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Executive Summary

While we can debate various approaches to what adequately provides a fair “hearing”, it seems intuitively obvious that the Commission must follow the United States Supreme Court’s established legal precedents for determining a fair rate of return for ratemaking purposes. The Court historically maintains three standards of fairness for a return allowance: financial integrity, capital attraction and comparable earnings.

The Staff ignores and thus does not properly incorporate into its analysis one of the biggest factors that should be considered in this represcription proceeding – the Commission’s own Transformation Order. The Staff Report devotes only a single paragraph to discussing changes in the telecommunications marketplace and regulatory environment, but fails to consider the significance these changes might have on the represcription process. This is surprising, considering the active role played by the Bureau in proposing and implementing these significant regulatory shifts in the past few years. It is essential that the Commission fully take into account the impacts these changes have had on the overall telecommunications marketplace. While these reductions are the subject of ongoing and yet to be resolved appellate proceedings, to simply ignore these impacts in the current docket is disingenuous.

We support the approach that was offered by the Rural Associations (RA) in their comments. The additional information provided in Appendix B demonstrates that the Associations’ proposed FCF method is analytically sound, as it is tied to a standard DCF practice for evaluating firms previously endorsed by the Commission and relied upon, in part, by the Bureau for its analysis. Moreover, the proposed FCF approach uses a statistically unbiased sample that is representative of RLECs as a group.

I. INTRODUCTION AND BACKGROUND

GVNW Consulting, Inc. (GVNW) submits reply comments filed pursuant to the Commission's Public Notice (DA 13-1110), released on May 16, 2013. The instant Public Notice seeks comment on a Wireline Competition Bureau staff report¹ (WCB Staff Report) setting forth data and procedures the Bureau recommends the Commission use to represcribe the authorized interstate rate of return.

The comments filed in this proceeding were highly critical of the WCB Staff Report. We note with concern that the staff has failed to recognize a realistic risk portfolio for small rural carriers. The staff report identifies a zone of reasonable estimates of the weighted average cost of capital (WACC) and concludes that the Commission should establish the revised authorized rate of return between 8.06 and 8.72 percent.

GVNW is a management consulting firm that provides a wide variety of consulting services, including regulatory and advocacy support on issues such as universal service, intercarrier compensation reform, and strategic planning for communications carriers in rural America. We are pleased to have the opportunity to offer reply comments addressing the issues the Bureau staff has raised in the *Public Notice*, focusing on issues for rural carriers.

¹ *Prescribing the Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 10-90, Staff Report, DA 13-1111 (Wireline Comp. Bur. rel. May 16, 2013) (Staff Report).

II. PROCEDURAL ISSUES ARE PREREQUISITE TO DOCKET INTEGRITY

In the codified Commission rules for rate of return matters, there are several important parameters that should be followed in a rate of return review. The Alaska Rural Coalition (ARC) offered comments that highlighted the deficiencies in the WCB Staff Report.

The Commission must evaluate the Staff Report using the well established legal standards for the rate of return adopted by the Supreme Court in the Hope and Bluefield decisions.² The evidence presented to date by the entities that supply capital to rural RoR carriers indicates that capital attraction, a key component of the Hope and Bluefield decisions, is not being met with the current 11.25% rate of return. In fact, the evidence in the record suggests that the increased uncertainty and risk facing small RoR carriers should cause the Commission to increase the current rate of return. Based on the facts in the record, the Commission should reject the Staff Report and, at a minimum, take no action to reduce the rate of return from the currently authorized 11.25% level.

The Commission must follow the United States Supreme Court's established legal precedents for determining a fair rate of return for ratemaking purposes.³ The Court historically maintains three standards of fairness for a return allowance: financial integrity, capital attraction and comparable earnings.⁴ In Permian Basin Area Rate Cases, the Supreme Court stressed that an agency decision regarding the rate of return should "reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable."⁵

For a represcription to yield defensible results that could withstand legal review, the rules of law should be followed in the proceeding. It appears that Bureau staff is

² See *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

³ See *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) and *Duquesne Light Company v. Barasch*, 488 U.S. 299 (1989).

⁴ See *Bluefield Waterworks*, 262 U.S. at 692-93 and *Hope Natural Gas Co.*, 320 U.S. at 605.

⁵ See *Permian*, 390 U.S. at 792.

attempting to represcribe the interstate authorized rate of return without a proper⁶ and necessary process⁷.

III. THE RISK PORTFOLIO FOR RURAL CARRIERS IS NOT REFLECTED IN THE STAFF RECOMMENDATION

In the Public Notice, the Bureau asserts that it initiates this proceeding because certain triggers have been reached. The Staff then proceeds to ignore and thus does not properly incorporate into its analysis one of the biggest factors that should be considered in this represcription proceeding – the Commission’s own Transformation Order. The comments of the Oregon Telecommunications Association and the Washington Independent Telecommunications Association reinforce this notion at page 6:

The real world is clear. Investment in rural telecommunications infrastructure has already decreased as a result of the Transformation Order. This reduction in new investment reflects an increase in risk to the rate-of-return carriers as a result of the Commission’s orders and its academic focus rather than real world focus.

The Rural Association filing group (National Exchange Carrier Association, Inc.; NTCA – The Rural Broadband Association; US Telecom; Eastern Rural Telecom Association; and Western Telecommunications Alliance) provides another reinforcement of this concern with regard to the risk portfolio for rural carriers increasing since the last rate of return represcription:

⁶ In prior represcription rounds, detailed testimony and exhibits have been submitted and carefully considered in the course of the docket.

⁷ The WCB Staff Report attached to the Public Notice discusses opinions of the Bureau staff that have been developed in isolation from the normal rate of return represcription process where the affected carriers are allowed to present factual evidence. The WCB Staff Report does not address or attempt to answer the important question of what process will be used in the coming months to achieve compliance with the law found in Section 205(a). Offering comments and replies in a short time frame to the WCB Staff Report falls far short of offering the type of process required under the rules

The Staff Report devotes only a single paragraph to discussing changes in the telecommunications marketplace and regulatory environment, but fails to consider the significance these changes might have on the represcription process. This is surprising, considering the active role played by the Bureau in proposing and implementing these significant regulatory shifts in the past few years. It is essential that the Commission fully take into account the impacts these changes have had on the overall telecommunications marketplace⁸, and the plight of RLECs in particular, as it evaluates recommendations set forth in the Staff Report.

IV. ADDITIONAL CONSIDERATION SHOULD BE GIVEN TO THE RURAL ASSOCIATION METHODOLOGY

We support the approach that was offered by the Rural Associations (RA) in their comments.

As the Rural Associations state at pages 32-33 of their filing:

In these comments, the Associations update and resubmit the FCF method originally filed in the January 2012 Rural Association Comments. The additional information provided in Appendix B demonstrates that the Associations' proposed FCF method is analytically sound, as it is tied to a standard DCF practice for evaluating firms previously endorsed by the Commission and relied upon, in part, by the Bureau for its analysis. Moreover, the proposed FCF approach uses a statistically unbiased sample that is representative of RLECs as a group. In this respect, the FCF produces a far more accurate estimate of WACC for RLECs than methods that rely on samples of unrepresentative publicly-traded companies. The application of the FCF method is also superior in that it focuses exclusively on valuation of the regulated portion of the business, rather than total company operations. The Bureau's suggestion that the Rural Associations arbitrarily reduced per-line prices for purposes of this analysis is incorrect. In fact, the Rural Associations conservatively excluded low per-line price data from their analysis. Had this information been included in the analysis, resulting cost of capital estimates would be higher.

⁸ Footnote not part of citation. The marketplace today looks very different from the market at the time of the last rate of return proceeding. Competition from wireless providers, cable companies, and VoIP providers has proliferated and shows no sign of slowing anytime soon. A corollary recognition of this factor is appropriate in the instant proceeding. With regard to the national macroeconomic situation, the current interest rates are historically low due to the unprecedented intervention of the Federal Reserve Board.

As we stated in our comment filing, various forms of Discounted Cash Flow (DCF) models used in cost of equity capital analysis for regulatory proceedings represent a marriage of common sense and financial theory. The model attempts to answer the seminal investment question: “How much is this stock worth?” The common sense portion of the answer stems from the fact that the answer depends on what the investor expects to get out of the stock and over what period of time they expect to receive it. The “what” portion is the expected cash flow stream that will be generated by the stock and the “what period” aspect is the projected timing of the expected cash flow stream.

Conclusion

We respectfully submit that the Commission would be well served to interject some common sense into this docket as it seeks to represcribe an interstate rate of return that will have a large impact on the deployment and sustainability of broadband infrastructure in the large portion of the land area served by rural carriers in this country. For a broadband plan to actually be considered a National Broadband Plan, the public policies adopted to implement the plan must meet the needs of both urban and rural consumers. A revised interstate rate of return set at the level recommended in the WCB Staff Report does not meet such a test for rural customers. It is time for the Staff to pass this important test.

Respectfully submitted,

Via ECFS at 8/26/13

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