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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

In the Matter of Application of Volcano Telephone Company (U 1019 C) to Review Intrastate Rates and Charges, Establish a New Intrastate Revenue Requirement and Rate Design, and Modify Selected Rates	A.15-12-002 (filed December 1, 2015)

JOINT RESPONSE OF VOLCANO TELEPHONE COMPANY (U 1019 C) TO THE JUNE 30, 2016 ALJ EMAIL RULING DIRECTING THE PARTIES TO PROVIDE ADDITIONAL INFORMATION IN SUPPORT OF THE JUNE 23, 2016 ALL-PARTY SETTLEMENT AGREEMENT

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The Office of Ratepayer Advocates ("ORA") and Volcano Telephone Company (U 1019 C) ("Volcano") (collectively, the "Parties") hereby respond to Administrative Law Judge ("ALJ") Ayoade's Email Ruling Directing The Parties To Provide Additional Information In Support of the June 23, 2016 All-Party Settlement Agreement (the "Information Requests").

On June 13, 2016, the Parties held a duly-noticed all-party settlement conference in compliance with Rule 12.1(b). As a result of their negotiations, Volcano and ORA ultimately agreed upon terms that would settle all outstanding issues raised by their dispute in this proceeding. On June 14, 2016, the Parties informed ALJ Ayoade that they had reached a settlement. On June 23, 2016, the Parties filed their Joint Motion for Adoption of All-Party Settlement Agreement. On June 30, 2016, ALJ Ayoade issued the Information Requests.

The Parties have reviewed the requested information, and offer these responses to address the questions presented in the Email Ruling. However, the Parties emphasize that the clarifications and responses offered herein are not intended to modify the Parties' Settlement Agreement, which embodies an integrated set of terms that the Parties have agreed would be a reasonable basis upon which to resolve this proceeding. The Settlement Agreement is the product of significant discussions and mutual compromises amongst parties with disparate interests, and the provisions are neither severable nor subject to modification based on these responses.

In offering these responses, the Parties are also mindful of the restrictions of Rule 12.6 of the Commission's Rules of Practice and Procedure, which forbids parties from disclosing communications or positions presented during settlement discussions. Nothing in these responses should be interpreted to reveal such communications, and to the extent that the questions appear to call for such communications to be revealed, the Parties have limited their answers to avoid such disclosures.

Subject to these clarifications, the Parties respond to the Information Requests as follows:

SPECIFIC JOINT RESPONSES

1. Clarification and/or explanation regarding the formula used in the Settlement Agreement for Volcano's Revenue requirement (Page 3, item #b), including:

(a) a description or [sic] each value/figure contained in the formula; and

(b) a description what each value/figure used represents, and how each value/figure is derived.

Response: This formula appears in Section (b) of the Settlement Agreement and page 3 of the Joint Motion for Adoption of All-Party Settlement Agreement.

Revenue requirement = $11,148,636- [($2,443,887 {current return} x 1.66208) – ($16,842,777 {rate base} x *new cost of capital percentage* x 1.66208)][1].

A multiplier of 1.66208 is incorporated into the formula for updating the revenue requirement once the new cost of capital is released in A.15-09-005. The 1.66208 multiplier is a "net to gross" multiplier designed to "gross up" the anticipated return on rate base (also known as "income") under the Settlement Agreement for the effects of taxes. The multiplier itself was derived through a methodology that has been consistently used in ratemaking calculations before the Commission. This methodology involves a determination of the tax effects on a single dollar of income, and then that tax effect is multiplied by the anticipated net income under the anticipated rate structure.

The formula in the Settlement Agreement is designed to start with a revenue requirement under a specific cost of capital assumption, and then provide a methodology for updating that revenue requirement for the new cost of capital when it is adopted. This methodology allows a settlement to be reached without prejudging the outcome of A.15-09-005 or compromising either Party's positions in that proceeding. The Settlement Agreement is based on a cost of capital of 14.51%. With an assumed cost of capital of 14.51%, the parties' Settlement Agreement reflects

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[1] The formula in the parties' joint motion and settlement agreement inadvertently included an extra bracket following the first 1.66208 multiplier , which has been removed here.

that a revenue requirement of $11,148,636 would be reasonable. If the cost of capital is lower based on the outcome of A.15-09-005, the Parties supplied a formula to make appropriate adjustments to the revenue requirement.

The formula in the Settlement Agreement would provide an accurate update to revenue requirement based on an alternative cost of capital to the assumed 14.51% rate. Specifically, the formula begins with $11,148,636, and then subtracts from that figure the difference between the return (income) and tax effects under the 14.51% assumption and the return (income) and tax effects under the cost of capital to be determined. This formula will correctly update the revenue requirement for the new cost of capital as long as the new cost of capital is equal to or less than the 14.51% figure.

The $2,443,887 in the formula is the current return under the Settlement Agreement. The 1.66208 is the tax multiplier discussed above. The product of these figures yields $4,061,936, which is the combined revenue requirement impact of the anticipated return and taxes. The $16,842,777 is the rate base figure utilized in the formula to be multiplied by the new cost of capital to yield the new return. This figure would then also be multiplied by the tax multiplier to be methodologically parallel to the $4,061,936.

For clarification, the terms in braces in the formula, including the terms {current return} and {rate base}, are just included to clarify the function of the numbers preceding the terms in braces. These are not separate variables. This formula has only one unknown variable, which is the cost of capital that will be produced from the cost of capital proceeding, A.15-09-005.

As an example of how the formula would work, if a 10% cost of capital is assumed, the resulting revenue requirement would be $9,886,104 instead of the $11,148,636 that is used as the starting point of the formula. The grossed-up return under the assumption of a 14.51% cost of capital is $4,061,936, as explained in the Parties' Joint Motion for Adoption of Settlement. When the rate base figure in the formula ($16,842,777) is multiplied by 10% and grossed up using the 1.66208 multiplier, it yields a return figure of $2,799,404. When this grossed-up return at 10% is subtracted from the grossed-up return at 14.51%, there is a difference of $1,262,532.

When this is subtracted from the revenue requirement in the formula, an adjusted revenue requirement for adoption in this case of $9,886,104 is the result. If different costs of capital are chosen, different results would occur, but the formula accounts for these differences once the cost of capital is inserted.

Finally, the Parties note that they met with Communications Division staff on July 13, 2016 to discuss the operation of the formula in the Settlement Agreement. The Parties explained the inputs in the formula and provided examples of how it would function given different assumptions regarding cost of capital. Following that meeting, on July 14, 2016, Mr. Sazedur Rahman of Communications Division Staff sent an email to the ALJ and the service list in this proceeding recommending an alternative formula. With certain revisions to confirm the mathematical order of operations applicable in the formula, the formula produced by Mr. Rahman should reach the same results as the formula presented by the Parties. However, it is critical that additional brackets be inserted into Mr. Rahman's formula to ensure that it operates as the Parties intend and reaches a reasonable result. At a minimum, the formula should be modified to include brackets in the following bolded and highlighted areas:

> Adopted Revenue Requirement = $11,148,636 (stipulated revenue requirement at assumed 14.51% rate of return on rate base) – **[[**$2,443,887 (stipulated net operating revenue/income) x 1.66208 (net-to-gross multiplier)**]** – **[**$16,842,777 (stipulated rate base) x adopted rate of return on rate base x 1.66208**]]**

Absent these additions, the figures in the formula could inadvertently be multiplied by the wrong numbers prior to performing the subtractions necessary to modify the assumed revenue requirement at 14.51%.

In addition to the above-explained crucial adjustment to the formula, the formula includes labels that do not correctly reflect the Parties' agreement. As the Settlement Agreement reflects, the Parties have not agreed on the individual components of revenue requirement. Rather, they have agreed on an overall revenue requirement based on an assumption of a 14.51% cost of capital, and an accompanying formula to adjust the revenue requirement based on the cost of capital to be derived from A.15-09-005. Specifically, the term "stipulated net operating revenue/income" is not accurate because the Parties have not agreed on a specific "net operating revenue/income" figure. Rather, the Parties have agreed on the use of a "return on rate base" figure for the purposes of the equation, and that return on rate base is also subject to an assumption of 14.51% cost of capital. That "return on rate base" figure should equal the "net operating revenue/income" figure in Mr. Rahman's formula, but it is not correct to state that the Parties have "stipulated" to that figure except as it informs this equation. The term "stipulated rate base" is imprecise for the same reason. The Parties offer further adjustments to Mr. Rahman's formula to make these terms more precise, as reflected in redline below:

> Adopted Revenue Requirement = $11,148,636 (stipulated revenue requirement at assumed 14.51% rate of return on rate base) – [[$2,443,887 (stipulated net operating revenue/income <u>at assumed 14.51% rate of return on rate base</u>) x 1.66208 (net-to-gross multiplier)] – [$16,842,777 (stipulated rate base <u>for use in calculating adopted revenue requirement</u>) x adopted rate of return on rate base <u>from A.15-09-005</u> x 1.66208]]

With these adjustments, the Parties believe that the formula expressed by Mr. Rahman will reach the same results as the Parties' Settlement Agreement and correctly reflects the nature of the inputs to the formula.

2. Specific and comparative information regarding the actual figures proposed by Volcano, ORA and those adopted in the Settlement Agreement as follows:

3. Rate Case Item	**Volcano's Proposed Amount**	**ORA's Proposed Amount**	**Amount Adopted Per the Settlement Agreement**
Operating Revenues			
Operating Expenses			
Operating [Taxes][sic]			
Average Rate Base			
Rate of Return			

Response: The Settlement Agreement speaks for itself, and it does not specify the individual elements of the agreed-upon revenue requirement. Rather, the Settlement Agreement was reached with reference to an overall revenue requirement figure without identifying specific figures for operating expenses, operating taxes, or rate base. However, as discussed above, the parties agree that a rate base of $16,842,777 would be reasonable for use in the cost of capital equation. Using that rate base, a tax liability figure could be calculated once the cost of capital from A.15-09-005 is known. Absent a known cost of capital, a final tax liability figure cannot be calculated at this time, even if the parties were to agree to supply one to accompany the settlement. Once the cost of capital figure is known, if the resulting return on rate base and tax liability – as produced by the parties' recommended formula – are calculated, the Commission could produce an expense figure by subtracting the tax liabilities and return collectively from the overall agreed-upon return.

Notwithstanding the limitations described herein, using 14.51% cost of capital as an example, the figures requested in the question have been populated in a document provided herewith labeled as Appendix A. As an alternative example, the chart has been populated using a 10% cost of capital in the document provided herewith as Appendix B. Other examples could be provided, but they would only be examples, as the Parties' intent is to rely on the overall revenue requirement identified in the Settlement Agreement along with the formula designed to update that revenue requirement for the new cost of capital.

4. Section 1(c) of the Settlement Agreement (End user rates and rate design) provided that Volcano rate designs $759,475 in Interstate Universal Service Fund support for intrastate revenue requirement.

Please provide additional terms for settlement addressing the contingency that the actual amount received for the Interstate Universal Service Fund support for intrastate revenue requirement differs from the proposed amount of $759,475.

Response: Differences between anticipated federal support for intrastate operations and actual received support for intrastate operations are handled through the annual CHCF-A advice letter process pursuant to D.91-09-042. The Settlement Agreement does not address this subject because it is addressed through a different regulatory mechanism under D.91-09-042, and the Parties neither propose to modify the Settlement Agreement to account for that contingency nor propose to modify the process under D.91-09-042 in any respect.

5. The Settlement Agreement appears to presume that the final decision in A.15-09-005 will be issued prior to January 1, 2017.

Please provide additional terms for settlement addressing the contingency a final decision is not issued in A.15-09-005 prior to January 1, 2017.

Response: The Parties understand that the Commission is committed to issuing a final decision in the cost of capital proceeding well in advance of January 1, 2017, and the Parties have no reason to suspect that this timeline would not be met. Therefore, the Settlement Agreement did not address this possibility, and the Parties do not modify it by this response. Nevertheless, should the cost of capital proceeding not be resolved by January 1, 2017, the Parties would support retention of a 10% cost of capital, unless and until a new cost of capital is adopted in A.15-09-005.

6. Provide or explain why the parties should not be required to file an Amended "Separated Result of Operations Forecast" for the Test Year 2017 based on the adopted total Revenue Requirement in the Settlement Agreement.

Response: A "Results of Operations" table cannot be prepared at this time because the cost of capital to be inserted into the return on rate base, tax liability, and revenue requirement calculations is not currently known. The Parties do not believe that such a table is a requirement for settlement, so such a table was not provided along with the Settlement Agreement. However, a simple Results of Operations document – including the items identified in the chart in Question 3 – could be prepared based on the assumptions in the formula once a cost of capital is known and the formula in the Settlement Agreement can be populated. Although the parties' Settlement Agreement is based on an overall revenue requirement, once the new cost of capital is known, the Commission could use the total revenue requirement and formula in the Settlement Agreement to derive figures for return on rate base, tax liabilities, and operating expenses. These figures could be incorporated into a simple Results of Operations document within a reasonable number of days of a final decision in A.15-09-005.

CONCLUSION

The Settlement Agreement is the product of significant discussions between the Parties and the Parties continue to believe that the Settlement Agreement is reasonable as presented. The Parties are hopeful that the above responses and clarifications provide useful information in further support of the Settlement Agreement. Should there be any other questions regarding the Settlement Agreement, please contact the Parties.

Dated this 15th day of July, 2016.

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APPENDIX A

Ratemaking Elements Based on Assumption of 14.51% Cost of Capital

1. Rate Case Item	Volcano's Proposed Amount	ORA's Proposed Amount	Amount Adopted Per the Settlement Agreement
Operating Revenues*	$11,372,823	$10,920,481	$11,148,636
Operating Expenses**	$7,300,472	$7,002,619	$7,086,700
Tax Liabilities***	$1,687,975	$1,626,435	$1,618,049
Average Rate Base****	$17,570,660	$16,930,074	$16,842,777
Rate of Return	Defer to cost of capital proceeding	Defer to cost of capital proceeding	Defer to cost of capital proceeding, but 14.51% assumed for this example

*The parties expressed their settlement in terms of the cost components of revenue requirement, not with reference to "revenues," which are not a cost component. Nevertheless, operating revenues should equal total revenue requirement, so these figures are the same.
**The parties did not reach a stipulated operating expense figure, but one can be imputed through a calculation by subtracting anticipated return on rate base and tax liabilities using an assumption of 14.51% from the total revenue requirement at an assumed 14.51% cost of capital. This imputed operating expense figure under the 14.51% cost of capital scenario is reflected here.
***The information request includes the term "operating expenses" on this line, which appears to be a mistake because it replicates the line above. The Parties understand this row to be addressing tax liabilities because that would be the other input necessary to calculate a revenue requirement.
****The parties did not necessarily reflect their rate base proposals in terms of "average" rate base, but their rate base proposals are reflected here. The rate base used in the formula is reflected here as the settlement figure even though the parties did not specifically agree on a rate base except as it informs the formula.

APPENDIX B

Ratemaking Elements Based on Assumption of 10.00% Cost of Capital

2. Rate Case Item	Volcano's Proposed Amount	ORA's Proposed Amount	Amount Adopted Per the Settlement Agreement
Operating Revenues*	$11,372,823	$10,920,481	$9,886,104
Operating Expenses**	$7,300,472	$7,002,619	$7,086,700
Tax Liabilities***	$1,687,975	$1,626,435	$1,115,126.50
Average Rate Base****	$17,570,660	$16,930,074	$16,842,777
Rate of Return	Defer to cost of capital proceeding	Defer to cost of capital proceeding	Defer to cost of capital proceeding, but 10.00% assumed for this example

*The parties expressed their settlement in terms of the cost components of revenue requirement, not with reference to "revenues," which are not a cost component. Nevertheless, operating revenues should equal total revenue requirement, so these figures are the same.
**The parties did not reach a stipulated operating expense figure, but one can be imputed through a calculation by subtracting anticipated return on rate base and tax liabilities using an assumption of 10.00% from the total revenue requirement at an assumed 10.00% cost of capital. This imputed operating expense figure under the 10.00% cost of capital scenario is reflected here.
***The information request includes the term "operating expenses" on this line, which appears to be a mistake because it replicates the line above. The Parties understand this row to be addressing tax liabilities because that would be the other input necessary to calculate a revenue requirement.
****The parties did not necessarily reflect their rate base proposals in terms of "average" rate base, but their rate base proposals are reflected here. The rate base used in the formula is reflected here as the settlement figure even though the parties did not specifically agree on a rate base except as it informs the formula.