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Ellensburg Telephone Company
Discussion of Revenue Requirements

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The Changing Telecom Environment

- The traditional telecom ILEC operating environment is much different now than it was 10 -15 years ago. While continuing to bear the responsibility of Provider of Last Resort/Carrier of Last Resort requirements, incumbent ILECs currently experience much more competition in the marketplace from wireless providers, traditional cable TV providers and Competitive Local Exchange Companies (CLECS), none of which have the same regulatory burdens as ILECs.

Technology

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- Technology has also changed which has caused a reduction in traditional capital expenditures resulting in lower investment due to decreased costs of COE equipment and outside plant equipment. Stimulus grants and other aid to construction projects have also had an effect on reducing rate base.

- These changes have also led to the need to drive further efficiencies into operations as well as reducing overall expense. Reduced numbers of access lines due to competition and competitive pricing on broadband service as well as less expensive special access delivery has also reduced revenues.

Changes

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- These changes require a different way of determining support for incumbent rural telecom companies striving to compete while being required to deal with regulatory requirements and rapidly changing technology.
- Price Cap Carriers, like FairPoint, have already been moved to "model" support on the federal side in the form of the Connect America Fund (CAF). Traditional Rate-of-Return carriers are also being considered for elective model support under the Alternative Connect America (ACAM) Model being implemented by the FCC.
- States have to consider changing their means of determining support as well.

Traditional Revenue Requirement

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- Using traditional rate-of-return on rate base earnings review methods, Ellensburg's latest year results shows a 22% return on rate base, which exceeds its authorized rate of return.
- However, these results are skewed because Plant in Service is more than 90% depreciated, resulting in artificially low annual depreciation expense and net rate base.
- Mass asset accounting methods for regulated depreciation contributes to the problem because once a company has fully depreciated an asset category it tends to fully write off each year's capital additions. This is because mass asset depreciation is based on plant in service amounts. While depreciation expense is high in one annual period, it is fully used up and not recognized in subsequent periods making an annual review of rate base regulation even less meaningful.

Traditional Rate Base Regulation does not provide adequate Revenue

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- The Supreme Court, in Hope Natural Gas, explains that utilities are entitled to recover their expenses plus a return adequate to cover interest expense and investor return sufficient to attract capital.
  - *"[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. Chicago & Grand Trunk R. Co. v. Wellman, 143 U.S. 339, 345-346. By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 291 (Mr. Justice Brandeis concurring)."*

Changes in Competition and Technology require a Modified Approach to Revenue Requirement

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- When Ellensburg was investing in rate base due to growing customer demand, service quality improvements and technology changes, traditional rate-of-return regulation made sense because depreciation expense and net rate base produced reasonable revenue requirement calculations.
- With depreciation artificially reduced and rate base near zero, these calculations do not produce sufficient return to cover capital costs. They barely cover annual Capital Expenditures.

Traditional Revenue Requirements

Ellensburg Telephone Company		
Traditional Earnings Review		
Most Recent Year		
Regulated Revenue		11,496,000
Expenses		
Cash Operating Exp.	7,490,000	
Depreciation Exp.	1,525,000	
Other Tax Exp.	329,000	
Income Taxes	694,000	
Total Expenses		10,038,000
Net Income (Return after Taxes)		1,458,000
Rate Base		
Plant in Service	76,690,000	
Depreciation Reserve	(72,008,000)	
Other Rate Base Items	1,738,000	
Net Rate Base		6,420,000
Return on Rate Base		23%
Excess Earnings		
Revenue Requirement at 8%		10,894,000
Revenue		11,496,000
Excess Earnings		602,000

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An Alternative Approach

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- Ellensburg's Revenue Requirements can be set on a more forward-looking basis. This makes sense since a forward-looking basis is what the FCC has developed for the Connect America Fund (CAF).

- If depreciation expense were calculated as though no asset categories are fully depreciated, annual depreciation expense would be $6,485,000.

- If net rate base were calculated as though depreciation reserves are set at a more forward-looking basis, such as at 60%, then Net Rate Base would be $47,752,000.

- Using normalized depreciation calculations to determine revenue requirements that produce sufficient Return for FairPoint's capital costs shows a revenue deficiency of nearly $10 million.

Ellensburg Telephone Company

Ellensburg Telephone Company			
Forward Looking Earnings Review			
Most Recent Year			
Regulated Revenue			11,496,000
Expenses			
	Cash Operating Exp.	7,490,000	
	Depreciation Exp.	6,485,000	
	Other Tax Exp.	329,000	
	Income Taxes	694,000	
Total Expenses			14,998,000
Net Income (Return after Taxes)			(3,502,000)
Rate Base			
Plant in Service		76,690,000	
Depreciation Reserve		(30,676,000)	
Other Rate Base Items		1,738,000	
Net Rate Base			47,752,000
Return on Rate Base			-7.33%
Revenue Deficiency			
	Revenue Requirement at 8%		21,364,933
	Revenue		11,496,000
	Revenue Deficiency		(9,868,933)

Conclusion

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- Traditional Rate-of-return regulation, carried to an extreme, produces revenue requirements equal to cash operating expenses, which are clearly insufficient to provide funding for capital expenditures, pay interest on bonds and attract capital.
- Therefore, an alternate approach to development of "revenue requirement" is necessary.
- Ellensburg has demonstrated one approach using normalized depreciation expenses and reserves. Regardless of how this is approached, it is clear the existing revenues are insufficient to meet the Supreme Court description of the amount of earnings Ellensburg can have the opportunity to earn which allow it to attract capital, make investment and be a viable competitor.

Docket UT-151600

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- In Docket UT-151600 Ellensburg Telephone demonstrated a revenue deficiency of $407,243 resulting from a transition from traditional high cost support to Connect America Fund (CAF) support. Ellensburg is requesting State USF funding in 2016 of $390,481 which will be used for specific projects not funded by CAF II. These investments will bring more robust broadband service which will make Ellensburg and the State of Washington more competitive and more attractive for residential and business customers.

- Under the CAF Program, FairPoint has been awarded $1,321,014 annually for 6 years for the state of Washington. FairPoint will have to put up additional, internally generated, CAPEX in order to reach the 3191 locations required by the FCC. These locations will receive 10/1 Mbps broadband service. State USF funding will allow areas not economically feasible, and not covered by CAF funding to receive this same level of service.