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MEMORANDUM

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TO: Docket Control

FROM: Steven M. Olea
Director
Utilities Division

2014 MAR 21 P 12:20

AZ CORP COMMISSION
DOCKET CONTROL

ORIGINAL

Date: March 21, 2014

RE: IN THE MATTER OF THE APPLICATION OF SOUTHWESTERN TELEPHONE COMPANY FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, AND TO INCREASE RESIDENTIAL RATES AS NECESSARY TO COMPENSATE FOR THE RATE IMPACTS OF THE FCC'S USF/ICC TRANSFORMATION ORDER. (DOCKET NO. T-01072A-13-0412)

Attached is the Staff Report for Southwestern Telephone Company's Application to increase residential rates to compensate for the rate impacts of the Federal Communications Commission's Universal Service Fund/Intercarrier Compensation ("FCC's USF/ICC") Transformation Order.

Staff recommends approval of Southwestern Telephone Company's request to increase its monthly residential local exchange service rate from \$14.00 to the lesser of \$19.00 or the 2014 local service rate floor established by the FCC. Staff further recommends that the rate increase become effective on the rate floor compliance date, as determined by the FCC.

SMO:PJG:red\CHH

Originator: Pamela J. Genung

Attachment: Original and Thirteen copies

Arizona Corporation Commission

DOCKETED

MAR 21 2014

DOCKETED BY	
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SERVICE LIST FOR: SOUTHWESTERN TELEPHONE COMPANY
DOCKET NO. T-01072A-13-0412

Mr. Craig A. Marks
Craig A. Marks PLC
10645 N. Tatum Blvd.,
Suite 200-676
Phoenix, Arizona 85028

Ms. Janice M. Alward
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Mr. Steven M. Olea
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

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

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

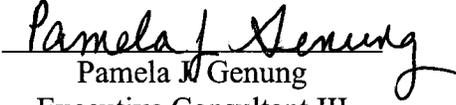
SOUTHWESTERN TELEPHONE COMPANY
DOCKET NO. T-01072A-13-0412

IN THE MATTER OF THE APPLICATION OF SOUTHWESTERN TELEPHONE
COMPANY FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY,
THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, AND TO
INCREASE RESIDENTIAL RATES AS NECESSARY TO COMPENSATE FOR THE RATE
IMPACTS OF THE FCC'S USE/ICC TRANSFORMATION ORDER

MARCH 21, 2014

STAFF ACKNOWLEDGMENT

The Staff Report for Southwestern Telephone Company, Docket No. T-01072A-13-0412, was prepared by the Staff member shown below.


Pamela J Genung
Executive Consultant III

EXECUTIVE SUMMARY
SOUTHWESTERN TELEPHONE COMPANY
DOCKET NO. T-01072A-13-0412

On November 27, 2013, Southwestern Telephone Company (“Southwestern Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased as necessary to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, USF/ICC Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250.

Staff recommends that the Southwestern Telephone monthly residential local exchange rate increase from \$14.00 to the lesser of \$19.00 or the 2014 local service rate floor established by the FCC. Staff further recommends that the rate increase become effective on the rate floor compliance date, as determined by the FCC. Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC’s November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the Federal Universal Service Fund (“FUSF”) funds that may flow to Southwestern Telephone pursuant to the FCC’s rules;
- The increase will minimize/reduce the amount of future rate increases; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

Staff further recommends that any future rate increase applications filed by Southwestern Telephone be processed per full A.A.C. R14-2-103 requirements, not streamlined.

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INTRODUCTION

On November 27, 2013, Southwestern Telephone Company (“Southwestern Telephone” or “Applicant”) filed an application for a determination of its earnings and the fair value of its investment and requested that its residential rates be increased as necessary to compensate for the rate impacts of the Federal Communication Commission’s (“FCC’s”) November 18, 2011, USF/ICC Transformation Order (“USF/ICC Order”) pursuant to Arizona Revised Statute (“A.R.S.”) § 40-250. A.A.C. R14-2-103(A)(1) requires specific financial and statistical information be filed with a request by a public service corporation doing business in Arizona for a determination of the value of the property of the corporation and of the rate of return earned. Southwestern Telephone submitted a streamlined filing containing the following five exhibits to support the requested increase in residential rates:

- Regulated Results of Operations Twelve Months Ending June 30, 2013
- Rate Base as of June 30, 2013
- Cash Working Capital
- Proposed Rate Design
- Year 2 Estimated ICC Impact of FCC Order

On December 17, 2013, the Applicant filed a Time Clock Waiver for thirty (30) days.

On January 29, 2014, the Applicant filed a Supplemental Filing.

BACKGROUND

Southwestern Telephone is a corporation duly organized and existing under and by virtue of the laws of the State of Arizona. Southwestern Telephone is authorized to engage in and is now engaged in the conduct of a general communications business within the State of Arizona. Southwestern Telephone is a small rate-of-return (“RoR”) regulated incumbent local exchange carrier (“ILEC”).

On November 18, 2011, the FCC issued the USF/ICC Order. The USF/ICC Order transitions the outdated federal universal service programs and most intercarrier compensation systems into a new Connect America Fund (“CAF”). The FCC’s press release characterized the USF/ICC Order as “the most significant policy step ever taken to connect all Americans to broadband.”

In its USF/ICC Order, the FCC stated that it will reduce intercarrier compensation rates to zero by July 1, 2020, for RoR companies, with limited recovery from customers and partial recovery from the CAF. The recovery from the CAF will phase out over time at 5 percent annually. The USF/ICC Order adds new rules that will reduce federal high-cost loop support (“FHCLS”) to carriers by the amount their flat-rate residential local service rates fall below a specified annual rate floor. The rate floor includes state subscriber line charges, state universal service fees, and mandatory extended area service charges, if any are assessed. The FCC’s order establishes single line residential local service rate floors of \$10.00 as of June 1, 2012, \$14.00 as

of June 1, 2013, with the floor thereafter being determined annually by the FCC's Wireline Competition Bureau, based on a nationwide average. To date, the Wireline Competition Bureau has not determined the rate floor to be in effect for June 1, 2014. The FCC is conducting a survey of urban rates for fixed voice residential services, required by the USF/ICC Order. The information collected in this survey will be used to establish a rate floor for voice services that eligible telecommunications carriers ("ETCs") receiving high cost loop support ("HCLS") or frozen high-cost support must meet in order to receive their full support amounts.

To maintain FHCLS, Southwestern Telephone and other rural ILECs must increase single line residential local rates to the FCC-mandated residential rate floors. Otherwise, the amount of FHCLS funds will be reduced dollar-for-dollar for each customer by the difference between the existing single line local rate and the new rate floor.

The Arizona Corporation Commission's ("Commission") last considered Southwestern Telephone's rates in Docket No. T-01072A-12-0472, which resulted in Commission Decision No. 73874¹, dated May 8, 2013. With this application, Southwestern Telephone seeks Commission approval to raise its residential local service rate from \$14.00 to the lesser of \$19.00 or the 2014 local service rate floor established by the FCC.

CONSUMER SERVICES

On December 18, 2013, the Records Section of the Corporations Division responded that Southwestern Telephone is in Good Standing. A review of the Consumer Services database revealed that no complaints, inquiries and opinions were received pertaining to Southwestern Telephone for the period January 1, 2010 through December 20, 2013.

PUBLIC NOTICE

On February 28, 2014, Southwestern Telephone filed a Proof of Mailing indicating that the required notice was provided to Southwestern Telephone's Arizona customers in the format prescribed in the Procedural Order dated January 24, 2014.

COMPLIANCE

A check of the Utilities Division Compliance Section database showed that Southwestern Telephone is in Compliance with all items.

¹ Decision No. 73874 authorized Southwestern Telephone to raise its residential one-party rates to \$14.00/month, effective June 1, 2013.

OPERATING INCOME STATEMENT

Southwestern Telephone submitted Regulated Results of Operations for Twelve Months Ending June 30, 2013 in its streamlined filing. The submitted information was accepted without adjustment for the purposes of this streamlined Application.

Operating Revenue and Expenses

According to the information provided by the Applicant, Southwestern Telephone Total Intrastate

Operating Revenues for the Twelve Months Ending June 30, 2013 were \$1,638,894. Subcategories of Total Intrastate Operating Revenues are noted below:

Local	\$695,034
Universal Service Fund (USF-HCL)	\$385,743
Access Revenues	\$490,375
Billing & Collecting	\$ 17,583
Other Misc., Uncollectibles	\$ 50,159

The Applicant also stated that its Total Intrastate Operating Expenses for the Twelve Months Ending June 30, 2013 were \$1,690,262. Subcategories of Total Intrastate Operating Expenses are noted below:

Plant Specific Operations	\$365,039
Plant Non-specific Operations	\$129,505
Depreciation & Amortization Exp.	\$613,515
Customer Operations Expenses	\$210,290
Corporate Operations Expenses	\$277,502
Other Operating Taxes and (Income)	\$ 94,411

Operating Income

As provided by the Applicant, Southwestern Telephone's Total Intrastate Operating Income for the Twelve Months Ending June 30, 2013 was negative \$51,368 before taxes and negative \$31,062 after taxes.

RATE BASE

According to Southwestern Telephone, the interstate and intrastate rate base is \$3,504,514, as stated in the table below:

**Southwestern Telephone Company
Rate Base as of June 30, 2013**

	Total Company	Interstate	Intrastate
Plant In Service	\$ 18,462,869	\$ 7,892,320	\$10,570,549
<i>Accumulated Depreciation</i>	<u>(14,544,450)</u>	<u>(6,324,721)</u>	<u>(8,219,729)</u>
Net Plant in Service	\$ 3,918,419	\$ 1,567,599	\$ 2,350,820
Plant Under Construction	20,587	8,757	11,830
Material & Supplies	118,826	34,484	84,342
Deferred Income Taxes	(690,039)	(293,463)	(396,576)
Cash Working Capital	<u>136,721</u>	<u>48,719</u>	<u>88,002</u>
Rate Base	\$ 3,504,514	\$ 1,366,096	\$ 2,138,418

CUSTOMER BASE

Southwestern Telephone reported 1,770 residential lines and 879 business lines in its Utilities Annual Report received April 15, 2013.

REVENUE REQUIREMENT

As stated above, the Applicant's filing was based on streamlined requirements to meet the FCC's deadline for federal USF funding. Therefore, the Applicant's filing does not contemplate rate adjustments based on a typical revenue requirement analysis.

RATE DESIGN

The Applicant is seeking to increase its residential local exchange service rate up to \$19.00. The actual rate implemented would be set at the lesser of the approved 2014 local service rate floor or \$19.00. Southwestern Telephone indicated that it will file the new FCC rate floor as soon as it is available. The Applicant's filing only contemplates changes to residential local exchange rates to compensate for the rate impacts of the FCC's USF/ICC order. With this filing, Staff will only address the monthly increase of all residential local exchange service rates from \$14.00 to the lesser of \$19.00 or the 2014 local service rate floor established by the FCC.

STAFF ANALYSIS

Staff did not perform a regulatory audit of the information submitted by Southwestern Telephone. However, Staff reviewed the information filed in the context of the FCC's November 18, 2011 USF/ICC Order, which is intended to transition the outdated federal universal service programs and most intercarrier compensation systems into a new CAF.

Staff has analyzed this application in terms of whether there were fair value implications. For the purposes of this matter, the Applicant stipulated to the use of original cost less depreciation as the basis for a determination of its fair value rate base ("FVRB"). The Applicant states that its intrastate rate base is \$2,138,418. The Applicant provided information that indicates that its Total Intrastate Operating Revenue for the Twelve Months Ending June 30, 2013 was \$1,638,894.

According to the Applicant, the annual revenue effect of the increase in residential local telephone service rates to \$19.00 is \$87,360.² Southwestern Telephone's return on rate base would increase from being negative to 1.0 percent. In the Applicant's Supplemental Filing, Southwestern Telephone indicated that the annual revenue effect of the increase in residential local telephone service rates to \$17.50 is \$61,152.³ At the \$17.50 residential local service rate, Southwestern Telephone's Return on Rate Base would be 0.3 percent, versus 1.0 percent if the residential rate floor is set at \$19.00 per month. Compared to the Applicant's total revenues, any revenue impact from this rate increase would be small and any impact on the Applicant's FVRB would be de minimus.

STAFF'S RECOMMENDATIONS

Staff recommends approval of Southwestern Telephone's request to increase its monthly residential local exchange service rate from \$14.00 to the lesser of \$19.00 or the 2014 local service rate floor established by the FCC. Staff further recommends that the rate increase become effective on the rate floor compliance date, as determined by the FCC.⁴ Staff believes the proposed increase is just, fair and reasonable for the following reasons:

- The increase is necessitated by the FCC's November 18, 2011 USF/ICC Order;
- The increase is necessary to preserve the entirety of the Federal Universal Service Fund ("FUSF") funds that may flow to Southwestern Telephone pursuant to the FCC's rules;
- The increase will minimize/reduce the amount of future rate increases; and
- The increase will allow the Applicant to receive matching funds from the FUSF.

Staff further recommends that any future rate increase applications filed by Southwestern Telephone be processed per full A.A.C. R14-2-103 requirements, not streamlined.

Staff has reviewed the rate application and the federal rule changes that have prompted the rate application. Staff concludes that the costs appear reasonable and appropriate under the unique circumstances of this case. However, Staff's recommendation in these unique

² Based on 1,456 one-party residential lines.

³ Based on 1,456 one-party residential lines.

⁴ The rate floor compliance date is the date (currently June 1) on which the local service rate must equal or exceed the FCC rate floor so a company receiving federal high-cost loop support may continue to receive all of its authorized Federal Universal Service Fund revenues.

Southwestern Telephone Company

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circumstances should not be viewed as precedent for the processing of future rate case applications.