

ORIGINAL

MEMORANDUM



0000004984

RECEIVED

30A

TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division

2004 MAY 26 A 11:42

AZ CORP COMMISSION
DOCUMENT CONTROL

DATE: May 25, 2004

RE: IN THE MATTER OF THE APPLICATION OF COMPUTER NETWORK TECHNOLOGY CORPORATION FOR A CERTIFICATE OF CONVENIENCE AND NECESSITY TO PROVIDE RESOLD LONG DISTANCE, FACILITIES-BASED LOCAL AND RESOLD LOCAL EXCHANGE SERVICES IN ARIZONA AND PETITION FOR COMPETITIVE CLASSIFICATION OF PROPOSED SERVICES WITHIN THE STATE OF ARIZONA (DOCKET NO. T-04221A-03-0832)

Attached is the Amended Staff Report for the above referenced application. The Applicant is applying for approval to provide the following services:

- Private Line Service

Staff is recommending approval of the application.

/ajl

Originator: Adam Lebrecht

Attachment: Original and Ten Copies

Arizona Corporation Commission
DOCKETED

MAY 26 2004

DOCKETED BY	
-------------	--

SERVICE LIST FOR: Computer Network Technology Corporation
DOCKET NO. T-04221A-03-0832

Michael Pattan
Roshka Heyman & DeWulf, PLC
One Arizona Center
400 East Van Buran Street, Suite 800
Phoenix, Arizona 85004

Robert K. Lock
Windfall Resources International, LLC
7144 North Harlem Avenue, Suite 323
Chicago, Illinois 60631

Mr. Ernest G. Johnson
Arizona Corporation Commission
Utilities Division
1200 West Washington
Phoenix, Arizona 85007

Mr. Christopher C. Kempley
Arizona Corporation Commission
Legal Division
1200 West Washington
Phoenix, Arizona 85007

Ms. Lyn Farmer
Chief Administrative Law Judge
Arizona Corporation Commission
Hearing Division
1200 West Washington
Phoenix, Arizona 85007

AMENDED STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

COMPUTER NETWORK TECHNOLOGY CORPORATION

DOCKET NO. T-04221A-03-0832

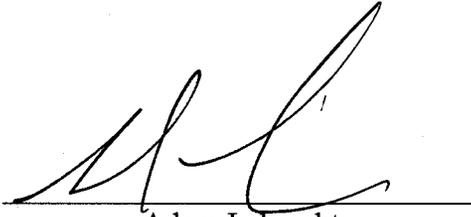
IN THE MATTER OF THE APPLICATION OF COMPUTER NETWORK
TECHNOLOGY CORPORATION FOR A CERTIFICATE OF CONVENIENCE AND
NECESSITY TO PROVIDE RESOLD LONG DISTANCE, FACILITIES-BASED
LOCAL AND RESOLD LOCAL EXCHANGE SERVICES AND PETITION FOR
COMPETITIVE CLASSIFICATION OF PROPOSED SERVICES WITHIN THE
STATE OF ARIZONA

TABLE OF CONTENTS

	PAGE
1. Introduction.....	1
2. The Application for a Certificate of Convenience & Necessity	1
2.1 Description of the Geographic Market to be Served	1
2.2 Description of Requested Services	2
2.3 The Organization	2
2.4 Technical Capability to Provide the Requested Services	2
2.5 Financial Capability to Provide the Requested Services	2
2.6 Establishing Rates and Charges	2
3. Provision of Basic Telephone Service and Universal Service.....	3
4. Review of Complaint Information	3
5. Competitive Services Analysis	3
5.1 Competitive Services Analysis for Local Exchange Services	4
6. Recommendations.....	5
6.1 Recommendations on the Applicant's Application For a CC&N	5
6.2 Recommendation on the Applicant's Petition to Have Its Proposed Services Classified as Competitive.....	6
7. Private Line Service.....	6

STAFF ACKNOWLEDGMENT

The Amended Staff Report for Computer Network Technology Corporation, Docket No. T-04221A-03-0832, was the responsibility of the Staff member listed below. Adam Lebrecht was responsible for the review and analysis of the application for a Certificate of Convenience and Necessity to provide private line service and its petition for a determination that its proposed services should be classified as competitive.

A handwritten signature in black ink, appearing to be 'AL', written over a horizontal line.

Adam Lebrecht
Executive Consultant I

1. INTRODUCTION

On November 17, 2003, Computer Network Technology Corporation ("CNTC" or "Applicant") filed an application for a Certificate of Convenience and Necessity ("CC&N") to provide resold long distance, resold local exchange and facilities-based local exchange services within the State of Arizona. In addition, the Applicant petitioned the Arizona Corporation Commission ("Commission") for a determination that its proposed services should be classified as competitive.

On March 9, 2004, a Staff Report was filed based on the initial application. However, on April 27, 2004, the Applicant amended its application. In this amendment, the Applicant stated that it will not be providing resold long distance, resold local exchange or facilities-based local exchange services (See "Attachment A"). Instead, the Applicant intends to provide only private line service on an individual case or contract basis ("ICB"). Because private line services are tailored to meet individual customer's demands, the Applicant indicated its rates will be determined on an ICB.

Staff now files an Amended Staff Report, in which Staff reviewed the amended application as indicated in Attachment A. This review addresses the overall fitness of the Applicant to receive a CC&N to provide private line service only. Staff's analysis also considers whether the Applicant's services should be classified as competitive and if the Applicant's initial rates are just and reasonable.

Private line service is a direct circuit or channel specifically dedicated to the use of an end user organization for the purpose of directly connecting two or more sites in a multisite enterprise. Private line service provides a means by which customers may transmit and receive messages and data among various customer locations over facilities operated and provided by the Applicant. The Applicant is therefore engaged in providing telecommunications service for hire to the public, which fits the definition of a common carrier and a public service corporation. Staff believes the Commission has jurisdiction over the services to be provided by CNTC. Staff also believes a hearing is necessary.

2. THE APPLICATION FOR A CERTIFICATE OF CONVENIENCE & NECESSITY

This section of the Amended Staff Report contains descriptions of the geographic market to be served by the Applicant, the requested services, and the Applicant's technical and financial capability to provide the requested services. In addition, this section contains the Staff evaluation of the Applicant's proposed rates and charges and Staff's recommendation thereon.

2.1 DESCRIPTION OF THE GEOGRAPHIC MARKET TO BE SERVED

CNTC seeks authority to provide private line services throughout the State of Arizona.

2.2 DESCRIPTION OF REQUESTED SERVICES

CNTC proposes to provide only private line service. Private line service is a direct circuit or channel specifically dedicated to the use of an end user organization for the purpose of directly connecting two or more sites in a multisite enterprise. CNTC indicated that its private line service would be used by business customers for the purposes of transferring data.

2.3 THE ORGANIZATION

CNTC is incorporated under the laws of the State of Minnesota and has authority to transact business in Arizona.

2.4 TECHNICAL CAPABILITY TO PROVIDE THE REQUESTED SERVICES

CNTC reported that it currently has a staff of 1200 employees of which its management has over 50 years of total combined experience in the telecommunications industry and private line services. CNTC has indicated that it has engaged the services of the consulting firms 20-20 Technologies ("20-20") and Windfall Resources International, LLC ("Windfall"). CNTC reported that when combined, the employees of 20-20 and Windfall have over 200 years of combined experience in the telecommunications industry. Based on the above, Staff believes CNTC possesses the technical capabilities to provide the services it is requesting the authority to provide.

2.5 FINANCIAL CAPABILITY TO PROVIDE THE REQUESTED SERVICES

The Applicant did provide financial statements for the twelve months ending January 31, 2004. The Applicant indicated that these financial statements were audited. These financial statements list current assets in excess of \$412 million; total equity in excess of \$142 million; and a net loss in excess of \$24 million. The Applicant did provide notes related to the financial statements.

2.6 ESTABLISHING RATES AND CHARGES

The Applicant would initially be providing service in areas where an incumbent local exchange carrier ("ILEC"), along with various competitive local exchange carriers ("CLECs") and interexchange carriers are providing telephone and private line services. Therefore, the Applicant would have to compete with those providers in order to obtain subscribers to its services. The Applicant would be a new entrant and would face competition from both an incumbent provider and other competitive providers in offering service to its potential customers. Therefore, the Applicant would generally not be able

to exert market power. Thus, the competitive process should result in rates that are just and reasonable.

Staff obtained information from the company indicating that its fair value rate base is zero. Accordingly, the company's fair value rate base is too small to be useful in a fair value analysis. In addition, the rate to be ultimately charged by the company will be heavily influenced by the market. Therefore, while Staff considered the fair value rate base information submitted by the company, it did not accord that information substantial weight in its analysis.

3. PROVISION OF BASIC TELEPHONE SERVICE AND UNIVERSAL SERVICE

The Commission has adopted rules to address the level of funding for universal telephone service during and after the transition to a competitive telecommunications services market. The rules contain provisions for non-basic local exchange and interexchange carriers as they relate to the Arizona Universal Service Fund ("AUSF"). Under the rules, the Applicant will be required to contribute to the AUSF and may be eligible for AUSF support. Therefore, Staff recommends that approval of the application for a CC&N be conditioned upon the Applicant's agreement to abide by and participate in the AUSF mechanism established in R14-2-1204(B)(3)(b).

4. REVIEW OF COMPLAINT INFORMATION

Consumer Services reports no complaint history within Arizona.

The Applicant indicated the following:

1. There have not been any civil or criminal proceedings against the Applicant;
2. There have not been any formal complaint proceedings involving the Applicant;
3. The Applicant has not had an application for service denied or revoked in any state;
4. None of the Applicant's officers, directors or partners have been involved in any civil or criminal investigations;
5. None of the Applicant's officers, directors or partners have been convicted of any criminal acts in the past ten (10) years.

5. COMPETITIVE SERVICES ANALYSIS

The Applicant has petitioned the Commission for a determination that the services it is seeking to provide should be classified as competitive. Staff's analysis and recommendations are discussed below.

5.1 COMPETITIVE SERVICES ANALYSIS FOR PRIVATE LINE SERVICES

5.1.1 A description of the general economic conditions that make the relevant market for the service one that is competitive.

Interexchange carriers ("IXCs") hold a substantial share of the private line service market. Also, a number of ILECs and CLECs have been authorized to provide private line service. The Applicant will be entering the market as an alternative provider of private line and, as such, the Applicant will have to compete with several existing companies in order to obtain customers.

5.1.2 The number of alternative providers of the service.

IXCs are the primary providers of private line service in the State. Several ILECs and CLECs also provide private line service.

5.1.3 The estimated market share held by each alternative provider of the service.

IXCs hold a substantial share of the private line market. ILECs and CLECs likely have a smaller share of the private line market.

5.1.4 The names and addresses of any alternative providers of the service that are also affiliates of the telecommunications Applicant, as defined in A.A.C. R14-2-801.

None

5.1.5 The ability of alternative providers to make functionally equivalent or substitute services readily available at competitive rates, terms and conditions.

IXCs have the ability to offer the same services that the Applicant has requested in their respective service territories. Similarly, many of the ILECs and CLECs offer substantially similar services.

6. RECOMMENDATIONS

The following sections contain the Staff recommendations on the application for a CC&N and the Applicant's petition for a Commission determination that its proposed services should be classified as competitive.

6.1 RECOMMENDATIONS ON THE APPLICATION FOR A CC&N

Staff recommends that the application for a CC&N to provide private line service, as listed in Section 2.2 of this Report, be granted. In addition, Staff recommends the following:

1. That the Applicant be required to notify the Commission immediately upon changes to the Applicant's name, address or telephone number;
2. That the Applicant comply with all Commission rules, orders, and other requirements relevant to the provision of intrastate telecommunications service;
3. That the Applicant maintain its accounts and records as required by the Commission;
4. That the Applicant file with the Commission all financial and other reports that the Commission may require, and in a form and at such times as the Commission may designate;
5. That the Applicant maintain on file with the Commission all current tariffs and rates, and any service standards that the Commission may require;
6. That the Applicant cooperate with Commission investigations including, but not limited to, customer complaints;
7. That the Applicant abide by and participate in the AUSF mechanism established in R14-2-1204(B)(3)(b);
8. Staff obtained information from the company indicating that its fair value rate base is zero. Accordingly, the company's fair value rate base is too small to be useful in a fair value analysis. In addition, the rate to be ultimately charged by the company will be heavily influenced by the market. Therefore, while Staff considered the fair value rate base information submitted by the company, the fair value information provided should not be given substantial weight in this analysis;
9. The Applicant should be ordered to file an application with the Commission pursuant to A.A.C. R14-2-1107, if the Applicant desires to discontinue service. The Applicant should be required to notify each of its private line service

customers and the Commission 60 days prior to filing an application to discontinue service;

10. That the Applicant be subject to the Commission's rules and the 1996 Telecommunications Act to the extent that they apply to Private Line Service Carriers.

Staff further recommends that the Applicant be ordered to file conforming tariffs for its CC&N to provide private line service within 365 days from the date of an Order in this matter or 30 days prior to providing service, whichever comes first, and in accordance with the Decision.

6.2 RECOMMENDATION ON THE APPLICANT'S PETITION TO HAVE ITS PROPOSED SERVICES CLASSIFIED AS COMPETITIVE

Staff believes that the Applicant's proposed services should be classified as competitive. There are alternatives to the Applicant's services. The Applicant will have to convince customers to purchase its services, and the Applicant has no ability to adversely affect the local exchange, interexchange or private line service markets. Therefore, the Applicant currently has no market power in the local exchange, interexchange or private line service markets where alternative providers of telecommunications services exist. Staff therefore recommends that the Applicant's proposed services be classified as competitive.

7. PRIVATE LINE SERVICE

Private line service is a direct circuit or channel specifically dedicated to the use of an end user organization for the purpose of directly connecting two or more sites in a multisite enterprise. Private line service provides a means by which customers may transmit and receive messages and data among various customer locations over facilities operated and provided by the Applicant. The Applicant is therefore engaged in providing telecommunications service for hire to the public, which fits the traditional definition of a common carrier and a public service corporation. Staff is recommending approval of CNTC's application to receive a CC&N to provide private line service in Arizona.

If, in the future, CNTC wishes to provide telecommunications service(s) different from those addressed in this application, Staff recommends that an application be filed concerning the type of CC&N sought.

COPY

ATTACHMENT A



AZ CORP COMMISSION
DOCUMENT CONTROL

2004 APR 27 1 A 9: 24

RECEIVED

Mr. Adam Lebrecht
Arizona Public Service Commission

April 26, 2004

RE: Computer Network Technology Corporation application for Certificate of Public Convenience and Necessity to provide telecommunications services in the State of Arizona

Dear Adam:

I am responding to the requests of the Arizona Public Service Commission for additional information regarding the application of Computer Network Technology Corporation (CNT) for a Certificate of Public Convenience and Necessity to provide telecommunications services in the State of Arizona.

While CNT has applied for resale and facilities based authority, in its initial market entry, and for the foreseeable future, CNT will restrict itself to the provision of private line point to point and point to multi-point high speed data services. These services will be marketed to existing customers of CNT's data storage and management products and services. CNT will not be offering voice grade services at the present time, and will not be using the public switched telephone network to provide its data services. Please regard this letter as a formal request to amend the original application for CPCN filed by CNT with the Commission.

I hope that this answers any questions that the Commission may have with respect to CNT's application, and I am available to discuss any aspect of this matter.

Respectfully,

Robert K Lock

Arizona Corporation Commission

DOCKETED

APR 27 2004

DOCKETED BY	<i>[Signature]</i>
-------------	--------------------

7144 North Harlem Avenue
 Suite # 323
 Chicago, Illinois 60631
 (773) 631-0064
 BLOCK@windfallintl.com
 www.windfallintl.com

Item 8. Consolidated Financial Statements and Supplementary Data

COMPUTER NETWORK TECHNOLOGY CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	January 31,	
	2004	2003
Assets		
Current assets:		
Cash and cash equivalents	\$ 75,267	\$ 98,341
Marketable securities	2,219	111,143
Receivables, net	99,815	56,040
Inventories	29,976	24,091
Other current assets	4,400	2,118
Total current assets	211,677	291,733
Property and equipment, net	40,313	22,566
Field support spares, net	11,951	6,009
Deferred tax asset	872	—
Goodwill	105,203	14,113
Other intangibles, net	33,225	1,669
Other assets	9,140	3,079
	\$412,381	\$339,169
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	\$ 47,696	\$ 16,889
Accrued liabilities	43,733	25,060
Deferred revenue	47,058	19,340
Current installments of obligations under capital lease	1,619	708
Total current liabilities	140,106	61,997
Convertible subordinated debt	125,000	125,000
Deferred tax liability	—	541
Obligations under capital lease, less current installments	4,468	—
Total liabilities	269,574	187,538
Shareholders' equity:		
Undesignated preferred stock, authorized 965 shares; none issued and outstanding	—	—
Series A junior participating preferred stock, authorized 40 shares; none issued and outstanding	—	—
Common stock, \$.01 par value; authorized 100,000 shares; issued and outstanding 27,501 at January 31, 2004, and 26,921 at January 31, 2003	275	269
Additional paid-in capital	187,652	173,955
Unearned compensation	(319)	(675)
Accumulated deficit	(46,999)	(22,946)
Accumulated other comprehensive income	2,198	1,028
Total shareholders' equity	142,807	151,631
	\$412,381	\$339,169

COMPUTER NETWORK TECHNOLOGY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Years Ended January 31,		
	2004	2003	2002
Revenue:			
Product sales	\$239,839	\$145,355	\$129,276
Service fees	121,038	66,160	57,747
Total revenue	360,877	211,515	187,023
Cost of revenue:			
Cost of product sales	143,992	89,110	76,254
Cost of service fees	72,262	38,210	37,328
Total cost of revenue	216,254	127,320	113,582
Gross profit	144,623	84,195	73,441
Operating expenses:			
Sales and marketing	88,396	57,849	52,156
Engineering and development	42,719	26,872	23,452
General and administrative	16,073	10,694	9,311
In-process research and development	19,706	—	—
Goodwill impairment	204	—	—
Restructuring charge	—	1,666	996
Total operating expenses	167,098	97,081	85,915
Loss from operations	(22,475)	(12,886)	(12,474)
Other income (expense):			
Write-down of investment	—	(1,000)	—
Loss on sale and write-down of webMethods stock	—	—	(10,283)
Net gain on sale of marketable securities	747	—	—
Interest income	1,609	6,183	6,166
Interest expense	(4,435)	(4,326)	(285)
Other, net	411	12	(344)
Other income (expense), net	(1,668)	869	(4,746)
Loss from continuing operations before income taxes	(24,143)	(12,017)	(17,220)
Provision (benefit) for income taxes	625	16,527	(5,292)
Loss from continuing operations	(24,768)	(28,544)	(11,928)
Discontinued operations:			
Gain on disposition of discontinued operations, net of tax	—	—	8,222
Income from discontinued operations, net of tax	715	207	—
	715	207	8,222
Net loss before cumulative effect of change in accounting principle	(24,053)	(28,337)	(3,706)
Cumulative effect of change in accounting principle	—	(10,068)	—
Net loss	\$ (24,053)	\$ (38,405)	\$ (3,706)
Basic and diluted income (loss) per share:			
Continuing operations	\$ (.91)	\$ (1.02)	\$ (.40)