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**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

In the matter of Application of Kerman Telephone Co. (U 1012 C), 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.

A. 11-12-011
(Filed December 28, 2011)

**NOTICE OF EX PARTE COMMUNICATION
OF KERMAN TELEPHONE CO. (U 1012 C)**

Mark P. Schreiber
Patrick M. Rosvall
Ann L. Ten Eyck
Priya D. Brandes
COOPER, WHITE & COOPER LLP
201 California Street, 17th Floor
San Francisco, California 94111
Telephone: (415) 433-1900
Facsimile: (415) 433-5530
Email: prosvall@cwclaw.com

Attorneys for Kerman Telephone Co.

May 6, 2016

NOTICE OF EX PARTE COMMUNICATION

Pursuant to Rule 8.3 and 8.4 of the Commission's Rules of Practice and Procedure, Kerman Telephone Co. (U 1012 C) ("Kerman") hereby provides notice of the following *ex parte* communications.

On May 3, 2016, Patrick M. Rosvall (Kerman's attorney), Priya D. Brandes (Kerman's attorney), David Clark (Kerman's Regulatory Manager), and Rhonda Armstrong (Kerman's Vice President of Operations) (collectively, "Kerman Representatives") held two meetings with Commissioner advisors related to the Proposed Decision that the Commission released in the above-captioned proceeding. Starting at approximately 11:30 a.m. through 12:15 p.m., the Kerman representatives met with Advisor to President Picker, Christine Hammond. From approximately 1:00 p.m. through 1:30 p.m., the Kerman Representatives met with Advisor to Commissioner Peterman, John Reynolds. Each of these meetings occurred in the conference rooms at 505 Van Ness Ave, San Francisco, California. Written materials were exchanged in connection with the meetings. Kerman Representatives provided Ms. Hammond and Mr. Reynolds with portions of the record pertaining to depreciation expense, operating expenses, other work equipment expense, and State regulatory proceedings in which Kerman was an active participant. Attached hereto as Exhibit A is a true and correct copy of the aforementioned portions of the record that were provided to Ms. Hammond and Mr. Reynolds. In addition, Kerman Representatives provided Mr. Reynolds with a copy of the Proposed Decision. Attached hereto as Exhibit B is a true and correct copy of the Proposed Decision.

During each meeting, the Kerman Representatives expressed significant concerns regarding the Proposed Decision and demonstrated ways in which it deviates from the record and the law. The Kerman Representatives emphasized how profoundly damaging this Proposed Decision would be if adopted, and that Kerman would be faced with negative net earnings. The Kerman Representatives explained that the Proposed Decision would reduce revenue requirement below the levels adopted as reasonable in Kerman's

2008 and 2003 rate cases.

The Kerman Representatives highlighted the errors in the Proposed Decision, including identifying errors with the depreciation expense, operating expenses, rate case expenses, other work equipment expense, and the warehouse/annex expense. The Kerman Representatives explained that:

- The Proposed Decision wrongfully disallows depreciation on Kerman's copper plant that is in service and will continue to be in service in the foreseeable future. A depreciation estimate for Kerman's copper plant is included in Kerman's rate base. A map of the Kerman local exchange that was part of an exhibit on the record clearly demonstrates a majority of the Kerman exchange is unaffected by the FCC 5 Year Plan for the replacement of copper with fiber technologies.
- It is not true that Kerman does not use its "Other Work Equipment." To the contrary, "Other Work Equipment" is used on a fairly regular basis and is necessary to respond immediately to emergency situations.
- The terms of the oral contract between Kerman and Kertel are in the record (Data Request No. ORA-A.11-12-001 CC3002). This includes a detailed estimated hourly expense for each service provided by Kertel, including security, equipment installation and repair, maintenance, upgrades etc. The process used to negotiate and review the oral contract is also in the record. Further, Kertel identifies power supply needs and ensures the network's functionality with necessary emergency requirements of a carrier grade switched network.
- The annex/warehouse lease was not executed for the first time right before the hearings; it was re-executed because the signed version was lost. ORA had a copy of the lease long before the hearings.
- Rate case expense for a regulated utility is necessary and is unavoidable.

The Kerman Representatives explained that these are necessary expenses that Kerman would continue to incur, irrespective of the Commission's decision. Since it cannot avoid

them, negative net earnings is likely to result.

In addition, the Kerman Representatives suggested that the Proposed Decision's affiliate proposals would unreasonably restrict Kerman's ability to efficiently manage its operations. The Kerman Representatives explained that these affiliate proposals are outside of the scope of this proceeding and should be addressed, if at all, in a generic rulemaking where all perspectives from all parties could be considered upon proper notice.

The Kerman Representatives explained that it would be more appropriate to defer the issue related to cost of capital to the open, ongoing proceeding, in which Kerman's cost of capital is currently being examined along with the cost of capital for other Independent Small LECs. Addressing cost of capital issues in this matter creates the possibility for confusion and inconsistent results. The Kerman Representatives proposed that Kerman's rate of return remain at 10% until conclusion of the generic cost of capital proceeding, after which Kerman's rate of return could be adjusted prospectively to match the results of that proceeding.

Finally, to adequately address the Proposed Decision's shortcomings, Kerman requested a hold from both Ms. Hammond and Mr. Reynolds.

This notice has been provided to the service list for A.11-12-011, as stated in the Certificate of Service attached hereto. Please direct any questions regarding this notice to prosvall@cwclaw.com.

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EXHIBIT A

IT SERVICES

KERMAN TELEPHONE CO.
ORA-A.11-12-011 CC3003
Kerman GRC Test Year 2016 (A.11-12-011)
February 23, 2015
Supplemental Response to Question 1

The following narrative statements and associated documents provided with this response constitutes Kerman Telephone Co.'s ("Kerman") supplemental response to Data Request No. ORA-A.11-12-011 CC3002. This supplemental response specifically addresses the request for supporting documentation for sample expenses related to internet technology ("IT") expenses.

This supplement is being provided subject to the objections and clarifications identified in Kerman's initial response. Further, this supplement does not constitute an agreement or admission by Kerman regarding the sufficiency of its initial response. Kerman's initial response to Question 17 was based on Kerman's understanding of the question presented in the Data Request. These supplemental responses are provided pursuant to clarifications and follow-up requests identified by ORA, which Kerman did not believe were within the scope of the question, as initially presented.

Subject to and without waiving the above objections, Kerman responds as set forth below. Kerman reserves the right to offer additional objections to this data request at any time and further reserves the right to challenge the admissibility of the information provided herewith in this proceeding. Should you have any questions regarding these responses, please direct your further questions to Kerman's attorneys Patrick M. Rosvall (prosvall@cwclaw.com) or Lisa P. Tse (ltse@cwclaw.com).

Data Request No. ORA-A.11-12-011 CC3002

1) **For each amount selected in the attached excel spreadsheet labeled, "ORA Sample Expenses – Kerman," please provide all supporting documentation. The supporting documentation should include but not be limited to: purchase orders, invoices, agreements/contracts when applicable (example: prepaid expenses, partial/allocated expenses, leases, rents), bank statements and reconciliation to support amounts represented as "bank reconciliation", Credit card statements to support related fees, sample marketing materials, explanation of any subsequent adjustments affecting any amount selected.**

SUPPLEMENTAL RESPONSE:

Kerman objects to this data request to the extent that it seeks information or documentation that is not within Kerman's custody, care, or control. Kerman understands, based on follow-up discussions and correspondence from ORA, that ORA is seeking supporting documentation in the form of a formal executed agreement or contract that describes the terms and conditions for the line item IT expenses identified in the list of sample expenses provided in the Data Request. Subject to these objections and clarifications, Kerman responds as follows:

Kerman has not entered into a formal executed agreement or contract with Kertel Communications (“Kertel” or “Fresno”) for the IT services performed for Kertel on behalf of Kerman. The charges were developed based on an initial assessment made by Kerman and its affiliate regulated telephone company, Foresthill Telephone Co. (“Foresthill”), regarding Kerman’s and Foresthill’s computer-related service requirements, or specifically for Data Center and IT Network Services. These estimated requirements are identified and summarized in the charts below:

Estimated Yearly Work Hour Distribution by Task

Data Center	%	Hours
Helpdesk ticket responses	37.53%	1,434
Programming for reporting	11.73%	448
Custom programming	8.53%	326
Server & Network Monitoring & management	7.68%	293
Billing Support	6.40%	244
Software Monitoring & Management	5.97%	228
Database (SQL) Management	6.18%	236
Validate & Update Inventory/Purchasing	3.84%	147
Security	3.41%	130
Microsoft Maintenance	2.99%	114
Backup Process Monitoring & Management	4.04%	155
Administration	1.71%	65
TOTAL	100%	3,822

IT Network Services	%	Hours
Report Generation, Customer Service, Training	4.5%	319
Equipment Install	7.0%	494
Equipment Repair	1.8%	125
Maintenance, Upgrades, Blades, Shelves, GR303, Routines, Etc.	7.6%	542
Service Order # (jumpers, testing, provisioning, tech calls)	8.9%	632
Nortel CS1500 Switch Provisioning Translations	18.9%	1,343
Testing with ATT, Verizon, Etc.	4.0%	282
T1s, Trunks, Specials, File Docs	5.5%	389
Testing PRI, Repair T1 Equip	2.7%	195
Trouble Ticket #	1.2%	82
Administration, Network Maintenance, Database Administration	34.3%	2,431
Work Order #	3.7%	265
TOTAL	100%	7,098

Estimated Combined Total Yearly Hours	10,920
Estimated Hourly Bill Rate	\$100.00
Estimated Annual Costs	\$1,092,000

Based on the functions and tasks that would need to be performed by the Data Center and

IT Network Services, Kerman and Foresthill estimated the number of total hours that would be necessary to meet their needs. These functions, tasks, and corresponding estimated hours are summarized in the charts above. Based on Kerman and Foresthill's initial estimates, it was determined that the companies would require 10,920 hours to complete these tasks and functions. These requirements were subject to the standard rate charged by Kertel to its other computer services customers (\$100). Based on these analyses, the estimated annual cost for providing IT services performed by Kertel on behalf of Kerman and Foresthill was \$1,092,000 per year. Since these services were being performed for both Kerman and Foresthill, the \$1,092,000 annual charge was allocated between Kerman and Foresthill based on each company's total number of access lines. For Kerman, this resulted in a 70% allocation of the IT services costs, or 7,700 hours and a cost of \$770,00 per year. Prior to this arrangement, Kerman employed eleven additional employees who exclusively performed these IT-related functions and tasks.

Kerman and Kertel periodically reviews this arrangement to ensure that it remains cost optimal and that it continues to meet Kerman's IT-related requirements. A subsequent review indicated that Kerman's IT services needs generally exceeded the 7,700 hours initially estimated, and a 3% adjustment was made, increasing the annual billing rate to \$793,100 effective January 1, 2013. This annual IT-related expenses is assessed on monthly basis in the amount of \$66,092 (\$793,100/12), and is reflected in the line items identified in the sample expenses in the Data Request..

Based on Kerman's most recent review of this arrangement in 2014, Kerman believes that this arrangement continues to remain cost-effective. Kerman understands that in 2014, Kertel provided 8,738 hours (8,118 hours of regular time, 602 hours of overtime, and 18 hours of premium holiday time) of IT-related services to perform the previously-identified tasks and functions for the agreed upon annual amount of \$793,1000. This means that Kerman is assessed \$90.76 per hour for IT-related services, which is almost 10% lower than Kertel's standard rate as assessed for other non-affiliated customers.

The services that are provided for this agreement generally include:

- Maintenance and programming on all major components of the voice network. This primarily relates to the central office switch and all electronic central office connections and remotes operation. This includes the functioning of Class 5 switch, AFC, Tellabs, Telstrat, Calix, DAX, SS7 STP interoffice trunking, and data transport functions. Further, these services also provide for compliance with all CPUC, FCC and other government regulations and reporting.
- Configuration of all network circuits, including special access, T1, DS3, Ethernet, toll trunks, DSL, channel banks, multiplexing, terminals, and cross connects with cabling plant.
- Identify power supply needs and ensure functionality with necessary emergency requirements of a carrier grade switched network.
- Install and maintain operator service delivery and platforms.
- Monitor and respond to switch alarms.

- Monitor and respond to network usage issues.
- Provide database and reporting demographics and program solutions for company needs.
- Business systems support including servers, operating systems and personal computer hardware and software configurations.
- Provide data back-up and recoverability of software files.
- Support billing and bill formatting.

Attachment 2-10 [CONFIDENTIAL]

Confidential and Proprietary Subject to Public Utilities Code Section 583 and G.O. 66-C

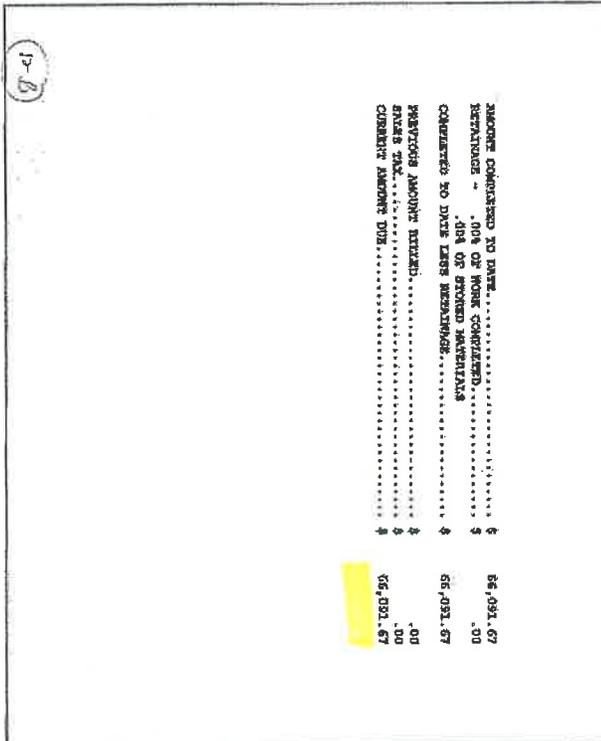
SEBASTIAN
 1600 NORTON PATH AVENUE
 TAYLOR, CA 95111
 P (415) 432-3100
 F (415) 432-3552

Invoice No.	KS797
Page	1 OF 2

D I L I I R	O H H H H
ORACLEMAN - HERMAN 811 E MADRERA AVE HERMAN CA 91500-1740	REC 2014 MONTH MAINTENANCE CO

Invoice Date	Customer No.	Payment Terms	Job Reference
01/29/14	12750	NET 30	22900026

AMOUNT COMPLETED TO DATE..... \$ 66,091.67
 RETAINAGE " .00% OF WORK COMPLETED..... \$.00
 .00% OF SCHEDULED MAINTENANCE.....
 COMPLETED TO DATE LAST BILLINEAGE..... \$ 66,091.67
 PREVIOUS AMOUNT BILLINEAGE..... \$.00
 OTHER TAX..... \$.00
 CURRENT AMOUNT DUE..... \$ 66,091.67



[CONFIDENTIAL]

DEPRECIATION

KERMAN TELEPHONE CO
DEPRECIATION ESTIMATE

2016

DEEXP1-2
31-Oct-14

ACCOUNT DESCRIPTION	ACCOUNT NUMBER	BEGINNING BALANCE	ADDITIONS	RETIREMENTS	ADJUSTMENTS	ENDING BALANCE	AVERAGE BALANCE	PROPOSED DEPR. RATES	CALCULATED DEPRECIATION	ADJUST	ADJ EXPL	ADJUSTED DEPRECIATION
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)
LAND	2111.10	129,323	-	-	-	129,323	129,323	-	-	-	-	-
MOTOR VEHICLES	2112.10	430,176	50,000	-	-	480,176	455,176	5.10%	23,214	-	-	23,214
SPEC PURPOSE VEHICLES	2114.10	-	-	-	-	-	-	-	-	-	-	-
GARAGE WORK EQUIP	2115.10	-	-	-	-	-	-	-	-	-	-	-
OTHER WORK EQUIP	2116.10	1,229,638	40,000	-	-	1,269,638	1,249,638	6.59%	82,351	-	-	82,351
BUILDINGS	2121.10	1,613,386	15,000	-	-	1,628,386	1,620,886	1.66%	26,955	-	-	26,955
FURNITURE	2122.10	356,350	-	-	-	356,350	356,350	3.88%	13,809	-	-	13,809
OFFICE SUPPORT EQUIP	2123.10	295,434	-	-	-	295,434	295,434	34.68%	-	-	-	-
GNRL PURPOSE COMPUTERS	2124.10	2,900,849	324,900	(85,980)	-	3,139,769	3,020,309	19.35%	584,430	-	-	584,430
DIGITAL SWITCHING	2212.10	1,817,324	15,000	-	-	1,832,324	1,824,824	9.62%	15,000	-	-	15,000
OPERATOR SYSTEM	2220.10	433,461	-	-	-	433,461	433,461	11.95%	51,799	-	-	51,799
COE RADIO IMTS	2231.10	-	-	-	-	-	-	-	-	-	-	-
CIRCUIT EQUIP	2232.10	10,717,218	311,000	(60,000)	-	10,968,218	10,842,718	14.05%	1,523,402	-	-	1,523,402
STATION APPS	2311.10	-	-	-	-	-	-	-	-	-	-	-
911 EMER EQUIP	2312.30	-	-	-	-	-	-	-	-	-	-	-
CUSTOMER PREM WIRE	2321.10	-	-	-	-	-	-	-	-	-	-	-
PUBLIC TEL EQUIP	2351.10	-	-	-	-	-	-	-	-	-	-	-
POLES	2411.10	-	-	-	-	-	-	0.00%	-	-	-	-
AERIAL CABLE	2421.10	-	-	-	-	-	-	0.00%	-	-	-	-
UNDERGROUND CABLE/METAL	2422.10	1,979,264	85,000	-	-	2,064,264	2,021,764	5.79%	117,060	-	-	117,060
UNDERGROUND CABLE/NON-METAL	2422.10	8,938,389	1,045,200	-	-	9,983,589	9,460,989	4.19%	396,415	-	-	396,415
BURIED CABLE	2423.10	8,175,503	-	(40,000)	-	8,135,503	8,155,503	4.23%	232,971	-	-	232,971
AERIAL WIRE	2431.10	-	-	-	-	-	-	0.00%	-	-	-	-
CONDUIT SYSTEMS	2441.10	9,483,234	696,800	-	-	10,180,034	9,831,634	3.64%	357,871	-	-	357,871
LEASEHOLD IMPROVEMENTS	2682.10	-	-	-	-	-	-	0.00%	-	-	-	-
TOTAL DIRECT OPERATING PLANT		48,499,549	2,582,900	(185,980)		50,896,469	49,698,009		3,425,277			3,425,277

117,060
396,415
232,971
350,031

ADJUSTMENT:

CONFIDENTIAL, per G.O. 66-C and Public Utilities Code Section 583.

1 exhaust the available capacity in this cable which would reduce the availability of service
2 available to the business customers in the area that depend on them.

3 In addition, our construction plans call for a long-term transition to extend fiber facilities
4 further into the network from the central office to customer premises. This will enhance our
5 ability to provide access to advanced services as well as to address facilities limitations that are
6 either currently an issue or are becoming an issue in providing service to our customers. Kerman
7 has planned its construction projects accordingly and is installing cable facilities and electronic
8 circuit equipment that will provide for current and future needs, which will help to reduce ongoing
9 maintenance costs and replacement of dated network equipment. Mr. Thompson provides
10 additional support in his testimony explaining why it is prudent to upgrade this plant from the
11 standpoint of changing customer demand and evolving regulatory requirements.

12 **Q.8. Can you identify cable or service issues existing in the service area that**
13 **necessitate the investments proposed?**

14 **A.** Yes, as described above, the facilities in the main downtown area are over 40 years
15 old. Many of the cable pairs in these facilities have become corrupted, making them unusable or
16 of poor quality. The general condition of this plant, which is a natural result of its age, causes
17 signal attenuation which interferes with service quality and in some cases interferes with the
18 provision of certain services completely.

19 For example, we have had issues with providing voice and special access services, such as
20 DS-1s, and broadband DSL. In an area where there are banks, stores, health care facilities, and the
21 police station and city hall, the reliability of the facilities is of critical importance. Copper cables
22 such as those serving downtown Kerman could fail for several reasons. Most problems are due to
23 the ingress of water into a section of plastic insulated conductor (PIC) cables, sheath damage, and
24 splice closure failures. If copper cables remain in the presence of water for any extended period of
25 time, migration of water into the cable is inevitable. This is because extruded plastics (jacketing
26 and insulating materials) that protect the copper from the elements are porous materials and
27 inherently have microscopic pinholes that provide a path for water to enter. Once water migrates
28 through the jacket and insulation and contacts the copper conductors, corrosion begins. Corrosion

NOTE: FORM 481 LINE 112 – CONFIDENTIAL FINANCIAL INFORMATION SUBJECT TO PROTECTIVE ORDER IN WC DOCKET NOS. 10-90, 07-135, 05-337, 03-109, CC DOCKET NOS 01-92, 96-45, GN DOCKET NO. 09-51, WT DOCKET NO. 10-208, BEFORE THE FEDERAL COMMUNICATIONS COMMISSION.

Overall, the company anticipates construction levels by year as:

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Investment ² (\$000)	\$2,197	\$2,674	\$2,568	\$2,467	\$2,949	\$2,647

A detailed breakdown of the investment and underlying information is provided on Attachment A.

Specific projects would include:

- 2014
 - o Kerman Commercial North – extend fiber past all business and residences along the main north section of town (Madera Ave). Replaces aging copper facilities approximately 45 years old. (see light blue on map)
 - o North Central Subdivision - extend fiber past residential area south of Whitesbridge. Replaces aging copper facilities approximately 45 years old. (see light blue on map)
 - o Ongoing plant requirements including development and growth projects, Interoffice ring configurations, service order connections, and support facilities.
 - o Continued additions of loop and ONTs for FTTH connections.
- 2015
 - o Kerman Commercial South - extend fiber past all business and residences along the main south section of town (Madera Ave). Replaces aging copper facilities approximately 45 years old. (see pink on map).
 - o K- Remotes – Extend fiber past customers in each of three different concentrators (remotes) along the south edge of town (see pink on map). Remotes are numbered. Remotes addressed in this construction include remotes 4-6.
 - o Ongoing plant requirements including development and growth projects, Interoffice ring configurations, service order connections, and support facilities.
 - o Continued additions of loop and ONTs for FTTH connections.
- 2016
 - o K- Remotes – Extend fiber past customers in each of three different concentrators (remotes) along the north and west edge of town (see tan on map). Remotes are numbered. Remotes addressed in this construction include remotes 2, 3, 7.

² Excludes investment in switching equipment.

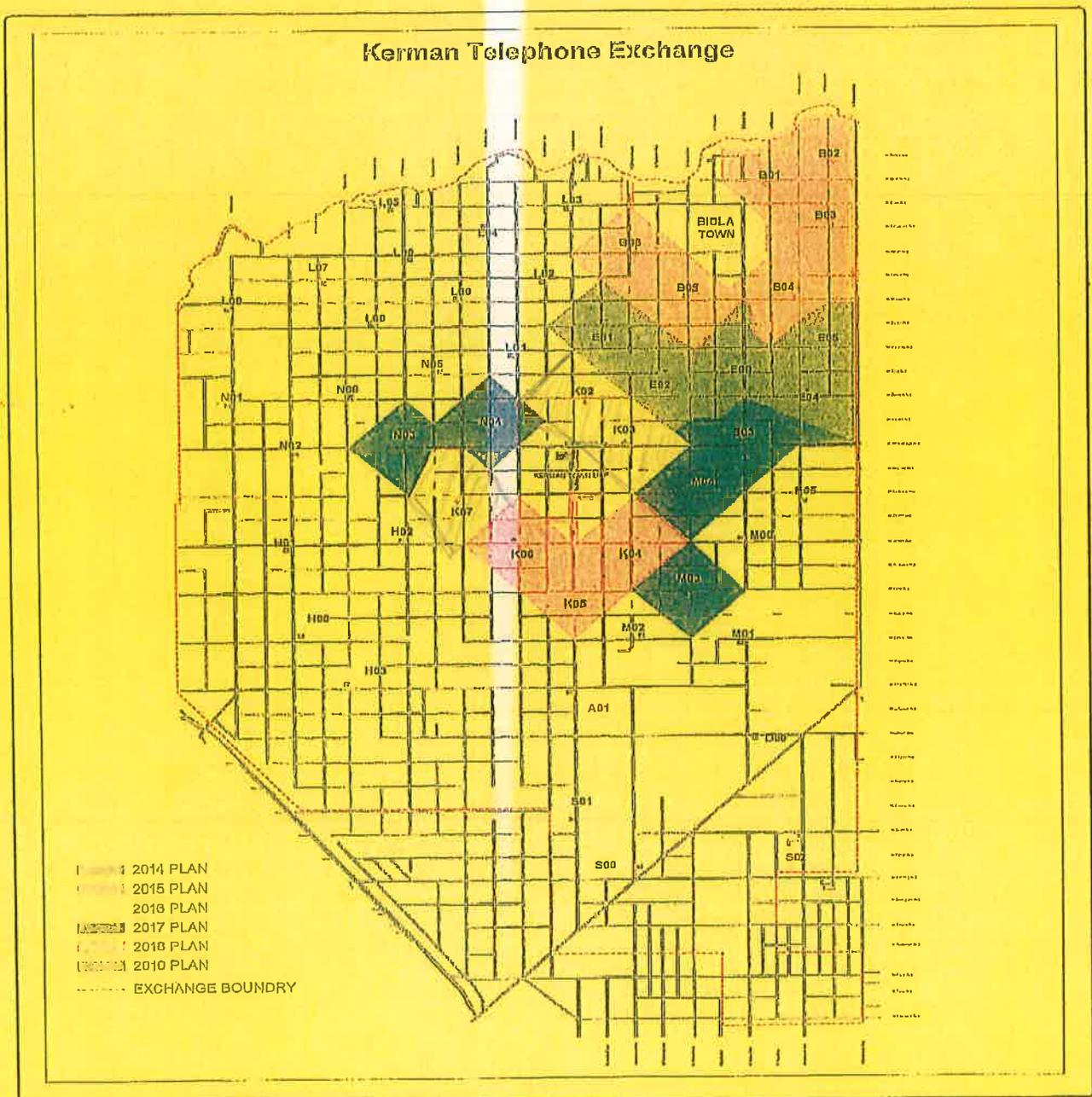
NOTE: FORM 481 LINE 112 – CONFIDENTIAL FINANCIAL INFORMATION SUBJECT TO PROTECTIVE ORDER IN WC DOCKET NOS. 10-90, 07-135, 05-337, 03-109, CC DOCKET NOS 01-92, 96-45, GN DOCKET NO. 09-51, WT DOCKET NO. 10-208, BEFORE THE FEDERAL COMMUNICATIONS COMMISSION.

Kerman Telephone Co.
SAC 542324
Five Year Construction Plan 2014-2019
FCC 54.313

ATTACHMENT A
Specific Project Plans

Wire Center Name and CLI	Description of Improvement	Cost Estimate	Regulated % Allocation	Amount In USF Support Area	% Voice	% Broadband	Area Impacted	Population Impacted	Target Completion Date	Actual Completion Date	Notes
A	B	C	D	E-CXD	F	G	H	I	J	K	
Kerman KRMNCAXF84E	Kerman Commercial North	500,000	100%	500,000	100%	100%	5 square miles	164	12/31/2014		
	North Central Subdivision	460,000	100%	460,000	100%	100%	25 square miles	94	8/30/2014		
	Development/Growth (new cust/replace)	593,000	100%	593,000	100%	100%	Across Exchange	5215	12/31/2014		
	Interoffice Ring Configuration	200,000	100%	200,000	100%	100%	Across Exchange	5215	12/31/2014		
	Service Order Station Connections	25,000	100%	25,000	100%	100%	Across Exchange	50	12/31/2014		
	FTTH Electronics	58,000	100%	58,000	100%	100%	Across Exchange	50	12/31/2014		
	Support Facilities (remote batteries/test equipment/vehicles/buildings/computers /etc.	361,750	100%	361,750	100%	100%	176 square miles	5215	12/31/2014		
TOTAL 2014 Projects		2,197,750		2,197,750							
Kerman KRMNCAXF84E	Kerman Commercial South	525,000	100%	525,000	100%	100%	25 square miles	65	4/30/2015		
	K4 Remote	250,000	100%	250,000	100%	100%	1 square miles	66	6/30/2015		
	K5 Remote	202,000	100%	202,000	100%	100%	1 square miles	61	9/30/2015		
	K6 Remote	150,000	100%	150,000	100%	100%	1 square miles	26	12/30/2015		
	Development/Growth (new cust/replace)	400,000	100%	400,000	100%	100%	Across Exchange	200	12/30/2015		
	Service Order Station Connections	210,000	100%	210,000	100%	100%	Across Exchange	100	12/30/2015		
	FTTH Electronics	100,000	100%	100,000	100%	100%	Across Exchange	70	12/30/2015		
	Support Facilities (remote batteries/test equipment/vehicles/buildings/computers /etc.	661,500	100%	661,500	100%	100%	Across Exchange	5215	12/30/2015		
Network Electronics	175,000	100%	175,000	100%	100%	Across Exchange	1300	12/30/2015			
TOTAL 2015 Projects		2,673,500		2,673,500							
Kerman KRMNCAXF84E	K7 Remote	180,000	100%	180,000	100%	100%	1 square miles	41	4/30/2016		
	K2 Remote	224,000	100%	224,000	100%	100%	1 square miles	57	6/30/2016		
	K3 Remote	208,000	100%	208,000	100%	100%	1 square miles	73	9/30/2016		
	Rural North CO Feed (K2,K3,K4)	480,000	100%	480,000	100%	100%	1 square miles	NA	12/30/2016		
	Development/Growth (new cust/replace)	400,000	100%	400,000	100%	100%	Across Exchange	150	12/30/2016		
	Service Order Station Connections	210,000	100%	210,000	100%	100%	Across Exchange	100	12/30/2016		
	FTTH Electronics	100,000	100%	100,000	100%	100%	Across Exchange	70	12/30/2016		
	Support Facilities (remote batteries/test equipment/vehicles/buildings/computers /etc.	625,900	100%	625,900	100%	100%	Across Exchange	5215	12/30/2016		
	Network Electronics	140,000	100%	140,000	100%	100%	Across Exchange	1300	12/30/2016		
	TOTAL 2016 Projects		2,567,900		2,567,900						
Kerman KRMNCAXF84E	K8 Remote	282,000	100%	282,000	100%	100%	1 square miles	67	4/30/2017		
	K1 Remote	173,000	100%	173,000	100%	100%	1 square miles	17	6/30/2017		
	K9 Remote	173,000	100%	173,000	100%	100%	1 square miles	32	8/30/2017		
	K10 Remote	188,000	100%	188,000	100%	100%	1 square miles	51	10/30/2017		
	K11 Remote	201,000	100%	201,000	100%	100%	1 square miles	35	12/30/2017		
	Development/Growth (new cust/replace)	400,000	100%	400,000	100%	100%	Across Exchange	150	12/30/2017		
	Service Order Station Connections	210,000	100%	210,000	100%	100%	Across Exchange	100	12/30/2017		
	FTTH Electronics	200,000	100%	200,000	100%	100%	Across Exchange	70	12/30/2017		
	Support Facilities (remote batteries/test equipment/vehicles/buildings/computers /etc.	592,200	100%	592,200	100%	100%	Across Exchange	5215	12/30/2017		
	Network Electronics	50,000	100%	50,000	100%	100%	Across Exchange	1300	12/30/2017		
TOTAL 2017 Projects		2,467,200		2,467,200							
Kerman KRMNCAXF84E	Blola 01 (Total All Remotes)	1,500,000	100%	1,500,000	100%	100%	6 square miles	61	12/30/2018		
	Blola 02							20	4/30/2018		
	Blola 03							30	6/30/2018		
	Blola 04							45	8/30/2018		
	Blola 05							36	10/30/2018		
	Blola 06							52	12/30/2018		
	Development/Growth (new cust/replace)	400,000	100%	400,000	100%	100%	Across Exchange	150	12/30/2017		
	Service Order Station Connections	210,000	100%	210,000	100%	100%	Across Exchange	100	12/30/2017		
	FTTH Electronics	225,000	100%	225,000	100%	100%	Across Exchange	70	12/30/2017		
	Support Facilities (remote batteries/test equipment/vehicles/buildings/computers /etc.	564,200	100%	564,200	100%	100%	Across Exchange	5215	12/30/2017		
Network Electronics	50,000	100%	50,000	100%	100%	Across Exchange	1300	12/30/2017			
TOTAL 2018 Projects		2,949,200		2,949,200							
Kerman KRMNCAXF84E	East Rural Remote 00 (Total All Remotes)	1,200,000	100%	1,200,000	100%	100%	5 square miles	31	4/30/2019		
	East Rural Remote 01							58	6/30/2019		
	East Rural Remote 02							28	8/30/2019		
	East Rural Remote 04							17	10/30/2019		
	East Rural Remote 05							31	12/30/2019		
	Development/Growth (new cust/replace)	400,000	100%	400,000	100%	100%	Across Exchange	100	12/30/2017		

NOTE: FORM 481 LINE 112 – CONFIDENTIAL FINANCIAL INFORMATION SUBJECT TO PROTECTIVE ORDER IN WC DOCKET NOS. 10-90, 07-135, 05-337, 03-100, CC DOCKET NOS 01-92, 96-45, GN DOCKET NO. 09-51, WT DOCKET NO. 10-208, BEFORE THE FEDERAL COMMUNICATIONS COMMISSION.



DRAWN BY:
MSC

CHECKED BY:

DATE:
6/16/14

WORK ORDER NO:
N/A

SCALE:
N.T.S.

SHEET
1 of 1

SEBASTIAN
Putting people first.
011 B, MADERA AVE.
KERMAN, CALIFORNIA 93630

Kerman Telephone Exchange

FCC 5 Year Plan



OTHER WORK EQUIPMENT

1 Q.8. Is this equipment used by the telephone company?

2 A. Yes, it is used by the telephone company. I note that there are two different types
3 of equipment at issue here. There is a small percentage of the overall plant investment that is test
4 equipment, tools, generators, and other equipment that are used on a fairly regular basis or are
5 needed and used on site in emergency situations. This equipment is definitely used and by the
6 telephone company for necessary functions. This test equipment consists of cable fault locating
7 equipment, time domain reflectometers (TDR), optical time domain reflectometers (OTDR),
8 splicing media equipment and cable path locators. This equipment is essential in finding location
9 of physical facilities and faults within the respective media types and repair. This equipment
10 constitutes \$416,050 of the total amount in the OWE account. See Exhibit EK-3.

11 The second types of equipment are larger construction such as backhoe, trenchers,
12 horizontal directional drill rig, cable dollies, and associated trailers. This equipment constitutes
13 \$805,677 of the OWE and is the issue in ORA's testimony. See Exhibit EK-3. This equipment is
14 also used by the company to perform necessary functions. The company has a number of issues
15 during the year where a single customer needs a facility installed or where a repair is required.
16 The company uses the OWE equipment it has to deal with these issues. This is more cost effective
17 than having the construction company bring its equipment to Kerman to address these limited
18 issues. If the construction company were already working on the Kerman's facilities, it might
19 make sense to have them fix these individual customer issues, but, otherwise, Kerman addresses
20 the issue itself and uses the OWE to make the repair/install. Kerman had 43 of these individual
21 type issues in 2014.

22 Q.9. In footnote 128 on page 60 of ORA's testimony, ORA states that Mr. Clark or
23 Ms. Dukes indicated that the OWE was not used by the telephone company. Were you a
24 part of this call?

25 A. No, I was not.
26
27
28

1. Accelerated Copper Depreciation

In order to construct the FTTH infrastructure, KTC requests early removal of portions of its existing copper network.⁸⁰ As part of this removal, KTC is requesting accelerated depreciation of its “Underground Metallic and Buried Metallic Cable & Wire Facilities”, which are the associated accounts for the copper wire infrastructure.⁸¹ 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 plant is still useful and in good repair.⁸² Thus, the sole reason to remove the copper wires is presumably to make room for the new fiber lines.

The PD carefully considered and balanced the costs to ratepayers associated with the new FTTH, which are a substantial \$7.8 million over 5 years, with the additional costs of removing copper wire that is still used and useful. The PD correctly finds that disallowing \$350,031 in accelerated depreciated expense related to functioning underground copper wire facilities for Test Year 2016 is an equitable distribution of costs.

2. Other Work Equipment (OWE)

KTC maintains a substantial amount of heavy construction equipment such as cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment, and concrete saws, as part of its 2016 Plant in Service.⁸³ However, ORA was informed by KTC that KTC rents or leases the equipment to its unregulated construction affiliate, Kertel Communications.⁸⁴ ORA was informed by KTC employees Dave Clark and Carolyn Dukes, confirmed by KTC employee Eric Kehler during cross-examination at the hearings, and also confirmed by KTC in a data request response, that KTC does not

⁸⁰ ORA-1 at 58.

⁸¹ ORA-1 at 58.

⁸² ORA-1 at 59.

⁸³ PD at 76.

⁸⁴ ORA-1 at 61.

itself use the equipment but rents or lease the equipment out.⁸⁵ The PD correctly discounts subsequent contradictory testimony that KTC does use some of the equipment, because it “raises a credibility issue.”⁸⁶

Moreover, the equipment was leased to its affiliate Kertel at hourly rates far below market value, and apparently to no other companies other than its affiliate.⁸⁷ For example, KTC leased a generator for \$3.23/hour to Kertel, when the market price is \$66/hour; a backhoe for \$36 that goes for \$275; a forklift for \$36.95 that goes for \$379; a ditch digger for \$56.71 that goes for \$414; and an air compressor for \$24.51 that goes for \$225.

The Commission should be concerned that ratepayers are paying excessive amounts to essentially subsidize the construction work of KTC’s unregulated affiliate. The PD correctly removes KTC’s OWE plant average balance and the corresponding accumulated depreciation balance because KTC does not actually use the equipment to provide regulated phone service.

E. Chamber of Commerce Use of KTC’s Central Office Building

The PD raises one issue not discovered by ORA prior to preparing its Opening Testimony; the issue of the City of Kerman’s Chamber of Commerce use of KTC’s old central office building, which is a block away from Sebastian’s current central office building where KTC is currently located.⁸⁸ The PD correctly notes that since the building is owned by KTC but used by the Chamber of Commerce, KTC should be collecting fair market rent, and failure to do so is unreasonable.⁸⁹ The PD is correct to impute an amount of revenue equal to the fair market rent that the Chamber of Commerce

⁸⁵ PD at 78.

⁸⁶ PD at 80.

⁸⁷ ORA-1 at 61.

⁸⁸ PD at 80.

⁸⁹ PD at 80.

1 ALJ HALLIGAN: I have not admitted
2 those exhibits yet. But your motion is
3 noted.

4 Mr. Kehler, thank you.

5 But before we begin, I have a
6 question regarding, can you direct me in your
7 KTC-04, is there an indication regarding is
8 it only Exhibit EK1 that you are -- is that
9 the reason you have this marked as
10 confidential?

11 MR. ROSVALL: That's correct, your
12 Honor. And that is the confidential
13 five-year plan submitted as confidential to
14 the FCC that addresses Kerman's plants
15 investment forecasts for the five-year
16 period.

17 ALJ HALLIGAN: Mr. Kehler, is that your
18 understanding?

19 THE WITNESS: Yes, it is.

20 ALJ HALLIGAN: Mr. Foss.

21 MR. FOSS: I reserve my questions on
22 Mr. Kehler's topics for other witnesses. No
23 further questions.

24 ALJ HALLIGAN: We'll be off the record
25 for a moment.

26 (Off the record.)

27 ALJ HALLIGAN: We'll be back on the
28 record.

STATE REGULATORY PROCEEDINGS

California Public Utilities Commission - Proceedings Referenced in State Proceedings Chart						
Proceeding Number	Short Name	2010	2011	2012	2013	2014
A. 07-12-026	RTB	1	1	1	1	1
I. 14-05-012	Rural Call Completion					1
R. 06-05-028	LifeLine	1	1			
R. 06-06-028	CHCF-B	1	1			
R. 06-10-006	CEQA	1			1	1
R. 07-04-015	Emergency Back-Up Power	1				
R. 08-11-005	Pole Safety	1	1	1	1	1
R. 09-06-019	CHCF-B	1	1	1	1	1
R. 10-04-011	E-911	1	1	1		
R. 10-12-008	CASF	1	1	1		
R. 11-03-013	LifeLine		1	1	1	1
R. 11-11-006	CPCN/WIR		1	1	1	1
R. 11-11-007	CHCF-A		1	1	1	1
R. 11-11-008	VoIP		1	1	1	
R. 11-12-001	Service Quality		1	1	1	1
R. 12-10-012	CASF			1	1	1
R. 13-01-010	CTF				1	1
R. 13-12-011	Water Energy Nexus				1	1
R. 14-05-001	CMRS/Right of Way					1
R. 14-11-001	California Public Records Act					1
	TOTAL	9	12	11	12	14

*Lehman Testimony
Exhibit C*

EXHIBIT B

**PUBLIC UTILITIES COMMISSION**505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298**FILED**3-29-16
04:04 PM

March 29, 2016

Agenda ID #14774
Ratesetting

TO PARTIES OF RECORD IN APPLICATION 11-12-011:

This is the proposed decision of ALJ Robert Mason. Until and unless the Commission hears the item and votes to approve it, the proposed decision has no legal effect. This item may be heard, at the earliest, at the Commission's May 12, 2016, Business Meeting. To confirm when the item will be heard, please see the Business Meeting agenda, which is posted on the Commission's website 10 days before each Business Meeting.

Parties of record may file comments on the proposed decision as provided in Rule 14.3 of the Commission's Rules of Practice and Procedure.

The Commission may hold a Ratesetting Deliberative Meeting to consider this item in closed session in advance of the Business Meeting at which the item will be heard. In such event, notice of the Ratesetting Deliberative Meeting will appear in the Daily Calendar, which is posted on the Commission's website. If a Ratesetting Deliberative Meeting is scheduled, ex parte communications are prohibited pursuant to Rule 8.3(c)(4)(B).

/s/ KAREN V. CLOPTONKaren V. Clopton, Chief
Administrative Law Judge

KVC:jt2

Attachment

Decision PROPOSED DECISION OF ALJ MASON (Mailed 3/29/2016)

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)

(See Appendix D for list of Appearances)

**DECISION ADOPTING INTRASTATE RATES AND CHARGES,
RATE OF RETURN, AND MODIFYING SELECTED RATES
FOR KERMAN TELEPHONE COMPANY**

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**DECISION ADOPTING INTRASTATE RATES AND CHARGES,
RATE OF RETURN, AND MODIFYING SELECTED RATES
FOR KERMAN TELEPHONE COMPANY**

Summary

This decision authorizes a revenue requirement for Kerman Telephone Company (Kerman) as summarized in the following table, and discussed in greater detail throughout this decision and in Appendix A:

Rate Case Item	Kerman's Proposed Amount	Amount Adopted by this Decision
Operating Revenues	\$10,442,787	\$6,826,853
Operating Expenses	\$7,474,394	\$6,017,228
Average Rate Base	\$12,956,237	\$12,621,990
Rate of Return	13.74%	8.97%

As explained in this decision and in Appendices A and B, the adopted operating revenues include California High Cost Fund-A adopted support in the amount of \$1,858,914.

This decision adopts basic residential rates of \$30.00 per month and basic business service rates of \$36.30 per month. These rates are inclusive of the Extended Area Service Charge and the Access Recovery Charge. The decision also adopts increased rates for custom calling features such as call waiting and caller ID that are reasonably comparable to the rates urban customers pay, pursuant to Pub. Util. Code § 275.5(c)(3).

This decision adopts the proposals of the Office of Ratepayer Advocates regarding affiliate transactions.

Application 11-12-011 is closed.

1. Background and Procedural History

In December 28, 2011, Kerman Telephone Company d/b/a Sebastian (Kerman) filed this General Rate Case (GRC) application requesting review of its revenue requirement and an increase in net intrastate revenues of \$2.957 million. At that time, Kerman's proposed increase in revenue requirement equated to a California High Cost Fund-A (CHCF-A) draw of \$6.49 million for test year 2013. Kerman's GRC application did not request a change to its basic residential local exchange rate of \$20.25 per month, but requested other selected rate changes such as charges for Extended Area Service, premises visits, inside wire, intra-building network cable, and returned checks. On January 26, 2012, the Division of Ratepayer Advocates¹ protested Kerman's GRC application requesting that it be stayed during the pendency of Order Instituting Rulemaking (OIR) Rulemaking (R.) 11-11-007, in which the Commission is currently conducting a detailed review of the CHCF-A program pursuant to Decision (D.) 10-02-016. The Office of Ratepayer Advocates (ORA)'s protest in Application (A.) 11-12-011 reflected the same concerns raised in its January 18, 2012, motion filed in R.11-11-007, i.e., to freeze the "waterfall" provisions of the CHCF-A,² stay A.11-12-011, and suspend processing all CHCF-A company GRC applications until completion of R.11-11-007. The Administrative Law Judge (ALJ) assigned to R.11-11-007 denied ORA's motion for a stay of A.11-12-011, finding that the request to stay should be considered in A.11-12-011.

¹ The Division of Ratepayer Advocates was renamed the Office of Ratepayer Advocates in September 2013.

² Under the "waterfall" provision, a small Local Exchange Carrier's (LEC) CHCF-A subsidy level is set at 100% for the first three years following completion of a GRC, and reduced to 80% the fourth year, 50% the fifth year, and zero thereafter.

Subsequently, in R.11-11-007, on October 15, 2012, the Small LECs³ filed a motion for a one-year freeze in the CHCF-A Rate Case Schedule and “waterfall mechanism.”

On June 15, 2012, in A.11-12-011, following two prehearing conferences (PHCs), the Assigned Commissioner and ALJ issued a Scoping Memo and Ruling (June 15th Scoping Memo) that identified two threshold issues to be briefed and decided by the Commission prior to the scheduling of ORA’s testimony and evidentiary hearings. The two “threshold” issues identified in Kerman’s GRC were: 1) whether to freeze Kerman’s revenue requirement and CHCF-A draw at current levels until the Commission concludes or reaches its decision in R.11-11-007, and 2) the timing of Kerman’s future GRC filing if its CHCF-A draw and waterfall are frozen.

Upon request by the parties, the ALJ in A.11-12-011 extended the date for briefing the “threshold” issues twice, first to June 28, 2012, and then again to July 2, 2012. On June 29, 2012, Kerman and ORA submitted a Joint Motion for adoption of an all-party settlement and advised the ALJ that hearings would not be necessary. Among other things, the Settlement Agreement would have increased Kerman’s CHCF-A draw by \$831,735 for test year 2013.

The Commission rejected the settlement proposal in D.12-12-003, finding it was not reasonable in light of the whole record and not in the public interest, and thus fell short of the requirements for adoption of a settlement agreement set

³ The Small LECs include Calaveras Telephone Co., Cal-Ore Telephone Co., Ducor Telephone Co., Foresthill Telephone Co., Kerman Telephone Company, Pinnacles Telephone Company, the Ponderosa Telephone Company, Sierra Telephone Company, Inc., the Siskiyou Telephone Company, and Volcano Telephone Company.

forth in Article 12 of the Commission's Rules of Practice and Procedure.⁴ In addition, the Commission found that it was "premature to allow an increase in the CHCF-A draw for Kerman at this time."⁵

On January 9, 2013, Kerman filed a motion requesting immediate interim rate relief in the form of additional CHCF-A funds for calendar year 2013, and continuing until A.11-12-011 is fully adjudicated. Specifically, Kerman requested that the Commission grant it an additional \$1,969,907 in CHCF-A funding for calendar year 2013 (for a total of \$5,412,943) through interim rates, subject to true-up when a final decision issues in this proceeding.⁶ Kerman's request equated to a 57% increase in its A-fund subsidy.⁷

On January 24, 2013, ORA filed a response opposing Kerman's motion for interim rate relief and recommending coordination of the issue of increasing Kerman's CHCF-A subsidy with the R.11-11-007 proceeding "to ensure consistent and nondiscriminatory treatment between the Small LECs."⁸ On February 26, 2013, the Assigned Commissioner in A.11-12-011 issued an Amended Scoping Memo and Ruling, clarifying that since the issuance of D.12-12-003, the scope of the A.11-12-011 is now: (1) whether an interim rate increase is warranted; (2) should Kerman's GRC be stayed until completion of R.11-11-007; and (3) if the Kerman GRC application is stayed, should its CHCF-A

⁴ D.12-12-003, Conclusion of Law 4 at 15, line 1.

⁵ D.12-12-003 at 8-9.

⁶ Kerman Motion at 10, line 14.

⁷ *Id.*

⁸ January 28, 2013, ORA Response at 2.

draw be frozen at its current level of 100%. Parties filed opening and reply briefs on the identified issues on March 7, 2013 and March 21, 2013, respectively.

On February 20, 2013, the Commission issued D.13-02-005 in R.11-11-007, adopting a one-year stay of the Small LECs pending GRC proceedings and a one-year freeze in the Small LECs' CHCF-A waterfall provisions. Kerman was exempted from D.13-02-005. D.13-02-005 determined that Kerman's GRC request would be addressed in A.11-12-011.

On May 22, 2013, a Scoping Memo and Ruling of the Assigned Commissioner (Rulemaking Scoping Memo) was issued in R.11-11-007. The Rulemaking Scoping Memo adopted and confirmed the initial scope set forth in the OIR, and identified additional issues based on the comments, the results of the PHC and the passage of Senate Bill 379. The Rulemaking Scoping Memo adopted a procedural schedule, with a Proposed Decision anticipated in the fourth quarter of 2013.

On November 18, 2013, ORA filed a motion for an extension of the stay and freeze of D.13-02-005, which was granted on December 31, 2013. On March 18, 2014, the Assigned Commissioner in R.11-11-007 issued an Amended Scoping Memo and Ruling, revising the scope of the OIR and dividing it into two phases. Phase 1 of R.11-11-007 was scheduled to conclude with a decision issued by December 31, 2014.

D.14-08-010, issued on August 14, 2014, in R.11-11-007 extended the waterfall provision and freeze of the other Small LECs GRCs for another six months, with the potential for two additional extensions. The Phase 1 Decision (D.14-12-084) was issued on December 19, 2014.

2. The Stay of Kerman's Application

D.13-10-051, issued in A.11-12-011 on November 4, 2013, denied Kerman's motion for an interim rate increase requesting a total of \$5,412,943 from the CHCF-A program, and ordered a stay of Kerman's pending rate case application (A.11-12-011) until December 31, 2013. D.13-02-005 also provides the stay may be extended for up to six months.⁹ D.13-10-051 also froze Kerman's CHCF-A draw at 100%.¹⁰

D.13-10-051, as modified by D.14-02-044, found that Kerman's request for interim relief would result in an even greater increase in the CHCF-A draw than the request denied by D.12-12-003. The Commission stated that it would continue processing A.11-12-011, and it intends to set rates in accordance with Public Utilities Code Sections 451, 454, 455, and 726, but must do so in an administratively feasible manner.¹¹ D.13-10-051, as modified by D.14-02-044, further ordered the rate proceeding to be adjudicated as soon as possible following the conclusion of R.11-11-007.

Another PHC was held on May 20, 2014. The PHC addressed, among other things, whether the stay imposed on A.11-12-011 should be extended, and if so, for how long. The PHC also addressed the updates to A.11-12-011 in light of the passage of time.

During the May 20, 2014 PHC, ORA requested a further extension of the stay granted by D.13-10-051 as modified by D.14-02-044, so that Kerman's

⁹ D.13-10-051 at 21.

¹⁰ Other features of the CHCF-A program remain in effect during the freeze, e.g., annual CHCF-A funding adjustments via the Advice Letter process.

¹¹ Hereafter all statutory references are to the Public Utilities Code unless otherwise indicated.

pending GRC will proceed following issuance of a final decision in R.11-11-007.¹² Kerman objected to ORA's request.

On August 28, 2014, the Second Amended Scoping Memo and Ruling of the Assigned Commissioner and Administrative Law Judge was issued scheduling updated testimony be served no later than November 1, 2014, followed by intervenor testimony in March 2015. Evidentiary hearings were set for April 2015.

On November 3, 2014, Kerman filed a response to the Second Amended Scoping Memo and served updated testimony. Among other things, Kerman noted that Mr. Kehler provided updated testimony addressing Kerman's construction plans. Mr. Burke provided supplemental testimony updating his analysis in light of the passage of time. Mr. Clark's updated testimony is intended to replace his original testimony.

Kerman submitted a writ petition to the California Court of Appeals seeking review of both D.12-12-003 and D.13-10-051.¹³ The Court declined to review the case on November 18, 2014.

On December 19, 2014, Kerman filed a Motion for Interim Rate Relief, requesting that ratemaking decisions adopted in this proceeding be effective as of January 1, 2015, and requesting an increase in its revenue requirement. ORA filed an objection to Kerman's request on January 5, 2015.

On January 9, 2015, ORA filed a Motion to Compel Production of Unredacted Customer Information.

¹² Reporter's Transcript (RT) at 132:18-28.

¹³ Kerman Telephone Co. d/b/a/ Sebastian v. The California Public Utilities Commission, F068856.

On January 16, 2015, Administrative Law Judge Halligan issued an e-mail ruling granting Kerman's request to respond to ORA's filing objecting to Kerman's request for Interim Rate Relief. On January 15, 2015, Kerman filed a reply to ORA's response to Kerman's Motion for Interim Rate Relief.

On January 21, 2015, Kerman and ORA submitted a joint motion to modify the procedural schedule to accommodate the submission of a supplement to Kerman's application to address the effects of D.14-12-084, the Commission's Decision Adopting Rules and Regulations in Phase 1 of the Rulemaking for the CHCF-A Program. Kerman and ORA also filed a joint request to shorten time to reply on the joint motion.

Kerman filed a response to ORA's Motion to Compel on January 26, 2015. By e-mail ruling dated January 30, 2015, ORA's Motion to Compel was granted.

In addition, on January 30, 2015, the Joint Motion of Kerman and ORA to Modify the Procedural Schedule was granted. Kerman served a supplement to its proposal and associated supplemental testimony on January 30, 2015. Kerman's supplemental testimony was intended to: 1) provide an updated rate design based on a modified local residential service rate that would bring Kerman within the range of reasonableness for basic, residential rates established in the Phase 1 Decision, and 2) a revised revenue requirement to account for the Federal Communications Commission's (FCC) cap on corporate operations expenses adopted in the Phase 1 Decision, along with information to rebut the appropriateness of applying the cap to Kerman.¹⁴

¹⁴ January 30, 2105, Kerman response at 1.

ORA served testimony on March 27, 2015 and Kerman's rebuttal testimony was served on April 16, 2015.

Four days of evidentiary hearings were held beginning on April 28 and ending on May 12, 2015.

Post-hearing opening briefs were filed and served on June 29, 2015.

Post-hearing reply briefs were filed and served on July 17, 2015.

The proceeding will be submitted following oral argument, which will be scheduled following the mailing of the proposed decision.

This proceeding was reassigned to ALJ Robert M. Mason III on January 20, 2016, following the announcement that ALJ Halligan, who had been the ALJ assigned to this proceeding since April 29, 2013, accepted another position at the Commission.

On February 26, 2016, the Commission issued Decision 16-02-022, which granted Kerman's Third Motion for Interim Rate Relief. Kerman's interim relief was set at \$1,112,373 and payable from the CHCF-A, and is subject to true-up and adjustment once the Commission reaches a final decision in this general rate case proceeding.

3. Public Participation Hearing

On May 27, 2015, the Commission held a Public Participation Hearing at the Kerman High School, in Kerman, California, to take comment from the public. Speakers included the Kerman City Manager, Public Works Director, representatives from the Chamber of Commerce, employees of the City Of Kerman, the Superintendent of Kerman Unified School District as well as current and former school board members.

4. Legal and Policy Framework for this GRC

Under the Public Utilities Act, our primary purpose is to “insure the public adequate service at reasonable rates without discrimination...”¹⁵

Under Pub. Util. Code § 451, public utilities may demand and receive only just and reasonable charges, and they must provide “adequate, efficient, just and reasonable service” in a way that promotes the “safety, health, comfort, and convenience of [their] patrons, employees, and the public.” Under Pub. Util. Code § 454, public utilities must make a showing to the Commission that any proposed rate change is justified, and receive a finding by the Commission to that effect before making such a change. Under Pub. Util. Code §§ 701 and 728, the Commission has the authority to determine what is just and reasonable, and to disallow costs not found just and reasonable. In particular, the Commission “has the power to prevent a utility from passing on to the ratepayers unreasonable costs for materials and services by disallowing expenditures that the Commission finds unreasonable.”¹⁶

Pub. Util. Code § 275.6 requires the Commission to minimize telephone rate disparities between rural and metropolitan areas to keep rates affordable in areas with lower population densities. Specifically, Pub. Util. Code § 275.6(c)(2) requires that the Commission shall “employ rate of return regulation to determine a small independent telephone corporation’s revenue requirement in a manner that provides revenues and earnings sufficient to allow the telephone corporation to deliver safe, reliable, high-quality voice communication service

¹⁵ *Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1950) 34 Cal.2d 822,836 [215P.2d 441].

¹⁶ *Id.*

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.”

The intent of the CHCF-A is to provide a source of supplemental revenues to small Incumbent Local Exchange Carriers whose basic exchange access line service rates would otherwise be increased to levels that would threaten universal service. As stated in D.14-12-084, “[u]niversal, reliable, affordable, service is critical to public safety and benefits that state as a whole.”¹⁷ The CHCF-A currently supports ten of the eligible thirteen small independent telephone companies to allow rural residents to stay connected to essential services to maintain public health and safety.

The CHCF-A program is funded by a surcharge assessed on revenues collected from end users of intrastate telecommunications services subject to surcharge. The Commission periodically reviews the program fund levels and adjusts the surcharge rate to ensure the program is sufficiently funded. All telecommunications carriers¹⁸ and interconnected Voice-over Internet Protocol service providers¹⁹ are required to assess the CHCF-A surcharge rate of 0.35%.²⁰

In this GRC, as in all others, we seek to promote the public interest. However, promoting the public interest in this case requires that we carefully

¹⁷ D.14-12-084 at 53.

¹⁸ See Pub. Util. Code § 275.

¹⁹ See Pub. Util. Code § 285(c).

²⁰ Resolution T-17453, issued on November 21, 2014, set a surcharge rate of 0.35% effective January 1, 2015.

review the revenue requirement request of Kerman with an eye toward protecting not only Kerman's ratepayers and customers, but also all other carriers' customers that pay into the CHCF-A from which Kerman is requesting funding. In carrying out this responsibility, we assess whether Kerman has justified its revenue increase proposals and disallow those proposals to the extent that they have not been justified.

Kerman enjoys an effective monopoly in the provision of voice services in its service territory. Kerman therefore has the exclusive control over the costs and conditions of such service. Kerman also has exclusive control over the information about these costs and conditions. Of particular note in this proceeding is the fact that, while Kerman is requesting a significant increase in its revenue requirement, Kerman did not initially request an increase in its rates to support its requested revenue requirement increase. Instead, Kerman requested an increase in the CHCF-A subsidy.

Reflecting this concern, Pub. Util. Code § 275.6(b)(7) requires us to "ensure that [CHCF-A] support is not excessive so that the burden on all contributors to the CHCF-A is limited." Similarly, Pub. Util. Code § 275.6(f) states, "the Commission shall structure the CHCF-A program so that any charge imposed to promote the goals of universal service reasonably equals the value of the benefits of universal service to contributing entities and their subscribers." In its response to the ALJ's January 30, 2015 ruling, Kerman asked for \$6,011,945 in CHCF-A support, which represents an increase in CHCF-A support of \$2,472,220.²¹

²¹ Resolution T-17505 adopted \$3,539,725 in CHCF-A funding for Kerman for calendar year 2016.

Pursuant to Pub. Util. Code § 309.5, consumer interests in this GRC are represented by ORA. ORA's statutory mandate requires it to pursue the lowest possible rates for ratepayers consistent with safe and reliable service. Despite ORA's participation in the case, the burden of presenting evidence of the need for its request never shifts from Kerman to ORA. The scope of our proceeding must include all relevant information necessary to determine whether the applicant's proposed revenue requirement and other requests are just and reasonable, and permit the utility to fulfill its duties under section 451.

5. Kerman

Kerman operates a telecommunications company that offers interexchange service to approximately 4,800 access lines in the central San Joaquin County City of Kerman and in the surrounding unincorporated areas of Fresno.²² The City of Kerman is an agricultural and residential community located approximately 15 miles west of Fresno. Kerman is wholly owned and controlled by Sebastian Enterprises, Inc. (SEI), which is in turn owned by the descendants of the Sebastian family. SEI owns three other companies: Foresthill Telephone Company (FTC), a regulated telecommunications carrier that receives CHCF-A subsidies; Kertel, which provides information services and construction services to Kerman; and Audeamus, which provides broadband services in Kerman's service area.

Kerman does business under the name Sebastian. FTC, Kertel, and Audeamus also do business under the name Sebastian. SEI, Kerman, FTC, Kertel and Audeamus share many of their resources and facilities, such as the Central

²² Exhibit KTC-1 at 3.

Office Building in Kerman, California, the adjoining warehouse; the work yard, vehicles, employees, and other facilities. The Central Office Building in the City of Kerman is branded with the name Sebastian on the exterior, as is Sebastian's other office building in the City of Fresno. The affiliates do not maintain separate offices from Kerman.

Kerman's last GRC was filed by Advice Letter and was resolved in Resolution T- 17081 for a test year of 2008.

Kerman anticipates investing approximately \$5,300,000 in Kerman for plant upgrades during the years 2015 and 2016 collectively. Kerman asserts that this level of investment will provide a reasonable investment amount given the need to upgrade to a fiber platform over time. The fiber platform is necessary to meet the projected demand of broadband customers (500 megabytes per second (Mbps) within the next 10-15 years) and the expected directives of state and federal legislators and regulators. Kerman plans to invest in facilities that will be capable of delivering the services that customers will want in the years and decades to come.²³

Mr. Barcus states that "customer demand for basic services like voice is flat or declining, while demand for advanced services, especially broadband, continues to increase."²⁴ According to Kerman, the FCC is continuing to work on and develop rule changes that reflect this since the release of its *Universal Service Fund/Intercarrier Compensation Transformation Order* (FCC 11-161) and *Further Notice of Proposed Rulemaking*. Kerman further states that "the state Legislature

²³ Exhibit KTC-4 at 3-9.

²⁴ Exhibit KTC-1 at 7.

has concluded that investments in broadband capable services be incorporated into the rate base for small telephone companies.”²⁵

Many Small LEC service areas, such as the area served by Kerman, are already served by wireless and cable companies (some of whom are affiliates of the Small LECs, like Kerman’s affiliate Audeamus). The service territories are not open to wireline competition, so Kerman is both the carrier of last resort and the monopoly carrier. Normally, as a monopoly carrier Kerman would have an incentive to raise its rates for services, however, with access to the CHCF-A, Kerman does not have that incentive, in fact, as it argues in this case, it appears to have the opposite incentive, to keep rates low. Keeping rates low does not negatively impact Kerman due to the availability of the CHCF-A subsidy.

On December 19, 2014, the Commission issued D.14-12-084 resolving Phase 1 of R.11-11-007, the CHCF-A rulemaking. D.14-12-084 determined that the Small LEC’s Basic Residential Service Rates “must be in a range of \$30, inclusive of additional charges, to \$37, inclusive of additional charges,” but also finds that “[a]ctual rates will be set in the individual General Rate Cases of the Small Incumbent Local Exchange Carriers.”²⁶ The Phase 1 Decision also found that the “Small Incumbent Local Exchange Carriers which received funds from the California High Cost Fund-A must adhere to the Federal Communications Commission’s (FCC’s) standards for corporate expense limits in their General Rate Cases,” but the results of the corporate expense cap may be rebutted in individual company rate cases.²⁷

²⁵ *Id.*

²⁶ D.14-12-084 at Ordering Paragraph 9.

²⁷ *Id.* at Ordering Paragraphs 2 and 3.

On January 30, 2015, Kerman updated its rate request in response to D.14-12-084 in R.11-11-007. Kerman revised its revenue requirement and expense estimates, forecasting intrastate revenue requirements of \$10,274,968 for test year 2016, a 28% increase over the past five-year average. Kerman proposed an increased CHCF-A subsidy amount of \$6,011,945, a \$2,472,220 increase over its current subsidy. The request is 70% greater than the 2016 authorized support.²⁸

Kerman proposes a local residential service rate be adopted that is \$30.00, inclusive of the local service rate, Extended Area Service Charges (EAS) charges, federal subscriber line charges (SLC), Access Recovery Charge (ARC), and miscellaneous public program surcharges. Kerman proposes that the tariffed basic rate to be adopted should be calculated by starting with \$30.00 and subtracting out the additional charges to reach the reasonable basic rate.²⁹

Kerman also addresses the impact of the FCC's corporate expense cap. Kerman proposes adjustments to the results of the cap calculation and provides arguments to rebut the presumption that amounts above the cap are unreasonable.

According to Kerman, the Supplemental Testimony "only modifies and supplements the November 3, 2014 testimony of David Clark (Exhibit KTC-7(b)) related to the local service rate and the corporate expense adjustments. "All other aspects of my original testimony remain as presented in the November 3,

²⁸ Resolution T-17505, adopted \$3,539,725 in CHCF-A funding for Kerman for calendar year 2016.

²⁹ Exhibit KTC-10 at 3.

2014 update.”³⁰ Kerman initially requested an intrastate revenue requirement of \$11,000,111 and an associated CHCF-A draw of \$6,804,638.³¹ Kerman calculated the expense portion of the requested revenue requirement using eight months of unaudited financials for 2014 and annualizing the partial year expenses and adjusting them by a 2% and 2.4 % inflation factor, and utilized company proposed investment projections to calculate the revenue requirement for 2016.³²

Kerman’s request was then updated in its rebuttal testimony of April 16, 2015. Kerman revised its 2016 revenue requirement calculation to \$10,442,787 based on the final, audited “end of year” financials, including \$7,474,394 in projected operating expenses, a \$1,779,871 return on rate base, \$1,188,521 in estimated tax liabilities and a CHCF-A draw of \$6,044,785.³³

Kerman notes that its proposed \$1,779,871 return on rate base is calculated by multiplying its proposed rate base of \$12,953,938, by its proposed rate of return of 13.74%. Kerman maintains that, with the exception of “Other Work Equipment,” ORA does not dispute its proposed rate base, and that, “at a minimum, the Commission should follow the consensus of the parties on this issue and accept Kerman’s rate base proposal of \$12,509,966 as to everything but “Other Work Equipment.”³⁴ Kerman also proposed a five-year plan including \$5,271,400 in plant additions. Kerman notes that ORA does not object to

³⁰ Exhibit KTC-10 at 3.

³¹ Exhibit KTC-1 at 9.

³² Kerman Opening Brief at 26.

³³ Although ORA does not object to Kerman’s updating its request in its rebuttal testimony to reflect updated financials, to avoid a never-ending cycle of updating information, we do not adopt this process as a policy or precedent.

³⁴ Kerman Opening Brief at 28.

Kerman's plant recommendation and therefore the Commission should adopt Kerman's \$5,271,400 plant additions figure for 2015/2016.³⁵

Kerman notes that in its last rate case, which was resolved by Commission Resolution T-17801, the Commission required Kerman to evaluate Local Measured Service (LMS) options as part of its next rate case. Kerman's application does not address local measured service options as requested. Instead, Kerman states that it does not support implementation of LMS and has not had any requests from customers for a measured service offering. Kerman notes that in its 2003 rate case – before the LMS directive from the Commission – customers voiced opposition. Kerman states that LMS runs “counter to industry usage and would impose implementation costs and investment requirements that are not justified by any customer benefits.”³⁶

Kerman also notes that the FCC has adopted a local service rate floor, and the adoption of LMS would put Kerman below the price floor for any LMS offerings, thereby reducing federal support for Kerman's intrastate revenue requirement, and would be counterproductive to both the company and ratepayers who would be responsible for a larger portion of Kerman's revenue requirement that could have been fulfilled through federal funding.³⁷

Kerman takes issue with ORA's criticism of its operations and argues that ORA should support Kerman “instead of focusing so closely on Kerman's

³⁵ Kerman Opening Brief at 30.

³⁶ Exhibit KTC-1 at 9.

³⁷ *Id.*

CHCF-A draw so that AT&T's customer and wireless customers statewide can save a few pennies"³⁸

6. ORA's Position

ORA recommends that the Commission authorize intrastate revenue requirements totaling \$6,602,548 for the 2016 test year. When combined with its forecast of other revenues, ORA calculates a total CHCF-A subsidy of \$1,938,638 from the CHCF-A in test year 2016.³⁹

ORA also makes nine recommendations to separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to do the following:

- Be held in separate legal entities.
- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no overlapping of employees or responsibilities.
- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at "arms-length".

³⁸ Exhibit KTC-2 at 3.

³⁹ Exhibit ORA-1 at 1. This amount was later reduced to \$1,905,695 in ORA's subsequent March 27, 2015 report and recommendation

- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.⁴⁰

We discuss ORA's proposal, along with Kerman's opposition, *infra*, at Section 14 of this decision.

7. Cost of Capital/Rate of Return

"The legal standard for setting the fair rate of return has been established by the United States Supreme Court in the *Bluefield* and *Hope* cases.⁴¹ The *Bluefield* decision states that a public utility is entitled to earn a return upon the value of its property employed for the convenience of the public, and sets forth parameters to assess a reasonable return. Such return should generally be equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings attended by corresponding risks and uncertainties. That return should also be reasonably sufficient to ensure confidence in the financial soundness of the utility, and adequate, under efficient management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties." (D.09-05-019 at 13-41.)

ORA notes that Kerman's requested 13.63% cost of capital is substantially higher than the 10% authorized in recent years, and is counter to all reasonable analysis of market changes that have occurred since 1997 when the Commission adopted 10% as the weighted average cost of capital for the small telephone

⁴¹ *Federal Power Commission v. Hope Natural Gas Company* (1944) 320 U.S. 51, and *Bluefield Water Works & Improvement Company v. Public Service Commission of the State of Virginia* (1923) 262 U.S. 679.

companies.⁴² ORA maintains that current low Treasury rates should logically be reflected in lower adopted costs of capital than those adopted during times of higher Treasury rates.⁴³

Kerman maintains that certain proposed regulatory rules create a great deal of uncertainty regarding its revenue streams. That uncertainty in turn creates greater risks for Kerman's investors⁴⁴ and therefore requires a higher rate of return.

Calculating the cost of capital involves consideration of three components; capital structure (debt to equity ratio), cost of debt, and cost of equity. Each component affects the final cost of capital percentage which is then applied to the utility's ratebase. The result is incorporated into the revenue requirement which determines the rates customers pay for utility services.

Each of the cost of capital components is discussed more fully in the following sections.

7.1. Capital Structure

Kerman proposes a capital structure of 20% debt and 80% equity for ratemaking purposes. As support for its hypothetical capital structure, Kerman cites "increased uncertainty surrounding the future revenue streams for small local telephone companies."⁴⁵ Kerman states that its proposed capital structure is consistent with the range identified in several 1997 Commission decisions for

⁴² ORA Opening Brief at 56.

⁴³ *Id.*

⁴⁴ Exhibit KTC-16 at 5.

⁴⁵ *Id.*

telephone companies.⁴⁶ Kerman further states that “it is not aware of any decisions by the Commission that would alter these ranges.”⁴⁷ In the decisions cited by Kerman, the Commission declined to adopt a specific capital structure, instead the Commission determined that the range was reasonable and used a projected capital structure for each applicant that was similar to the projected capital structure for its calculation. The specific decisions cited by Kerman find that the various applicants’ test year capital structures consisted of 63.33% equity,⁴⁸ 60% equity,⁴⁹ and 70% equity.⁵⁰

Kerman’s current actual capital structure includes 50.9% equity and 49.1% debt, compared to the hypothetical capital structure that it requests.⁵¹ Kerman claims that it is difficult to find a publicly-traded telephone company that can serve as a direct benchmark for Kerman, which is a small, closely-held company that is not publicly traded.⁵²

ORA expressed concerns about Kerman’s proposed capital structure for ratemaking purposes. ORA states that the 2015 Sebastian Strategic Plan (Strategic Plan) that ORA obtained through discovery identified a target capital structure of 60% debt and 40% equity.⁵³ ORA claims that the rate of return of the

⁴⁶ Exhibit KTC-16 at 3, citing D.97-04-034 and D.97-04-036.

⁴⁷ *Id.*

⁴⁸ D.97-04-035 at COL 4.

⁴⁹ D.97-04-036 at COL 3.

⁵⁰ D.97-04-034 at COL 4.

⁵¹ Exhibit KTC-15 at 11.

⁵² *Id.*

⁵³ Attachment 4-1: 2015 Sebastian Strategic Plan at 6.

capital structure proposed in Kerman's application is vastly different from its actual capital structure or the capital structure targeted in the Strategic Plan.

ORA demonstrates that using the Strategic Plan's targeted capital structure of 60% debt to 40% equity with Kerman's requested 13.63% rate of return and 3.2% cost of debt, results in a 29.28% return on equity for Kerman's investors. That figure is above the 16.24% return on equity proposed in Kerman's application and well above the return on equity allowed for regulated utilities.⁵⁴ ORA urges the Commission to look at the impact each component has on the overall cost of capital and focus on establishing a fair return on equity, a reasonable cost of debt and a reasonable capital structure.

In its Reply Brief Kerman stated that "there is no reason to rely on either Kerman's actual capital structure or the speculative Strategic Plan data in assessing what a reasonable, hypothetical capital structure should be for a company like Kerman."⁵⁵

ORA asserts that Kerman's fears about increased uncertainty surrounding the future revenue streams for small local telephone companies is misplaced and that incorporating such a high equity ratio for ratemaking purposes when it is counter to Kerman's actual and strategic plan capital structure is unreasonable.⁵⁶

ORA recommends a capital structure of 60% debt and 40% equity that more accurately reflects Kerman's current and targeted capital structures.

The Commission adopts neither Kerman's nor ORA's proposed capital structure. Despite Kerman's position that a 20% debt and 80% equity structure is

⁵⁴ Exhibit ORA-1 at 66-67.

⁵⁵ Kerman Reply Brief at 49.

⁵⁶ Exhibit ORA-1 at 69.

justified based on historical precedence, we find that a capital structure of 40% debt and 60% equity is equally justifiable in light of Kerman's current ratio of 49.1% debt and 50.9% equity. ORA's proposed structure is excessive regarding the debt ratio and therefore also unreasonable. The Commission has found that in the past, Kerman's debt ratio has been above 46% consistently. For these reasons we find a capital structure of 40% debt and 60% equity reasonable.

7.2. Cost of Debt

Kerman asserts that it calculated its actual cost of debt using the company's interest expenses from its 2013 audited financial statements, divided by average long-term debt during 2013, resulting in a cost of debt of 3.2%.⁵⁷ Although this represents a decrease in the cost of debt of 4.2% calculated in its direct testimony, Kerman does not believe its cost of debt will continue to decline.⁵⁸

ORA does not disagree with Kerman's calculated cost of debt of 3.2%.⁵⁹ The Commission finds Kerman's proposed and ORA's recommended 3.2% cost of debt reasonable.

7.3. Cost of Equity/Return on Equity

Initially, Kerman sought authority to earn a 12.69% return on equity, based on its 2013 rate base. However, in its updated direct testimony, supplemental testimony and rebuttal testimony, Kerman seeks Commission approval of a 16.24% cost of equity. Kerman argues that it is reasonable to expect an increase

⁵⁷ Exhibit KTC-16 at 7.

⁵⁸ *Id.* at 8.

⁵⁹ Exhibit ORA-1 at 69.

in the cost of equity because telephone companies such as Kerman face greater uncertainty. The method and individual factors used to determine the cost of equity component are discussed in the sections below.

7.3.1. Capital Asset Pricing Model

The cost of equity is typically calculated using one or more financial models. Kerman uses the Capital Asset Pricing Model (CAPM) which is a risk premium analysis to gauge the cost of equity. As a theory, it examines the risk and returns associated with holding common stocks. It addresses two risks; firm-specific risk and market risk, which is measured by a firm's beta.⁶⁰ Investors receive a return for bearing the systematic risk.

Estimating the cost of equity using the CAPM requires three inputs; the risk-free rate of interest (typically measured by looking at the returns on long-term treasury bonds), the beta, and the expected market risk premium. Of these three inputs, the most difficult to measure is the expected market, or equity risk premium. The data on both Treasury bond interest rates and various measures of beta are readily available, although disputed. Kerman uses an Ibbotson industry risk premium as a substitute for the application of a beta to the equity risk premium because Kerman is not a publicly-traded company. An expected market risk premium is a highly subjective forecast of future market returns.

The factors used in Kerman's calculations for its proposed 16.24% overall cost of equity include a risk free rate and an equity risk premium. Kerman also

⁶⁰ Beta is a mathematical measure of the sensitivity of rates of return on a portfolio or given stock compared with rates or return on the market as a whole. A high beta (greater than 1.0) indicates moderate to high price volatility. A beta of 1.5 forecasts a 1.5% change in the return on an asset for every 1% change in the return on the market.

modified the CAPM calculation to incorporate an industry risk premium and a size premium.⁶¹

ORA also uses the CAPM for its calculations, but recommends different percentages and does not include an industry risk premium or a size premium.

The Commission finds using the CAPM to calculate the cost of equity reasonable.

7.3.2. Risk Free Rate

Kerman uses an average of 20-year long-term Treasury yields from January 3, 2000, through October 24, 2014 as the risk-free rate for its analysis. Kerman argues that a longer-term average of the Treasury rate is appropriate because it believes the Federal Reserve has a policy of artificially keeping interest rates low to stimulate the economy. The median yield over this period was 4.64%, and the average yield was 4.47%.⁶²

Kerman believes that 4.47% “represents a conservative and reasonable expectation of what the future yield would be on a treasury investment and serves as a good indicator of the risk-free treasury rate for the CAPM analysis.”⁶³

ORA maintains that Kerman’s proposed risk free rate does not reflect current 20-year Treasury rates, which are 2.32% as of January 5, 2015.⁶⁴ ORA further notes that the recent 10-year average of 20-year Treasury rates is 3.93%.

ORA recommends using the recent three-year average of the 20-year Treasury rate of 2.91% for the risk-free rate. ORA explains that this 2.91% rate

⁶¹ Exhibit KTC-16 at 13.

⁶² Exhibit KTC-16 at 9.

⁶³ *Id.*

⁶⁴ Exhibit ORA-1 at 71.

falls within the range of risk-free rates recommended by other regulatory agencies in recent analyses.⁶⁵ ORA also notes that its proposed 3-year average represents the more likely borrowing costs during the rate cycle, and that using a 15-year average captures a period of much higher rates than are likely to occur in the next three years.⁶⁶

The Commission adopts neither Kerman's nor ORA's risk-free rates based on 20-year long-term Treasury rates. Using Kerman's 15-year average results in an unreasonably high rate given current low rates. ORA's 3-year average is too heavily influenced by recent low rates. We find the 10-year average calculated by ORA more reasonable as a stable indicator of the rates, and therefore adopt the risk-free rate of 3.93%.

7.3.3. Equity Risk Premium

Kerman uses an equity risk premium of 6.96%, citing Duff and Phelps, *2014 Valuation Handbook – Guide to Cost of Capital*. This is an update from Kerman's initial request of 6.7% based on an older, now out of publication, valuation guide.⁶⁷

ORA recommends an equity risk premium of 5.88%. ORA explains that that "studies by leading academics indicate the forward-looking equity risk premium is actually in the 4.0% to 5.0% range." ORA notes that on May 13, 2013, the Wireline Competition Bureau of the Federal Communications Commission issued a Staff Report titled "Prescribing the Authorized Rate of Return," in which

⁶⁵ *Id.* at 71-72.

⁶⁶ ORA Opening Brief at 55.

⁶⁷ Exhibit KTC-16 at 10.

the average market (equity) premium for the period 1928-2012 was shown to be 5.88%. ORA also notes that the Washington Department of Revenue used an average risk premium of 5.0% derived from multiple sources.⁶⁸

Kerman's requested equity risk premium is based on only one source and results in an unreasonable high risk premium of 6.96%. ORA's recommended 5.88% equity risk premium more accurately reflects the documented market premium years 1928 to 2012 and is therefore reasonable. On that basis the Commission adopts ORA's equity risk premium of 5.88%.

7.3.4. Industry Risk Premium

Kerman includes an industry risk premium of -1.18, which is the industry risk premium for Standard Industrial Classification (SIC) Code 4813, Telephone Communications Except Radiotelephone. The SIC is a system for classifying industries. SIC Code 4813 includes telephone communications companies. Kerman states that the SIC Code 481 it has previously used is "too heavily dominated by large wireless carriers, such as AT&T Mobility and Verizon." According to Kerman, SIC Code 4813 "reflects companies without wireless operations and is a better comparison to Kerman for this analysis..."⁶⁹ Kerman also argues that Kerman's investors have been pulling out substantial equity in the form of dividends and is evidence they are concerned about their investments.

⁶⁸ Exhibit ORA-1 at 73.

⁶⁹ Exhibit KTC-16 at 10.

ORA opposes the use of an industry risk premium, noting that not all firms included in the SIC Code 4813 are regulated telephone companies.⁷⁰

Kerman's industry risk premium of -1.18% reflects SIC 4813, which appears to be the appropriate Classification and is therefore reasonable. The Commission adopts the industry risk premium of -1.18%.

7.3.5. Size Premium

Kerman includes a size premium of 5.99% based on data from the Duff & Phelps 2014 *Valuation Handbook – Guide to Cost of Capital*.⁷¹ Kerman's size premium is calculated using data reported from 1926 through 2013.

ORA maintains that as a regulated entity supported by both state and federal mechanisms to subsidize and guarantee revenue, the risk associated with Kerman's size is moot and a size premium is not appropriate. On that basis, ORA's recommended cost of equity calculation does not include a size premium.

The Commission adopts neither Kerman's nor ORA's recommended size premium. ORA's recommendation assumes a complete absence of risk and is therefore unreasonable. Kerman's recommendation over-emphasizes the risk related to its size, line loss and alternative communication resources associated with the transitional nature of Kerman's geographic location and is therefore unreasonable. A size premium equal to 70% of Kerman's 5.99% proposal is a reasonable compromise. Therefore, the Commission adopts a size premium of 4.19%.

⁷⁰ Exhibit ORA-1 at 74.

⁷¹ Exhibit KTC-16 at 11.

A comparison of Kerman's proposed, ORA's recommended and the Commission's adopted positions on the components of return on equity are shown in Table 1.

Table 1

	Kerman Proposed	ORA Recommended	Commission Adopted
Risk-Free Rate	4.47%	2.91%	3.2%
Equity Risk Prem.	6.96%	5.88%	5.88%
Indust. Risk Prem.	-1.18%	0	-1.18%
Size Premium	5.99%	0	4.19%*
Total of Equity Components	16.24%	8.79%	12.82%

*This represents 70% of Kerman's requested 5.99%.

Conclusion

A comparison of Kerman's proposed, ORA's recommended and the Commission's adopted cost of capital, based on the issues discussed and resolved above, is shown in Table 2. A total cost of capital of 8.97% is reasonable and therefore adopted.

Table 2

	Kerman Proposed	ORA Recommended	Commission Adopted
Debt	20%	60%	40%
Equity	80%	40%	60%
Cost of Debt	3.2%	3.2%	3.2%
Return on Equity*	16.24%	8.79%	12.82%
Total Cost of Capital	13.63%	5.44%**	8.97%

* These numbers are based on the results of the return on equity calculations illustrated in Table 1.

** ORA's recommended cost of capital increased to 5.71% as a result of its March 27, 2015 report and recommendation update, and reflected in Results of Operations line item changes in Appendix A.

8. Corporate Expense Cap

In D.14-12-084 the Commission determined that it was necessary to adopt a uniform standard for determining a reasonable level of corporate expenses for carriers that receive subsidies from the CHCF-A program. Adopting a uniform standard “allows the program to achieve its goals while ensuring that the level of support is not excessive or wildly disparate across companies, and avoids imposing an undue burden on California ratepayers who contribute to the fund.”⁷²

The Commission wrote, “Small Incumbent Local Exchange Carriers which receive funds from the California High Cost Fund-A must adhere to the Federal Communications Commission’s standards for corporate expense limits in their General Rate Cases.”⁷³ The Commission also found that adopting and applying the FCC Corporate Expense Caps will “cap the amount of corporate expenditures that can be recovered from the CHCF-A program,” and “create incentives to align expenditures with the cap to reduce rate case litigation costs.”⁷⁴

The Commission also found that applying the FCC Corporate Expense Cap will not limit the amount of a company’s corporate expenditures, but will limit the amount of corporate expenditures that can be recovered from the CHCF-A program. D.14-12-084 determined that there is a “rebuttable presumption” that any amount above the FCC’s Corporate Expense Cap is

⁷² D.14-12-084 at 28.

⁷³ D.14-12-084 at 86.

⁷⁴ D.14-12-084 at 29.

unreasonable.⁷⁵ Carriers have the opportunity to demonstrate that a different level of corporate expenses is reasonable.⁷⁶ The FCC used state averages in its calculation of the national corporate expense cap formulas, therefore some states are below California and some are above.

Effective January 1, 2012, the FCC in FCC 11-161232 modified the limitation on corporate expenses using the following formulas:

- For Study areas with 6,000 or fewer total working loops the monthly amount per loop shall be -
 - $\$42.337 (.00328 \times \text{number of total working loops})$, or
 - $\$63,000 / \text{number of total working loops}$, whichever is greater.
- For study areas with more than 6,000, but fewer than 17,887 total working loops, the monthly amount per loop shall be -
 - $\$30.07 + (117,990 / \text{number of total working loops})$; and
- For study areas with 17,887 or more total working loops, the monthly amount per loop shall be $\$9.56$.⁷⁷

8.1. Kerman's Estimated Corporate Expenses

Kerman calculates that application of the FCC Corporate Expense Cap without any modification results in a cap on Kerman's corporate expenses of \$1,692,783 (\$1,537,917 allowable corporate expenses plus \$154,865 CPI growth allowance).⁷⁸ Kerman states that it has 4,848 loops. In its Direct Testimony,

⁷⁵ *Id.*

⁷⁶ D.14-12-084 at Ordering Paragraph 3.

⁷⁷ FCC Report And Order And Further Notice of Proposed Rulemaking, FCC 11-161, rel. November 18, 2011, 232.

⁷⁸ Exhibit KTC-8, att. DC 011, "Calculation of Corporate Expense Limitation".

Kerman's request for corporate expenses totaled \$3,365,417 (after excluding \$175,603 in legal expenses related to the general rate case).

In Rebuttal Testimony, Kerman's proposed corporate expenses totaled \$1,559,228.⁷⁹ Kerman arrived at this figure by applying intrastate allocation factors to its total corporate expense amount of \$2,269,950. Kerman goes on to state that the corporate expense adopted should at least be the \$1,544,761 calculated in its rebuttal testimony.

Kerman's objection to the strict application of the Corporate Expense Cap is based on three factors that Kerman argues make its corporate expenses justifiably higher than the proxy group used to create the cap;

- Application of the corporate expenses cap seriously compromises its ability to perform necessary functions and continue to operate in an efficient and reliable manner;⁸⁰
- Higher wages that Kerman must pay to its corporate employees in California relative [to] companies in other states where labor is less expensive; and,
- The added regulatory costs of operating in California, which has far more extensive regulatory burdens than most states."⁸¹

Kerman recommends adjustments for wages and regulatory intensity for its corporate expense estimate. Kerman argues that with these adjustments the Commission should adopt an adjusted intrastate expense cap of \$1,559,228 which it states is \$595,273 lower than Kerman's actual intrastate corporate expenses.⁸²

⁷⁹ Exhibit KTC-11.

⁸⁰ Exhibit KTC-10 at 18.

⁸¹ Kerman Opening Brief at 18.

⁸² *Id.* at 58.

Kerman argues that it is located in a high cost area in general, which makes the cap unreasonable as applied to Kerman.⁸³ To support this argument Kerman presents evidence from the U.S. Bureau of Labor Statistics to demonstrate that the Kerman area has high labor costs.⁸⁴ According to Kerman, the area's average corporate wage is \$76,548 and the average California corporate wage is \$93,956.⁸⁵

Kerman also claims that the number of regulatory proceedings is higher in California at ten per year than other states at four per year and provides a calculation to increase its corporate expenses to allow for this additional expense.

8.2. ORA's Analysis of Kerman's Corporate Expense Caps

ORA argues that Kerman has failed to address specific corporate expenses and explain how those expenses are reasonable. ORA states that it analyzed only 3% of Kerman's 2014 expense transactions and identified areas where corporate expenses could be reduced.

8.2.1. Executive Benefits and Bonuses

ORA states that Kerman's corporate wages are above both the Kerman-area and California averages (\$76,548 and \$93,956 respectively), noting that Kerman's IS manager earns \$138,480 and Kerman's president earns \$236,202 per year. ORA also asserts that Kerman's testimony is contradictory when it states that Kerman is a low-income area and its residents cannot afford rate increases, while at the same time arguing that it is a high-cost labor area.

⁸³ Exhibit KTC-22 at 19.

⁸⁴ *Id.*

⁸⁵ *Id.* at 23.

ORA notes that it required a series of requests, and correction of several errors to obtain an accurate figure for Kerman's total executive compensation.⁸⁶ ORA was eventually informed that Kerman's total actual 2014 corporate compensation expenses totaled \$1,681,509.86 including benefits and bonuses. However, ORA subsequently identified, and Kerman confirmed, that this amount does not include additional compensation of \$294,705 paid to Kerman's executives. This figure includes amounts that Kerman paid in bonuses for board meeting fees and a quarterly retainer which combined totals \$294,705, as shown in the Table 3 below.

Table 3

Description	Adjustment
Executive Bonuses	\$200,000
Board Meeting Distribution	30,705
Quarterly Retainer	64,000
Total Additional Executive Compensation	\$294,705

The additional executive benefits and bonuses bring Kerman's total 2014 executive compensation to \$1,976,214.86

ORA maintains that Kerman has not shown that these amounts are reasonable or necessary to retain employees. For example, ORA points out that Kerman's president, William Barcus, is also a shareholder and therefore it is not apparent why Kerman must pay a bonus to retain him. ORA adds that most of the board members are family members who own a portion of the company and

⁸⁶ Exhibit ORA-1 at 28.

thus have an incentive to actively participate and would likely do so without remuneration.

ORA maintains that since these amounts are not reasonable and prudent expenditures, they reflect rate making adjustments that would allow Kerman to more easily meet the FCC's corporate expense cap.⁸⁷

The Commission adopts ORA's recommendation. Kerman's additional \$294,705 in executive compensation is not warranted and is therefore unreasonable as a justification to exceed the corporate expense cap.

8.2.2. Terminated Temporary Executive Position

ORA recommends that \$58,144 be removed from Kerman's 2016 corporate expenses estimate. ORA asserts the amount represents the salary of a temporary executive position filled in May 2013 and terminated in May 2014. ORA suggests that Kerman's corporate expenses be reduced by \$58,144, to more easily meet the corporate expense cap.

The Commission agrees that including temporary executive compensation in corporate expenses for a position that no longer exists is unreasonable. Therefore we adopt ORA's recommendation and disallow the corporate expense of \$58,144.

8.2.3. Salary and Benefits for New Information Services (IS) Manager

Kerman is in the process of hiring a new IS manager to replace the one that retired at the end of 2014. Kerman projected the new IS manager's salary at \$138,480, the level of compensation of the previous manager at the time of

⁸⁷ Exhibit ORA-1 at 29.

retirement. ORA states that it is unreasonable for Kerman to project the total salary and benefits of a new IS manager using the retired manager's final salary. ORA suggests that Kerman use an average of the retired IS manager's total salary and benefits from 2010 to 2014, with annual escalations, to project the new IS manager's salary of \$99,516 for 2016.⁸⁸ On that basis, ORA suggests that Kerman's forecast of corporate expenses could be reduced by \$38,964, the difference between Kerman's original forecast and ORA's recommended salary, to more easily meet the FCC corporate expense Cap.

Kerman asserts that ORA's recommendation ignores the wage premium that Kerman must pay to operate in California. Kerman also states that the reasonableness of Kerman's IS manager's salary cannot be judged by an overall average that includes wages for entirely different positions.

The Commission finds that Kerman paying the new IS manager the same as the retiring IS manager is unjustified and therefore unreasonable. Kerman could more easily meet the corporate expense cap if its salaries were more in line with the Kerman and California averages it cites. On that basis Kerman's projected operating expenses are reduced by \$38,964. This is not a prohibition on Kerman actually paying its new IS manager \$138,480, however, Kerman's justification for this salary is insufficient to warrant an adjustment to the corporate expense cap.

8.2.4. Payments for Affiliate Memberships in Industry Groups

According to ORA, Kerman pays the membership fees in a broadband industry group called Calcom for Kerman's parent company Sebastian. ORA

⁸⁸ Exhibit ORA-1 at 30.

states that according to Calcom's website, its mission is to accelerate broadband deployment. ORA points out that Kerman does not deploy broadband. ORA also points out that Kerman has not demonstrated why it, rather than its broadband affiliates, Audeamus or Sebastian, pay the membership fees.

Kerman paying Calcom membership fees of \$14,857, which do nothing to enhance service to Kerman's customers, is unreasonable. Therefore, the \$14,857 of fees will be disallowed, making it easier for Kerman to meet the corporate expense cap.

8.2.5. Charitable Donations, Contributions and Sponsorships

According to ORA, Kerman included in proposed rates the corporate expenses incurred to promote Sebastian's image in the community through donations, sponsorships, and contributions, including contributions to political action organizations. ORA maintains that Kerman could save \$241,465 by eliminating donations, contributions, and corporate sponsorships that are intended solely to enhance the "brand image of Sebastian." For example, ORA explains that state subsidies are currently used by Kerman for the funding of Fresno State Bulldog sporting events, a polo festival in Sebastian's name, the Kerman Christian School, a golf tournament, catering for a Fresno State tailgate party, and the California Independent Telephone Political Action Committee.⁸⁹

⁸⁹ See, Attachments 2-4, 2-6 and 2-7 to Exhibit ORA-1, Kerman's supporting documentation to ORA Data Request C3002 and e-mail confirmation, including invoices, for the Bulldog Sports Properties (\$70,560 annual cost), Sierra Foundation (2013 Polo Fest) (\$10,000), Golf tournament (several invoices totaling \$5,100), Fresno State Tailgate (\$16,830 allocated to Kerman), California Independent Telephone Political Action Committee (\$6,800), Kerman Quarterback Club, The First Tee of Fresno (\$1,200).

ORA notes that the Commission has previously found that donations, contributions, and sponsorships are not typically paid for by ratepayers of regulated utilities, because these expense do little to increase safety and reliability of the services provided.⁹⁰ ORA further notes that because these donations and sponsorships are done in the name of Sebastian, which includes Kerman's parent company and affiliates, any benefit to Kerman is limited.

Table 4 lists the 2014 Donations, Dues, and Sponsorships charged to Kerman.

Table 4

Description	Amount
Sebastian Image	\$123,903
Sponsorships	70,993
Donation/Contribution	46,569
Total	\$241,465

In D.86-01-026, the Commission stated, "Staff identifies \$13,000 as PacBell's share of Bellcore's dues, donations and contributions for test year 1986. It naturally recommends disallowing this expense consistent with our long-standing rationale that ratepayers should not fund discretionary contributions to organizations when they have no voice in selecting the recipients. We will adopt this adjustment."⁹¹

⁹⁰ 62 Cal. 2nd 634.

⁹¹ D.86-01-026 at 285.

Consistent with D.86-01-026 we adopt ORA's suggested reduction of \$241,465 to corporate expenses for donations, dues, and sponsorships for ratemaking purposes. These expenses are not reasonable as ratepayers have no voice in selecting the recipients and these activities do not increase safety and reliability for Kerman's customers. The elimination of these expenses will allow Kerman to more easily meet its corporate expense cap.

8.2.6. Employee Parties and Retreats

ORA notes that Kerman also bears a significant portion of the costs of several parties and retreats arranged by Sebastian for the employees of SEI, Kerman and the other affiliates, Foresthill, Audeamus, and Kertel. According to ORA, Kerman pays 75% of the costs of a holiday party, 45% of the costs of the holiday retreat and 40% of the annual banquet. ORA notes that for Kerman's 69 employees, 80% of which work part time for Kerman, the expense of \$33,863 for a holiday party equates to a cost of \$491 per employee, paid for by California ratepayers.⁹²

Table 5

Description	Total 2014 Cost	Total Charged to Kerman	% Cost to Kerman
Holiday Party	\$43,130	\$33,863	79%
Annual Retreat	9,635	4,307	45%
Annual Banquet	44,060	17,546	40%
Total	\$96,855	\$55,716	58%

⁹² Exhibit ORA-1 at 33.

Table 5 shows Kerman corporate expenses of \$55,716 for party, retreat and banquet costs are not reasonable. We agree with ORA that California ratepayers should not be subsidizing parties and retreats and disallow \$55,716 in corporate expenses related to these events.

8.2.7. Corporate Education and Planning Expenses

ORA explains that Kerman's total corporate expense also include the costs of corporate education and planning. ORA states that it selected a sample of Kerman's recorded education and planning expenses to test for reasonableness and found that the expenses identified far exceed the lodging and per diem rates authorized by the State of California. ORA maintains that because Kerman draws from the CHCF-A to subsidize its revenues and expenses, Kerman's business travel expenses included in rates should be made in accordance with the state's lodging and per diem rates.⁹³

We view ORA's recommendation as reasonable and limit Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes.

8.2.8. Corporate Rental Apartment

Kerman maintains a corporate rental apartment and records one-half of the rental apartment expense as a corporate expense. Initially Kerman stated that the apartment was used to host business visitors. However, in its Opening Brief, Kerman stated that employees who live in or near Foresthill must often travel to Kerman on business, therefore the use of the apartment saves money because otherwise its employees would have to rent a hotel room.

⁹³ Exhibit ORA-1 at 34.

Kerman explains that it pays \$1,175 per month for the apartment, \$403 of which is assigned to intrastate non-corporate expenses. Kerman maintains that even assuming the lowest recommended per-night hotel stays for Commission employees of \$105 per night, it would take just over 11 nights per month of hotel stays to exceed the cost of the apartment.⁹⁴

ORA objects to including the cost of the apartment in the corporate expenses as Kerman did not offer an explanation for hosting business visitors or how hosting these visitors might enhance Kerman's ability to provide safe and reliable service. ORA also states that Kerman has not provided any documentation to support the business use of the apartment. For example, ORA claims that Kerman has not provided information regarding which employee or employees used the apartment for what assignment and period of time. ORA asserts that Kerman has not demonstrated why any business visitors who might use the apartment should have their business expenses subsidized by the CHCF-A.

ORA notes that in its last GRC, Kerman's request for apartment rental expense was also denied as unreasonable.

In order to overcome a presumption that expenses above the FCC's corporate expense cap are unreasonable, Kerman must make a showing that the corporate apartment is reasonable. Kerman did not demonstrate why the apartment rent should be borne by the ratepayers and it is therefore not reasonable. We continue to disallow the total rent expense of \$7,050, whether categorized as a corporate or operational expense, for ratemaking purposes.

⁹⁴ Kerman Opening Brief at 51.

8.2.9. Kertel Maintenance Contract

Kerman states that its affiliate Kertel provides network service to Kerman, in the amount of \$793,100 per year.⁹⁵ According to Kerman, Kertel provides Network Operating Center and Information Technology Technician labor to support Kerman's operations and customers. For this service, SEI bills Kerman \$66,091.67 per month. Of this amount, \$8,081.25 per month (\$96,975 per year) is allocated to Kerman's total corporate expenses.⁹⁶ The remaining \$58,010.42 per month is allocated to other operating expenses of Kerman.

ORA explains that Kerman could not provide a copy of the contract between Kerman and Kertel, nor could it provide any detailed invoices.⁹⁷ ORA explains that Kerman only provided an invoice for \$66,091.67 to support its position. The invoice, included as Attachment 2-10 to Exhibit ORA-1, does not describe the specific services provided to Kerman and does not identify any labor or materials. Without more information regarding the terms and conditions of the contract, ORA cannot review the contract for reasonableness.

Without documentation providing details of the maintenance contract with Kertel, Kerman's \$96,975 per year for such services is unreasonable and does not justify corporate expenses above the FCC cap.

8.2.10. Litigation Expenses

Kerman projected its legal expenses for 2015 to be \$525,475, approximately 4% of its operating expenses and argues that the rate case costs in the amount of \$175,603 should be considered outside of the corporate expense cap.

⁹⁵ ORA Report at 36.

⁹⁶ Exhibit ORA-1 at Attachment 2-10.

⁹⁷ ORA Opening Brief at 32.

ORA counters that Kerman's projected legal expenses for 2016 of \$525,475 are included in the \$3,365,417 that Kerman argues would be unreasonable to reduce by 50% if the corporate expense cap were applied.

ORA states that Kerman did not provide any supporting documentation for this amount, claiming that information documenting its legal expenses is protected by "attorney-client privilege." Without the ability to verify the reasonableness of the costs, ORA is concerned that Kerman has no incentive to control the amount of money it spends on legal services. ORA posits that absent any supporting documentation, it is impossible for the Commission to determine if the legal expenses requested are reasonable or related to the provision of safe and reliable utility service. For example, the year 2015 could have included a number of unusual, or one-time legal expenses that are unlikely to reoccur.

ORA states that although it did not have access to any documentation supporting 2015 legal expenses, it did review a sample of 2014 legal expenses and claims and three invoices totaling \$35,095 should not be included for forecasting purposes because those three invoices were for services rendered in 2013, and Kerman uses 2014 expense to project 2016 expenses.

ORA also objects to Kerman's position that the rate case costs of \$175,603 should be considered outside of the corporate expense cap.

Kerman has not provided sufficient justification for any legal expenses above the corporate expense cap. Kerman claims it participates in 10 cases per year, yet does not list what those cases are and we can identify only this general rate case, which includes cost of capital, and the rulemaking on CHCF-A, which is not a recurring event. We see no reason to adjust the cap for expenses that are unverified.

The \$35,095, in 2013 legal expenses used for 2016 forecasting purposes is unreasonable and is therefore disallowed. If Kerman wants legal expenses to be considered above the corporate expense cap, detailed invoices must be provided. Kerman can submit them as confidential, subject to Public Utilities Code Section 583 and General Order 66-C, as is the case with all other utilities regulated by this Commission.

8.2.11. Regulatory Position

Kerman states that it needs an additional regulatory person at \$120,000 per year to assist with the number of proceedings in which Kerman participates. Kerman states that a regulatory employee left at the beginning of 2014 and the regulatory manager's time is currently split between Kerman and FTC.

ORA argues that Kerman's request is not reasonable, because the regulatory manager's time has been split between Kerman and FTC since at least 2010.⁹⁸ ORA notes that, in addition to splitting his time between Kerman and FTC, Kerman states that the regulatory manager also spends a portion of his time on SEI's entities other than FTC (e.g., Kertel and Audeamus).⁹⁹ ORA also notes that "since the one regulatory manager left the company at the beginning of 2014, Kerman's regulatory manager's total time allocated to Kerman work has not varied significantly despite the fact that in 2014, alone, Kerman "actively participated in several general telecommunications proceedings."¹⁰⁰

⁹⁸ Exhibit ORA-1 at 38.

⁹⁹ *Id* at Attachment 2-15.

¹⁰⁰ Exhibit KTC-10 at 28.

ORA posits that because Kerman's regulatory manager can handle the demands of several Kerman proceedings working only part time, the need for an additional full time regulatory position is not justified. ORA recommends that the \$120,000 in expense requested for the regulatory employee should not be used as a means to justify exceeding the corporate expense cap.

Kerman argues that if the regulatory manager is required to devote full-time to Kerman, it will leave FTC without any regulatory support and that ORA would surely oppose a new regulatory position in FTC's next general rate case.

We agree that it appears another regulatory manager position is unnecessary and therefore unreasonable as justification to exceed the corporate expense cap. However, we leave it to Kerman to use its best judgment regarding hiring decisions, within the limits of the FCC corporate expense cap we adopt here.

Conclusion

Although we agree with ORA's recommended reductions in Kerman's estimated corporate expenses (see table below), in its Rebuttal Testimony, Kerman adjusted its corporate expenses downward significantly to \$1,559,288, so much of the \$842,971 that ORA recommends be disallowed has been removed by Kerman, as shown in Table 6.

Table 6 - ORA's Recommended Ratemaking Adjustments

Description of Adjustment	Amount
Additional Executive Compensation	\$294,705
Terminated Temp. Executive Position	\$58,144
Retired Manager Salary Adjustment	\$38,964
Calcom Membership	\$14,857
Donation/Contribution/Sponsorship	\$241,465

Annual Party/Banquet/Retreat	\$55,716
Rental Apartment	\$7,050
Unsubstantiated Corporate Maintenance Cost	\$96,975
2013 Attorney Fees	\$35,095
Total Identified Adjustments	\$842,971

Kerman has not provided sufficient documentation to support an adjustment of corporate expenses above the FCC cap. However, the cap does not limit Kerman's ability to spend above the cap, it merely limits its ability to have those expenditures paid for via the CHCF-A fund.

The Commission sets the corporate expense cap for Kerman at \$1,541,031 (\$1,530,319 plus the CPI adjustment of \$10,712) based on the FCC calculations¹⁰¹ and an updated loop number of 4,789.¹⁰² The difference between the FCC corporate expense cap of \$1,530,319 that we adopt here, and Kerman's updated estimate of \$1,559,288 is \$18,257. Kerman has not justified any expenses above the FCC calculated corporate expense cap. We are not persuaded by Kerman's argument that the difference between the unmodified cap and Kerman's estimate will cause the "major, customer-affecting issues to arise in Kerman in the long-term and possibly even in the short-term," as alleged in Kerman's Opening Brief.¹⁰³

¹⁰¹ $\$42.337 - (.00328 \times 4789) \times 12 \times 4789$.

¹⁰² Exhibit ORA-1 at 7, Footnote 15.

¹⁰³ Kerman Opening Brief at 59.

9. Non-Corporate Expenses

9.1. Central Office Building

Kerman's central office building is located at 811 S. Madera Avenue in Kerman, California. It is owned by SEI and leased to Kerman. Kerman 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 and includes this amount in its non-corporate expense.

Under the terms of the December 1, 1999 lease, provided at hearings, the "base rent" is \$592,800.¹⁰⁴ ORA states that Kerman was not able to provide ORA with specific information regarding the taxes and insurance for this leased building, claiming that "insurance premiums on properties leased by KTC are not assessed on an asset by asset basis... rather are assessed collectively for all Kerman's assets. Kerman made a similar claim regarding tax assessments."¹⁰⁵

ORA maintains that Kerman should provide supporting documentation for taxes and insurance it paid to justify recovering this expense from ratepayers and contributors to the CHCF-A program. ORA notes that in Resolution T-17081, the amount allowed by the Commission for ratemaking purposes was \$570,941 per year. Given the lack of documentation to support the increase from \$592,800 to \$760,800 per year, ORA recommends that rent in the amount of \$570,941 is reasonable.¹⁰⁶

Kerman claims that holding it to the terms of the 2008 lease are unreasonable. Kerman states that the central office building is critical to the

¹⁰⁴ Exhibit KTC-38.

¹⁰⁵ Exhibit ORA-1 at 41, citing Kerman e-mail dated February 24, 2015.

¹⁰⁶ *Id.* at 43.

provisioning of services to its customers, housing the central office switch in which all end user lines are connected in order to permit local and long distance calls. It contains all the necessary plant network elements, including distribution frames, interoffice facility points and other equipment necessary for Kerman's operations. Kerman posits that given the critical functions of the central office building, its rental expense claim of \$760,800 is more than reasonable and that ORA's recommendation ignores even inflationary adjustments.

Kerman argues the necessity and importance of the central office building, a point not in contention. The issue here is whether the rental expense claimed by Kerman for the central office building is reasonable. The only information we have for Kerman's rental expense is the lease amount from Resolution T-17081, from Kerman's last rate case. Kerman provided no documentation to support the rent increase from \$570,941 to \$760,800. Additionally, Kerman was unable to provide separate figures for taxes and insurance for the central office building, claiming both taxes and insurance are assessed collectively for all its assets and so no individual figures were available.

Absent supporting documentation for the rent increase, insurance and the tax assessment expenses, Kerman's request for \$760,800 in rental expense is unreasonable. The Commission adopts \$570,941 as the reasonable annual rent expense for the central office building, resulting in a reduction of \$189,859 in total non-corporate expense.

9.2. Maintenance Non-Corporate Expense – Kertel

Kerman's unregulated affiliate, Kertel provides Network Operating Center (NOC) and IT (Information Technology) technician labor to support Kerman's operations and customers. A portion of this IT maintenance expense is reported as a corporate expense. SEI bills Kerman 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 \$696,124 per year is allocated to Kerman's total non-corporate expenses.¹⁰⁷

ORA states that despite numerous requests, Kerman has not produced a copy of a contract with Kertel to provide the services. ORA asserts that as of March 27, 2015, the due date for ORA's opening testimony, Kerman was unable to produce a copy of a contract in order for ORA to determine the scope of the work and resources required to meet Kerman's needs.

ORA asserts that the sole documentation provided by Kerman is a monthly invoice that contains no description of the materials provided, the number of hours worked or the work performed.¹⁰⁸ ORA states that in its rebuttal testimony Kerman provided a general description of the maintenance services provided by Kertel,¹⁰⁹ but Kerman has not provided sufficient documentation or information to justify the expenses.

ORA notes that Kerman 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.¹¹⁰ Kerman fails to explain why the apparently redundant IT services of Kertel are necessary or reasonable.

ORA is concerned by the fact that Kertel is an affiliate of Kerman, and it appears that the contract was not executed at arms-length in that William Barcus is the president of both companies, and the contract was entered into without

¹⁰⁷ Exhibit ORA-1 at 43.

¹⁰⁸ *Id.* Att. 2-10.

¹⁰⁹ KTC-12 at 28.

¹¹⁰ ORA Opening Brief at 37.

anything in writing and no description of the labor, materials, or work to be done.¹¹¹ ORA asserts that without sufficient documentation, it is not possible to determine whether the expense for the work performed is reasonable.

ORA recommends that the Commission disallow the \$696,124 Kerman identified as expense for maintenance services provided by Kertel.

Kerman states that the services Kertel provides under the IS agreement are critical, as they support the operation of Kerman's switch along with other necessary telephone company functions and are not redundant of the network services provided by Neo Nova.¹¹² Kerman goes on to state that without the IT services provided by Kertel, Kerman would not be able to complete a single telephone call because no problems with the switch could be repaired and this could threaten 911 connectivity for the entire Kerman area.¹¹³

Kerman claims that in response to a data request from ORA, it provided specific terms regarding the services Kertel provided well in advance of the due date for ORA's testimony. Kerman asserts this was sufficient information and the agreement between Kerman and Kertel does not have to be in the form of a written contract in order to be valid. Kerman also claims that information including a description of materials, hours worked or work performed is not necessary information for an invoice for fixed-cost services agreements.

The Commission shares ORA's concern about the lack of documentation for these services, the relationship between Kertel and Kerman, and the contract for IT services with Neo Nova Network which may be redundant.

¹¹¹ *Id.*

¹¹² Exhibit KTC-11 at 21-24.

¹¹³ *Id.*

Kerman has the burden of proof regarding the reasonableness of its estimated expenses. Written documentation of the claimed expense is an essential element of that proof and here it is sorely lacking. The only written documentation of this agreement is one invoice Kerman provided in its rebuttal testimony. Kerman's invoice contained no specific information regarding materials used, services performed or hours worked, claiming that this information is unnecessary.

Given that our purpose here is to review the reasonableness of Kerman's expenses, and since Kerman has the burden of proof, it is in Kerman's best interest to provide as much information as possible to support its expense claim. Due to the lack of written documentation between Kertel and Kerman describing the exact nature and terms of the services provided, questions as to whether the agreement was negotiated at arms-length, and the possible redundancy of the contract, the Commission finds the \$696,124 for maintenance services provided by Kertel unreasonable and disallows it as a non-corporate expense.

**9.3. Kerman's Warehouse Facility –
15061 W. C Street**

Kerman leases a warehouse facility located at 15061 W. C Street in Kerman from its affiliated entities, the Barcus Family Partnership and the S&K Moran Partnership. Kerman pays rent in the amount of \$17,885.59 to the Barcus Family Partnership and \$17,885.59 to the S&K Moran Family Limited Partnership for a total of \$35,771.18 per month or \$429,254 per year.¹¹⁴

ORA states that Kerman was not able to produce a lease agreement until April 28, 2015, the first day of hearings and the lease had been executed just a

¹¹⁴ Exhibit ORA-1 at 45.

few days prior. The base rent in the re-executed lease agreement is \$382,577.04 per year, less than the lease expense claimed in Kerman's application.

According to ORA, the square footage of the warehouse is 14,058, which equates to \$2.27 per square foot per month under the re-executed lease. For comparison, Sebastian's corporate building leases office space in Fresno for \$1.95 per square foot per month.

ORA identified comparable warehouse spaces for \$0.31 per square foot per month, \$0.75 per square foot per month, and \$0.50 per square foot per month. Based on this information, ORA maintains that the lease is far above market value, was negotiated between William Barcus and his mother Ruth Barcus, and was therefore not an arms-length transaction.

Kerman states that it was unable to find the original executed lease and so re-executed a lease. Kerman also states that ORA's comparison rents are invalid because they are not in the same area as the existing warehouse, and ORA does not state whether the comparable spaces are specially equipped with adequate facilities to operate a telephone company.

Because Kerman was unable to provide an original executed lease agreement, the monthly rent paid appears to be well above market rate and the recently re-executed lease was between William Barcus and Ruth Barcus, ORA recommends that Kerman's entire lease amount be disallowed.

As an alternative, ORA suggests that the Commission could allow a portion of the lease. According to ORA, base rent is listed in the re-executed lease is \$382,577.04.¹¹⁵

¹¹⁵ Exhibit ORA-1 at 36.

Again, Kerman has the burden of proof here. It is not up to ORA to prove that Kerman's estimated expenses are unreasonable, but up to Kerman to prove they are reasonable. Kerman's request for non-corporate warehouse lease expense of \$382,577.04¹¹⁶ is unsupported by anything other than a recent, hastily re-executed lease. There is nothing in the record to support Kerman's original claim of \$429,254 for the lease expense because apparently neither the lessee nor the lessor is in possession of a copy of the original lease. In addition, even the hastily executed contract appears to provide for an above-market rental rate and is between family members involved in affiliated entities. For these reasons the Commission finds Kerman's requests for \$429,254, or \$382,577.04 in warehouse rental expense unreasonable and disallows this expense.

9.4. Marketing Expense

Kerman reported total company marketing expenses as of December 31, 2014 of \$373,069. ORA notes that Kerman does business under the name Sebastian, along with all of its affiliates. ORA reviewed a sample of Kerman's marketing expense transactions, which showed that some of its marketing expenses are charged 100% to Kerman, while others are allocated between the four affiliated entities doing business as Sebastian, including Kerman, Foresthill, Audeamus, and Kertel. ORA notes that the split between the four entities was not evenly divided to each affiliate. ORA states that most were allocated 66.66% to the regulated entities (33.33% each to Foresthill and Kerman) with the remaining 33.33% split between the unregulated affiliates Audeamus and Kertel.

¹¹⁶ Kerman's original request was for \$429,254.

ORA suggests that the Commission consider whether certain marketing expenses for a regulated carrier for its basic telephone service are necessary or reasonable, because Kerman experiences no competition for basic landline telephone service.¹¹⁷ Despite Kerman's claims that its marketing expenses were reasonable to "promote [Kerman's] business opportunities, compete against competitors, and make customers aware of services,"¹¹⁸ ORA found that much of Kerman's marketing is in the form of sponsorships and branding in the name of Sebastian. In addition, ORA notes that some items included in the "marketing" category were actually for hotel stays and restaurant meals.¹¹⁹

ORA suggests that while the Commission could find that no advertising or marketing expense is reasonable for a regulated monopoly, at a minimum, ORA argues that a more reasonable allocation of marketing expenses is required.

Kerman states that like any company it incurs legitimate and necessary marketing expenses in order to promote its business opportunities, compete against competitors, make customers aware of services and encourage customer retention. Kerman also asserts that its marketing efforts provide important benefits to its ratepayers and promote consumer education for critical services and safety issues.

Kerman allocated \$373,069 to marketing expenses. After reducing the \$373,069 by the \$42,000 in fees unreasonably paid to Audeamus (discussed below), the remainder is \$331,069. ORA recommends that this total be divided equally by the number of affiliates. Although in its Opening Brief Kerman

¹¹⁷ Exhibit ORA-1 at 46.

¹¹⁸ Kerman Opening Brief at 48.

¹¹⁹ Exhibit ORA-1 at 46.

argues that its marketing expenses are actually 28% of the total SEI budget and that a 25% allocation would be incorrect, Kerman does not provide documentation to support or explain why Kerman's allocation is 28%.

While we find that marketing expenses for a monopoly carrier of last resort are not by definition unreasonable, we are troubled by the fact that based on ORA's review of a sample of expenses, the majority of the marketing expenses are borne by the regulated CHCF-A carriers, Kerman and Foresthill, while the affiliates, who would benefit equally or more from any marketing under the name "Sebastian" bear lower marketing expenses. We are also troubled by the fact that Kerman has included hotel stays and restaurant meals as marketing expenses, seeing no benefit to its customers in these expenses. The brochures describing services, brochures offering public service information, and white and yellow pages directory fees can reasonably be assumed to benefit Kerman's customers.

The Commission finds that a regulated monopoly, subsidized by CHCF-A funds, paying a larger, unsubstantiated share of marketing costs than its unregulated affiliates is unreasonable. The Commission removes \$248,302 in marketing expenses from Kerman's total reported non-corporate expenses. The Commission adopts \$82,767, which is one fourth of Kerman's total marketing expense, as reasonable.

9.5. Fees Paid to Audeamus

ORA reports that its review of a subset of Kerman's expenses revealed that Kerman's operating expenses include a yearly expense of \$42,000 for "customer retention fees." Kerman pays these fees to its affiliate, Audeamus on a monthly

basis and is charged to its marketing expense account.¹²⁰ According to ORA, Audeamus sells retail broadband services and charges Kerman a “customer retention fee” for each customer it acquires where the customer also retains telephone service from Kerman. Kerman does not provide a description of how the fees were calculated.

Audeamus purchases wholesale access to Kerman’s local loop in order to sell retail broadband services to customers in Kerman’s service territory.¹²¹ The fees that Kerman charges Audeamus for wholesale access to its network are assessed according to the National Exchange Carrier Association (NECA) Tariff No. 5. The “customer retention fees” that Kerman pay Audeamus are not part of the NECA Tariff.

ORA states that Kerman argues that the fees are paid to compensate for the “added value” associated with the broadband services provided by Audeamus. The fees Kerman pays to Audeamus serve only to offset a portion of the wholesale network access fees paid by Audeamus to Kerman. ORA maintains that these fees are unreasonable.

We agree with ORA, Kerman should be compensated for finding a customer for Audeamus, not the other way around. Therefore, the customer retention fee of \$42,000 paid by Kerman to Audeamus is unreasonable and disallowed as an expense.

¹²⁰ Exhibit ORA-1 at 47.

¹²¹ Exhibit ORA-1 at 39.

9.6. Apartment Rental Expense

In Section 9.2.8. we discussed the expense of a corporate apartment, found the expense unreasonable and disallowed \$7,050 in corporate expense for the apartment. The same rationale applies here and so we find the non-corporate apartment expense unreasonable and disallow an additional \$7,050 for the apartment allocated to customer operations expense.

10. Non-Discretionary Revenue**10.1. Residential Service Rate**

Ordering Paragraph 9 of D.14-12-084 provides as follows:

The Small Incumbent Local Exchange Carriers' Basic Residential Service Rates must be in a range of \$30, inclusive of additional charges, to \$37, inclusive of additional charges. This rate range of \$30 to \$37 will be presumptively reasonable and non-rebuttable. Actual rates will be set in the individual General Rate Cases of the Small Incumbent Local Exchange Carriers.

Kerman recommends the \$30 inclusive rate at the lower end of the range. Kerman states that its rates should reflect a total cost of \$30 for basic service, inclusive of the SLC, EAS, ARC, and state and federal high-cost and universal service charges.

Kerman maintains that given the low-income demographics of the Kerman service area, the lower end of the range is reasonable. Kerman notes that it had 2,031 lifeline customers at the end of 2014, constituting 52% of its total residential customers. Kerman also notes that the poverty rate in Fresno County is 26% as compared to a statewide rate of 15.9%. According to Kerman, the median income level in Fresno County is \$45,563 compared to the median income in the

City of Kerman of \$49,748 and a statewide median income level of \$61,094.¹²² Kerman also notes that over 50% of the households in the City of Kerman and almost 54% of the households in Fresno County make less than \$50,000 (compared to 41.9% for California as a whole).¹²³

Kerman explains that current unemployment rates for Fresno County are in the 10-15% range. Kerman also states that over a quarter of the households in both the City of Kerman and Fresno County fall into the range of \$25,000 to \$50,000, which is above the Lifeline threshold of \$25,000.¹²⁴

Kerman proposes a local service rate of \$22.58 for residential service. Kerman also proposes to eliminate the EAS and ARC fees, which are currently included in basic residential rates.

Kerman states that the current elements that would constitute additional or "all inclusive" charges referenced in the FCC's USF/ICC Transformation Order for residential service area all of the following:

Local Residential Service Rate

Extended Area Service Rate (EAS)

Subscriber Line Charge (SLC)

ARC

Public Purpose Program Surcharges:

California High-Cost Fund (CHCF)-A

¹²² Exhibit KTC-10 at 6.

¹²³ *Id.* citing United States Census Bureau, available at <http://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml> (visited January 30, 2015).

¹²⁴ The Income threshold for the California Lifeline program are \$25,700, \$29,900, and \$35,900, for family sizes of 1-2, 3-4, and 4+ respectively, with an additional \$6,200 income allotment for each additional family member. (D.14-01-036.)

California High-Cost Fund (CHCF-B)
Universal Lifeline Telephone Service (ULTS)
California Teleconnect Fund (CTF)
Deaf and Disabled Telecommunications Program (DDTP)
California Advanced Services Fund (CASF)

911 Surcharge

Kerman states that, to be within the range established in the Phase 1 Decision, Kerman would need to increase its local residential rate to reach the \$30 lower end of the range. Kerman therefore proposes a local service rate of \$22.58, along with the elimination of the \$0.63 charge for EAS service and the \$1.50 ARC charge.

If the inclusion of the EAS charge and the ARC charge are not incorporated into the basic local service rate, Kerman maintains that the local service rate should be \$20.45. According to Kerman, under either scenario, the local residential rate would be consistent with the lower end of the range established in the Phase 1 Decision.

Kerman states that the proposed rate change in response to D.14-12-084 would result in an increase in local revenues of \$103,995 for 2016 over what was provided in the November 3, 2014 update.¹²⁵

ORA agrees with Kerman's proposal to increase basic residential service rates to \$22.58, as well as Kerman's proposal to eliminate the EAS and ARC charges for residential customers.¹²⁶ ORA agrees that the EAS, which allows

¹²⁵ Exhibit KTC-10 at 10.

¹²⁶ Exhibit ORA-1 at 10.

customers in Kerman to make a local call to Fresno, is outdated as a result of the FCC's transition away from access/reciprocal compensation to bill-and-keep for terminating minutes.

Kerman also seeks to eliminate the collection of the ARC from customer's bills, and to "neutralize the ARC charge by increasing support for intrastate revenue requirement."¹²⁷ According to Kerman, 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 exceeds \$30, inclusive of additional charges, the ARC charge cannot be assessed.¹²⁸ ORA agrees that the all-inclusive basic residential rate should be raised to \$30 to account for eliminating the ARC.

The Commission finds that increasing Kerman's basic residential service rates to \$22.58 and eliminating the EAS and ARC charges for residential customers is reasonable. Therefore, the basic residential rate should be raised to \$30 inclusive, which will increase Kerman's local revenue for 2016 by \$103,995.

10.2. Basic Business Rate

In its direct testimony, Kerman recommended that the basic business service rate should be \$30. In its rebuttal testimony, Kerman states that "ORA's proposal to increase business rates in the amount of the EAS increment that I propose to eliminate is sensible."¹²⁹ Kerman agrees that "it would be appropriate

¹²⁷ *Id.*

¹²⁸ *Id.* at 30.

¹²⁹ KTC-12 at 3.

to increase the basic business service rate to offset the EAS charge currently imposed (\$59,092) and roll it into the basic service rate."¹³⁰

ORA recommended that the basic business rate be \$36.30, inclusive of additional charges, and eliminating the EAS for business customers.¹³¹ ORA and Kerman agree that increasing the basic business service rate by \$4.60, the same amount as the EAS that will be eliminated, results in an additional \$59,092 in revenue.¹³²

However, ORA states that Kerman does not address the shortfall from the lost ARC charges of \$1.50 per customer (a revenue loss of \$19,269), which accounts for the difference in ORA's recommended revenue adjustment related to business service of \$78,361.

ORA and Kerman agree that the total revenue of \$59,092 from the discontinued EAS charge for business should be rolled into the new basic rate for business customers. The Commission finds this proposal reasonable.

We also find ORA's recommendation that the lost ARC revenue of \$19,269 be rolled into business rates reasonable. Kerman provides no justification why the EAS and ARC charges should be treated differently. Therefore, a total revenue adjustment of \$78,361 should be rolled into Kerman's new business service rate of \$36.30.

¹³⁰ *Id.* at 24.

¹³¹ ORA Opening Brief at 14.

¹³² *Id.*

10.3. Universal Service Fund and Intrastate Access Revenues

ORA states that it confirmed Kerman's representations regarding mandatory Universal Service Fund (USF) charges compared to those in the 2015 NECA calculation. ORA notes that while Interstate USF revenue fluctuated between 2010 and 2014, it averaged \$1.95 million per year. Kerman projects an increase in 2015 to \$2 million, which is forecasted to continue in 2016. ORA accepts Kerman's estimate.

ORA also accepts Kerman's projections for Intrastate Access revenues, which Kerman derived by applying growth rates to an estimated 2014 annual total. Kerman used a 2012-2013 growth rate for the special access volume charges, but used judgment-based growth rates for switching, originating and terminating volume changes.¹³³

We find Kerman's projections and ORA acceptance of USF and Intrastate Access revenues reasonable.

11. Discretionary Revenue

Kerman offers certain telecommunications services which are not part of basic telephone service, including inside wire maintenance service, caller ID service, call waiting and rental telephone equipment. ORA describes these services as discretionary because customers do not necessarily need them and Kerman is not required to provide them. Kerman disagrees with ORA's characterization, and argues that because they are included in Kerman's tariffs, Kerman is required to provide them.¹³⁴

¹³³ Exhibit ORA-1 at 22.

¹³⁴ Kerman Reply Brief at 56.

Kerman's revenue projection for local network services for test year 2016 is \$1,759,865.¹³⁵ ORA estimates that Kerman should earn \$2,118,030 in revenues from local services priced more reasonably. ORA also adjusts the methodology for estimating growth rates. The difference between Kerman's estimate and ORA's is \$358,165.¹³⁶

Kerman argues that the filed rate doctrine forbids a regulated entity to charge rates for its services different from those filed with the appropriate authority. Kerman's argument that it "must" provide customers with optional services is false. The difference is that Kerman may choose to discontinue offering optional services such as inside wire maintenance service, but Kerman may not choose to discontinue offering basic telephone service because it is the carrier of last resort.

ORA's primary assertion is that Kerman is offering certain services at rates that are far below the rates charged for similar services by other carriers. ORA argues that undercharging for similar services results in other customers subsidizing the provision of these optional services through the CHCF-A. ORA notes that Pub. Util. Code § 275.6(c)(3) requires the Commission to find that rates charged are "reasonably comparable" to rates charged to customers of urban telephone corporations.

Kerman's response to ORA's proposal to increase rates for optional services is that the increases could place these services out of reach for many of Kerman's customer's. Kerman also states that many of its senior citizens use

¹³⁵ Exhibit ORA-1 at 7. Increased to \$1,850,745 in Kerman's April 16, 2015 rebuttal testimony.

¹³⁶ This difference includes the adjustment of \$78,361 attributable to business basic rate differences as discussed in Section 12.

these services. Kerman is essentially arguing that it must charge well below market rates for all of its services. Kerman does not rebut the argument that its rates are not reasonably comparable.

11.1. Tariff A-22 Employee Discounts

Kerman offers its employees a 50% discount for phone service. ORA recommends that Kerman eliminate the employee discount because Kerman's basic service residential rates are already heavily discounted due to the CHCF-A subsidy and only six of Kerman's employees work full time for Kerman.

Kerman argues that its employee discount is an important benefit that helps Kerman attract high-quality employees. Kerman further argues that the fact that Kerman utilizes these employees across different business platforms does not diminish the reasonableness of offering a discount.¹³⁷

Given that Kerman's basic service rate is heavily subsidized by Kerman customers and telecommunications ratepayers in general through the CHCF-A, and only six of Kerman's 69 employees work full-time for Kerman, although all 69 are gainfully employed by Kerman and one or another affiliate of Kerman, the Commission finds an employee discount of 50% unreasonable.

We do not dispute the quality of Kerman's employees or whether they deserve a discount. The question here is whether the discounts should be underwritten by the CHCF-A. Our decision does not preclude Kerman shareholders from providing discounts to its employees.

The Commission's disallowance of a 50% employee discount for telephone service results in an additional \$5,026 in local network revenues.

¹³⁷ Exhibit KTC-12 at 4.

11.2. Tariff A-28 Custom Calling Features

Kerman's Tariff A-28 describes the rates for custom calling features, which are not included in Kerman's basic service. The custom calling features include caller ID, call waiting, call forwarding, three-way calling, and anonymous call rejection. For each of these services, ORA suggests that Kerman is undercharging for its services relative to other carriers, contrary to Public Utilities Code Section 275.6(c)(3). ORA's comparison of some of Kerman's and AT&T's custom calling rates, and ORA's proposed custom calling rates is shown in Table 7.

Table 7

	Kerman's Rates	AT&T's Rates	ORA's Proposal for Res. & Bus.
Caller ID	\$6.17	\$9.99	\$9.99
Call Waiting	\$3.23	\$9.00	\$8.50
Call Forwarding	\$3.23	\$7.50	\$6.50
3-Way Calling	\$3.23 Res. \$5.00 Bus.	\$7.50	\$7.00
Anonymous Call Rejection	\$3.00 Res. \$5.00 Bus.	\$7.50	\$6.50

Pursuant to Section 275.5(c)(3), the rates for Kerman's custom calling features must be "reasonably comparable" to the rates that urban customers pay. ORA's recommended rates for the Tariff A-28 services are reasonable. Therefore the Commission adopts ORA's recommended rates for Tariff A-28 which increases Kerman's local network revenue projections by \$121,410.¹³⁸

¹³⁸ Exhibit ORA-1 at 14.

11.3. Tariff A-32 Inside Wire Maintenance

Kerman's Tariff A-32 covers inside wire maintenance service. Kerman's inside wire maintenance service includes installation of the service and the monthly maintenance charges and Kerman charges \$1.10 per month for the service.

Again, ORA points out that pursuant to Section 275.5(c)(3), Kerman's rates, including those for discretionary services, must be "reasonably comparable" to the rates that urban customers pay. ORA points out that as of 2013, AT&T and Verizon charge \$8.00 and \$7.99 respectively. ORA recommends that Kerman increase the charge for inside wire maintenance to \$7.50 per month for residential customers and \$8.00 for business customers. According to ORA, raising these rates would generate an additional \$151,073 in 2016 revenues.¹³⁹

Kerman contends that the value of inside wire maintenance service would be diminished if ORA's proposed rate changes were adopted. Kerman states that this service acts as an insurance policy for customers against potential inside wire repair services that may be required.

Kerman states that it has 1,143 Lifeline customers who subscribe to the inside wire service for \$1.10 per month (61.8% of inside wire subscribers). Although it has not done any elasticity studies to identify the effect of ORA's proposal,¹⁴⁰ Kerman states that it expects a minimum reduction of 50% in the customer counts for this service if ORA's recommendation is adopted.¹⁴¹ Kerman then assumes that 90% of current inside wire customers would decline future

¹³⁹ Exhibit ORA-1 at 14.

¹⁴⁰ Exhibit KTC-12 at 13.

¹⁴¹ *Id.* at 15.

inside wire service, and argues that based on this customer loss, the revenues should be estimated at only 10% of the proposed revenue, or \$17,765.¹⁴²

Kerman also argues that because Kerman serves a low-income area, many of its customers would discontinue this service if ORA's proposed rate was adopted.¹⁴³ Kerman also argues that adopting ORA's proposal would cause the company to experience "a significant reduction in both customers and revenues". Kerman recommends the Commission create a memorandum account to allow a "one-time and recurring adjustment to the CHCF-A draw" so that Kerman can adjust for the actual "demand loss" from this proposal.¹⁴⁴

ORA states that Kerman's position is essentially that it may lose customer lines as a result of the inability to undercharge for inside wire maintenance service. Kerman is not arguing that the actual cost of providing inside wire maintenance service is in the neighborhood of its \$1.10 per month charge or indeed any particular amount. Instead, Kerman argues that its customers are low income and therefore to keep its customers, it should be permitted to continue to offer inside wire maintenance service at a substantial discount compared to AT&T and Verizon.

The Commission finds that Kerman's rates for inside wire maintenance are not "reasonably comparable" to the rates that urban customers pay, and are therefore not reasonable. The Commission finds that increasing the rates for inside wire maintenance to \$7.50 per month for residential customers and \$8.00 for business customers, comparable to AT&T's and Verizon's rates, are

¹⁴² *Id.* at 16.

¹⁴³ *Id.* at 14.

¹⁴⁴ *Id.* at 16.

reasonable. Increasing these rates will generate an additional \$151,073 in 2016 revenues.

11.4. Growth Rates

ORA asserts that in addition to the revenue differences created by Kerman's underpriced discretionary services, revenue projections are also affected by the difference in growth rate projections. Kerman forecasted its growth rate using the years 2012-2013, resulting in an 87% growth rate, meaning a forecasted decline of 13% of customers who subscribe to the custom calling features. ORA argues that usage rates for this service have remained fairly steady over time. ORA compares a three-year average growth rate in 2012-2014 of 97%, and a five-year average of 2010-2014 of 100% to Kerman's one-year growth rate of 87%. ORA projections result in revenue of \$100,674, an increase in revenue of \$17,766 above Kerman's revenue projections for custom calling features such as residential caller ID and call waiting.

In rebuttal, Kerman explains that it "modified growth rates in certain instances where prior periods seemed to indicate higher numbers for some reason,"¹⁴⁵ but that it can support ORA's adjustment on this point. This adjustment would add \$17,766 to Kerman's proposed revenue calculation.

The Commission adopts the parties' projected growth rates as reasonable. The adjusted growth rates result in increased revenue of \$17,766 for custom calling features such as caller ID and call waiting.

¹⁴⁵ Exhibit KTC-12 at 18.

11.5. Call Waiting Caller ID

ORA states that Kerman does not assess a separate charge for residential or business call waiting caller ID and recommends an \$8 per month charge for these services that results in an additional revenues of \$7,296.

Kerman admits that its tariff does not assess a separate charge for residential or business call waiting ID services. Kerman explains that there is no separate charge for call waiting ID services since customers who purchase both call waiting and caller ID, have call waiting ID included in their services.

The Commission finds Kerman's explanation of how these services are provided and represented in its tariff reasonable. Therefore we do not increase the revenue for call waiting caller ID.

11.6. Directory Assistance Revenue

Kerman agrees with ORA's recommendation that 2016 projected revenues should include \$2,200 in directory revenue.¹⁴⁶

The Commission finds the parties' recommendation regarding \$2,200 in directory assistance revenue reasonable. Adopting the recommendation results in an additional \$2,200 in Kerman's projected revenue for 2016.

11.7. Late Fees

Kerman agrees with ORA's recommendation that 2016 projected revenues should include \$6,306 for anticipated late fees, stating that it inadvertently failed to charge late fees for certain customers.

¹⁴⁶ *Id.* at 3.

The Commission finds the parties' recommendation regarding \$6,306 in late fee revenue reasonable. Adopting the recommendation results in an additional \$6,306 in Kerman's projected revenue for 2016.

11.8. Customer Premises Equipment (CPE)

ORA recommends that revenue generated from CPE be added to Kerman's revenue for ratemaking purposes. CPE is the telephone equipment that Kerman rents to its customers. Kerman reported no revenue for CPE maintaining that it is outside the Commission's jurisdiction to count CPE revenue as part of Kerman's ratemaking calculations.¹⁴⁷

ORA likens CPE to a company truck, or other company equipment. The sale and manufacture of these items is not regulated by the Commission, but the Commission must determine the reasonable level of associated costs to include in rates.¹⁴⁸ ORA cites D.13-09-038 that holds, "states have no role whatsoever in overseeing CPE manufacture or distribution" but asserts the decision does not address the costs or revenues associated with CPE. ORA recommends that Kerman's revenue be increased by \$6,288 to account for the 71 customers who are charged \$2 per month for CPE and thereby reduce the CHCF-A subsidy by an equal amount.

Kerman states that unlike a company truck, it does not own the CPE and the CPE is not used by the company in serving customers. Kerman states its affiliate owns the CPE. Kerman also asserts that expenses associated with CPE

¹⁴⁷ Exhibit KTC-12 at 19.

are not generated by the company and therefore the CPE revenue should not be included in revenue.

The Commission does not adopt ORA's recommendation to include revenue generated from CPE in Kerman's revenue for ratemaking purposes. The CPE is not owned by Kerman, but an affiliate. The costs associated with CPE are not generated by Kerman and therefore, including \$6,288 of CPE revenue in Kerman's revenue is unreasonable.

12. Plant, Depreciation and Ratebase Adjustments

12.1. Plant in Service

ORA approves of Kerman's "Five Year Plan" for additions to plant with one minor adjustment for depreciation of copper assets. Kerman's five-year plan includes projects for the development of Fiber to the Home (FTTH) infrastructure throughout downtown Kerman and eventually to customers outside of the downtown area. Kerman's estimated total for all the projects over the three years considered in this rate case is \$7,811,197, which would be added to Kerman's ratebase.

The FCC found that 53% of individuals who live in rural areas lack access to minimum broadband benchmark speeds of 25 Mbps download/3Mbps upload, compared to 8% of urban areas. Kerman states that a fiber network based on the FTTH technology is necessary to provide high speed service to its unserved or underserved customers.¹⁴⁹ By completing the proposed projects, Audeamus, Kerman's affiliate would be able to deliver broadband speeds to the Kerman service area that match the speeds of urban systems.

¹⁴⁹ Exhibit KTC-4 at 7.

ORA believes there are safety benefits to the FTTH projects. For example, during emergency situations fiber systems allow for rapid communication between emergency service providers. However, ORA points out two safety concerns identified by the Commission; lack of requirements governing back-up power and consumer notification and education about the impact of the transition.¹⁵⁰

ORA states that 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 connect to the line (excluding cordless/wireless phone systems) to remain viable methods of communication.¹⁵¹ The life of most back-up power sources is only 4 – 8 hours and the use of back-up power changes customer expectations of how telephone service is provided. In this case, who is responsible for maintenance of back-up power? ORA recommends that Kerman 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 new responsibilities they must undertake.

Kerman states that it currently monitors the battery life for all of its fiber-to-the-home customers, has an alarm system that provides notice that battery

¹⁵⁰ 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, at 3-7.

¹⁵¹ Exhibit ORA-1 at 56.

issues exist, and Kerman has assumed responsibility for replacing these batteries. Kerman also provides a notice to every customer that is put on fiber-to-the-home facilities, both at the time service using fiber facilities is initiated and every year thereafter in an annual notice. This notice identifies the issues related to power outages, phone limitations with corded and cordless phones, and battery life issues. It also indicates the length of time the battery may last and that customers can obtain additional batteries and keep them on hand if they choose.¹⁵²

The Commission finds Kerman's plans regarding back-up power and information for customers adequate and therefore reasonable. No additional reporting is required.

12.2. Accelerated Copper Depreciation

Kerman proposes to replace its current copper based services with FTTH technology at a cost of \$7,811,197 added to ratebase. Kerman is requesting accelerated depreciation of its Underground Metallic Buried Metallic Cable and Wire Facilities¹⁵³ which are associated accounts of the copper wire infrastructure. Kerman states that copper depreciation is necessary because metallic cable facilities are not capable of providing the services customers will need and therefore these facilities will likely need to be replaced long before they become fully depreciated.¹⁵⁴

ORA states that Kerman's current copper plant is still useful and in good repair and has the capacity to exceed current CPUC and FCC minimum standards for

¹⁵² Exhibit KTC-5 at 3.

¹⁵³ Exhibit KTC-4 at 10-11.

¹⁵⁴ *Id.* at 11.

broadband services in rural areas.¹⁵⁵ ORA asserts that Comcast already serves over 70% of the Kerman area and that Kerman is asking to remove useful copper and depreciate it at an accelerated rate so that it can advance its five year plan. ORA asks the Commission to require Kerman's shareholders to absorb the accelerated depreciation (\$350,031) while still receiving the full \$7.8 million cost of the FTTH project.¹⁵⁶ ORA states that this is a more equitable distribution of the costs of building the fiber networks immediately.

We find that asking shareholders to absorb \$350,031 in accelerated depreciated expense related to underground copper wire facilities for Test Year 2016 is an equitable distribution of costs. The \$350,031 removed from Kerman's ratebase will offset the \$7,811,197 in new FTTH projects added to its ratebase, and is therefore reasonable.

12.3. Other Work Equipment (OWE)

Kerman's proposal for Plant in Service for test year 2016 includes an account for OWE. According to Kerman, this account includes construction equipment such as cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment, and concrete saws.¹⁵⁷

For test year 2016, Kerman projects the OWE account to have an average balance of \$1,249,638, with related accumulated depreciation of \$566,870. A net total of \$682,768 associated with OWE is included in ratebase.¹⁵⁸

ORA maintains that Kerman's ratebase should exclude the entire plant balance recorded in the OWE and any related accumulated depreciation for this

¹⁵⁵ WC Docket No.10-90, FCC 14-90, Dec.18, 2014 at 6 and CPUC D.12-02-015, Feb. 1, 2012, at 17.

¹⁵⁶ Exhibit ORA-1 at 59.

¹⁵⁷ Exhibit KTC-4 at 9.

¹⁵⁸ Exhibit KTC-12 at DC-3.

account on the basis that Kerman does not use the equipment to provide service to customers. ORA asserts that instead, Kerman rents or leases the equipment to its unregulated construction affiliate, Kertel Communications.¹⁵⁹

ORA recommends that Kerman's 2016 Plant in Service be adjusted to remove this account and its associated effects on ratebase and depreciation expense, while removing the credit to the related expense account for the \$17,154 in rental fees that Kertel paid to Kerman in 2014. The net adjustment would result in a decrease to Kerman's revenue requirement in the amount of \$138,852.

As support for its position, ORA cites a telephone conversation with Mr. Clark and Carolyn Dukes on March 11, 2015. ORA also cites a Data Response provided by Kerman in which Kerman states that "2116.10 Other Work Equipment" is provided on a time leased basis to the affiliate and is also reflected as an offset to the Other Work Equipment expense accounts (611410 and 61120).¹⁶⁰

Kerman further states that "[w]ith the Other Work Equipment ("OWE") account, Kerman develops an hourly lease rate using the GE-100 model that was developed by the Commission for determining such items as lease rates."¹⁶¹

In addition, ORA argues that the hourly lease rates that Kerman charges its unregulated affiliate Kertel are problematic because they are extremely outdated.¹⁶²

¹⁵⁹ Exhibit ORA-1 at 60-61.

¹⁶⁰ Exhibit ORA-1 at Attachment 3-8 (page 4 of 5).

¹⁶¹ *Id.*

¹⁶² Exhibit ORA-1 at 61.

On rebuttal, Kerman's witness Kehler states that there are two different types of equipment in the OWE category. The first type includes \$416,050 of "test equipment, tools, generators, and other equipment that are used on a fairly regular basis or as needed and used on site in emergency situations."¹⁶³

According to Kehler, the second type of equipment are "larger construction equipment such as backhoes, trenchers, horizontal directional drill rig, cable dollies, and associated trailers." According to Kehler, "this equipment constitutes \$805,677 of the OWE and is the issue in ORA's testimony."¹⁶⁴

Kehler states that "the company" uses the OWE equipment it has to deal with these issues. Kehler asserts it is more cost effective than having the construction company bring its equipment to Kerman to address limited issues.

Kerman's witness subsequently testified that Kerman does in fact use the OWE itself for installation and repair. The witness did not explain why his testimony contradicted the previously provided information that OWE is leased to the affiliate. This information was provided to ORA in response to a data request. ORA posits that this makes the testimony less reliable. ORA states that, it is worth noting that among the services provided by "Audeamus to telco" as identified in Attachment 2-24, of Exhibit ORA-1, is the service "regulated installation and repair services."

ORA states that it researched lease rates for similar equipment and provided a comparison of rates as shown in Table 8.¹⁶⁵

¹⁶³ Exhibit KTC-5 at 4.

¹⁶⁴ *Id.*

¹⁶⁵ Exhibit ORA-1 at Attachment 3-9 through 3-14.

Table 8

Kerman Rates		Competitive Rates	
Equipment	Daily Rate	Equipment	Daily Rate
Generator 7200 Watt	\$3.23	Generator 7500 Watt	\$66.00
Backhoe Deere 3000	\$36.00	4 WD Std. Backhoe	\$275.00
Forklift 10,000 lb.	\$36.95	Forklift 10,000 lb.	\$379.00
Ditch Witch 6510	\$56.71	Ditch Witch 4500	\$414.00
Air Compressor Leroi	\$24.51	Air Compressor 375 CFM	\$225.00

Based on the current market rental information presented by ORA for similar equipment in the Kerman area, it is clear that the lease rates paid by the affiliate to Kerman for use of the OWE are far too low. Kerman's reliance on outdated lease rates is unreasonable. As with all other expenses, Kerman bears the burden of proving that its plant is used for utility purposes and that the lease rates used are reasonable. Kerman has not provided sufficient information to support its proposed lease rates.

We agree with ORA that the use of extremely outdated GE-100 lease rates is unreasonable. The fact that Kerman believes it is appropriate to charge its affiliate such outdated rates increases our concerns regarding Kerman's affiliate transactions. The Commission is under no obligation to periodically provide the small LECs with updated lease rates. Instead, it is the small LECs responsibility to demonstrate that its costs are just and reasonable. Furthermore, the affiliate rules are clear that the affiliate must pay the market rates for goods and services

provided by the utility. In this case, it is clear that the affiliate is not paying the market rate.

We are also concerned that Kerman's witnesses contradict the information previously provided to ORA in response to a data request. It raises a credibility issue with the subsequent testimony.

For these reasons, we find that Kerman's ratebase should exclude the entire plant balance recorded in the OWE and any related accumulated depreciation for this account on the basis that Kerman does not use the equipment to provide service to customers, but instead rents or leases the equipment to its unregulated construction affiliate, Kertel Communications. By removing Kerman's OWE plant average balance of \$1,249,638 and the corresponding accumulated depreciation balance of \$566,870 from Kerman's revenue model, the net adjustment results in a decrease to Kerman's revenue requirement in the amount of \$138,852.

13. Chamber of Commerce Use of Kerman's Central Office Building

During the evidentiary hearing on April 29, 2015, Kerman Witness David Clark confirmed that Kerman's Chamber of Commerce occupies the old central office building, which is one block from Kerman's current central office building. When the witness was asked if the Chamber of Commerce pays rent, the witness was unsure.¹⁶⁶ Since this property is owned by Kerman, and is being occupied by the Chamber of Commerce, Kerman should be collecting market rate rent and reporting it as revenue. Kerman's failure to do so is unreasonable.

¹⁶⁶ RT at 295.

In order to impute rental income for the space, the Commission's Communications Division did an Internet search of available rental properties in Fresno, CA¹⁶⁷ and found six office spaces for rent. The rents ranged from \$12 to \$22 per square foot per year with the average being \$16.90 per square foot. If we assume the Chamber of Commerce occupies 2,000 square feet of office space, the monthly rent is \$2,817 and the annual rent is \$33,800, at the average cost per square foot of \$16.90. The Commission takes Official Notice of these rental figures pursuant to Rule 13.9 of the Commission's Rules of Practice and Procedure.

Because we have found that Kerman not collecting rent from the Chamber of Commerce is unreasonable, the Commission finds imputing rental revenue of \$33,800 for the Chamber of Commerce occupancy of Kerman's old central office building is reasonable.

In addition, we will require Kerman to provide our Communication's Division staff with information regarding rental of this office space. No later than 10 days after the effective date of this decision, Kerman shall provide a report to the Commission's Communications Division, and serve the report on the service list of this proceeding, responding to the following questions:

- Does the Kerman Chamber of Commerce rent the Old Central Office Building?
- How much rent does the Chamber of Commerce pay?
- How many square feet is the building and how many square feet does the Chamber of Commerce occupy?
- Are any other tenants of the Old Central Office Building?

¹⁶⁷ <http://www.loopnet.com/for-lease/fresno-ca/office/?e=u>

- Are there executed leases for occupants of the old Central Office Building? If so, provide copies of the leases.
- If there are no executed leases for tenants of the Old Central Office Building, explain why.
- What is comparable office space leasing for per square foot in Kerman? Provide three examples of office space lease rates in the area.

14. Affiliate Transaction Issues

The second amended scoping memo and ruling states that the “[i]dentification of all Kerman affiliates and the affiliate revenues, consistent with section 275.6” as being within the scope of the proceeding.¹⁶⁸ In ORA’s Corrected Report and Recommendations, it asserts that Kerman, along with its affiliates, does business under the name Sebastian, and that in “addition to creating a tangle of business records that are difficult to segregate, the business name and organizational structure of Kerman” allows unregulated affiliates to reap the benefits and rewards.¹⁶⁹ In its Opening Brief, ORA alleges that Kerman failed to demonstrate that its transactions with its affiliates were conducted on an arms-length basis to protect ratepayers and avoid excessive costs and that as a result, the CHCF-A is subsidizing the expenses and operations of unregulated non-telephone companies.¹⁷⁰ Although not set forth in its Corrected Report and Recommendations, ORA’s Opening Brief makes nine recommendations to

¹⁶⁸ Second Amended Scoping Memo and Ruling at 8.

¹⁶⁹ Exhibit ORA-1(a) at 3.

¹⁷⁰ ORA’s Opening Brief at 5. In support, ORA refers to the discussion of Other Work Equipment and Kertel’s maintenance and construction for KTC, which are discussed in Exhibit ORA-1(a) at 3, 46, and 60.

separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to do the following:

- Be held in separate legal entities.
- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no overlapping of employees or responsibilities.
- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at "arms-length".
- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.¹⁷¹

Kerman challenges ORA's affiliate interaction and structure proposals on a variety of grounds. Kerman argues that the Commission cannot and should not consider the proposals because they are outside the scope of the proceeding, were never examined during the evidentiary hearings (thus denying Kerman of the opportunity to examine ORA's witnesses about the basis for the proposals), and are inconsistent with prior Commission precedent and federal law.¹⁷²

Kerman further asserts that if the Commission were to consider and adopt ORA's proposals, the Commission would not be acting as required by law since the decision would be resolving an issue that is not identified in the Scoping

¹⁷¹ *Id.* at 5-6.

¹⁷² Kerman's Reply Brief at 66-67.

Memo.¹⁷³ But it is also true that Kerman did submit rebuttal testimony from William Barcus on ORA's charge in its report and recommendations that Kerman has a "tangle of business records that are difficult to segregate."¹⁷⁴

Given the state of the record and the challenges that Kerman has made, it is necessary for the Commission to discuss its authority to address affiliate-transaction issues in general, ORA's recommendations in particular, and the level of notice that must be provided to an applicant that the Commission may address affiliate transactions in its decision.

14.1. Commission Authority and Standards for Addressing the Legality and Structure of Affiliate Relationships and Transactions

In D.81896, wherein Continental Telephone Company of California sought permission to increase the rates charged for classified directory advertising, the Commission stated it "has often expressed its concern with affiliated interests and their impact on the cost of service furnished to the public." D.81896 cautioned that when a utility purchases services, commodities, capital equipment, the construction of new properties, and the use of funds from its parent or an affiliate:

There is an absence of arm's length bargaining with the loss of all of the protection which independent bargaining affords both the investors and the consumers. The unregulated development of affiliated relationships with utilities subject to our jurisdiction forces us to scrutinize affiliated intercompany transactions when a rate case is being considered to safeguard the interests of consumers and investors.

¹⁷³ *Id.*

¹⁷⁴ Exhibit KTC-2 at 4:7-16.

The Commission echoed its policy to protect the ratepayer from utility burdens years later in *Re Pacific Bell*,¹⁷⁵ in which Pacific Bell had filed an application requesting authority to increase intrastate rates. The Commission set forth its duty to analyze affiliate relationships in order to protect ratepayers from having to pay higher service rates to subsidize excessive payments to unregulated affiliates:

The Commission has historically scrutinized transactions between regulated utilities and affiliated corporations, and has in several cases imposed disallowances to account for excessive payments to unregulated affiliates. These actions have been premised on the need to carefully scrutinize affiliated transactions given the inherent lack of arms-length bargaining.¹⁷⁶

D.81896 and *Re Pacific Bell* provide clear direction that in proceedings seeking rate increases, this Commission must ensure that the prices that a regulated company charges its affiliates for its goods and services should be the same as those they would charge other competitors in arms-length transactions (*i.e.* transaction in which the parties involved act independently of each other, and without some special relationship.)¹⁷⁷ Ideally, affiliates should purchase services from the telephone company under tariffs equally available to all. Similarly, prices for goods and services that the carrier pays its affiliates should be the

¹⁷⁵ D.87-12-067, 27 CPUC 2d 1.

¹⁷⁶ 27 CPUC 2d at 96.

¹⁷⁷ See *Allegheny Ludlum Corp v. U.S.* (Fed. Cir. 2004) 367 F.3d 1339, 1348 (“An authoritative legal dictionary defines ‘arm’s-length’ as ‘of or relating to dealings between two parties who are not related or not on close terms and who are presumed to have roughly equal bargaining power; not involving a confidential transaction,’” quoting *Black’s Law Dictionary* 103 (7th ed.1999); and *Santomenno v. Transamerica Life Insurance Company* (2013) U.S. Dist. LEXIS 22354, * 19 (“[A]rm’s length negotiations or transactions are characterized as adversarial negotiations between parties that are each pursuing independent interests.”)

lower of cost or market value. To ensure these protections, the Commission has exercised its authority to open rulemakings in order to adopt and revise its regulations for utilities and their affiliate transactions.¹⁷⁸

This Commission went further in *Re Pacific Bell* and explained that its power to investigate and disallow unreasonable affiliate expenses is grounded in authority recognized by the California Supreme Court:

The California Supreme Court has held that for ratemaking purposes, the Commission may disallow excessive and unreasonable payments between affiliated corporations (*Pacific Telephone and Telegraph Company v. Public Utilities Commission* (1965) 62 Cal. 2d 634 at 659.) In addition, the Commission may disregard the separate corporate entities established around the regulated enterprise and may regard the operations of the separate entities and the operations of the corporate enterprise as a whole (*General Telephone of California v. Public Utilities Commission* (1983) 34 Cal. 3d 817; *City of Los Angeles v. Public Utilities Commission* (1972) 7 Cal. 3rd 331 at 344).¹⁷⁹

As these payments are ultimately borne by ratepayers in the form of higher rates for service, the Commission serves a significant public service by protecting end users from unreasonable service charges. (See *Re Pacific Bell*: "In conclusion, we find that this set of disallowances, additional ratepayer protections, and the exercise of this Commission's authority for ongoing review will appropriately

¹⁷⁸ See, e.g. D.06-12-029 (*Opinion Adopting Revision to (1) the Affiliate Transaction Rules and (2) General Order 77-L, as Applicable to California's Major Energy Utilities and Their Holding Companies*); and D.93-02-019 (*Order Revising but Denying Rehearing of Rulemaking 92-08-008 with regard to Affiliated Interest Reports Required to be Submitted by Telephone Carriers*).

¹⁷⁹ 27 CPUC 2d at 96-97.

shield ratepayers from any adverse consequences as a result of Pacific Bell's relationships with [its] holding company and affiliates.")¹⁸⁰

The Commission also stressed in *Re Pacific Bell* that the utility seeking the rate increase plays an active role in assuring the proper separation between it and its affiliates:

Ultimately, it will be management's decision that determines the future path of diversification and affiliate transactions. A high road result will most probably come from management decision that structurally separate regulated and unregulated operations, protect the regulated company's name, identity, capital, personnel, technology, "know how" and business income and pay a fair price for all interests of value received by the affiliate from the regulated company. The "other road" is full of uncertainties and other dangers caused by confusion of the regulated company's property and interests with the business of the affiliate. We prefer the high road because it is the smooth and sure road into the future.¹⁸¹

Yet in saying it is management's decision to determine whether to take the high road, this Commission did not intend to divest itself from its responsibility to scrutinize affiliate relationships and transactions, and to make determinations in order to protect the ratepayer. The California Supreme Court recognized the waning viability of the "invasion of management" rationale in *General Telephone Company v. Public Utilities Commission* (1983) 34 Cal. 3d 817, 824.¹⁸²

¹⁸⁰ 27 CPUC 2d at 141.

¹⁸¹ *Id.* at 141.

¹⁸² "Later cases, however, have cast serious doubt on the continuing vitality of much of the reasoning in *Pac. Tel.* The *Pac. Tel.* court's primary justification for refusing to imply the commission's power to regulate the arrangement between Pacific and American was the 'invasion of management' rationale. [Citation omitted.] Nevertheless, only a few years later, we severely limited the 'invasion of management' argument in *Southern Pac. Co. v. Public Utilities*

Footnote continued on next page

Furthermore, while in *General Telephone*, the California Supreme Court was faced with the issue of whether to affirm the Commission's order that General Telephone implement a competitive bidding procedure, it relied on statutes conferring broad authority on the Commission, statutes that we find are also applicable to the Commission's ability to adopt rules regarding affiliate transactions: Pub. Util. Code §§ 728,¹⁸³ 761,¹⁸⁴ and 701.¹⁸⁵ In construing these

Com. (1953) 41 Cal.2d 354 [260 P.2d 701]." And as the "invasion of management" rationale has waned, the California Supreme Court said "we have been more willing to permit regulatory bodies to exercise powers not expressly stated in their mandate[.]" citing to *Ralphs Grocery Co. Reimel* (1968) 69 Cal.2d 172, 176 ("In determining whether a specific administrative rule falls within the coverage of the delegated power, the sole function of this court is to decide whether the department reasonably interpreted the legislative mandate.) and *Ford Dealers Association v. Department of Motor Vehicles* (1982) 32 Cal. 3d 347, 362 ("[The] absence of any specific [statutory] provisions regarding the regulation of [an issue] does not mean such a regulation exceeds statutory authority...").

¹⁸³ "Whenever the commission, after a hearing, finds that the rates or classifications, demanded, observed, charged, or collected by any public utility for or in connection with any service, product, or commodity, or the rules, practices, or contracts affecting such rates or classifications are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

¹⁸⁴ "Whenever the commission, after a hearing, finds that the rules, practices, equipment, appliances, facilities, or service of any public utility, or the methods of manufacture, distribution, transmission, storage, or supply employed by it, are unjust, unreasonable, unsafe, improper, inadequate, or insufficient, the commission shall determine and, by order or rule, fix the rules, practices, equipment, appliances, facilities, service, or methods to be observed, furnished, constructed, enforced, or employed. The commission shall prescribe rules for the performance of any service or the furnishing of any commodity of the character furnished or supplied by any public utility, and, on proper demand and tender of rates, such public utility shall furnish such commodity or render such service within the time and upon the conditions provided in such rules."

¹⁸⁵ "The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

provisions against the challenge to the Commission's regulatory authority, the California Supreme Court found that:

... since the major purpose of the order concerning competitive bidding for COSE was better service for the consumer, rather than an officious desire to run General's business, *Pac. Tel.* is not applicable. With that legal roadblock out of the way, the basic powers of the commission, contained, *inter alia*, in sections 701, 728 and 761 are ample to sustain the challenged order.¹⁸⁶

Thus, in any rate increase request such as the one filed by Kerman, as well as the one resolved in *Re Pacific Bell*, both affiliate scrutiny and the responsibility to take prophylactic measures action are imbedded in the proceeding by virtue of settled statutory and judicial law vesting the Commission with such authority.

14.2. Kerman's Burden of Proof

We must also articulate and affix the appropriate burden of proof. While Kerman claims that timing of ORA's affiliate-transaction proposals affected its ability to confront ORA's witnesses, it is important to remember that Kerman, as the applicant, bears the burden of proving that its affiliate transactions are reasonable and need not be revised. In D.81896, the Commission stated:

A special burden must be borne by the applicant in a rate case to demonstrate conclusively not only that affiliated intercompany transactions are reasonable in that they do not create a burden on the consumer, but that the affiliated relations afford the maximum gains in efficiency or productivity and the greatest savings in costs to the consumer.

In other words, Kerman bears the burden of proving that its affiliate relations are of such a reasonable nature where the ratepayer is concerned that the

¹⁸⁶ 34 Cal. 3d at 827.

Commission would not need to consider any additional affiliate-transaction proposals.

14.3. Kerman Has Not Met its Burden of Proving That its Affiliate Transactions Did Not Create a Burden on California Consumers

14.3.1. Connections Between Kerman and Its Affiliates

From the Evidentiary Hearing, we can discern multiple examples that demonstrate a lack of separation between Kerman and its affiliates:

Corporate structure: Kerman is wholly owned by Sebastian Enterprises, Inc. (SEI) and operates under the fictitious business name Sebastian. (KTC-01 at 1:20-22.) SEI is the parent company of four affiliates: Kerman, Foresthill, Audeamus, and Kertel. (*Id.* at 2:23-24.) The testimony of David Clark expands on this corporate structure and states: “Kerman’s affiliates are as follows: Sebastian Enterprises, Inc. (SEI) – parent company, Foresthill Telephone Co., Kertel Communications, Inc., Audeamus, CVIN, LLC, S&K Moran Limited Partnership, and Barcus Family Limited Partnership.” (KTC-07(a) at 25:23-25.)

Corporate operations: Kerman and Foresthill are rural incumbent local exchange telephone companies that provide regulated local exchange telephone service and related services. (KTC-01 at 2:24-26.) Audeamus provides toll service and a range of what it terms non-regulated services such as video, Digital Subscriber Line, and alarm system services. (*Id.* at 3:1-2.) Kertel is a construction company that provides electrical and low voltage construction and non-telecom-related services. (*Id.* At 3:2-4.)

Corporate designation: Kerman and the other subsidiaries do business as Sebastian. (RT 4/28/2015, 55:19-24; KTC-01 at 3:4.)

SEI is a holding company for Kerman Telephone Company and Foresthill Telephone Company. (RT 4/28/2015, 49:24-50:3.)

Location: Kerman, Sebastian and Audeamus are located at 811 South Madera, Kerman, California according to records reviewed from the California Secretary of State.

Rental agreements: Kerman rents the entire Central Office Building. But there are employees there from the internet affiliate that serves Kerman customers.

Service: Kerman, Kertel, Foresthill, and Audeamus use trucks marked Sebastian. (RT 4/28/2015, 56:4-6; 28-57:3-13.)

Sponsorships: Certain event sponsorships are done under the name Sebastian. (RT 4/28/2015, 59:24-60:5.)

Finances: by Kerman's own testimony, its finances have a "complexity" to them that is a "natural consequence of compliance" with "FCC accounting a separation rules." (KTC-2 at 4:11-12.) It is not certain, standing alone, what FCC accounting and separation rules this testimony is referencing. Though with some cross referencing, we see that another of Kerman's witnesses -- under the heading SEPARATIONS -- refers to the FCC and the Code of Federal Regulations, Title 47, Part 36 regarding rules "governing allocation of the total costs to the interstate jurisdiction for telecommunications companies" (KTC-07(a) at 15:1-2.) yet these separation rules do not appear to address separation of finances between a parent and its affiliate.

14.3.2. Connections Between Kerman and Its Affiliates Create a Burden on California Consumers

The question that must be addressed is whether this connectedness is creating a burden on the consumer that would warrant the adoption of ORA's

proposals. In its testimony, ORA claims that this organizational structure facilitates the loading of costs that benefit its unregulated affiliates at ratepayer expense.¹⁸⁷ As examples, ORA cites to (1) the “Other Work Equipment,” which includes costs of construction equipment that is not primarily used by the regulated entity but is included in the regulated rate base; (2) Kertel’s maintenance and construction for Kerman; (3) IT services that are provided without a contract; and (4) image marketing where Kerman pays the majority of the marketing expenses for Sebastian, although the expenses are not related to the services that Kerman provides.¹⁸⁸ Kerman counters that none of the proffered examples defeat the conclusion that Kerman is interacting with its affiliates on an arm’s-length basis.¹⁸⁹ But as we discuss further, *infra*, at § 14.4, in our review of the four foregoing examples, we find that there is evidence that California ratepayers have been burdened in the form of unnecessary expenses that should have been born by the affiliates

ORA also argues that Kerman and its three affiliates (FTC, Kertel, Audeamus) do business under the name Sebastian, the Central Office Building is branded Sebastian, bills vehicles, and other items have the name Sebastian, and that such a tangle facilitates the loading of costs to the regulated entity while the unregulated affiliates reap the benefits. In response, Kerman argues that not only is there nothing in the record to support ORA’s position, but there is also nothing unusual about Kerman’s use of a fictitious business name as part of a

¹⁸⁷ ORA Opening Brief at 2 and 5; and ORA-1(a) at 3 (Executive Summary).

¹⁸⁸ *Id.*

¹⁸⁹ Kerman Reply Brief at 9:27-10:1.

broader branding strategy.¹⁹⁰ Kerman goes further and claims that it “derives a significant benefit from its association with the Sebastian brand, not the other way around,” citing Bus. & Prof. Code § 7532 in support thereof.¹⁹¹

Yet Kerman failed to meet its burden of proof. It is up to Kerman to demonstrate that the affiliate transactions do not impose a burden on consumers in the form of higher rates, something that Kerman does not provide evidentiary support for in its post-hearing brief. It is also unclear how Kerman’s “significant benefit” results in a benefit for the consumer. Similarly, it is not clear how Bus. & Prof. Code § 7532 protects consumers against burdensome charges that are the result of a corporation’s affiliate structure. This provision is located in Chapter 11.3 of the Bus. & Prof. Code and is entitled “Private Investigators.” Assuming this reference is not in error, we are at a loss to determine how § 7532 advances Kerman’s argument in any manner relevant to this proceeding.

¹⁹⁰ Kerman Reply Brief at 9:4-6.

¹⁹¹ Bus. & Prof. Code § 7532 states:

No licensee shall conduct a business under a fictitious or other business name unless and until he or she has obtained the written authorization of the bureau to do so. The bureau shall not authorize the use of a fictitious or other business name which is so similar to that of a public officer or agency or of that used by another licensee that the public may be confused or misled thereby. The authorization shall require, as a condition precedent to the use of any fictitious name, that the licensee comply with Chapter 5 (commencing with Section 17900) of Part 3 of Division 7. A licensee desiring to conduct his or her business under more than one fictitious business name shall obtain the authorization of the bureau in the manner prescribed in this section for the use of each name. The licensee shall pay a fee of twenty-five dollars (\$25) for each authorization to use an additional fictitious business name and for each change in the use of a fictitious business name. If the original license is issued in a nonfictitious name and authorization is requested to have the license reissued in a fictitious business name the licensee shall pay a fee of twenty-five dollars (\$25) for the authorization.

Nor is Kerman's position assisted by the rebuttal testimony of William Barcus. In response to ORA's claim that the Kerman business records are tangled and difficult to segregate, Mr. Barcus refers to the claimed hundreds of hours of time spent with ORA explaining its records, but there is no testimony from Mr. Barcus explaining how the affiliate relations have not placed a burden on the consumer.¹⁹² Mr. Marcus then claims that Kerman's records are consistent with FCC accounting and separations rules, but fails to cite any of those rules or explain how the consumer is protected by the rules.

Given this level of interconnectedness, we believe it is appropriate to consider ORA's proposals to ensure greater separation between Kerman and its affiliates in order to protect ratepayers against unreasonable rate charges.

14.4. The Lack of Arms-Length Transactions Between Kerman and its Affiliates

The four examples cited in § 14.3.2 demonstrate the lack of arms-length transactions between Kerman and its affiliates, the result of which has been the imposition of unnecessary costs onto the ratepayers. We consider each of these examples in order to explain our conclusion.

14.4.1. Other Work Equipment

ORA asserts that Kerman's proposal for Plant In Service during the Test Year 2016 includes an account for "Other Work Equipment," which consists of construction equipment such as cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment and concrete saws.¹⁹³ ORA argues that this category includes the costs of construction equipment that

¹⁹² KTC-2 at 4:7-10.

¹⁹³ ORA-1(a) at 60:3-6.

is not primarily used by Kerman to provide customer service. Instead, Kerman leases the equipment in this account to unregulated affiliates that reimburse Kerman at often just 1/10 of the competitive market rate.¹⁹⁴

In response, Kerman asserts that it is following a longstanding Commission guideline regarding the development of these rates, and cites to Decision (D.) 90-11-029.

But it is unclear how the *Order Approving a Permanent Rate Structure for an Interexchange Telephone Carrier's READYLINE, MEGACOM, and PRO WATS Services* assists Kerman as Kerman has provided no references to the text, findings of fact, conclusions of law, or ordering paragraphs to explain how it is appropriate to charge less than the competitive market rate for a lease.

14.4.2. Kertel's Maintenance and Construction for Kerman

ORA asserts that the majority of Kerman's actual construction (65% in 2014) is procured through Kertel.¹⁹⁵

In response, Kerman argues that ORA fails to identify anything "problematic about that relationship."¹⁹⁶

Yet Kerman fails to demonstrate that Kerman's procurement of construction through its affiliate is not creating a burden for the consumer.

¹⁹⁴ ORA- 1(a) at 3:10-12; and 60:2-61:5.

¹⁹⁵ *Id.* at 3:13-14.

¹⁹⁶ Kerman Reply Brief at 9:20-21.

14.4.3. IT Services

ORA asserts that “Kertel provides IT services to Kerman with no contract and basically no documentation.”¹⁹⁷ While ORA fails to cite any evidentiary support for this assertion, we have found a reference in the record:

Now, you mentioned an IT contract. That’s with your – with Kerman’s affiliate Kertel?

Yes.

Okay. And are you aware that there’s no written contract between Kertel and Kerman for the services they provide?

Yes, I am.¹⁹⁸

In light of this evidence in the record, we reject Kerman’s claim that ORA’s assertions are “outright fabrications” that are “discussed in further detail herein.”¹⁹⁹ In fact, Kerman fails to provide a citation where in its 72-page reply brief this matter is addressed.

14.4.4. Image Marketing

ORA asserts that as of 2014, Kerman indicated that its total actual marketing expenses were \$337,069.²⁰⁰ The regulated entities pay the majority (66/66%) of the marketing expenses with the remaining 33.33% split between the unregulated affiliates Kertel and Audeamus.²⁰¹ Some expenses are not related to customer services and instead go towards hotel stays and restaurant meals.²⁰²

¹⁹⁷ ORA Opening Brief at 5.

¹⁹⁸ RT April 28, 2015 at 112:25-113:4.

¹⁹⁹ Kerman Reply Brief at 9:23-24.

²⁰⁰ ORA-1(a) at 45:19-20.

²⁰¹ *Id.* at 46:3-5.

²⁰² ORA-1(a) at 46:6-7.

ORA argues that \$248,302 should be removed from Kerman's total reported non-corporate expenses for ratemaking purposes.

Kerman counters that the marketing department interacts directly with consumers by coordinating customer education efforts that included battery backup information and the availability of LifeLine services.²⁰³ Kerman argues further that through the marketing department, Kerman develops and provides brochures that describe the services that it offers, information on how to understand a telephone bill, and other public service information that Kerman claims is Commission mandated.²⁰⁴

Kerman also argues that the proposed disallowance is flawed as it proposes an allocation to an expense account that has already been allocated between the SEI affiliates.²⁰⁵ Kerman claims that in fact only 28% of the total marketing expense for all of the SEI affiliates was allocated to Kerman.²⁰⁶ But what is apparent is that Kerman has not shown that the claimed 28% allocation is not placing a burden on the consumer. For example, Kerman provided the rebuttal testimony of Mr. Clark who first explained, generally, the allocation approach:

Kerman reviews its marketing efforts to determine which companies are involved with specific marketing effort. Kerman then makes an assessment to determine how much each company is affected by the marketing effort. Marketing expenses are apportioned based on this review.²⁰⁷

²⁰³ KTC-11 at 37:22-23.

²⁰⁴ *Id.* at 37:22-27.

²⁰⁵ Kerman Opening Brief at 49:1-19, citing to RT May 8, 2015 at 528:7-25; and KTC-11 at 40:13-19.

²⁰⁶ Kerman Opening Brief at 49, citing to KTC-11 at 40:13-19.

²⁰⁷ KTC-11 at 39:6-9.

It is unclear how Kerman determined how each company is “affected by the marketing effort” so it cannot be said that the 28% is the appropriate allocation.

We agree with ORA that these expenses do not aid the consumers utilizing Kerman’s service.

When we consider the current state of corporate affiliation, along with the examples that SED has provided, we conclude that Kerman has failed to meet its burden of proving that the current corporate affiliations have not placed a burden on the consumer. We also conclude that ORA’s four examples demonstrate that the transactions between Kerman and its affiliates were not conducted at arm’s length. As a result, the Commission’s concerns can be addressed by the adoption of ORA’s proposals to provide greater separation between Kerman and its affiliates.

14.5. Kerman Had Adequate Notice That Changes Might be Proposed to its Affiliate Relations and Transactions Even if the Matter Had Not Been Specifically Identified in the Scoping Memo

Since affiliate transactions are part of rate proceedings, Kerman had adequate notice that changes to its relations with the affiliates might be proposed and considered by the Commission. The question of adequate notice was addressed in *Pacific Gas and Electric Company v. Public Utilities Commission* (2015) 327 Cal.App.4th 812, Cal.App. LEXIS 512. On August 19, 2013, the Commission issued an order for Pacific Gas and Electric Company (PG&E) to show cause (OSC) why it should not be sanctioned for violating Rule 1.1. But the OSC did not state that the Commission would also consider whether PG&E separately violated Rule 1.1 by failing to disclose the corrected pipeline specification information a month after the first preliminary information was discovered, or that PG&E

might face continuing violation sanctions based on any breach of disclosure or filing obligations. (237 Cal.App.4th at 859.) In rejecting the notion that the precise charges must be set forth in the OSC, the Commission stated due process does not require any particular form of notice. The details can be flexible depending on the circumstances, and this is especially true where administrative procedures are concerned. (*Id.* At 860.) All that is required is that the notice be reasonable. In articulating this standard, the Court relied on *Lusardi Construction Co. v. Aubry* (1992) 1 Cal.4th 976, 990; *Drummev v. State Bd. Of Funeral Directors* (1939) 13 Cal.2d 75, 80; *Litchfield v. County of Marin* (1955) 130 Cal.App.2d 806, 813; *Sokol v. Public Utilities Commission* (1966) 65 Cal.2d 247, 254; *Haas v. County of San Bernardino* (2002) 27 Cal.4th 1017, 1037, and *Jonathan Neil & Assoc., Inc. v. Jones* (2004) 33 Cal.4th 917, 936, footnote 7. (*Id.*)

In sum, the Court concluded that a “fair reading of the OSC discloses that the PUC was not merely concerned with how the filing was titled.” (237 Cal.App. 4th at 860.)

Applying the above legal standard to the instant proceeding, we conclude that Kerman was given reasonable notice that the Commission might consider proposals – either made by a party in a post hearing brief or on the Commission’s own motion – that would impact affiliate relations and transactions. As noted previously, the Kerman scoping memo stated that the “identification of all Kerman affiliates and the affiliate revenues, consistent with section 275.6” was part of the proceeding. The Commission has a duty pursuant to Pub. Util. Code § 275.6 to ensure affordable high-quality communications services in rural areas of the state. Certainly determining if services are affordable will require the Commission to decide if CHCF-A is subsidizing the expenses and operations of unregulated non-telephone companies. It is clear

from the scoping memo, which required the identification of Kerman's affiliates and their revenues, that the Commission was going to consider the relationship between Kerman and its affiliates.²⁰⁸

Furthermore, when it is considering a rate case, the Commission also has a duty pursuant to Pub. Util. Code § 728 to "fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force." (See also Pub. Util. Code §§ 701 and 761, cited, *supra*, in footnotes 184 and 185.)

In R.92-08-008, the Commission has also spoken decades ago about its duty to review affiliate transaction rules in a general rate case such as the instant proceeding:

The utility-affiliate relations of almost all utilities that the Commission regulates are already subject to some form of review through either Commission established reporting requirements or as part of Commission rate-making proceedings....Additionally, the Commission almost always examines affiliate transactions in each utility's General Rate Case (GRC) and in reasonableness and prudence reviews.

As part of its review of GRCs, and in recognition of the need to protect the ratepayers, the Commission has noted that part of its evaluation of the application for a rate increase "has been the development of sufficient

²⁰⁸ Our conclusion also distinguishes the instant proceeding from the one discussed in *Southern California Edison Co. v. Public Utilities Commission* (2006) 140 Cal.App.4th 1085, 1106, which Kerman relies on in its Reply Brief at 67. There the Court found that the scoping memo's reference to bid shopping and reverse auction was not broad enough to also encompass the prevailing wage proposal. *Southern* also found that the late notice of the new issue was prejudicial since "three business days was insufficient time for the parties to comment on the issues raised by the proposals, including issues of public policy, economic effects, legal implications, and effective administration and implementation of the proposed new rules." As we explain, *infra*, at § 14.6, there is no similar prejudice to Kerman.

accounting, financial, and procedural safeguards to ensure that there are no abuses of the utility-affiliate relationship.”²⁰⁹

In Decision 92399, this Commission made it clear that “it is axiomatic that one who enters into a regulated business is presumed to know the applicable law and assumes all the risks and responsibilities.” (* 3.) Kerman is presumed to know the law and, therefore, was on notice that it was within the Commission’s power to adopt affiliate-transaction rules by virtue of the Commission’s duty to protect ratepayers, and by the existence of Pub. Util. Code §§ 701, 728, and 761.

**14.5.1. The Factual Bases Underlying ORA’s
Proposals Were Examined at the Evidentiary
Hearing Even Though the Proposals
Themselves Were Not Presented at the
Evidentiary Hearing**

We must also address Kerman’s claim that ORA did not present its affiliate-transaction proposals at the Evidentiary Hearings. While it is true that ORA’s proposals were not presented at the Evidentiary Hearings, as the following chart demonstrates, the subject categories that formed the basis of ORA’s proposals were raised during the examination of ORA’s and of Kerman’s witnesses:²¹⁰

²⁰⁹ 1992 Cal.PUC LEXIS 576 at *3.

²¹⁰ A=April 28, 2015 hearing date; B=April 29, 2015 hearing date; C=May 8, 2015 hearing date; and D= May 12, 2015 hearing date.

Separation of the legal entities	A, Page 49:21-55:11
Separation of books and bank accounts for all transactions	A, Page 64:22-65:6 B, Page 202:20-203:19 B, Page 299:1-17 B, Page 300:1-7 C. Page 525:12-17 C. Page 527:16-528:6
Joint advertising or marketing	B, Page 255:16-256:3 B, Page 257: 7-258:17
Overlapping of employees or responsibilities	A, 67:2-11 A, Page 95:8-26 B, Page 201:12-19 B, Page 217:21-25 B, Page 219:15-20 B, Page 274 :11-275:21 B, Page 278: 21-24 B, Page 279 :14-19 B, Page 310:14-311:3
Joint events, sponsorships, fundraisers, or charitable donations	A, Page 67:26-68:16
Financial transactions conducted at arms-length	A, Page 112: 25-113:19 A, Page 114: 7-115:17 B, Page 241: 26-242:11 B, Page 245 :5-20 B, Page 248: 9-23 B, Page 271-: 28-272:5 B, Page 297:15-298:18 C. Page 474:6-16 C. Page 515-9:12 C. Page 529 :10-18 C. Page 598: 27-599:22

Tellingly, at no time during the Evidentiary Hearings did Kerman object to this line of examination as being beyond the scope of the proceeding.

To the contrary, Kerman went on the offensive and presented testimony in support of its corporate-affiliate structure. In response to the charge in ORA's

report that Kerman has “a tangle of business records that are difficult to segregate,”²¹¹ Kerman presented the rebuttal testimony of William Barcus, Kerman’s president and vice president of Sebastian, Kerman’s parent company, who stated:

ORA fails to mention the hundreds of hours that Kerman employees spent as part of this rate case to provide detailed information to ORA regarding Kerman’s finances and walk through Kerman’s records. In reality, Kerman’s finances are organized just as the FCC accounting and separations rules require, and the complexity is a natural consequence of compliance with those rules.²¹²

In sum, an examination of the four days of testimony reveals that Kerman’s relationship with its affiliates was an issue that both parties had an opportunity to explore at the Evidentiary Hearings. It was within the scope of the Commission’s authority to consider proposals that impact Kerman and its affiliates.

14.6. Kerman Has Failed to Demonstrate Prejudice (i.e., a Denial of Due Process)

Finally, even if one were to accept Kerman’s claim that it was denied the opportunity to question ORA’s witnesses, we must also address the issue of how was Kerman prejudiced. In *PG&E*, the Court recognized that in administrative proceedings, “a variance between the allegations of a pleading and the proof will not be deemed material unless it has actually misled the adverse party to his prejudice in maintaining his action or defense on the merits, and a variance may be disregarded when the action has been as fully

²¹¹ ORA-1(a) at 3:3-4.

²¹² KTC-2 at 4:8-12.

and fairly tried on the merits as though the variance had not existed.” (237 Cal.App.4th at 862, quoting *Stearns v. Fair Employment Practice Com.* (1971) 6 Cal.3d 205, 213.) Applied to the instant proceeding, the variance between the scoping memo, Evidentiary Hearing testimony, and the recommendation in ORA’s Opening Brief will be disregarded if the adverse party has not been misled to its prejudice.

When we speak of prejudice in an administrative proceeding, the question we are considering is whether the party claiming prejudice has been denied due process, a concept that the United States Supreme Court has recognized is difficult to define by a rigid set of principles. (See *Wolff v. McDonald* (1974) 418 U.S. 539, 560 [“The very nature of due process negates any concept of inflexible procedures universally applicable to every imaginable situation.”]) This is especially true in administrative actions, where the Supreme Court has recognized that the “origin and function of administrative agencies ‘preclude wholesale transplantation of the rules of procedure, trial, and review which have evolved from the history and experience of courts.’” (*Matthews v. Eldridge* (1976) 424 U.S. 319, 348, quoting *FCC v. Pottsville Broadcasting Company* (1940) 309 U.S. 134, 143.) Nevertheless, from a review of the authorities, it appears that in the administrative context, due process has two components: adequate notice and a reasonable opportunity to be heard. (See, e.g., *Goss v. Lopez* (1975) 419 U.S. 565, 579 and 581; and *Matthews, supra*, 424 U.S. at 333 [“The fundamental requirement of due process is the opportunity to be heard ‘at a meaningful time and in a meaningful manner.’” Quoting *Armstrong v. Manzo* (1965) 380 U.S. 545, 552.]

14.6.1. Adequate Notice vs. Reasonable Notice

We do not see a material difference between the concept of reasonable notice as used by the California Court of Appeal in PG&E, discussed supra, and the concept of adequate notice that has been developed by the United States Supreme Court. Both concepts require a determination of whether the complaining party was made aware of the issue or charge that the administrative agency has either been asked or legally tasked to determine.

Under either standard, we find that Kerman had received the requisite notice. Generally, Kerman was aware that the Commission has the authority to impose affiliate transaction requirements and, as Kerman acknowledges, the Commission has imposed such requirements on Kerman in prior decisions.²¹³ Kerman's witnesses were examined about the predicate bases for ORA's proposals. Specifically, Kerman was made aware of ORA's proposal that was made in the June 29, 2015 post-hearing legal briefing and had until July 17, 2015 in which to present its position.

14.6.2. Opportunity to be Heard at a Reasonable Time and Manner

Here, Kerman also fails to make a credible showing of prejudice. Kerman alleges that it was denied the opportunity to have examined any of ORA's witnesses regarding the basis for its affiliate-transaction proposals.²¹⁴ In making this argument, Kerman assumes that in all instances where there is an issue or proposal before the Commission, there will be an opportunity for cross examination in order to satisfy the requirements of due process. We are not

²¹³ Kerman Reply Brief at 67.

²¹⁴ Kerman Reply Brief at 68.

aware of such a hard and fast rule, and the United States Supreme Court has not adopted such a rule to apply in all civil administrative proceedings.²¹⁵ In fact, in *Bennett v. National Transportation Safety Board* (10th Cir. 1995) 55 F.3d 495, 501, the Court questioned the applicability of the right to confront witnesses in all administrative proceedings: “Of course Bennett’s invocation of the Confrontation Clause speaks only of ‘all criminal prosecutions.’ That constitutional right does not apply to civil administrative matters generally.”²¹⁶ Instead, in civil administrative actions, the United States Supreme Court has recognized that something less than a full evidentiary hearing is sufficient for due process purposes prior to the rendering of an adverse administrative action. Instead, a review of the authorities reveals that the concept of the opportunity to be heard is fluid and can mean either something less than a full evidentiary hearing where there are no genuine issues of material fact to be determined by the particular issue;²¹⁷ the opportunity to be heard through the presentation of

²¹⁵ For example, in *Boddie v. Connecticut* (1971) 401 U.S. 371, 378, the Court observed that the “formality and procedural requisites for the hearing can vary, depending upon the importance of the interests involved and the nature of the subsequent proceedings.” The Court expressed a similar sentiment in *Brock v. Roadway Express, Inc.* (1987) 481 U.S. 252, 261: “[T]he Court has upheld procedures affording less than a full evidentiary hearing if some kind of a hearing ensuring an effective initial check against mistaken decisions is provided before the deprivation occurs, and a prompt opportunity for complete administrative and judicial review is available.”

²¹⁶ See also *Hannah v. Larche* (1960) 363 U.S. 420, 440, footnote 16 (The Sixth Amendment “is specifically limited to criminal prosecutions, and the proceedings of the Commission clearly do not fall within that category.”); *Renchenski v. Williams* (3rd Cir. 2010) 622 F.3d 315, 336 (citing *Hannah*); and *Denius v. Dunlap* (7th Cir. 2000) 209 F.3d 944, 953 (same).

²¹⁷ See *Matter of Grand Jury Proceedings Empanelled May 1988* (7th Cir. 1989) 894 F.2d 881, 882 (in federal civil contempt proceeding, evidentiary hearing can be held only if there are genuine issues of material fact); and *Landesman v. Board of Regents of State of New York* (1983) 463 N.Y.S. 2d 118, 94 A.D. 2d 827, 829 (“ the regents review committee did not abuse its discretion or violate petitioner's due process rights by denying petitioner's request for an evidentiary hearing on the charge against him.”

written argument and evidence;²¹⁸ or the right to cross examine the author when the author of a report is subject to subpoena and examination.²¹⁹ It is also true that if ORA's proposals were in its Staff Report that was proffered at the Evidentiary Hearing, then Kerman would have been entitled to cross-examine the authors.²²⁰

But ORA's proposals were presented by legal briefing and were based on the record developed at the Evidentiary Hearing, and Kerman has had the opportunity to respond with legal briefing of its own where it has set forth its factual and legal arguments why the Commission should not adopt ORA's proposals. Kerman argues in its Reply Brief that the first three proposals are unnecessary as they "do not appear to reflect any change from current practice and are therefore unwarranted[.]"²²¹ If Kerman's argument is correct, it is unclear what additional showing it would have made had it been able to cross examine ORA's witnesses. As for proposals 4-7, Kerman claims that would

²¹⁸ See *In Vill. Of Hales Corners v. Larson* (Ct. App. 2009) 320 Wis.2d 485, 2009 Wisc. App. LEXIS 548 at *12_ ("Denial of the opportunity to participate in oral argument, following a party's full participation in the hearing and filing of briefs, does not deny procedural due process."); and *Union State Bank v. Galecki* (Wis.CtApp. 1987) 417 N.W.2d 60, 142 Wis. 2d 118, 126 ("We have found no case suggesting that denial of the opportunity for oral argument, following a party's full participation in the hearing and filing of briefs, is contrary to accepted notions of due process or fair play in administrative hearings.")

²¹⁹ See *Richardson v. Perales* (1971) 402 U.S. 389, 407 ("The physicians' reports were on file and available for inspection by the claimant and his counsel. And the authors of those reports were known and were subject to subpoena and to the very cross-examination that the claimant asserts he has not enjoyed.")

²²⁰ Such a result would be consistent with the right to cross-examine a witness who has offered oral or written testimony. (See Evidence Code § 711: "[A] witness can be heard only in the presence and subject to the examination of all the parties to the action, if they choose to attend and examine.")

²²¹ Kerman Reply Brief at 64.

constitute dramatic changes from the current practices of nearly all utilities under the Commission's jurisdiction and are contrary to law.²²² This statement is unsupported by any factual or legal showing and will not be given any consideration. Kerman also claims that proposals 4-7 could not be adopted without major disruptions to its operations, and presents arguments to support its position. It is unclear what additional evidence Kerman would have presented at the Evidentiary Hearing. As for proposals 8 and 9, Kerman argues that they are already covered by existing rules governing affiliate transactions, and cites to R.11-11-007, D.03-10-006, and D.93-02-019 in support of its position.²²³ As the evaluation of these last two proposals appears to be legal in nature, it is unclear what evidence Kerman would have introduced at the Evidentiary Hearings. In short, Kerman makes no showing of what testimony or evidence it would have offered if the scoping memo and the Evidentiary Hearings expressly identified and addressed ORA's nine proposals regarding Kerman and its affiliates.

Kerman will also have another opportunity to address this and other issues when it appears for oral argument. Pursuant to Rule 13.13 (b), a party in a ratesetting proceeding in which hearings were held has "the right to make a final oral argument before the Commission[.]" Kerman availed itself of this right on June 29, 2015, when it requested the right to present final oral argument. Kerman will be free to raise its concerns regarding the ORA affiliate-transaction proposals, or any other issue within the scope of the proceeding.

²²² *Id.*

²²³ *Id.* at 66.

Finally, we note that Kerman also had the option to move to reopen the record but chose not to invoke that opportunity. Pursuant to Rule 13.14 (b), a motion to set aside submission and reopen the record for the taking of additional evidence:

shall specify the facts claimed to constitute grounds in justification thereof, including material changes of fact or of law alleged to have occurred since the conclusion of the hearing. It shall contain a brief statement of proposed additional evidence, and explain why such evidence was not previously adduced.

All the arguments that Kerman has set forth in its Reply Brief could have formed the basis for a Motion to Reopen the Record, yet Kerman opted not to avail itself of this procedural vehicle. [add the following sentence here] A party's failure to avail itself of procedural remedies to secure cross-examination can seriously undermine that party's claim of prejudice through the denial of due process.²²⁴ This Commission finds that Kerman has waived its right to claim a denial of its right to cross examine by failing to seek to reopen the record.

14.7. ORA's Proposals are Neither Unprecedented nor Inconsistent with Existing Affiliate Transaction Law

Kerman faults ORA for failing to cite a Commission decision that ever adopted the recommendations that ORA now wishes to impose on Kerman.²²⁵ That failure, however, is not fatal to ORA's position or to this Commission's

²²⁴ See *Bennett v. National Transportation Safety Board* (19th Cir. 1995) 55 F.3d 495, 502 ("Thus having forgone the available opportunities for cross-examination, he cannot ascribe error on that ground."); and *Valkering, U.S.A., Inc. v. U.S. Department of Agriculture* (8th Cir. 1995) 48 F.3d 305, 308 ("Valkering was not deprived of its right to cross-examine the USDA's witnesses, but rather forfeited that right.")

²²⁵ Kerman Reply Brief at 67.

ability to consider such proposals. In fact, our review of ORA's nine proposals reveals that many similar rules were adopted by the Commission in another proceeding involving affiliate transactions – R.05-10-030, Order Instituting Rulemaking Concerning Relationship Between California Energy Utilities and Their Holding Companies and Non-Regulated Affiliates. A side-by-side comparison will demonstrate that D. -12-029 adopted affiliate transaction rules for public utility gas corporations and electric corporations, that are similar in many ways to ORA's proposals:

ORA's Proposals	Appendix A-3 Affiliate Transaction Rules adopted by D.06-12-029
Be held in separate legal entities	V. Separation A. Corporate Entities: A utility, its parent holding company, and its affiliates shall be separate corporate entities. (10)
Maintain separate books for all transactions	V. Separation B. Books and Records: A utility, its parent holding company, and its affiliates shall keep separate books and records. (11)
Maintain separate bank accounts for all transactions	V. Separation B. Books and Records: A utility, its parent holding company, and its affiliates shall keep separate books and records. (11)
Have no joint advertising or marketing	V. Separation F. Corporate Identification and Advertising 4. A utility shall not participate in joint advertising or joint marketing with its affiliates. (13)

<p>Have no overlapping of employees or responsibilities</p>	<p>V. Separation G. Employees 1. Except as permitted in Rule V E (corporate support), a utility and its affiliates shall not jointly employ the same employees. This Rule prohibiting joint employees also applies to Board Directors, and corporate officers except for the following circumstances... (14)</p>
<p>Have no joint events, sponsorships, fundraisers, or charitable donations</p>	<p>V. Separation F. Corporate Identification and Advertising 4.b. Except as otherwise provided for by these Rules, a utility shall not participate in any joint activity with its affiliates. The term "joint activities" includes, but is not limited to, advertising, sales, marketing, communications and correspondence with any existing or potential customer; c. A utility shall not participate with its affiliates in trade shows, conferences, or other information or marketing events held in California.</p>
<p>Not transfer any physical assets without first obtaining the necessary approvals from the Commission</p>	<p>III. Nondiscrimination B. Affiliate Transactions 1. Resource Procurement. No utility shall engage in resource procurement, as defined in these Rules, from an affiliate without prior approval from the Commission. (7)</p>
<p>Conduct financial transactions with each other at "arms-length"</p>	<p>III. Nondiscrimination B. Affiliate Transactions: Transactions between a utility and its affiliates shall</p>

PROPOSED DECISION

	<p>be limited to tariffed products and services, to the sale of goods, property, products or services made generally available by the utility or affiliate to all market participants through an open, competitive bidding process, to the provision of information made generally available by the utility to all market participants, to Commission-approved resource procurement by the utility or as provided for in Rules VD (joint purchases), VE (corporate support) and VII (new products and services) below. (5)</p>
<p>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</p>	<p>III. Nondiscrimination</p> <p>A. No Preferential Treatment Regarding Services Provided by the Utility: Unless otherwise authorized by the Commission or FERC, or permitted by these Rules, a utility shall not:</p> <ol style="list-style-type: none"> 1. Represent that, as a result of the affiliation with the utility, its affiliates or customers of its affiliates will receive any different treatment by the utility than the treatment the utility provides to other, unaffiliated companies or their customers; or 2. Provide its affiliates, or customers of its affiliates, any preference (including but not limited to terms and conditions, pricing, or timing) over non-affiliated suppliers or their customers in the

	provision of services provided by the utility. (5)
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In D.06-12-029, the Commission's actions made it apparent that it has the authority to revise affiliate-transaction rules. In Appendix A-3 to its decision, the Commission explained that the new rules it adopted superseded prior rules and guidelines:

Existing Commission rules for each utility and its parent holding company shall continue to apply except to the extent they conflict with these Rules. In such cases, these Rules shall supersede prior rules and guidelines[.]²²⁶

Regardless what affiliate rules the Commission may have adopted in the past, the Commission retains its authority to revise those affiliate rules if warranted by the particular factual record. Thus, it is immaterial that ORA's proposals may be different from those that Kerman claims the Commission adopted in D.86-08-015, as modified by D.87-03-065, D.05-05-045, D.93-02-019, and R.92-08-008.²²⁷

In fact, a closer look at these authorities reveals that they impose no legal or precedential impediment to the Commission's adoption of ORA's proposals. D.86-08-015, as modified by D.87-03-065, and D.05-05-045 were cases in which either Kerman or an affiliate was seeking to obtain control through the acquisition of outstanding stock. Neither case involved a rate increase which would have triggered Kerman's heightened burden of proof and closer scrutiny

²²⁶ D.06-12-029, Appendix A-3 at 4, ¶ F **Existing Rules**. *See also* D.87-12-067, Finding of Fact 124: "In order to best protect ratepayers, it is appropriate to periodically review the effectiveness of Commission-imposed restrictions and guidelines dealing with relationships between Pacific Bell, Pacific Telesis, and the various affiliates and subsidiaries." (*315.)

²²⁷ Kerman Reply Brief at 67.

by the Commission.²²⁸ Given the nature of the transaction, in D.86-08-015, the Commission required that Kerman and any other affiliate company transacting business with it to make all books and records available to the Commission. But the Commission never said that would be the extent of any separation that it would require of Kerman and its affiliates.

Similarly unpersuasive to Kerman's position is D.93-02-019,²²⁹ in which the Commission adopted interim reporting requirements for utility-affiliate transactions in light of the requirements in Pub. Util Code §§ 587 (requiring utilities to submit reports detailing significant transactions between a regulated corporation and every subsidiary or affiliate) and 797 (requiring the Commission to periodically audit all significant transactions covered by § 587). But the Commission never went so far as it say it could not invoke its other statutory to and adopt new proposals to create greater transparency between a regulated utility and its affiliates in order to protect the ratepayer from unreasonable services charges.

Nor have we found any authority to suggest that FCC separation rules preempt this area of the law and prevent the Commission from adopting additional affiliate-transaction proposals involving a LEC such as Kerman.²³⁰ In

²²⁸ The Commission observed as much in D.86-08-015: "Applicant will not engage in unregulated activities which compete with its regulated utility subsidiary nor engage in significant transactions with its regulated utility subsidiary. Therefore, we will approve the application without requiring an extensive showing of benefit to the ratepayers." (3.)

²²⁹ *Opinion* rendered in R.92-08-008 (Order Instituting Rulemaking on the Commission's Own Motion to Adopt Reporting Requirements for Electric, Gas, and Telephone Utilities Regarding Their Affiliate Transactions).

²³⁰ Derived from the Supremacy Clause in the United States Constitution (Article VI, Section 2), preemption can be express or implied (through field occupancy or where the enforcement of a

Footnote continued on next page

reviewing the FCC's regulations,²³¹ we find no provision that the Federal Government has expressly or impliedly preempted the field as to affiliate transactions. In fact, in D.03-10-006,²³² the approved settlement stated that Kerman would comply with existing Commission and FCC affiliate rules, as well as any modifications to same in the future:

By entering into this Settlement Agreement, Kerman affirms that it shall comply with the provisions of the Commission's Decision Number 93-02-019 establishing reporting requirements pertaining to affiliate transactions and that it shall further comply with rules of the Federal Communications Commission pertaining to affiliate transaction as those rules apply to Kerman and as those rules may be modified in the future.²³³

Kerman was aware the Commission had concurrent jurisdiction with the FCC as to affiliate-transaction rules when it entered into this prior settlement. Kerman has failed to cite any authority to suggest that that concurrent jurisdiction has been divested, and we conclude that the Commission retains jurisdiction in this area to regulate the affiliate relations of regulated entities in California. In

state law would frustrate the purpose behind a federal law). (*Altria Group, Inc.* (2008) 555 U.S. 70, 76-77.)

²³¹ 47 C.F.R. Parts 32 (Uniform System of Accounts for Telecommunications Companies), 36 (Jurisdictional Separations Procedures; Standard Procedures for Separating Telecommunications Property Costs, Revenues, Expenses, Taxes and Reserves for Telecommunications Companies), and 64, Subpart I, § 64.901, *et seq* (Allocation of Costs)

²³² *Opinion Approving Settlement Between Kerman Telephone Company and Office of Ratepayer Advocates.*

²³³ *Id.* Appendix B (Settlement Agreement) at B-12, ¶ 14.

making such a finding, the Commission is exercising its authority to determine if the field in which it regulates by decision is preempted by federal law.²³⁴

Equally important, we do not see that the adoption of the ORA proposals would conflict in any way with the FCC's requirements. At best, Kerman argues that two of ORA's recommendations are already covered by the existing FCC affiliate rules.²³⁵ If it turns out to be the case that some of the proposed recommendations are already being complied with, Kerman will be able to demonstrate that fact when CD either audits Kerman's records or when Kerman produces its records to CD.

14.8. Kerman Will Not be harmed by the Adoption of ORA's Proposals

We are unpersuaded by Kerman's claim of impending harm. Kerman asserts that the proposed restriction on joint marketing and employee responsibilities will significantly increase costs for ratepayers of Kerman's regulated services, which will "be a disaster for Kerman and a disaster for ratepayers."²³⁶ Kerman provides no proof for these claims. Moreover, the proposals that we adopt today have been applicable to regulated electric companies and regulated gas companies for over nine years. If they would have had such harmful impacts on the regulated utilities, the Commission certainly would have made alterations to the affiliated-transaction requirements.

²³⁴ See Decision 95-10-032 at *12: "[W]e can declare that a state statute is not preempted by federal law. We also can declare that requirements imposed only by Commission decisions (and not mandated by statute) are unenforceable due to federal preemption."

²³⁵ Kerman Reply Brief at 65:23-26, and 66:10-15.

²³⁶ Kerman Reply Brief at 69:17-25.

We also reject Kerman's argument that the timing of ORA's proposals denied Kerman the opportunity to make its evidentiary showing. Kerman had the right pursuant to Rule 13.14(b) to file a motion to reopen the record for the taking of additional evidence but chose not to do so. We will not now give any consideration to Kerman's speculative claims of harm.²³⁷

14.9. Kerman is Not Being Discriminated Against

We reject the notion that Kerman is being subjected to unequal treatment before the Commission and that, as a result is being discriminated against. Kerman bases this argument on the fact that D.14-12-084 in R.11-11-007²³⁸ declined to "change the affiliate transaction rules given the apparent success of the current rules[.]"²³⁹ Yet Kerman leaves out an important qualifying phrase from D. 14-12-084: the "lack of alternative."²⁴⁰ When read together, D.14-12-084 opted not to modify the affiliate transaction rules, in part, because no party had suggest any alternatives. In contrast, the Commission has been presented with an alternative to the current affiliate-transaction rules. As R.11-11-007 is an ongoing proceeding, the assigned Commissioner and assigned ALJ can decide if ORA's proposals adopted by this decision should be imposed industry wide.

It is also worth noting that the affiliate-transaction rules are not as static as Kerman would have this Commission believe. D.14-12-084 states that affiliate

²³⁷ For the same reason, we reject Kerman's claim that requiring separate employees with separate responsibilities for each affiliate would decrease rather than increase efficiency. The claimed is unsubstantiated by the record, and Kerman never sought to reopen the record.

²³⁸ Order Instituting Rulemaking into the Review of the California High Cost Fund-A Program.

²³⁹ Kerman Reply Brief at 71, quoting D.14-12-084 at 73.

²⁴⁰ D.14-12-084 at 73.

rules will be revisited in Phase 2 of R.11-11-007: “We, however, are interested in further information on the issue of ‘fair-market rates’ for affiliate use of regulated networks, and will plan to revisit the fair-market rate issue in Phase 2.”²⁴¹ Thus, R.11-11-007 is an open proceeding where the Commission may consider industry-wide modifications to affiliate-transaction rules consistent with what are being adopted in this decision.

Accordingly, we adopt ORA’s proposals to create greater transparency.

15. ORA’s Motion to Compel Production of Unredacted Customer Information

On January 30, 2015, the then assigned ALJ Halligan granted ORA’s Motion to Compel Production of Unredacted Customer Information from Kerman. Specifically, the ruling required Kerman to produce lists in Excel format for all customers (including their name, start date, address, phone, number, customer ID code, and service type). ORA requested this data pursuant to Pub. Util. Code § 309.5(e), which authorizes ORA to obtain “any information it deems necessary to perform its duties from any entity regulated by the Commission, “ without limitation by confidentiality. Pub. Util. Code § 314(a) also provides that the Commission, each Commissioner, and each officer and person employed by the Commission may at any time, inspect the account, books, papers and documents of any public utility. While Kerman objected to the request, citing the prohibition against releasing customer data in Pub. Util. Code § 2891, the Commission herein affirms the ALJ ruling that ORA is not required to invoke or explain the exemption from Pub. Util. Code § 2891(d)(7) each time it requests information from any regulated entity.

²⁴¹ *Id.*

16. Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with § 311 of the Public Utilities Code and comments are allowed pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were received on _____. Reply comments were received on _____ by _____.

17. Assignment of Proceeding

Michel P. Florio is the assigned Commissioner and Robert M. Mason III is the assigned ALJ in this proceeding. The case was assigned previously to ALJ Julie Halligan from April 29, 2013 to January of 2016.

Findings of Fact

1. On December 28, 2011, Kerman filed this GRC application requesting review of its revenue requirement and an increase in net intrastate revenues of \$2.957 million, which equated to a CHCF-A draw of \$6.49 million for test year 2013.

2. On January 30, 2015, Kerman updated its revenue and expense estimates, forecasting intrastate revenue requirements of \$10,274,968 for the 2016 test year, a 28% increase over the past five-year average and an increased CHCF-A subsidy amount of \$6,011,945. The request represents an increase of \$2,472,220 in CHCF-A support, 70% higher than the 2016-authorized \$3,539,725 CHCF-A support.

3. On January 26, 2012, the ORA protested Kerman's GRC application.

4. Kerman then revised its 2016 revenue requirement calculation to \$10,442,787 based on the final, audited "end of year" financials, including \$7,474,394 in projected operating expenses, a \$1,779,871 return on rate base, and \$1,188,521 in estimated tax liabilities.

5. ORA recommends that the Commission authorize intrastate revenue requirements totaling \$6,602,548 for the 2016 test year. When combined with its forecast of other revenues, ORA calculates a total CHCF-A subsidy of \$1,938,638 from the CHCF-A in test year 2016.

6. Kerman requests a 13.63% rate of return maintaining that certain proposed regulatory rules create uncertainty regarding its revenue streams, creating greater risks for its investors and therefore requiring a higher rate of return.

7. Kerman's requested 13.63% cost of capital is substantially higher than the 10% authorized in recent years.

8. Kerman's debt ratio has been consistently above 46%, therefore a capital structure of 40% debt and 60% equity is reasonable.

9. A 3.2% cost of debt is reasonable.

10. Kerman seeks Commission approval of a 16.24% cost of equity.

11. Using the CAPM to calculate the cost of equity is reasonable.

12. A 3.93% risk-free rate based on the 10-year average of the 20-year Treasury rate is reasonable.

13. Kerman recommends an equity risk premium of 6.96% based on data from the Duff & Phelps 2014 Valuation Handbook – Guide to Cost of Capital in its cost of equity calculation.

14. ORA's recommended 5.88% equity risk premium more accurately reflects the premium years 1928 to 2012 and is therefore reasonable.

15. Kerman's industry risk premium of -1.18% reflects SIC 4813, which appears to be the appropriate Classification and is therefore reasonable.

16. A size premium of 4.19%, equal to 70% of Kerman's 5.99% proposal, to calculate the cost of equity is reasonable.

17. The cost of equity of 12.82% based on the CAPM analysis is reasonable.

18. An 8.97% cost of capital based on a capital structure of 40% debt and 60% equity, 3.2% cost of debt, and 12.82% CAPM cost of equity is reasonable.

19. Applying the FCC Corporate Expense Caps will cap the amount of corporate expenditures that can be recovered from the CHCF-A program but will not limit the amount of a company's corporate expenditures.

20. Kerman's argues its proposed corporate expenses should be \$1,559,228 or at least the \$1,544,761 calculated in its rebuttal testimony.

21. Kerman has not shown that the additional executive compensation of \$294,705 is necessary to retain employees and is therefore unreasonable as a justification to exceed the corporate expense cap.

22. Including the salary of a temporary position that has been terminated is unreasonable.

23. Basing the new IS manager's salary on a five-year average of the retired IS manager's salary is reasonable. It allows Kerman to more easily meet the FCC corporate expenses cap by reducing corporate expenses by \$38,964.

24. Kerman's corporate expenses of \$241,465 for donations, dues, and sponsorships is unreasonable as these activities do not increase safety and reliability for Kerman's customers. The elimination of these expenses will allow Kerman to more easily meet its corporate expense cap.

25. Corporate expenses of \$55,716 for a party, retreat and banquet costs are not reasonable. California ratepayers should not be subsidizing parties and retreats.

26. Limiting Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes is reasonable.

27. Kerman has not demonstrated why apartment rent should be borne by the ratepayers and it is therefore unreasonable. We continue to disallow the total

rent expense of \$7,050, whether categorized as a corporate or operational expense, for ratemaking purposes.

28. Kerman affiliate Kertel provides Network Operating Center and Information Technology technician labor network service to Kerman, in the amount of \$793,100 per year. SEI bills Kerman \$96,975 per year which is allocated to Kerman's total corporate expenses.

29. Kerman could not provide a copy of the contract between Kerman and Kertel for network operations and information technology technician labor. Kerman provided an invoice for \$66,091.67 that does not identify any labor or materials.

30. Without information regarding the terms and conditions of Kertel's services, Kerman's requested corporate expense of \$96,975 is unreasonable.

31. Kerman's projected legal expense for 2016 is \$525,475.

32. ORA did not have access to documentation supporting Kerman's 2015 legal expenses, however, three invoices totaling \$35,095 were for services rendered in 2013, and Kerman uses 2014 expenses to project 2016 expenses.

33. Using \$35,095 in 2013 legal expenses for 2016 forecasting purposes is unreasonable. Kerman has not provided sufficient justification for any legal expenses above the corporate expense cap.

34. ORA argues that Kerman's requested \$120,000 for an additional regulatory person is not reasonable and should not be used as a means to justify exceeding the corporate expense cap, because the regulatory manager's time has been split between Kerman and FTC since 2010, and the regulatory manager also spends a portion of his time on Kertel and Audeamus.

35. In additional regulatory manager position is unnecessary and therefore unreasonable.

36. Calculating Kerman's corporate expenses based on the FCC corporate expense cap calculations, using an updated loop number of 4789, is reasonable.

37. Kerman's non-corporate expense includes rent it paid to SEI in the amount of \$760,800 per year for its central office building owned by SEI, in addition to taxes and insurance in 2014.

38. Kerman was not able to provide specific information regarding the taxes and insurance for this leased building.

39. In Resolution T-17081, the rent amount allowed by the Commission for ratemaking purposes was \$570,941 per year. Given the lack of documentation to support the increase from \$592,800 to \$760,800 per year, ORA recommends that rent in the amount of \$570, 941 is reasonable.

40. Kerman claims that holding it to the terms of the 2008 lease are unreasonable, ignore inflationary adjustments and its rental expense claim of \$760,800 is more than reasonable.

41. Kerman's request for \$760,800 in rental expense is unreasonable absent supporting documentation.

42. Kerman's unregulated affiliate, Kertel provides NOC and IT technician labor to support Kerman's operations and customers.

43. SEI bills Kerman \$793,100 per year for this maintenance service and \$696,124 per year is allocated to Kerman's total non-corporate expenses.

44. The sole documentation provided by Kerman for SEI's maintenance service is a monthly invoice that contains no description of the materials provided, the number of hours worked or the work performed.

45. Without sufficient documentation, it is not possible to determine whether SEI's maintenance expense for the work performed is reasonable. The

Commission should disallow the \$696,124 for maintenance services provided by Kertel.

46. Kerman leases a warehouse facility from its affiliated entities, the Barcus Family Partnership and the S&K Moran Partnership and pays rent in the amount of \$17,885.59 to the Barcus Family Partnership and \$17,885.59 to the S&K Moran Family Limited Partnership for a total of \$35,771.18 per month or \$429,254 per year.²⁴²

47. Kerman states that it was unable to find the original executed lease and so re-executed a lease for \$382,577.04

48. Kerman was unable to provide an original executed warehouse lease agreement, and the monthly rent paid appears to be well above market rate. The recently re-executed lease was between William Barcus and Ruth Barcus.

49. Kerman's requests for \$429,254 or \$382,577.04, in warehouse rental expense are unsupported and unreasonable.

50. Kerman reported total company marketing expenses as of December 31, 2014 of \$373,069.

51. Marketing expenses were allocated 66.66% to the regulated entities (33.33% each to Foresthill and Kerman) with the remaining 33.33% split between the unregulated affiliates Audeamus and Kertel.

52. It is unreasonable for Kerman to pay a larger, unsubstantiated, share of marketing costs than its unregulated affiliates.

53. Kerman's expenses include a yearly payment of \$42,000 to Audeamus, Kerman's broadband affiliate, as a customer retention fee.

²⁴² Exhibit ORA-1 at 45.

54. Kerman should be compensated for finding a customer for Audeamus, not the other way around.

55. The customer retention fee of \$42,000 paid by Kerman to Audeamus is unreasonable and disallowed as an expense.

56. Kerman includes \$7,050 in non-corporate expense for a corporate apartment.

57. Non-corporate expenses for apartment rental are unreasonable for the same reasons that apartment expenses were found unreasonable as a corporate expense in Section 8.2.8.

58. Raising the basic residential rate to \$30 inclusive is reasonable and will increase Kerman's local revenue for 2016 by \$103,995

59. ORA and Kerman agree that raising the basic business rate to \$36.30, including the EAS charge, will increase Kerman's local revenue for 2016 by \$59,092.

60. ORA recommends that ARC revenue of \$19,269 be rolled into business rates.

61. Raising the basic business rate to \$36.30, including the EAS and ARC charge is reasonable and will increase Kerman's local revenue for 2016 by \$78,361.

62. Kerman and ORA agree on the USF and Intrastate Access revenues.

63. Kerman's projections and ORA acceptance of USF and Intrastate Access revenues is reasonable

64. Kerman offers its employees a 50% discount for phone service.

65. Kerman's 50% employee discount is unreasonable because Kerman's basic service residential rates are already heavily discounted due to the CHCF-A subsidy and only six of Kerman's employees work full time for Kerman.

66. Kerman is undercharging for its customer calling services relative to other carriers, contrary to Pub. Util. Code § 275.6(c)(3).

67. ORA's recommended rates for Kerman's Tariff A-28 custom calling features are reasonable.

68. Kerman charges \$1.10 per month for inside wire maintenance service.

69. AT&T and Verizon charge \$8.00 and \$7.99, respectively, for inside wire maintenance.

70. Raising Kerman's rates for inside wire maintenance to \$7.50 per month for residential customers and \$8.00 for business customers is reasonable and complies with Pub. Util. Code § 275.6(c)(3).

71. ORA's and Kerman's revised projected growth rates are reasonable.

72. Kerman's explanation of how call waiting caller ID services are provided and represented in its tariff is reasonable.

73. Kerman and ORA agree that 2016 projected revenues should include \$2,200 in directory assistance revenue.

74. Kerman and ORA agree that 2016 projected revenues should include \$6,306 for anticipated late fees.

75. The costs associated with CPE are not generated by Kerman and therefore, including \$6,288 of CPE revenue in Kerman's revenue is unreasonable.

76. Kerman's plans regarding back-up power and information for customers related to a fiber system are adequate and therefore reasonable.

77. Requiring Kerman's shareholders to absorb the accelerated copper depreciation while still receiving the full \$7.8 million cost of the FTTH project is reasonable.

78. It is reasonable to exclude the entire plant balance recorded in the OWE on the basis that Kerman does not use the equipment to provide service to

customers, but instead rents or leases the equipment to its unregulated construction affiliate, Kertel Communications at below-market rates.

79. The Chamber of Commerce occupies Kerman's Old Central Office Building, but it is unclear if any rent is collected.

80. Kerman should be collecting market rate rent from the Chamber of Commerce and reporting it as income. Kerman's failure to do so is unreasonable.

81. Imputing rental revenue of \$33,800 for the Chamber of Commerce occupancy of Kerman's old central office building is reasonable.

82. ORA's makes nine recommendations to separate Kerman's operations from its parent company and its affiliates by requiring Kerman and its affiliates to 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.
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 Kerman from unaffiliated third parties for similar transactions.

83. Kerman is wholly owned by Sebastian Enterprises, Inc. (SEI) and operates under the fictitious business name Sebastian. SEI is the parent company of four affiliates: Kerman, Foresthill, Audeamus, and Kertel.

84. Kerman's affiliates are Sebastian Enterprises, Inc. (SEI) – parent company, Foresthill Telephone Co., Kertel Communications, Inc., Audeamus, CVIN, LLC, S&K Moran Limited Partnership, and Barcus Family Limited Partnership."

85. Kerman and Foresthill are rural incumbent local exchange telephone companies that provide regulated local exchange telephone service and related services.

86. Audeamus provides toll service and a range of what it terms non-regulated services such as video, Digital Subscriber Line, and alarm system services.

87. Kertel is a construction company that provides electrical and low voltage construction and non-telecom-related services.

88. Kerman and the other subsidiaries do business as Sebastian.

89. SEI is a holding company for Kerman Telephone Company and Foresthill Telephone Company.

90. Kerman, Kertel, Foresthill, and Audeamus use trucks marked Sebastian.

91. Certain event sponsorships are done under the name Sebastian.

92. Kerman fails to demonstrate that Kerman's procurement of construction through its affiliate is at arms-length and is not creating a burden for the consumer.

93. On February 26, 2016, the Commission issued Decision 16-02-022, which granted Kerman's Third Motion for Interim Rate Relief, subject to true-up. The interim relief was set at \$1,112,373 and payable from CHCF-A.

Conclusions of Law

1. Kerman's application should be granted as modified by this decision.

2. A capital structure of 40% debt and 60% equity is reasonable and should be adopted.

3. A 3.2% cost of debt is reasonable and should be adopted.

4. Using the CAPM to calculate the cost of equity is reasonable and should be adopted.

5. The risk-free rate of 3.93% for the cost of equity CAPM analysis is reasonable and should be adopted.

6. The equity risk premium of 5.88% for the cost of equity CAPM analysis is reasonable and should be adopted.

7. The industry risk premium of -1.18% for the cost of equity CAPM analysis is reasonable and should be adopted.

8. A size premium of 4.19% for the cost of equity CAPM analysis is reasonable and should be adopted.

9. A total cost of equity of 12.82% based on the CAPM analysis is reasonable and should be adopted.

10. An 8.97% cost of capital is reasonable and should be adopted.

11. Kerman's additional executive compensation is unreasonable as a justification to exceed the corporate expense cap and should not be adopted.

12. Including compensation in corporate expenses for a position that no longer exists is unreasonable should not be adopted.

13. Kerman's justification for the new IS manager's salary is insufficient to warrant an adjustment to the corporate expense cap and is therefore unreasonable and should not be adopted.

14. Kerman paying Calcom membership fees of \$14,857 is unreasonable and should not be adopted.

15. Kerman's corporate expense of \$241,465 for donations, dues, and sponsorships is unreasonable and should not be adopted.

16. Kerman's corporate expenses of \$55,716 for party, retreat and banquet costs are not reasonable and should not be adopted.

17. Because Kerman draws from the CHCF-A to subsidize its revenues and expenses, limiting Kerman's business travel expenses to the state's lodging and per diem rates for corporate expense ratemaking purposes is reasonable and should be adopted.

18. The corporate apartment rental expense of \$7,050 is unreasonable and should not be adopted for ratemaking purposes.

19. Without details of the services contract, Kerman's \$96,975 corporate expenses for services provided by its affiliate Kertel, is unreasonable and should not be adopted.

20. Kerman has not provided sufficient justification for any legal expenses above the corporate expense cap and the \$35,095, in 2013 legal expenses for 2016 forecasting purposes is unreasonable and should not be adopted.

21. Kerman's request for another regulatory manager position at \$120,000 is unnecessary and therefore unreasonable and should not be adopted.

22. Kerman's total corporate expenses of \$1,541,031, (1,530,319 plus the CPI adjustment of \$10,712) based on the FCC corporate expense cap calculations using an updated loop number of 4789, is reasonable and should be adopted.

23. The Commission should adopt \$570,941 as the reasonable annual rent expense for the central office building, resulting in a reduction of \$189,859 in Kerman's total non-corporate expense.

24. Absent sufficient documentation, Kerman's expense of \$696,124 for maintenance services provided by Kertel is not reasonable and should not be adopted.

25. Kerman's unsupported requests for \$429,254 or \$382,577.04, in warehouse rental expense are unreasonable and should not be adopted.

26. Kerman's total reported non-corporate expenses should be reduced by \$248,302 in marketing expenses. The Commission adopts \$82,767, one fourth of Kerman's total marketing expense, as reasonable.

27. The customer retention fee of \$42,000 paid by Kerman to Audeamus is unreasonable and should not be adopted.

28. The non-corporate apartment expense of \$7,050 is unreasonable and should not be adopted.

29. Raising the basic residential rate to \$30 inclusive of the EAS and ARC is reasonable and should be adopted. The new rate will increase Kerman's local revenue for 2016 by \$103,995.

30. Raising the basic business service rate to \$36.30 inclusive of the EAS and ARC is reasonable and should be adopted. The new rate will increase Kerman's local revenue for 2016 by \$78,361.

31. Kerman's projections and ORA's acceptance of USF and Intrastate Access revenues are reasonable and should be adopted.

32. Kerman's 50% employee discount is unreasonable and should not be adopted. This results in an additional \$5,026 in local network revenues.

33. ORA's recommended rates for Kerman's Tariff A-28 custom calling features is reasonable and should be adopted. The rates increase Kerman's 2016 local network revenue projections by \$121,410.

34. Raising Kerman's inside wire maintenance rates to \$7.50 per month for residential customers and \$8.00 for business customers, comparable to AT&T's and Verizon's rates, is reasonable and should be adopted. Raising the rates increases Kerman's 2016 local network revenue projections by \$151,073.

35. The revised projected growth rates are reasonable and should be adopted. The adjusted growth rates result in increased revenue of \$17,766.

36. Kerman's explanation of how call waiting caller ID services are provided and represented in its tariff is reasonable and no new rates should be adopted.

37. The parties' recommendation regarding adding \$2,200 in directory assistance revenue is reasonable and should be adopted.

38. The parties' recommendation regarding \$6,306 in late fee revenue is reasonable and should be adopted.

39. Including \$6,288 of CPE revenue in Kerman's revenue is unreasonable and should not be adopted.

40. Kerman's plans regarding back-up power and information for customers regarding a fiber system are reasonable and no additional reporting is required.

41. Requiring Kerman's shareholders to absorb \$350,031 for the accelerated copper depreciation is reasonable. The \$350,031 should be removed from Kerman's ratebase.

42. Excluding the entire plant balance recorded in the OWE is reasonable and should be adopted. The net adjustment results in a decrease to Kerman's revenue requirement in the amount of \$138,852.

43. Imputing rental revenue of \$33,800 for the Chamber of Commerce occupancy of Kerman's Old Central Office Building is reasonable and should be adopted.

44. Kerman has failed to meet its burden of proving that the current corporate affiliations are at arms-length and have not placed a burden on the consumer.

45. Kerman was given notice that the Commission might consider affiliate relations and transactions in this proceeding.

46. Adoption of ORA's affiliate transaction proposals is consistent with this Commission's duty pursuant to Pub. Util. Code § 728 to "fix, by order, the just, reasonable, or sufficient rates, classifications, rules, practices, or contracts to be thereafter observed and in force."

47. Since Kerman was on notice that the Commission might consider affiliate relations and transactions in this proceeding, Kerman has not been prejudiced by the Commission's consideration and adoption of ORA's proposal regarding affiliate transactions, and the affiliate transactions proposals are consistent with existing affiliate transaction law.

48. The Commission's ability to adopt ORA's proposal regarding affiliate transactions is not preempted by federal law.

49. Even with the presence of the ongoing Rulemaking 11-11-007, Kerman is not being subject to unequal treatment before the Commission because this decision is based on the evidence developed at this proceeding's Evidentiary Hearing.

O R D E R

IT IS ORDERED that:

1. Kerman Telephone Company's application for review of intrastate rates and charges and rate of return for telephone services in California is granted as set forth below and the accompanying Appendix A:

a) Kerman Telephone Company's operating revenues shall be \$6,826,853.

b) As part of its operating revenues, Kerman Telephone Company's total California High Cost Fund-A adopted support shall be \$1,858,914.

c) Kerman Telephone Company's operating expenses shall be \$5,371,748.

d) Kerman Telephone Company's rate base shall be \$12,621,290.

e) Kerman Telephone Company's rate of return shall be 8.97%

2. Kerman Telephone Company shall file a Tier 3 Advice Letter to true-up the difference between interim rates, including 2016 California High Cost Fund-A support and interim rate relief, for the period January 1, 2016 to the implementation date of the rates adopted in this order, in compliance with General Order 96-B, Industry Rule 7.3(5), an update by a GRC-LEC regarding its allocation from the high cost fund.

3. Kerman Telephone Company shall modify its tariffs to charge:

a) Basic residential rates of \$30.00 per month and basic business service rates of \$36.30 per month. These rates are inclusive of the Extended Area Service Charge and the Access Recovery Charge.

b) Increased rates for custom calling features such as call waiting and caller ID as set forth in Appendix A, that are reasonably comparable to the rates urban customers pay, pursuant to Pub. Util. Code §275.5(c) (3).

4. The Office of Ratepayer Advocates' proposal for revising the affiliate transaction rules as they relate to Kerman Telephone Company (Kerman) and its affiliates is granted. Within 60 days after this decision is issued, Kerman and its affiliates shall accomplish the following:

- Be held in separate legal entities.
- Maintain separate books for all transactions.
- Maintain separate bank accounts for all transactions.
- Have no joint advertising or marketing.
- Have no overlapping of employees or responsibilities.

- Have no joint events, sponsorships, fundraisers, or charitable donations.
- Not transfer any physical assets without first obtaining the necessary approvals from the Commission.
- Conduct financial transactions with each other at “arms-length.”
- Ensure that affiliate transactions are conducted at rates and upon terms no less advantageous than those otherwise available to Kerman from unaffiliated third parties for similar transactions.

5. The January 30, 2015 Administrative Law Judge Ruling Granting the Office of Ratepayer Advocates’ Motion to Compel is affirmed.

6. All previously filed motions that have not yet been ruled upon are denied

7. No later than 10 days after the effective date of this decision, Kerman shall provide a report to the Commission’s Communications Division, and serve the report on the service list of this proceeding, responding to the following questions:

- Does the Kerman Chamber of Commerce rent the Old Central Office Building?
- How much rent does the Chamber of Commerce pay?
- How many square feet is the building and how many square feet does the Chamber of Commerce occupy?
- Are any other tenants of the Old Central Office Building?
- Are there executed leases for occupants of the old Central Office Building? If so, provide copies of the leases.
- If there are no executed leases for tenants of the Old Central Office Building, explain why.
- What is comparable office space leasing for per square foot in Kerman. Provide three examples of office space lease rates in the area

8. Application 11-12-011 is closed.

This order is effective today.

Dated _____, at Sacramento, California.

Appendix A

Adopted Rates

APPENDIX A

**KERMAN TELEPHONE COMPANY
INTRASTATE RESULTS OF OPERATIONS
ADOPTED RATES**

	ORA PROPOSED * (A)	KERMAN PROPOSED ** (B)	ADJUSTMENTS TO KERMAN PROPOSED (C)	ADOPTED (D)	
OPERATING REVENUES:					
1	Local Network Services	\$ 2,118,030	\$ 1,850,745	\$ 536,137	\$ 2,386,882
2	Local Service - CHCF - A	1,938,638	6,044,785	(4,185,871)	1,858,914
3	Interstate USF	2,032,176	2,032,176	0	2,032,176
4	Network Access Services:				
5	Intrastate	252,956	252,299	0	252,299
6	Interstate	0	0	0	0
7	Miscellaneous	265,920	268,101	33,800	301,901
8	Less: Uncollectible Revenue	(5,171)	(5,319)	0	(5,319)
9	Total Oper. Revenue	\$ 6,602,549	\$ 10,442,787	\$ (3,615,934)	\$ 6,826,853
OPERATING EXPENSES:					
10	Plant Specific	\$ 1,363,294	\$ 2,285,407	\$ (1,268,560)	\$ 1,016,847
11	Plant Non-Specific (less depr.)	382,766	351,901	0	351,901
12	Depreciation & Amortization	1,761,597	2,002,440	(350,031)	1,652,409
13	Customer Operations	817,900	1,099,862	(290,302)	809,560
14	Corporate Operations	1,162,737	1,734,784	(193,753)	1,541,031
15	Subtotal	\$ 5,488,294	\$ 7,474,394	\$ (2,102,646)	\$ 5,371,748
16	Federal Income Taxes	\$ 166,013	\$ 765,238	\$ (422,530)	\$ 342,708
17	State Income Taxes	47,349	218,255	(120,510)	97,745
18	Taxes Other Than Operating	196,293	205,028	0	205,028
19	Total Oper. Expense	\$ 5,897,949	\$ 8,662,915	\$ (2,645,687)	\$ 6,017,228
20	Net Revenues	\$ 704,600	\$ 1,779,872	\$ (970,248)	\$ 809,624
AVERAGE RATE BASE:					
21	Telephone Plant-in-Service	\$ 31,426,520	\$ 32,585,754	\$ (804,990)	\$ 31,780,764
22	Tel. Plant Under Construction	1,025,652	546,738	0	546,738
23	Material & Supplies	198,257	194,333	0	194,333
24	Working Cash	301,100	439,800	0	439,800
25	Less: Deprec. Res.	(17,952,079)	(18,159,874)	473,043	(17,686,831)
26	Def. Taxes	(2,652,814)	(2,652,814)	0	(2,652,814)
27	Customer Deposit	0	0	0	0
28	Total Rate Base	\$ 12,346,636	\$ 12,953,937	\$ (331,947)	\$ 12,621,990
29	Rate of Return	5.71%	13.74%	Return on Rate Base	\$ 1,132,193 8.97%

Appendix B

Net-To-Gross Multiplier

**KERMAN TELEPHONE COMPANY
NET-TO-GROSS MULTIPLIER**

1	Gross revenue		1.00000
2	State Income Tax (Line 1 X 8.84%)		0.0884
3	Federal Taxable Income (Line 1 less Line 2)		0.91160
4	Federal Income Tax (Line 3 times .34)		0.309944
5	Net Income (Ln.3 Less Ln. 4)		0.60166
6	Net-To-Gross Multiplier (Ln.1 Divided by Ln. 5)		<u>1.66208</u>
Support Development			
7	State Rate Base	\$	<u>12,621,990</u>
8	Rate of Return on Rate Base		8.97%
9	Return on Rate Base (Line 9 times Line 10)	\$	1,132,193
10	Net Operating Income (minus proposed CHCF-A)	\$	(308,804)
11	Net Adjustment (Line 9 minus Line 10)	\$	1,440,996
12	Net to Gross Multiplier		1.66208
13	Gross Revenue Change Required	\$	2,395,051
14	Impact of Proposed Rates	\$	536,137
15	Total CHCF-A Adopted Support	\$	<u><u>1,858,914</u></u>

Appendix C

Trial Exhibits

Kerman Rate Case (A.11-12-011)
Evidentiary Hearings
April 28-29, 2015
List of Exhibits

Exhibit No.	Description
KTC = 38 Exhibits	
KTC-1	Direct Testimony of William S. Barcus, November 3, 2014
KTC-2	Rebuttal Testimony of William S. Barcus, April 16, 2015
KTC-3	Direct Testimony of Eric Kehler, November 3, 2014 [Public]
KTC-4	Direct Testimony of Eric Kehler, November 3, 2014 [Confidential]
KTC-5	Rebuttal Testimony of Eric Kehler, April 16, 2015
KTC-6	Rebuttal Testimony of Dale E. Lehman, April 16, 2015
KTC-7	Direct Testimony of David D. Clark, November 3, 2014 [Public]
KTC-8	Direct Testimony of David D. Clark, November 3, 2014 [Confidential]
KTC-9	Supplemental Testimony of David Clark, January 30, 2015 [Public]
KTC-10	Supplemental Testimony of David Clark, January 30, 2015 [Confidential]
KTC-11	Rebuttal Testimony of David Clark, April 16, 2015 [Public]
KTC-12	Rebuttal Testimony of David Clark, April 16, 2015 [Confidential]
KTC-13	Direct Testimony of Larry Thompson, December 28, 2011
KTC-14	Supplemental Testimony of Larry Thompson, November 3, 2014
KTC-15	Direct Testimony of Michael C. Burke, December 28, 2011
KTC-16	Supplemental Testimony of Michael C. Burke, November 3, 2014
KTC-17	Rebuttal Testimony of Michael C. Burke, April 16, 2015
KTC-18	KTC Compliance (Properties)
KTC-19	KTC Responses to DR ORA CC3003 dated April 15, 2015
KTC-20	Excel Files to ORA 8
KTC-21	Table 1A CPI For All Urban Consumers (CPI - U): US City Average, by expenditure category and commodity and service group
KTC-22	Lehman Rebuttal (struck/ redacted)
KTC-23	KTC's Supplemental Response to Question 1, ORA DR CC3003
KTC-24	KTC's Response to ORA Email Request Dated February 20, 2015
KTC-25	State Assessment Manual, March 2003, Reprinted January 2015 - California State Board of Equalization
KTC-26	KTC's Email Response to ORA DR CC3001
KTC-27	ORA DR CC3002, Dated January 15, 2015
KTC-28	Calcom Member List
KTC-29	FCC Report 43-02, ARMIS USOA REPORT, Foresthill Telephone Company
KTC-30	Email Reponse date March 27, 2015, ORA'S Responses and Objections to the March 13, 2015 2nd Set of DR from KTC dated March 27, 2015
KTC-31	ORA Responses and Objections to the March 30, 2015 3rd Set of DR from KTC dated April 8, 2015
KTC-32	Capitalization Rate Study
KTC-33	Meet and Confer Letter & ORA Responses and Objections to the March 31, 2015 Meet and Confer Letter from KTC
KTC-34	First Set of DR from KTC to ORA
KTC-35	Audeamus ORG Chart
KTC-36	Kertel ORG Chart
KTC-37	KTC's Floor Plans
KTC-38	Office Lease between Kerman Communications and KTC dated August 9, 1999
ORA = 15 Exhibits	
ORA-1	ORA's Report and Recommendations on the Application of Kerman Telephone Company to Review Intrastate Rates and Charges for Telephone Service within State of California (Test Year 2016), PUBLIC VERSION, March 27, 2015, With Attachments 3-1, 3-3, and 4-1 removed
ORA-2	ORA Attachment 3-1 [Confidential]
ORA-3	ORA Attachment 3-3 [Confidential]
ORA-4	ORA Attachment 4-1 [Confidential]
ORA-5	Employee List
ORA-6	KTC ORG CHART
ORA-7	Warehouse Lease
ORA-8	KTC DR Response (Board Members)
ORA-9	n/a
ORA-10	KTC DR Response CC3001 Q17
ORA-11	Sebastian Office Rental Advertisement
ORA-12	Lease Advertisement - 820 Lyman, Fresno, CA
ORA-13	Lease Advertisement - Building 21- North Pointe Business Park, Fresno, CA
ORA-14	Lease Advertisement - Seiland, Fresno, CA
ORA-15	Kerman Balance sheet (excerpt)

Appendix D

List of Appearances

***** SERVICE LIST *****

Last Updated on 29-MAR-2016 by: DC3
A1112011 LIST

***** PARTIES *****

Patrick M. Rosvall
MARK P. SCHREIBER;LISA P. TSE
COOPER, WHITE & COOPER LLP
201 CALIFORNIA STREET, 17TH FLOOR
SAN FRANCISCO CA 94111
(415) 433-1900
SmallLECs@cwclaw.com
For: Kerman Telephone Co., dba: Sebastian

Travis Foss
Legal Division
RM. 5026
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-1998
tff@cpuc.ca.gov
For: ORA

Sindy J. Yun
Legal Division
RM. 4300
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-1999
sjy@cpuc.ca.gov
For: DRA

***** STATE EMPLOYEE *****

Jessica T. Hecht
Alj
CALIFORNIA PUBLIC UTILITIES COMMISSION
EMAIL ONLY
EMAIL ONLY CA 00000
jhe@cpuc.ca.gov

Michael Coen
Comm
CALIFORNIA PUBLIC UTILITIES COMMISSION
EMAIL ONLY
EMAIL ONLY CA 00000
michael.coen@cpuc.ca.gov

Niki Bawa
CALIFORNIA PUBLIC UTILITIES COMMISSION
EMAIL ONLY
EMAIL ONLY CA 00000
(415) 703-1990
niki.bawa@cpuc.ca.gov
For: ORA

Richard Rauschmeier
Ora - Water
CALIFORNIA PUBLIC UTILITIES COMMISSION
EMAIL ONLY
EMAIL ONLY CA 00000
(415) 703-2732
richard.rauschmeier@cpuc.ca.gov
For: ORA

Legal Division
CPUC
EMAIL ONLY
EMAIL ONLY CA 00000
AppRhg@cpuc.ca.gov

Chris Ungson
CPUC - ORA
EMAIL ONLY
EMAIL ONLY CA 00000
(415) 703-2574
chris.ungson@cpuc.ca.gov
For: ORA

Brewster Fong
Safety and Enforcement Division
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-2187
bfs@cpuc.ca.gov
For: ORA

Richard Maniscalco
Communications Division
AREA 3-E
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-2005
rcm@cpuc.ca.gov

Robert Mason
Administrative Law Judge Division
RM. 5107
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-1470
rim@cpuc.ca.gov

Elizabeth Podolinsky
Executive Division
RM. 5306
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-3201
pod@cpuc.ca.gov

***** SERVICE LIST *****
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A1112011 LIST

Felix Robles
Communications Division
RM. 3-E
505 Van Ness Avenue
San Francisco CA 94102 3298
(415) 703-2801
fvr@cpuc.ca.gov

***** INFORMATION ONLY *****

David Clark
KERMAN TEL. CO., DBA SEBASTIAN (1012)
EMAIL ONLY
EMAIL ONLY CA 00000
(559) 846-6277
DClark@sebastiancorp.com

(End of Service List)

(End of Appendix D)