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ARIZONA CORPORATION COMMISSION

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DATE: August 8, 2001

DOCKET NO: T-02532A-00-0512

TO ALL PARTIES:

Enclosed please find the recommendation of Assistant Chief Administrative Law Judge Dwight D. Nodes and Administrative Law Judge Stephen Gibelli. The recommendation has been filed in the form of an Opinion and Order on:

MIDVALE TELEPHONE EXCHANGE, INC.
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

AUGUST 17, 2001

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

AUGUST 28 AND 29, 2001

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.

Arizona Corporation Commission
DOCKETED
AUG 0 8 2001
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BRIAN C. McNEIL
EXECUTIVE SECRETARY

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE, INC. FOR AUTHORITY TO INCREASE RATES AND FOR DISBURSEMENT FROM THE ARIZONA UNIVERSAL SERVICE FUND	DOCKET NO. T-02532A-00-0512 DECISION NO. ____________ **OPINION AND ORDER**

DATE OF HEARING:	May 21, 2001
PLACE OF HEARING:	Phoenix, Arizona
PRESIDING JUDGE:	Mr. Stephen Gibelli and Mr. Dwight Nodes[1]
APPEARANCES:	Mr. Conley Ward, GIVENS PURSLEY, L.L.P. and Ms. Tamara Herrera, RYLEY, CARLOCK & APPLEWHITE, on behalf of Midvale Telephone Exchange, Inc.; Mr. Todd C. Wiley, GALLAGHER & KENNEDY, on behalf of Citizens Communications Companies; Ms. Theresa Dwyer, FENNEMORE CRAIG, on behalf of Qwest Corporation; and Ms. Maureen A. Scott, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

On July 17, 2000, Midvale Telephone Exchange, Inc. ("Company" or "Midvale") filed with the Arizona Corporation Commission ("Commission") an application for authority to increase rates and for disbursement from the Arizona Universal Service Fund ("AUSF"). On August 2, 2000 Qwest Corporation ("Qwest") filed a Motion to Intervene. On August 11, 2000, the Commission's Utilities Division Staff ("Staff") filed a letter indicating the Company's rate application was sufficient and classifying the Company as a Class A utility. On August 15, 2000, by Procedural Order, Qwest was granted intervention. On August 28, 2000, a Procedural Order was issued setting the matter for

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[1] Mr. Stephen Gibelli presided over the pre-hearing conference and Mr. Dwight Nodes presided over the hearing. This Opinion and Order was prepared by Mr. Stephen Gibelli.

hearing on April 19, 2001. On January 24, 2001, Citizens Communications Companies ("Citizens") filed Motion to Intervene. On January 25, 2001, Staff and Midvale filed a Motion to Extend the Procedural Schedule due to Discovery Issues. By Procedural Order issued on February 1, 2001, the hearing was continued until May 21, 2001. On May 8, 2001, Citizens was granted intervention by Procedural Order.

The matter came before a duly authorized Administrative Law Judge of the Commission at the Commission's offices in Phoenix, Arizona on May 21, 2001. Midvale, Qwest, Citizens, and Staff appeared through counsel. At the conclusion of the hearing, the matter was adjourned pending submission of simultaneous initial and reply briefs on July 2, and July 13, 2001, respectively.

DISCUSSION

I. NATURE OF CASE

Midvale is an Idaho corporation authorized to do business in Arizona since 1989. Midvale provides service to approximately 2,000 subscribers in ten rural exchanges in Idaho, Oregon, and Arizona.

In its application, Midvale is seeking an increase in rates for its current customers. Midvale's existing rates were established in Decision No. 58736 (September 1, 1994). Midvale's application is based on a test year ("TY") ending December 31, 1999.

Midvale seeks an extension of its Certificate of Convenience and Necessity ("Certificate") to provide service to the Millsite and Silver Bell exchanges. Midvale also proposes that it receive AUSF funds and be allowed to offer extended area service ("EAS") from Midvale's Cascabel exchange to Qwest's Benson and San Miguel exchanges.

II. EXTENSION OF CC&N

As part of its application, Midvale is proposing to establish service in two separate areas that currently lack any wireline service. The Millsite exchange will include four contiguous subdivisions located about 15 miles south of Prescott, plus the Henderson Valley Ranch subdivision located north of the Millsite area, about 15 miles east of Prescott. The Silver Bell exchange will serve an area about 50 miles southwest of Phoenix including the Silver Bell, Sawtooth, and Rio Verde subdivisions. Over the next three years, Midvale expects the Millsite exchange to serve about 200 customers and the Silver Bell exchange to serve about 185 customers.

Staff is in support of the extension of Midvale's Certificate into the Millsite and Silver Bell exchanges.

Many customers in the proposed extension areas filed letters or provided public comment in support of Midvale's proposal to serve the Millsite and Silver Bell exchanges. Currently no telecommunications company is serving the areas. No telecommunications company has shown as much interest in serving the areas as much as Midvale has. The residents in the area have been without local telephone service and Midvale is a suitable entity to serve the area. Midvale's proposal to extend its Certificate to serve the Millsite and Silver Bell exchanges is reasonable and in the public interest and should be approved.

III. EXTENDED AREA SERVICE

As part of its application, Midvale requests authorization to offer EAS between the Cascabel exchange and the towns of Benson and San Manual. EAS is a service offered in a geographic area beyond the local service area to which traffic is classified as local for selected customers. It allows subscribers in one exchange to call subscribers in another exchange without a toll charge.

Although the Commission has no rule or regulation on the issue of when EAS is appropriate, in Decision No. 58927 (January 3, 1995), the Commission discussed a process to determine if there is a "community of interest" in EAS. In that case, Staff recommended that the Commission "consider calling volumes, socio-economic linkages, contiguity and public input as factors in determining whether a community of interest exists." (Id.) Staff also suggested in that docket that a community of interest may be present if at least 10 percent of the customers in the exchange or 200 customers, whichever is less, have submitted a petition to the Commission. The purpose behind those recommendations was to determine whether or not consumers want the service. Once that was determined, then cost and rate design issues were considered.

In this case, Midvale has not submitted a petition on behalf of residents in the Cascabel exchange indicating an interest in EAS. In support of its application, Midvale states that the towns of Benson and San Manuel have a "strong community of interest" with Cascabel and that its studies show that there is sufficient voice traffic to support extending the local calling area.[2] However, Qwest's studies demonstrate that fewer than two percent of its customers in the Benson and San Manuel exchanges called Cascabel in the months studied. (Rook Direct pg. 7). In addition, only 20 percent of Midvale's customers make a majority of the calls from Cascabel to Benson and San Manuel. (Buckalew Direct pg. 19).[3]

Staff recommends that Midvale's request to offer EAS should be denied. Staff points out that Midvale has not provided any socio-economic studies that would demonstrate that there is a "community of interest" between the exchanges for which EAS is proposed. In addition, Staff also notes that all consumers in Arizona would be paying for the service. Staff believes that to ask all Arizona consumers to finance these two EAS routes when only 20% of Midvale's customers make the majority of calls, is unreasonable.

As part of its application, Midvale is seeking AUSF funding, in the amount of $40 a month per customer, to fund its EAS proposal. This AUSF funding is paid for by all Arizona consumers who would, in essence, be subsidizing the EAS service. Staff believes that when considering the small percentage of customers who would benefit by EAS, it is not justifiable for all Arizona customers to subsidize the service when it is not necessary and there are reasonable alternatives such as less expensive toll plans.[4]

Citizens and Qwest both contended that Midvale's EAS proposal does not fully consider the potential for EAS fraud or bridging. EAS bridging is a form of illegal arbitrage whereby a company uses a combination of a line, call forwarding services, and possibly its own equipment to complete calls between two or more overlapping EAS areas in order to avoid paying toll or access charges. Midvale's proposal would result in local calling between San Manuel and Cascabel and Cascabel and Benson since the local calling areas of Benson and San Manuel will overlap into Cascabel. An EAS bridger could subscribe to local flat rated access lines in Cascabel and use call forwarding services to

[2] Midvale stated that Cascabel customers make 8.5 calls per line per month to Benson and 2.5 calls per line per month to San Manuel (Reading Direct pg. 22, see Exhibit 6, schedule 1).
[3] Qwest has concluded that less than 2% of its customers in San Manuel and Benson called Cascabel. (Rook Direct pg. 7).
[4] Staff has pointed out that Cascabel customers already have less costly alternatives to call Benson and San Manuel. Cascabel, Benson, and San Manuel are all in the same LATA, and Qwest offers 10 cents per minute, 24 hours, 7 days a week for residential customers. (Buckalew Direct pg. 20).

forward calls between Benson and San Manuel, allowing customers in those exchanges to avoid toll charges.

Other states have spent a great amount of effort to shut down illegal EAS bridging and Midvale's EAS proposal invites EAS bridging in Arizona. There was no evidence presented to show that such bridging is currently happening in Arizona. However, illegal bridging is a legitimate concern and will require a great effort to shut down once it has begun in Arizona.

Midvale has failed to demonstrate that its EAS proposal is necessary and reasonable at this time. Midvale has failed to provide sufficient evidence demonstrating that there is "strong community of interest" in support of EAS. Weighing this fact, the additional costs to Arizona consumers, and the added threat of EAS bridging against the small number of customers who would benefit, we find that Midvale's proposal is not reasonable or appropriate at this time. However, we agree with Qwest and Citizens that there are no rules in Arizona governing the review of EAS proposals. Other jurisdictions have established such rulemaking dockets for the purpose of developing standards for EAS proposals. We shall therefore open up a rulemaking docket to clarify the Commission's EAS requirements. This rulemaking docket should address, at a minimum, such issues as (1) how "community of interest" should be defined; (2) the significance of call volumes; (3) whether a customer petition should accompany a proposal; (4) how companies can recover the cost of EAS; and (5) how the potential for illegal EAS bridging should be evaluated.

IV. RATE BASE

In its application, the Company proposed an intrastate original cost rate base ("intrastate OCRB") of $1,807,096. Staff proposed adjustments which resulted in an intrastate OCRB of $1,244,841. Staff made five adjustments to the rate base proposed by the Company, prior to separation for intrastate items.

A. Plant in Service

The Company proposed a Plant in Service balance of $4,135,313, including both intrastate and interstate plant, compared to Staff's proposed balance of $3,042,091. Staff's proposed intrastate Plant in Service balance is $1,945,021.

Staff made five adjustments reducing the plant balances proposed by the Company. Staff removed four Pro Forma additions related to unserved areas proposed by the Company. The proposed additions were for land, plant, and equipment to serve the unserved areas. In total, Staff removed $1,087,603 in plant additions for the unserved areas. Staff states that it consistently does not allow Pro Forma plant in OCRB since it is not "used and useful" nor "known and measurable."

Staff also reduced the Public Telephone Equipment account for the Young exchange by $5,619 as a result of an April 1997 decision by the Federal Communications Commission deregulating pay telephones. Midvale has agreed to Staff's adjustments pertaining to Public Telephone Equipment. We concur.

Staff's adjustments resulted in a total decrease of $1,093,222 from the Company's proposed plant in service balance, resulting in a recommended amount of $3,042,091. After separation of the intrastate and interstate plant, Staff recommends an original cost plant in service of $1,945,021.

It is a fundamental rate making concept that revenues and expenses must be "known and measurable" before they are recognized in a ratemaking context. The pro forma adjustments proposed by Midvale are not "known and measurable." The plant has not yet been built. The costs are based solely on estimates and to include them in rate base would violate traditional ratemaking concepts. Therefore, we adopt Staff's adjustments to disallow Midvale's pro forma adjustments to plant in service.

B. Accumulated Depreciation

Midvale's application reflects an Average Accumulated Depreciation of $1,167,196 for the TY ending December 31, 1999, which includes $373,775 for the Cascabel exchange and $793,421 for the Young exchange. Staff recommends a decrease in Accumulated Depreciation of $224,220, resulting in Staff's proposal of $942,976 which includes Staff's recommended intrastate Accumulated Depreciation balance of $600,581.

For the Cascabel exchange, Staff reduced the amount of Accumulated Depreciation by $9,195. Staff's adjustment was based on the depreciation expense for each year sinc inception in August of 1993 through the end of the test year. Staff took the proposed Accumulated Depreciation at December 31, 1999 of $404,849 and averaged the balance with the Accumulated Depreciation balance as of December 31, 1998 ($324,311). Staff recommends an Average Accumulated

Depreciation balance of $364,580 for the Cascabel exchange.

For the Young exchange, Staff reduced the Company's proposed Accumulated Depreciation by $215,025, from $793,421 to $578,396. Staff calculated the Accumulated Depreciation at $514,326 and then averaged the December 31, 1999 balance with the Accumulated Depreciation balance as of December 31, 1998 to arrive at an Average Accumulated Depreciation of $578,396.

Altogether, Staff recommends a decrease in Accumulated Depreciation of $224,220 from the Company proposed amount of $1,167,196, resulting in Staff's calculated amount of $942,976. After applying in the intrastate factor of 63.69 percent, Staff recommends an intrastate Accumulated Depreciation balance of $600,581.

In its Rebuttal testimony, the Company accepted Staff's adjustments to the Accumulated Depreciation balances (Reading Rebuttal pg. 7).

Staff's adjustments to Accumulated Depreciation and corresponding changes to Average Accumulated Depreciation and the calculation of the intrastate Accumulated Depreciation are reasonable. We therefore adopt Staff's adjustments to Accumulated Depreciation.

C. Rate base summary

Intrastate Rate base (per Midvale)	$1,807,096
Intrastate Commission-approved adjustments	($565,255)
Intrastate Rate Base (per Commission)	$1,241,841

Midvale did not file any reconstruction cost new rate base amounts. Therefore, we find the above-described OCRB to be the adjusted Fair Value Rate Base ("FVRB") for the TY.

V. OPERATING INCOME

In its application, Midvale indicates that its total company TY operating revenues were $1,258,613 prior to intrastate separation. Staff's adjustments resulted in a recommended decrease of $170,988 for a Staff recommended operating revenue of $1,087,625. After adjustments for interstate revenues, Staff's recommended TY intrastate operating revenues are $730,428.

A. Local Service Revenues

Midvale proposes a TY amount of $172,369 for local service revenues and a pro forma adjustment to increase the amount by $81,599 to reflect Midvale's estimated revenues from serving the unserved areas, resulting in total adjusted local service revenues of $253,968.

Staff believes that the inclusion of the estimated revenues of $81,599 from the unserved areas is not appropriate because the estimated revenues are not "known and measurable."

We concur and adopt Staff's recommendation of $172,369 for local service revenues.

B. Network Access Service Revenues

In its application, Midvale included TY total company network access service revenues of $563,821. Midvale proposes a pro forma adjustment of $17,190 to reflect its removal of access revenue associated with its EAS request. Midvale is also seeking a pro forma adjustment to increase this amount by $120,908 as a result of estimated revenues expected from the unserved areas. Midvale's total network access revenues prior to intrastate adjustments amount to $667,539.

Staff rejected both of Midvale's proposed pro forma adjustments. Based upon its rejection of Midvale's EAS proposal, Staff also rejected the $17,190 revenue adjustment. Staff also rejects Midvale's pro forma adjustment to increase revenues based on estimated revenues from the unserved areas because they are not "known and measurable."

Since we are not adopting Midvale's EAS proposal, Midvale's proposed $17,190 adjustment should also not be adopted. In addition, Midvale's proposal to increase revenues based on estimates from unserved areas is not appropriate because the revenues are not "known and measurable." Therefore, we adopt Staff's recommended amount of $563,821 for network access service revenues prior to intrastate adjustments. After intrastate adjustments, Midvale's network access service revenues are $206,624.

C. Interstate Universal Service Fund Revenues

In its application, Midvale included $107,050 of TY universal service fund revenues. Midvale proposes a pro forma adjustment to increase this amount by $221,824 for the total company as a result of increased funding due to the lifting of federal caps on universal service funds. Midvale also proposes a pro forma adjustment to decrease these revenues by $15,687 as a result of loss of funding due to its EAS request. Midvale's total proposed universal service fund revenues are $313,187.

Staff agrees with Midvale's adjustment as a result of the lifting of universal service fund caps, but disagrees with Midvale's pro forma decrease of $15,687 for the loss of funding due to the EAS request.

Staff's adjustments are reasonable and should be adopted. Consistent with our determination on Midvale's EAS proposal, it is not appropriate to grant Midvale's pro forma adjustment for its loss of universal service funding. As a result, we adopt Staff's figure of $328,874 for universal service fund revenues.

D. Miscellaneous Revenues

In its application, Midvale includes $22,081 as its TY miscellaneous revenues. Midvale made a pro forma adjustment increasing these revenues by $2,073 to include estimated revenues expected from the unserved areas.

Staff recommends decreasing intrastate miscellaneous revenues by $2,073 since these estimated revenues are not "known and measurable."

We agree that estimated revenues are not "known and measurable" and therefore adopt $22,081 for Midvale's miscellaneous revenues.

E. Uncollectible Revenues

In its application, Midvale proposes TY uncollectible revenue of $1,279 and made a pro forma adjustment increase of $715 to include estimated uncollectible revenue from the unserved areas.

Staff rejected the inclusion of estimated revenues from the unserved areas since they are not "known and measurable." We concur.

F. Operating Revenues Summary

Midvale Total Company Operating Revenues as Filed	$1,258,613
Commission-approved adjustments	
Local Service Revenues	($81,599)
Network Access Service Revenues	($103,718)
Interstate USF	$15,687
Miscellaneous	($2,073)
Uncollectibles	$715
Total Company Operating Revenues (per Commission)	$1,087,625
Midvale Intrastate Operating Revenues (per Commission)	$730,428

G. Plant Specific Expenses

Midvale TY plant specific expenses are $127,720 for the total Company. Midvale proposed a pro forma adjustment increasing this amount by $27,462 for estimated expenses for the unserved areas.

Staff opposes Midvale's pro forma adjustments since they are not "known and measurable" as they are related to the unserved areas. Staff proposes plant specific total Company expenses of $127,720 which amounts to a total of $82,035 after the separation of interstate expenses.

Consistent with our exclusion of pro forma adjustments to revenues, we will exclude the corresponding pro forma adjustments to expenses. We concur with Staff's recommended intrastate plant specific expenses of $82,035.

H. Other Plant Expenses

Midvale's proposed TY amount is $62,925 for the total Company. Midvale proposes a pro forma adjustment increasing the amount by $21,595 to reflect its request to include estimated expenses from the unserved areas.

Staff disagrees with Midvale's pro forma adjustment since the expenses from the unserved areas are not "known and measurable." Staff proposed a total Company amount of $62,925. Staff proposes intrastate Other Plant Expenses of $82,035 to reflect intrastate expenses.

We concur with Staff and adopts Staff's proposed figure of $82,035 for intrastate Other Plant Expense.

I. Depreciation Expense

Midvale increased its TY Depreciation Expense of $186,282 by $101,161 to reflect its request to include estimated Depreciation Expense from the unserved areas.

Staff disallowed Midvale's pro forma adjustment since the expenses are not "known and measurable." Staff also determined that Midvale's current depreciation rates should be adjusted to better reflect plant lives. As a result of Staff's removal of Midvale's pro forma adjustment and the new depreciation rates, Staff proposes a Depreciation Expense of $236,039. After the removal of interstate Depreciation Expense, Staff recommends intrastate Depreciation Expense of $140,844.

Midvale concurs with Staff's proposed depreciation rates. We adopt Staff's proposed depreciation rates and Staff's proposal to not include expenses related to unserved areas. As such, Midvale's intrastate Depreciation Expense is determined to be $140,844.

J. Customer Operations Expense

Midvale proposed TY Customer Operations Expenses of $96,131 for the total Company. Midvale proposed a pro forma adjustment to account for expenses related to the unserved areas in the amount of $20,968.

Staff rejected Midvale's proposal since these expenses are related to the unserved areas and are not "known and measurable." As such, Staff determined Midvale's Customer Operations Expense to be $96,131 and $72,531 for intrastate Customer Operations Expense.

We concur with Staff's recommended intrastate Customer Operations Expense figure of $72,531.

K. Corporate Operations Expense

Midvale proposes a pro forma adjustment to increase the TY Corporate Operations Expense by $56,051 for the total Company to reflect its request to include estimated expenses from the unserved areas. Midvale also proposes a pro forma adjustment to increase this amount by $40,000 for the total Company to reflect its estimated rate case expenses for this proceeding. Midvale's proposed total Company Corporate Operations Expense is $350,931.

Staff opposes Midvale's proposal to include $56,051 in estimated expenses related to unserved areas since they are not "known and measurable." Staff also opposes Midvale's estimate of $149,000 for rate case expenses. Staff argues that $41,601 of the rate case expense are engineering costs which are related to the CC&N extension and are not related to the rate case. Staff recommends $60,000 for rate case expense amortized over three years. Staff is therefore recommending intrastate Corporate Operations Expense of $186,149.

Midvale claims in this case that "the biggest single factor in this expenditure has been the cost of responding to the Staff's discovery requests. All told, the Staff served a total of six rounds of written discovery on the Company, totaling more than 115 questions...." (Williams Rebuttal 5-6). In addition, Qwest and Citizens did intervene and serve discovery requests on Midvale. We find that it is reasonable to amortize $90,000 in rate case expense over a three-year period, and concur with Staff's exclusion of the $56,051 for the unserved areas.

L. Property Taxes and Other Taxes

According to its application, Midvale's TY Property Taxes and Other Taxes are $81,282 for the total Company. Midvale proposes a pro forma adjustment to increase this amount by $9,103 for the total Company to include estimated taxes for the unserved areas.

Staff opposes Midvale's pro forma adjustment to TY Property Taxes and Other Taxes since it believes that the estimated taxes from the unserved area are not "known and measurable." As a result, Staff is recommending $81,282 in Property Taxes and Other Taxes for the total Company which amounts to $51,630 in intrastate Property Taxes and Other Taxes.

We concur.

M. Miscellaneous (Interest Expense)

In its application, Midvale has listed its TY Miscellaneous (Interest Expense) as $25,107 for the total Company. Midvale is proposing a pro forma adjustment to increase this amount by $55,023 to reflect additional Miscellaneous (Interest Expense) for the unserved areas.

Staff disagrees with Midvale's proposal. Staff opposes the inclusion of any interest expense in the calculation of operating income since it is considered a "below the line" item. As such, Staff has eliminated all Miscellaneous (Interest Expenses) from Midvale's proposal and is recommending a zero balance. Staff opposes Midvale's pro forma adjustment to increase Miscellaneous (Interest Expense) for the unserved areas since these expenses are not "known and measurable."

Staff's recommendations are reasonable and should be adopted. Interest Expenses are "below the line" and are not included in the calculation of Operating Income. As such, Staff's recommendations shall be adopted.

N. Federal and State Income Tax

In its application, Midvale did not cite any Federal or State Income Taxes. According to Staff, Midvale's general ledger shows TY intrastate Federal and State Income Tax of negative $3,040. It is Staff's position that income tax expense should be calculated based on the adjusted jurisdictional revenues and expenses. Staff calculated the TY income tax liability using the Arizona jurisdictional revenues and expenses. Staff is recommending increasing intrastate federal and state income tax by $43,577. We concur.

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O. Statement of Net Operating Income

Total Company Operating Revenues	$1,087,625
Operating Expenses (per Application)	$1,165,690
Commission-approved Adjustments	
Plant Specific Expenses	($27,462)
Other Plant Expenses	($21,595)
Depreciation Expense	($51,404)
Customer Operations Expense	($20,968)
Corporate Operations Expense	($66,051)
Property Taxes and Other Taxes	($9,103)
Miscellaneous (Interest Expense)	($80,130)
Federal and State Income Tax	$43,577
Total Operating Expenses	$932,554
Total Company Net Operating Income	$155,071
Net Intrastate Operating Income	$113,439

VI. RATE OF RETURN

Witnesses from Staff and Midvale presented cost of capital analyses to be considered as evidence by the Commission in determining a fair value rate of return for purposes of these proceedings.

A. Capital Structure

Midvale's actual capital structure at December 31, 1999 and the configurations recommended by the parties are as follows:

	12/31/99	Midvale	Staff
Short-Term Debt	0.00%	1.8%	0.00%
Long-Term Debt	20.0%	22.2%	22.6%
Common Equity	80.0%	76.0%	77.4%

The difference between Midvale and Staff's proposed capital structures is due to Midvale's inclusion of $37,695 in Short-Term Debt in its capital structure. Staff disagreed with Midvale's inclusion of this Short-Term Debt since it has not been included in Midvale's capital structure since 1997, indicating that short-term debt does not appear to be a permanent method of financing. We concur.

B. Cost of Debt

Midvale proposes a weighted cost of short and long-term debt of 5.51 percent. Staff recommends that a cost of long-term debt of 5.47 percent be adopted. This represents the cost rates on Midvale's Rural Telephone Finance Cooperative and Rural Utility Services loans. This is the same cost of debt proposed by Midvale after accounting for Staff's removal of the $37,695 in short-term debt.

During the hearing, Midvale agreed that Staff's removal of the $37,695 in short-term debt was proper. We concur.

C. Cost of Equity

Midvale proposed a cost of equity of 13.0 percent. Midvale used three distinct methodologies to determine its cost of equity. Midvale used a Discounted Cash Flow ("DCF") analysis, a risk premium analysis, and a comparable earnings method. Midvale believes that the Commission should focus on the mid-range of its estimates which is 10.9 percent to 12.25 percent for the DCF method, 11.0 percent to 12.25 percent for the risk premium analysis, and 12.0 to 14.0 percent for the comparable earnings approach.

Midvale's DCF analysis analyzed market data from Regional Bell Operating Companies to arrive at a midpoint of 11.58 percent. Midvale estimated the cost of equity capital for other major telecommunications carriers at 10.9 to 12.25 percent.

Midvale also used a risk premium approach which is intended to measure the additional return required by investors for bearing the additional risk. Midvale used market returns and yields on three-month Treasury Bills reported by the Federal Reserve. Midvale's risk premium approach resulted in a midpoint of 11.63 percent.

In using the comparable earnings method, Midvale analyzed the returns of a wide range of firms in both the industrial and telecommunications sectors reflecting data for over 900 companies. Midvale then considered the full spectrum of information concerning returns earned in the unregulated sectors and concluded that the average opportunity cost of equity capital to a typical unregulated firm is in the neighborhood of 12.5 to 14.5 percent.

Staff proposed an 11.50 percent cost of equity. Staff arrived at this proposal based on its analysis which used comparable earnings, DCF and Capital Asset Pricing Model ("CAPM") methodologies. Staff selected five publicly traded telecommunications companies in its analysis. Staff's comparable earnings method resulted in historic earned returns ranging from 24.3 to 26.7 percent which it claims was skewed by U S WEST's reported return on equity of 199.7 and 130.8 percent for 1998 and 1999 respectively.

Staff's DCF analysis, using combinations of spot and average stock prices and earnings, dividend and sustainable growth, produced results ranging from 4.6 to 16.5 percent. Staff believes that its DCF analysis using earnings growth with the average and spot stock price were both 11.8 percent. Staff believes these results to be the most reasonable.

Staff also considered the CAPM results which reflected the average holding periods of investors. Staff's CAPM analysis resulted in cost of equity of 12.0 to 12.6 percent. Staff then factored in a beta of 0.60 to reflect a lower risk for Midvale as a company providing regulated telecommunications services.

Staff is recommending a cost of equity of 11.50 percent for Midvale. Staff's recommendation is based upon the result of Staff's DCF analysis which produced a cost of equity of 11.80 percent. Staff then adjusted this calculation downward to account for what Staff believes is Midvale's decreased financial risk related to its Arizona capital structure as well as Midvale's risk as compared to the earnings of the companies analyzed in the comparable earnings approach which are from unregulated, competitive operations.

While Midvale has risks which may be less than those associated with unregulated, competitive carriers, Midvale has risks inherent to a small rural carrier providing service to less than 2,000 total customers, 638 of which are in Arizona. A small rural exchange carrier may face a greater risk from increased telephone competition than does a larger provider. Therefore, we do not agree with Staff's proposal to decrease its DCF analysis. A cost of equity of 11.80 percent is reasonable for a carrier such as Midvale and we want to encourage such carriers to extend service to rural unserved areas.

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D. Cost of Capital

	Percentage of total	Cost	Composite Cost
Total Long Term Debt	22.6	5.47%	1.24%
Total Equity	77.4	11.80%	9.13%
			10.37%

VII. GROSS REVENUE CONVERSION FACTOR

Midvale initially proposed a gross revenue conversion factor of 1.6762 in its application. Staff proposed a gross revenue conversion factor of 1.7652 as a result of changes to federal and state tax rates. Midvale agrees with Staff's proposed gross revenue conversion factor of 1.7652. We therefore adopt a gross revenue conversion factor of 1.7652.

VIII. AUTHORIZED INCREASE

With the adjustments adopted herein, the adjusted TY operating income is $113,439. Further, the 10.37 percent cost of capital is a reasonable rate of return on FVRB as authorized hereinabove. Applying the 10.37 percent rate of return by the FVRB of $1,241,841 produces required net operating income of $129,090. This is $15,651 more than Midvale's TY adjusted operating income. Multiplying the shortfall by the revenue conversion factor of 1.7652 results in an increase in revenues of $27,627.

IX. RATE DESIGN

A. New Service Territory

In its application, Midvale proposes basic single-line residence and business rates for the new exchanges at $24.00 for basic residence and $32.00 for business. Midvale proposes to equalize all of its rates as set forth above. Midvale is basing its rates on the combination of its projected costs from the new service territory as well as its existing costs from serving the Young and Cascabel exchanges.

Staff proposes local exchange rates for the new service territory of $24.00 for residential customers and $30.00 for business customers. Staff based its recommendation on the initial cost projections filed by Midvale using a rate of return on rate base of 10.37% and an estimated 278 lines for the unserved areas. Staff is proposing slightly higher charges for the extension areas based on the higher costs of serving this area.

Midvale's proposed rates are reasonable and will allow the Company a fair rate of return on its investment. These rates are based on projected costs and, therefore, will need to be revisited in the future. At that time, a determination can be made if Midvale is entitled to receive AUSF funding. While the Commission normally charges existing rates in extension areas, in this case the projected cost of serving the unserved areas exceeds the average cost of providing local service in the other exchanges. We concur with Staff's proposed residential rate of $24.00 and with Midvale's proposed business rate of $32.00.

B. Young and Cascabel Exchanges

As discussed above, Midvale proposes to standardize its rates for all of its Arizona customers. Midvale proposes rates of $24.00 for residential customers and $32.00 for business customers. At present, Cascabel's local exchange rates are $21.00 for both residential and business customers. For the Young exchange, the rates are $12.40 for residential customers, plus zone charges, and $32.00 for business customers. In addition, Midvale proposes to reduce its intrastate access charges in both exchanges to $.06 per minute.

Staff believes that the rates for the Millsite and Silver Bell exchanges should be slightly higher to reflect the higher cost of serving those areas. Staff proposed residential rates of $17.15 for the Young exchange and $21.00 for the Cascabel exchange. Staff also proposes business rates of $30.00 for both exchanges. Staff opposes Midvale's proposal to decrease access charges. Staff believes that the higher access charges will help compensate Midvale for the higher cost of serving these two exchanges.

If Midvale's proposed rate design is adopted, the residential rates for the Young exchange would increase 94 percent, while the increase for the Cascabel residential rate would increase only 14 percent. While it is desirable to standardize Midvale's rates for the entire state of Arizona, moving to such a standardization at this time would create a rate shock to those residential customers in Young. In fact, on March 7, 2001 residents of Young circulated a petition signed by 206 customers opposing Midvale's proposed 94 percent rate increase. The petition states that many of the residents of Young are low income, retired, or on disability. We believe it is appropriate to adopt the lower staff rate design recommendation. After adjusting for higher allowances for rate case expense and return on equity than that recommended by Staff, we will adopt residential rates of $18.60 for the Young exchange and $22.50 for the Cascabel exchange (See Exhibit A). We agree with Staff that the reduction in access charges is not necessary or warranted at this time.

C. Custom Calling

As part of its application, Midvale seeks to consolidate custom calling with its local exchange rates. Custom calling includes such features as call waiting, call forwarding, three-way calling, speed calling and fixed calling. Midvale states that the demand for these services in the Cascabel exchange is low.

Staff is opposed to Midvale's custom calling proposal. Staff states that custom calling is not a part of basic local exchange service and should have a separate price. Staff also believes that demand may be low due to the current rates being charged. Currently the rates for all of these services combined totals about $15.50. Staff proposes a rate of $2.00 for custom calling which it believes will encourage greater usage of the custom calling feature. We concur.

X. ARIZONA UNIVERSAL SERVICE FUNDING

As part of its application, Midvale seeks to become a member of the Arizona Universal Service Fund ("AUSF") and proposes to begin drawing from the fund. Midvale is seeking to draw funds from the AUSF to cover the costs involved in serving the currently unserved areas of Millsite and Silver Bell. Midvale expects that 200 customers will ultimately be served in the Millsite exchange and approximately 185 customers will be served in the silver Bell exchange. Midvale estimates that it will need to invest approximately $1.45 million to serve these areas and the Company requests $221,306 annually from the AUSF for its proposal to serve these areas (Ex.S-4, at 11).

Staff recognizes that the Commission has been seeking a solution to the problem of rural unserved areas. The Commission has asked Arizona telephone companies to serve these rural areas but Staff concedes that this goal has achieved little success (Transcript pg. 125). Midvale states that "the goal of universal service is to make telephone service as pervasive as possible and to 'make available, directly or indirectly, the funds necessary to accomplish such a policy'" (Midvale Brief pg.

11-12 citing Morton I. Hamburg & Stuart N. Broadman, *Communications Law and Practice* §5.01(1) (1998). However, the current Commission rules require that, prior to receiving AUSF funds, a company's costs should not be estimated [5] and that a company should already be providing service *prior* to seeking AUSF funds.[6] In this case, Midvale has submitted estimated costs for plant and equipment to serve the Millsite and Silver Bell exchanges. Midvale has not begun providing service and has no current "embedded costs."

Contrary to Midvale's claims, the Commission's AUSF rules require more than hypothetical costs in order to qualify for AUSF. As indicated above, the rules contemplate that the area in question is already being *served* and that the cost of providing service be calculated based on the *embedded* costs of the carrier. As Staff points out, embedded costs are generally recognized as historical or "sunk" costs, as opposed to pro forma or estimated costs that are based on estimated or anticipated data. This interpretation of the Commission's rules is consistent with the FCC's requirement (absent the granting of a waiver) that the requesting carrier must have facilities in place for two years prior to receiving FUSF funding. This process enables the FCC to base the release of high cost funding on fully embedded facilities.

In addition, the Commission's rules require that AUSF funding is to be provided "net of any universal service support from federal sources" (A.A.C. Rule 14-2-1202.A.). This rule clearly intends AUSF to supplement FUSF and, implicitly, that federal funding should be pursued as the primary source of high cost support rather than AUSF being provided as a precursor to FUSF funding.

Staff's analysis of the costs to provide service to Millsite and Silver Bell concludes that those areas can be served with little or no support from the AUSF. However, until the plant is in service, the costs will be unknown. Staff recommended that the rates for Millsite and Silver Bell be set based on Midvale's estimated costs, which Staff calculated as $24.00 for residential customers and $30.00

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[5] R14-2-1202(A) states "The amount of AUSF support to which a provider of basic local exchange service is eligible for a given AUSF support area shall be based upon the difference between the benchmark rates for basic local exchange telephone service provided by the carrier, and the appropriate cost to provide basic local exchange telephone service as determined by the Commission, net of any universal service support from federal sources."

[6] R14-2-1202(B) states in relevant part "For a small local exchange carrier, the AUSF support area shall include all exchanges *served* by the local exchange carrier in Arizona. The appropriate cost of providing basic local exchange telephone service for purposes of determining AUSF support for a small local exchange carrier shall be the *embedded* cost of the incumbent provider (emphasis added)."

for business customers. Staff points out that Midvale currently receives $328,874 per year in FUSF support, which equates to $43.50 per access line per month averaged over Midvale's existing access lines (Staff Brief at 14). Based on this calculation, Staff conservatively assumed that Midvale would receive approximately half that amount ($21.50 per month) for new customers in the Millsite and Silver Bell exchanges. Staff concluded that the initial local residential exchange rate should be set at $24.00 to cover all expenses for providing service to these areas.

Midvale also opposes Staff's arguments with respect to the timing of FUSF funding. Although Midvale concedes that it is virtually certain that it will be able to obtain FUSF support (Transcript pg. 84), the Company objects to the inclusion of $21.50 per line per month of FUSF since it believes it will not be receiving FUSF at the time the plant is put into service. Midvale claims that, because it will not be able to immediately receive FUSF support until approximately the first quarter of the third year of service, the Company needs AUSF support until the FUSF funding is available (Reading Rebuttal pg. 8). Staff also points out that the Commission's rules require that AUSF support be "net of any universal service support from federal sources." A.A.C. R14-2-1202(A). Accordingly, companies should seek FUSF funding *prior* to seeking AUSF funding.

Under FCC rules, plant must normally be in place for two years before a company can receive FUSF support (47 C.F.R. Secs. 36.611 and 36.612). However, Staff argues that carriers can apply to the FCC for a waiver of this rule and that such waivers have routinely been granted in the past. In the Matter of Border to Border Communications, Inc. 10 F.C.C.R. 5055 (1995). In South Park Telephone Co., AAD 97-41, DA 97-2730 (rel. December 31, 1997), the FCC cited to Border to Border for the proposition that an immediate waiver is likely to be granted in instances where a carrier is serving a previously unserved area and the area would likely have remained without service if the carrier were unable to provide service to the area. The FCC found that such instances present "compelling reasons to permit immediate high cost loop support" (Id.). Midvale cites In the Matter of Freemont Telecom Co., AAD97-56, DA 98-127 (January 23, 1998) to support its argument that the FCC has previously denied waiver requests from carriers seeking FUSF funding prior to the two-year waiting period. Although the FCC denied Freemont's request for a waiver of FCC Rules 36.611 and 36.612, it specifically stated that waivers of those rules had been granted in the past "when a requesting carrier proposes to serve or is serving previously unserved areas" (Id. at 5). Based on these prior decisions, it is clear that the FCC has distinguished waiver requests for unserved areas from those that seek funds for serving high cost areas that were previously receiving service. the FCC more recently granted a waiver request under similar circumstances to a carrier that proposed to serve customers in previously unserved areas. In the Matter of Mescalero Apache Telecom, Inc., CC Docket No. 96-45 (Rel. January 18, 2001). In that case, the FCC stated that "[d]enial of immediate high-cost loop support could have the unintended effect of discouraging Mescalero's planned expansion of service to unserved remote areas, thereby frustrating the Commission's goal of promoting the provision of telecommunications services at reasonable rates" (Id. at 12). Given the fact that it will take Midvale considerable time to build out its plant to serve the new customers, there should be ample time for the Company to submit its request for waiver to the FCC prior to the commencement of service to those customers. Indeed, the Staff has offered to assist Midvale in its waiver request application to the FCC (Transcript pg. 170).

The Commission's rules provide that a local exchange carrier may request AUSF support in the context of a rate case or "other method as the Commission may prescribe." R14-2-1203. The current Commission rules indicate that a company must already be providing service to the area in which it is seeking AUSF funding after applying for FUSF funding. In this case, Midvale is not serving any customers in the Millsite and Silver Bell exchanges and can only provide estimated costs. While Midvale will undoubtedly have costs in conjunction with serving Millsite and Silver Bell, it has none at this time. Therefore, it is not appropriate for this Commission to award AUSF funding to Midvale at this time. However, it may be appropriate to examine AUSF funding in the near future.

We wish to make clear that we strongly encourage Midvale, as well as other similarly situated carriers, to invest in facilities that will enable the provision of telephone service to remote areas that are not served by any other carrier. In fact, we have provided in this order for a higher rate of return and rate case expense than the levels recommended by Staff, partly in recognition of Midvale's willingness to serve the Millsite and Silver Bell exchanges. In the event that Midvale is not able to receive a waiver of the FCC's rules within one year of the date of its application to the FCC, the Company may return to the Commission to seek funding from AUSF. In order to provide expedited treatment of a future AUSF request by Midvale, within the parameters of our rules, we will keep the record in this docket open for a period of one year to enable the Company to commence construction of facilities for the Millsite and Silver Bell exchanges, and to seek a waiver from the FCC's waiting period. We direct Staff to assist Midvale in preparing and supporting the Company's waiver request, to the extent Midvale deems such assistance to be necessary.

* * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Midvale is an Idaho corporation engaged in the business of providing telephone utility service to the public in Arizona.

2. On July 17, 2000, the Commission received from Midvale an application requesting authority to increase its rates and charges and for disbursement from the Arizona Universal Service Fund.

3. On August 11, 2000, Staff determined that Midvale's application met the sufficiency requirements of A.A.C. R14-2-103 and that the Company had been classified as a Class A utility.

4. In accordance with A.A.C. R14-2-101, a Procedural Order was issued on February 1, 2001 which set the matter for hearing on May 21, 2001.

5. In accordance with the Procedural Order, Midvale published notice of its application in a newspaper of general circulation in its service areas and mailed, by means of a bill insert, a copy of the notice to each of its customers.

6. For ratemaking purposes, the Company's intrastate OCRB and FVRB for the TY ended December 31, 1999 was $1,241,841.

7. For ratemaking purposes, the Company's adjusted intrastate TY revenues were $730,428, its intrastate TY operating expenses were $616,989, and its existing rates provided intrastate TY net operating income of $113,439.

8. A fair and reasonable rate of return on the Company's FVRB is 10.37%.

9. Operating income of $129,090 is necessary to yield a 10.37 percent rate of return on

the FVRB.

10. The Company must increase operating revenues by $27,627 to produce net operating income of $129,090.

11. The Company's proposed increase of $181,991 would produce an excessive return on its FVRB.

12. Based on the move toward rate consolidation between the Company's exchanges, the level of revenues authorized herein, and the revenue distribution methods described herein, the rates set forth in Exhibit A attached hereto and incorporated herein, are appropriate in this case.

CONCLUSIONS OF LAW

1. Midvale is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. Sections 40-250 and 40-251.

2. Midvale is a telecommunications carrier within the meaning of 47 U.S.C. § 252.

3. The Commission has jurisdiction over Midvale and of the subject matter of the Application.

4. Midvale is a fit and proper entity to receive an extension of its CC&N.

5. Notice of the application was provided in the manner prescribed by the law.

6. The Commission's resolution of the issues pending herein is just and reasonable, meets the requirements of the Commission's rules, is consistent with the best interests of the parties, and is in the public interest.

ORDER

IT IS THEREFORE ORDERED that Midvale Telephone Exchange, Inc. be, and hereby is, authorized and directed to file, on or before August 31, 2001, revised tariffs setting forth the rates and charges for the provision of telephone service authorized herein and in accordance with the Discussion, Findings of Fact and Conclusions of Law herein.

IT IS FURTHER ORDERED that Midvale Telephone Exchange, Inc.'s request for an extension of its Certificate of Convenience and Necessity to serve the Millsite and Silver Bell exchanges shall be granted.

IT IS FURTHER ORDERED that the rates and charges contained in said tariffs shall become effective for all service provided on and after September 1, 2001.

IT IS FURTHER ORDERED that Midvale Telephone Exchange, Inc. shall notify its customers of the rates and charges authorized hereinabove and the effective date of same by means of an insert in its next regular monthly billing.

IT IS FURTHER ORDERED that this docket will remain open for one year in order to allow Midvale to file an application for FUSF and a request for waiver of the two year moratorium.

IT IS FURTHER ORDERED that a rulemaking docket shall be opened to address, at a minimum, EAS issues such as (1) how "community of interest" should be defined; (2) the significance of call volumes; (3) whether a customer petition should accompany a proposal; (4) how companies can recover the cost of EAS; and (5) how the potential for illegal EAS bridging should be evaluated.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN	COMMISSIONER	COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _____ day of _________, 2000.

____
BRIAN C. McNEIL
EXECUTIVE SECRETARY

DISSENT _______________
SG:dap

SERVICE LIST FOR: MIDVALE TELEPHONE EXCHANGE, INC.

DOCKET NO.: T-02532A-00-0512

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MIDVALE TELEPHONE EXCHANGE
LOCAL RATE AND REVENUE SUMMARY – TOTAL ARIZONA

DESCRIPTION	RATES ADOPTED
Local	
Young	
Residence – R1	$ 18.60
Business – B1	30.00
Business – pay	21.00
Foreign Exchange	250.00
Vacation – Zone 1 Charge	10.50
Cascabel	
Residence – R1	22.50
Business – B1	30.00
Business – pay	21.00
Vacation	10.50
Non-Recurring Charges	
Young	
Service Order	10.00
Line Connection	25.00
Premise Visit	30.00
Cascabel	
Service Order	10.00
Line Connection	25.00
Premise Visit	30.00
Other Rates & Charges	
Young	
Custom Calling Bundle	3.50
Miscellaneous	
Young	
Vacation Rate – Zone 1	10.50
Private Line Extension	7.00

EXHIBIT A