearly, the Commission intended for utilities to have reasonable debt-to-equity ratios in the middle of spectrum, not at the far ends. Thus, if KTC's current and actual capital structure is at a reasonable level, there is nothing in the Commission decisions that require it to assume a more lop-sided and extreme result.

Table 4-2 of ORA's Report illustrates how arbitrarily selecting a high equity to debt ratio results in what appears to be a more reasonable level of return on equity, when in fact it is not. Variables in the formula can be manipulated by raising one variable which can cause another variable to decrease. This becomes apparent when looking at the consequences of different equity ratios.

[220] KTC-15 at 6.

Table 4-2: Comparison of Kerman's Exhibited and Implied Return on Equity		
	Exhibited ROE presented in Kerman Workpapers	Implied ROE using Kerman's Target Capital Structure
(1) Rate of Return	13.63%	13.63%
(2) Debt	20%	60%
(3) Equity	80%	40%
(4) Cost of Debt	3.2%	3.2%
Return on Equity [(1)-(2)*(4)]/(3)	**16.24%**	**29.28%**

If KTC were to achieve the debt-to-equity ratios projected in its Strategic Plan, it would in fact earn a return on equity of 29.28%, which is clearly far above reasonable investor expectations.

2. Cost of Debt

KTC's supplemental testimony requests a cost of debt of 3.2%.[221] KTC's calculation is based on the company's interest expense from its 2013 audited financial statements divided by the average long term debt outstanding during 2013.

As discussed above (see Footnote 28), ORA is concerned that continually providing updated "actuals" creates procedural problems for the Commission and ORA in providing a final analysis. For cost of debt, in its Rebuttal Testimony, KTC states that the end-of-year updated cost of debt is 3.76%.[222] While ORA has not had the opportunity to verify this data with audited 2014 financial statements, ORA does not dispute this updated number for cost of debt.

[221] KTC-16 at 7.

[222] KTC-17 at 10.

3. Cost of Equity

The cost of equity, also referred to as return on equity (ROE), is the return an investor expects for the level of risk inherent in the investment.[223] The lower the risk the lower the expected return.[224] In seeking equity investors, utilities compete with other sellers of common stock, or in the case of privately held utilities, the owners (investors) have the option of making investments elsewhere. Since regulated utility stocks are generally regarded as relatively safe investments, a typical investor in utility stocks is selecting a lower risk of loss coupled with a steady stream of dividends or predictable earnings.[225]

The return on equity is typically calculated using one or more financial models. Both Kerman's and ORA's return on equity calculations are based on the Capital Asset Pricing Model (CAPM).[226] When calculating return on equity, the CAPM utilizes two numbers: the forecasted risk-free rate of interest,[227] and the "equity risk premium," which is the amount of additional return required to produce a return on equity high enough to attract the necessary capital.

ORA recommends a return on equity of 8.79%. ORA's calculated cost of equity is the risk free rate of 2.91% plus an equity risk premium of 5.88%, which equals 8.79%. ORA uses the recent three-year average of the 20-year Treasury rate of 2.91% as of January 5, 2015 to estimate the risk-free rate.[228]

ORA recommends using an equity risk premium of 5.88% because it falls within the range of historical analysis, while moving closer to the findings of more recent

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[223] ORA Report at 70.

[224] *Ibid*.

[225] *Ibid*.

[226] ORA Report at 71.

[227] The "risk free rate" is generally defined as the forecasted yield on the U.S. Treasury bonds over the next several quarters.

[228] ORA Report at 71.

academic studies and more recent market returns.[229] On May 16, 2013, the Wireline Competition Bureau of the Federal Communications Commission issued a Staff Report titled "Prescribing The Authorized Rate of Return". In this report the average market (equity) premium for the period 1928 – 2012, was shown to be 5.88%. For its 2014 Assessment Year, Telecommunications, the Washington Department of Revenue used an average risk premium of 5.0% derived from multiple sources.[230]

a) KTC's Recommended Return on Equity is Excessive

KTC uses a modified CAPM that differs from ORA's recommendation in several respects, including the Risk Free Rate, Equity Risk Premium, Size Premium, and an Industry Risk Premium. KTC elected to incorporate additional factors for an Industry Risk Premium and a Size Premium. KTC's analysis results in an effective equity return of 29.28% (if one uses actual numbers for capital structure and a set amount for rate of return). The ROE implied in Kerman's proposed rate of return is more than three times greater than the average return calculated by CAPM models used by other regulatory bodies. KTC states that its requested cost of equity is "only" 16.24%, but this can only be calculated by assuming an artificial 20% debt to 80% equity ratio, as described above.

Table 4-4: Cost of Equity Computations

Description	Kerman	ORA
Risk Free Rate	4.47%	2.91%
Equity Risk Premium	6.96%	5.88%
Industry Risk Premium	- 1.18%	n/a
Size Premium	5.99%	n/a
Cost of Equity	**16.24%**	**8.79%**

[229] ORA Report at 73.

[230] ORA Report, Attachment 4-2: Department of Revenue Washington State, Cost of Capital Study, Telecommunications, 2014 Assessment Year, page 6.

The first difference between KTC and ORA is in the risk-free rate selected by KTC. KTC based its risk-free rate on an average of the 20-year Treasury rate over the period from January 3, 2000 through October 24, 2014. However, the resulting average does not reflect current 20-year Treasury rates which are currently 2.32% as of January 5, 2015.[231] The recent three-year average represents the more likely borrowing costs during the rate cycle. By using the period 2000 to 2014, KTC captures a period of much higher rates than are unlikely to occur in the next 3 years. The averages of both 20-year and 30-year Treasury rates have been declining since 2000 and current rates more accurately reflect current and near term financial conditions. Moreover, contrary to the suggestion of KTC's witness that rates were likely to be increased[232], at the recent June 2015 Federal Reserve Board meetings the Fed held rates unchanged.[233] KTC's proposed risk-free rate does not adequately reflect recent rates or current rates, and it is well above the current reasonable range and should not be adopted.

The second difference is in the equity risk premium. KTC estimated an equity risk premium of 6.96%. One way to estimate the equity risk premium is to compare the mean returns on bonds and stocks over long historical periods. Measured in this manner, the equity risk premium has been in the 5% to 7% range. However, studies by leading academics indicate the forward-looking equity risk premium is actually in the 4.0% to 5.0% range.[234] These lower equity risk premium results are in line with the findings of equity risk premium surveys of CFOs, academics, analysts, companies, and financial forecasters.[235]

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[231] ORA Report, Attachment 4-3.

[232] HT 734:19.

[233] http://blogs.wsj.com/economics/2015/06/18/grand-central-a-roadmap-for-2015-and-other-takeaways-on-fed-june-meeting/

[234] Testimony of Dr. J. Randall Woolridge On Behalf of the Division of Ratepayer Advocates Cost of Capital Applications 12-05-001; 12-05-002; 12-05-004; 12-05-005; San Francisco, California August 27, 2012, Attachment JRW-11, pages 5-6; www.ora.ca.gov/DrWoolridgeTest.aspx

[235] *Id.*

The third difference is a size premium of 5.99%, which KTC derived from data included in the Duff & Phelps 2014 Valuation Handbook – Guide To Cost of Capital. However, as a rate regulated entity supported by both state and federal mechanisms to subsidize and guarantee revenue, the risk associated with Kerman's size is moot. Furthermore, the FCC in its analysis on the issue of size premiums found that recent research indicates that the size effect seems to vary over time or even disappears, with smaller firms in the United States not performing significantly better than large ones from 1980 onward and therefore did not recommend adding a risk premium based upon firm size to the cost of equity.[236]

Finally, ORA does not include an explicit adjustment to reflect a size premium, which is consistent with recent professional observations and FCC determinations.[237] Although Kerman's proposed negative adjustment would lower ROE, ORA does not include an explicit industry risk adjustment in its estimate because not all the firms included in the 4813 SIC Code are regulated telephone companies.

B. Conclusion - Rate of Return

KTC's requested cost of capital is 13.63%, which is substantially higher than the 10% it has been permitted historically. Moreover, KTC uses an artificial equity ratio to impute a hypothetical debt to equity ratio that does not reflect reality, to artificially achieve their intended result. If KTC's target capital structure is considered, in effect KTC will receive 29.28% in investor returns, which is excessive and unreasonable.[238] KTC's proposed rate of return is counter to all reasonable analysis of market changes that have occurred since 1997 when the Commission adopted 10.00% as the weighted average cost of capital for the small telephone companies. Current historically low Treasury rates should logically be reflected in lower adopted costs of capital than those adopted during times of higher Treasury rates.

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[236] FCC, "Prescribing the Authorized Rate of Return," WC DOCKET NO. 10-90, 5/16/2013

[237] ORA Report at 73.

[238] This assumes 60/40 equity ratio, and keeps the 13.63% requested rate of return.

ORA has focused its analysis on identifying a reasonable capital structure and determining a reasonable cost of equity that reflects reasonable investors' expectations. Combining the results of this analysis yields an overall cost of capital of 5.44%, but investors will receive a healthy 8.79% return on their equity. The overall cost of capital calculated and recommended by ORA will result in a reduction of approximately $1.7 million in revenue requirements.

X. SERVICE QUALITY

ORA examined KTC's compliance with service quality and reliability standards, such as General Order (GO) 133-C regarding Out of Service Repair and Installation Commitment Intervals and Customer Trouble Reports.[239] Overall, ORA finds KTC's service quality to be good. This section also addresses potential gaps in security and safety, particularly as it relates to disaster planning and preparedness.

A. GO 133-C

ORA examined KTC's compliance with specific provisions of GO 133-C, and found that KTC meets the minimum standards. ORA looked at telephone service installation intervals, installation commitments, customer trouble reports per number of 100 working telephone lines, and out of service repair intervals. ORA found no issues with these standards, as summarized on Table 5-1 of ORA's Report.

B. Other Issues

1. Disaster/Service Outage Communications Plan

ORA reviewed Kerman's "Disaster/Service Outage Communications Plan".[240] The Plan outlines disaster protocols and provides useful contact information. ORA identified two areas of potential concern in Kerman's Disaster Services Outage Plan. The first relates to contact information for community organizations that are beneficial in times of disaster. Potentially valuable contact information for the Red Cross and the SPCA is absent in Kerman's Disaster/Service Outage Communications Plan, Community Contacts

[239] ORA Report at 75.

[240] ORA Report at 77.

section. Therefore, ORA recommends that contact information for the American Red Cross, and animal protective services such as the SPCA to be included in Community Organizations section of the Disaster/Service Outage Communication Plan.

The second issue regards fuel for maintaining service during an extended power outage and or disaster. For public safety and continuity of service Kerman should ensure that an adequate supply of fuel is readily accessible at all times in the event of disaster or a prolonged power outage. Kerman should make a compliance filing describing in detail its internal standards, methods, and procedures for ensuring that an adequate and readily accessible supply of fuel is available for maintaining services during disasters and prolonged power outages.

2. Alarm Protocols

While touring the Kerman Central Office Building ORA photographed signage indicating that there may be a faulty manual process for detecting and reporting temperature changes which could adversely affect essential services.[241] The photograph shows a temperature in the room of sixty-three degrees and the signage states: "the temperature range of this room needs to be between 68-70 degrees." The picture indicates a failure to remedy falling temperature promptly. This situation captured photographically is a clear indication of benefits that might be derived by an automated reporting system and redundant reporting of alarm conditions being met.

Therefore, KTC should file a report with the Commission within 90 days which provides an analysis of the net benefits gained from adding redundancy to its alarm notification protocol such that a call is made automatically to designated managers off-site when temperature, moisture, and sprinkler activation occurs.

3. Availability of Tariffs

Kerman's tariffs are currently not available on its website and therefore not readily accessible to customers or the Commission.[242] General Order 96-B strongly urges all

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[241] ORA Report at 78.

[242] *Ibid*.

utilities to keep up-to-date tariffs on their website.[243] Having tariffs readily available in searchable electronic form in Kerman's website would enable customers and prospective customers to view the rates, terms and conditions of service. In order to advance customer protections, Kerman should be ordered to make its tariffs available in searchable electronic form on its website.

XI. CONCLUSION

The Commission's statutory obligation is to provide rural high cost carriers with a fair opportunity to earn a reasonable return on its investments and to attract capital for investment on reasonable terms, while also ensuring that the state-funded subsidies given to them are not an excessive burden on ratepayers. In this case, the Commission should be concerned that KTC is proposing an increased subsidy amount for test year 2016 that is **70%** greater than the 2015 authorized amount. ORA's analysis shows that KTC's subsidy request includes dozens of examples of undue, unreasonable and imprudent costs and expenses. For example, KTC requests a 13.63% rate of return, which is higher than any historical norm, and would in effect provide shareholder returns over 29%. KTC also requests imprudent and unnecessary expenses such as sponsorships of polo festivals and Fresno State sporting events. The Commission should apply the corporate expense cap, as adopted in D.14-12-084, to limit unreasonable expenses. ORA's analysis provides numerous instances where KTC could limit its expenses in order to meet the cap and avoid excessive burdens on the rest of the state, which must pay for the subsidies.

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[243] General Order 96-B, section 8.1.2.

Respectfully submitted,

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