

Agenda Date: December 11, 2014
Item Number: A1

Docket: UT-141470

Company Name: Skyline Telecom, Inc.

Staff: Roger Hahn, Regulatory Analyst
Tim Zawislak, Regulatory Analyst
William Weinman, Assistant Director - Telecommunications

Recommendation

The commission enter an order granting the distribution of funds from the state universal communications service program (State USF Program) no later than January 15, 2015, to Skyline Telecom, Inc. (Skyline). The distribution of the funds in the amount of \$49,581 reimburses the company for the cumulative reduction in support from the Federal Communications Commission's (FCC) Connect America Fund (CAF) Phase 1 up through and including the year for which program support is distributed.

I. Background

On June 27, 2013 the Legislature passed bill 2E2SHB 1971 during the Second Special 2013 Legislative Session. The legislation addressed a number of telecommunications issues including a repeal of the sales tax exemption for residential landline phone service and establishment of the State USF Program to be administered by the Washington Utilities and Transportation Commission (commission). The State USF Program is primarily intended to provide direct financial support to Washington's small incumbent Class B telephone companies¹ serving high-cost rural areas of Washington. Financial support from the program is a five year transitional fund designed to offset certain revenue reductions imposed on the small companies as a result of the FCC's order FCC 11-161, commonly known as the FCC Transformation Order.² The commission may distribute an annual amount of \$5 million (less commission administrative costs) to qualifying companies during this transitional period.

On May 22, 2014, the commission issued General Order R-575 in Docket UT-131239 amending and adopting rules in WAC 480-123 to implement the State USF Program established by the legislature. The State USF Program addresses two concerns. First is the temporary replacement support for the elimination of intrastate access rate element or the Traditional USF pool created in Docket U-85-23 and administered by the Washington Exchange Carrier Association (WECA).

¹ Class B companies that are affiliates of CenturyLink are not eligible for state universal communications program funds.

² *Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing a Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility 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, 17694, 17751, paras. 84-85, 238 (2011) (*USF/ICC Transformation Order*).

The second is replacing the cumulative reduction in support the company previously received from the federal CAF disbursements, up through and including the year for which program support is distributed.³

A company is eligible to receive distributions from the State USF Program if the company demonstrates that its financial circumstances are such that its customers are at risk of rate instability, or service interruptions, or cessations absent a distribution to the company that will allow it to maintain local telephone rates that are reasonably close to the benchmark the commission has established.

In determining eligibility the commission will consider the following factors:

- a. The provider's earned rate of return on a total Washington company books and unseparated regulated operations basis;
- b. The provider's return on equity;
- c. The status of the provider's existing debt obligations;
- d. Other relevant factors including, but not limited to, the extent to which the provider is planning or implementing operation efficiencies;
- e. Business plan modifications to transition or expand from primary provision of legacy voice telephone service to broadband service or otherwise reduce its reliance on support from the program.⁴

II. Discussion

Skyline filed its petition, including financial information, on or before August 1 in accordance with the appropriate State USF Program rules. Skyline did not receive Traditional USF pool support because it is only eligible to receive disbursements from the fund replacing the cumulative reduction in support the company received from the federal CAF Phase 1 up through and including the year for which program support is distributed.

Staff determined that the company met the prerequisites for requesting program support, petition requirements and eligibility requirements as stated in WAC 480-123-100, 480-123-110 and WAC 480-123-120.

Staff reviewed the company's Petition, including the financial and operational results of the Petition and has determined that the company meets the requirements of WAC 480-123. Staff finds that the company's Washington total operations rate of return is not excessive.

³ WAC 480-123-120(2)

⁴ WAC 480-123-120(1)

Skyline is affiliated with North-State Telephone Company (North-State) and Oregon Telephone Corporation (Oregon Telephone), both affiliates provide incumbent local exchange telecommunications services in Oregon. The consolidated return on equity both regulated and non-regulated, for Oregon Telephone is 38 percent for the calendar year ended 2013. Although the return on equity is high, staff believes the following factors need to be considered:

- The three operating entities are highly leveraged; their debt is held by Rural Utility Service (RUS) borrowers, and their use of funds is subject to restrictions in their RUS loan covenants. These restrictions require written authorization in advance by the majority of RUS note holders and Bank note holders to loan or extend credit to an affiliated company unless it meets a minimum total asset ratio as defined in the loan covenants. Oregon Telephone does not meet the minimum total asset ratio.
- The three companies are current on both principal and interest payments to RUS.
- Staff has looked at a hypothetical capital structure of 50 percent debt and 50 percent equity. Using that hypothetical capital structure, Oregon Telephone's return on equity is 9 percent.

Skyline filed a supplement to their petition stating that the switches currently serving the Mt. Hull and Silverton exchanges have limited capabilities and the company believes both central office switches need to be replaced or significantly upgraded to ensure quality service is available to their customers. The Company also states that in order to provide acceptable levels of broadband service, both exchanges need fiber cable enhancements to remote switching modules. The project cost for Mt. Hull is \$331,000 and Silverton is \$438,000.⁵ The company plans to make these replacements over multiple years or seek additional financing to replace the facilities.

After reviewing the factors for eligibility, staff believes the Skyline's has demonstrated that its financial circumstances place its customers at risk of rate instability and while the consolidated return on equity is high, the factors causing the high return on equity should not be considered in this instance to deny the company from receiving State USF Program funds during this period.

Skyline is only eligible to receive approximately \$50,000 in 2015 from the State USF Program. In Skyline's supplement, the company proposes that the funds it is eligible to receive be applied to these projects with the monies held in a separate account. Reports would be provided to the commission to demonstrate what the money is spent for and how the money was used to help fund, at least in part, the contemplated projects.

⁵ Staff followed-up with the company regarding its need to replace both switches and how additional financing would be obtained. The company met with the switch manufacturer's representatives and they believe total replacements may not be needed and the lives of the switches can be extended to offer more advanced services through upgrades. The approximate cost of the upgrades is approximately \$150,000 to \$200,000.

Accordingly, staff concludes and recommends that Skyline should be eligible to receive State USF Program support in the amount of \$49,581 and be disbursed to the company in January 2015.

III. Conclusion

The commission should grant the request for funds from the State USF Program in the amount of \$49,581, which, consistent with the commission's rules, reflect the cumulative reduction in support the company received from CAF Phase 1 up through and including the year for which program support is to be distributed. The commission should also require Skyline to deposit funds from the State USF Program in a specific account dedicated to the described projects and provide an accounting of such funds by July 1, 2015, and January 31, 2016.