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

In the Matter of Application of Sierra Telephone Company, Inc. (U 1016 C) to Review Intrastate Rates and Charges, Establish a New Intrastate Revenue Requirement and Rate Design, and Modify Selected Rates

A.16-10-003
(Filed Oct. 3, 2016)

**REBUTTAL TESTIMONY OF CAROL E. MATTEY
ON BEHALF OF SIERRA TELEPHONE COMPANY, INC. (U 1016 C)**

April 10, 2017

[PUBLIC]

1 **I. Introduction and Background**

2 **Q.1. Please state your name and business address.**

3 A.1. My name is Carol E. Matthey. I am the sole member of Matthey Consulting LLC, a
4 consulting firm which provides strategic and public policy advisory services to service providers,
5 non-profit organizations, and others active in the telecommunications industry. The firm's
6 business address is 5904 Devonshire Dr., Bethesda, MD 20816.

7 **Q.2. Please summarize your work experience and educational background.**

8 A.2. I have over 30 years of experience in the telecommunications industry. Most
9 recently, from 2009 until February 2017, I was employed by the Federal Communications
10 Commission (FCC). I was Deputy Bureau Chief of the Wireline Competition Bureau from 2010
11 until 2017, and Senior Policy Advisor on the FCC's National Broadband Plan team from 2009 to
12 2010. Between 2005 and 2009, I was a Director at Deloitte & Touche LLP, providing regulatory
13 consulting services to telecommunications carriers and other entities. Previously, I was employed
14 by the FCC from 1994 to 2005, serving in several management positions, culminating in my
15 service as Deputy Bureau Chief of the Wireline Competition Bureau (formerly known as the
16 Common Carrier Bureau) from January 2000 until January 2005. Prior to that, from 1989 to 1994,
17 I held the position of Telecommunications Policy Specialist at the National Telecommunications
18 and Information Administration within the U.S. Department of Commerce, which is the Executive
19 Branch agency that advises the President on telecommunications policy. I was an attorney in
20 private practice at the firm now known as Wilmer Hale (formerly Wilmer, Cutler & Pickering)
21 from 1983 to 1989. While a lawyer in private practice, I specialized in communications law,
22 starting in 1985.

23 I received a BA with High Distinction in Urban Studies from the University of Virginia in
24 1979, a JD *cum laude* from the University of Pennsylvania in 1983, and a MA in Public Policy
25 Analysis from the University of Pennsylvania in 1983. My full Curriculum Vitae is provided with
26 this testimony as Attachment A.

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1 **Q.3. For which party do you offer this rebuttal testimony?**

2 A.3. The views presented in this testimony are my own, but I offer this testimony on
3 behalf of Sierra Telephone Company, Inc. (Sierra), the applicant in this proceeding.

4 **Q.4. What is the purpose of your testimony?**

5 A.4. The purpose of my testimony is to offer my public policy expertise and personal
6 views regarding the operation and applicability of the FCC rules in Title 47 of the Code of Federal
7 Regulations, Parts 32, 36, and 64 regarding cost allocation, jurisdictional separation, and affiliate
8 transactions. I have reviewed the proposals made by the Office of Ratepayer Advocates (ORA)
9 Testimony Regarding Expenses (filed March 20, 2017) (Tully Testimony), to adopt a
10 uniform<<BEGIN CONFIDENTIAL>> ██████████ <<END CONFIDENTIAL>> allocation ratio for
11 determining the allocation of regulated expenses to Sierra. I believe ORA's cost allocation
12 proposal is inconsistent with the FCC's rules and contrary to the intent and guiding principles
13 underlying those rules. I also think that ORA's proposal could result in significant harm to
14 customers in Sierra's service territory. I offer this testimony to highlight the problems with ORA's
15 cost allocation methodology and to confirm that Sierra's cost allocation methodology for the most
16 part appears to be consistent with the FCC's rules.

17 **Q.5. What specific background do you have that is relevant to the subject matter of**
18 **your rebuttal testimony?**

19 A.5. I have subject matter knowledge and experience with the FCC's accounting rules
20 based on my employment at the FCC. Among other responsibilities while employed at the FCC, I
21 supervised a former division of the Common Carrier Bureau known as the Accounting & Audits
22 Division from 2000 until 2002. That division was responsible for rulemaking and other activities
23 involving the FCC's Part 32 Uniform System of Accounts (USOA), the Part 32 affiliate
24 transaction rules, and the Part 64 cost allocation rules. During that time period, I supervised the
25 work that led to the adoption of an order that consolidated and streamlined Class A accounting
26 requirements, relaxed certain aspects of the affiliate transaction rules, reduced the cost of
27 regulatory compliance with cost allocation rules for mid-sized incumbent local exchange carriers,
28

1 and reduced financial reporting requirements.¹

2 During my more recent employment at the FCC, I was responsible for overseeing the work
3 of the Telecommunication Access Policy Division, the division with responsibility for rulemaking
4 and adjudicatory proceedings relating to the federal universal service fund. I supervised the
5 development of the FCC's landmark decision in 2011 to transform the traditional high-cost
6 program into a new regime that explicitly supports broadband-capable networks to provide voice
7 and broadband service to consumers in rural America.² I was responsible for all subsequent
8 Bureau actions to implement that framework, including addressing issues relating to the
9 broadband public interest obligations of eligible telecommunications carriers. I oversaw the
10 proceeding to comprehensively reform universal service programs and related rules applicable to
11 rate-of-return regulated incumbent carriers, culminating in the FCC's adoption in March 2016 of
12 the *Rate-of-Return Reform Order*.³ In the Further Notice of Proposed Rulemaking developed
13 under my supervision, the FCC sought comment on potential changes to the Part 32 and Part 64
14 rules, specifically the affiliate transaction rules and the cost allocation rules. As part of my job
15 responsibilities as Deputy Bureau Chief, I also reviewed draft audit reports of incumbent local
16 exchange carriers prepared by the Universal Service Administrative Company (USAC), the FCC's
17 administrator of the federal universal service fund, and considered issues relating to the
18 application of the FCC's affiliate transaction and cost allocation rules that have arisen in the
19 context of specific FCC adjudicatory matters.

20
21 ¹ *2000 Biennial Regulatory Review -- Comprehensive Review of the Accounting Requirements and ARMIS Reporting*
22 *Requirements for Incumbent Local Exchange Carriers: Phase 2 et al.*, CC Docket Nos. 00-199, 97-212, 80-286, 99-
23 301, Report and Order and Further Notice of Proposed Rulemaking, 16 FCC Rcd 19911(2001) (*2000 Biennial*
24 *Regulatory Review: Phase 2 Order*).

25 ² *See Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates*
26 *for Local Exchange Carriers; High-Cost Universal Service Support; Developing a Unified Intercarrier Compensation*
27 *Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform – Mobility*
28 *Fund*; WC Docket Nos. 10-90, 07-135, 05-337, 03-109, CC Docket Nos. 01-92, 96-45, GN Docket No. 09-51, WT
Docket No. 10-208, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd 17663 (2011)
(*USF/ICC Transformation Order and/or FNPRM*); *aff'd sub nom.*, *In re: FCC 11-161*, 753 F.3d 1015 (10th Cir.
2014).

³ *Connect America Fund et al.*, WC Docket No. 10-90 et al., Report and Order, Order and Order on Reconsideration,
and Further Notice of Proposed Rulemaking, 31 FCC Rcd 3087 (2016) (*Rate-of-Return Reform Order/FNPRM*).

1 **Q.6. Please summarize your testimony and present your major conclusions.**

2 A.6. First, I will discuss the history, purpose and overall function of the FCC's cost
3 allocation and affiliate transaction rules. Second, I will address how ORA's position that common
4 costs should be allocated between Sierra and its affiliate that provides retail broadband Internet
5 access service, Sierra Tel Internet (STI), based on the relative subscribership of each entity is a
6 novel position not supported in the FCC's rules. Third, I will evaluate Sierra's policies and
7 procedures to comply with the FCC's cost allocation rules and conclude that, based on the
8 materials I have reviewed from Sierra and materials presented in ORA's testimony, Sierra's cost
9 allocation policies and procedures for the most part appear to be appropriately designed to comply
10 with the FCC's rules. Fourth, I will conclude with several observations about the negative policy
11 implications of adopting ORA's cost allocation proposal.

12 **Q.7. Are there any qualifications to your testimony?**

13 A.7. I am testifying as a subject matter expert on the FCC rules. The opinions expressed
14 are my personal opinions based on my knowledge and experience as a former FCC employee. I
15 am generally familiar with Sierra's methodology to allocate expenses associated with insurance,
16 human resources, land and buildings, office supplies, advertising/legal//marketing/membership
17 fees, customer care office equipment and life insurance. However, I have not verified the specific
18 implementation of the processes in the particular accounts at issue, nor have I reviewed specific
19 calculations made using the cost allocation procedures employed by Sierra. My opinions are based
20 on the materials provided to me by Sierra at the direction of its legal counsel in connection with
21 this proceeding.

22 **Q.8. What did you review in preparing your testimony?**

23 A.8. I reviewed the FCC rules discussed in my testimony, a number of FCC decisions
24 relating to those rules, the Opening Testimony of David A. Lashua on behalf of Sierra Telephone
25 Company, Inc. (filed Oct. 3, 2016), Sierra's Response to ORA-009 (Expenses) (filed Dec. 9,
26 2016), Sierra's Response to ORA-14 (Expenses) (filed Jan. 24, 2017), Sierra's Supplemental
27 Response to ORA-014 (Expenses) Question 14.3 (filed Jan. 27, 2017), Sierra's Supplemental
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1 Response to ORA-014 (Expenses) Question 14.2 (filed Feb. 28, 2017) and accompanying
2 Attachment 14.2(b) (Sierra Telephone 2015 Expenses) [CONFIDENTIAL], the Office of
3 Ratepayer Advocates Testimony Regarding Expenses (filed Mar. 20, 2017), and the rebuttal
4 testimony offered by Mr. Rennard, Mr. Baumgarner, and Ms. Huber on behalf of Sierra.

5 **II. History, Purpose of Overall Functioning of the FCC's Cost Allocation Rules**

6 **Q.9. What FCC rules are relevant to determining a carrier's intrastate revenue**
7 **requirement?**

8 A.9. Parts 32, 36, and 64 of the FCC's rules contain the principal cost allocation
9 requirements that apply to the development of an intrastate revenue requirement. Part 32 requires
10 carriers to record their assets, expenses, and revenues in prescribed accounts. Part 64's cost
11 assignment rules, located in 47 C.F.R. Section 64.901, *et seq.*, apportion the investment, expenses,
12 and revenues between regulated and nonregulated activities.⁴ Part 36 prescribes rules for
13 separating regulated investment, expenses, and revenues between the interstate and intrastate
14 jurisdictions.⁵

15 **Q.10. Please describe in more detail how costs are recorded pursuant to Parts 32, 64,**
16 **and 36.**

17 A.10. Incumbent local exchange carriers such as Sierra record their investments,
18 expenses, and other financial activity in accordance with the Part 32 uniform system of accounts
19 (USOA). The USOA prescribes uniform financial accounts, providing standardized account and
20 reporting of financial transactions on a total company level with sufficient information to facilitate
21 subsequent cost allocation processes. The USOA includes accounts referred to as regulated
22 accounts and nonregulated accounts. Investment and expenses that are entirely associated with the
23 provision of regulated services, or that are used for both regulated and non-regulated services, are
24 recorded in the regulated accounts. 47 C.F.R. Section 32.14(c). Investment and expenses that are

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26 ⁴ 47 C.F.R. §§ 64.901–05.

27 ⁵ *See* 47 C.F.R. Part 36.

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1 entirely associated with the provision of nonregulated services are assigned to nonregulated
2 accounts. 47 C.F.R. Section 32.14(f). Part 32 also specifies standards for transactions between
3 regulated carriers and their affiliates. Services offered by regulated carriers under tariff are
4 charged to nonregulated affiliates at the tariffed rate.

5 Once they are recorded, the investment and expenses in the regulated accounts under the
6 USOA are then allocated between regulated and nonregulated activities in accordance with the
7 FCC's cost allocation procedures set forth in Part 64, specifically 47 C.F.R. Section 64.901. The
8 FCC's cost allocation rules are designed to ensure the reasonableness of regulated rates. The intent
9 of the rules is to inhibit carriers from imposing the costs and risks of nonregulated ventures on
10 ratepayers of regulated services. The regulated investment and expenses that remain after the
11 application of the Part 64 process are then split between the interstate and intrastate jurisdictions in
12 accordance with the separations process set forth in Part 36. This result is an isolated set of costs
13 that are regulated and assigned to the intrastate jurisdiction. That is the set of costs over which the
14 state commissions have jurisdiction and which should be the proper focus of ratemaking in
15 Sierra's rate case.

16 **Q.11. What does it mean for something to be a nonregulated activity?**

17 A.11. A nonregulated activity refers to an activity that is not subject to rate regulation.
18 For example, retail broadband Internet access is not subject to rate regulation by the FCC.
19 Similarly, that service is not subject to rate regulation by state public utility commissions.

20 **Q.12. You mentioned that certain services offered by regulated carriers to affiliates**
21 **may be provided at tariffed rates. Can you explain what a tariff is and what role tariffs play**
22 **in interactions between affiliates?**

23 A.12. A tariff is a standing set of rates, terms, and conditions filed with a regulatory
24 agency that has jurisdiction which define the terms under which the service identified in the tariff
25 will be provided. Once effective, a tariff has the force of law and its terms are binding on the
26 customer-carrier relationship as to the subject service. The pricing in a tariff is designed to reflect
27 the reasonable costs of providing the service such that when the customer pays the tariffed rate for
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1 the service, the customer is providing the carrier with an opportunity to recover its costs of service
2 and earn a reasonable profit as to that service. Tariffed terms are offered to any customer who can
3 meet the qualifications for service defined in the tariff. The customer of a tariffed service could be
4 an affiliate or an unaffiliated person or entity.

5 As an example of how tariffs operate, I understand that STI purchases access to Sierra's
6 local exchange network pursuant to federal and state tariffs. Where the tariffed service is
7 interstate, such as the broadband access tariff, NECA Tariff No. 5, the resulting revenue to Sierra
8 is assigned to the interstate jurisdiction. Where an affiliate purchases a state-regulated tariffed
9 service, the resulting revenue would be considered intrastate revenue.

10 **Q.13. What is the relevance of tariffs to the issue of cost allocation?**

11 A.13. Tariffs are relevant because when an affiliate is purchasing access to facilities
12 pursuant to tariff, and it is paying the tariffed rate that includes cost recovery as to that access,
13 there would be no reason to engage in an additional cost allocation to account for the affiliate's
14 use of the regulated facilities.

15 **Q.14. How did the FCC's cost allocation and affiliate transaction rules come about**
16 **and what is significant about this historical context?**

17 A.14. Historically, telephone companies were regulated monopolies that only provided
18 telephone service. In the 1960s, with the advent of data processing, the FCC began to consider
19 whether and how telephone companies would be allowed to enter this new market. The underlying
20 policy concern was to protect captive ratepayers of the monopoly services from paying higher
21 rates for regulated services because of the costs of providing nonregulated services, and to prevent
22 the distortions associated with below-cost pricing in the market for competitive services. Initially,
23 under the *Computer I* regime, the FCC required common carriers other than AT&T to offer data
24 processing services through separate corporate entities. Then, under *Computer II*, the FCC updated
25 its policy to allow all telephone companies other than AT&T to offer so-called "enhanced
26 services" – namely, services other than basic common carrier transmission services – on an
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1 integrated basis. It required only AT&T to maintain structural separation.⁶ In the late 1980s, the
2 FCC moved away from structural separation for AT&T and the divested Regional Bell Operating
3 Companies in favor of *Computer III* non-structural safeguards, which it found would allow the
4 more efficient provision of enhanced services, for the benefit of consumers. It expressly
5 recognized that the nonstructural safeguards included the specific cost allocation and affiliate
6 transaction standards adopted in the *Joint Cost Order*.⁷

7 The rules adopted in the *Joint Cost Order* were intended to ensure that telephone
8 ratepayers would continue to receive reasonable protections against improper cross-subsidization
9 in the event that the companies chose to provide enhanced services on an integrated basis, rather
10 than through separate subsidiaries. The FCC also sought to ensure that ratepayers would share in
11 any savings achieved through the integrated provision of regulated and nonregulated activities and
12 to improve the cost allocation procedures then used by the independent telephone companies (like
13 Sierra), which previously had been relieved of the structural separation requirements in *Computer*
14 *II*.⁸ The *Joint Cost Order* adopted rules that require all local exchange carriers to allocate and
15 assign costs either to regulated or nonregulated activities.

16 The *Joint Cost Order* also established affiliate transaction rules that require carriers to
17 record on their books of account, at the appropriate price, all assets or services transferred between
18 a regulated entity and a nonregulated affiliate. The underlying policy concern was that the risk of
19 cost misallocation is increased when carriers engage in transactions with nonregulated affiliates.

20 After Congress adopted the Telecommunications Act of 1996, the FCC revised the affiliate
21

22 ⁶ *Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, Final
23 Decision, 77 FCC 2d 384 (1980) (*subsequent history omitted*).

24 ⁷ See generally *Separation of Costs of Regulated from Nonregulated Activities, Amendment of Part 31, the Uniform*
25 *System of Accounts for Class A and Class B Telephone Companies to Provide for Nonregulated Activities and to*
26 *Provide for Transactions Between Telephone Companies and Their Affiliates*, Report and Order, 2 FCC Rcd 1298
(1987) (*Joint Cost Order*), Order on Reconsideration, 2 FCC Rcd 6283 (1987) (*Joint Cost Reconsideration Order*),
Order on Further Reconsideration, 3 FCC Rcd 6701 (1988), *aff'd sub nom. Southwestern Bell Corp. v. FCC*, 896 F.2d
1378 (D.C. Cir. 1990).

27 ⁸ *Joint Cost Order*, 2 FCC Rcd at 1304, para. 39; *Joint Cost Reconsideration Order*, 2 FCC Rcd at 6283-84, paras. 1,
28 6.

1 transactions rules in order to implement the statutory provisions prohibiting cross-subsidization.⁹
2 The FCC maintained the overall framework, however, under which the preferred approach is to
3 value transactions at publicly available rates, wherever possible. The rules require the provision of
4 services to an affiliate to be recorded at an existing tariff rate if available. 47 C.F.R. Section
5 32.27(c).

6 **Q.15. What was the FCC’s goal in adopting these rules?**

7 A.15. The FCC’s stated goal in adopting the cost allocation and affiliate transaction rules
8 was to “promote just and reasonable rates” through the accounting separation of regulated from
9 nonregulated activities, using a fully allocated costing methodology, and “to prevent cost shifting
10 to ratepayers by means of improper transfer pricing.”¹⁰ The FCC thus intended the cost allocation
11 rules and the affiliate transaction rules to operate together to ensure just and reasonable rates for
12 regulated services. In adopting such rules, the FCC effectively recognized that it was appropriate
13 for telephone companies to engage in nonregulated activities, either directly or through an
14 affiliate, and that consumers would benefit from the breadth of services offered by the regulated
15 companies or their nonregulated affiliates. For decades, the FCC has recognized that regulated
16 companies share resources with nonregulated affiliates, and that nonregulated affiliates utilize
17 services provided by regulated telephone companies to serve their customers.

18 **Q.16. Please describe the cost allocation rules in Part 64 in more detail.**

19 A.16. As I noted above, 47 C.F.R. Section 64.901 is the operative aspect of Part 64 that
20 addresses cost allocation between regulated and nonregulated activities. It has several provisions.
21 The first requirement is that tariffed services provided to nonregulated activities will be charged at
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23 ⁹ *Accounting Safeguards under the Telecommunications Act of 1996*, CC Docket No. 96-150, Report and Order, 11
24 FCC Rcd 17539 (1996) (*Accounting Safeguards Order*), Order on Reconsideration, 14 FCC Rcd 11396 (1999),
Second Order on Reconsideration, 15 FCC Rcd 1161 (2000).

25 ¹⁰ *Joint Cost Order*, 2 FCC Rcd at 1335, para. 290. *See also id.* at 1299, para. 2 (rules necessary to “deter cost shifting
26 both in the form of misallocation of joint and common costs and in the form of improper intracorporate transfer
27 pricing”); *id.* at 1303, para. 37 (“[P]rotecting ratepayers from unjust and unreasonable rates is the primary purpose
28 behind the accounting separation of regulated from nonregulated activities, just as it is the purpose behind all of our
accounting and cost allocation rules.”).

1 tariffed rates. 47 C.F.R. Section 64.901(b)(1). Second, costs shall be directly assigned to either
2 regulated or nonregulated activities whenever possible. 47 C.F.R. Section 64.901(b)(2). Third,
3 costs that cannot be directly assigned – common costs – should be grouped into homogenous cost
4 categories and then allocated according to the following hierarchy:

- 5 1. If possible, common costs are allocated based on direct cost causation. 47 C.F.R.
6 Section 64.901(b)(3)(i).
- 7 2. If common costs cannot be allocated based on direct cost causation, they should be
8 allocated based on indirect cost causation, based on linkage to other costs that are
9 directly assigned or allocated. 47 C.F.R. Section 64.901(b)(3)(ii).
- 10 3. To the extent that common costs cannot be allocated on direct or indirect cost
11 causation principles, common costs are allocated based on a general allocator that
12 is the ratio of all expenses directly assigned or attributed to regulated and
13 nonregulated activities. 47 C.F.R. Section 64.901(b)(3)(iii).

14 **Q.17. Do the FCC’s rules provide flexibility to carriers in how they allocate their**
15 **costs?**

16 A.17. Yes. The FCC declined to adopt prescriptive procedures as to how these cost
17 allocation principles would be implemented by individual carriers. Notably, the FCC expressly
18 recognized that “most accounts will require the use of more than one of our allocation principles to
19 achieve a complete apportionment of their costs.”¹¹ It thus rejected the notion that any single
20 account could be allocated between regulated and nonregulated activities pursuant to a single
21 method. Any methodology utilized must be consistent with the cost causation principles in Part
22 64, but the same methodology need not be used as to every cost, and companies are not required to
23 use the exact same way of allocating costs as each other.¹² In rejecting arguments to reconsider
24

25 ¹¹ *Joint Cost Order*, 2 FCC Rcd at 1319, para. 163.

26 ¹² *See also Rate-of-Return Reform FNPRM*, 31 FCC Rcd 3220, para. 353 (under part 64, “carriers currently apply
27 broad principles in making such allocations, and the lack of specificity in the rules gives carriers a degree of discretion
28 in making these allocation decisions.”).

1 the requirement that small companies comply with the cost allocation principles adopted in the
2 *Joint Cost Order*, the FCC stated, “An examination of most carriers’ current allocation procedures
3 would likely find that most existing methods of allocating costs are in compliance with our
4 Order.”¹³ The FCC thus expressly recognized that there could be more than one acceptable
5 method of allocating costs.

6 **Q.18. What does it mean to “directly assign” something?**

7 A.18. Direct assignment involves a determination that a specific cost has been caused by
8 a specific regulated or nonregulated activity, such that the cost may be directly recorded in an
9 account associated with the regulated or nonregulated activity. Costs that are directly assigned are
10 not common costs subject to the cost allocation principles set forth in Section 64.901(b)(3).

11 **Q.19. What is a “common cost?”**

12 A.19. The FCC’s rules define a common cost as “any cost that cannot be directly
13 assigned to regulated or nonregulated activities.”¹⁴

14 **Q.20. What are some examples of costs that a company may allocate based on a
15 “direct analysis” of the origin of a cost?**

16 A.20. When the FCC adopted the *Joint Cost Order*, it stated that “[e]xamples of Part 32
17 Accounts which are likely to be allocable on the basis of a direct analysis are the central office
18 switching and transmission accounts (2211–2215 and 2231–2232), operator systems (2220), most
19 of the information origination/termination accounts (2311–2351), most of cable and wire facilities
20 accounts (2421–2431), the marketing expense accounts (6611–6613), and portions of accounts
21 6623 and 6722.”¹⁵ For example, for such accounts, a company could perform a study based on the
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¹³ *Joint Cost Reconsideration Order*, 2 FCC Rcd at 6300, para. 157.

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¹⁴ 47 C.F.R. § 64.901(b)(3).

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¹⁵ *Joint Cost Order*, 2 FCC Rcd at 1318, para. 160 n.279.

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1 historical usage of non-divisible assets that are utilized by both regulated and nonregulated service
2 divisions within a company.

3 **Q.21. What are examples of common costs that typically are assigned through**
4 **indirect linkage to another cost category?**

5 A.21. Costs that are associated with general and administrative functions and
6 management functions often are allocated based on indirect cost causation.

7
8 **Q.22. What are some examples of cost drivers that can be used to establish a cost-**
9 **causative linkage between a common cost and a cost for which there is an established**
10 **assignment or allocation?**

11 A.22. Where costs cannot be directly assigned, but they vary in direct proportion to other
12 cost categories that have been directly assigned, the proportion of the related cost category can be
13 used as a legitimate cost-causative link in establishing how to apportion the common cost. For
14 example, a company could use directly assigned labor hours of customer service representatives
15 performing customer service functions for regulated and nonregulated services to determine how
16 to apportion the cost of the equipment used to perform such functions. As a second example, labor
17 hours could be used as a proxy for how to allocate the “common cost” of life insurance for certain
18 employees, with the cost of the insurance based on an allocation of the labor hours assigned
19 between regulated and nonregulated activities. The key point is that there must be some
20 reasonable relationship between the cost that is being used as a proxy and the cost that is being
21 allocated through indirect cost causation.

22 **Q.23. In practice, how do companies implement the cost allocation rules in 47 C.F.R.**
23 **Section 64.901?**

24 A.23. Under the FCC rules, so-called Class A companies (larger companies based on a
25 revenue threshold) historically were required to develop and file with the FCC a Cost Allocation
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1 Manual (CAM) describing how they separated regulated from nonregulated costs.¹⁶ However, the
2 FCC subsequently eliminated the requirement to maintain a CAM for the mid-size companies in a
3 2001 decision and subsequently removed that requirement for the largest companies as well.

4 Smaller companies such as Sierra have never been required to maintain a CAM. In the *Joint*
5 *Cost Order*, the Commission applied cost allocation standards and affiliate transactions rules to all local
6 exchange carriers, but exempted the smaller carriers from several enforcement provisions. For example,
7 smaller carriers were exempted from CAM annual filing requirements, an annual independent audit, and
8 reporting requirements.¹⁷ In doing so, the FCC assumed that smaller carriers would need to develop cost
9 allocation processes to identify regulated costs to support their tariff filings, but it declined to adopt a
10 requirement that such internal procedures be maintained in a single formal document called a Cost
11 Allocation Manual. Thus, companies are free to implement their internal procedures using
12 whatever documentation they deem appropriate. The FCC also declined to adopt prescriptive
13 rules regarding how to implement the general cost allocation principles adopted in the *Joint Cost*
14 *Order*, explicitly recognizing that there could be more than one correct way to implement the cost
15 allocation principles. Thus, for more than three decades, the FCC has recognized that small
16 companies like Sierra should be afforded flexibility to develop their specific cost allocation
17 procedures consistent with this general framework.

18 My expectation, given the FCC rules and decisions in this area, is that companies such as
19 Sierra would have internal processes that will be applied to allocate costs. Companies will
20 operationalize these processes by applying them to specific cost categories using spreadsheets and
21 other documents that contain the specific calculations for allocating common costs. Those
22 procedures will not necessarily be captured in a single document, however, but instead may be
23 memorialized in multiple documents that contain other information not relevant to cost allocation.

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26 ¹⁶ 47 C.F.R. § 64.903.

27 ¹⁷ See *Joint Cost Order*, 2 FCC Rcd at 1304, para. 47.

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1 **III. ORA's Proposal to Allocate Common Costs Based on Customer Subscribership is**
2 **Inconsistent with FCC Rules**

3 **Q.24. Please describe your understanding of the ORA proposal to modify Sierra's**
4 **allocation of regulated expenses.**

5 A.24. Mr. Tully's allocation calculation is not clearly presented, and his testimony
6 contains significant inconsistencies that make it difficult to discern the nature of his calculations.
7 On page III-16 of his testimony, Mr. Tully explains that he is recommending a reduction in
8 Sierra's expenses of approximately <<BEGIN CONFIDENTIAL>> [REDACTED] <<END
9 CONFIDENTIAL>> based solely on his allocation theory, but the manner in which he arrived at
10 this figure is not transparent. On page III-16, he states that he calculated this amount by applying
11 a <<BEGIN CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>> ratio to "the total expenses
12 subject to allocation." However, it appears from the amount of his proposed reduction that he is
13 not limiting the application of his ratio to total expenses that are properly "subject to allocation"
14 under the FCC's rules. Rather, he appears to have applied this <<BEGIN
15 CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>> ratio to a larger figure that includes
16 expenses that do not require allocation under the FCC's rules. Similarly, he does not define what
17 he considers to be the "total expenses subject to allocation" in his testimony, so the "total" is
18 unclear. *See Tully Testimony*, at p. III-16.

19 In Mr. Tully's deposition, which took place on April 4, 2017, he offered a different
20 description of his allocation calculation. First, Mr. Tully stated that his calculation involved
21 applying a <<BEGIN CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>> figure to the
22 overall expenses for Sierra. *Tully Deposition*, at p. 89. Later in the deposition, he amended that
23 view and explained that the <<BEGIN CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>>
24 figure was applied to all expense categories except for depreciation and corporate expenses. *Tully*
25 *Deposition*, at pp. 97-99. He clarified this by noting that depreciation was computed by another
26 witness and that corporate expenses were computed by using the FCC's corporate expense cap.
27 *Tully Deposition*, at pp. 98-99. Still later in the deposition, he stated that his proposal was to apply
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1 this ratio based on customer subscribership to “the total expenses prior to allocation” of the Sierra
2 Tel Communications Group, namely the expenses of Sierra and all of its affiliates. *Tully*
3 *Deposition*, at p. 145.

4 Despite the lack of clarity in ORA’s presentation of its allocation methodology, based on
5 the Tully deposition, I believe that ORA’s calculation reflects the application of <<BEGIN
6 CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>> to the expense figure in the annual
7 financial report for Sierra’s holding company, Sierra Tel Communications Group. This overall
8 expense figure includes the expenses for Sierra and its six principal affiliates. The <<BEGIN
9 CONFIDENTIAL>> [REDACTED] <<END CONFIDENTIAL>> figure reflects Mr. Tully’s calculations
10 of the number of customers that Sierra has relative to the total number of subscribers for all the
11 companies within the Sierra Tel Communications Group.

12 In summary, my understanding is that ORA is taking a subscribership ratio of regulated
13 telephone subscribers compared to the total of regulated telephone and STI’s Internet access
14 subscribers and applying it to an expense figure that includes one regulated company (Sierra) and
15 six companies that are not subject to the Commission’s ratemaking authority. As I will explain,
16 this methodology is inconsistent with 47 C.F.R. Section 64.901 because it results in an allocation
17 of costs to the regulated company that are not “common costs,” but rather are costs that have been
18 directly assigned to nonregulated operations. It also results in a misallocation of common costs
19 themselves, as it adopts an allocation methodology that is based neither on “direct analysis,” an
20 “indirect cost-causative linkage to another cost category,” or a “general allocator.” Allocating an
21 entire company’s costs – and its affiliates’ costs – according to subscribership is not a recognized
22 methodology that would be consistent with the FCC’s cost allocation rules.

23 **Q.25. What reasoning does ORA offer to support its cost allocation proposal?**

24 A.25. ORA’s argument seems to rest upon two premises. First, ORA claims that Sierra’s
25 current allocation methodologies are “unreasonable and cannot be verified.” *See Tully Testimony*,

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1 at p. III-16. ORA cites to an “inability to account for transaction allocations,”¹⁸ which I
2 understand to mean that ORA did not receive information regarding all expenses directly assigned
3 to Sierra’s affiliates. Second, ORA argues that Sierra’s overall ratio of Sierra’s recorded regulated
4 expenses is disproportionate compared to the nonregulated expenses incurred by its affiliates. *See*
5 *Tully Testimony*, at p. III-5.

6 **Q.26. Is it correct that Sierra has failed to properly document its cost allocations?**

7 A.26. It does not appear so. Sierra does not have a Cost Allocation Manual, but it is not
8 required to have one. Sierra does have extensive documentation of the manner in which it assigns
9 and allocates costs, and this information has been supplied to ORA, as explained in Mr.
10 Baumgarner’s testimony. Based on this information, Sierra directly assigns costs where possible,
11 and it relies on allocation methods that generally comport with Part 64 rules as to the costs that
12 cannot be directly assigned.

13 **Q.27. What is the ratio of regulated expenses to nonregulated expenses that ORA**
14 **finds unreasonable?**

15 A.27. ORA computes a 71% figure that it contends reflects the percentage of expenses
16 that Sierra’s regulated operations represent as a function of the expenses for all members of the
17 Sierra Tel Communications Group. *See Tully Testimony*, at p. III-4.

18 **Q.28. Why does ORA believe that this ratio is too high?**

19 A.28. ORA’s view appears to be grounded in the notion that the relative costs of the
20 regulated and nonregulated operations should grow in proportion to increases or decreases in their
21 respective customer bases. This proposition is incorrect because subscribership is not a principal
22 driver of cost, let alone the sole driver of cost, for small telephone companies. ORA’s view also
23 reflects an apparent incorrect assumption about Sierra’s Internet affiliate use of Sierra’s facilities,
24 and certain shared human resources, to provide service.

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27 ¹⁸ *Id.*

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1 **Q.29. What is the faulty assumption about Sierra’s ISP affiliate use of Sierra’s**
2 **network to provide service?**

3 A.29. ORA’s position fails to recognize that Sierra’s ISP affiliate pays for access to
4 Sierra’s network pursuant to a tariff that reflects the costs of accessing Sierra’s regulated local
5 exchange network. Moreover, such a position fails to acknowledge that Sierra is being fully
6 compensated through the tariffed rate for the costs of providing this common carrier transmission
7 service over its regulated network.

8 **Q.30. Is ORA’s proposal consistent with the FCC’s rules?**

9 A.30. No. ORA’s proposal to use a uniform allocation for all costs that are potentially
10 subject to allocation is facially inconsistent with the FCC’s rules. First, ORA is proposing to
11 apply this proposed allocator to costs that Sierra has directly assigned to regulated activities –
12 namely, to costs that are not common costs in the first place. *See Tully Deposition*, at pp. 100-101.
13 This is inconsistent with the requirement in the *Joint Cost Order* that companies directly assign
14 costs wherever possible.

15 Second, ORA’s proposal to apply this uniform allocator to all common costs is
16 inconsistent with the framework adopted by the FCC for allocation of common costs. Under the
17 FCC’s cost allocation rules as discussed above, companies follow a hierarchy of principles when
18 allocating common costs to regulated and nonregulated activities. The preferred approach under
19 Section 64.901(b)(3)(i) of the FCC’s rules is to allocate common costs based on direct analysis of
20 the origin of the cost. If common costs cannot be directly allocated pursuant to Section
21 64.901(b)(3)(i), then under Section 64.901(b)(3)(ii) such costs are to be allocated based on a cost
22 causative linkage to another cost category for which direct assignment or allocation is available.¹⁹
23 Only if common costs cannot be directly or indirectly assigned or allocated are they allocated
24 using a general allocator pursuant to Section 64.901(b)(3)(iii).

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27 ¹⁹ *See Joint Cost Order*, 2 Rcd at 1317, para. 152 (finding it reasonable to adopt principle that common costs should
be allocated based upon a direct measure of relative use if possible, otherwise on an indirect measure of use).

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1 **Q.31. Does ORA’s treatment of common costs comport with the FCC’s rules?**

2 A.31. No. ORA’s approach does not follow any one of these three methods for allocating
3 common costs. First, the proposal does not purport to allocate common costs based on a direct
4 analysis of the cost in question, as required under Section 64.901(b)(3)(i).

5 Second, the proposal does not allocate common costs based on indirect cost causation, as
6 required under Section 64.901(b)(3)(ii). ORA acknowledges that subscribership is not a “cost”,
7 and it is not a “cost category.” *See Tully Deposition*, at pp. 116-117. ORA does not explain how
8 customer subscribership is causally linked to other cost categories that are directly assigned. It
9 fails to identify which accounts contain directly assigned costs that these specific accounts are
10 related to. Indeed, it does not explain how customer subscribership is causally linked to any
11 specific expense accounts at all.

12 Third, ORA’s proposal is inconsistent with Section 64.901(b)(3)(iii), as a general allocator
13 is to be used only as a last resort in the event there is no cost causative method available to allocate
14 common costs.²⁰ That is not the case here, as my understanding is that Sierra allocates all costs
15 using either direct assignment, direct analysis, or indirect cost causation. Sierra does not utilize a
16 general allocator based on the overall ratio of all expenses directly assigned or attributed to
17 regulated versus nonregulated activities for any cost category.

18 **Q.32. In general, which are the types of expenses that Sierra allocates between**
19 **regulated and nonregulated affiliates because they are “common costs”?**

20 A.32. My understanding is that the common costs that Sierra shares with affiliates include
21 expenses associated with human resources, land and buildings, office supplies, advertising, legal
22 expenses, marketing, association membership dues, office equipment, exempt employee time, and
23 various types of insurance.

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27 ²⁰ *See Joint Cost Order*, 2 FCC Rcd at 1314, para. 120 (“emphasiz[ing] direct assignment of costs and discourag[ing]
28 use of broad composite allocators except as a last resort . . .”).

1 **Q.33. In your opinion, would it be reasonable to use customer subscribership to**
2 **allocate costs in the individual expense accounts where Sierra has identified common costs?**

3 A.33. No. Focusing on ORA’s reliance on customer subscribership, I will address each
4 account in turn.

5 First, ORA has failed to explain how human resource expenses are causally linked to
6 customer subscribership. These costs would largely be incurred by a regulated telephone company
7 regardless of the number of nonregulated subscribers. The human resources function is
8 responsible for all personnel matters, including administration of employee benefits and hiring of
9 new employees. ORA has made no showing that such costs decline in a predictable or linear
10 fashion as subscribership to regulated services declines. The amount of human resources
11 personnel would not automatically go up or down as customer subscribership increases or
12 declines, nor would it vary in proportion to such changes; rather, the amount of human resources
13 personnel needed by Sierra is more likely to go up or down as the number of employees overall
14 grows or declines, as it is the function of addressing various personnel-related issues that drives
15 the amount of human resources expense.

16 Second, ORA fails to explain why customer subscribership is indirectly linked to the cost
17 of land and buildings. The cost of land and buildings does not fall as Sierra’s customer
18 subscribership declines, but rather depends on what square footage is being used by Sierra, which
19 is the method that Sierra uses. Indeed, ORA concedes that the methodology used by Sierra “is
20 reasonable in theory,” but it is skeptical of the specific numbers produced by this methodology
21 because it perceives that Sierra is “entwined” with its affiliates. *Tully Testimony*, at p. III-12. That
22 argument fails to take into account, as explained above, that Sierra is receiving a fully
23 compensatory tariffed rate for the wholesale broadband transmission common carrier service that
24 it provides to its affiliate STI, a rate that already compensates Sierra for an appropriate amount of
25 the expense of land and buildings that support the provision of this service.

26 Third, ORA has failed to explain why office supplies should be allocated based on
27 customer subscribership. It merely makes the conclusory assertion that applying a ratio based on
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1 the ratio land and buildings is “unreasonable.” *Tully Testimony*, at p. III-12. Again, this argument
2 fails to recognize that Sierra is fully compensated through the tariffed NECA rate for the costs
3 associated with the provision of wholesale broadband transmission service to STI. And in any
4 event, I would expect the relative amount of office supplies used by regulated and nonregulated
5 functions more likely to be linked to the amount of office space used by regulated and
6 nonregulated functions than it would be linked to customer subscribership. There is no reason to
7 believe Sierra employees are using proportionately less office supplies as customer subscribership
8 to regulated services declines.

9 Fourth, ORA fails to offer any explanation of why advertising, marketing, legal expense
10 and membership fees should be allocated based on customer subscribership. While the amount
11 expended on advertising and marketing may have some causal relationship to the number of
12 subscribers, the opposite is not necessarily the case: as subscribers to regulated services decline,
13 one would not expect advertising and marketing costs for Sierra to decline in a proportional
14 fashion. If anything, it might be more likely that such costs would remain constant as the
15 regulated entity fights to preserve its existing customer base.

16 ORA’s criticism of the allocation of Sierra’s advertising and marketing expenses to
17 regulated activities appears to be based on a belief that there is no need for the “only landline
18 telephone provider” in the area to engage in such activities. That argument fails to acknowledge
19 that cellular voice service is available in Sierra’s service area, and there is a growing nationwide
20 trend for customers “to cut the cord” in favor of wireless service providers. The argument also
21 fails to acknowledge that in areas where Northland Cable Television operates, consumers can
22 choose from a multiplicity of over-the-top VoIP providers. It therefore is not surprising that a
23 significant portion of advertising and marketing expenses would be allocated to the regulated
24 entity as that entity seeks to prevent further declines in voice subscribership.

25 Fifth, ORA fails to offer any explanation of why it would be appropriate to allocate the
26 cost of customer care equipment based on customer subscribership. Here, like land and buildings,
27 ORA concedes that Sierra’s methodology of splitting such costs based on employee labor hours is
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1 reasonable, but it nevertheless proposes the radical outcome of using a uniform subscribership
2 allocation based on an expressed concern about the accuracy of Sierra's accounting of labor. *Tully*
3 *Testimony*, at p. III-13.

4 Sixth, ORA does not explain why it would be appropriate to allocate labor costs for non-
5 exempt employees based on customer subscribership. There is no reason to believe such costs
6 would decrease in a direct and proportional fashion as subscribership to regulated services
7 decrease. A more appropriate method to allocate such time would be based on a direct analysis of
8 the time that such employees devote to regulated and nonregulated activities.

9 Finally, ORA has not explained how customer subscribership is causally related to Sierra's
10 life insurance expenses. These costs would largely be incurred by a regulated telephone company
11 regardless of the number of nonregulated subscribers. ORA has made no showing that such costs
12 decrease in a predictable and linear fashion as subscribership to regulated services declines or
13 grows. To illustrate with a concrete example, the amount of life insurance for Sierra's exempt
14 employees would not automatically go down as Sierra's customer subscribership went down;
15 rather, the amount of insurance would go up or down as the number of insured employees grows
16 or declines. The same would be true for other insurance expenses as well, as it is the protection
17 for the value of those assets against loss that drives the need for insurance in the first place, not the
18 number of subscribers of the firm.

19 **Q.34. Are there any areas where you feel Sierra's cost allocations could be**
20 **improved?**

21 A.34. Yes. My understanding is that Sierra allocates some portion of its advertising, legal
22 expenses, marketing, and trade association membership dues based on the percentage of gross
23 revenues relative to the gross revenues for all entities. In my opinion, gross revenues are not a
24 cost, nor are they a cost category, and a cost causative linkage between these types of common
25 costs and gross revenues is not readily apparent. A preferable method of allocating such common
26 costs would be to use a ratio based on employee direct assignment of time to regulated and
27 nonregulated activities. Similarly, I understand that Sierra allocates common costs for insurance
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1 based on a methodology that uses gross revenues, but also considers the relative book value of
2 property and other fixed assets covered by the insurance. I believe utilizing the relative book
3 value of the property that is insured to allocate insurance cost is a reasonable approach, and
4 preferable to relying on gross revenues to allocate such expenses. Finally, I understand that Sierra
5 allocates human resource costs based on the relative number of employees employed by the
6 various entities within Sierra Tel Communications Group. A preferable method would be to use a
7 ratio based on labor hours assigned to regulated and nonregulated activities, rather than the
8 number of employees.

9 **Q.35. Are there any instances in which it would be appropriate to use customer**
10 **subscriberhip to allocate common costs?**

11 A.35. While there may be specific costs that could vary based on customer
12 subscriberhip, customer counts have never been the preferred way of allocating costs, and this
13 certainly cannot be a valid way to allocate all of Sierra's common costs, which is what ORA is
14 proposing.

15 In one limited instance, the FCC has recognized that customer counts could be used to
16 allocate costs, but that decision involved a situation significantly different from that presented
17 here. In the *Allband* case, which was developed under my supervision, the FCC addressed a
18 request for waiver of the FCC limitation to no more than \$250 per month of federal high-cost
19 support. In connection with the waiver request, the FCC found that the company's cost allocation
20 practices were unreliable, based on an extensive investigation. One situation uncovered in the
21 investigation was that Allband assigned to the regulated incumbent local exchange carrier (ILEC)
22 labor costs associated with competitive service offerings outside its incumbent territory. The
23 FCC's expectation in that case was that the company would have directly assigned its labor costs,
24 on a timesheet basis, to nonregulated activities.

25 Because the FCC found Allband's cost studies to be unreliable based on that extensive
26 investigation, it was concerned that Allband might have received excessive federal universal
27 service support for past periods that should be recovered as improper payments. The FCC ordered
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1 USAC to examine Allband’s cost allocations for the period 2012-2015. It provided Allband an
2 opportunity to produce to USAC “detailed breakdowns by percentage of how each category of
3 employee’s time is allocated” to demonstrate its compliance with FCC rules.²¹ Absent this
4 preferred information, the FCC directed USAC to use “alternative methods” to allocate costs
5 between the ILEC and the out-of-region affiliate, including comparisons of line counts between
6 regulated and nonregulated service lines. The FCC found as follows:

7 If information and records (such as service call locations, customer service records
8 and other detailed information sufficient to allocate properly employee time
9 between regulated and nonregulated activities) for this earlier period are not made
10 available for USAC to make this determination within three months of USAC
11 requesting such records and information, USAC may utilize alternative methods to
12 allocate costs between regulated and nonregulated activities, such as allocating
13 costs based on the relative number of [regulated] lines compared to [non-regulated]
14 lines.²²

15 In the unique situation presented in that case, the FCC concluded it could be appropriate to rely on
16 customer counts, but only when the preferred cost assignment information – time records – for the
17 past period 2012-2015 was not available.

18 The *Allband* case is notable for several reasons. First, this was not a case where the
19 regulated venture was selling a tariffed service utilizing the regulated network to its nonregulated
20 venture; the customer count method was to separate costs between incumbent local exchange
21 services and nonregulated services provided outside of the ILEC territory. Second, the case
22 underscores that the FCC’s preferred approach is to use time reporting to directly assign costs.
23 FCC provided the company a full opportunity to correct its time reporting practices, before
24 resorting to the use of customer counts to allocate costs to the out-of-region affiliate. The reason
25 why the FCC concluded it could be appropriate to use line counts to allocate costs between the
26 regulated ILEC and the out-of-region affiliate because it recognized that it could be difficult for
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28 ²¹ *Allband Communications Cooperative Petition for Waiver of Certain High-Cost Universal Service Rules*, Order and Order on Reconsideration, WC Docket No. 10-90, FCC 16-94, para. 23 (rel. July 20, 2016).

²² *Allband Communications Cooperative Petition for Waiver of Certain High-Cost Universal Service Rules*, Order and Order on Reconsideration, WC Docket No. 10-90, FCC 16-94, para. 25 (rel. July 20, 2016).

1 the company to determine in 2016 how employee time should have been properly recorded for
2 past periods (2012-2015). Third, the FCC was focused on determining whether the company had
3 received more federal universal service than it was entitled to in the past, so that it could fulfill its
4 obligation under federal law to recover past improper payments, if any. This case illustrates how
5 rare the use of customer counts would be, and the narrow circumstances in which they could be
6 used.

7 **Q.36. Based on the *Allband* case, wouldn't it be appropriate for the Commission to**
8 **use a subscribership ratio because ORA claims that Sierra could not produce records to**
9 **support its allocations?**

10 A.36. No. As explained in Mr. Baumgarner's testimony, the factual predicate for using
11 alternative allocation methods is not present because Sierra has provided reasonable
12 documentation of its allocation practices, which generally comport with Part 64. The fact that
13 Sierra indicated in January 2017 that it needed additional time to gather, create, analyze and
14 present information to ORA is not surprising. Based on my experience at the FCC, it is common
15 for companies to need some time to respond to data requests from regulators, as they first must
16 extract the relevant information that may be located in multiple documents, systems, or databases,
17 and then must create a new document that synthesizes such information in a manner that is
18 responsive to the data request and does not contain extraneous information.

19 In any event, to the extent that there may be better methodologies for allocating Sierra's
20 expenses, the solution is not to adopt an allocation theory that is not cost-causative, as ORA has
21 proposed. Rather, the better methodology, if available, should be applied. I am not aware of any
22 evidence in this case that Sierra's practices are parallel to what occurred in the *Allband* case. In
23 *Allband*, there was a failure of direct assignment, in the sense that the direct assignments that
24 *Allband* was making to its regulated entity reflected an improper treatment of costs associated with
25 its nonregulated, out-of-area operations. No such fact pattern is involved here. Sierra directly
26 assigns where it can, and where it cannot, it has documented methodologies for allocating
27 "common costs." ORA has not demonstrated anything approaching the level where the
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1 Commission would have to resort to subscribership ratios as a way to assign costs.

2 **Q.37. What would be the impact on Sierra of adopting the ORA proposal?**

3 A.37. My understanding is that adopting the ORA proposal to reallocate expenses based
4 on a ratio of Sierra's customer subscribers would result in approximately a \$2.6 million reduction
5 in Sierra's 2018 intrastate revenue requirement. Sierra no longer would be eligible for a
6 corresponding amount of support from the California High Cost Fund-A. This \$2.6 million cost
7 would be shifted to STI, which could render the operations of that affiliate unprofitable.

8 A private firm whose costs routinely exceed expenses is unsustainable. Any company
9 facing losses year-to-year would need to evaluate what changes are necessary. For broadband
10 Internet access, the largest expense typically is the tariffed transmission purchased out of the
11 NECA tariff, and another significant expense is the cost of transport to the nearest Internet point of
12 presence. Both of these expense categories are generally outside of the control of Sierra's
13 affiliate, as they depend on pricing from third parties needed to reach customers and to reach the
14 Internet. In order to remain profitable, STI therefore would need to raise the rates charged for the
15 nonregulated broadband services, as it would be difficult to cut the affiliate's expenses. Higher
16 prices for broadband, in turn, would likely lead to lower subscribership to those services,
17 particularly in areas where Northland Cable operates, where STI's customers have competitive
18 alternatives for such services.

19 Over time, declining subscribership may make the nonregulated STI venture unprofitable,
20 and Sierra's affiliate presumably would have to evaluate exiting the market for these nonregulated
21 services. That in turn would undermine the FCC's policy objective of ensuring that eligible
22 telecommunications carriers with public interest obligations to offer broadband in fact offer
23 broadband service to rural consumers. The FCC reformed its federal universal service program in
24 2011 in order to advance broadband to all areas of the country, and it would thwart those
25 objectives if Sierra were no longer able to provide these nonregulated services (through its
26 affiliate) because STI is disproportionately sharing the costs with the regulated entity. Moreover,
27 if STI were to cease offering nonregulated broadband services altogether, Sierra would still largely
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1 incur the costs now placed in common cost pools – and all of those costs then would be directly
2 assigned to regulated activities as there would be no nonregulated activities.

3 **Q.38. How does STI compensate the regulated telephone company, Sierra, for the**
4 **use of regulated assets, facilities, and employees?**

5 A.38. STI pays for wholesale broadband transmission service provided by Sierra at the
6 federally tariffed NECA rate. Pursuant to the affiliate transaction rules, this interstate revenue is
7 recorded by Sierra at the tariffed rate. As noted above in my description of the affiliate transaction
8 rules, the FCC’s preferred method of valuing services provided by a regulated company to a
9 nonregulated affiliate is to record such transactions based on a publicly available price, with a
10 tariffed rate the approach to use where available. The tariffed rate for such service reflects the
11 fully distributed cost of providing that regulated broadband transmission service; as such, it
12 compensates the regulated entity not just for the investment in the facility (the wire) but also the
13 plant specific, plant non-specific and customer operations expenses associated with the provision
14 of that wholesale service, and therefore there are no common costs to be allocated. By tariffing
15 this rate, Sierra is legally obligated to sell at this fully compensatory price to any entity, including
16 third parties, not just to its affiliate.

17 **Q.39. Does it benefit consumers for Sierra to offer nonregulated services through an**
18 **affiliate?**

19 A.39. Yes. The fact that Sierra directly assigns and allocates a portion of its corporate
20 operations expenses to nonregulated activities in effect provides an advantage to ratepayers as the
21 regulated company not only sells a regulated service to its affiliate at a compensatory price, but
22 also realizes the efficiencies inherent in sharing common costs in these accounts with a
23 nonregulated affiliate. This result is consistent, and indeed fully contemplated, by the FCC in
24 adopting the cost allocation and affiliate transaction rules. After its experience with complete
25 structural separation, the FCC concluded that there were beneficial effects of allowing telephone
26 companies to provide nonregulated services on an integrated basis, as efficiencies would flow
27 through to ratepayers. If STI were to cease offering these nonregulated services, these efficiencies
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1 would be lost, and many of these costs would need to be fully borne by the regulated entity.

2 **IV. Sierra is Following a Methodology Consistent with the FCC's Part 64 Framework**

3 **Q.40. Is Sierra allocating costs consistent with the FCC's rules?**

4 A.40. Yes. As discussed above, the FCC's preference is to directly assign costs to
5 regulated and nonregulated activities to the extent possible, and Sierra does that. Based on my
6 review of Sierra's cost allocation methodology as applied to common costs at issue, it appears that
7 the company is generally taking a reasonable approach in the procedures adopted to allocate its
8 common costs. The FCC's *Joint Cost Order* made clear the FCC's expectation that carriers
9 should strive to allocate costs based on direct analysis where possible, and then indirect cost
10 causation, and avoid the use of a general allocator to the extent possible.²³ Sierra meets this
11 directive, as Sierra allocates common costs based on direct analysis and indirect cost linkage
12 principles for the most part, and it does not utilize a general allocator for any cost category.
13 Although there are a few discrete areas where its methodology might be improved, as discussed
14 above, the net result of any modifications to the allocation of these specific costs would be minor.
15 While I have not reviewed all of the specific calculations for the accounts at issue, and I have not
16 undertaken any steps to confirm the accuracy of any individual numbers, I can say that the
17 procedures described in Sierra's response to ORA Question 14.3 and the rebuttal testimony of Mr.
18 Baumgarner generally appear to be based on cost causation principles.

19 **V. Public Policy Ramifications of Shifting Costs to Affiliates**

20 **Q.41. What are the adverse consequences of shifting costs to the nonregulated**
21 **affiliate?**

22 A.41. STI would be at a comparative disadvantage to offer alternative broadband
23 platforms such as cellular data, fixed wireless broadband, or cable broadband that may be
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25 ²³ See *Joint Cost Order*, 2 FCC Rcd at 1319, para. 162 ("We believe that a carrier can assign, through the use of a
26 well-designed cost allocation manual, a very high percentage of its costs on a cost causative basis, either directly,
27 through analysis of the origin of the costs themselves, or indirectly, through some logical linkage of cost causation to a
28 directly assigned cost.").

1 available in discrete portions of STI's service territory, if forced to shoulder a disproportionate
2 share of the costs of the regulated entity. Shifting an unreasonable amount of costs to the affiliate
3 would distort competitive markets, a result the FCC expressly sought to avoid in adopting the
4 *Joint Cost Order*.

5 As I discussed above, an unprofitable affiliate is not sustainable, and ultimately could
6 cease to operate. This would deprive STI's customers of the services that the FCC has made one
7 of its core policy priorities – advancing broadband to rural America. If, alternatively, STI must
8 raise its broadband rates to recover these new costs, that likely would have an adverse impact on
9 subscribership, again thwarting a core national public policy objective of advancing broadband
10 adoption.

11 Without broadband, the unemployed cannot apply for jobs online; students cannot do their
12 homework; and people cannot access critical governmental, health and other information. Without
13 broadband, the younger generation may ultimately be unwilling to live in rural communities, and
14 businesses in Sierra's communities will be at a competitive disadvantage vis-a-vis other
15 businesses in California and elsewhere. Broadband is critical to participating in the 21st century
16 economy, and ORA's proposal is at odds with state and federal goals to promote the proliferation
17 of broadband to rural communities.

18 To conclude, my personal opinion is that ORA's proposal is at odds with the FCC's rules
19 and underlying policies regarding the appropriate allocation of costs to regulated and nonregulated
20 activities. This proposal could thwart achievement of important federal and state public policies.

21 **Q.42. Does this conclude your pre-filed rebuttal testimony?**

22 A.42. Yes.

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Attachment A

Curriculum Vitae of Carol E. Matthey

Curriculum Vitae of Carol E. Matthey

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Summary

Seasoned executive with 30+ years of experience formulating, enforcing and advising on federal communications regulation. Deep expertise in developing U.S. policy on telecommunications and broadband issues, combined with field savvy gained from management consulting for private industry clients on business strategy and regulatory compliance matters. Proven success at developing strong relationships with leading business, strategy and regulatory professionals.

Work Experience

Matthey Consulting LLC, Bethesda, Maryland (February 2017–present) Founder and Member

Provide regulatory, strategic and public policy advisory services to broadband providers, non-profit organizations, and other entities active in the telecommunications industry.

Federal Communications Commission, Washington, D.C. Deputy Chief, Wireline Competition Bureau (2010–2017)

Oversaw \$9+ billion federal universal service fund (USF), which provides funding to private sector telecommunications providers, schools, libraries and health care providers to advance congressional objectives for universal communications. Led teams that completed major rulemakings requiring significant changes to all four USF programs to advance broadband, while implementing greater accountability for public use of funding. Worked closely with the Universal Service Administrative Company, the independent, not-for-profit corporation designated by the Federal Communications Commission (FCC) as the administrator for the USF. Maintained productive working relationships with key internal and external stakeholders, including congressional offices, Executive Branch agencies, and state public utility regulators. Represented FCC on Executive Branch inter-agency Broadband Opportunity Council.

Senior Attorney Advisor, Office of Strategic Planning and Policy (2009–2010)

Led development of universal service recommendations in the National Broadband Plan submitted to Congress in March 2010. Briefed congressional staffers on FCC recommendations and developed implementation plan for universal service and intercarrier compensation reform.

Deloitte & Touche LLP, McLean, Virginia (2005–2009) Director

Provided a comprehensive range of consulting services to clients in the technology, media and telecommunications industries, focusing on wireline and wireless operators, cable companies, and private equity firms. Led engagements focused on strategic and operational risks arising from regulation, implementation of new regulatory requirements, and response to regulatory investigations and audits. Assisted clients in developing strengthened internal controls to address compliance with federal regulation. Provided input to clients and multi-disciplinary client account teams on implications of public policy developments on business strategy. Spokesperson for practice on U.S. telecommunications public policy developments. Quoted in leading publications, including *The New York Times*, *The Wall Street Journal*, *The Washington Post*, *BusinessWeek*, *Wired*, Bloomberg, and the Dow Jones Newswire.

Federal Communications Commission, Washington, D.C. Deputy Chief, Wireline Competition Bureau (2000–2005)

Supervised rulemakings, adjudications, and data collection activities of several divisions. Managed ongoing administration of the federal USF. Simplified and streamlined program administration, while strengthening rules to minimize waste, fraud and abuse. Led the Bureau's response to congressional inquiries and General Accountability Office engagements regarding administration of the USF.

Chief, Policy and Program Planning Division, Common Carrier Bureau (1998–2000)
Deputy Chief, Policy and Program Planning Division, Common Carrier Bureau (1994–1998)

Managed various regulatory proceedings stemming from the Telecommunications Act of 1996, including local competition, initial implementation of local number portability, and privacy. Developed landmark framework for Bell entry into long distance market.

National Telecommunications and Information Administration, U.S. Department of Commerce (1989–2004)
Telecommunications Policy Specialist

Developed Administration's position on pending legislation, including predecessors to the Telecommunications Act of 1996, and before the FCC on various communications issues, including cable regulation, spectrum auctions, and the advent of PCS wireless licenses. Led initiative to study privacy requirements in the communications sector and served as NTIA's representative on White House inter-agency task force to address privacy implications of the emerging Internet.

Wilmer, Cutler & Pickering (now known as Wilmer Hale) (1983-1989)
Associate

Represented clients in adjudicatory, rulemaking, and licensing proceedings at the FCC and in commercial and antitrust litigation.

Education

J.D. *cum laude* 1983, University of Pennsylvania, Philadelphia, Pennsylvania
University of Pennsylvania Law Review, Order of the Coif

M.A. 1983, Public Policy Analysis, University of Pennsylvania, Philadelphia, Pennsylvania

B.A. with High Distinction 1979, Urban Studies, University of Virginia, Charlottesville, Virginia
Phi Beta Kappa

Awards

2016 Federal Communications Bar Association Excellence in Government Service Award

2002 Federal Communications Commission Gold Award for Distinguished Service

Professional

Member of the District of Columbia Bar

Member of the Federal Communications Bar Association, serving in the following leadership positions: Executive Committee, 2007-2010; Co-chair, Continuing Legal Education Committee, 2006-2007; Co-chair, IP-Based Communications Practice Committee, 2005-2006; Co-chair, Telecommunications Competition Committee, 2001-2002; Co-chair, Continuing Legal Education Committee, 2000-2001; Co-chair, Common Carrier Committee, 1999-2000; Co-chair, Membership Committee, 1991-1993