

Decision 14-02-043      February 27, 2014

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

In the Matter of the 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)

**ORDER MODIFYING DECISION 12-12-003  
AND DENYING REHEARING OF THE DECISION AS MODIFIED**

Decision (D.) 12-12-003,<sup>1</sup> an interim decision in this proceeding, denied a joint motion by Kerman Telephone Company, doing business as Sebastian (Kerman) and the Division of Ratepayer Advocates<sup>2</sup> (DRA) for approval of a settlement agreement dated June 29, 2012. Kerman and DRA are the sole parties in this rate application proceeding (A.11-12-011).

Kerman is a Small Incumbent Local Exchange Carrier (ILEC). Among other things, by its general rate case (GRC) application, Kerman sought a test year (TY) draw from the California High Cost Fund-A (CHCF-A or Fund-A) of \$6,490,463 which would have been 88% higher than its then-current draw of \$3,599,933.59 for 2012.<sup>3</sup> On November 10, 2011, more than one month prior to Kerman filing its rate application, we instituted a rulemaking proceeding (R.11-11-007 or OIR). The OIR discusses at length the changed regulatory environment since institution of the CHCF-A program. It discusses various policy reasons necessitating our thorough review of the CHCF-A program, as well as policies and practices associated with it, and sets forth the issues to

<sup>1</sup> All citations to Commission decisions refer to the Commission's decision number as found in the official pdf versions which are available on the Commission's website at: <http://docs.cpuc.ca.gov/cyberdocs/Libraries/WEBPUB/Common?decSearchDsp.asp>.

<sup>2</sup> Since September 2013, DRA is now known as the Office of Ratepayer Advocates.

<sup>3</sup> A description of Kerman's request is set forth in D.12-12-003 at page 5.

be addressed in that proceeding. (R.11-11-007 at pp. 31-32.)<sup>4</sup> The CHCF-A is funded by a surcharge on the end-user California intrastate jurisdictional revenues (other than Lifeline) of all telecommunications carriers under the Commission’s jurisdiction including, for this purpose, all interconnected Voice over Internet Protocol (VoIP) providers. (Pub. Util. Code, § 285.)

As a Small ILEC under the Commission’s jurisdiction, Kerman is subject to rate of return regulation and is eligible to receive revenue from the CHCF-A. (*Re Pacific Bell* (1988) 28 Cal.P.U.C.2d 371 [D.88-07-022], and *Re Alternative Regulatory Frameworks for Local Exchange Carriers* (1991) 40 Cal.P.U.C.2d 40 [D.91-05-016].) “The California High Cost Fund (HCF) was implemented by Decision (D.) 88-07-022, and modified by D.91-05-016 and D.91-09-042, to provide a source of supplemental revenues to three mid-size and seventeen Small ILECs whose basic exchange access line service rates would otherwise be increased to levels that would threaten universal service.” (Resolution (Res.) T-17427 at p. 2 (issued on December 20, 2013)<sup>5</sup>.)

D.91-09-042 adopted a phase-down of CHCF-A funding, known as a “waterfall.” (D.91-09-042, Appendix D.) Under the waterfall provision, funding levels are set at 100% for the first three years following the completion of a GRC, and are reduced to 80% the fourth year, 50% the fifth year and zero thereafter. In addition, Small ILECs (including Kerman) may additionally request annual CHCF-A funding adjustments through the Advice Letter (AL) process. Eligibility for supplemental funding is determined through a means test.<sup>6</sup> For calendar year 2013, Kerman was

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<sup>4</sup> “A detailed review of the program is warranted in response to market, regulatory, and technological changes since the California High Cost Fund program was first established in 1987. In this OIR, we seek comment on how the program can more efficiently and effectively meet its stated goals. To the extent deficiencies are identified, we solicit constructive proposals on whether the program should continue and if so, how should it be modified.” (R.11-11-007 at p. 2.)

<sup>5</sup> Pages 2-4 of Res. T-17427 review the history of the CHCF-A.

<sup>6</sup> The means test applies “seven months of [the] most-recently recorded data on rate of return as a basis for determining appropriate funding levels for the utility.” (*Re Alternative Regulatory Frameworks for Local Exchange Carriers* (1991) 40 Cal.P.U.C.2d 40, 44-46 Conclusion of Law No. 3, and Ordering Paragraphs Nos. 1 & 2, and Appendix A, § B [D.91-05-016].)

authorized monthly supplemental CHCF-A support of \$291,591.18, and for calendar year 2014, \$305,174.25 per month. (Res. T-17385 at pp. 10 & 16 Ordering Paragraph No. 2; Res. T-17427 pp. 1 & 16 Ordering Paragraph No. 2.)

On January 26, 2012, DRA filed a timely protest to Kerman's rate application, and requested a stay of A.11-12-011 pending completion of the OIR, and a "freeze" of Kerman's waterfall at 100%. (Previously, DRA had sought a ruling in the OIR proceeding staying A.11-12-011, but was directed that this is the proper proceeding in which to request the freeze and stay of A.11-12-011.) DRA renewed its request for a freeze of Kerman's waterfall and stay of this proceeding at the first pre-hearing conference (PHC) on March 20, 2012. The parties held an all-party settlement conference on May 29. A second PHC was held on May 30, 2012. At that PHC, the ALJ proposed that the parties would file comments on the threshold issues on June 28 (that date was later extended).

On June 15, 2012, the Assigned Commissioner and then-presiding administrative law judge (ALJ) issued a Scoping Memo and Ruling. The June 15 ruling provided in part:

In this proceeding, the Commission will first address the threshold issue of whether to freeze Kerman's revenue requirement and CHCF-A draw at current levels until the Commission concludes or reaches a decision on draws from the CHCF-A in R.11-11-007. A related threshold issue within the scope of this case is when would Kerman make a future GRC filing if its CHCF-A draw is frozen at this time.

(6/15/2012 Scoping Memo and Ruling at p. 2.)

On June 29, 2012, Kerman and DRA filed the joint motion for adoption of the all-party settlement agreement. The June 29 agreement did not address the threshold issues set forth in the June 15, 2012 ruling. However, among other things, under the agreement, Kerman would have been allocated a TY 2013 draw of \$4,274,774 from the CHCF-A, an increase of 24.16% from its then current Fund-A draw. The parties also agreed that Kerman's rate of return (ROR) would continue to be set at 10%, with no

specified capital structure. (The primary elements of the agreement are discussed at pages 7-8 of D.12-12-003.)

On October 12, 2012, the presiding ALJ issued her proposed decision (PD), denying the joint motion for adoption of the settlement agreement. The parties filed comments and reply comments on the PD. D.12-12-003 issued on December 24, 2012. In denying the joint settlement motion D.12-12-003 provides:

Given the pending CHCF-A Rulemaking and outstanding motions in that docket to freeze CHCF-A draws at existing levels and stay rate case applications until December 2013, we find it premature to allow an increase in the CHCF-A draw for Kerman at this time.<sup>7</sup> . . . [T]he threshold issues in this proceeding were whether anything other than maintenance of the status quo [i.e., a freeze on Kerman's CHCF-A draw and stay of the rate application] was appropriate . . . at this time. . . .

[Kerman's draw under] the settlement . . . [would be] . . . a significant reduction from Kerman's initial request for an 88% increase in its CHCF-A draw, [but] it still represents an almost \$1 million increase in Kerman's CHCF-A subsidy. . . . [W]e are concerned that this settlement would grant an increase in CHCF-A subsidy to one company while motions are pending to freeze subsidies to all other carriers. The ALJ emphasized [the threshold issues] at the two PHCs . . . . If the primary purpose of the settlement is to avoid contentious and lengthy rate case proceedings due to resource constraints and other more urgent business, a freeze or an effort to maintain the status quo is more appropriate. Although the ALJ stressed this . . . , the parties settled the matter on a significantly different basis. In hindsight, the ALJ perhaps . . . should have proceeded directly to the threshold issues. . . . The ALJ may have thought that her guidance to settle was understood to mean a settlement involving a freeze and how long it would

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<sup>7</sup> By D.13-02-005 (in R.11-11-007), we implemented a one-year freeze in GRC schedules and waterfall provisions for CHCF-A recipients from January 1-December 31, 2013. The December 20, 2013 ruling of the presiding ALJ in R.11-11-007, granted the October 24, 2013 joint motion of the Small ILECs and ORA to extend the freeze on the waterfall mechanisms until June 30 2014, and to extend on the rate case filings until June 23, 2014.

apply. While it is unfortunate that this direction was [not] taken as . . . the direction intended, it is not necessary for us to approve this settlement if we do not find it in the public interest.

(D.12-12-003 at pp. 9-10.)

In light of the limited record, and in view of the concerns and issues being addressed in the concurrent OIR regarding the CHCF-A program and the then-pending request to freeze the waterfall provisions of nine of ten Small ILECs and stay the filing of their rate case applications, we concluded that the settlement, which would have increased one carrier's CHCF-A by over 24% absent a developed record and closer scrutiny, was, at that time, inappropriate and the agreement did not meet the requirements of our settlement rules. (D.12-12-003 at p. 11.)

Kerman timely filed an application for rehearing of D.12-12-003. In its application for rehearing of D.12-12-003, Kerman generally contends that D.12-12-003 errs in relying on the concurrent CHCF-A rulemaking proceeding, R.11-11-007, in determining that any increase in CHCF-A funding at this time would be unreasonable. Kerman also argues that D.12-12-003 constitutes an unconstitutional refusal to process Kerman's rate case in a timely manner, and denies it due process of law. It further asserts that the challenged decision endorses DRA's position, and alleges D.12-12-003 is based on inaccurate and unfounded facts, contending these allegations establish that the Commission abused its discretion and acted arbitrarily and capriciously. In addition, Kerman argues that by denying the joint motion, the challenged decision unlawfully denies it an opportunity to earn a reasonable rate of return.

In reviewing Kerman's allegations of error, we have determined that the findings of fact and conclusions of law should be modified, as set forth in the Ordering Paragraphs below, to better explain the rationale discussed in the challenged decision.

We have carefully considered the arguments in the application for rehearing and are of the opinion that good cause for rehearing of D.12-12-003 as modified herein

has not been demonstrated. Accordingly, rehearing of D.12-12-003 as modified herein, is denied.

**THEREFORE, IT IS ORDERED** that:

1. Decision 12-12-003 is modified as follows:
  - a.) Finding of Fact No. 1.a is added as follows:

1.a. On November 18, 2011, the Commission issued an order opening a rulemaking into the review of the California High Cost Fund-A (CHCF-A), docketed as Rulemaking (R.)11-11-007. R.11-11-007 solicited comments on topics including whether the Fund-A has met its goals, and if so, whether it should be immediately discontinued or phased out over time, and whether the current 14 small ILECs should continue to be classified as rate of return carriers.
  - b.) Finding of Fact No. 1.b is added as follows:

1.b. The CHCF-A is funded through carriers' intrastate revenue. In 1985, by D.85-06-011, the Commission required rate case review as a prerequisite to CHCF support in order to prevent the utilities from drawing unnecessarily from the fund. In 1988, by D.88-07-022, the Commission adopted a phase-down of CHCF support for utilities, known as the "waterfall," in which funding levels are set at 100% for the first three years following the completion of a carrier's GRC proceeding, and are reduced to 80% the fourth year, 50% the fifth year and zero thereafter.
  - c.) Finding of Fact No. 1.c is added as follows:

1.c. Based on forecasting, the Commission uses a "means test" adopted by D.91-05-016, which applies seven months of the most-recently recorded data on rate of return as a basis for determining appropriate CHCF-A funding levels for a utility.
  - d.) Finding of Fact No. 1.d is added as follows:

1.d. At the time Kerman filed A.11-12-011, its CHCF-A funding level was at 100%, where it remains to date.
  - e.) Finding of Fact No. 2.a is added as follows:

- 2.a. On January 26, 2012, DRA filed a protest of Kerman's GRC application and requested a freeze in Kerman's CHCF-A draw and stay of Kerman's GRC application pending completion of R.11-11-007, which Kerman opposed.
- f.) Finding of Fact No. 2.b is added as follows:
- 2.b. On March 9, 2012, the Small ILECs (including Kerman) filed a motion in R.11-11-007 to hold that proceeding in abeyance.
- g.) Finding of Fact No. 2.c is added as follows:
- 2.c. DRA renewed its motion for a stay of A.11-12-011 at the March 20, 2012 pre-hearing conference. The presiding ALJ said that there was good reason not to proceed with the GRC at that time.
- h.) Finding of Fact No. 2d is added as follows:
- 2.d. At the second pre-hearing conference the presiding ALJ informed the parties that the threshold issues in this proceeding were whether anything other than maintenance of the status quo was appropriate given the pendency of R.11-11-007, and when would it be appropriate for Kerman to make a future GRC filing if its CHCF-A draw was frozen at this time.
- i.) Finding of Fact No. 2.e is added as follows:
- 2.e. On June 4, 2012, a pre-hearing conference was held in R.11-11-007.
- j.) Finding of Fact No. 2.f is added as follows:
- 2.f. A third pre-hearing conference in this proceeding was held by telephone, on June 13, 2012.
- k.) Finding of Fact No. 2.g is added as follows:
- 2.g. On June 15, 2012, an Assigned Commissioner and Assigned ALJ Scoping Memo and Ruling issued which provided that in this proceeding, the Commission will first address the threshold issue of whether to freeze Kerman's revenue requirement and CHCF-A draw at current levels until the Commission concludes or reaches a decision on draws from the CHCF-A in R.11-11-007, and that a related threshold

issue within the scope of this case is when would Kerman make a future GRC filing if its CHCF-A draw is frozen at this time. The June 15 ruling set dates for opening and reply comments and a proposed decision to be filed on the threshold issues.

l.) Finding of Fact No. 2.h is added as follows:

2.h. The June 15, 2012 Assigned Commissioner and Assigned ALJ Scoping Memo and Ruling notified the parties that once a decision issued on the threshold issues, and if the Commission votes against a freeze and determines that Kerman's application for a \$2.9 million revenue requirement increase should be considered, the scope of the proceeding will involve the following: (1) Determine the revenue requirement for Kerman using a 2013 test year; (2) Review Kerman's rates and charges and sources of supplemental intrastate funding through the CHCF-A; (3) Consider the impacts of the Federal Communications Commission's Connect America Fund Order and policies regarding federal funding mechanisms on Kerman's rate design; and (4) Whether the following proposals by Kerman in the application are reasonable: (a) \$5.8 million in network upgrades and use of CHCF-A fund for these investments; (b) Return on Equity of 14.81%; (c) Return on Rate Base of 12.69%; (d) Proposed changes to local service rates and charges; (e) CHCF-A support of \$6.49 million; (f) \$2.9 million in plant additions; and (g) Proposed depreciation expense for test year 2013.

m.) Finding of Fact No. 6.a is added as follows:

6.a. The joint motion for adoption of the settlement agreement contains no information regarding the threshold issues.

n.) Finding of Fact No. 6.b is added as follows:

6.b. The settlement agreement provides for a 10% rate of return with no specified Capital Structure.

o.) Finding of Fact No. 6.c is added as follows:

6.c. DRA has not yet filed prepared testimony or accompanying exhibits. While testimony in support of

the application was served by Applicant, it has not been identified or received.

- p.) Finding of Fact No. 6.d is added as follows:  
6.d. The record in this proceeding consists of the application, the protest of DRA, the settlement, and various representations at the PHCs.
- q.) Conclusion of Law No. 2a is added as follows:  
2.a. Given the pending CHCF-A Rulemaking and outstanding motions in that docket to freeze CHCF-A draws at existing levels and stay rate case applications until December 2013, we find it premature to allow an increase in the CHCF-A draw for Kerman at this time.
- r.) Conclusions of Law No. 2b is added as follows:  
2.b. Given our clear concerns about the scope and direction of the CHCF-A, we are not prepared to treat this application as though R.11-11-007 did not exist.
- s.) Conclusion of Law No. 3.a is added as follows:  
3.a. If parties do not renegotiate a settlement that comports with the directions given in this decision within 20 days of this decision, the ALJ should proceed to address the threshold issue, as stated in the scoping memo, of a freeze in the CHCF-A draw at the current level coupled with when a subsequent general rate case could be considered.
- t.) Conclusion of Law No. 4.a is added as follows:  
4.a. The settlement is not in the public interest because, given the Commission's expressed concerns and current scrutiny of the CHCF-A program, it is inappropriate to increase the CHCF-A subsidy to one carrier, absent close scrutiny of the need for the request.
- u.) Conclusion of Law No. 4.b is added as follows:  
4.b. Rule 12.1 et seq., of the Commission Rules of Practice and Procedure, is controlling with respect to settlement agreements in Commission proceedings.
- v.) Conclusion of Law No. 4.c is added as follows:

4.c. The Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest.

w.) Conclusion of Law No. 4.d is added as follows:

4.d. Given the totality of circumstances, including the current review of the CHCF-A, the all-party settlement is found to not meet all of the requirements for approval, specifically not being reasonable in light of the whole record nor being in the public interest.

x.) Conclusion of Law No. 4.e is added as follows:

4.e. The joint settlement agreement fails to meet the requirements for approval of a settlement agreement pursuant to our Rules of Practice and Procedure, rule 12.1, subdivision (d).

2. Rehearing of Decision 12-12-003 as modified herein is denied.
3. Application 11-12-011 remains open.

This order is effective today.

Dated February 27, 2014, at San Francisco, California.

MICHAEL R. PEEVEY  
President  
MICHEL PETER FLORIO  
CATHERINE J.K. SANDOVAL  
CARLA J. PETERMAN  
MICHAEL PICKER  
Commissioners