Agenda Date: November 10, 2016

Item Number: A20

**Docket: UT-160951**

Company Name: Skyline Telecom, Inc.

Staff: Roger Hahn, Regulatory Analyst

 Tim Zawislak, Regulatory Analyst

 Jing Roth, Assistant Director - Telecommunications

**Recommendation**

Issue an order granting the distribution of funds from the state universal communications service program (State USF Program) in the amount of $78,642 to Skyline Telecom, Inc. (Skyline or company) with Conditions:

1. The Commission requires that the company incur $78,642 in capital expenditures during 2017 prior to distributing funds.
2. After the distribution is made, the commission requires that Skyline submits a report no later than January 1, 2018. The report should include cost detail of the funds and a narrative how the expenditures further the goal of the State USF.
3. **Background**

In 2013, the Legislature established 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 companies[[1]](#footnote-1) serving high-cost rural areas of Washington. Financial support from the program is a five year transitional measure designed to offset certain revenue reductions imposed on small companies as a result of discontinuing TUSF and the Federal Communications Commission (FCC) order FCC 11-161, commonly known as the FCC’s USF/ICC Transformation Order.[[2]](#footnote-2) This is the third year of the five year State USF Program. The commission may distribute up to $5 million annually (less commission administrative costs) to qualifying companies during each year of this transitional period.

The State USF Program addresses two concerns. The first is the temporary replacement support for the State TUSF pool eliminated effective July 1, 2014.[[3]](#footnote-3) The second is replacing the annualized cumulative reduction in support the company previously received from the federal CAF-ICC mechanism up through and including the year for which program support is distributed.[[4]](#footnote-4)

Last year, Skyline received State USF program support of $64,484, granted in Docket UT-151526, Order 01, dated December 18, 2015, and was distributed no later than December 28, 2015. The financial results filed in last year’s petition showed that the company’s 2014 total Washington operations earned rate of return (ROR) was 12.9 percent.

1. **Discussion**

Skyline filed its petition, including financial information, on or before August 1 and meets the prerequisites for requesting program support and petition requirements in accordance with State USF Program rules.

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:

1. The provider’s earned ROR on a total Washington company books and unseparated regulated operations basis;
2. The provider’s return on equity (ROE);
3. The status of the provider’s existing debt obligations;
4. Other relevant factors including, but not limited to, the extent to which the provider is planning or implementing operational efficiencies;
5. 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.[[5]](#footnote-5)

Rate of Return Analysis:

For the purpose of granting distribution of funds from the State USF program, a Washington ROR of 10 percent was used and previously accepted by the commission in years one and two of the program as a threshold test to assess the relative earning levels of the petitioning companies in order to evaluate and make eligibility recommendations.[[6]](#footnote-6) Staff performed the following analysis by comparing the yield rates between 1990 and 2015[[7]](#footnote-7) for the following debt instruments to establish that an ROR of 10.00 percent is reasonable.

* The annual yield of 10-year U.S. Treasury securities decreased from 8.55 percent to 2.14 percent.
* Moody’s yield on all industry corporate bonds rated AAA decreased from 9.32 percent to 3.89 percent.
* Moody’s yield on all industry corporate bonds rated BAA changed from 10.36 percent to 5 percent.[[8]](#footnote-8)

Skyline meets the 10.00 percent threshold as its 2015 total Washington ROR decreased from 12.9 percent in 2014 to 9.8 percent as a result of higher expenses and partially offset by increased revenues. The decrease in Skyline’s 2015 ROR was primarily due to the increase in corporate operations expense driven by a consultant contract that the Parent company assumed from an acquired company. Services were used to identify operating efficiencies which included virtualizing network troubleshooting in the company’s two non-contiguous exchanges by installing network servers at each central office eliminating the requirement of a dedicated technician at either location. Staff confirmed the 2015 corporate operations expense level does not require an adjustment to existing high-cost loop and/or interstate common line support mechanisms as required by the FCC. Staff also reviewed year-to-date August 2016 operating expenses (excluding depreciation) to verify that when annualized are back to the lower 2014 levels.

Return on Equity and Debt Analysis:

The second and third factors staff considered are ROE and existing debt obligations.

Staff calculated the consolidated company’s ROE using audited financial statements. Skyline’s Parent is Oregon Telephone Corporation (Oregon Telephone) and its 2015 ROE exceeded 10 percent. The high ROE is driven by significant long-term debt as a result of acquisitions made in 2014. While Oregon Telephone, the parent entity, has an ROE that exceeds 10 percent, Skyline’s ROE is less than 10 percent. Skyline has long-term debt on its books and has an acceptable capital structure.

Staff’s analysis of ROE for the consolidated company enables the commission to consider the overall health of the company (i.e., regulated and nonregulated operations) before allowing the company to participate in the State USF Program.

Operational Efficiencies and Business Plan Modifications:

The goal of the State USF program is to transition from a company’s dependency on voice to broadband services. Staff questions whether the fund of $78,462 will be used in 2017 to accomplish this goal. Staff’s concern is based on the fact that Skyline has not begun to implement its own commitment for a $450,000 project to install a 30 mile aerial fiber build in the Silverton exchange. In its petition filed last year in Docket UT-151526, the company indicated that this project is dependent upon a new meet-point arrangement with Frontier Communications Northwest, Inc. (Frontier) and will require additional long-term financing. Nothing has happened. To date, there is no arrangement made between the company and Frontier. The company has postponed the $450,000 project that was originally budgeted for the year of 2016 and such delay could affect anticipated capital expenditures in 2017.

1. **Conclusion**

Staff concludes and recommends that Skyline receive State USF program support in the amount of $78,462 with conditions. The support shall not be released to the company until it has incurred $78,462 in capital expenditures during 2017. After the program funds are distributed, the commission requires that Skyline submits a report no later than January 1, 2018. The report should include cost detail of the funds and a narrative how the expenditures further the goal of the State USF.

1. Class B companies that are affiliates of CenturyLink are not eligible for state universal communications program funds. [↑](#footnote-ref-1)
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*).  [↑](#footnote-ref-2)
3. Skyline is not eligible for TUSF funding [↑](#footnote-ref-3)
4. WAC 480-123-120(2) [↑](#footnote-ref-4)
5. WAC 480-123-120(1) [↑](#footnote-ref-5)
6. The FCC’s 11.25 percent authorized rate of return was last set in 1990 when it was reduced from 12.00 percent. *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, Order, 5 FCC Rcd 7507 (1990) [↑](#footnote-ref-6)
7. On March 30, 2016, the FCC released the Rate-of-Return Reform Order which implemented a transitional approach to reducing the 11.25 percent rate of return. Effective July 1, 2016 the authorized rate of return was reduced to 11.00 percent and will be reduced 25 basis points each July 1 until reaching 9.75 percent on July 1, 2021. *Connect America Fund et al.,*WC Docket Nos 10-90 er al., Report and Order and Further Notice of Proposed Rulemaking, Report and Order, Order and Order on Reconsiderations, and Further Notice of Proposed Rulemaking, FCC 16-33 (rel. Mar. 30. 2016). [↑](#footnote-ref-7)
8. Source: Federal Reserve Board: H 15 Release – Selected Interest Rates – Historical Data; http://www.federalreserve.gov/releases/h15/data.htm

 [↑](#footnote-ref-8)