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)

REPLY BRIEF OF THE OFFICE OF RATEPAYER ADVOCATES

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I. INTRODUCTION

The Office of Ratepayer Advocates (ORA) submits this Reply Brief in the General Rate Case Application (A.) 11-12-011 of Kerman Telephone Company (U1012C) doing business as Sebastian (KTC). KTC's claim that it would be unable to provide safe and reliable service if ORA's proposals are adopted should be rejected. Contrary to KTC's statements, ORA has offered a comprehensive, holistic, and compelling review of KTC's operations and revenue requirement needed to provide safe and reliable basic telephone service. In fact, if adopted, ORA's recommendations eliminate only the items that contribute nothing to or have no effect on maintaining service quality and reliability, such as polo festivals, Fresno State sporting events, golf tournaments, excessive executive bonuses, and excessively high investor returns for the Sebastian family.[1]

There are two continuing major areas of disagreement between ORA and KTC. First, ORA recommends that the corporate expenses cap, created by the Federal Communications Commission (FCC) and adopted by the CPUC in D.14-12-084, should be imposed. KTC has failed to demonstrate which, if any, of its corporate expenses should be exempted from the cap. Second, ORA recommends that KTC's rate of return on equity should be a reasonable 8.79% instead of the excessive 16.24% requested by KTC. KTC's requested level exceeds all previous historical rates for rural carriers and also exceeds a level necessary to ensure ongoing investments, in violation of Public Utilities Code[2] Section 275.6(c)(7).

There are many other areas of ongoing disagreement, which are addressed herein. This Reply Brief generally tracks the arguments and structure of KTC's Opening Brief.

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[1] KTC is owned and controlled by Sebastian Enterprises, Inc., which is wholly owned by the descendants of the Sebastian family: Ruth Barcus, Susan Moran, Barbara Douglas, William Barcus, Brian Barcus, Amanda Moran, Evan Moran, and Christopher Moran.

[2] All statutory references herein are to the Public Utilities Code.

II. FACTUAL AND PROCEDURAL BACKGROUND

ORA does not dispute either KTC's lengthy description of its service territory[3], or its even lengthier description of the procedural history in this case.[4]

However, in its "Factual Background" section, KTC inappropriately addressed ORA staff's work on this case and the thoroughness of ORA's Report. ORA disagrees with KTC's description of ORA's approach to this case and its discovery methods as overly "aggressive."[5] KTC inappropriately characterizes ORA as having too many analysts assigned to the case, and having worked too hard and putting in too many hours.[6] The amount of work done by ORA on this case and the manner in which it was done is exemplary, and befitting the importance of this proceeding. Strangely, KTC on the one hand criticizes the amount of work done, but at the same time goes to great lengths to explain and demonstrate the "broader policy context" and "numerous dimensions" regarding the importance of this case.[7] This is an important case, and the amount of work and thoroughness shown by ORA in this case was justified.

KTC's slashing criticism of ORA staffs' work illustrates KTC's approach to this case, which involves repeated *ad hominem* statements against ORA. KTC should be reminded that the Commission's Rules of Practice and Procedure, Rule 1.1, require that any person who signs a pleading is obligated to "maintain the respect due to the Commission." KTC's pleading falls short of this standard. KTC's personal attacks do nothing to advance an understanding of this case, and do nothing to explain KTC's proposals. Rule 1.1 prohibits this kind of harsh brief-writing.

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[3] KTC Opening Brief (OB) at pp. 3-6.

[4] KTC OB at pp. 6-10. However, it seems unnecessary and excessive to describe every ORA attorney assigned to this case.

[5] KTC OB at 11.

[6] KTC OB at 11.

[7] KTC OB at 12.

KTC also alleges that ORA staff lacked coordination in their proposals.[8] However, ORA's proposals are all summarized in ORA's Executive Summary and Exhibit ES-1 attached to the ORA Report, which summarizes KTC's results of operations under ORA's proposals.[9] If adopted, KTC would have sufficient revenues (from both rates and from subsidies) to meet the revenue requirement that it has requested, with only certain items eliminated from its operations that have nothing to do with maintaining service quality and reliability.

III. KTC CITES TO ITS "EXTENSIVE" ANALYSIS WITHOUT PRESENTING ANY ACTUAL ANALYSIS

In this section, KTC summarizes its witnesses' testimony.[10] However, this section of KTC's OB does not present detailed analysis of KTC's requests. The section has no relevance to the merits of any of KTC's proposals.

In this section, KTC also praises its witnesses for their "straightforward application of existing law."[11] However, none of KTC's witnesses are attorneys and therefore their application of the law to the facts should be given only the weight merited by their lack of legal qualifications – none. For example, KTC's OB argues that KTC's revenue requirement requests are legal under Section 275.6(b)(4).[12] However, this analysis is shallow and incorrect, in that it ignores the fact that some items are not proper or legal, such as image advertising in the form of polo festivals and Fresno State sporting events. Merely stating that the company's requests are "legal" does not make them so. KTC's witnesses are not lawyers and their analysis of the law reflects only a general and superficial understanding of the specifics of the statutes and the applicable case law.

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[8] KTC OB at 23.

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

[10] KTC OB at 16.

[11] *Id.* at 20.

[12] KTC OB at 21.

IV. KTC'S CRITICISM OF ORA'S WORK MISSES THE MARK

KTC next devotes several pages to criticizing ORA's findings and conclusions in this case.[13] However, this criticism does not discuss the specific findings by ORA, and does nothing to refute ORA's recommendations. Instead, KTC makes broad generalizations that do not stand up to scrutiny. KTC's repeated attempts to undermine ORA's witnesses do not further a rational discussion of the merits of this case.

KTC cherry-picks its criticisms, accepting ORA's proposals when it suits them, and rejecting them when it does not. For example, KTC does not take issue with Mr. Goldman's recommendation for the Commission to adopt KTC's Five Year Plan, which includes $7 million for a Fiber to the Home (FTTH) project. KTC agrees with Ms. Chitadje's calculation of the FCC's corporate expense cap. KTC noted that Ms. Krannawitter was correct in the calculation of a new flat rate for basic residential service. Apparently, KTC agrees with all of these findings – its criticisms are selective.

Furthermore, KTC itself acknowledged that it made mistakes in this case. When ORA found those mistakes, KTC accepted ORA's criticisms and accepted ORA's adjustments. This proves that ORA staffs' analysis was sound, and discredits any attempt to paint all ORA staff with broad "unreliable" brushstrokes. For example, ORA noted that KTC failed to report any revenue for directory assistance, and KTC agreed.[14] ORA also noted that KTC incorrectly calculated the flat business rate. When notified of this error, KTC's witness stated that it was not their intent to have business customers pay less than they pay today, and accepted ORA's correction.[15] In another example, KTC's rebuttal testimony agrees that it made an error in the calculation of late payment charges, which ORA found, and makes the required adjustment.[16]

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[13] *Id.* at pp. 21-24.

[14] *Id.* at 24.

[15] KTC-12 at 3.

[16] KTC-12 at 24.

KTC's attempt to paint ORA as "unreliable" is merely rhetoric, and belied by the fact that KTC relies on many areas of agreement with ORA. This is especially true where KTC agrees that ORA found mistakes by KTC. As mentioned above, KTC's *ad hominem* attacks are prohibited by Rule 1.1, which requires parties to give the Commission and its staff the respect that they are due.

V. KTC'S REVENUE REQUIREMENT

A. KTC'S Revenue Requirement

KTC's analysis of its revenue requirement relies heavily on the authority and experience of its witnesses' testimony, without actually explaining *why* its requests are reasonable. KTC fails to persuasively demonstrate that the specifics of its requests have merit. KTC merely summarizes its testimony, without explaining the reasonableness of the specific components of that request.[17] For example, KTC's OB has a summary table, and then states: "Additional specificity regarding these categories of revenue requirement is provided in the exhibits to Mr. Clark's rebuttal testimony." This is in contrast to ORA's OB, which carefully analyzes each component of KTC's revenue requirement.

B. KTC's Plant Proposals

KTC and ORA basically are in agreement with regard to KTC's plant proposals.[18] ORA agrees with KTC that its Five Year Plan is reasonable and should be adopted. However, KTC and ORA continue to have two areas of disagreement: first, ORA's recommendation to disallow copper depreciation; second, ORA's disallowance of the "Other Work Equipment" account.

It should be noted that ORA has accepted KTC's plant proposals, with the exception of these two categories. This should ensure that KTC's service quality is unaffected – in fact, the FTTH project should increase service quality, as KTC's and ORA's witnesses both note. ORA's agreement with KTC's Five Year Plan is discussed

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[17] KTC OB at 27.

[18] KTC OB at 28.

thoroughly in ORA's OB, and not repeated here. ORA's acceptance of KTC's plant proposals proves that ORA has considered KTC service quality and approves of KTC's commitment to excellent service.

C. Copper Facilities Depreciation Expense

KTC's OB skips any discussion of depreciation of specific plant items, and instead goes directly to the area of dispute with ORA, which is the accelerated depreciation of its copper facilities.[19] KTC is proposing to replace its current copper based services with FTTH technology at a cost of $7,811,197 added to rate base. As part of this proposal, KTC is requesting ongoing depreciation of its Underground Metallic and Buried Metallic Cable and Wire Facilities,[20] which are the associated accounts of the copper wire infrastructure as noted in Table 3-1 of ORA's Report.

However, KTC's arguments are confusing with regards to its replacement of copper wires. On the one hand, KTC recommends shortening the lives of its copper wires to "better capture Kerman's reality, which is that its copper plant will be replaced by fiber…"[21] KTC's witness Eric Kehler points out that its copper wires will be "replaced long before they become fully depreciated under the existing lives."[22] KTC's FTTH project appears to replace most (or all) of the copper wires with fiber.[23]

On the other hand, KTC claims that "neither Kerman nor ORA is recommending removal of the copper from service…"[24] KTC further claims that "KTC's copper will remain in rate base in the test year and beyond."[25] This is confusing because it directly

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[19] TC OB at 31.

[20] KTC-4 at 10-11.

[21] *Ibid*.

[22] Direct Testimony of Eric Kehler, Nov. 3, 2014, pg. 11, lines 2-3.

[23] ORA Report at 58.

[24] KTC OB at 33.

[25] KTC OB at 34.

contradicts the earlier statements that the FTTH project will replace and remove the copper wires as they transition into obsolescence.[26]

However, ORA's review of the FTTH project documentation indicates that it is more likely than not that most or all of KTC's copper wire will be replaced by fiber during the rate case cycle. The confusing statements about copper being still in rate base for many years to come appear to be solely for the purpose of rebutting Mr. Goldman, as they are inconsistent with Mr. Kehler's testimony about the copper being removed. As a result, ORA's recommendation to remove the future copper depreciation as the copper is removed from rate base and replaced with fiber, is justified.

KTC takes a statement made by Mr. Goldman and turns it on its head, which illustrates how KTC contorts its own position merely to rebut Mr. Goldman's testimony. Mr. Goldman noted that KTC's removal of its copper wires was not strictly necessary because "KTC's copper is still useful and in good repair."[27] Reductions in depreciation expense are appropriate where the plant associated with the expense is removed from rate base.[28] Again, it is clear that copper wires will be removed by KTC. However, removing copper wires that are still used and useful is being done solely for the purpose of upgrading to fiber, not because the copper is in disrepair. Thus, it is not clear why KTC believes that it is appropriate for KTC to continue to receive a depreciation expense for copper wire after it is removed and replaced. KTC should not be allowed to remove the copper wires and yet continue to receive depreciation expense for those wires, when they are still useful and in good repair.

Despite the fact that the copper wires will be removed from rate base, KTC argues that this would result in an "unconstitutional taking" of "utility property."[29] However, the Commission has the discretion to disallow expenses where the circumstances call for

[26] Direct Testimony of Eric Kehler, Nov. 3, 2014, pg. 4-5.

[27] KTC OB at 34.

[28] KTC OB at 33.

[29] KTC OB at 35.

it.[30] The confusion arises because KTC attempts to have it both ways – to receive depreciation and a return on useful copper while receiving both depreciation and a return on the fiber that is replacing the same useful copper. Clearly, it is not unconstitutional for the Commission to disallow continued depreciation expense for facilities with useful lives that are being replaced with new facilities that receive their own depreciation expense and return in rate base.

D. Non-Corporate Expenses

To provide an estimate of test year 2016 non-corporate expenses, KTC used its 2014 non-corporate expenses and escalated them for inflation in 2015 and 2016.[31] KTC states that there is no reason to "deviate from this methodology", but ORA has no dispute with the methodology. However, ORA disputes the reasonableness of the expenses themselves.

In its OB, KTC does not describe or explain the majority of its non-corporate expenses.[32] Instead, KTC focuses on the areas of dispute between ORA and KTC. These disagreements include KTC's contract with its affiliate Kertel for "Information Services", the KTC warehouse, the Central Office Building lease, marketing expenses, and KTC's guest apartment. The full explanation for ORA's adjustments to these items is contained in its Opening Brief and Staff Report.[33] Below, ORA rebuts KTC's arguments regarding those areas.

1. KTC's "Information Services" Contract with Affiliate Kertel

KTC's parent company Sebastian Enterprises, Inc. (SEI) bills KTC $66,091.67 per month for a maintenance service allegedly provided by Kertel Communications

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[30] Section 795: The commission may, from time to time, ascertain and by order fix the proper and adequate rates of depreciation of the several classes of property of each public utility.

[31] KTC OB at 36.

[32] KTC states that "Mr. Clark's testimony identifies those non-corporate expenses…" without explaining what they are or why they are reasonable. KTC OB at 36.

[33] ORA Report at pp. 41-50.

(Kertel).[34] Kertel is an affiliate of KTC. ORA recommends disallowing the cost of the contract because despite repeated requests, KTC has been unable to produce a copy of the Kertel contract.[35] The sole documentation provided by KTC to prove the existence of a contract is a monthly invoice provided in Attachment 2-10 to ORA's Report. The invoice contains no description of the materials provided, the hours worked, or a description of the work performed. There is no other supporting documentation. Without any supporting documentation, it is simply impossible for ORA to provide a meaningful review of the Kertel services to determine whether the work was actually performed or was necessary and reasonable. Moreover, KTC 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.[36] KTC fails to explain why the apparently redundant Kertel IT services contract is necessary or reasonable. Finally, it appears the contract was not executed at "arms-length", in that Mr. Barcus is the president of both companies[37], and the contract was entered into without anything in writing and no description of the labor, materials, or work to be done. The Commission should apply strict scrutiny to such deals to determine if they were done at "arms-length."

KTC attempts to justify the contract in two ways. First, by arguing that verbal non-written contracts are valid; and second, by providing a general description of the services rendered and claiming that this is sufficient evidence that the work performed was necessary and reasonable.[38] KTC does not address why the contract with Neo Nova is insufficient, or why the Commission should be reassured that Mr. Barcus has not engaged in self-dealing.

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[34] ORA Report at 43.

[35] *Ibid.*

[36] *Id.* at 44.

[37] KTC-36, Kertel Org Chart.

[38] KTC OB at pp. 38-40.

First, ORA does not dispute that under some circumstances, non-written contracts are valid. However, this argument misses the mark. The lack of a written contract makes a review for reasonableness impossible. The non-existence of something in writing is especially problematic because there are no indicia that the work was actually done – no detailed invoices that show the time and location of the work, the services rendered, the materials provided, or the identity of the workers who performed the work. A contract for this amount, for a company of this size, would logically necessitate a written contract (as the written contract with Neo Nova proves). It is also problematic that Mr. Barcus is the president of both companies, and so it is especially prudent to review the contract carefully to determine whether ratepayers have received what they paid for with this contract, which is impossible without any detailed receipts or invoices. It is impossible to determine who performed the work, when it was done, where it was done, the materials purchased, or the need for the work.

Second, KTC presents evidence that allegedly proves that services were rendered under the contract. ORA finds this "evidence" to be highly misleading, because it is presented as if it is for past work done. In fact, the chart provided by KTC contains data that was never before shown to ORA nor contained anywhere in KTC's application or testimony.[39] In addition, KTC mischaracterizes the data as being specific and for past work. In reality, the chart is based on a "general understanding" of a prospective estimate of work to be done in the future.

KTC has taken a chart from discovery and added extra information to it, and then mischaracterized it. A careful review of attachment DC-10 to the Rebuttal Testimony of Dave Clark (KTC-12) is in order. There are many important differences between the chart in DC-10 and the chart in KTC's OB.

First, it should be noted that unlike the chart in KTC's OB, the chart in DC-10 contains no column entitled "Annual Cost." That information is entirely new, added for the purpose of making the chart appear more specific than it really is. The chart in

[39] KTC OB at 41.

KTC's OB also contains an entirely new column (with new data) entitled "Annual Cost to Kerman" which is not contained in DC-10. Finally, KTC has added the column "2013 Billing Adjustment (3%)" which is not present in the chart in DC-10. The Commission is required to base its decisions on the evidence in the record. None of these columns actually appear in the record, and therefore the Commission cannot make any findings of fact based on the data in these columns. The data must be disregarded, which means that KTC has still not presented evidence that any specific work was performed under the contract.

Second, the charges in the chart in KTC's OB are presented in a different light than in the chart in DC-10. KTC's OB presents the data as if it is for past work that was actually done. For example, KTC says the chart shows "services provided", "hours utilized", "prices for each service", and "the costs associated with specific tasks."[40] These items are stated in the past tense as if they occurred, which is misleading. Instead, DC-10 shows that there is no contract with Kertel. The preface to the chart states: "Kerman has not entered into a formal executed agreement or contract with Kertel Communications..." (Emphasis added. See Attachment DC-10 to KTC-12.) In an attempt to explain why it is paying $66,091.67 per month, Kerman (in DC-10) explained that Kerman has only a "general understanding of how the charges were developed and the terms of the arrangement." The chart in DC-10 shows "estimated requirements" for yearly work, demonstrating that it is an estimate of future work. The charges listed in DC-10 represent only an "initial assessment" of work to be done, not specific work already performed. The preface in DC-10 also states that the chart is an aggregate estimate of both Foresthill's and KTC's computer-related needs, not just KTC's. This is directly at odds with how the chart is described in KTC's OB.

Furthermore, the specificity of DC-10 is mischaracterized by KTC's OB, which states that the chart provides "costs associated with specific tasks."[41] In fact, the chart

[40] KTC OB at 40.

[41] *Ibid*.

provides no specificity at all. As noted in ORA's OB, KTC has provided only the most general description of the Kertel services, defying any attempt to determine whether the costs were actually incurred or whether they are reasonable. For example, the chart on DC-10 describes 1,434 hours for "Helpdesk Ticket Responses", and 448 hours for "Programming for Reporting." The other categories contain only the most general descriptions, such as "monitoring", "purchasing", and "administration."[42] No reasonable person could conclude that these are "highly detailed" descriptions of specific tasks. Vague descriptions such as "monitoring and management" preclude the Commission from doing any meaningful review of the services rendered. KTC's attempt to characterize these descriptions as "highly detailed" and for past work done are misleading, at best.

KTC next claims that DC-10 shows that 11 employee positions were eliminated from KTC's payroll because of the Kertel IS contract.[43] However, this appears to be a fabrication, as nothing in DC-10 suggests that employee positions were eliminated. Instead, DC-10 merely states that the Kertel services were previously performed by 11 employees, while never stating that these employee positions were eliminated. There is nothing in the record to indicate that KTC's operating budget has been reduced by 11 employees' wages and benefits.

The Kertel IS contract illustrates a pattern of affiliate abuse that is noticeable throughout KTC's application and testimony.

2. The Warehouse

Based on new evidence provided to ORA after it submitted its Report, ORA now finds that the KTC warehouse is owned by the Barcus Family Partnership and the S&K Moran Partnership.[44] An executed copy of the lease (Exhibit ORA-7) was provided to

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[42] Attachment DC-10 to KTC-12.

[43] KTC OB at 42.

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

ORA on the first day of hearings, signed in April 2015 by Ruth Barcus and Susan Moran (on behalf of the family partnerships), and William Barcus (on behalf of KTC). Rent is listed as $382,577.04 per year.[45]

However, KTC continues to request the amount of $429,254 per year in rent, and does not address the discrepancy between the actual lease amount and KTC's requested amount. KTC also fails to address the large discrepancy between KTC's per square foot costs for the warehouse and other similar warehouses. It is especially concerning that KTC pays $2.27 per square foot per month for the warehouse, while Sebastian's corporate building in Fresno leases office space for $1.95 per square foot per month.[46] This illustrates a repeated pattern with KTC – that KTC overpays for services provided by its affiliates.

3. Central Office Building

KTC next disputes ORA's recommended adjustment of $189,859 ($760,800 - $570,941) for the Central Office Building.[47] KTC argues that ORA's recommendation is based on data from 7 years ago, and that "existing market and economic conditions" have changed.[48] However, in light of the recent "great recession", it is commonly known that real estate values have generally declined, in some places quite severely. Rental prices in Kerman could very well be lower than they were in 2008, as many rural areas have suffered sharp declines. The Commission's rules continue to place the burden of proof on the applicant to show that conditions have changed, especially after a "great recession" that caused real estate to fall dramatically. Yet KTC presents no studies that show that rental prices have increased. KTC presents nothing to justify raising the rent on the Central Office Building. The Commission should be especially concerned in light of

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[45] ORA-7.

[46] ORA-11.

[47] KTC OB at 45.

[48] KTC OB at 46.

the fact that Mr. Barcus is both the president of KTC and a member of the family trusts to which KTC pays rent.

To properly determine the value of the property, ORA propounded discovery seeking property tax assessments and insurance payments on the Central Office Building.[49] The tax assessments or insurance records would reflect the value of the building. However, KTC failed to provide such records, stating that no such records existed.[50] The lack of documentation proves that KTC cannot justify its request for higher rent for this building.

In addition, since 2007 KTC has paid SEI at least $9,277,400 in rent plus all taxes and insurance for a building that SEI built in 2006 at a total cost of $3,221,534.[51] The Commission could well find that the Central Office Building has been a financial disaster for ratepayers, who would have paid a far lower amount if KTC had simply built the building itself. Yet KTC argues that SEI's profits at the expense of ratepayers are a "red herring" and "not relevant."[52] This is another illustration of how KTC appears to be overpaying for services provided by its affiliates.

4. Marketing Expenses

ORA recommends an equitable allocation of KTC's marketing expenses between KTC and its affiliates, on the grounds that all of KTC's marketing is done in the name of Sebastian, which benefits all of KTC's affiliates equally. KTC argues that its marketing expenses are reasonable and legitimate because they are for things that are not affiliate-related, such as to "promote [KTC's] business opportunities, compete against competitors, make customers aware of services, and encourage customer retention."[53]

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[49] ORA Report at 41.

[50] ORA Report at 42.

[51] CPUC Resolution T-17081.

[52] KTC OB at 47.

[53] KTC OB at 48.

First, there is no evidence that KTC's marketing expenses promote KTC's business opportunities and make customers aware of services. Instead, ORA found that KTC included in its marketing expense category non-marketing items such as hotel stays and restaurant meals.[54] KTC makes no attempt to explain how hotel stays and restaurant meals promote anything. In fact, much of KTC's marketing is in the form of sponsorships and branding in the name of Sebastian, which promotes all of KTC's affiliates equally and does nothing to explain or describe its services or "business opportunities."

Second, KTC experiences no competition for basic landline telephone service.[55] Thus, KTC's rationale that marketing expenses are necessary to compete against competitors is inapplicable. KTC's affiliate broadband provider Audeamus has competition from Comcast[56], but marketing expenses for Audeamus should not be borne by KTC. ORA recommends that the Commission follow long-established precedent that "all institutional advertising shall be disallowed for ratemaking purposes."[57]

Third, KTC pays its affiliate broadband provider Audeamus a $42,000 per month "customer retention fee", which it charges to its marketing expense account.[58] KTC's total working telephone lines have steadily declined since 2010, thus the customer retention fee does not appear to be working.[59] Moreover, the fees are paid to an affiliate of KTC, with no indication of how they were arrived at or calculated. These fees are essentially SEI paying itself to unsuccessfully retain its own customers, with ratepayers footing the bill. Notably, KTC's OB makes no effort to explain or justify this expense.

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[54] See, e.g., Attachment 2-22 to ORA's Report.

[55] ORA Report at 46.

[56] ORA Report at 59.

[57] D.86794.

[58] ORA Report at 47.

[59] ORA Report at 48.

Finally, KTC attempts to explain that KTC's marketing expenses are merely 28% of the total SEI budget.[60] There is no explanation why the allocation is 28% rather than 25% - 1/4 would be more logical in light of the fact that there are 4 affiliates under SEI. Apparently, SEI's marketing budget is not carefully segregated between KTC and its affiliates. Instead, SEI has one total marketing budget of $1,189,078 for all of its affiliates.[61] This again illustrates how KTC may be overpaying for items that benefit its affiliates at ratepayers' expense.

5. Company Rental Apartment

KTC maintains a corporate rental apartment for $1,175 per month or $14,100 per year in Kerman, California.[62] KTC recorded half of this lease expense as a KTC corporate expense and half as a KTC customer operations expense. ORA recommends eliminating this expense, because it is not necessary for provision of safe and reliable utility service. KTC argues that the apartment is necessary to house employees who work for Foresthill Telephone Company (Foresthill) to travel to Kerman, which is located several hours away by car.[63] KTC argues that the work provided to KTC by these employees of Foresthill is necessary, and that having employees who work for both KTC and Foresthill results in "efficiencies."[64]

However, KTC does not explain what work is done by the Foresthill employees, or why it is necessary. There is no explanation why this work must be done in person rather than by computer or by telephone. KTC claims that if a Foresthill employee used the apartment just 11 days a month, it would pay for itself.[65] However, KTC provides no receipts, invoices, or other evidence to show that the apartment is typically used for 11

[60] KTC OB at 49.

[61] KTC-12 at 40.

[62] ORA Report at 46.

[63] KTC OB at 51, KTC-12 at 71.

[64] KTC OB at 50.

[65] *Id*. at 51.

days a month. There is no evidence that the apartment is actually used for business. This is another example of how KTC pays for services that benefit its affiliates at the expense of the ratepayers.

E. Corporate Expense Cap

KTC calculates that application of the cap without any modification results in a cap on corporate expenses of $1,692,783 ($1,537,917 allowable corporate expenses plus $154,865 CPI growth allowance).[66] Prior to its Rebuttal Testimony, KTC's request for corporate expenses was $3,365,417 (after excluding $175,603 in legal expenses related to the general rate case).[67] In its Rebuttal Testimony and OB, KTC lowers its request for total corporate expenses to $2,269,950.[68] KTC explains that it has partially applied the cap to arrive at this reduction, but it does not explain which expenses were lowered, how they lowered, or by how much. Instead, KTC merely states that its new position is a "compromise."[69]

The difference between the cap and KTC's "compromise" position is $577,167. As described in ORA's OB, this difference can be achieved by lowering or eliminating certain corporate expenses that are excessive. After reviewing just 3% of KTC's expense items (299 out of 9,361 line items from KTC's general ledger of expenses), ORA identified $822,051 in excessive corporate expenses.[70] Thus it appears that the expense cap can be imposed without affecting any of KTC's core services.

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

[67] ORA Report at 23. It should be noted that KTC's end-of-year data for 2014 showed corporate expenses of only $3,085,840. See Attachment 2-1 to ORA-1: "Kerman GL Detail Expense 2014 YTD 11-30", and "Preliminary Kerman GL Detail Expense December 2014 as of 1-30-15."

[68] KTC OB at 52.

[69] *Ibid*. ORA wonders whether KTC's initial request was artificially inflated for such a large reduction to be so easily achieved.

[70] ORA Report at 39.

In D.14-12-084, the Commission determined that that there is a "rebuttable presumption" that any amount above the cap is *per se* unreasonable.[71] The Commission explained that a rebuttable presumption means "a presumption of unreasonableness and carriers would have the opportunity to rebut the presumed level of expenses imposed under the cap by demonstrating that a different level of corporate expenses is reasonable."[72] Thus, it is KTC's burden of proof to show that $577,167 in corporate expenses above the cap are reasonable.

1. KTC Has Failed to Show That the Corporate Expense Cap is Unreasonable

KTC has failed to address specific corporate expenses and explain how those expenses are reasonable. Instead, KTC attacks the cap itself as unreasonable.

KTC states that a "central issue" in the CHCF-A rulemaking proceeding (R.11-11-007) was whether to require the application of a corporate expense cap.[73] KTC criticizes the cap itself as a "crude mechanism" that has "no bearing on the reasonableness of individual company expenses."[74] However, this represents a collateral attack on the cap that should have been done in an application for rehearing of D.14-12-084, which KTC failed to do. Instead, KTC inserted its criticism of the cap in its testimony. ORA brought a motion to strike the portions of KTC's testimony that attacked the adoption of the cap. On May 28, 2015, during the hearings in this case, the ALJ granted the request and ordered KTC to remove any collateral attacks on D.14-12-084 from its testimony.[75] KTC then re-served the redacted testimony of Mr. Lehman, removing the collateral attacks. KTC now seeks to renew those arguments.

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

[72] Ibid.

[73] KTC OB at 52.

[74] Ibid.

[75] HT 11:19-12:1.

In two ways, KTC's OB attacks the caps themselves. First, KTC argues that "Kerman operates in an area with significantly higher labor costs than rural companies in practically every state", and thus application of the cap in California would be unreasonable.[76] Second, KTC argues that "Kerman operates in a more intense regulatory environment than companies in other state."[77] In both cases, KTC argues that the FCC failed to account for those differences when it created the cap, and thus the Commission erred in adopting the cap without modification.

Finally, KTC argues application of the cap would result in either eliminating almost all of its corporate positions, or eliminating almost all of its corporate functions.[78] ORA addresses these arguments in turn.

a) KTC's Corporate Labor Costs Already Exceed Local and Statewide Averages

KTC argues that it is located in a high cost area in general, which makes application of the cap unreasonable.[79] To support this argument, KTC cites to Mr. Lehman's evidence from the U.S. Bureau of Labor Statistics that purports to show that the Kerman area has high labor costs.[80] Mr. Lehman shows that the Kerman area's average corporate wage is $76,548.[81] He shows that the California average corporate wage is $93,956.[82] Mr. Lehman further shows that there are four states with higher rural corporate occupational wages.[83] KTC uses this data to argue that KTC's corporate wages should be higher than other states. Indeed, to account for this, Mr. Clark recommends an

[76] KTC OB at 53.
[77] *Ibid*.
[78] KTC OB at 60.
[79] KTC OB at 54.
[80] *Ibid*.
[81] KTC-22 at 22.
[82] *Id.* at 23.
[83] KTC-22 at 22.

increase of 19% above the cap.[84] However, the request must fail because KTC's corporate wages are already substantially above the Kerman-area and California averages.

As noted in ORA's Report, KTC's IS manager earns $138,480.[85] KTC's president earns $236,202 per year.[86] Its wages and benefits are generally far above the state average. Thus, KTC has not shown that application of the cap would reduce wages to a point below the Kerman-area average, or even the California statewide average, such that harm might occur to its operations. Raising the cap by 19% would only serve to ensure that KTC's wages remain well above state averages, which negates the purpose of the cap.

Moreover, KTC argues at length against adopting ORA's recommended increase in rates for custom calling features, arguing that its residents cannot afford rate increases. Mr. Clark claims that KTC is in a "low-income area, and an increase of this magnitude would constitute a hardship for many customers."[87] Mr. Lehman shows that over half of Kerman's households make less than $25,000 per year, which makes Kerman an "extremely low income" area.[88] Yet it cannot be simultaneously true that Kerman is both a high-labor-cost area and a low income level area. KTC merely presents the facts as it suits them, despite the inherent contradictions.

b) KTC Has Not Demonstrated That It Has Extra Responsibilities Due To California's Regulatory Environment

KTC attacks the cap in general by pointing out that the FCC failed to account for the additional regulatory burdens in California.[89] KTC argues that Mr. Lehman

[84] KTC OB at 54.

[85] ORA Report at 30.

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

[87] KTC-12 at 14.

[88] KTC-22 at 31.

[89] KTC OB at 54.

established that California has a more intense regulatory environment as demonstrated by the higher costs associated with regulatory proceedings in California.[90] Mr. Lehman cites to a Forbes article that purportedly shows "Forbes Ranking of Business Costs and Regulatory Environment across States"; however, this ranking system ranks seven states higher than California. By definition, the FCC used state averages in its calculation of the national corporate expense cap formula – thus it is not surprising that some states are below California, and some states are above. This does not establish that the cap is unreasonable as applied to Kerman. Moreover, if the Commission determines in this proceeding that the cap is *per se* unreasonable in California, the concern is that the cap would be unreasonable for every other A-Fund carrier as well, because they are all in California. This would mean in effect that the cap can never be applied, because it would be *per se* unreasonable to apply it anywhere in California.

Mr. Lehman also states that the number of regulatory proceedings is higher in California than other states.[91] However, the high average number (if true) of regulatory proceedings in California does not apply to KTC, which has only had one GRC since 2008, and no other mandatory proceedings. ORA is informed that KTC may have also participated in other non-mandatory rulemaking proceedings, such as the Service Quality rulemaking, the Lifeline rulemaking, the California Technology Fund (CTF) rulemaking, and the California Advanced Services Fund (CASF) rulemaking[92] (that ORA is aware of – none of which were mandatory). KTC does not describe the proceedings that it has been a party to, but it appears to be far less than the 12.3 average proceedings cited by Mr. Lehman.[93] Mr. Lehman acknowledges that his data applies to generic regulatory proceedings, not to KTC specifically.[94]

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[90] KTC OB at 55.

[91] KTC-22 at 18.

[92] The CTF and CASF rulemakings both relate to broadband, so if KTC participated the associated expenses should have been charged to KTC's broadband affiliate, Audeamus.

[93] KTC OB at 55. KTC states that it participated in "10" proceedings in 2014, but does not name them or describe the amount of time or resources spent. Thus, it is not possible to evaluate whether KTC

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KTC does not specifically address or support the claim that its regulatory costs have been higher than the national average, nor does KTC describe the high regulatory costs spent by KTC. Instead, KTC cites vaguely to "external legal costs" and "internal personnel costs" without any description of what those are. KTC arrives at the figure of $17,669 per proceeding without explaining which proceedings it participated in or the level of participation in those proceedings.[95] Instead, KTC took the total amount of legal expenses and divided them by the number of proceedings, and then multiplied that number by 6, which is the hypothetical difference between the 10 regulatory proceedings in California and the 4 proceedings it would have participated in, if KTC was located in Oregon or Nevada.[96] This calculation simply makes no sense. Clearly, the Commission would be better served to impose the cap and allow KTC to determine how best to allocate its expenses between mandatory regulatory expenses (such as this GRC) and non-mandatory proceedings that may have little or no connection to KTC. KTC should not be awarded regulatory expenses for participating in proceedings that are unrelated to KTC or provision of telephone service. In any event, the underlying purpose of the cap is to provide incentives to the company to limit unnecessary expenses, such as extensive participation in unnecessary and unrelated Commission proceedings.

2. KTC's Dire Warnings That It Could Not Operate Under The Cap Are Belied By The Ease With Which ORA Identified Excessive And Unnecessary Corporate Expenses

KTC next argues that application of the cap would mean eliminating 10 employees from its corporate side, or eliminating important functions such as "representation in key regulatory proceedings, [] preparing an annual audit, and foregoing key strategic

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participation was reasonable or necessary, or whether it actually occurred.

[94] KTC-22 at 18. It should be noted that KTC's participation in proceedings other than this GRC is through the group of small, independent Local Exchange Carriers, in which KTC participates.

[95] KTC OB at 56.

[96] *Ibid.*

direction."[97] In essence, KTC warns that it could not operate under the cap. The Commission should give these false warnings little weight. KTC never considers other alternatives to the drastic measures it warns of, such as lowering corporate bonuses or executive salaries. There are many options for KTC to reduce corporate expenses without eliminating their entire corporate staff or all its functions. The multitude of ways in which KTC could lower its expenses without eliminating positions or functions is described in detail in ORA's Report and its Opening Brief.

At no place in its OB does KTC rebut the many excessive corporate expenses identified by ORA. Instead, KTC dismisses such excesses as polo festivals and holiday parties as only a "small portion" of KTC's expenses, and accuses ORA of including these items solely to "condemn" KTC as "profligate company."[98] Many of the items are indeed relatively small, but when added together they would reduce KTC's corporate expenses sufficiently to meet the cap.

Moreover, the ease with which KTC "compromised" and lowered its corporate expenses request by several hundred thousand in its Rebuttal Testimony illustrates that KTC has already included many excessive and unnecessary expenses, such that cutting them immediately does not present a problem. In looking at just 3% of KTC's expense items in detail, ORA was able to easily identify items that no reasonable person would conclude are necessary to the provision of basic phone service. Apparently, KTC was able to do the same.

KTC obtusely claims that ORA in fact examined 91% of KTC's expenses, despite ORA's description of its methodology, but the basis for this 91% figure is unknown.[99] Most likely it represents a misunderstanding. KTC also argues that ORA's sample was

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[97] KTC OB at 60.

[98] KTC OB at 24.

[99] KTC OB at 62. Mr. Clark simply states that it is 91%. Perhaps he means that ORA thoroughly examined 9,361 expense items in detail, and that this is 91% of the total number of KTC's corporate expense items. However, ORA staff testified that they only reviewed 299 line items in detail.

not random and was not representative.[100] However, ORA's witnesses explained that they focused more on the expense items that appeared to be larger, because of time constraints. ORA simply lacked the time and resources to examine the other 9,062 expense line items in detail.

F. KTC's Legal Expenses Do Not Deserve Special Treatment Outside the Corporate Expense Cap

General Rate Case expenses related to legal representation are properly recorded as corporate expenses, and are therefore subject to the corporate expense cap.[101] However, KTC requests that it be allowed to separately recover its legal expenses outside the cap, because KTC argues that "rate case expense is appropriate for inclusion in revenue requirement."[102] KTC's 2016 projected legal expense of $525,475 was included in the $3,365,417 of corporate expenses request by KTC in its supplemental testimony.[103] As support for this, KTC cites to prior Commission resolutions that authorize recovery of rate case expenses.[104]

It is true that prior Commission decisions typically allow for recovery of rate case expenses. However, in light of D.14-12-084, the law has changed. Now, rate case expenses are subject to the cap because they are recorded as corporate expenses. Nothing in any FCC decisions or D.14-12-084 provides for an exception to the corporate expense cap for legal expenses related to rate case expenses. KTC's citations to precedent are not applicable to the current cap rules as set forth in D.14-12-084.

KTC claims that if the Commission denied an exception for rate case expenses it would "strip Kerman of the ability to defend itself."[105] However, KTC misinterprets how the cap works, because the cap does not disallow rate case expenses. Under the cap, KTC

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[100] *Ibid*.

[101] ORA Report at 36.

[102] KTC OB at 63.

[103] ORA Report at 36.

[104] KTC OB at 63.

[105] KTC OB at 65.

continues to be able to pay its legal expenses. One of the specific goals of adopting the FCC corporate expense caps articulated by the Commission in D.14-12-084 was to "create incentives to align expenditures with the cap to reduce rate case litigation costs." Including legal expenses in the cap would incentivize KTC to reduce its legal expenditures on its own, without Commission oversight over specific legal costs. Without it, KTC has little or no incentive to control the amount of money it spends on legal services. Application of the caps to legal expenses will motivate KTC to incur legal costs only when it is reasonable and prudent to do so.

Finally, KTC used "attorney client privilege" to shield its invoices from discovery, which prevented any meaningful review of the expenses.[106] This demonstrates the necessity and utility of the expense cap, because if the cap is applied to KTC's legal expenses there is no reason for ORA or the Commission to review and evaluate them, and KTC is motivated to keep its costs under control on its own.

G. Other Work Equipment

Although the category of Other Work Equipment is a component of Plant, KTC's discussion of the costs related to Other Work Equipment is contained here, not in the Plant section of its brief.

The Other Work Equipment account consists of construction equipment such as: cable plows, boring rigs, cable testing equipment, work equipment trailers, splicing equipment, and concrete saws.[107] Based on the information provided by KTC in its application and provided to ORA in discovery, ORA learned that KTC rents or leases the construction equipment listed above to its unregulated construction affiliate Kertel.[108] KTC does not use the equipment that has been recorded to this account to provide

[106] *Id.* at 37.

[107] KTC-4, Testimony of Eric Kehler, November 3, 2014, Question 12.

[108] ORA Report at 60, and Attachment 3-8: Kerman's Response to Data Request ORA RRA001. See Questions 4(a) and 4(b).

services to customers. KTC does not directly use this equipment at all.[109] As a consequence, the entire account should be disallowed.

After ORA discovered this error, KTC quickly updated its Rebuttal Testimony and claimed that there are other items in the Other Work Equipment account besides the items listed in its application.[110] KTC now claims that the equipment in this account is used.[111] ORA had never been provided with this information previously, despite numerous data requests.

In addition, KTC takes issue with a statement made by KTC witness Dave Clark and KTC employee Carolyn Dukes, who on March 11, 2015 told ORA staff that KTC did not use the equipment.[112] KTC claims the statements are "inadmissible hearsay", and are mistaken.[113] However, KTC is incorrect because hearsay is admissible as a matter of law in Commission proceedings, and also because Mr. Clark admitted he made the statement.

First, as KTC should be well aware, Commission Rules of Practice and Procedure Rule 13.6 provides that the rules of evidence do not "ordinarily" apply to Commission proceedings. Therefore, it is simply wrong to assert that hearsay is inadmissible in Commission proceedings. Use of hearsay makes the Commission's work possible. If not, the Commission would be unable to efficiently administer large evidentiary proceedings. This is true *even with regards to Mr. Kehler's testimony* about the Other Work Equipment because he does not personally use all of the equipment, and he relies on hearsay from other KTC employees to describe how the equipment is used. If hearsay were truly inadmissible, KTC would not be able to put most of its testimony in the record here.

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[109] ORA Report at 60.

[110] KTC OB at 68. Mr. Kehler provided new information never before provided to ORA, that items such as "cable fault locating equipment, time domain reflectometers (TDR), optical time domain reflectometers (OTDR), splicing media equipment and cable path locators" were also included in that account. See KTC-5 at 4.

[111] KTC OB at 68.

[112] HT 667:2, and KTC OB at 68.

[113] KTC OB at 68.

Second, *Mr. Clark admits he made the statement*.[114] Therefore, any hearsay concerns have been alleviated. Mr. Clark stated: "I believe I did make a comment regarding the use of this equipment. I recollect that I indicated that the equipment was seldom used or "almost never used.""[115] Mr. Clark goes on to state that he now believes that he was "mistaken."[116]

It is a common tactic in GRC proceedings to provide supplemental information at the last minute. When questioned about the sufficiency of its application, the applicant typically supplements the record in its rebuttal testimony, despite the longstanding Commission rule that applications for a rate increase must contain all of the data required by Rule 3.2, which includes an description of the applicant's property and equipment (Rule 3.2(a)(4)).

ORA's conclusion that Other Work Equipment is not used is supported and corroborated by the fact that KTC leases its Other Work Equipment to its affiliates.[117] In addition to the problem that KTC leases equipment that it does not use, the rates charged by KTC are well-below market rates.[118] KTC's OB contains no discussion of the lease rates charged by KTC for its equipment. The low lease rates charged to its affiliates is another example of how KTC benefits its affiliates at the expense of ratepayers.

H. Cost of Capital

"Cost of Capital" (also referred to as Rate of Return) is the amount of money that the utility has the opportunity to earn on its rate base.[119] Calculating the cost of capital

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[114] KTC 12 at 49.

[115] *Ibid*.

[116] *Ibid*.

[117] ORA Report at 60, and Attachment 3-8: Kerman's Response to Data Request ORA RRA001. See Questions 4(a) and 4(b).

[118] *Ibid*.

[119] ORA Report at 64.

(COC) requires consideration of three components: cost of equity, cost of debt, and capital structure, each of which are important and will affect the final cost of capital.[120]

KTC requests an overall rate of return of 13.74%.[121] KTC calculated this by imputing an 80% equity to 20% debt ratio for its capital structure.[122] KTC also used the end-of-year cost of debt figure of 3.76%.[123] Finally, KTC recommends that its cost of equity be set at 16.24%.[124] Inserting these numbers into the formula for the overall rate of return produces a result of 13.74%.[125]

KTC rejects ORA's recommendations for cost of equity, cost of debt, and capital structure, arguing that if the rate is set too low KTC "will be unable to attract capital for investments."[126] ORA's recommendations to use a capital structure of 40% equity and 60% debt, a cost of debt of 3.2%, and a cost of equity of 8.79%, are fully explained in ORA's OB and are not repeated here. ORA addresses each of KTC's arguments with regards to cost of capital in turn.

KTC quotes ORA witness Mr. Hoglund as saying that "If Kerman's investors cannot derive sufficient returns to justify the risks of investing in the rural telecommunications business, they can – and will – take their capital elsewhere."[127] KTC further quotes Mr. Hoglund as saying that "the ultimate losers would be Kerman's ratepayers" if KTC were unable to attract capital.[128] However, Mr. Hoglund never made those statements. His testimony is taken out of context – in fact, he was being asked a hypothetical during cross-examination that did not involve anything specific to KTC. At

[120] *Ibid*.

[121] KTC OB at 73.

[122] *Id.* at 74.

[123] *Id.* at 77.

[124] KTC's OB never actually states or explains the total figure for its cost of equity, but it is contained in Exhibit KTC-16 at 8, Supplemental Testimony of Michael C. Burke.

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

[126] KTC OB at 70.

[127] KTC OB at 70.

[128] *Ibid*.

no time did Mr. Hoglund ever refer to KTC's ratepayers as "losers." Mr. Hoglund was asked:

> Q. And would you generally agree that investors will generally place their capital where they believe they can get the best return relative to the associated risk?
>
> A. As a general statement, given an array of options, that seems reasonable to expect an investor to do so.[129]

In fact, when Mr. Hoglund was asked whether he believed KTC is in danger of defaulting on its loans, Mr. Hoglund noted that:

> I reviewed at our estimate and our recommendations what the loan covenant in RUS loan is. And I believe the TIER coverage was for a minimum of 1.5 be maintained. And at ORA's recommendation, I believe the calculation came out at just over six for the TIER, which I felt was sufficient evidence that we would not be jeopardizing the loan covenant and anything to do with the loan.[130]

The loan covenants referred to here are the terms of the RUS loans[131] which mandate a minimum of 1.5 "Times Earned Interest Ratio" or TIER. At six points over the TIER, ORA's recommendation is well over the required level to ensure compliance with the RUS loan covenants – which means that KTC will have ample revenues to meet its financial obligations and remain sufficiently attractive to investors.

KTC also criticizes ORA's recommendation by comparing it to the FCC adopted rate of return of 11.25%.[132] However, the 11.25% FCC rate is now 25 years old.[133] Many things have changed, including the United State Treasury rates. The FCC adopted the rate in 1990, and the data used by the FCC Commission is no longer current and substantial

[129] HT 766:8-15.

[130] HT 829:16 – 830:13.

[131] See KTC-16 at 5. The USDA's Rural Utilities Service (RUS) administers programs that provide infrastructure or infrastructure improvements to rural communities. http://www.rd.usda.gov/about-rd/agencies/rural-utilities-service.

[132] KTC OB at 71.

[133] ORA Report at 72. On May 16, 2013, the Wireline Competition Bureau of the Federal Communications Commission issued a Staff Report titled "Prescribing The Authorized Rate of Return". http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0607/DA-13-1111A1.pdf.

changes in technology, regulation, and the marketplace since 1990 raise a number of issues with the old rate.[134] The FCC is working to update this number as shown in their May 2013 staff report.[135] The FCC recognized a need for change – they simply have not completed their process.

1. ORA's Witness Credentials

KTC attempts to undermine Mr. Hoglund personally, claiming that he has "a total lack of awareness" of FCC proceedings and has "virtually no experience" with the CHCF-A.[136] However, Mr. Hoglund's conclusions speak for themselves. His analysis looks at past Commission precedent and applicable FCC decisions. KTC may not like the conclusions of the FCC report that Mr. Hoglund cites to, but that does not mean that Mr. Hoglund is unaware of FCC proceedings.

Despite the *ad hominem* attacks, it is clear that KTC's criticism focuses on differences of opinion in the calculation of the CAPM model, not his personal experience. In any event, Mr. Hoglund is a graduate of the University of California, Berkeley, with a degree in Industrial Engineering and Operations Research, and an MBA in Finance and Corporate Accounting from the University of Rochester, William E. Simon School of Business, and a licensed professional Industrial Engineer with 25 years of experience working in rate analysis and design at the Commission and PG&E. He has prepared or supervised the preparation of cost of capital testimony in several previous GRCs. He is a well-qualified and respected Commission employee.

2. KTC's Overall Rate of Return is Excessive

KTC argues that its overall rate of return is "consistent" with constitutional standards.[137] However, KTC never explains how it is consistent, nor what those standards are. Instead, KTC quotes a U.S. Supreme Court decision that says that "a public utility is

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[134] *Id.*, Executive Summary at page "i".

[135] *Id.*, Executive Summary at page "i".

[136] KTC OB at 72.

[137] KTC OB at 73.

entitled to such rates as will permit it to earn a return…" This citation provides no real guidance. ORA's recommendation does include a rate of return, and does not violate any constitutional mandates.

KTC further quotes the U.S. Supreme Court as saying its rate of return should be "equal to that generally being made at the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[138] Again, this provides no real guidance, other than to say that KTC's rate of return should generally be equal to similar utilities. As ORA has shown, its recommendations are closer to other utilities than KTC's recommended rate of return, which is substantially higher than other utilities' rates and its own historic norms. Across the country since the year 2000 adopted energy utilities return on equity rates have declined.[139] KTC's statement that the only permissible and legal rate of return is Mr. Burke's calculation of 13.74%, is simply unsupportable and inconsistent with other utilities' rates.[140]

KTC criticizes ORA for considering only the components of the rate of return calculation.[141] However, the formula exists for a reason – to assist the parties in calculating the rate of return. KTC would like to come up with a rate of return first, and then find numbers to backfill into the formula to achieve its desired number.

KTC notes that ORA's rate of return is lower than "the lowest rate of return established for any telephone company in the modern era."[142] However, the Commission has not adopted a new cost of capital rate since 1997, so ORA's recommendation only "appears" to be a dramatic reduction. If regular revisions had taken place every three

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[138] *Ibid.*

[139] Publicly available document: Edison Electric Institute – 2014 Rate Case Summary. http://www.eei.org/resourcesandmedia/industrydataanalysis/industryfinancialanalysis/QtrlyFinancialUpdates/Documents/QFU_Rate_Case/2014_Q1_Rate_Case.pdf.

[140] KTC OB at 73; "only Mr. Burke's proposal could be a lawful rate of return."

[141] *Ibid.*

[142] KTC OB at 74.

years as they have in water and energy, ORA's recommendation may not seem so dramatic. It represents the cumulative effect of 18 years of financial market changes. With interest rates at historically low levels it only follows that rates of return would also be at low levels.

3. KTC's Calculation of Cost of Capital is Flawed

a) KTC Recommends an Unreasonable Equity Ratio of 80/20

KTC's recommendation to impute a capital structure of 80% equity and 20% debt is unreasonable and flawed. Rather than looking at KTC's current situation (approximately 50/50 equity ratio), or at what KTC's strategic plan calls for in the near future (60/40), KTC instead looks to other companies' capital structures. Specifically, KTC recommends a capital structure "that reflects the forward-looking capital management strategy that small telephone companies are likely to employ."[143] However, KTC is being inconsistent in following its own logic. In other areas, KTC wants to use actual data; but here, KTC is happy to use hypothetical figures to produce the desired result. KTC's strategic plan and its actual capital structure indicate that KTC has no intention of achieving an 80/20 equity ratio.

KTC claims that its approach is consistent with Commission precedent.[144] However, it is not. The Commission's decisions show a concern where "a utility's actual equity ratio is too high or too low", indicating a concern over extremely high or extremely low equity ratios, not ratios in the mid-range.[145] The Commission stated "This is because a utility's capital ratio affects its equity return, the more equity in the capital structure, the lower the return."[146] Essentially, the Commission found that extreme ratios, either too high or too low, were not financially sound. In other words, companies should

[143] KTC OB at 75.

[144] *Ibid*.

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

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

not go above the 80% threshold. The Commission certainly did not mandate that a utility maintain a minimum of 80% equity.

KTC's own witness agrees that equity ratios at the extreme ends of the spectrum are unreasonable. Mr. Burke stated:

> Regulatory bodies may use a hypothetical capital structure that differs from the historical or expected capital structure of the utility if that actual capital structure leads to an unreasonable result for determining the overall cost of capital. For example, a capital structure that is 100% equity funded may be deemed unreasonable or inefficient, leading to an inflated rate of return. Likewise, if the level of debt capitalization is too high, it may subject the utility to unreasonable risks or impairment of capital.[147]

KTC's claim that its current capital structure of "approximately 50% debt" cannot be "sustained"[148] is belied by the fact that KTC has been operating since at least 2011 with this capital structure. There is simply nothing in the record to support KTC's claim that its current capital structure is somehow damaging.

In its 2015 Strategic Plan, parent company SEI identified a target capital structure of 40% equity and 60% debt for its regulated operations, which includes KTC and Foresthill.[149] ORA accepts this target goal for purposes of calculating the rate of return, because it represents a reasonable expectation of what KTC will do in the future with regards to its capital structure. Nevertheless, KTC argues that the target ratio in the Strategic Plan is "artificially low because of the debt used to fund the acquisition of Foresthill by Sebastian."[150] Tellingly, KTC does not include a citation to the record for this alleged fact. Nor could it, because it was never addressed anywhere in KTC's

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[147] KTC-15 at 6.

[148] KTC OB at 75.

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

[150] KTC OB at 76.

testimony or during the hearings. ORA questions whether it is even true – but at this late date it is not possible to propound data requests to discover Foresthill's actual capital structure. Certainly, KTC was aware that ORA had obtained the Strategic Plan and was relying on it in its testimony, and failed to discuss Foresthill's debt level in its rebuttal testimony. The Commission is required to base its decision on the factual record. In this case, the Commission cannot consider this new "fact" because it is outside the record.

KTC next argues that ORA fails to adjust for KTC's "highly-leveraged structure."[151] What is a high level of debt? KTC provides no citation and no context for this statement. ORA finds KTC's current structure to be reasonable, and it appears that KTC has been operating normally since its last GRC. KTC provides no comparison to other regulated entities to allow the Commission to determine that KTC is over-leveraged. KTC's witness Mr. Burke provides no benchmark for comparison. Because there is nothing in the record about this, it is impossible to evaluate whether KTC's fears of risk due to being "highly leveraged" are legitimate. Certainly, there is no basis for the Commission to find that in this case KTC is overly leveraged.

b) Cost of Debt

KTC uses the end-of-year 2014 cost of debt figure of 3.76%.[152] ORA has not had the opportunity to verify this data with audited 2014 financial statements. Until then, the Commission should not rely on unaudited and unverified financial data. ORA does not update this number for its calculation of cost of capital.

c) 20-Year U.S. Treasury Rate Average

Both KTC's and ORA's return on equity calculations are based on the Capital Asset Pricing Model (CAPM).[153] When calculating return on equity, the CAPM utilizes two numbers: the forecasted risk-free rate of interest,[154] and the "equity risk premium."

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[151] KTC OB at 76.

[152] KTC OB at 77.

[153] ORA Report at 71.

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

ORA uses the recent three-year average of the 20-year Treasury rate of 2.91% as of January 5, 2015 to estimate the risk-free rate.[155]

KTC based its risk-free rate of 4.47% on an average of the 20-year Treasury rate over the period from January 3, 2000 through October 24, 2014, which is a 15-year average.[156] KTC argues that ORA's 3-year average is "artificially deflated", and that these low rates cannot be "riskless" because KTC is making long term investments.[157] KTC claims that using the 3 year rate will "unreasonably deflate the starting point" for the rate of return calculation.[158] KTC appears to use the risk-free rate as merely a way to achieve a high rate of return, rather than a measurement of investor expectations.

However, KTC misunderstands the nature and purpose of the use of U.S. Treasury rate average. The "risk free rate" is defined as the forecasted yield on the U.S. Treasury bonds over the next several quarters.[159] The purpose of using an average of recent years is to get an accurate prediction of the market for the near future – or at least the current rate case cycle. In the next GRC, if the markets do not perform as expected during the previous cycle, the predictions can be adjusted. It makes no sense to use historical averages that have little or no relation to the current market; e.g., KTC's 15 year average of 4.47% does not reflect current 20-year Treasury rates which were 2.32% as of January 5, 2015.[160] Despite KTC's warnings that rates are increasing, the 20-year U.S. Treasury rate has remained flat.[161] If adopted, KTC's returns on equity would be artificially inflated above a reasonable expectation for investors during the next 3 years. Given the current low rates, it is unreasonable to expect investors to take their money elsewhere in

[155] ORA Report at 71.
[156] KTC OB at 78.
[157] KTC OB at 79.
[158] Ibid.
[159] ORA Report at 64.
[160] ORA Report, Attachment 4-3.
[161] http://www.federalreserve.gov/releases/h15/current/default.htm

the near future. A rate that is over twice the current U.S. Treasury rate is simply not necessary to attract investment dollars.

d) Equity Risk Premium

ORA followed the CAPM by adding an "equity risk premium" to the risk-free rate, to produce the amount of additional return necessary to produce a return on equity high enough to attract the necessary capital for KTC to operate.[162] KTC and ORA's equity risk premiums fall within the same general range, but KTC selects a number at the high end of the range.

The equity risk premium, also called a "market premium", is defined in the CAPM as the difference between the return one can expect to earn holding a market portfolio and the risk-free interest rate.[163] The FCC noted that the Ibbotson Associates report *Stocks, Bonds, Bills and Inflation:2010 Yearbook Valuation Edition*, (the source used by KTC), estimates the expected market premium to be 6.7 percent based on the historical market premium over the twenty-year U.S. government bond rate. The FCC noted that the calculation used the arithmetic average difference between the S&P 500 company stock total annual returns and the government bond *income* returns (i.e., excluding capital gains on the bonds) over the period 1926-2010.[164]

However, the FCC rejected the Ibbotson Associates report. Instead, the FCC Report used the average historical market premium above the 10-year risk free rate for the time period 1928-2012, which was 5.88%. This calculation is the arithmetic average of the difference between the annual return on the S&P 500, and return on the 10-year U.S. government bond including capital returns. The FCC found that "Statistically, we are approximately 95 percent confident that the true mean value of the market premium

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[162] ORA Report at 72.

[163] FCC Report at para. 69, "Prescribing the Authorized Rate of Return," WC DOCKET NO. 10-90, 5/16/2013.

[164] FCC Report at para. 71, "Prescribing the Authorized Rate of Return".

lies within these ranges."[165] ORA elected to use the 5.88% rate because it was adopted by the FCC report.

e) Size Premium

A major difference between between ORA and KTC is the addition of a "size premium."[166] A size premium is added to address a theoretical difference in the amount of risk attributable to the small size of the company.[167] ORA elects not to add a size premium, because recent research indicates that the size effect seems to vary over time or even disappear, with smaller firms in the United States not performing significantly better than large ones from 1980 onward.[168]

KTC claims that the size premium is necessary because small firms such as KTC suffer from "additional risks."[169] However, KTC fails to describe a single risk to KTC's operations due to its size. KTC's revenues have remained fairly constant, but even if they decline in the future the CHCF-A will provide a subsidy increase.

In 1997, when the Commission adopted a 10.00% rate of return for the rural carriers, applicants requested a size premium that the Commission rejected. For example, in D.97-04-032 the applicant requested a 3.60% (360 basis points) size premium, which the Commission rejected.[170] KTC requests a size premium of 5.99% (599 basis points).

Similarly, in 2013, when the FCC issued its report "Prescribing the Authorized Rate of Return", the FCC was asked to add a premium based on the size of small companies. However, the FCC rejected the recommendation noting that "recent research indicates that the size effect 'seems to vary over time or even disappears,' with smaller firms in the United States not performing significantly better than large ones from 1980

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[165] *Id.* at para. 72.

[166] KTC OB at 81.

[167] KTC OB at 81.

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

[169] KTC OB at 81.

[170] D.97-04-032 at *32; "We do not necessarily concur with applicant's 30% risk premium to compensate applicant for its small size as compared to the large companies in the study group."

onward. Therefore, we do not recommend adding a risk premium based on size to the cost of equity."[171]

KTC argues that the "most compelling reason" to adopt a size premium is that small rural companies have difficulty accessing debt capital.[172] The Rural Utilities Service (RUS - discussed above) is a lending institution that provides ready access to debt for the small rural carriers. KTC claims that the RUS is "reducing" availability of debt to the carriers.[173] As discussed above, one of the indications of this is the TIER covenants that RUS inserts into its debt agreements. However, ORA has examined these covenants and found that a minimum of 1.5 TIER must be maintained, but ORA's calculation found over 6 for the TIER for KTC.[174] Moreover, the fact that KTC's average cost of debt is only 3.2%, below the market rate, indicates that lenders see little risk in KTC.

As a rate regulated entity, supported by both state and federal mechanisms to subsidize and guarantee revenue, the risk associated with KTC's size is moot. The Commission should not adopt KTC's size premium.

4. ORA's Use Of The FCC Report Is Not "Misleading"

KTC claims that ORA relies on "irrelevant and misleading" citations in its Report.[175] KTC implies that somehow ORA has misled the Commission because the FCC report cited by ORA has not yet been adopted into a final FCC decision.[176] However, the relevance of the FCC Report, entitled "Prescribing the Authorized Rate of Return - Analysis Of Methods For Establishing Just And Reasonable Rates For Local Exchange Carriers", is unquestionable. Moreover, as KTC well knows FCC proceedings can take a

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[171] FCC at para. 75, "Prescribing the Authorized Rate of Return," WC DOCKET NO. 10-90, 5/16/2013.
[172] KTC OB at 83.
[173] Ibid.
[174] HT 829:16 – 830:13.
[175] KTC OB at 84.
[176] Ibid.

long time. The FCC's timeline does not negate the analysis contained in the report. While it is true that some carriers have showed opposition to the report, there were many publicly filed comments in support of it.

KTC also takes issue with the use of a Washington State Department of Revenue report, noting that it has not been cited by any state Commissions.[177] However, ORA does not rely on this report, but merely cites to it as an example of the range of estimates for the 20-year Treasury rate recently published and/or adopted.

Finally, KTC criticizes ORA's citation to Dr. Randall Woolridge solely on the grounds that the Commission has not "explicitly endorsed" his work.[178] However, the same could be said of Ibbotson or any of the other experts cited by KTC – none of them have been "explicitly endorsed" by the Commission, either. This is largely because the current research all occurred after 1997, when the last litigated GRCs for rural carriers took place.

VI. REVENUES

A. KTC's Rate Design

KTC correctly states that the three primary components of revenue are its revenues from customers, federal subsidies, and state subsidies.[179] The first step to calculate rate design is to calculate KTC's revenues from customers; the second step is to identify the level of federal subsidies; and the final step is to calculate the amount of state subsidies necessary to bridge the gap between the total of KTC's customer revenue plus federal subsidies, and KTC's revenue requirement.[180]

KTC claims that ORA's revenue recommendations violate statutory requirements under Section 275.6, on the grounds that ORA's recommended level of state subsidies

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[177] Ibid.

[178] KTC OB at 85.

[179] KTC OB at 85.

[180] KTC OB at 86.

would not bridge the gap between its revenues and its revenue requirements.[181] However, this argument is predicated on the assumption that every single one of KTC's requests are deemed reasonable and are approved. It simply ignores the fact that ORA has found many items that are simply unreasonable and excessive and should not be included in KTC's revenue requirement.

It is easy to see from ORA's Attachment ES-1 to its Report how ORA's rate design provides for a sufficient level of state subsidies to cover KTC's revenue requirement, once all of the excessive and unreasonable items are removed.

KTC criticizes ORA's customer revenue witness for failing to consider the impact of ORA's recommendations to reduce or eliminate the excessive expenses on its revenues.[182] However, customer revenues are not directly tied to the revenue requirement due to the CHCF-A. KTC's own explanation of its rate design, summarized above, demonstrates that it is not essential for ORA's customer revenues witness to know the entirety of KTC's revenue requirement. This is apparent when looking at the rate design process, which involves bridging the gap using state subsidies, whatever that gap may be. ORA's witness is not required to ensure that customer revenues match perfectly with KTC's revenue requirements, because the state subsidies make up the difference.

B. Basic Residential Rates

In order to comply with D.14-12-084, KTC has proposed to increase basic residential service rates to $22.58, which including taxes and fees comes to a total of $30.00.[183] As discussed in ORA's OB, ORA agrees with this proposal. This would bring KTC's basic residential rate within the $30-37 range mandated by the Commission in D.14-12-084.

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[181] *Id.* at 87.
[182] *Id.* at 87.
[183] KTC OB at 88.

C. Inside Wire and Vertical Service Rates

1. Inside Wire Maintenance

KTC claims that ORA ignores "the effects on Kerman's vulnerable ratepayers" from an increase in inside wire maintenance.[184] However, KTC has not provided any studies, surveys, or other evidence to show that Kerman's residents would be adversely affected by this rate increase. There is simply nothing in the record to indicate that Kerman's residents cannot pay the same rates paid by the customers of AT&T and Verizon.

ORA's recommendation is consistent with the inside wire maintenance charges by AT&T and Verizon. More importantly, Section 275.6(c)(3) requires the rates charged by the small rural carriers to be "reasonably comparable" to those charged by urban telephone corporations.[185] KTC's current rates are not reasonably comparable, and must be raised.

KTC claims that it presented "compelling evidence" that customers will discontinue inside wire maintenance if the charges are increased.[186] However, KTC's OB contains no citation to any evidence at all. There are no studies, surveys, questionnaires, or other evidence in the record to support KTC's claim. If AT&T and Verizon are able to charge those rates, it stands to reason that KTC could do so as well.

The Legislature expressed its intent in Section 275.6 by requiring rural rates to be reasonably comparable to urban rates; had the Legislature intended to subsidize rural rates at a level far below urban rates, it would have said so.

2. Vertical Services

KTC argues that ORA's recommendations to increase rates for vertical, optional services such as caller ID, call forwarding, call waiting, etc. should be rejected for similar

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[184] KTC OB at 90.

[185] Section 275.6(c)(3) states that the Commission shall: "Ensure that rates charged to customers of small independent telephone corporations are just and reasonable and are reasonably comparable to rates charged to customers of urban telephone corporations."

[186] KTC OB at 91.

reasons.[187] For similar reasons to those stated above, those rates must be increased. The Legislature did not intend for small rural carriers' customers to get service for practically nothing, but only at rates reasonably comparable to those that urban customers pay.

3. ORA Did Not Make A Comparison to "Comparable Market Rates"

KTC claims that ORA improperly analyzed "comparable market rates" for vertical, optional services.[188] In fact, ORA compared KTC's rates to urban telephone companies such as AT&T and Verizon because that is what the law requires.[189] Thus, it is flatly wrong that "ORA simply identified rates on the highest end of the range" of comparable telephone companies.

KTC also takes issue with ORA's consistency relating to an ORA position taken in a different proceeding, C.13-12-005.[190] In that proceeding, ORA took the position that AT&T's rate for basic residential service is too high. However, there is nothing contradictory in stating that KTC's rates for vertical, optional services should be comparable to AT&T's rates, because the issue here is KTC's vertical, optional services rates, not its basic telephone service rate. In any case, AT&T's basic telephone rates are well above the $22.58 proposed by KTC, so there is no inconsistency there either.

4. Customer Premises Equipment

Customer Premises Equipment (CPE) are telephone sets that are sold or leased by KTC to end users.[191] KTC reported no CPE revenue; however, ORA found 5 instances in a sample of 71 customer bills where KTC charged $2 for CPE.[192] ORA thus projects 262

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[187] KTC OB at 93.

[188] KTC OB at 95.

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

[190] KTC OB at 96.

[191] KTC OB at 97.

[192] ORA Report at 16.

instances in 2016 where a $2 CPE charge will be collected from the residential customers as unregulated revenues, for a total of $6,288.[193]

KTC argues that the Commission has held that it has no jurisdiction over the revenues collected by KTC in relation to charges for CPE.[194] However, in the only case decided by this Commission involving CPE, the Commission rejected a complaint by three individuals against Verizon in which the complainants claimed that Verizon failed to fix their computer and charged them for unwanted virus protection software.[195] The Commission agreed with Verizon that there was no jurisdiction over the complainants' computer, and dismissed the case. However, the complaint case did not involve the determination of whether the revenue generated by the sale or lease of CPE is within the Commission's jurisdiction. It is simply inapplicable. It is well within the Commission's authority to impute revenues under the appropriate circumstances.

For example, KTC maintains work equipment such as borers and trenchers that are purchased with ratepayer money; the expenses related to purchase and maintenance would be under the Commission's jurisdiction, and the revenues generated with the lease or sale of the equipment would be under the Commission's jurisdiction. However, it cannot be said that the Commission has jurisdiction over the manufacture or distribution of the work equipment.

VII. KTC'S REQUEST FOR INTERIM RATE RELIEF SHOULD BE REJECTED

KTC requests interim rate relief effective as of January 1, 2015.[196] KTC cannot raise its rates, thus KTC in effect wants a retroactive increase in subsidies from the CHCF-A fund. KTC states that it is in "desperate need of additional rate support", but cites to no specific data for support.[197] KTC points out that its 2014 earnings of 4.15%

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[193] ORA Report at 17.

[194] KTC OB at 97.

[195] D.13-09-038.

[196] KTC OB at 98.

[197] *Id.* at 100.

were "perilously low", but KTC provides no data to support the claim that its operations in 2015 are in a perilous condition.[198] In its motion, KTC provides no data whatsoever with regards to its current financial situation. Without any supporting data, is difficult to ascertain whether KTC's operations are truly in an emergency situation.

Moreover, ORA's review of KTC's expenses has revealed many items that are excessive, and should not be subsidized. After removing these items, it does not appear that KTC is in "desperate need" of financial support.

The Commission should be wary of KTC's claims of financial hardship. In a prior motion for rate relief (which was denied), KTC alleged "financial harm" and offered as evidence the prediction that the company's 2013 financial performance would result in a negative 1.58% return on the Intrastate Rate Base regulated by the Commission. The actual return of 6.11% for 2013 was more than 486% higher than KTC's predictions.

KTC's request cites to D.03-03-009, in which the Commission required KTC to provide a "cash flow analysis" in order to justify an interim rate relief request.[199] However, no cash flow analysis has been presented here.

Typically, the existence of a financial emergency is a prerequisite. Delays in the case have been another factor in granting interim relief.[200] However, KTC's request for rate relief assumes that the Commission will approve all of KTC expenses, which is unlikely. Many of KTC's expenses are unreasonable and should be disallowed. If ORA's adjustments are adopted, KTC's CHCF-A subsidy would fall below its current subsidy level. This would make rate relief problematic, because KTC would actually owe the CHCF-A a refund if a decrease in subsidies were retroactive to January 1, 2015.

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[198] Ibid.

[199] KTC OB at 99.

[200] *Re Southern California Edison Company* (28 CPUC 2d 203, 212 (1988) D.88-05-074).

VIII. ORA DOES NOT OPPOSE KTC'S REQUEST FOR ORAL ARGUMENT

KTC requests an oral, closing argument before the Commission.[201] ORA does not oppose a brief oral argument, with both sides to have opening and closing remarks.

IX. CONCLUSION

KTC's Opening Brief is unpersuasive in many respects. Among the many other excessive and imprudent costs that are not explained, it fails in two important ways; first, it fails to justify any exceptions to the FCC corporate expenses cap, because it fails to overcome the presumption that items that exceed the cap are unreasonable. ORA, on the other hand, has shown that KTC has many options to reduce corporate expenses. Second, KTC fails to demonstrate that a return on equity of 16.24% is necessary to continue to attract capital investments. ORA's recommendation of 8.79% is reasonable and comparable to current investor expectations. The Commission should carefully review and reject KTC's expenses that are clearly excessive in violation of Public Utilities Code Section 275.6(c)(7).

Respectfully submitted,

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[201] KTC OB at 101.