Agenda Date: November 13, 2015
Item Number: A20

**Docket: UT-151600**

Company Name: Ellensburg Telephone Company dba FairPoint Communications

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

## Recommendation

Issue an order denying the petition of Ellensburg Telephone Company dba FairPoint Communications (Ellensburg or company) to receive eligible support from the state universal communications services program (State USF).

## I. 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] 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 discontinuing the state Traditional Universal Service Fund (TUSF) pool and the Federal Communications Commission (FCC) order FCC 11-161, commonly known as the FCC's USF/ICC Transformation Order.[2] This is the second 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] The second is replacing the annualized cumulative reduction in support the company previously received from the federal Connect America Fund Intercarrier Compensation (CAF-ICC) mechanism up through and including the year for which program support is distributed.[4]

Last year Ellensburg received State USF Program support of $313,127, granted in Docket UT-143022, Order 01, dated December 11, 2014, and distributed on January 15, 2015. The financial

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[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*).

[3] Ellensburg is not eligible for TUSF funding.

[4] WAC 480-123-120(2)

results filed in last year's petition showed that the company's 2013 total operations rate of return (ROR) exceeded 10.00 percent but was less than the FCC's 11.25 percent authorized ROR. The company then filed a supplement to its petition describing how program support would be spent on capital expenditure projects which would transition it from legacy voice telephone service to broadband service. The commission granted the request for funds, but required Ellensburg to deposit the funds in a specific account dedicated to the projects described in Docket UT-143022 and provide an accounting of the use of the funds by July 1, 2015, and a final report by January 31, 2016. The company provided a report to staff complying with the accounting of the funds dedicated to the projects by July 1, 2015.

## II. Discussion

Ellensburg 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 the appropriate 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.

The commission considers the following factors to determine eligibility:

a. The provider's earned ROR 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 operational 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.[5]

Staff used a total Washington earned ROR of 10.00 percent as a threshold test to assess the relative earning levels of the petitioning companies in order to evaluate and make eligibility recommendations. If a company's ROR is greater than 10.00 percent staff also considered the other State USF program factors.

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[5] WAC 480-123-120(1)

It is important to note that the FCC's current 11.25 percent authorized ROR was last set in 1990[6] when it was reduced from 12.00 percent. The FCC's currently allowed ROR of 11.25 percent is pending review by the FCC.[7] Absent an FCC decision, staff also compared the yield rates of 1990 and 2014 for the following debt instruments to establish reference points 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 2.54 percent.

- Moody's yield on all industry corporate bonds rated AAA decreased from 9.32 percent to 4.16 percent.

- Moody's yield on all industry corporate bonds rated BAA changed from 10.36 percent to 4.85 percent.[8]

Staff reviewed the financial results included in the petition and found that the company's Washington 2014 total operations ROR exceeded 21.00 percent.[9] The increase in ROR between 2013 and 2014 is due primarily to operating income increasing as a result of expenses decreasing 12.9 percent. Table 1 of the Attachment provides company financial trends between 2012 and 2014 with rate base and depreciation expense trending downward.

After staff's initial examination of a company's ROR, staff considered other factors in order to determine whether a company is eligible to receive any USF distribution. Staff reviewed the parent company's, FairPoint Communications (FairPoint), consolidated return on equity and debt obligations. Ellensburg is a subsidiary of FairPoint which emerged from Chapter 11 bankruptcy proceedings on January 24, 2011. FairPoint's consolidated total long-term debt was $908 million as of the end of 2014.[10] FairPoint's total stockholders' equity at the end of 2014 had a deficit balance resulting in a negative consolidated return on equity of all business units, both regulated and non-regulated.[11]

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[6] *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, CC Docket No. 89-624, Order, 5 FCC Rcd 7507 (1990)

[7] *Prescribing the Authorized Rate of Return*, *Wireline Competition Bureau Staff Report*, DA 13-1111, concludes that the commission should consider establishing the authorized rate of return between 8.06 percent and 8.72 percent.

[8] Source: Federal Reserve Board: H 15 Release – Selected Interest Rates – Historical Data; http://www.federalreserve.gov/releases/h15/data.htm

[9] If Ellensburg's Washington 2014 total operations ROR had been 10.00 percent or less it would receive disbursements of $407,243 from the fund replacing the annualized cumulative reduction in support the company received from the federal CAF-ICC mechanism up through and including the year for which program support is distributed.

[10] FairPoint Communications Inc. and Subsidiaries Consolidated Balance Sheet per the 2014 10-K Annual Report, pages 62 - 64. Ellensburg Telephone does not have any long term debt on its balance sheet.

[11] FairPoint Communications Quarterly 10-Q report for the period ended June 30, 2015, reported a positive total stockholders' equity balance resulting from the elimination of post-employment healthcare benefits for active employees effective August 28, 2014 and termination of the plan effective January 1, 2015. This reduced the benefit obligation and a corresponding prior service credit of $619.4 million recognized in accumulated other comprehensive income, pages 18 – 19.

Staff also considered implemented operating efficiencies and business plan modifications meant to transition the company from voice telephone to broadband service. The company began this transition with the use of last year state USF funds for the initial launch of VoIP services. In addition, Ellensburg accepted CAF-II funds in August 2015 totaling approximately $6.4 million over the next 6 years which will be used to provide broadband service to over 2,300 supported household and business locations. The acceptance of CAF-II funds will gradually replace the current frozen high-cost support received and eventually reduce the company's overall annual federal support revenue by approximately $500,000 after a four-year transition period. However, even if the reduction in annual support of $500,000 was to occur immediately; the company's Washington ROR would still remain in excess of 11.25 percent. Table 2 of the Attachment shows the amount of gross revenue decrease required to achieve either an 11.25 percent or a 10.00 percent ROR.

Staff believes that the company is transitioning from its dependency upon voice service revenue to broadband services as demonstrated by its initial launch of VoIP services and acceptance of federal CAF-II funds. However, staff cannot overlook an ROR of 21.00 percent in 2014 and 2013 which exceeded 10.00 percent.

Based on the discussion and the analysis of all relevant information, staff believes customers are not at risk of rate instability, or service interruptions or cessations, and that the company has not demonstrated a need for distribution from the fund.

## III. Conclusion

Staff recommends the commission should issue an order denying the company's petition request for eligible funds from the State USF Program.

Attachment