BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking into the Review of the California High Cost Fund-A Program.	R.11-11-007

OPENING BRIEF OF

CALAVERAS TELEPHONE COMPANY (U 1004 C)
CAL-ORE TELEPHONE CO. (U 1006 C)
DUCOR TELEPHONE COMPANY (U 1007 C)
FORESTHILL TELEPHONE CO. (U 1009 C)
KERMAN TELEPHONE CO. (U 1012 C)
PINNACLES TELEPHONE CO. (U 1013 C)
THE PONDEROSA TELEPHONE CO. (U 1014 C)
SIERRA TELEPHONE COMPANY, INC. (U 1016 C)
THE SISKIYOU TELEPHONE COMPANY (U 1017 C) AND
VOLCANO TELEPHONE COMPANY (U 1019 C)
("INDEPENDENT SMALL LECS")

PUBLIC VERSION

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I. INTRODUCTION.

Pursuant to the briefing schedule set during the final day of evidentiary hearings, the Independent Small LECs[1] hereby submit their opening brief addressing the issues in the Fourth Amended Scoping Memo ("Scoping Memo"), with the exception of issues that have been resolved through separate comment cycles or which are the subject of ongoing analysis under the Fifth Amended Scoping Memo.[2] Consistent with the parties' agreement, this brief utilizes the overall headings in the common briefing outline, with sub-headings added within that structure.

Phase 2 of this proceeding offers an important opportunity for the California Public Utilities Commission ("Commission") to confirm its commitment to rural communities by ensuring the continued success of the California High Cost Fund A ("CHCF-A"). For decades, the California Legislature has recognized the crucial ongoing role of the CHCF-A in advancing universal service and promoting safe, reliable, and affordable service in "rural, insular, and high-cost areas." The Legislature has extended the CHCF-A seven times since 1996, including in 2018.[3] Over that timeframe, technology has evolved and consumer needs have shifted, but the high costs of service in rural areas remain, and, as the COVID-19 pandemic has confirmed, the need for rural telecommunications connectivity is as critical as ever.

The record underscores the critical role of the CHCF-A in bridging the digital divide, keeping rates affordable, and preserving the public safety functions that the Independent Small LECs fulfill as Carriers of Last Resort ("COLRs") in their service territories. Despite serving some of the most rural and remote areas in California, the Independent Small LECs have greatly expanded their broadband capabilities over the past five years, and, collectively, they provide access to speeds of 10 Megabits per second ("Mbps") download and 1 Mbps upload to

[1] The Independent Small LECs are the following small, rural telephone companies: Calaveras Telephone Company (U 1004 C), Cal-Ore Telephone Co. (U 1006 C), Ducor Telephone Company (U 1007 C), Foresthill Telephone Co. (U 1009 C), Kerman Telephone Co. (U 1012 C), Pinnacles Telephone Co. (U 1013 C), The Ponderosa Telephone Co., (U 1014 C), Sierra Telephone Company, Inc. (U 1016 C), The Siskiyou Telephone Company (U 1017 C), and Volcano Telephone Company (U 1019 C).

[2] The status of the Mission Consulting "study" has already been addressed in comments on the Scoping Memo and the September 12, 2019 ALJ Ruling. The question of whether to open Independent Small LEC territories to competition from Competitive Local Exchange Carriers ("CLECs") was the subject of a separate comment cycle, as explained in the November 8, 2019 ALJ Ruling. Proposals to address the needs of tribal communities have been subsumed within the Fifth Amended Scoping Memo, and comments on February 28, 2020 and March 16, 2020. As discussed on the final day of hearings, it would also be inappropriate to raise new subjects in these briefs.

[3] SB 207 (Polanco 1996); AB 994 (Wright 2000); SB 1276 (Bowen 2004); SB 780 (Wiggins 2008); SB 3 (Padilla 2011); SB 1364 (Fuller 2014); AB 1959 (Wood 2018) (extending to 2023).

approximately 94.1% of households in their territories.[4] However, as the record shows, "[b]roadband deployment is not a destination, it is a journey," and continued access to CHCF-A is essential for the Independent Small LECs' networks to reach the current Federal Communications Commission ("FCC") broadband standard of 25 Mbps and beyond.[5] Likewise, without the CHCF-A, residential basic service rates would have to rise to between $63.96 and $186.24 to recover the companies' costs of service.[6] Rates of this magnitude would be profoundly unaffordable and compromise the public safety benefits provided by these COLRs, most of which provide the only reliable wireline service in their areas.[7]

Unfortunately, most of the proposals in this proceeding would weaken the CHCF-A program and compromise customer benefits that the program has produced for rural Californians. The centerpiece of The Utility Reform Network's ("TURN") and the California Public Advocates Office's ("Cal Advocates") proposals is to "impute" retail profits earned by the Independent Small LECs' non-regulated Internet Service Provider ("ISP") affiliates into the regulated intrastate ratemaking equation. This "broadband imputation" is categorically illegal, as it would overstep the jurisdictional boundaries that the FCC has established for "information services" like Internet access service.[8] As the record shows, the implementation of TURN's broadband imputation proposal would result in a regulated rate design for each Independent Small LEC that would not equal its revenue requirement – a flagrant violation of Public Utilities Code Section 275.6(b)(4).[9] Cal Advocates would widen this revenue gap – and deepen the

[4] LEC-2-C (Duval Reply), Exh. B; LEC-4-C (Boos Opening), Att. A; TURN-2-C (Roycroft Reply) at 57, Table 4. The individual figures in Dr. Roycroft's Table 4 accurately reflect the latest data produced to TURN except as to Volcano. LEC-2-C (Duval Reply), Exh. B; LEC-4-C (Boos Opening), Att. A. However, the Table 4 totals do not reflect the sum of the individual figures. By recalculating the totals and fixing the error for Volcano, 62,682, the sum of the figures in the 10/1 column, divided by 66,617, the sum of the figures in the 6/1.5 and Unserved columns, produces a percentage of 94.1%.

[5] LEC-1 (Duval Opening) at 79:15-16; *see In the Matter of Connect America Fund*, WC Docket No. 10-90, *Report and Order, et al.*, FCC 18-176 (rel. Dec. 13, 2018) (*"ETC Reform Order"*), at ¶ 3 ("access to 25/3 Mbps broadband service is not a luxury for urban areas").

[6] LEC-4 (Boos Opening) at 7:10-22.

[7] Phase 1 Exh. 11 (Thompson Opening) at 28:6-17 (describing the lack of alternative options in Independent Small LEC territories); LEC-7 (Votaw Opening) at 5:8-16 (noting the benefits of a robust network in the face of increased fire dangers and distance from social and emergency services).

[8] *See In the Matter of Restoring Internet Freedom*, WC Docket No. 17-108, *Report and Order, et al.*, FCC 17-166 (rel. Jan. 4, 2018) ("*Restoring Internet Freedom Order*") at ¶ 20 ("[w]e reinstate the information service classification of broadband Internet access service."), *vacated in part on other grounds by Mozilla Corp. v. FCC*, 940 F.3d 1, 35 (D.C. Cir. 2019) (upholding "information service" classification).

[9] Pub. Util. Code § 275.6(b)(4) defines "rate-of-return regulation" for participants in the CHCF-A program. It requires that a "rate design" be fashioned to "provide the company a fair opportunity to meet the revenue requirement." Pub. Util. Code § 275.6(b)(4). The Commission must apply "rate-of-return regulation" to these companies. Pub. Util. Code § 275.6(c)(2). TURN's proposal would compute a rate

illegality of broadband imputation – by extending imputation to interstate wholesale revenues.

Imputation would also create perverse economic incentives and manifestly harmful regulatory consequences. If adopted, broadband imputation is likely to cause many of the Independent Small LECs' owners to sell their ISPs, depriving rural communities of the local touch that has benefitted consumers in these areas for decades. Imputation would also multiply the complexity and cost of the rate case process, escalate telephone companies' risks, disincentivize broadband investments, discourage innovation, and spur price increases.

Cal Advocates proposes additional changes that would compound these harms. Without any legal basis, Cal Advocates asks the Commission to disallow all new investments in broadband-capable facilities for any Independent Small LEC whose unregulated ISP affiliate cannot reach an 87% adoption rate. It seeks rigid application of the FCC's corporate expense cap and operating expense limitation, ignoring California-specific cost drivers like Public Safety Power Shutoff ("PSPS") events and recent expense drivers like the COVID-19 crisis. Cal Advocates requests inclusion of rate case expense in the corporate cap, which would force companies to endure a burdensome and expensive rate case process without cost recovery, even if their annual operating expenses match the cap. Cal Advocates would set rate base using purely historical data, ignoring rural communities' forward-looking needs. It would raise rates for all retail voice services every year, making rates less affordable for rural consumers. While these ideas are presented as "reforms," they are nothing more than opportunistic ways to reduce the already-small CHCF-A surcharge by a few cents a month without regard to the negative consequences for rural consumers.[10]

The Commission should not reinvent a successful program just because Cal Advocates or TURN have made proposals to radically alter it. The Commission should follow the record and focus on streamlining the rate case process and restoring balance to the Commission's ratemaking standards. For nearly a decade, this protracted proceeding has posed an existential threat to the companies and the future of universal service in Independent Small LEC territories. The Commission should close this proceeding and implement a regulatory platform that gives the companies the confidence to advance broadband deployment, construct robust, resilient networks, and continue providing safe, reliable service to rural Californians.

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design that is disjunct from regulated revenue requirement.

[10] The current CHCF-A surcharge is 0.350%, or approximately 9 cents a month on a $25.00 phone bill.

II. PROCEDURAL HISTORY AND FACTUAL BACKGROUND.

A. Pertinent Factual and Regulatory Background.

1. The Independent Small LECs and Their Service Territories.

The Independent Small LECs are 10 small, rural telephone companies serving rural areas of California, principally in central and northern California.[11] The companies are not formally affiliated with each other, but they have a shared history, and they continue to have many operational and regulatory similarities. Each of the Independent Small LECs was formed in the early 1900s to address community needs in areas that AT&T was unwilling to serve.[12] Each remains locally operated, and most are owned by the same families who founded them.[13] The companies serve some of the most rugged and remote areas of the state, where customer locations are often distant from one another and the costs of service remain high.[14] None of the companies serve large population centers, and most are separated from urban areas by a drive of an hour or more.[15] Wireless coverage is unreliable in many of these areas, and some have limited options for middle mile access.[16] The households in these areas are generally low-income and middle-income, and most businesses are small and locally oriented.[17]

Each Independent Small LEC serves a dedicated service territory in which it is designated as an Incumbent Local Exchange Carrier ("ILEC"), a COLR, and an Eligible Telecommunications Carrier ("ETC").[18] Each qualifies as a "rural telephone company" under federal law.[19] The Commission regulates each company according to a traditional, rate-of-return model, and each company qualifies for and receives CHCF-A.[20] The companies provide regulated voice service, including basic residential and business service, vertical services, custom calling features, switched access, and special access services pursuant to tariffs filed with the Commission.[21] They also provide services classified as interstate, including wholesale Digital Subscriber Line ("DSL") transmission, a regulated service provided pursuant to a federal tariff

[11] LEC-1 (Duval Opening) at 8:19-22.
[12] *Id*; *see also* LEC-4 (Boos Opening) at 4:12-13.
[13] *Id.* at 8:13-14.
[14] *Id.* at 8:14-17.
[15] LEC-7 (Votaw Opening) at 3:12-14; D.17-11-013 at 9-10; D.19-04-017 at 3.
[16] Phase 1 Exh. 11 (Thompson Opening) at 15:16-18:3; LEC-11 (Lehman Opening) at 9:20-23.
[17] LEC-7 (Votaw Opening) at 3:8-12; LEC-11 (Lehman Opening) at 7:21-9:23.
[18] LEC-1 (Duval Opening) at 8:19-22, 9:5-15.
[19] *Id.* at 9:9-10.
[20] In addition to the Independent Small LECs, there are three small, rural ILECs in California, but each is affiliated with TDS Telecom, a large, national provider traded on the New York Stock Exchange.
[21] LEC-1 (Duval Opening) at 14:8-13; LEC-4 (Boos Opening) at 14:4-6; *see also* D.14-12-084 at 79.

administered by the National Exchange Carrier Association ("NECA"), NECA Tariff No.[22] The terms of this tariff are available to any ISP – affiliated or otherwise – that may wish to use it.[23]

2. The Independent Small LECs' ISP Affiliates.

Each Independent Small LEC is associated with a different ISP that provides Internet access service within the same geographic areas as the ILEC.[24] For nine of the 10 companies, the ISP is a separate affiliate, and one company offers ISP service through a separate unregulated division.[25] The affiliated ISPs use the DSL transmission service offered in NECA Tariff No. 5 to access customer locations within the Independent Small LEC's local exchange area.[26] Some of the affiliated ISPs also offer Internet access service outside of the regulated ILEC service territories and some provide service over alternative service platforms, such as fixed wireless.[27] In these situations, the ISPs neither subscribe to NECA Tariff No. 5 nor rely on local exchange facilities from Independent Small LECs.[28]

In general, these ISP affiliates are struggling small businesses with high expenses and limited revenues. Like most ISPs, these are not investment-intensive, but expense-intensive businesses.[29] They face large and unavoidable expenses for wholesale access to the local exchange, middle mile connectivity, and transport to the Internet backbone.[30] Five of the 10 ISPs are either unprofitable, barely profitable, or inconsistently profitable. The remaining five ISPs have profit margins that are lower than – or similar to – the profit margins that the Commission found reasonable for their regulated ILEC affiliates.[31]

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[22] NECA is the FCC's designated administrator, charged with managing the interstate access pools and calculating federal high-cost support for rural telephone companies nationwide. *See* 47 C.F.R. § 69.601.
[23] NECA Tariff No. 5 is available at the following link: http://neca.org/docs/default-source/public---tariff-5/currently-effective-tariff-no_-5.pdf. During the hearings, the Commission took official notice of the NECA tariff, and permission was granted to reference the tariff through a link.
[24] Foresthill and Kerman are affiliates, so they share an ISP – Audeamus, LLC ("Audeamus") operates in these ILEC territories and in other areas. TURN-1 (Roycroft Opening), App. 2 at NC0009-NC0011.
[25] Pinnacles, the smallest Independent Small LEC, operates its ISP as a separate, unregulated division, but the costs and revenues of the ISP are independent of the ILEC operation and are segregated in accordance with the FCC's rules. *See* 47 C.F.R. § 64.901; TURN-1 (Roycroft Opening), App. 2 at NC0013-NC0014.
[26] LEC-1 (Duval Opening) at 10:21-23.
[27] LEC-4 (Boos Opening) at 14:7-9; LEC-1 (Duval Opening) at 9:25-10:1.
[28] LEC-7 (Votaw Opening) at 11:14-19; *see also* LEC-4 (Boos Opening) at 14:7-9.
[29] LEC-4-C (Boos Opening) at 14:15-16:13; LEC-7-C (Votaw Opening) at 6:1-8; 12:14-13:9; LEC-9-C (Aron Opening) at 31-32, Q37, Exh. 3.
[30] LEC-4-C (Boos Opening) at 14:21-16:3; LEC-7-C (Votaw Opening) at 6:1-8; 12:14-13:9.
[31] These profitability descriptions rely on the three-year averages for the ISP affiliates, as reflected in Dr. Roycroft's work papers, with one adjustment for Kerman's revised response to TURN 4.18, which he did not incorporate. *See* TURN-1-C (Roycroft Opening), App. 3 at C0127-C0138; TURN-2-C (Roycroft Reply) at 19. Table 1 and n. 40 (citing Roycroft_Confidential_Reply_Workpaper.xlsx). The profit margins deemed reasonable for the regulated telephone companies are reflected in the results of

3. Rate of Return Regulation for Rural Telephone Companies.

The Independent Small LECs are regulated under a "rate of return" model, by which the Commission identifies a company's costs of providing regulated service and then establishes a rate structure that will give the company a reasonable opportunity to recover those costs, including a reasonable return on its regulated investments.[32] First, the Commission must establish a "revenue requirement," which is a measurement of cost that includes operating expenses, return on rate base, and tax liabilities.[33] The equation reflecting revenue requirement is: Revenue Requirement = expenses + (rate base x cost of capital) + tax liabilities.[34] "Rate base" reflects the amount of net investment that has been dedicated to public use in connection with providing regulated utility service.[35] Second, the Commission must set a "rate design," which is a mix of revenue sources that collectively will give the company a reasonable opportunity to fulfill its revenue requirement. Since 1995, the Commission has adjudicated 49 small telephone company rate cases, and each one had the same five categories of revenue in the rate design: (1) end user revenue; (2) federal High Cost Loop Support ("HCLS"); (3) intercarrier revenues, including access charge revenues; (4) miscellaneous intrastate revenues, including revenues from the licenses of regulated assets; and (5) CHCF-A.[36] When the Commission performs its ratemaking calculations, revenue requirement and rate design must be equal.[37]

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operations tables from the decision resolving each company's last rate case, modified in some cases for subsequent tax impacts. See Exh. 13-C (Duval Numbered Pages) at 5, 17, 29, 41, 53, 65, 77, 90, 103, 115. The profit margin adopted *See also* LEC-9 (Aron Opening) at 23 (reflecting correct Kerman data for 2018), Exh. 1; LEC-1 (Duval Opening) at 77:10-24.

[32] Pub. Util. Code § 275.6(b)(4); *City & Cty. of San Francisco v. Pub. Util. Comm'n*, 39 Cal. 3d 523, 531 (1985); *see also Ponderosa v. Pub. Util. Comm'n,* 197 Cal.App.4th 48, 52 (2011) ("The Commission sets rates that are designed to enable a telephone company to generate sufficient revenue to meet the revenue requirement.").

[33] Pub. Util. Code § 275.6(b)(5); *Calaveras Telephone Co. v. Pub. Util. Comm'n*, 39 Cal.App.5th 972, 976 (2019) ("revenue requirement is the amount a telephone corporation needs to recover its 'reasonable expenses and tax liabilities and earn a reasonable rate of return on its rate base,' i.e., investments").

[34] *See* LEC-1 (Duval Opening) at 13:27.

[35] Pub. Util. Code § 275.6(b)(2); *Pacific Tel. & Tel. Co. v. Pub. Util. Comm'n,* 62 Cal.2d 634, 644-645 (1965) (rate base is the "value of property devoted to public use" less depreciation).

[36] Res. T-16006; D.97-04-035; D.97-04-036; D.97-04-034; Res. T-16004; Res. T-16005; D.97-04-032; Res. T-16008; Res. T-16007; Res. T-16001; Res. T-16002; Res. T-16000; D.97-04-033; Res. T-16003; Res. T-15999; Res. T-15998; Res. T-15997; Res. T-16720; Res. T-16697; Res. T-16707; Res. T-16711; D.03-10-006; Res. T-16756; Res. T-16764; Res. T-16762; Res. T-16755; Res. T-16771; Res. T-16968; Res. T-17048; Res. T-17108; Res. T-17082; Res. T-17081; Res. T-17158; Res. T-17157; Res. T-17184; Res. T-17133; Res. T-17132; D.10-11-007; D.11-12-001; D.16-06-053; D.16-09-047; D.16-09-049; D.17-11-013; D.17-11-016; D.18-01-011; D.18-04-006; D.19-04-017; D.19-06-025; D.19-12-011.

[37] "The Commission sets rates that are designed to enable a telephone company to generate sufficient revenue to meet the revenue requirement." *Ponderosa v. Pub. Util. Comm'n,* 197 Cal.App.4th 48, 52 (2011); *Re Pac. Tel. & Tel. Co.*, 13 CPUC 2d 331 (Dec. 7, 1983), D.83-12-024 ("A precondition to the detailed design of rates is a determination of the revenue requirement which the rates are intended to

During the rate case, the revenue requirement and rate design are measured with reference to a future test year.[38] The test year is generally at least one full year beyond the filing date of the rate case. While historical data may be used to inform the Commission's reasonableness analysis, the backward-looking figures are not the determinant of whether a given revenue, expense, return on rate base, or tax liability is reasonable.[39] If projected financials are reasonable for the prospective test year, they must be approved, even if they differ from the past.

4. The CHCF-A Program.

The CHCF-A is a state universal service and high-cost support program, grounded in the policies that customers in rural areas should have access to safe, reliable telecommunications services at affordable prices and that the telecommunications network is more valuable if more people are connected.[40] The Commission has also recognized that the CHCF-A "is critical to public safety and benefits the state as a whole."[41]

The CHCF-A was conceived in 1985 as part of the "High Cost Fund," or "HCF," which originally encompassed the functions of both the CHCF-A and the CHCF-B.[42] The creation of

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satisfy."); *City & Cty. of San Francisco*, *supra*, 39 Cal. 3d at 531 (in general rate cases, "the commission determines the revenue requirement, and then fixes the rates for the consumers to produce sufficient income to meet the revenue requirement. . . ."); *see also In the Matter of Regulation of Business Data Services for Rate-of-Return Local Exchange Carriers*, WC Docket No. 17-144, *Report and Order, et al.,* FCC 18-146 at ¶ 34 (rel. Oct. 24, 2018) ("Rate-of-return carriers set rates at levels that when multiplied by demand will yield revenues equal to their revenue requirement, and are targeted to earn the Commission's prescribed rate of return."); *Duquesne Light Company v. Barasch*, 488 U.S. 299, 308 (1989) ("If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments.").

[38] *See PT&T*, *supra*, 62 Cal.2d at 644-645 ; *City & Cty. of San Francisco*, *supra*, 39 Cal.3d at 531.

[39] *See City & Cty. of San Francisco*, *supra*, 39 Cal.3d at 529, 531 ("It is obvious revenue, expense, and rate base arrived at on historical data will not remain constant in future years when the rates take effect. The assumption underlying fixing of future rates on historical data is that for future years changes in the revenue, expense, and rate base will vary proportionately so that the utility will receive a fair rate of return."); *see also Pacific Tel. & Tel. Co*, *supra*, 62 Cal.2d at 644-645.

[40] *See* D.85-06-115, 18 CPUC 2d 133, 229 ("[t]he beneficiaries of the [high cost fund] would not be the [Independent Telephone Companies], . . . but rather their ratepayers"); D.88-07-022, 28 CPUC 2d 371, 476 ("It is our fundamental concern that a source of supplemental revenue be maintained for the [Independent Telephone Companies] in order to protect the availability of universal service for all California's citizens once we have eliminated the pooled surcharge these ITCs presently depend on."); D.18-04-006 at 10 ("The purpose of the CHCF-A is to provide a source of supplemental revenues to Small Incumbent Local Exchange Carriers (Small ILECs) whose basic exchange access line service rates would otherwise be increased to levels that would threaten universal service."); AB 1959 (2018 Wood) (extending the CHCF-A until 2023 and noting "the principle that consumers in all regions of the nation, including . . . those in rural, insular, and high-cost areas, should have access to telecommunications and information services that are reasonably comparable to those services provided in urban areas . . .").

[41] D.14-12-084 at 53; *see also* Res. T-17682 at 20-21 (noting value of CHCF-A in maintaining 911 service, promoting undergrounding, facilitating network resiliency, and aiding emergency response).

[42] D.85-06-115, *supra,* 18 CPUC 2d 248 (COL 41-42) (adopting a "pooled surcharge" to "provide for HCF relief"); D.88-07-022, 28 CPUC 2d 371, 483, Table 2 (noting participation from mid-sized ILECs, Roseville Telephone Company and Citizens Utilities Company of California).

the HCF was part of the transition away from implicit universal service support mechanisms, inter-company transfers, and pooling arrangements as a means of recovering the costs of local exchange service.[43] As the Commission explained, "[t]he intrastate HCF would be available only to fill the gap between, on the one hand, a revenue requirement determined reasonable after rate case review and, on the other hand, existing sources of revenue including interstate HCF assistance and basic exchange rates."[44]

Through a series of decisions in the late 1980s and early 1990s, the Commission implemented the HCF, culminating in the implementation rules in Appendix A to D.91-09-042, which have remained substantively unchanged since 1991.[45] Paralleling these developments, the Legislature directed the Commission to "establish a fair and equitable local rate structure aided by transfer payments to small independent telephone corporations."[46] In 1996, the CHCF-B was bifurcated from the CHCF-A, leaving the CHCF-A as the sole state high-cost fund available to the Independent Small LECs.[47] The CHCF-A was originally managed by Pacific Bell pursuant to an pooling arrangement, but the Commission terminated this structure in 2001.[48] Later that year, it issued its first resolution reflecting the full scope of the CHCF-A budget.[49]

The basic mechanics of the CHCF-A are the same today as in 2001. In rate cases, CHCF-A operates as a "residual" funding mechanism, fulfilling the component of revenue requirement that cannot be supplied by end user rates, federal high-cost support, or other intrastate jurisdictional local exchange revenues.[50] Between rate cases, the CHCF-A is subject to

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[43] For decades, the Independent Small LECs participated in an access charge and pooling process with Pacific Bell, from which the companies fulfilled large portions of their revenue requirements. *See* D.01-02-018 at 5; D.85-06-115, *supra*, 18 CPUC 2d 229 ("access revenues are a relatively high proportion of total revenues for most [Independent Telephone Companies]"); D.91-07-044, 41 CPUC 2d 1, 9-10 ("the rate design options available to the small LECs are too limited to absorb any significant amount of the additional revenue requirement resulting from the termination of settlements.").

[44] D.85-06-115, *supra*, 18 CPUC 2d 234.

[45] *See* D.88-07-022; D.91-05-016; D.91-09-042, Appendix; *see* D.00-09-072 (granting Small LECs' request for extension of waterfall at 100% level for additional year); D.01-02-018 (authorizing CHCF-A to replace intercompany settlement payments previously made by Pacific Bell); D.01-05-031 (extending waterfall until 2002 for certain Small LECs); D.14-12-084 (clarifying timing of submissions).

[46] AB 1466 (1987 Waters) (adopting Public Utilities Code 739.3, later renumbered as Section 276.5).

[47] D.96-10-066, 68 CPUC 2d 524, 584.

[48] D.91-09-042, App. § C ("[t]he HCF funding process shall be administered by Pacific Bell . . . and the HCF shall function as a separate fund rather than a pool"); D.01-02-018 at 23-27, 81 (COL 5) (terminating pooling and settlement arrangement with Pacific Bell, authorizing the CHCF-A as the source of replacement funding, and incorporating such funding into the CHCF-A advice letter process).

[49] Res. T-16521 (July 29, 2001) (O.P. 2). Because this shift occurred mid-year, the full budgetary impact requires an annualization of the months of July through December).

[50] Pub. Util. Code § 275.6(c)(4); *see* D.19-12-011 at 32 (COL 6) (outlining components of Pinnacles' rate design and noting that CHCF-A represents the "remainder" necessary to fulfill its revenue requirement

three specific types of prospective annual adjustments: (1) increases or decreases in CHCF-A needs based on the "net settlement effects" of "regulatory changes of industry-wide effect;" (2) "means test" reductions in CHCF-A for companies who exceed their authorized rates of return based on seven months of annualized data; and (3) "waterfall" reductions in funding for companies who choose not to file rate cases within the timeframe specified in the rules, with successive annual reductions to 80%, 50%, and 0% support for each year in which a rate case is not filed.[51] The annual CHCF-A process has no impact on revenue requirement, as determinations regarding companies' costs can only be changed in a rate case.[52] Since 1996, the CHCF-A has been subject to a "sunset" provision, but the sunset has been extended 7 times since 2000, including the 2018 extension until 2023.[53]

5. The 2012 Statutory Changes to CHCF-A.

Public Utilities Code Section 275.6 is the principal statute governing the Commission's administration of the CHCF-A and its ratemaking determinations regarding CHCF-A participants.[54] Section 275.6 was created in 2008, when the Legislature adopted different statutory provisions to govern the CHCF-A and the CHCF-B.[55] In 2012, Section 275.6 was modified to include more specific guidance to the Commission in implementing the CHCF-A.[56]

The 2012 revisions advanced two chief objectives. First, they codified existing practice and current law regarding the operation of rate-of-return regulation for Independent Small LECs.[57] Second, the Legislature specifically recognized that investments in broadband-capable facilities are appropriate for inclusion in rate base.[58] This clarification aligned the CHCF-A with

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after accounting for local network service revenues, interstate Universal Service Fund support for intrastate revenue requirement, intrastate access revenues and miscellaneous revenues).

[51] D.91-09-042, App. §§ B, D; Res. T-17682 at 10-11.

[52] *See* RT at 2047:15-22 (Duval) (confirming that there are no changes to costs or revenue requirement in the annual CHCF-A filing process); 2113:8-13 (Ahlstedt) (acknowledging that revenue requirement and rate design are set in rate cases and that they are not set in the annual CHCF-A filing).

[53] *See supra,* n 3.

[54] The record reflects wide agreement regarding the centrality of Public Utilities Code Section 275.6 to the issues in Phase 2 of the proceeding. RT at 1269:25-1270:1 (Parker); 1765:21-25 (Roycroft), 2163:12-16 (Montero); 2236:27-2237:5 (Hoglund); Cal Adv-1 (Ahlstedt Opening) at 4-3:4-10.

[55] *See* SB 780 (Wiggins 2008) (creating Public Utilities Code Section 275.6 to govern the CHCF-A and leaving Section 739.3 as the basis for the CHCF-B).

[56] SB 379 (Fuller 2012)

[57] The basic framework and definitions in Section 275.6 reflect longstanding Commission precedent regarding "rate-of-return regulation." *See City & Cty. of San Francisco*, *supra*, 39 Cal. 3d at 529, 531 (reflecting parallel concepts of "rate-of-return regulation" to Pub. Util. Code § 275.6(c)(2)).

[58] *See* Pub. Util. Code §§ 275.6(c)(6) ("the commission shall . . . Include all reasonable investments necessary to provide for the delivery of high-quality voice communication services and the deployment of broadband-capable facilities in the rate base of small independent telephone corporations."); 275.6(c)(5)

federal universal service programs, which had shifted in 2011 to support the deployment of broadband-capable facilities in addition to voice service.[59] The Legislature was concerned that if the CHCF-A did not support investments in broadband-capable facilities, disconnects with federal universal service objectives could arise, and significant federal funding could be lost.[60]

The 2012 revisions did not augment the Commission's jurisdiction or expand the types of revenues that could be included in ratemaking calculations for "small independent telephone corporations."[61] Section 275.6(c)(6) prescribes the treatment of "reasonable investments" by "small independent *telephone corporations*" in "broadband-capable *facilities*," but it does not extend Commission jurisdiction to ISP *affiliates* or the broadband *services* they provide.[62] All of the ratemaking standards in Section 275.6 refer to "small independent telephone corporations," not their affiliates.[63] The only statutory reference to ISP affiliates or unregulated service is in sub-section (h), a purely informational provision.[64] None of the other provisions state or imply any intent to bring Internet access service within intrastate ratemaking calculations.[65]

(confirming the role of the CHCF-A in "promot[ing] customer access to advanced services and deployment of broadband-capable facilities").

[59] *See* SB 379 (Fuller 2012) (noting the "intent of the Legislature to preserve . . . [f]ederal universal service funding"); *In the Matter of Connect America Fund*, WC Docket No. 10-90, *Report and Order*, *et al.*, FCC 11-161 (rel. Nov. 18, 2011) ("*USF/ICC Transformation Order"*) at ¶¶ 60, 64 (noting the legal authority under 47 U.S.C. Section 254 to "support not only voice telephony but also the facilities over which it is offered" and to "condition the receipt of universal service support on the deployment of broadband networks").

[60] *See* SB 379 Senate Energy, Utilities and Communications Committee Analysis (Aug. 29, 2012) (SB 379 "codifies policy direction for the CPUC's administration of the CHCF-A to support investment in today's modern broadband technology rather than in the minimal facilities needed for providing voice service" and "helps prevent loss of substantial federal funds specifically targeted for broadband facilities in rural areas."). The Legislature's concern was fueled in part by the Commission's refusal to support fiber installations in certain of the Independent Small LECs' 2009 rate cases. *See, e.g.*, Res. T-17133 (Cal-Ore) at 11 (disallowing fiber infrastructure deployment in Dorris and Tulelake, suggesting instead that Cal-Ore install copper).

[61] Pub. Util. Code § 275.6(b)(6). Neither the language of SB 379 nor any aspect of its Legislative history suggests an intent to confer Commission jurisdiction over interstate or non-regulated services.

[62] Pub. Util. Code § 275.6(c)(6) (emphasis added). It is well established that the Commission does not regulate interstate services or services that the FCC has designated as non-regulated "information services." Pub. Util. Code § 202 (restricting Commission jurisdiction over "interstate commerce"); D.07-01-005 at 4; *Restoring Internet Freedom Order* at ¶ 20 ("[w]e reinstate the information service classification of broadband Internet access service."), *petition for review granted in part on other grounds and denied in part by Mozilla Corp.*, *supra*, 940 F.3d at 35.

[63] *See* Pub. Util. Code §§ 275.6(c)(2), 275.6(b)(3)-(b)(5).

[64] Pub. Util. C. § 275.6(e) (requiring that a "small independent telephone corporation" identify, upon request, "revenues derived from the provision of unregulated Internet access service by that corporation or its affiliate within that corporation's telephone service territory.").

[65] Section 275.6(c)(7) provides that CHCF-A support should not be "excessive," but there is no nexus between this standard and interstate or non-regulated operations. Indeed, the Commission has considered the level of CHCF-A surcharge contributions as part of its reasonableness analysis for many years, long before the 2012 changes to Section 275.6. *See, e.g.,* D.85-06-115, *supra at* 18 CPUC 2d 226-228.

B. The Procedural Context of Phase 2.

1. The Origins of the Rulemaking and Phase 1 Events.

This proceeding was opened in November 2011 based on an assumption that major changes to the CHCF-A should be pursued. Citing broad industry dynamics, the Order Instituting Rulemaking ("OIR") questioned "whether the program remains necessary" and asked whether it "should terminate immediately."[66] The OIR proposed multiple changes to the CHCF-A, including caps on support, "per access line" limitations, "total operations" ratemaking, "end-user-direct-subsidy" models, and even outright "purchasing services for rural customers from alternative providers."[67] As support for these unprecedented ideas, the OIR cited to misleading data about the size of the CHCF-A,[68] false comparisons between the Independent Small LECs and the TDS Companies,[69] unfounded analogies to the CHCF-B,[70] and alleged demographic and technological shifts that are not reflective of Independent Small LEC territories.[71]

Through a series of scoping events, the proposals in Phase 1 were narrowed to a few issues, including questions about "counting" broadband revenues toward fulfillment of intrastate revenue requirement, the proposal to open rural telephone company areas to competition, the potential imposition of the FCC's corporate expense cap on intrastate expense calculations, metrics for determining reasonable end user rates, and the role of federal funding in intrastate ratemaking.[72] Evidentiary hearings took place to address the Phase 1 issues in September 2014 and a full briefing of the issues took place during September and October 2014.

2. The Phase 1 Decision.

The Phase 1 Decision was issued in December 2014, and it resulted in two principal

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[66] *OIR* at 3, 24.
[67] *OIR* at 32-34. These proposals were unlawful at the time they were proposed and they are unlawful today. *See* Pub. Util. Code § 275.6(c)(2).
[68] *See OIR* at 23-24 (alleging "significant increases [in CHCF-A] from one year to the next" by using the partial-year 2001 funding as the starting point and focusing on the historical trough in CHCF-A support in 2005). The correct picture of the carriers' CHCF-A claims is presented in Mr. Boos's testimony. *See* LEC-4 (Boos Opening) at 9.
[69] *OIR* at 19-20 (presenting a comparison between "CHCF-A carriers" and "non-CHCF-A carriers," without acknowledging that the "non-CHCF-A carriers" were all affiliated with large, national companies and not comparable to the Independent Small LECs). The comparison between the Independent Small LECs and the TDS Companies has been debunked as part of the Phase 1 record and again in comments on the Scoping Memo. *See Independent Small LECs Opening Comments on OIR* at 31-32; *Independent Small LECs Opening Comments on 4th Amended Scoping Memo* at 41.
[70] The OIR falsely assumed "similarities between populations served by the CHCF-A and the CHCF-B" and proffered "per line" figures that ignore fundamental differences between the programs. *OIR* at 17, 21.
[71] *OIR* at 23 (assuming statewide population density trends apply to Independent Small LEC territories and that industry dynamics facing larger markets are true in rural areas).
[72] *See Amended Scoping Memo* (March 18, 2014) at 10-12.

adjustments to the ratemaking process for CHCF-A participants. First, the Commission adopted the FCC's corporate expense cap as a rebuttable presumption, which could be rebutted by evidence in an individual company's rate case.[73] Second, the Commission established a "range of reasonableness" for residential basic service rates from $30.00 to $37.00, inclusive of the surcharges and "additional charges" used to apply the FCC's Access Recovery Charge ("ARC") benchmark.[74] The Commission declined to "impute" broadband revenues into intrastate ratemaking, and it declined to authorize CLEC competition in rural telephone company areas. Instead, it decided to "revisit" these issues in Phase 2.[75] To inform its Phase 2 analysis, the Commission ordered the preparation of a "Broadband Network and Competition" study.[76]

3. The 2015 Rate Case Plan.

During the pendency of Phase 1, the Commission imposed a stay on rate cases, so no new rate cases were filed from January 2012 through the November 2015.[77] Therefore, at the conclusion of Phase 1, the Commission initiated a transitional phase of the proceeding to reinitiate rate cases and establish a "rate case plan" for the 10 Independent Small LECs.[78]

Following comments from the parties and a one-day workshop, the rate case plan was released.[79] It outlined two rounds of rate cases for each company over a nine-year period. The 10 companies were divided into three "Groups," each of which would have the same test year and overall procedural schedule.[80] The rate case plan also established a 14-month timeframe for completion of each rate case and internal procedural deadlines for each rate case.[81] In addition,

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[73] D.14-12-084 at 29.
[74] *Id.* at 66-69.
[75] *Id.* at 24, 60. In light of Commission's conclusion not to impute broadband revenues in Phase 1, its legal conclusions on the merits of this practice have only the value of dicta. *See* D.12-08-031 at 16-17 (noting that "it is settled law that arguments and general observations, unnecessary to the decision, i.e., dicta, carry no weight as judicial precedent."), *citing Trope v. Katz* (1995) 11 Cal.4th 274, 284 and *Childers v. Childers* (1946) 74 Cal.App.2d 56, 61 ("A decision is not authority for what is said in the opinion but only for the points actually involved and actually decided").
[76] D.14-12-084 at 59.
[77] One rate case was already underway when the stay was imposed. Kerman had filed its application in 2011 according to the ordinary timeframe under the CHCF-A rules to avoid a 20% reduction in CHCF-A under the "waterfall" provision. *See* D.91-09-042, App. § D at 5; Res. T-17081 (Kerman's prior rate case test year was 2008). Nevertheless, the schedule for that case was also suspended, resulting in extensive delays in its completion. *See* D.13-10-051 at 21 (staying rate case after more than a year of delay in processing the application); D.16-06-053 at 4-11 (final decision issued in June 2016).
[78] *See Third Amended Scoping Memo* (December 9, 2014) at 6.
[79] D.15-06-048 at 6-17 (describing comments and workshops), App. A (presenting rate case plan).
[80] Group A includes Kerman, which had a test year of 2016, and Siskiyou and Volcano, with test years of 2017. Group B includes Calaveras, Cal-Ore, Ponderosa, and Sierra, with test years of 2018. Group C included Foresthill, Ducor and Pinnacles, using test years of 2019. D.15-06-048, App. A, at p. 1.
[81] D.15-06-048, App. A at 2-3.

the rate case plan identified pre-application deadlines, notices, and informational requirements.[82]

4. The 2016-2019 Rate Case Cycle.

The first cycle under the rate case plan is complete. Of the 10 rate case applications, Cal Advocates protested nine.[83] In all contested cases, Cal Advocates proposed higher end user rates than the applicants.[84] Six cases were resolved by settlement and three produced fully-litigated decisions.[85] In general, the cases were characterized by extensive procedural delays; only two were completed within the 14-month timeframe in the rate case plan.[86]

Now that each of the rate cases in the first cycle have been implemented, the overall impact of the first cycle can be discerned. From 2016 to 2020, the CHCF-A carrier claims grew by only 9.3%.[87] Over the same time period, the companies' collective revenue requirements were reduced by 15.6%, reflecting significant efficiencies and cost savings.[88]

5. The Mission Consulting Study.

The Commission engaged Mission Consulting to study certain questions related to the principal issues that were deferred to Phase 2: "broadband imputation" and "CLEC competition in rural telephone company territories." Mission Consulting produced its findings in a report dated September 2018.[89] The report reflects numerous inaccuracies, methodological flaws, false factual and legal predicates, and material omissions.[90] It was widely criticized by the parties, and, at the Phase 2 Pre-hearing Conference ("PHC"), ALJ McKenzie confirmed that "this study

[82] *Id.*, App. A at 2-3. The rate case plan provided authorization to Cal Advocates (then known as the "Office of Ratepayers Advocates") to issue "Minimum Data Requirements" in advance of a rate case filing. *Id.* at 3. Cal Advocates proposed this front-loading of data requests based on the premise that it would streamline the process and facilitate more timely resolutions of rate cases. *Id.* at 6-7, 13-14.
[83] *See* A.11-12-011 (Kerman); A.15-12-001 (Siskiyou); A.15-12-002 (Volcano); A.16-10-001 (Ponderosa); A.16-10-002 (Calaveras); A.16-10-003 (Sierra); A.16-10-004 (Cal-Ore); A.17-10-003 (Ducor); and A.17-10-004 (Foresthill). Only Pinnacles, the smallest ILEC in the state, had an uncontested application. *See* A.17-12-004.
[84] LEC-12 (Lehman Reply) at 4-5.
[85] The rate cases for Ducor, Foresthill, and Kerman involved full evidentiary hearings and briefing, and were resolved by Commission decisions. D.19-06-025 (Ducor); D.19-04-017 (Foresthill); D.16-06-053 (Kerman). Pinnacles' case was uncontested, so there was no adversarial process. D.19-12-011. The remaining cases were resolved by settlement. D.16-09-047 (Siskiyou); D.16-09-049 (Volcano); D.17-11-013 (Ponderosa); D.17-11-016 (Sierra); D.18-01-011 (Cal-Ore); D.18-04-006 (Calaveras).
[86] The procedural timelines for each case are discernible from the dockets for each case. *See* n. 83, above.
[87] *See* LEC-4 (Boos Opening) at 9, Att. C; *see also* Res. T-17682.
[88] *Compare* Res. T-17616; Res. T-17617; Res. T-17618; Res. T-17619; Res. T-17626; D.19-04-017; D.19-06-025; D.19-12-011 *to* Res. T-17081; D.10-11-007; Res. T-17108; Res. T-17132; Res. T-17184; Res. T-17082; Res. T-17133; Res. T-17157; D.11-12-001; Res. T-17158.
[89] *See March 26, 2019 ALJ Ruling*, Att. A.
[90] *See Independent Small LECs Opening Comments on 4th Amended Scoping Ruling*, App. A.

is not currently part of the evidentiary record."[91] No party sought to introduce the study into the evidentiary record, so it remains extra-record material and cannot be a basis for decision-making.

6. Phase 2 Procedural and Evidentiary Events.

Following initial scoping events in 2017, Phase 2 began with the issuance of the Scoping Memo on March 26, 2019.[92] Opening and reply comments addressed the Mission Consulting study and identified proposals for Phase 2. The Commission then refined the issues to be addressed through evidentiary hearings.[93]

III. BROADBAND DEPLOYMENT AND SUBSCRIPTION IN INDEPENDENT SMALL LEC TERRITORIES [SCOPING MEMO, ISSUES (1)(A), (1)(E), 1(F), (9); HEARING ISSUES (1), (3), (4), (5)].

To inform its policy decisions in this proceeding, the Commission requested information about the extent of Independent Small LECs' broadband deployment, the "maturity" of their networks, and the parameters of their affiliates' broadband service offerings.[94] The Independent Small LECs responded to these questions and provided vast amounts of additional data to TURN and Cal Advocates through the discovery process.[95] The Commission has amassed an extensive record on these subjects that provides a detailed picture of each Independent Small LEC's broadband facilities and the operational platform of each affiliated ISP. The facts underscore the need for continued investment in Independent Small LEC territories and the importance of precision in measuring broadband deployment. The record does not support proposals to impose operational regulations or price controls on affiliated ISPs, nor would such a result be lawful.

A. Broadband Deployment in Rural Areas Requires Ongoing Investments and Depends Upon Continued Support from the CHCF-A.

The Independent Small LECs have made great strides in their broadband deployment since the Phase 1 Decision was issued, but continued investment must be made to meet current

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[91] RT at 383:14-16; RT at 384:6-9 (ALJ McKenzie).
[92] *Scoping Memo*. In April 2017, the Assigned Commissioner had issued a Third Amended Scoping Memo and Ruling seeking input on the scope of Phase 2. *Third Amended Scoping Ruling*, at 4-8. The parties provided opening and reply comments, and an initial PHC took place on June 8, 2017.
[93] For the "competition" and "tribal" issues, separate procedural vehicles were established. *See November 8, 2019 ALJ Ruling* at 5; *Fifth Amended Scoping Ruling*, at 4, 6-7.
[94] *Scoping Memo* at 4-5; *Ruling Setting Hearings* at 1-3.
[95] The specific responses to the questions posed in the Ruling Setting Hearings are dispersed throughout the parties' testimony. To consolidate the information in one place, the Independent Small LECs prepared a compendium of the responses, shared it with the parties, and sought its introduction at the beginning of the evidentiary hearings. RT at 904:13-914:19 (ALJ, Rosvall, Mailloux, Choe, Kalish). The request was denied, but the materials responsive to the questions about broadband deployment and ISP operations can be found in Mr. Duval's, Mr. Boos', and Dr. Roycroft's testimony. TURN-1 (Roycroft Opening), App. 2 at NC0084-0143, NC0179-NC0200, App. 3 at C0014-C0024, C0037-0082; LEC-1-C (Duval Opening), Att. A-B; LEC-2-C (Duval Reply), Exh. B-D; LEC-4-C (Boos Opening), Att. A.

and future broadband standards. Based on the record in Phase 1, the Independent Small LECs had generally achieved speed capabilities of 4/1 Mbps, but most companies had not yet reached widespread deployment at the 10/1 Mbps level.[96] 25/3 deployments were rare.[97] The Phase 2 record shows material improvements, spurred by continued support from the CHCF-A through the most recent round of rate cases.[98] Based on 2019 data, the Independent Small LECs have attained approximately 94% deployment at 10/1 Mbps, but network capabilities still fall short of the FCC's 25/3 Mbps standard at approximately 45% of customer locations.[99] Further investment will be needed to deliver 25/3 to all reasonable locations, which necessitates ongoing cost recovery, including CHCF-A support.[100]

Broadband deployment is never "finished" because broadband-based applications continue to advance and consumer needs evolve and grow. The Commission should ensure that the Independent Small LECs are equipped to meet their communities' broadband needs both now and in the future.[101] Indeed, the COVID-19 crisis and the accompanying "shelter in place" order serve as a reminder of the vital importance of broadband-capable networks in our society.[102] In

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[96] *See* TURN-1 (Roycroft Opening) at 38:16-18 ("Viewed as a group, the Small LECs have improved broadband speed over the past five years. In 2013, broadband speeds at the 10/1 Mbps level were relatively rare among the Small LECs, and even more rare were speeds at the 25/3 Mbps level.")

[97] *Id.*

[98] For example, in 2016, Ducor's network only achieved maximum broadband speeds of 6 Mbps download and 1 Mbps upload, but Ducor now provides extensive access at the 10/1 Mbps level. *See* LEC-7 (Votaw Opening) at 5:4-6. Based on the results of its recent rate case and the support that it authorized, Ducor is working actively to upgrade its facilities to fiber. *See* D.19-06-025 at 25 (noting Ducor's "planned investments in fiber deployment to customers' homes").

[99] *See* LEC-2-C (Duval Reply), Exh. B; LEC-4-C (Boos Opening), Att. A; TURN-2 (Roycroft Reply) at 57, Table 4. Neither Table 4 nor Dr. Roycroft's Appendix 1 Errata explain his reasoning behind changing Volcano's data (decreasing customer access numbers by 10 in each speed category), which has not changed since production in opening testimony. TURN 2-C (Roycroft Reply), App. 1 at 0008-0009; LEC-4-C (Boos Opening), Att. A, Volcano; TURN-1-C (Roycroft Opening), App. 3 C0024. However, the totals in Table 4 do not reflect the sum of the individual figures. In recalculating the totals to Dr. Roycroft's Table 4, 36,691, the sum of the individual figures in the 25/3 column, divided by 66,617, the sum of the individual figures in the 6/1.5 and Unserved columns, produces a percentage of 55.08% of customer locations with access to 25/3; *see also* TURN -1 (Roycroft Opening) at 39:9-10 ("the Small LECs significantly lag behind broadband performance in urban areas.").

[100] LEC-1 (Duval Opening) at 11:20-23 (". . . state and federal universal service funding remains necessary to ensure that the Independent Small LECs are able to deploy broadband capable facilities in order to the meet the FCC's continually growing broadband requirements and satisfy customer demand, which also continues to expand."). The CHCF-A is not a grant program, so it does not supply investment capital, but it offers essential support for investments by helping fulfill companies' revenue requirements, which include a "return on investment in broadband-capable facilities." RT at 932:15-18 (Duval).

[101] LEC-1 (Duval Opening) at 11:18-19 ("Broadband deployment is not a finish line; it is an ever-evolving set of check points to ensure that customers are able to receive broadband at the then-current public interest standards.")

[102] *See* Res. M-4842 at 3 (finding that "shelter in place" orders will likely cause "increased usage of utility service" and noting that some broadband providers have increased speeds and lifted data caps).

rural areas, which are distant from many social services and economic opportunities, it is especially critical that broadband networks keep up with customer demand, increasing needs for bandwidth-intensive applications, and evolving regulatory requirements.[103] When the Phase 1 Decision was issued, the FCC's broadband capability standard was still 4/1 Mbps, and it has rapidly risen to 10/1 Mbps and now 25/3 Mbps.[104] By the time the next rate cases are completed under the rate case plan, customer expectations and regulatory requirements are likely to have increased well beyond 25/3 Mbps, which will necessitate fiber-to-the-premise architecture in substantially all locations.[105]

B. Accurate Tracking of Broadband Capabilities Requires Identifying the Actual Capabilities of the Network.

To evaluate the forward-looking broadband deployment needs in the Independent Small LECs' service territories and to reach informed ratemaking decisions regarding proposed investments, the Commission should rely on precise information about companies' broadband capabilities. The Independent Small LECs report their broadband deployment to the Commission on an annual basis using the same criteria as the FCC's Form 477 submission.[106] While this information is valuable and the companies will continue to make these filings as required, the Form 477 relies on definitions and assumptions that reduce its usefulness in accurately depicting the state of deployment.

The record points to three specific improvements that should be made in the

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[103] *See* LEC-8 (Votaw Reply) at 2:27-3:1 ("In rural areas like Ducor's … the advancement of broadband-capable infrastructure is essential to the social and economic health of the areas.").

[104] *See In the Matter of Connect America Fund,* WC Docket No. 10-90, *Report and Order,* FCC 14-190 (rel. Dec. 18, 2014) at ¶¶ 13 and 15 (confirming that the standard was 4/1 Mbps but adopting a new minimum speed standard of 10/1.Mbps.); *see also ETC Reform Order* at ¶ 3 ("Access to 25/3 Mbps broadband service is not a luxury for urban areas, but important to Americans wherever they live.").

[105] *See* RT at 1416:1-5 (Boos) ("We're looking ahead, too, and we don't believe that a 25/3 network is going to be adequate, and we believe the FCC's going to increase that requirement, and so we're trying to anticipate that."); *see also* Phase 1 Exh. 11 (Thompson Opening) (engineering expert confirming that "[a]s the need for increased speeds continues, all wireline providers will eventually install FTTP, which is the most cost-effective way to provide wireline services from a long-term perspective when considering the capital expenditures, scalability factors, broadband capabilities, and operational expenses involved."); RT at 1362:5-6 (McNally) (in response to a question about upgrading Sierra's network: "Our plan is to build fiber to the home."); RT at 1509:1-15 (Boos) (explaining that speeds of 25/3 Mbps could not be achieved over copper, and necessitated fiber).

[106] *See* Cal-Adv-17-C (LEC responses to PHH-011 and PHH-012) at 10 (indicating that the Independent Small LECs respond to an annual Communications Division data request that supplies broadband subscribership data at the census block level.); *see also* D.16-12-025 at OP 1 ("all communications providers certificated and/or registered with the California Public Utilities Commission that also file Forms 477 with the Federal Communications Commission shall submit annually to the Communications Division by April 1st, voice and broadband subscriber and deployment data at a census block level as of the prior calendar year's end in a form designated by Communications Division Staff.").

Commission's measurement of broadband deployment. First, the Commission should utilize data regarding the actual network capabilities, not the advertised speed.[107] The extent to which a speed is included in marketing materials has no bearing on whether the network can deliver that speed. Second, the Commission should not deem a household to be "served" just because it is identified in Form 477 reports as a location that could be served within "10 business days."[108] The Independent Small LECs have supplied more precise information about their network capabilities, which include determinations of whether a service drop has been connected that can enable service at the reported level.[109] As Sierra's network engineering witness explained:

> Until a location is equipped with the broadband-capable drop, it is not actually served, and additional investment would be needed to reach the location. The "served" locations in the Form 477 reports are based on whether a given location "could be served" within a standard interval which companies have interpreted to be 10 business days if a request for service were received. In some locations, "drops" do not exist to deliver service at the indicated speeds, but a drop could be installed within 10 business days – with an additional associated cost.[110]

The Commission could reach inaccurate ratemaking conclusions if it ignores these distinctions.[111] Third, the Commission should abandon its practice of altering deployment data based on broadband subscription.[112] Regardless of whether there is a subscriber at the highest available speed, the capabilities of the network should be catalogued without alteration through

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[107] *See* LEC-26 (Form 477 Instructions) at 18 (availability is evaluated by "advertised" speeds.)
[108] Form 477 data utilize a "reasonable service interval" standard that has been operationalized in the industry as "10 business days." *See id.* at 18 (defining fixed broadband as available in a census block if the provider could provision service "within a service interval that is typical for that type of connection . . . "); *see also* RT at 1338:5-11 (McNally) (confirming that the Form 477 requires carriers to report the locations to which they can deploy service to within ten days under the application of "the reasonableness standard"); *see also* RT at 1948:27-1949:1 (Duval) ("So in general, the industry standard is that it's a 10-day requirement.").
[109] *See* LEC-2-C (Duval Reply), Exh. B; LEC-4-C (Boos Opening), Att. A.
[110] LEC-3 (McNally Reply) at 3:26-4:7; *see also* RT at 1306:9-13 (Parker) ("I also say we should use service drops as a part of the measuring for broadband. Because a service drop has to be installed at a property in order to count as a broadband-deployed location."). The company "service drop" data yield materially different results from the Form 477 submissions, with a higher level of accuracy. *See* LEC-22-C (Cal Advocates Response to CWC 10) at 5 (debunking Parker's misleading comparison of overall "service drop" and "10 business day" data by showing significant company-specific variances in the source data); *see also* RT at 1304:28-1305:1 (Parker) ("I would say some of them do appear different…").
[111] LEC-3 (McNally Reply) at 4:16-18 ("If the drop has not yet been installed, but the location is described as "served" in the Form 477 reporting terminology, it could lead to the incorrect conclusion that no additional investment is needed.")
[112] D.16-12-025 at 53 (Communications Division will "only recogniz[e] a service's availability in a census block if that service has at least one actual subscriber in the census block"); *see also* RT at 1326:1-4 (Parker) (data was received "by the CPUC from the small LECs, and it was validated. And part of the process of validating is using, accepting census blocks only that have subscribers…").

this improper "validation" exercise.[113]

C. Parties' Low-Income Broadband Discount Proposals Should Be Rejected.

Cal Advocates recommends that the Commission require the Independent Small LECs to directly offer a "low-cost broadband Internet service plan for customers who qualify for California's LifeLine program" that resembles the voluntary offerings from some of the largest ISPs in California, such as AT&T and Comcast.[114] While the Independent Small LECs support efforts to improve the affordability of Internet access service, Cal Advocates' proposal involves impermissible price regulation of the Independent Small LECs' ISP affiliates, ignores the barriers of offering low-income broadband in the Independent Small LECs' rural service areas, and would compel the Independent Small LECs' ISP affiliates to operate at a loss without just compensation.[115] Rather than singling out ten small carriers for a prescriptive pricing mandate, affordable broadband for low-income customers should be considered on an industrywide basis in the LifeLine rulemaking. An industrywide approach is especially important now, as many Californians are experiencing financial distress from the COVID-19 pandemic.

The legal restrictions on price-regulating an ISP are well-established. The Telecommunications Act prohibits common carrier regulation of "information services," and the FCC has recently adopted this classification for Internet access service, thereby freeing ISPs from "common carrier" and "public utility-style" regulations.[116] While telecommunications carriers are subject to common carrier regulation, such as requirements that rates be "just and reasonable," information service providers "are not subject to mandatory common-carrier regulation . . . ."[117] A mandate to offer Internet access at a certain price would irreconcilably

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[113] LEC-3 (McNally Reply) at 5:9-11 ("The Commission should strive to determine the actual capabilities of the network in terms of what the network can deliver and what level of speed a customer could purchase – even if a customer chooses not to do so.").
[114] Cal Adv-1 (Ahlstedt Opening) at 2-2:5-6; 2-2:9-11 and 2-4, Table 2-2.
[115] *See, e.g.*, LEC-4 (Boos Reply) at 22:16-23:1; LEC-8 (Votaw Reply) at 4:10-15, 10:17-28; LEC-2 (Duval Reply) at 2:26-3:9.
[116] *See Restoring Internet Freedom Order* at ¶ 20 ("[w]e reinstate the information service classification of broadband Internet access service."), *petition for review granted and denied in part on other grounds by Mozilla*, *supra*, 940 F.3d at 35 (upholding the FCC's classification of broadband Internet access as an "information service"); *see also* 47 U.S.C. § 153(51) ("A telecommunications carrier shall be treated as a common carrier under this chapter only to the extent that it is engaged in providing telecommunications services."); 47 U.S.C. § 230(b)(2) ("It is the policy of the United States . . . to preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services, unfettered by Federal or State regulation."); *Nat'l Cable & Telecommunications Ass'n v. Brand X Internet Servs. ("Brand X")*, 545 U.S. 967, 975 (2005) ("The [Telecommunications] Act regulates telecommunications carriers, but not information-service providers, as common carriers.").
[117] *Brand X*, *supra*, 545 U.S. at 975-976.

conflict with the affiliated ISPs' status as "information services" providers, leading inevitably to conflict preemption.[118] As TURN's expert admitted, the Commission does not regulate broadband rates,[119] nor could it regulate ISPs because they are not public utilities.[120]

The fact that the Independent Small LECs are CHCF-A recipients does not diminish the force of federal law or avoid the jurisdictional restrictions on the Commission's authority. Mr. Ahlstedt argues that the CHCF-A program enables his proposal to control the price of broadband *services*, but his only statutory citation is to Public Utilities Code Section 275.6(c)(6), which concerns the inclusion of broadband-capable *facilities* in rate base.[121] Neither this section nor any other provision of Section 275.6 confers regulatory authority over broadband services. Likewise, Section 275.6 applies to "telephone corporations," not ISPs.[122]

Even if Cal Advocates' proposal could be squared with jurisdictional authorities, it would force the ISPs to operate at substantial losses at to low-income customers. This outcome would cripple the ISPs' operations and create an unconstitutional taking of their property.[123] Cal

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[118] *California v. FCC*, 39 F.3d 919, 933-934 (9th Cir. 1994) (upholding preemption of state requirements on enhanced services where "it would not be economically or operationally feasible" to comply with state requirements without doing so for interstate services as well, "thereby defeating the FCC's more permissive policy"); *Fischer v. Time Warner Cable Inc.*, 234 Cal. App. 4th 784, 791 (2015) (finding that "a federal agency's regulations will preempt any state or local laws that conflict with or frustrate the regulations' purpose."); *see also Charter Advanced Servs. (MN), LLC v. Lange*, 903 F.3d 715, 718 (8th Cir. 2018) (finding that "any state regulation of an information service," such as broadband services, "conflicts with the federal policy of nonregulation" and is preempted); *Minn. Pub. Utils. Comm'n v. FCC*, 483 F.3d 570, 580-81 (8th Cir. 2007) ("[D]eregulation [is] a valid federal interest[] the FCC may protect through preemption of state regulation.") (quotation marks omitted);

[119] TURN-1 (Roycroft Opening) at 23:7-9. Although TURN expressed overall policy support for this proposal, Dr. Roycroft explained at the hearing that retail Internet service pricing is not part of TURN's proposal. RT at 1779:17-24 (Roycroft). Dr. Roycroft's imputation proposal includes an optional compliance plan by which ISPs could voluntarily reduce broadband rates. TURN-2 (Roycroft Reply) at 53:3-5; TURN-1 (Roycroft Opening) at 9:29-10:32. This issue is addressed in Section IV(A)(4), below.

[120] As discussed in Section IV(A)(1), below, ISPs cannot meet definitions of a "telephone corporation" or a "public utility," so they are outside the Commission's jurisdiction. *See* Pub. Util. Code §§ 234, 216(a).

[121] Cal Adv-2 (Ahlstedt Opening Errata) at 2-2:17-25. As Mr. Duval points out, Mr. Ahlstedt is confusing broadband-capable facilities with broadband services. LEC-2 (Duval Reply) at 17:24-26.

[122] *Id.* at 17:26-18:5; *see also* Phase 1 Exh. 1 (Duncan Reply) at 5-9; Section II(A)(5), *supra*. Mr. Ahlstedt attempts to avoid the distinction between ISPs and telephone corporations by suggesting that the Independent Small LECs should offer low-income broadband "directly, without an affiliate." Cal Adv-2 (Ahlstedt Opening Errata) at 2-2:26. However, forcing companies to move their ISP operations under the telephone company would not change the unregulated character of the service.

[123] The Takings Clause of the Fifth Amendment, as incorporated by the Fourteenth Amendment, prohibits states from taking private property for public use without just compensation. *Chicago, Burlington & Quincy Rail. Co. v. City of Chicago*, 166 U.S. 226, 239 (1897) (incorporating the Takings Clause). The California Constitution, Article 1, § 19 similarly provides that "[p]rivate property may be taken or damaged for public use only when just compensation, ascertained by a jury unless waived, has first been paid to ... the owner." Cal. Const., art. I, § 19. *See also Brooks-Scanlon Co. v. R.R. Comm'n of Louisiana*, 251 U.S. 396, 399–400 (1920) ("A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage"); *Duquesne*, *supra*, 488 U.S. at 308; *Federal Power Commission v. Hope Natural Gas Co.*, , 320 U.S. 591, 603(1944).

Advocates' witness admitted that the proposal would result in lost customer revenues of between $35-50 per LifeLine-eligible customer.[124] While the larger, national providers in Mr. Ahlstedt's Table 2.3 may have the economies of scale to offer service in Cal Advocates' target price range, small, rural ISPs do not have that luxury. Mr. Ahlstedt overlooks the many operational differences between the Independent Small LECs' affiliates and the proxy group that he identifies.[125] As the record reflects, none of these providers provide service through NECA Tariff No. 5, and there is no evidence that any of them face the large wholesale and middle mile costs that the Independent Small LECs affiliates experience.[126] Mr. Ahlstedt admitted that ISPs' costs do not change based on whether a customer is low-income.[127] Unlike larger providers, small, rural ISPs would need support to offer discounts of this magnitude.

The Independent Small LECs support the goal of affordable broadband, and the companies support the development of low-income offerings, if they can be properly funded. However, this is an issue for the LifeLine proceeding, not a proceeding designed to review the CHCF-A. As TURN's expert noted, "the matter of low-income subscription to broadband services is worthy of this Commission's attention on a statewide basis."[128] The recently-issued Scoping Memo in the LifeLine proceeding includes this issue and the Commission is moving forward rapidly with its consideration there.[129] It should be removed from consideration here.

D. State-Specific Broadband Performance Metrics Are Not Needed.

TURN and Cal Advocates propose that the Commission adopt broadband service performance requirements on the Independent Small LECs or their ISP affiliates as a condition

[124] RT at 2104:16-2105:2 (Ahlstedt).
[125] Cal Adv-1 (Ahlstedt Opening) at 2-2:5-6; 2-2:9-11 and 2-4, Table 2-2. On cross-examination, Mr. Ahlstedt acknowledged that he did not consider important information necessary to contextualize the plans offered by these large ISPs, including the number of subscribers and whether the plans are even offered in rural areas similar to the Independent Small LEC territories. RT at 2101:15-21, 2100:19-24, 2098:21-2099:1 (Ahlstedt).
[126] LEC-5 (Boos Reply) at 23:4-5; LEC-8 (Votaw Reply) at 10:2-5, 10:12-15 ("Unlike the carriers listed in Mr. Ahlstedt's testimony, Varnet does not have a broad customer base over which to absorb such discounts, so offering a service with the parameters that he suggests would either cut into Varnet's very low profits, or it would cause significant rate increases for the customer base as a whole."); LEC-2 (Duval Reply) at 2:26-3:3; *id.* at 22:16-23:9 (it is unreasonable to compare to prices offered by largest broadband providers because cost of broadband capable loop is far lower in metropolitan areas); *id*. at 21:19-22:15 (because of the fixed wholesale rates an ISP must pay under the NECA tariff, Cal Advocates' proposal would provide "no opportunity to even recover its expenses let alone earn a profit.").
[126] LEC-5 (Boos Reply) at 23:5-11.
[127] RT at 2105:21-2106:7 (Ahlstedt).
[128] TURN-2 (Roycroft) Reply at 53:8-11.
[129] R.20-02-008, *April 13, 2020 Assigned Commissioner's Scoping Memo and Ruling* at 5-6.

of CHCF-A support under Public Utilities Code Section 275.6(c)(6).[130] Neither TURN nor Cal Advocates provide any details regarding their proposals, so adopting broadband service standards at this stage would violate the Independent Small LECs' due process rights.[131]

To the extent the proposed requirements relate to retail broadband services, they would be jurisdictionally barred as an illegal attempt to regulate an information service and subject to conflict preemption, just like the low-income broadband proposal. Moreover, such regulations are not justified by any record evidence.[132] To the extent that the proposed regulations are focused on network performance, they are also unjustified as nothing in the record points to any problems with the companies' network performance. In addition, state broadband performance metrics are unnecessary as the FCC already has broadband performance rules and layering on California rules would unnecessarily increase regulatory burdens without cost recovery.[133]

IV. BROADBAND IMPUTATION [SCOPING MEMO, ISSUES (1)(C), (1)(D), HEARING ISSUE (2)].

A. Retail Imputation.

The central ratemaking question in Phase 2 is whether the Commission should "impute broadband revenues towards intrastate revenue requirement."[134] In general, "broadband imputation" refers to the possibility that the Commission would count some portion of the revenues earned from the provision of retail Internet access service by unregulated affiliates of the Independent Small LECs toward the fulfillment of regulated intrastate revenue

[130] TURN-1 (Roycroft Opening) at 73:17-74:9; *Cal Advocates Opening Comments* at 20-21; *Scoping Memo*, Question (1)(f).
[131] *See Mathews v. Eldridge*, 424 U.S. 319, 348-349 (1976), *citing Joint Anti-Fascist Comm. v. McGrath*, 341 U.S. 123, 171-172 (1951); *Goldberg v. Kelly* 397 U.S. 254, 267-68 (1970) *citing Armstrong v. Manzo*, 380 U.S. 545, 552 (1965); *Fuentes v. Shevin* 407 U.S. 67, 80 (1972). While Cal Advocates made this proposal in its Opening Comments and suggested that the Commission develop standards at a workshop, it failed to address this issue in testimony. *Cal Advocates Opening Comments* at 20-21.
[132] *See also* LEC-2 (Duval Reply) at 64:4-8 (explaining that the CHCF-A "does not provide any support for the cost of broadband capable facilities when they are used in the provision of broadband services, as the cost of facilities used in the provision of broadband are assigned to the interstate jurisdiction in the jurisdictional cost separations process and federal funding provides support for these costs that cannot be recovered through wholesale broadband transmission and end user rates.").
[133] LEC-2 (Duval Reply) at 64:8-25 (describing FCC's broadband deployment, testing and reporting rules and that statewide rules "would just add to the already tremendous regulatory reporting burden of the Independent Small LECs . . . ."); LEC-5 (Boos Reply) at 4:19-20 ("These proposals are certain to increase Ponderosa's regulatory costs without any corresponding recovery"); *see also In the Matter of Connect America Fund,* WC Docket No. 10-90, *Order*, DA 18-710 (rel. Jul 6, 2018) (issuing rules concerning network speed and latency measurements for ISPs for Connect America Fund ("CAF") recipients); *In the Matter of Connect America Fund,* WC Docket No. 10-90, FCC 19-104, *Order on Reconsideration* (rel. Oct. 31, 2019) (adjusting performance measures and testing procedures for CAF recipients).
[134] *Scoping Memo* at 4 (Issue 1(c)).

requirements.[135] Either through affiliates or through unregulated divisions of the telephone companies, the Independent Small LECs' owners have operated ISPs in these rural service territories for approximately two decades.[136] During this time, more than 25 rural telephone company rate cases have occurred, and the Commission has never attempted to treat unregulated ISP revenues as regulated or impute them into regulated revenue calculations.[137]

In Phase 1, TURN and Cal Advocates asked the Commission to adopt broadband imputation, but the Commission declined to change the status quo, citing concerns about the potential stifling effect of imputation on these small, rural ISPs.[138] In Phase 2, TURN and Cal Advocates again support broadband imputation. TURN's imputation model would create a "pro forma," treating the Independent Small LEC's and its ISP affiliate's operations in the regulated service territory as one company.[139] This proposal would count all revenues, investments, and expenses for both companies and adjust the CHCF-A draw based on their collective results of operations.[140] Cal Advocates proposes that the Commission confiscate all profits of all profitable ISPs, but make no adjustments for companies with unprofitable ISPs.[141]

Regardless of their nuances, these imputation proposals are categorically illegal and profoundly unwise. If adopted, either proposal would conflict with federal, state, and constitutional law, violate basic jurisdictional separations and cost recovery principles, and create perverse incentives and distortionary economic consequences. Whether as a matter of law or as a matter of consumer welfare, broadband imputation cannot and should not be adopted.

1. Retail Broadband Imputation Is Illegal.

These imputation proposals would involve regulation of ISPs and an assertion of

[135] *See* D.14-12-084 at 13 (describing the imputation question as "whether revenues from these broadband affiliates or operations should be 'imputed' to carriers that are subsidized by the CHCF-A when a carrier's revenue requirement is established . . . and the amount of A-Fund subsidy is determined"). Of the 10 Independent Small LECs, nine have ISP affiliates, and Pinnacles offers broadband services through an unregulated division of the telephone company. LEC-1 (Duval Opening) at 9:24-10:9.
[136] TURN-1 (Roycroft Opening), App. 2 NC0083-NC0093.
[137] Each rural telephone company rate case since 1997 is identified in n. 36, above.
[138] D.14-12-084 at 17-18 (confirming ORA's and TURN's support for imputation), 22 (noting the "importance of the services RLECs provide to the economies of their service territories and the state"), 23 ("it is premature to adopt a standard imputation amidst a nascent regulatory climate and diverse broadband landscape").
[139] TURN-1 (Roycroft Opening) at 14:7-8.
[140] *Id.* at 14:19-22; *see, e.g.,* TURN-3-C at 80-81 (reflecting results of operations under TURN's imputation proposal as applied to Ponderosa); RT at 1780:11-28 (Roycroft) (confirming that Duval's calculations of TURN's pro forma correctly reflect TURN's imputation calculations).
[141] Cal Adv-2 (Ahlstedt Opening Errata) at 1-7:6-16 (explaining that "only positive revenues after expenses should be imputed").

ratemaking authority over Internet access service. Imputation would either confiscate the ISP's revenues by diverting them to intrastate cost recovery, or create material shortfalls in recovery of intrastate revenue requirement. Either way, this practice would violate state and federal law.

Imputation contravene violate federal law by intruding on the FCC's interstate regulatory authority and conflicting with the FCC's recent, definitive designation of ISPs as non-regulated "information service" providers in the *Restoring Internet Freedom Order*.[142] Although the D.C. Circuit Court of Appeals vacated the categorical preemption of state and local laws set forth in the FCC's *Restoring Internet Freedom Order*, the remainder of the FCC order is intact, and it would compel preemption of broadband imputation requirements that include ISP revenue in regulated intrastate ratemaking calculations.[143] The preemption aspects of the *Mozilla* case addressed the narrow question of whether the FCC has statutory authority to broadly preempt all state and local regulations of broadband in advance, without a specific statute or regulation to evaluate under conflict preemption principles.[144] The D.C. Circuit declined to authorize conflict preemption "in the abstract," but preserved this longstanding doctrine to address any "specific state regulation" that *under the circumstances of a particular case* stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[145] As the Court

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[142] *Restoring Internet Freedom Order* at ¶ 20 (ordering a "return to Title I classification," which removes "common carrier" regulations under Title II); ¶ 199 (confirming interstate nature of Internet access service); *see also* 47 U.S.C. § 153(51). Dr. Roycroft admitted that ISPs are not "common carriers" and that RT at 1787:17 (Roycroft). Dr. Roycroft also recognized the FCC standard for determining the jurisdictional status of Internet traffic, and he agreed that "the boundaries of what a person is able to access [over the Internet] don't end at the California border." RT at 1770:1-11 (Roycroft). Dr. Roycroft admitted that "interstate" revenues are not "appropriate" for wholesale imputation. RT at 1788:25-1789:1 (Roycroft). While he later attempted to distinguish "interstate" revenues from "unregulated" revenues, the FCC precedent does not make this distinction. Rather, the FCC classifies Internet access as both "interstate" and an "information service." *See Restoring Internet Freedom Order* at ¶¶ 20, 199; *see also High-Cost Universal Service Support*, WC Docket No. 05-337, *Order on Remand, et al.*, FCC 08-262, (rel. Nov. 5, 2008) at n. 69 ("[S]ervices that offer access to the Internet are jurisdictionally interstate services. . . . [T]he Commission has reaffirmed this ruling for a variety of broadband Internet access services.") (collecting authorities).

[142] *Mozilla*, *supra*, 940 F.3d at 74; *see also id.* at 86 ("[B]ecause no particular state [action] is at issue in this case and the [FCC] makes no provision-specific arguments, it would be wholly premature to pass on the preemptive effect, under conflict or other recognized preemption principles," of the FCC's order); *see also id.* at 81 (acknowledging that *Restoring Internet Freedom Order's* preemption of state laws under "conflict preemption" principles has "intuitive appeal" but was waived by FCC at oral argument).

[143] *Mozilla*, *supra*, 940 F.3d at 74; *see also id.* at 86 ("[B]ecause no particular state [action] is at issue in this case and the [FCC] makes no provision-specific arguments, it would be wholly premature to pass on the preemptive effect, under conflict or other recognized preemption principles," of the FCC's order); *see also id.* at 81 (acknowledging that *Restoring Internet Freedom Order's* preemption of state laws under "conflict preemption" principles has "intuitive appeal" but was waived by FCC at oral argument).

[144] *Id*.

[145] *Id.* at 81, citing *Geier v. American Honda Motor Co.*, 529 U.S. 861, 873 (2000), *Alascom, Inc. v.* FCC, 727 F.2d 1212, 1220 (D.C. Cir. 1984) and *Time Warner Entertainment v. FCC*, 56 F.3d 151, 195 (D.C. Cir.

recognized, state laws that present obstacles to federal policy will be invalidated regardless of their form—whether they "go[] by the name of conflicting; contrary to; repugnance; difference; irreconcilability; inconsistency; violation; curtailment; interference; or the like."[146] Thus, the *Mozilla* decision does not preclude preemption of specific state rules that conflict with federal law or undermine federal policy.[147] The proffered imputation policy does not present a close case of preemption, as both its intent and its effect are to place "information services" providers under rate-of-return regulation, a clear example of the economic regulations that the FCC's reclassification of ISPs was designed to avoid.[148]

Even without federal preemption, California jurisdictional limitations independently prohibit the Commission from pursuing broadband imputation. The Commission's regulatory authority only extends to "public utilities."[149] While "telephone corporations" like the Independent Small LECs fit the definition of a "public utility," ISPs do not.[150] To qualify as a "telephone corporation," an entity must "own[], control[], operat[e], or manag[e]" a "telephone line," and "telephone line is defined to include specified types of facilities used "in connection

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1995) (emphasis in original).

[146] *Id.*

[147] *Id.* at 81; *id*. at 85 (noting that if a "state practice actually undermines" the *Restoring Internet Freedom Order*, the FCC "can invoke conflict preemption."); *see also* RT at 1765:9-13 (Roycroft) (acknowledges federal law would preempt state law if conflict).

[148] *Restoring Internet Freedom Order* at ¶ 87 ("[W]e conclude that economic theory, empirical studies, and observational evidence support reclassification of broadband Internet access service as an information service rather than the application of public-utility style regulation on ISPs. We find the Title II classification likely has resulted, and will result, in considerable social cost, in terms of foregone investment and innovation."); *see also* LEC-9 (Aron Opening) at 19 ("Imputation of an ISP affiliate's profits is equivalent to pulling the ISP affiliate under rate-of-return regulation because for every dollar of positive profit earned by the ISP affiliate, the Independent Small LEC's CHCF-A support is decreased by a dollar until the return on the combined "rate base" for the "pro forma" telephone company and the ISP is equal to the regulated rate of return."). In addition, broadband imputation would result in disparate regulatory treatment of the ISP affiliates relative to other ISPs, in conflict with federal policy and in violation of their constitutional rights to equal protection of the laws under the Fourteenth Amendment. *See, e.g.*, *Walgreen Co. v. City & Cty. of San Francisco*, 185 Cal.App.4th 424, 443–44 (2010); Cal. Const. art. I § 7(a) ("A person may not be deprived of life, liberty, or property without due process of law or denied equal protection of the laws."); *see also In the Matter of Petition of NTCA—The Rural Broadband Association and the United States Telecom Association for Forbearance et al.*, WC Docket No. 17-206, *Order,* FCC 18-75 (rel. June 8, 2018) at ¶15 ("By forbearing from application of USF contribution requirements to rural LEC-provided broadband Internet access transmission services, we eliminate the disparate treatment of these services and level the playing field to allow rural LECs to compete more effectively with other broadband providers.").

[149] Cal. Const., art. XII, §§ 3 (defining public utilities that are "subject to control by the Legislature"), 6 (the CPUC "may fix rates . . . for all *public utilities* subject to its jurisdiction.") (emphasis added); *see also City & Cty. of San Francisco v. W. Air Lines, Inc.*, 204 Cal.App.2d 105, 131 (1962) ("Unless the enterprise or activity in question is a public utility as defined in the Constitution or Public Utilities Code, it is not subject to the jurisdiction of such commission.") *citing Television Transmission v. Pub. Util. Comm'n.*, 47 Cal.2d 82, 84 (1956).

[150] Pub. Util. Code § 216 (defining "public utility" to include "telephone corporation.").

with or to facilitate communication by telephone."[151] As Dr. Roycroft admitted, ISPs are not "telephone corporations," nor can they meet any other definition of a "public utility" under state law.[152] Consistent with these constraints on the Commission's authority, and the FCC's exclusive jurisdiction over "information services," the Commission has often recognized that it cannot regulate Internet access service.[153] ISPs are beyond the reach of the Commission's authority, so the Commission cannot compel them to participate in broadband imputation.

TURN and Cal Advocates attempt to evade these jurisdictional prohibitions by suggesting that imputation only impacts the regulated telephone company, not the ISP. For example, TURN argues that its broadband imputation proposal does not involve rate of return regulation because it "does not include any price control for the ISP affiliate."[154] This artifice cannot obscure the obvious regulatory intent and practical effect of imputation, which is to subject the ISP to "rate of return" regulation.[155] As Dr. Roycroft admitted, TURN's "pro forma" imputation model "does create a similar incentive structure for the ISP's operations and potentially their decision to establish rate base investment."[156] Consistent with TURN's objective, this ratemaking device would restrict collective profits of the ISP and the telephone company to a regulated "rate of return" on rate base.[157] As the testimony shows, the common owners of the telephone companies and the ISPs would experience these profit restrictions

[151] Pub. Util. Code §§ 234, 233.
[152] RT at 1787:13-19 (Roycroft) (the Independent Small LECs' affiliate ISPs are neither "telephone corporations" nor "common carriers."). Dr. Roycroft also confirmed that ISPs do not own the "telephone network" over which their services are delivered. RT at 1774:10-13 (Roycroft).
[153] *See, e.g.*, D.13-12-005 at 2 ("It is well-established that Internet service is classified for state and federal regulatory purposes as an "information service" and that state commissions such as the [CPUC] do not have jurisdiction over information services even if the providers also provide "communications services" that are subject to state regulation."); R.13-01-010 at 9 ("internet access is not regulated by the Commission"); D.06-03-013, App. A at A-4 ("In adopting these principles the [CPUC] does not assert regulatory jurisdiction over broadband service providers; Internet Service Providers; Internet content or advanced services; or any other entity or service not currently subject to regulation by the [CPUC].").
[154] RT at 1779:11-24 (Roycroft).
[155] LEC-9 (Aron Opening) at 19-20 and App. 3; LEC-10 (Aron Reply) at 18 ("Under either option, the ISP affiliate would be subjected to rate-of-return regulation because the combined intrastate revenue sources of the Independent Small LEC and its ISP affiliate (whose revenues would be treated as intrastate) would be limited to a "revenue requirement" determined by the combined "rate bases," operating expenses, and tax liabilities of the two companies.").
[156] RT at 1780:1-4 (Roycroft).
[157] RT at 1653:17-23 (Aron) (imputation "would effectively put the ISP under rate of return regulation . . . . [b]ecause it would take away their revenues in a way that would limit their rate of return to the regulated rate of return."); *see also* LEC-9 (Aron Opening) at 19-20; *see also* LEC-10 (Aron Reply) at 51 ("When companies are confronted with a constraint on their ability to earn profits, they will inevitably adopt a legal alternative that allows them to avoid that constraint.").

collectively, an effect that mimics the imposition of rate-of-return regulation on both entities.[158] The mechanics of the imputation process have all the trappings of rate-of-return regulation, including establishing a "revenue requirement," a "rate base," and a projected revenue calculation for the ISP.[159] To execute these calculations, the ISP would be forced to disgorge its financials, and – directly or indirectly – the ISPs would have to respond to data requests regarding the reasonableness of its expenses, investments, and revenues. These realities dispel the fiction that the ISP would be spared from "rate of return regulation" under this policy.

TURN also suggests that it could circumvent the state and federal jurisdictional restrictions by relying on Section 706 of the Telecommunications Act.[160] However, Section 706 does not provide the Commission with authority to regulate Internet access service. It is a limited grant of authority circumscribed by state and federal jurisdictional boundaries and the parameters of other legal requirements, including Public Utilities Code Section 275.6. The FCC recently explained that "provisions in section 706 . . . are better interpreted as *hortatory* rather than as independent grants of regulatory authority."[161] Similarly, Section 706 does not give state commissions the power to impose rules on services that are beyond their subject matter jurisdiction, By its plain terms, Section 706(a) applies to "[t]he [FCC] and each State

[158] LEC-6-C (Lundgren Reply) at 5:1-6:5 (explaining Volcano's owners' concerns regarding the impact of broadband imputation, which "would transform this successful business into a business that is barely profitable in Volcano's local exchange area."); LEC-4-C (Boos Opening) at 21:5-22:2, 22:16-25, 24:17-25:12 (explaining that Ponderosa would not be able to meet its revenue requirement if broadband imputation were adopted and describing numerous other negative impacts of broadband imputation on consumers, investment, competition and continued viability of ISP); LEC-7 (Votaw Opening) at 13:10-16:11 (explaining that "immediate consequence of broadband imputation would be to strip Varnet of all meaningful profit through a reduction in CHCF-A to Ducor" and describing other harmful impacts on customers, investments and viability of ISP).

[159] RT at 1779:25-1780:10 (Roycroft) (in terms of earnings, TURN's broadband imputation proposal would create similar incentives as rate of return regulation as to the ISP's investment decisions), 1783:28-1784:12 (Roycroft) (the review of an ISP's revenues, expenses and investments would mimic the review and prospective test year aspect of the rate case process for the regulated telephone companies), 1802:13-19 (Roycroft) (agreeing that "the process that exists for small telephone companies would begin to exist for the ISP for the purpose of calculating the pro forma as a predicate to the pro forma."); *see also* LEC-9 (Aron Opening) at 19-20 and App. 3; LEC-10 (Aron Reply) at 18.

[160] Section 706 of the Telecom Act is codified at 47 U.S.C. Section 1302. *TURN Opening Comments on 4th Amended Scoping Memo* at 9-10, Roycroft Decl. at 30-32. Dr. Roycroft's statements about Section 706 should be given no weight, as they are based on uniformed lay opinions from a witness with no formal legal training and hearsay statements from an unidentified attorney who was not subject to cross-examination. *See* RT at 1751:22-24, 1752:10-12 (Roycroft) (witness is not a lawyer and did not got to law school; RT at 1754:19-1755:4 (Roycroft) (confirming hearsay nature of legal testimony).

[161] *Restoring Internet Freedom Order* at ¶¶ 267-270 (emphasis added) (Section 706 provisions merely "exhort[] the Commission to exercise market-based or deregulatory authority granted under other statutory provisions," rather than acting as "independent grants of regulatory authority."). The *Mozilla* court did not vacate this portion of the Restoring Internet Freedom Order.

commission *with regulatory jurisdiction* over telecommunications services" and only permits commissions to use "regulating methods" already available to them under state law.[162] Since the Commission's subject matter jurisdiction is limited to intrastate services and expressly excludes interstate services, Section 706 is of no help to TURN's argument.[163]

Even if these jurisdictional problems could be ignored, subjecting an information service provider to rate-of-return regulation would be an anomalous application of Section 706's directive to "*remove* barriers to infrastructure development" through measures such as "regulatory forbearance," consider "price cap regulation," or "remove barriers" to investment.[164] A hyper-regulatory scheme like rate-of-return regulation does not fit the Congressional intent reflected in these examples.[165] These attempts to recast the imputation policy are unavailing; under any formulation, the Commission will overstep its jurisdictional bounds if it pursues this.

2. Retail Broadband Imputation Would Create Unlawful Disconnects Between Revenue Requirement and Rate Design That Violate Basic Rate-of-Return Ratemaking Requirements.

Even if broadband imputation were viewed solely as an impact on regulated telephone companies, it still would violate statutory and constitutional ratemaking standards. As explained above, the Commission cannot set a revenue requirement and then refuse to fulfill it,[166] but retail broadband imputation would effectuate exactly this result for any Independent Small LEC with a profitable ISP affiliate.[167] Neither the statutory framework governing ratemaking for "small

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[162] 47 U.S.C. § 1302(a) (emphasis added).
[163] *See also Ivy Broad. Co. v. AT&T Co.*, 391 F.2d 486, 490 (2d Cir. 1968) ("this broad scheme for the regulation of interstate service by communications carriers indicates an intent on the part of Congress to occupy the field to the exclusion of state law"); Phase 1 Exh. 1 (Duncan Reply) at 20-23.
[164] 47 U.S.C. § 1302(a) (emphasis added); *see also Restoring Internet Freedom Order* at ¶¶ 89-90 (describing the negative impact on broadband investment caused by regulation).
[165] Imputation would unfairly restrict the Independent Small LECs' ISPs but would be inapplicable to their competitors, thereby harming the ISPs' competitive positions in the broadband market. *Restoring Internet Freedom Order* at ¶¶ 103 (explaining extreme burdens and costs imposed on small, rural ISPs in complying with burdensome regulation); 295 (imposing regulations on some, but not all ISPs, "can distort the marketplace and undercut competition.").
[166] When the Commission engages in ratemaking for rate-of-return carriers, it must establish a rate structure that gives companies a fair opportunity to recover their costs and earn a reasonable rate of return on their investments. *See* Pub. Util. Code §§ 275.6(c)(2), 275.6(b)(4), 275.6(b)(5); RT at 1767:11-18 (Roycroft) (TURN's expert admitting that "rate design" must "provide the company a fair opportunity to meet the revenue requirement"); *see generally* n. 32, *supra.*
[167] The reverse is also true. For any company with an unprofitable ISP affiliate, TURN's imputation model would result in a rate design that exceeds revenue requirement. This would also violate Public Utilities Code Section 275.6, as it would authorize "revenue sources" beyond what is needed to "provide a fair opportunity to meet the revenue requirement of the telephone corporation." Pub. Util. Code § 275.6(b)(3). Unlike the revenue shortfall scenario, however, this institutional over-earning would be checked to some extent by the "means test" through the CHCF-A annual filing process. As explained below, the "means test" is a one-way mechanism, and no additional money is provided through the annual

independent telephone corporations" nor the applicable constitutional takings standards could countenance this institutional disconnect between revenue requirement and rate design.[168]

The extent of the revenue shortfalls from broadband imputation has been extensively documented. Mr. Duval prepared a modified "results of operations" calculation starting with the ratemaking conclusions from each Independent Small LEC's last rate case, with modifications to the rate design to include the output of TURN's "pro forma" using 2018 ISP profitability data.[169] These calculations reflect a disconnect between revenue and revenue requirement in every case. For the five companies with a materially-profitable ISP, the modified results of operations show that imputation would create significant revenue shortfalls, ranging from 3% to 18%.[170] Similarly, these companies would only earn a fraction of their authorized rates of return even if actual results were to materialize exactly as the "results of operations" calculation predicts.[171] No party has rebutted Mr. Duval's calculations, and TURN's expert even confirmed that Mr. Duval's exhibits correctly apply TURN's imputation model.[172] These undisputed calculations

process if companies experience under-earnings. *See* Section XI(A), *infra*.

[168] TURN and Cal Advocates' proposals undercut this core ratemaking principle and effectuate an unconstitutional taking of property without just compensation. U.S. Const., amends. V, XIV; Cal. Const., art. I, § 19; *see also Duquesne*, *supra*, 488 U.S. at 308 ("If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."); *Hope, supra*, 320 U.S. at 603 (1944); *Bluefield Water Works & Improvement Co. v. Pub. Service Comm'n of West Virginia*, 262 U.S. 679, 690-693 (1923).

[169] LEC-2-C (Duval Reply) at 66:7-15, Exhibit B; *see also* LEC-13-C (Duval Numbered Exhibits) at 8-9 (Calaveras), 20-21 (Cal-Ore), 32-33 (Ducor), 44-45 (Foresthill), 56-57 (Kerman), 68-69 (Pinnacles), 80-81 (Ponderosa), 92-83 (Sierra), 104-105 (Siskiyou), 116-117 (Volcano); RT at 1815:15-19 (Roycroft) (confirming the portions of Mr. Duval's exhibits that summarize the impacts of TURN's imputation proposal). The even-numbered pages reflect the application of TURN's imputation model to each company's ratemaking calculations from its last rate case, using 2018 ISP data. The odd-numbered pages show the underlying calculations by which TURN's "pro forma" is computed. RT at 1074:9-1075:20 (Duval); RT at 1815:22-1817:6 (Roycroft).

[170] LEC-13-C (Duval Numbered Exhibits) at 44, 80, 92, 104, 116. In each case, the shortfall can be seen by comparing the Commission-approved revenue requirement in the first column of Line 23 to the post-imputation revenue figures on the third column of Line 9. The delta between these figures appears in the middle column of Line 9. For example, Volcano's revenue shortfall from imputation is **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL >>**.

[171] For example, imputation would reduce Volcano's anticipated rate of return from the Commission-approved level of 9.12% to a paltry **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL >>** LEC-13-C (Duval Numbered Exhibits) at 116 (below Line 36). Likewise, Ponderosa's imputation-adjusted rate design would only be structured to produce a **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL >>** rate of return, whereas the Commission found it required a return of 8.44% on its rate base. *Id.* at 80 (below Line 36). The adjusted returns for each of the other companies can be shown on pages 8, 20, 32, 44, 56, 68, 92, and 104 below Line 36.

[172] Dr. Roycroft admitted that the "odd-numbered pages" in Mr. Duval's labeled "TURN Imputation Proposal" are a "correct reflection" of TURN's proposal. RT at 1815:27-28 (Roycroft). As explained above, the "odd" pages of the workpapers inform the proper display of results of operations on the "even" pages. The only difference between these pages is that the "odd" pages show the revenue, expenses, and investments from the ISP affiliates as if they are telephone company figures, so Dr. Roycroft's testimony confirms the accuracy of the overall calculations.

show that imputation would upset the proper functioning of rate-of-return regulation, in violation of statutory and constitutional mandates.

TURN appears to believe that it can bridge the ratemaking gap between revenue requirement and rate design by treating the ISP's net profits as the telephone company's revenue in the results of operations table.[173] However, both TURN and Cal Advocates acknowledged that ISP net profits would not actually be paid to the telephone companies, so the inclusion of these revenues in regulated rate design would be illusory and misleading.[174] This manipulation of "operating revenues" would violate Public Utilities Code Section 275.6, which requires "rate design" to be tailored to the "revenue requirement of the *telephone corporation*," not the operations of an affiliate or a fictional "pro forma" combination of the two.[175] TURN's approach would also conflict with decades of Commission precedent in rate cases, as the "operating revenues" are limited to revenues that the telephone companies are reasonably expected to receive in connection with their local exchange operations.[176] The Commission cannot lawfully adopt a *regulated* rate design that depends on an infusion of *unregulated* revenue.

TURN's imputation scheme is not the first creative attempt to harness unregulated revenues to satisfy regulated utility obligations, and the United States Supreme Court has struck down similar attempts in the past. For example, in *Brooks-Scanlon Co. v. Railroad Comm'n of Louisiana*, the state commission attempted to compel a short-line railroad utility to continue

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[173] As shown in the "odd-numbered" pages of Mr. Duval's Reply Exhibit A, revenue requirement and rate design can appear to be equal under TURN's proposal, but only by including a line item for "ISP Revenues" that do not belong to the telephone company and which it will not actually receive. RT at 1815:27-28 (Roycroft) (endorsing the odd pages in Mr. Duval's Reply Exhibit A, displayed as part of TURN-3-C and LEC-13-C); *see also* LEC-13-C at 9, 21, 33, 45, 57, 69, 81, 93, 105, 117 (showing "ISP Revenues" on Line 8 of telephone company "operating revenues" summary).

[174] RT at 1784:17-22; 1785:1-13 (Roycroft) (agreeing that the ISP revenue figures on Line 8 of Exhibit TURN 3-C would not actually be paid to the telephone company); *see also* LEC-13-C (Duval Numbered Exhibits) at 81 (confirming that TURN 3-C is an excerpt of LEC-13-C); RT at 1183:10-28 (Ahlstedt).

[175] Pub. Util. Code § 275.6(b)(3) (emphasis added). Section 275.6 contains 21 separate references to "telephone corporations," which serves as a reminder to the Commission to focus on regulated operations in applying the statute. Only one reference to "affiliates" appears, and it pertains to a purely informational requirement that has been fulfilled in each of the nine Independent Small LEC rate case applications filed since the 2012 statutory changes to Section 275.6. *See* Pub. Util. Code § 275.6(e); *see also* LEC-15 (Rate Case Application Excerpts) (A.16-10-001 at 11:14-12:9; A.16-10-002 at 11:8-12:2; A.16-10-004 at 11:10-12:6; A.17-10-004 at 14:27-15:22); LEC-16-C (A.16-10-001 Boos Testimony) at 13:5-11; RT at 1169:3-10 (Ahlstedt).

[176] As explained in Section II(A)(3), above, regulated telephone companies receive five types of intrastate revenue, which collectively comprise the rate design. These five sources are displayed on Lines 1 through 8 of each "results of operations" table adopted in Independent Small LEC rate cases. *See, e.g.* LEC-17 (Foresthill 2019 Rate Case Decision), App. A Ln. 1-8. TURN's line item for "ISP Revenues" would be the only rate design element that does not actually generate revenue to the telephone company.

operating at a loss based on the perception that it had a profitable affiliate who benefitted from its railroad operation.[177] This attempted "imputation" was justified on the grounds that "although the railroad showed a loss," the "net result of the whole enterprise" was profitable if it was defined to include a non-utility "log and lumber" business whose materials were carried on the railroad.[178] The Court rejected this reasoning and found the state commission's order in violation of the 14th Amendment of the United States Constitution, noting that the "test applied" to determine earnings was "wrong" and that "[a] carrier cannot be compelled to carry on even a branch of business at a loss."[179] These same fundamental ratemaking principles would doom TURN's imputation model as a matter of law.

TURN and Cal Advocates hide behind the fiction that "broadband imputation" will not deprive the ISP of any money, but the legal result of this scheme is to confiscate property from either the ISP or the telephone company, or both. Under whatever guise this may be pursued, it would be an unconstitutional taking of property without just compensation.[180]

3. Retail Broadband Imputation Would Create Perverse Economic Incentives That Will Harm Consumers.

The Commission has a statutory responsibility to "assess the economic effects of its decisions," and the record shows broadband imputation is likely to have a highly distortionary impact on broadband markets in the rural areas that the Independent Small LECs and their affiliates serve.[181] As acknowledged in the Phase 1 Decision, the Commission should be "mindful of the importance of the services the RLECs provide to the economies of their service territories and the state, and their generally high service quality performance."[182] Following Phase 1, the Commission "[did] not accept the contentions of ORA and TURN that imposing broadband [imputation] would have no negative consequences for the Small ILECs and their affiliates" and acknowledged that imputation may lead to "possible service reductions or possible price increases."[183] The record in Phase 2 amplifies this concern, and shows that imputation

[177] *Brooks-Scanlon Co. v. Railroad Comm'n of Louisiana*, 251 U.S. 396 (1920).
[178] *Id.* at 398-399.
[179] *Id.* at 397, 399.
[180] If the policy confiscates utility property, it would be an unlawful taking by ratemaking. *See* n. 123, *supra*. If it seizes money from the ISP, it would be a taking "per se." *See Ponderosa v. Pub. Util. Comm'n*, 197 Cal.App.4th 48, 59-60 (2011) (seizure of returns on unregulated investments unconstitutional).
[181] Pub. Util. Code § 321.1 (assessment of economic effects is mandatory).
[182] D.14-12-084 at 22.
[183] *Id.*

would create perverse economic incentives and harm customers.

In the short-term, broadband imputation is likely to encourage price manipulation and cost-cutting measures that could threaten broadband service quality. Since the imputation model would deny the ISPs any meaningful profit, the companies would naturally look for ways to increase profits in between "imputation events."[184] As Mr. Boos explained, these efforts would likely include "raising prices," but this reaction would be limited based on "competitive forces" and the income demographics of Ponderosa's service territory.[185] Both Mr. Boos and Mr. Votaw predicted that broadband imputation would lead to expense reduction strategies that could diminish "customer service, maintenance and responsiveness."[186] Again, these measures would be somewhat limited, as the unregulated ISPs are "already efficient operation[s]" that "already [have] incentives to reduce expenses to the extent reasonable."[187] As Mr. Votaw observed, these efforts would be futile in the long run because they would "just increase the amount of imputation that occurs" and, at some point, "we simply could not cut anything else."[188]

TURN provides no remedy for the potential consumer harms from imputation except to apply additional layers of regulation to the ISPs. TURN proposes to apply the CHCF-A "means test" to any ISPs that raise prices, thereby generating additional imputation penalties through reduced CHCF-A.[189] TURN and Cal Advocates suggest the adoption of broadband service quality rules,[190] but these measures will only amplify the economic distortions from imputation and generate more perverse incentives and regulatory burdens for ISPs.[191]

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[184] LEC-7 (Votaw Opening) at 14:20-21 ("the Commission would put the companies in a perpetual cycle of struggling to cut costs to achieve some kind of return in between imputation reductions.").
[185] LEC-4 (Boos Opening) at 23:8; *see also* LEC-7 (Votaw Opening) at 14:24-25 ("as the downward spiral under broadband imputation advances, all options would have to be considered").
[186] *Id.* at 23:16-17; *see also* LEC-7 (Votaw Opening) at 14:18-19 ("broadband imputation . . . would necessarily involve cuts to customer service and technical support.").
[187] LEC-4 (Boos Opening) at 23:9-10.
[188] LEC-7 (Votaw Opening) at 14:5-8.
[189] TURN-1 (Roycroft Opening) at 76:6-11; RT at 1827:13-1828:17 (Roycroft).
[190] *See* TURN-1 (Roycroft Opening) at 73:17-74:9; *Cal Advocates Opening Comments* at 20-21.
[191] *See* LEC-2 (Duval Reply) at 64:9-25 (describing FCC's broadband deployment, testing and reporting requirements and that adding additional statewide requirements "would just add to the already tremendous regulatory reporting burden of the Independent Small LECs, and further exacerbate the impact of the FCC's Corporate Cap that both TURN and Cal Advocates support in this proceeding."); LEC-5 (Boos Reply) at 4:16-5:3 ("I am also concerned about the additional expenses associated with the "audit" process that TURN has proposed and the additional broadband service quality reports that TURN and Cal Advocates have proposed. These proposals are certain to increase Ponderosa's regulatory costs without any corresponding recovery"); *see also* LEC-9 (Aron Opening) at 57 (Dr. Roycroft's proposal to impose multiple layers of regulation and regulatory burdens on ISP affiliates on top of imputation proposal will increase incentives for disaffiliation); LEC-10 (Aron Reply) at 30-31 (TURN's proposal to require affiliate ISPs to increase download speeds would exacerbate the anticompetitive effects of

Broadband imputation would also create economic anomalies by skewing the playing field in favor of unaffiliated competitors. Whereas the Independent Small LECs' affiliates would be stripped of all but the most nominal profits, third-party competitors could continue to earn market profits, generating cash flow and potential investment capital that far exceed the affiliate ISPs' paltry earnings under the imputation model.[192] These disparities would also invite unfair competition, as any third-party ISP could purchase wholesale access on the same terms as the affiliate and compete freely in the service territory without any impact from imputation.[193] Imputation would result in arbitrage and competitive disparities, leading inevitably to customer confusion and instability in the markets for these critical services.[194]

In the long run, the impacts of broadband imputation would be even more profound. If broadband imputation is implemented and it survives a legal challenge, it is likely to cause each of the profitable ISPs – and those who have a reasonable prospect of being profitable – to disaffiliate from the Independent Small LECs. As Dr. Aron explained, profitable ISPs will not "submit themselves to rate-of-return regulation" and remain under a regulatory paradigm that denies them any meaningful profit.[195] Rather, "in an economic market," the "expected and inevitable outcome" of broadband imputation would be for profitable or potentially profitable ISPs to "sell themselves to an independent (and, thereby, unregulated) owner" or "shut down their retail broadband business."[196] The company testimony confirms this expert judgment, as each witness concluded that a sale of the ISP would be a serious consideration under an imputation policy.[197] Even for ISPs that are not currently profitable, or which have vacillated

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TURN's price reduction proposal), 40-41 (explaining negative impacts of imposing additional regulations on affiliate ISPs in an attempt to control the perverse incentives created by the imputation proposal).

[192] *See* LEC-9 (Aron Opening) at 43 (explaining competitive disadvantages and negative consequences resulting from an imputation requirement applied only to the ISP affiliates and not independent ISPs).

[193] LEC-4 (Boos Opening) at 25:17-26:5 (competitive distortions would be exacerbated by a competitive ISP that chooses to use the NECA tariff to access local exchange locations because "the competing ISP would have no regulatory requirement to pay an imputation amount. This would create a highly uneven playing field that is likely to attract arbitrage providers to the Ponderosa territory to take advantage of Ponderosa Cablevision's disfavored regulatory status as an affiliate of an Independent Small LEC."); *see also* RT at 1068:18-1069:2 (Duval) (NECA Tariff No. 5 is open to all ISPs).

[194] *See* LEC-9 (Aron Opening) at 57 (proposed imputation proposal will lead to regulatory arbitrage and it is not possible to predict and regulate away every opportunity for manipulation).

[195] LEC-9 (Aron Opening) at 18; LEC-10 (Aron Reply) at 19 ("any company that has a reasonable expectation of earning a return in excess of the regulated return on average over time would rationally prefer to . . . avoid not only the constraints on its returns but also the risks that legitimate expenses and investments would be disallowed."). As explained above, the five ISPs that currently achieve more than nominal profits would experience dramatic reductions in earnings under an imputation model.

[196] *Id.*

[197] The company witnesses include two owners of the ISPs and a General Manager, and each confirmed

between positive and negative earnings, imputation would encourage disaffiliation. While today these firms can strive toward market-based profits, imputation would cap their expected returns at extraordinarily low levels, eliminating their incentives to continue aspiring to profitability.[198]

TURN expresses disbelief that the ISP affiliates would disaffiliate, but Dr. Roycroft admitted that there are no legal restrictions on selling these businesses.[199] The record also points to several realistic scenarios through which these sales could occur. National companies who specialize in rural markets, such as TDS or Frontier, may have an interest in such purchases.[200] Some or all of the affiliates could be spun off and sold to a regional middle-mile provider, such as CVIN, who could derive efficiencies from operating multiple ISPs within California.[201] Owners of ISPs in contiguous exchanges, such as Ponderosa and Sierra, could sell their ISPs to each other, thereby remaining in the ISP business but removing both ILECs from the imputation model.[202] In competitive areas, a cable company could pursue such a purchase to solidify its market position.[203] An ISP could be sold to a trusted employee, such as one of the current company managers, giving the owners a high level of confidence that mutually beneficial coordination between the disaffiliated entities could be maintained.[204] The ISPs could even pursue more creative options like employee-owned cooperatives.[205] There are no regulatory

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that, in the long run, a sale of the ISP would be preferable to retaining the business under an imputation policy. RT at 1915:22-1916:15 (Votaw) (transcript should say "imputation," not "education"), 1604:14-1605:8 (Lundgren); LEC-7 (Boos Opening) at 24:7-23. A sale of the ISP would generate the dual benefit of a profitable sale and a restoration of the full amount of authorized CHCF-A to the Independent Small LEC. If imputation is imposed, the common owners of these businesses will have strong incentives to pursue this course.

[198] RT at 1707:28-1708:21 (Aron) (for a company that vacillated between positive and negative earnings and only recently became profitable, imputation would "deprive that company of the fruits of its labors to become profitable if and when it is able do"); 1677:22-1678:10 (Aron) (expert Aron would expect companies that only recently became profitable to disaffiliate); 1707:21-25 ("an imputation policy deprives companies of an opportunity to recoup losses unless they disaffiliate at such time as they become profitable, or before."); *see also* LEC-9 (Aron Opening) at 28-29 (explaining that even unprofitable ISPs that expect to become profitable may seek to disaffiliate to avoid rate-of-return regulation under proposed imputation policy); LEC-10-C (Aron Reply) at 33-34.

[199] RT at 1830:3-12 (Roycroft).

[200] *See* LEC-10 (Aron Opening) at 44 (imputation could result in conglomerations of independent ISPs or acquisition by one or more already existing larger or multi-market ISPs).

[201] *See* RT at 1651:22-28 ("options include joining up with other ISP, becoming acquired by a conglomerate that operates across state or across the country, becoming part of . . . C[V]I[N], which is a company that is currently owned by the LEC, but could be separated or shutting down").

[202] LEC-10 (Aron Reply) at 22 ("ISP affiliates may choose to provide broadband services only in the territories of the unaffiliated Independent Small LECs."); *see also* LEC-4 (Boos Opening) at 24:20-23.

[203] As the procedural record of this proceeding reflects, Comcast is actively engaged in competition with Ponderosa in the more suburban areas of Ponderosa's territory. *CCTA Reply Comments on November 8, 2019 ALJ Ruling* at 8, n. 22 (Jan. 20, 2020); *CCTA Comments on 4th Amended Scoping Memo* at 2, 8.

[204] RT at 1839:11-28 (Roycroft).

[205] RT at 1838:21-1839:2 (Roycroft).

restrictions on these disaffiliation strategies, as the ISPs are unregulated.

Contrary to the unanimous testimony of the company witnesses, TURN claims that the Independent Small LECs' owners would be better off retaining the affiliates.[206] A simple comparison dispels this notion. If a potential sale price for a profitable ISP is juxtaposed with the annual returns available under an imputation model, there is no doubt that an economically rational actor would sell the ISP. For example, as a highly conservative estimate of a sale price,[207] assume that a buyer of Ponderosa's ISP would be willing to pay a purchase price in the amount of one year of profit, or approximately **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL>>** If Ponderosa's ISP remained affiliated, it would take nearly **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL>>** for it to achieve cumulative earnings that would equal the dollars derived from a potential sale.[208] Similar assumptions could be made for each of the other profitable ISP affiliates, and each comparison shows that it would be far more rational to sell than to retain the business.[209] Even if the assumed purchase price were reduced by a factor of 10, which is a preposterously low valuation for profitable business, the conclusion would be the same.

In addition to its unfounded incredulity about potential buyers, TURN suggests that the Independent Small LECs' owners would be compelled to retain the ISP affiliates to ensure the continuation of operational synergies and cost savings between the two entities.[210] From the ISP's perspective, this concern is illusory, as it could achieve economies of scale and scope without the Independent Small LEC by attaching itself to a larger operational platform, such as would exist in many of the scenarios mentioned above.[211] And even if synergies are lost, the

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[206] TURN-2 (Roycroft Reply) at 4:4-10:12.

[207] *See* D.15-12-005 at 12 (in approving sale and transfer of Verizon California to Frontier and describing supporting public interest factors, Commission noted parties' position that "purchase price suggests an estimated 3.7X multiple based on 2014 estimated pro forma Day 1 EBITDA.").

[208] *Compare* TURN-1-C (Roycroft Opening), App. 3 at C0135 (Ponderosa response to TURN 4.18) to LEC-13-C (Duval Numbered Exhibits) at 81 (reflecting Ponderosa Cablevision's profits under TURN's imputation model).

[209] Parallel calculations show that the following number of years of operation would be necessary under imputation for the materially profitable ISPs' earnings to equal one year of profit in the current environment: **<<BEGIN CONFIDENTIAL** [redacted] **END CONFIDENTIAL.>>.** *See* TURN-1-C (Roycroft Opening), App. 3 at C0138, C0136, C0132, C0137; LEC-13-C (Duval Numbered Exhibits) at 117, 93, 44, 105.

[210] TURN-2 (Roycroft Reply) at 7:1-9:18.

[211] LEC-10 (Aron Opening) at 44-45; RT at 1591:24-1592:2 (Lundgren) (a larger company purchasing Volcano's ISP affiliate could bring efficiencies from economies of scale to the ISP).

potential for reduced efficiencies from disaffiliating is far outweighed by the prospect of losing almost every dollar of its future profits if it remains affiliated. From the telephone company's perspective, disaffiliation would involve a loss of certain synergies, which would make the cost of regulated service more expensive, but those increased expenses would be recoverable through the regulated ratemaking process.[212] The social costs of imputation would be unfortunate, but they would not compel ISPs to remain affiliated.

Consumers would be the ultimate losers of disaffiliation. The resulting reduction in operational efficiencies and elimination of common cost sharing would increase regulated expenses for the telephone companies, necessitating increases in the CHCF-A, or end user rates, or both.[213] Quality of service could also suffer.[214] Perhaps most importantly, customers would lose the local touch that has been the hallmark of the Independent Small LECs and their affiliates for decades.[215] For the benefit of these rural consumers, the Commission should not put the owners of these small businesses in the position where they have to disaffiliate their ISPs just to avoid being forced under a *de facto* rate-of-return framework that confers only nominal profits.

4. Retail Broadband Imputation Would Dramatically Increase the Costs, Burdens, and Uncertainties of the Rate Case Process and the Annual CHCF-A Advice Letter Process.

In addition to harming the California economy and rural consumers, broadband imputation would greatly complicate the Commission's ratemaking processes and lead to further delays, increased burdens, and greater rate case expense. Today, the rate case process consists of

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[212] RT at 1645:9-1646:6, 1654:3-28, 1656:11-16, 1703:19-28 (Aron); 1832:10-18 (Roycroft).
[213] *Id.*
[214] Dr. Aron notes that customer service could become more complicated and duplicative with two unaffiliated entities involved in addressing trouble reports. She also explains that the disaffiliated entities may be less able to respond to community needs and both entities would be less able to "justify a business case for a higher quality resource," such as "employees with more experience or specialized expertise." LEC-9 (Aron Opening) at 38-40.
[215] LEC-10 (Aron Opening) at 9-10 (imputation would result in providers that are "less locally-tailored and community-oriented."); 45 (unaffiliated ISP "would be less sensitive to local demands"); 53 ("Unaffiliated ISPs would not have long-term relationships with customers via the provision of voice service through an affiliate and therefore bear less potential adverse consequences if they were to suddenly abandon internet service without provision of an alternative for their customers. Unaffiliated ISPs would therefore tend to be less patient in times of financial stress and more inclined to engage in a disorderly exit of the market in response to a downturn in demand or uptick in costs."); LEC-5 (Boos Reply) at 6:18-20 ("It is unlikely that whatever unaffiliated ISP emerges to replace Ponderosa Cablevision would be as responsive to community needs in Ponderosa's rural service territory as Ponderosa Cablevision."); 7:7-12 (it is unlikely that unaffiliated ISP "would be as committed to providing Internet access service throughout the territory. It is more likely that such a competitor would focus on higher-density, higher-revenue areas within the territory. Customer service, service availability, and community touch are likely to suffer in the long-run.").

two analytical exercises, consistent with the requirements of Public Utilities Code Section 275.6. The Commission first sets a revenue requirement to determine the utility's costs, and then it fashions a rate design to give the company a reasonable opportunity to recover those costs through regulated revenues.[216] The imputation policy would add multiple new calculations and ratemaking mechanics. As a precursor to imputation, the ISP would be subject to an "audit," to be conducted by the Commission, its staff, or its agents.[217] Unlike a financial audit, the purpose of this review would not focus on whether the ISP's financials are fairly stated; rather, this "audit" would assess the reasonableness of revenues, expenses, and investments for inclusion in the imputation equation.[218] Even if a cost or revenue were actually incurred and correctly recorded on the ISP's books, it could be questioned as part of this review and "disallowed" for the purpose of applying the imputation formula.[219]

In effect, this "audit" would create a second "rate case" within each rate case, focused on establishing a "revenue requirement" and revenue forecasts for the ISP for use in the imputation analysis. These ISP-specific determinations would be at least as complex as the rate cases themselves, and proposals would have to be backed by testimony, financial models, and demonstrations of prudency. In practice, applying rate of return regulation to an unregulated business through the "audit" is likely to lead to more disputes than would occur in a typical telephone company rate case. The Commission has never conducted a reasonableness review of a rural ISP's costs, so there is no historical practice or precedent to guide the analysis. Similarly, the rate-of-return model is ill-suited to expense-intensive businesses, which would invite debates about how to contextualize ISP investments and require an analysis of "cost of capital" for these

[216] Pub. Util. Code § 275.6(b)(4) (establishment of revenue requirement and rate design are the two sequential ratemaking steps for "rate of return regulation); RT at 1090:15-1091:3 (Duval), 2249:19-2250:14 (Hoglund).
[217] *See* TURN-1 (Roycroft Opening) at 15:3-4; Cal Adv-2-C (Ahlstedt Opening Errata) at 1-4:15-1-5:3; RT at 1801:1-1803:23 (Roycroft) (audit would be in addition to financial audit and involve evaluation by Cal Advocates, the Commission or third party of the reasonableness of an ISP's expenses and revenues similar to evaluation of an Independent Small LEC's expenses in a rate case); RT at 1184:1-1187:26 (Ahlstedt) (although claiming Cal Advocates' audit proposal is "very similar" to TURN's audit proposal, Mr. Ahlstedt states that Cal Advocates' audit would be similar to an audit conducted by a financial auditor and subject to review by Cal Advocates in a rate case).
[218] RT at 1801:16-1802:12 (Roycroft) (explaining that TURN does not propose a financial audit, which determines whether financials are "fairly stated," but rather proposes a reasonableness analysis of revenues and expenses); *Compare* RT at 1186:9-12 (Ahlstedt) (explaining that Cal Advocates proposes a financial audit and agrees that the purpose of a financial audit is to determine whether financials are "fairly stated"); *see also* LEC-2 (Duval Reply) at 9:6-17 (explaining that the Independent Small LECs are already subject to a financial audit by an independent auditor on an annual basis, which would include the affiliate ISP operations, and that a further review is unnecessary).
[219] RT at 1802:13-28 (Roycroft).

differently-situated businesses.[220] New questions would arise about transactions between the ISP affiliate and other non-regulated affiliates, questions that have no relevance today because they have no impact on regulated rates or high-cost support.

As TURN's expert recognized, the prospective nature of the rate case would extend to the imputation model so an ISP's costs and revenues would have to be projected into the test year.[221] This would spark additional debates about ISP demand projections, forward-looking investment needs and growth factors.[222] The revenue projections would be especially troublesome because – as TURN acknowledges – the ISP would retain full pricing flexibility.[223] In light of the dynamic nature of the broadband market and the varying levels of competition that the ISP affiliates face, ISP revenue projections would be a moving target that cannot be reliably ascertained in advance. Moreover, while TURN and Cal Advocates insist that imputation would not involve price regulation, extensive "auditing" of prices and the development of assumptions about what price is "reasonable" are certain to emerge if the Commission is called upon to project revenues for these unregulated providers.[224] Consistent with it approach to the last round of rate cases, Cal Advocates is likely to oppose the ISP's cost and revenue calculations, pushing for higher revenue projections and lower cost assumptions to maximize the imputation amounts.[225]

In addition to the "audit," the mechanics of ratemaking under an imputation model would also be difficult. TURN and Cal Advocates both clarified that their imputation proposals would only apply to the extent an ISP's service relies on its affiliate's regulated telephone facilities accessed through NECA Tariff No. 5.[226] To implement this nuance, the rate case process would have to include a mechanism to exclude ISP financials associated with services in other service

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[220] *See* LEC-9-C (Aron Opening) at 31-34 (explaining differences of capital intensity between Independent Small LECs and their ISP affiliates and concluding that "[r]ate-of-return regulation is particularly undesirable, risky, and ill-suited for expense intensive companies like ISPs."); LEC-7-C (Votaw Opening) at 12:12-13:9 (explaining that rate of return on investment would be ill-suited to Ducor's ISP affiliate's expense-intensive business); LEC-5 (Boos Reply) at 14:17-25, 22:7-15 (explaining that because Ponderosa's ISP affiliate is an expense intensive business, rate of return on the ISP's investment could not make up for the revenue shortfall caused by the imputation of the ISP's profits); LEC 4-C (Boos Opening) at 22:7-9 (same).

[221] RT at 1784:7-12 (Roycroft) (admitting that imputation would involve "determining the forecasted revenue and expenses and investments" for the ISP).

[222] *See* RT at 1805:4-18 (Roycroft) (agreeing that "demand for broadband have to be examined to determine what the forward-looking expectations would be for the ISP's revenue"); 1806:24-1807:6 (Roycroft) (expenses, revenues and investments would also be subject to a reasonableness analysis).

[223] RT at 1779:17-19 (Roycroft).

[224] RT at 1805:4-18; 1806:7-16 (agreeing that the "audit" would involve a review of demand and pricing).

[225] *See* RT at 1172:18-21 (Ahlstedt); *see also* D.16-06-053 at 24-25, 87-88.

[226] RT at 1173:14-21 (Ahlstedt), 1799:7-17 (Roycroft).

territories and using other technologies, such as fixed wireless.[227] As the Phase 2 hearings themselves show, the scope of the imputation model would have to be resolved through the adversarial process in each rate case.

While some details of the imputation model are unexplained, the known mechanics only point to more areas for debate. The "pro forma" itself would generate disputes, as any effort to conceptually combine the ISP and the telephone company will engender arguments about whether costs are "duplicative" and whether additional efficiencies should be assumed from the "pro forma" entity.[228] Further, TURN advocates for application of the FCC's operating expense limitation and the corporate expense cap to the ISP, but neither of the associated algorithms include the ISP affiliates.[229] When pressed on this subject, Dr. Roycroft was unable to describe how these FCC expense caps could be implemented, ultimately concluding that "this is an area where there's some more work that needs to be done to get something that's implementable."[230] TURN's "alternative compliance" plan is also under-developed and lacking in details; however, for any company that selects that option, a third phase of the rate case would be required, again extending the schedule for the case and increasing the associated expense.[231]

Even outside of the rate case process, the imputation proposal would create additional regulatory burdens and debate. TURN proposes to modify the annual CHCF-A process to apply the "means test" to affiliate ISPs, but only in situations where ISPs have increased their prices.[232] This would require an additional layer of earnings review in the annual filings and result in disputes over whether a rate increase occurred.[233] As TURN acknowledges, changes to cost of

[227] RT at 1172:1-14 (Ahlstedt).
[228] RT at 1806:24-1807:24 (Roycroft).
[229] TURN-1 (Roycroft Opening) at 15:4-5 ("Expense caps that are applied to the Small LEC should also be applied to the ISP affiliate"); LEC-2 (Duval Reply) at 47:10-48:2; *see also* RT at 1826:26-1827:2 (Roycroft) ("I recognize that the formula associated with both of these caps are essentially it's developed for telephone companies, not developed for companies that are combined with their ISP affiliates").
[230] RT at 1825:10-12 (Roycroft); *see also* RT at 1824:3-22 (Roycroft) (TURN witness unable to clearly explain how the expense caps would apply to the combined "pro forma" entity).
[231] TURN-1 (Roycroft Opening) at 24 ("optional compliance plan" could only be proposed "[o]nce the needed adjustment in CHCF-A draws is identified," which would require a full execution of the imputation model and reasonableness analysis in the rate case).
[232] *Id.* at 76:6-11 (means test should be applied through the annual CHCF-A advice letter process to the combined operations of the Small LECs and their ISP affiliates on a pro forma basis, "with the addition of broadband rate increases receiving the same treatment as voice rate changes do today.") RT at 1828:5-10 (Roycroft) (under TURN's proposal, means test would only apply in years where companies choose to raise broadband retail rates).
[233] If a new ISP-focused "means test" is triggered by price increases, further monitoring of ISP prices will likely be imposed, generating even more expenses for the companies. Debates are also likely to occur about whether changes to the terms and conditions of Internet access service constitute price increases.

capital may also result from broadband imputation.[234] Indeed, broadband imputation would augment the risks associated with the Independent Small LEC operations, and corresponding increases to returns would be needed to preserve the proper investment incentives. The cost of capital issue would involve yet another Commission proceeding.

All of these contested issues and time-consuming processes are a direct consequence of broadband imputation and are likely to be just the tip of the iceberg. In an environment where the Commission was unable to timely complete eight of the 10 rate cases under the 2015 rate case plan, broadband imputation will take the Commission in exactly the wrong direction.[235] In addition, the Commission's refusal to reinstate the informal advice letter option for rate cases and Cal Advocates' continued opposition to recovering the full costs of formal rate cases will exacerbate the harm caused by imputation.[236]

5. Retail Broadband Imputation Cannot Survive a Cost-Benefit Analysis.

Whereas the detriments of broadband imputation are tangible, far-reaching, and thoroughly documented, the proponents of broadband imputation have struggled to articulate a compelling reason to support imputation. The policy justifications for broadband imputation have morphed over the course of this proceeding, but none can overcome the costs of this policy.

The original impulse behind broadband imputation was a desire to decrease the CHCF-A

[234] TURN admits that adjustments to the cost of capital might be warranted where a company is expense intensive and "insolvency risks exist," but TURN vastly understates the increase in equity risk that broadband imputation would create for each regulated telephone company. TURN-2 (Roycroft Reply) at 38:11-39:14. Operating in an environment with no prospect of anything but a nominal profit, which imputation ensures, is far riskier than the current paradigm where each company's rates are set based on its own costs. *See* LEC-8 (Votaw Reply) at 2:6-9 ("The collective effect of the proposals from TURN and Cal Advocates would make it difficult or impossible for Ducor and Varnet to continue operating. Through broadband imputation, all of Varnet's profits would be confiscated by reducing Ducor's CHCF-A, except for a nominal 'rate of return' on Varnet's small net investments that TURN would support.")

[235] *See* D.16-06-053 at 4 (issued 41 months after deadline for completion in the rate case plan); D. 17-11-013 at 4 (issued 1 month after deadline for completion in the rate case plan); D.17-11-016 at 3 (issued 1 month after deadline for completion in the rate case plan); D.18-01-011 at 4 (issued 2 months after deadline for completion in the rate case plan); D.18-04-006 at 3 (issued 6 months after deadline for completion in the rate case plan); D.19-04-017 at 4 (issued 6 months after deadline for completion in the rate case plan); D.19-06-025 at 3 (issued 8 months after deadline for completion in the rate case plan); D.19-12-011 at 3 (issued 11 months after deadline for completion in the rate case plan); *see also* D.15-06-048, App. A at 2-3, Table 2.

[236] D.18-10-033 at 8-9; Cal Adv-10 (Tully Opening) at 1-6:1-18; *see also* D.19-04-017 at 74 (COL 14) (finding it is reasonable to include Foresthill's rate case expense within its corporate cap), 32, 37 & App. A (the Commission's adoption of corporate cap in the amount of $768,448 effectively disallows requested $166,667 in amortized rate case expense as Foresthill's proposed corporate expenses are $938,198).

budget,[237] and this objective continues to pervade Cal Advocates' presentation.[238] However, reducing CHCF-A support is not a legitimate goal in itself. Even if it were, the record shows that broadband imputation is unlikely to produce material savings for CHCF-A contributors. As Dr. Aron explained, an imputation policy would ultimately compel profitable ISP affiliates to "disaffiliate" from the regulated telephone companies, leaving only unprofitable ISPs as participants in imputation.[239] This effect would either increase the CHCF-A or have no meaningful budgetary effect.[240] And even if all ISPs remained affiliated, Cal Advocates estimates that the total impact of retail imputation would be "$3-4 million annually."[241] Assuming a total CHCF-A budget of $40 million, and using the current surcharge of .350%, Cal Advocates' estimates would "save" CHCF-A contributors *less than a penny* on a $25 phone bill, or approximately 10 cents a year.[242] During cross-examination, Cal Advocates' imputation witness admitted how small this impact would be, but nevertheless doubled down on the CHCF-A reduction argument as a basis for imputation: "[t]hat's 10 cents that . . . ratepayers should not be paying the High Cost Fund-A if they don't need to."[243] Despite this assertion, saving pennies on an already tiny surcharge cannot outweigh the demonstrated harms of the imputation policy.

TURN's original basis for imputation was the notion that affiliated ISPs are receiving a "free ride" by offering their unregulated services over the regulated telephone networks of the Independent Small LECs.[244] The record in Phase 1 repudiated this premise, as the "ride" is

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[237] In the OIR, the impetus for reforming the CHCF-A was based on claims about "significant increases" in carrier claims, but these assertions have been discounted on the record. *Compare OIR* at 23-24 (presenting misleading data regarding CHCF-A growth over time) to LEC-4 (Boos Opening) at 9:1-10 (showing carrier claims are stable and below inflationary levels).

[238] Mr. Ahlstedt's testimony reflects Cal Advocates' myopic fixation on reducing the CHCF-A. The centerpiece of his reasoning in favor of broadband imputation is that it will "save California ratepayers between $3-4 million annually" in CHCF-A contributions. Cal Adv-3 (Ahlstedt Reply) at 1-1:23; *see also* Cal Adv-2-C (Ahlstedt Opening Errata) at 1-7:1-3 ("Imputing positive net retail broadband revenues from the ISP affiliates shifts the burden of funding the Small ILECs away from ratepayers and onto the Small ILECs themselves."). Mr. Ahlstedt's testimony should be understood in the context of Cal Advocates' agenda to eliminate the CHCF-A or dramatically reduce its size. *See DRA Comments on OIR*, at 2-3 (Cal Advocates' predecessor proposing to phase out the CHCF-A over a six-year period on the theory that the "program appears to have met its goals").

[239] LEC-9 (Aron Opening) at 18-19, 26-28, 34-35, 55-56.

[240] Under TURN's proposal, the CHCF-A is likely to increase marginally because TURN would include a return on the ISPs' small net investments in its imputation model. LEC-9 (Aron Opening) at 55-56. Since Cal Advocates' imputation model would only impute positive net revenues, the disaffiliation of profitable ISPs would have a net zero effect.

[241] Cal Adv-3 (Ahlstedt Reply) at 1-1:23.

[242] LEC-1 (Duval Opening) at 34:2-7.

[243] RT at 1210:2-5 (Ahlstedt).

[244] Phase 1 Exh. 14 (Roycroft Opening) at 4:19-23; *see also* D.14-12-084 at 16 (referencing TURN argument that "ISP affiliates unfairly benefit from access to the loop without paying an appropriate

neither "free" nor preferentially available to affiliates.[245] Phase 2 confirms these conclusions.[246]

TURN's Phase 2 advocacy contains echoes of its original argument, embedded in allegations of "excessive profits" and "market failure."[247] The central thesis of these suggestions remains false. The characterization of the ISP profits as "excessive" is counterfactual, as three of the ISPs are unprofitable, two are barely profitable, and the other five have profit margins that fall short of or are similar to the profit margins that the Commission has deemed reasonable in approving regulated results of operations for the Independent Small LECs' telephone operations.[248] The tariffed wholesale paradigm for DSL transmission service further undercuts any concern about "market failure," as the retail broadband market is open to unaffiliated ISP competitors on the exact same terms as the affiliates.[249] As with any market, the ISP affiliates reflect varying degrees of financial success, but this is not proof of market dysfunction. Likewise, the affiliate ISPs may have higher prices than some providers in urban areas, but this reflects the high fixed costs of operating a rural ISP, not endemic inefficiencies on the part of the companies.[250] And even if mismanagement or inefficiency existed, the lack of any meaningful barriers for competitors would inevitably lead to a market correction through competitive entry.

In Phase 2, TURN's "free ride" concept also sublimated into rhetoric surrounding efforts to bridge the "digital divide."[251] TURN's theory rests on the premise that it can facilitate broadband adoption by luring profitable ISP affiliates into pursuing price reductions rather than losing substantially all of their profits to imputation.[252] As Dr. Aron explained, erecting this Hobson's choice would not change the basic economics of imputation; Dr. Roycroft's "alternative" would just eviscerate ISP profits through a different mechanism.[253] This option

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amount for the loop costs").

[245] Phase 1 Exh. 2 (Douglas Opening) at 8:13-15; Phase 1 Exh. 4 (Duval Opening) at 9 ("[p]articipating carriers must charge the rates in their assigned rate bands to all customers that order services out of the NECA tariff.").

[246] In fact, the ISPs pay handsomely for access to local exchange networks through a federal tariff, and any unaffiliated ISP could do so on the same exact terms. LEC-1 (Duval Opening) at 10:21-25; LEC-4 (Boos Opening) at 14:9-14. Likewise, the ISPs' payments for accessing the local exchange network are booked as regulated interstate revenue to the telephone company and help recover the interstate costs of the local loop, in accordance with federal cost separations rules. LEC-1 (Duval Opening) at 21:13-22:4.

[247] TURN-1 (Roycroft Opening) at 26:17-20, 57:5.

[248] *See* LEC-9 (Aron Opening) at 23, Exh. 1; TURN-1 (Roycroft Opening), App. 3 at C0127-C0138; TURN-2-C (Roycroft Reply) at 19. Table 1 and n. 40 (citing Roycroft_Confidential_Reply_Workpaper.xlsx); *see also* n. 31, 88.

[249] LEC-1 (Duval Opening) at 10:21-25; RT at 1716:17-1717:12 (Aron).

[250] LEC-9-C (Aron Opening) at 31-32, Q37, Exh. 3; LEC-2 (Duval Reply) at 2:26-3:3.

[251] TURN-1 (Roycroft Opening) at 10:29-32; 25:3-5.

[252] *Id.* at 26:8-16 (suggesting that the "alternative" compliance option would benefit "the Small LECs").

[253] LEC-10 (Aron Reply) at 19 ("Instead of choosing between Scylla and Charybdis, the wise mariner

will be especially unattractive because it would add a third phase to a rate case process that will already be rendered unwieldy by broadband imputation.[254] In the long run, profitable ISPs will choose to disaffiliate from the telephone companies rather than accept the miniscule returns that either of Dr. Roycroft's formulations would provide.[255] While the Independent Small LECs share TURN's policy goals of facilitating rural broadband connectivity, TURN failed to establish a nexus between its imputation proposal and the state's broadband objectives. A straightforward economic analysis shows that these alleged benefits would not materialize.

The proponents of broadband imputation also imply that this policy is necessary to rectify a perceived institutional unfairness in the FCC's cost recovery rules.[256] During the hearings, both Cal Advocates and TURN asked numerous questions to confirm that 75% of local loop costs are assigned to the intrastate jurisdiction.[257] As Mr. Duval has explained, these separations reflect a trade-off between the federal and state jurisdictions, and extensive federal support is provided to offset the greater assignment of loop costs to intrastate revenue requirements.[258] Even if TURN finds these tradeoffs to be sub-optimal, they reflect the correct application of federal law and the California Legislature has confirmed its intent to "preserve . . . [a]pplication of the Federal Communications Commission's cost allocation and separations rules to the

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would not sail that strait at all if another route is possible").

[254] TURN-1 (Roycroft Opening) at 24:15-16 (the optional plan would "still require the application of the imputation approach, including an evaluation of ISP affiliates['] audited operating results").

[255] LEC-10 (Aron Reply) at 19 ("any company that has a reasonable expectation of earning a return in excess of the regulated return on average over time would rationally prefer to extract itself . . . and avoid not only the constraints on its returns but the risks that legitimate expenses and investments will be disallowed.").

[256] *See* TURN-2 (Roycroft Reply) at 16:21-17:17 (agreeing with The National Association of Regulatory Utility Commissioner's comments that 75%/25% cost separations split is outdated and does not reflect the increased usage of the mixed used network for interstate services); 18:6-10 (acknowledging that Independent Small LECs are not doing anything improper, but simply following the established federal regulatory framework); *see also infra*, n. 49.

[257] *See, e.g.,* RT at 940:20-943:23 (Duval) (Choe questioning Duval about loop cost assignments); RT at 972:15-973:19 (Duval) (Mailloux questioning Duval about 75%/25% jurisdictional split of loop costs). As Mr. Duval explained during cross-examination, loop costs are not assigned exactly 75% to the intrastate jurisdiction because some loop costs are directly assigned to the interstate jurisdiction, making the actual intrastate component somewhat lower than 75%. RT at 947:19-23 (Duval).

[258] *See* LEC-1 (Duval Opening) at 29:28-30:15; RT at 945:17-20 (Duval) ("And so the FCC provides High Cost Loop Support that helps to recover a portion of the 75% of the local loop that is assigned to the intrastate jurisdiction); *see also* LEC-1 (Duval Opening) at 21:1-4 (Part 36 of the FCC's jurisdictional separations rules require 75% of the cost of local loops used in the provision of voice or voice and broadband services to be assigned to intrastate jurisdiction and HCLS then provides support for the portion of the cost of the local loop that exceeds 115% of the national average cost per loop ("NACPL"), 29:25-30:3; *see also In the Matter of Connect America Fund*, WC Docket No. 10-90, *Report and Order*, FCC 16-33, (rel. Mar. 30, 2016) at ¶ 82, n. 160 ("*Rate-of-Return Reform Order*") ("HCLS provides support for up to 75% of a carrier's unseparated loop costs (i.e., up to the full amount in the intrastate jurisdiction) above a specified threshold); 47 CFR §§ 54.1301 - 54.1310.

expenses and investment of the telephone corporations that participate in the California High Cost Fund-A program."[259] If the Commission were to nevertheless find these allocations unacceptable, the appropriate recourse is to raise its concerns with the FCC, not to manipulate intrastate ratemaking mechanisms to achieve a result that is contrary to current law.

The record in this proceeding reflects shifting policy justifications for broadband imputation, which strongly suggests that it "is a proposal in search of a valid objective."[260] The Commission's assessment of broadband imputation should be based on the record evidence, not an *a priori* judgment or preconceived notion. TURN and Cal Advocates have failed to substantiate any benefits of imputation that could outweigh the countervailing harms.

B. Wholesale Imputation.

Cal Advocates would compound the illegality and amplify the harm from the imputation policy by extending it to wholesale revenues derived from the telephone companies' provision of DSL transmission service to ISPs.[261] Imputing these interstate revenues into intrastate ratemaking calculations would interfere with a federally-regulated, tariffed service and create millions of dollars in intrastate revenue shortfalls for the Independent Small LECs.[262] The impact of Cal Advocates' wholesale proposal alone would result in a collective revenue shortfall of $6,854,623 and an average reduction in rate of return of 52%.[263] This would be destabilizing to the companies and compromise their abilities to reasonably operate.[264] Only Cal Advocates supports this radical proposal, and neither the law nor the record support its adoption.[265]

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[259] SB 379 (Fuller 2012) § 1(b); *see also* 47 C.F.R. § 36.154(c) (confirming 25% allocation of "jointly used" cable and wire facilities to interstate jurisdiction); LEC-1 (Duval Opening) at 27:11-23.
[260] LEC-10 (Aron Reply) at 9.
[261] Cal Adv-2 (Ahlstedt Opening Errata) at 1-7 ("the Commission should impute wholesale broadband revenues generated from the sale of wholesale access to the Small ILECs' broadband capable network.").
[262] LEC-2 (Duval Reply) at 13:4-6 ("Wholesale broadband revenues are the interstate tariffed revenues that the Independent Small LECs receive from ISPs for the broadband transmission service that they provide, which the ISP in turn uses in the provision of retail broadband service to end users."); *see also Restoring Internet Freedom Order* at ¶ 425 (noting that participants in the NECA tariff offer a regulated "Title II" service on a "common carrier" basis).
[263] LEC-2-C (Duval Reply), Exh. A at 2; *see also* LEC 13-C, Exh. A at 2. If all of Cal Advocates' proposals were implemented, the Independent Small LECs would experience a collective revenue shortfall of almost $18 million, or a -24.11% collective rate of return. LEC-2-C (Duval Reply) at 67-68, Table 6. Sustained losses of this magnitude would drive some or all of the companies into bankruptcy.
[264] *See* LEC-5 (Boos Reply) at 18:26-27 (wholesale imputation would mean that Ponderosa has "$1,251,805 less revenue than the amount the Commission found was necessary for Ponderosa to fulfill its revenue requirement").
[265] TURN-2 (Roycroft Reply) at 63:22-24 ("No, the Commission should not impute interstate revenues, as those revenues are addressed by the FCC when it establishes the interstate revenue requirement for the Small LECs.").

1. Wholesale Broadband Imputation Would Interfere With a Well-Established Federal Ratemaking Scheme and Conflict With Federal Determinations Regarding DSL Transmission Revenues.

Wholesale imputation would violate both federal and state law. DSL transmission service is an exclusively federal service provided pursuant to an interstate tariff administered by NECA. The revenues from this service are already accounted for and applied toward fulfillment of the companies' interstate revenue requirements.[266] Attempting to redirect those revenues to intrastate revenue requirements would interfere with federal ratemaking mechanisms and conflict with federal jurisdictional separations rules,[267] making the proposal unconstitutional under multiple federal preemption doctrines.[268] Wholesale imputation would also exceed the Commission's authority under state law.[269]

On cross-examination, Cal Advocates' imputation witness admitted all of the factual predicates necessary to show that wholesale imputation is illegal. Mr. Ahlstedt confirmed that DSL transmission service is governed by a federal tariff.[270] He acknowledged that NECA administers the tariff on the FCC's behalf. [271] He agreed that DSL transmission is an "interstate service" and that the revenues derived from it are "interstate revenues."[272] He recognized that the California Commission does not regulate interstate revenue requirements. [273] Mr. Ahlstedt

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[266] LEC-2 (Duval Reply) at 14:9-20 (explaining how DSL transmission revenues are accounted for in the interstate ratemaking process).
[267] *See* NECA Tariff No. 5, Title Page (confirming that NECA tariff sets forth "Rates and Charges . . . for connection to *interstate* communications facilities for *Interstate* Customers") (emphasis added); 47 C.F.R. § 36.213 ("Network access services revenues," including revenues in FCC account 5083, are "directly assigned"); *see also* SB 379 (2012 Fuller) § 1(a) ("it is the intent of the Legislature to preserve . . . [a]pplication of the Federal Communications Commission's cost allocation and cost separation rules to the expenses and investments of telephone corporations who participate in the [CHCF-A].")
[268] The supremacy clause of the United States Constitution makes "the Laws of the United States" the "supreme Law of the Land." U.S. Const., art. VI, cl. 2. In applying the supremacy clause to state law, there are "four species of federal preemption: express, conflict, obstacle, and field." *Viva! International Voice for Animals v. Adidas*, 41 Cal.4th 929, 935 (2007). Both "conflict" and "obstacle" preemption bar the imputation of wholesale revenues. "Conflict preemption" applies where "simultaneous compliance with both state and federal directives is impossible." *Id.* at 936. Cal Advocates' proposal creates such a conflict because it would be impossible to count wholesale revenues as both intrastate and interstate. "Obstacle preemption," which the *Mozilla* court refers to as a type of conflict preemption, exists where "under the circumstances of [a] particular case, [the challenged state law] stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Crosby v. National Foreign Trade Council*, 530 U.S. 363 (2000), citing *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941); *Mozilla*, *supra*, 940 F.3d at 81. This form of preemption is also triggered by wholesale imputation, as it would "undermine the cost separation and cost recovery process" that the FCC has implemented pursuant to Congressional authorization. LEC-2 (Duval Reply) at 36:14-15.
[269] Pub. Util. Code § 202 (restricting the Commission's authority over "interstate commerce")
[270] RT at 1191:28-1192:3 (Ahlstedt).
[271] RT at 1192:4-8 (Ahlstedt).
[272] RT at 1192:13-15, 1193:6-7 (Ahlstedt).
[273] RT at 1194:15-21 (Ahlstedt)

described the NECA pooling process that accounts for DSL transmission revenues.[274] These admissions alone are sufficient to reject the wholesale imputation proposal as unlawful.

2. Wholesale Broadband Imputation Would Create Impermissible Shortfalls in Intrastate Revenue Necessary to Fulfill Intrastate Revenue Requirements.

Even if it were structured strictly as a reduction to CHCF-A without any impact on the federal regulatory apparatus, wholesale imputation would result in a rate design that produces far less revenue than necessary to meet the intrastate revenue requirement, in violation of Public Utilities Code Section 275.6 and constitutional takings requirements.[275] The Commission cannot set an intrastate revenue requirement and then refuse to fulfill it just because the same company's interstate operations generate revenues that would be convenient to count as intrastate.[276]

During his live testimony, Mr. Ahlstedt attempted to avoid the inescapable conflicts with federal law by claiming that his proposal "does not reallocate money, or change accounts for money or redesignate it as intra or interstate" and that it "simply is an accounting mechanism to adjust the High Cost Fund-A amount draw . . . ."[277] This formulation of wholesale imputation is equally damning, as the revenues do not double just because they are counted twice. Mr. Ahlstedt admitted that his proposal would "offset what the company would otherwise receive in CHCF-A."[278] As TURN's expert observed, "wholesale DSL revenues cannot be counted in both . . . intrastate and interstate revenue requirements."[279] Federal cost separations rules require that this revenue be counted as interstate, so Cal Advocates' proposal would create an intrastate revenue shortfall for every dollar of DSL transmission revenue that a company receives.[280]

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[274] Part of Mr. Ahlstedt's basis for recommending wholesale imputation is his assertion that these revenues are "unaccounted for." Cal Adv-2 (Ahlstedt Opening Errata) at 1-8. The record squarely contradicts that assertion, as the revenues are accounted for through the federal ratemaking process according to NECA Tariff No. 5. LEC-2 (Duval Reply) at 14:20 ("The revenues are 'accounted for' as interstate revenues"). On cross-examination, Mr. Ahlstedt initially claimed not to know whether DSL transmission revenues are "accounted for through the NECA process," but minutes later demonstrated an awareness of the pooling process through which the accounting takes place. RT at 1193:24 (Ahlstedt) ("I'm not certain of that"), 1195:22-25 (Ahlstedt) (explaining treatment of revenues under NECA's pooling process), 1197:28-11198:9 (Ahlstedt) (explaining that initial ISP payments differ from receipts through pooling).

[275] Pub. Util. Code § 275.6(b)(4) (the Commission must "fashion[] a rate design to provide the company a fair opportunity to meet its revenue requirement."); n. 181, *supra*.

[276] In the Commission's ratemaking determinations, revenue requirement and rate design must be equal. *See* n. 37, *supra*.

[277] RT at 1195:7-15 (Ahlstedt).

[278] RT at 1196:12-16 (Ahlstedt)

[279] TURN-2 (Roycroft Reply) at 65:16-17.

[280] LEC-2 (Duval Reply) at 13:25-27 (the Commission "has never" imputed interstate revenues into intrastate ratemaking "because it is completely contrary to the FCC's Part 36 jurisdictional cost

The financial ramifications of this proposal are profound, and would result in intrastate revenue shortfalls of between 2.73% and 21.35%.[281] As Mr. Duval explained, this would "leav[e] a gaping hole in each of the Independent Small LECs' intrastate cost recovery and not allow[] them an opportunity to achieve their authorized rate[s] of return."[282] Wholesale imputation is a misguided policy that would compromise established cost recovery mechanisms and have crushing effects on operational stability and ongoing investment incentives.

V. ROLE OF FEDERAL FUNDING IN RATEMAKING [SCOPING MEMO, ISSUE (6)].

A. Only The Intrastate Components of Federal Funding Are Appropriate for Inclusion in Intrastate Rate Design.

The Scoping Memo asks about "each federal Universal service support program" and its "accounting and ratemaking treatment."[283] As the record shows, only HCLS and the intrastate portion of Alternative Connect America Cost Model ("A-CAM") support are relevant to intrastate ratemaking.[284] These funds are already incorporated into intrastate rate design and are part of the "Results of Operations" table that describes the outcome of each rate case.[285] All other federal high-cost support is interstate and plays no part in intrastate ratemaking.[286]

For companies on the "legacy" federal funding system, there are only two sources of federal high-cost funding – HCLS and Connect America Fund-Broadband Loop Support ("CAF-BLS").[287] One is intrastate and the other is interstate. HCLS supports companies' intrastate revenue requirements through an "interstate expense allocation" or "expense adjustment" that has the effect of shifting intrastate costs to the interstate jurisdiction.[288] The result of this

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separations rules, which the Commission follows"); LEC-5 (Boos Reply) at 18:3-4 ("The same revenues would still be counted as interstate revenues, as part of fulfilling interstate revenue requirements."); TURN-2 (Roycroft Reply) at 66:1-2 ("the jurisdictional separations process creates boundaries that should not be violated for the imputation process.").

[281] LEC-2 (Duval Reply) Exh. A; *see also* LEC-13-C at 2.

[282] LEC-2 (Duval Reply) at 13:17-18. Mr. Duval calculated the impact of this proposal on rates of return, and the results range from reductions of 7% to 98%, with eight of the 10 companies experiencing reductions of more than 40%. *Id.*, Exh. A; *see also* LEC-13-C at 2, 7, 19, 31, 43, 55, 67, 79, 91, 103, 115.

[283] *Scoping Memo* at 8 (Issues 6(a) and 6(b)).

[284] LEC-1 (Duval Opening) at 29:17-31:16.

[285] *See* LEC-17, App. A, ln. 3 (incorporating federal support into rate design); *see also id.* at 13 (confirming that "USF" figure in App. A is comprised entirely of HCLS).

[286] *See* LEC-1 (Duval Opening) at 31:12-16.

[287] RT at 2044:27-2045:10 (Duval) (explaining that HCLS and CAF-BLS "go hand in hand" and collectively represent "Legacy Rate of Return Support").

[288] *See* 47 C.F.R. § 54.1301(a) ("[t]he expense adjustment calculated pursuant to this subpart M shall be added to interstate expenses and deduced from state expenses after expense and taxes have been apportioned pursuant to subpart D of part 36 of this chapter."); 47 C.F.R. § 54.1310 (explaining mechanics of "interstate expense allocation" used to shift costs to interstate jurisdiction).

mechanism is to devote HCLS to intrastate rate design and reduce the amount of revenue that would otherwise be required to fulfill intrastate revenue requirement from intrastate revenue sources, such as end user revenues or the CHCF-A.[289] CAF-BLS fulfills an exclusively interstate revenue requirement subject to the FCC's regulatory authority.[290]

For A-CAM carriers,[291] HCLS and CAF-BLS are no longer available and a fixed annual A-CAM amount is provided as a substitute.[292] Because it replaces both intrastate and interstate legacy funding, A-CAM must be jurisdictionalized to ensure that the federal and state revenue requirements receive appropriate contributions from this single source.[293] As with HCLS, the Commission is already performing this calculation in rate cases for A-CAM carriers.[294]

HCLS, CAF-BLS, and A-CAM are the only federal high-cost funds, and each has an established jurisdictional treatment that governs its use in ratemaking.[295] Beyond its high-cost funds, the FCC administers other universal service programs that support low-income households, schools and libraries, and rural health care entities.[296] These programs do not impact

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[289] RT at 1031:2-5 (Duval) (intrastate rate design includes "local service revenues, Federal high cost loop support, intercarrier compensation revenues, miscellaneous revenues, [and] CHCF-A); *see also* Pub. Util. Code § 275.6(c)(4) (CHCF-A must supply "the portion of revenue requirement that cannot reasonably be provided by . . . customers . . . after receipt of federal universal service support").

[290] RT at 2038:1-4 (Duval) (". . . when companies receive CAF-BLS support, that is support for interstate-only costs and is part of the interstate rate design"); 2038:11-12 ("[s]o the election of CAF-BLS has no impact on the CHCF-A"); RT at 2238:11-13 (Hoglund) (agreeing that CAF-BLS is 100% interstate); *see also* 47 C.F.R. § 54.901(a) (CAF-BLS supports the "Interstate Common Line" and "Consumer Broadband-Only" revenue requirements); *ETC Reform Order* at ¶ 90 ("the costs of a broadband-only line are all interstate").

[291] Since 2017, the FCC has given companies the option to select model-based support through the A-CAM program, and three Independent Small LECs opted into this alternative high-cost funding platform. 47 C.F.R. § 54.311 (summarizing A-CAM program operation and requirements); LEC-1 (Duval Opening) at 22:12-15, n. 9 (explaining that Cal-Ore and Pinnacles accepted the original "A-CAM I" offer commencing on January 1, 2017 and Ducor accepted the "A-CAM II" offer in 2019); *see* 47 C.F.R. § 311(a)(1)-(3) (defining "A-CAM I" and "A-CAM II").

[292] LEC-1 (Duval Opening) at 22:6-9 (explaining how A-CAM support replaces HCLS and CAF-BLS); RT at 2238:23-26 (Hoglund) (agreeing that A-CAM replaces HCLS and CAF-BLS); *see also* 47 C.F.R. § 54.311 (explaining that "voluntary election" of A-CAM is provided "in lieu" of "support pursuant to subparts K [CAF-BLS] and M [HCLS].").

[293] LEC-1 (Duval Opening) at 30:18-31:5; RT at 2239:6-8 (Hoglund) (agreeing that because A-CAM replaces intrastate and interstate funding, [s]ome mechanism or methodology would be needed to allocate intrastate and interstate").

[294] In resolving the Cal-Ore and Pinnacles rate cases, the Commission included the intrastate component of A-CAM on the "Interstate USF" line of each company's Results of Operations table. *See* D.18-01-011 (Cal-Ore), Exh. 2, Line 4; D.19-12-011 (Pinnacles), App. A, Line 4; *see also* RT at 1971:2-5 (Duval) (Cal-Ore and Pinnacles were both on A-CAM at the time of their rate case decisions).

[295] Connect America Fund-Intercarrier Compensation ("CAF-ICC") support is sometimes described as a "high-cost" support program, but, as explained below, this funding is strictly an intercarrier compensation replacement mechanism designed to offset reductions in revenues stemming from federal intercarrier compensation reforms.

[296] *See* LEC-1 (Duval Opening) at 20:8-13 (summarizing other universal service programs); *see also* 47 C.F.R. §§ 54.400*, et seq.* (federal Lifeline program); 54.500, *et seq.* (schools and libraries program);

intrastate ratemaking calculations because they function as direct pass-throughs to customers.[297]

B. The Intrastate Component of Connect America Fund-Intercarrier Compensation Funding Should Be Incorporated into Intrastate Rate Design Through the Overall "Eligible Recovery" for Intercarrier Compensation Permitted by Federal Law.

The Independent Small LECs also receive Connect America Fund-Intercarrier Compensation ("CAF-ICC") support, a portion of which is intrastate revenue.[298] Unlike true "high-cost funds," CAF-ICC is not designed to mitigate high costs of service; it is a replacement mechanism for revenue that previously was derived from access charges and reciprocal compensation prior to the FCC's sweeping intercarrier compensation reforms in 2011.[299] Starting in 2012, the FCC began a 5% annual phase-down in terminating access and reciprocal compensation revenues.[300] Each year, rate-of-return carriers are entitled to receive 95% of what they received in the previous year.[301] CAF-ICC is one of three revenue sources that contribute to reaching that 95% annual revenue "baseline."[302] To the extent that revenues from carrier access charges and the end user Access Recovery Charge ("ARC") are not sufficient to reach eligible recovery, CAF-ICC makes up the difference.[303]

Regardless of the combination of carrier revenues, ARC, and CAF-ICC that comprise the "eligible recovery," each of these revenues is incorporated into intrastate rate design by computing the intrastate component of the "eligible recovery" itself.[304] As Mr. Duval explained:

54.600, *et seq.* (rural health care program).

[297] *See* LEC-1 (Duval Opening) at 20:13-21 (explaining that federal funding for Lifeline, schools and libraries, and rural health care discounts are "not designed to recover any portion of the interstate or intrastate revenue requirements of Independent Small LECs" and therefore "not relevant" here).

[298] LEC-1 (Duval Opening) at 23:2-12 (explaining role of CAF-ICC in recovering terminating switched access revenue requirements); 47 C.F.R. §§ 51.917(b)(1), (b)(4) (acknowledging that "switched access revenue requirement" is "calculated in compliance with the provisions of part[] 36," which governs jurisdictional separations and determines the intrastate portion of the associated revenues).

[299] *USF/ICC Transformation Order* at ¶ 917 (". . . to ensure a measured, predictable transition, we thus find it appropriate to supplement end user recovery with transitional ICC-replacement CAF support."), ¶ 36 ("[we adopt a transitional recovery mechanism to mitigate the effect of reduced intercarrier revenues on carriers and facilitate continued investment in broadband infrastructure . . . .").

[300] 47 C.F.R. § 51.917(d) (outlining annual phase-down in "eligible recovery"); *see also* RT at 2240:23-2041:25 (Hoglund) (confirming mechanics of "eligible recovery" phase-down).

[301] 47 C.F.R. § 51.917(b)(3) (establishing 95% annual "rate-of-return carrier baseline adjustment factor").

[302] Contributions toward the annual "rate-of-return carrier baseline" include "expected revenues" from transitional intercarrier compensation rates, ARC revenues, and CAF-ICC support. *See* 47 C.F.R. §§ 51.917(b)(2) (defining "expected revenues"); 51.917(d) (defining "eligible recovery"); 51.917(e) (explaining ARC mechanics); 51.917(f) (identifying CAF-ICC eligibility and calculations).

[303] *USF/ICC Transformation Order* at ¶ 917, n. 1818 ("The ICC-replacement CAF support for carriers that are eligible . . . is the remainder of Eligible Recovery not recovered through the ARC"); *id.* at ¶ 801 (terminating access charges will be reduced to $0.00 in July 2020).

[304] LEC-1 (Duval Opening) at 23:15-17 ("[t]here is no need to separately budget for CAF-ICC in the revenue projections in a rate case because the annual terminating access 'eligible recovery' figures, which

> You can determine it from the revenue requirement. It's been frozen and phasing down. So, you look at that number from 2011 and you transition it down by five percent. When we build the revenues in the rate case process, that's how we do it. We don't look at individual components. We don't try to forecast what switched access revenues are going to be or CAF-ICC revenue will be. We just input what the number is regardless of the sources. That's the amount of revenue that will be received. [305]

There is no need to separately account for CAF-ICC in the ratemaking process, and none of the rate cases under the 2015 rate case plan performed such a calculation.[306]

C. Federal Funding Supports Revenue Requirement, Not Specific Expenses or Investments.

The Scoping Memo asks whether there is a link between "federal Universal Service Funds" and companies' "operating expenses and plant investments."[307] This question implies that "sources" of funds can be traced directly to their "uses," which is a false premise.[308] As explained above, HCLS is the only federal high-cost support mechanism with any relevance to intrastate ratemaking. HCLS supports intrastate revenue requirement through the interstate expense adjustment; it does not purchase assets or pay expenses.[309] The record demonstrates that the Independent Small LECs provide cash to cover expenses and invest in capital projects, and that cash is derived from one of two sources: shareholder equity or loans.[310] Once revenue is received and income is earned, it becomes the property of the company and is commingled with the other dollars earned by the company.[311]

The original source of a dollar has no relevance to how that dollar may ultimately be spent. For ratemaking purposes, companies' revenue requirements are limited to what is "necessary for a telephone corporation to recover its reasonable expenses and tax liabilities and

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phase down 5% per year, already include these impacts."), 29:21-22 (CAF-ICC is "included in the intercarrier compensation or 'access' revenues reported in [a] rate case . . .").

[305] RT at 1060:7-19 (Duval).

[306] *See, e.g.,* D.19-12-011 at 32 (approving Pinnacles' "access revenue" calculation without separate calculation of CAF-ICC).

[307] *Scoping Memo* at 8 (Issue 6(c)).

[308] LEC-1 (Duval Opening) at 62:23-63:2 ("'Sources and uses of funds' is an accounting concept that addresses the sources from which a company obtains cash . . . and how the company uses its cash . . . . The use of funds is the company's cash, not a particular source of that cash; sources do not pay for particular expenses or assets. From a ratemaking perspective, the source of funds are the rate design and the uses of funds are the revenue requirement.").

[309] LEC-1 (Duval Opening) at 65:25-26 ("HCLS is not dispensed to pay for specific investments; it is a source of revenue, not a use of revenue.").

[310] *See* RT at 1455:22-24 (Boos) ("Ponderosa's shareholders invest their retained earnings or loan amounts."); RT at 1061:9-12 (Duval) ("Sources of investment capital could come from loans or it can come from the shareholders, their equity in the company. It's essentially one or the other.").

[311] RT at 930:20-24 (Duval) ("Once revenues are received, they are all commingled. You don't trace that source of revenue through the purchase of any asset or the payment of any expense . . .").

earn a reasonable rate of return on its rate base."[312] The Commission determines the reasonableness and necessity of these costs, but this determination does not depend on the source of the dollars through which the costs are ultimately fulfilled.[313]

D. Federal Funding Amounts Have No Impact on Rate Base Calculations.

The Scoping Memo questions whether "federal USF amounts estimated to be used for plant investment" should be part of "plant-in-service accounts" for inclusion in rate base.[314] This question is misguided because federal support is not earmarked for specific uses, and rate base calculations do not depend on the sources of revenue through which revenue requirement is ultimately fulfilled.[315] As the record shows, there is no nexus between federal funding and "plant-in-service" calculations.[316] No party has proposed to adjust rate base by federal funding amounts, and no such practice could be justified.[317]

VI. RATEMAKING TREATMENT OF EXPENSES.

A. Corporate Expense Cap. [Scoping Memo, Issues (2)(b)(i)-(ii), (2)(b)(iv)].

1. Application of the Corporate Expense Cap in Intrastate Ratemaking Has Resulted in Arbitrary and Inflexible Calculations of Corporate Expenses That Do Not Account for California-Specific Costs.

The Commission's strict application of the corporate expense cap in the Independent Small LECs' rate cases has resulted in inaccurate calculations of their corporate expenses. As is explained in the Phase 1 decision, the "corporate expense cap" was adopted for intrastate ratemaking only as a rebuttable presumption, which can be overcome with specific

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[312] Pub. Util. Code § 275.6(b)(5).
[313] Mr. Hoglund, whose expertise is informed by participation in seven of the last 10 Independent Small LEC rate cases, confirmed that the Commission's revenue requirement calculation is analytically distinct from the sources needed to fulfill that revenue requirement. RT at 2250:2-5, 10-14 (Hoglund) ("I would say it's actually the reverse. That the revenues would be determined would be dependent on those plant-specific costs . . . . The Commission determines a revenue requirement that determines how the identifiable and available revenue sources can be put together to meet that revenue requirement.").
[314] *Scoping Memo* at 8 (Issue 6(d)).
[315] LEC-1 (Duval Opening) at 61:22-24 ("Federal universal service funds are not grant programs, where recipients may receive support in advance of incurring expenditures, and support is provided as a dollar for dollar offset of the investment or expense."), 62:6-7 ("This revenue is fungible with other company revenues, not earmarked for specific expenses or investments.").
[316] HCLS is calculated based on a comparison of a carrier's "study area average unseparated loop cost" to the "national average" cost per loop. *See* 47 C.F.R. §§ 54.1310(a)-(b). By contrast, the "plant-in-service" element of rate base is computed by assessing the reasonable level of forward-looking investment needed in the community being served. Pub. Util. Code § 275.6(b)(2) ("rate base" is the "value of a telephone corporation's plant and equipment that is reasonably necessary to provide regulated voice services and access to advanced services"); *see* D.19-06-025 at 10-11 (approving broadband-capable network upgrades based on findings that "projects are critical forward-looking projects which will ensure that Ducor customers will have significantly more reliable service . . .").
[317] RT at 2269:11-16 (Hoglund) (Cal Advocates expert confirms that previous "proposal to reduce rate base by High Cost Loop Support" is "no longer the Public Advocates Office's proposal.").

demonstrations that expenses above the cap are "reasonable."[318] The Commission "decline[d] to prescribe the type of factors to rebut [the] presumption [of the corporate cap]," and concluded that "such factors may be developed in the GRCs."[319] In reality, the Commission has not considered any of the Independent Small LECs' evidence to rebut the application of the cap by showing that expenses above the cap are reasonable to account for the higher costs incurred to operate in California.[320] This arbitrary and "one-size-fits-all" approach fails to recognize the actual expenses incurred by the Independent Small LECs.[321]

It is undisputed the corporate expense cap is based on only two variables—the number of access lines and the monthly corporate expenses for rural telephone companies throughout the country.[322] Thus, this cap does not account for any California-specific expense drivers that make it more expensive to operate in California, such as the increased cost of living, which increases the cost of attracting and retaining qualified employees, or the intensive regulatory environment.[323] The Massachusetts Institute of Technology ("MIT") *Living Wage Calculator* presented by Mr. Duval shows that "California has the highest cost of living of any state in the country, yet the FCC's corporate cap does not take cost of living into consideration and treats all companies in the country the same."[324] In addition, the U.S. Bureau of Economic Analysis ("BEA") *Regional Price Parities by Portion* data show that "the cost of living in non-metropolitan areas of California is substantially higher than the average cost of living in non-metropolitan areas around the country and that California has one of the highest costs of living in non-metropolitan areas across the country."[325]

The documented expense premia associated with California operations were not considered when the FCC created the corporate cap. Accordingly, a blind application of the cap would fail to account for important factors that may impact the Independent Small LECs'

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[318] D.14-12-084 at 28-29.
[319] *Id.* at 29. The Commission affirmed this principle in the Ducor rate case, noting that there are "infinite rationales and calculations that theoretically could be employed to rebut the corporate expense cap." D.19-06-025 at 16-17.
[320] *See* LEC-1 (Duval Opening) at 44:11-14 ("In the end, the Commission stood firm on the application of the FCC's corporate expense cap, regardless of the extensive evidence presented that it should be modified to account for the unique situations faced by the Independent Small LECs.").
[321] *Id.* at 44:5-18.
[322] RT at 1826:1-14 (Roycroft); 2293:27-2294:6 (Tully).
[323] *See* LEC-1 (Duval Opening) at 45:8-17. As Mr. Duval notes, based on his extensive experience, "California has by far the most intensive regulatory environment that I have seen rate of return carriers subjected to." *Id.* at 45:15-17; *see also* LEC-2 (Duval Reply) at 33:19-28.
[324] LEC-2 (Duval Reply) at 34:1-5; *see also* LEC-1 (Duval Opening) at 39:17-40:5.
[325] LEC-2 (Duval Reply) at 34:6-10.

expenses, including the amount of revenue that the companies generate, the number of exchanges, labor costs in the serving area, population, density, competitive pressures, the amount of investment that the company has, the complexity of the company's network, and the debt and equity structure of the company.[326] The rate case process is a more precise and comprehensive vehicle for determining a reasonable level of corporate expenses than the FCC's model.[327] The Commission should ensure that all expense drivers are considered in ratemaking, either by removing the cap, or, at a minimum, allowing a regional adjustment that accounts for California.

2. Removal of the Rebuttable Presumption from the Corporate Expense Cap Mechanism Would Constitute Legal Error.

The cornerstone of ratemaking for small telephone companies is "revenue requirement," which must include "reasonable expenses."[328] Cal Advocates acknowledges this standard, and agrees that "if an expense is reasonable, it must be included in revenue requirement."[329] However, Cal Advocates proposes to remove the rebuttable presumption from the corporate cap mechanism, which would deny the Commission critical flexibility to accurately determine expenses and respond to company-specific circumstances that require a deviation from the cap. Without this discretion, the corporate cap mechanism would be unlawful, as it would necessarily foreclose recovery of reasonable expenses just because they are deemed to exceed the cap. The statute does not permit such an inflexible application of the reasonableness standard, so the rebuttable presumption must be retained to avoid legal error.

B. Rate Case Expenses.

1. Rate of Return Carriers are Entitled to Recover Reasonable Rate Case Expense As a Matter of Law.

Precedent dictates that rate of return carriers are entitled to recover reasonable rate case expense. In *Driscoll v. Edison Light & Power Co*.,[330] the U.S. Supreme Court endorsed the recovery of rate case expense in sweeping terms: "[e]ven where the rates in effect are excessive, on a proceeding by a commission to determine reasonableness, . . . the utility should be allowed

[326] Phase 1 Exh. 9 (Lehman Reply) at 32:14-34:2; LEC-2 (Duval Reply) at 35:11-14. The FCC has also recognized errors in the methodology that it used to create the corporate expense cap, which makes it even more important that this Commission give the companies a reasonable opportunity to present evidence of individual factors that impact their corporate expenses. LEC-1 (Duval Opening) at 45:6-7.
[327] *See* Phase 1 Exh. 9 (Lehman Reply) at 35:23-36:1.
[328] Pub. Util. Code § 275.6(b)(5).
[329] *Id.*; RT at 2165:3-7 (Montero) ("if an expense is reasonable, it must be included in revenue requirement.").
[330] 307 U.S. 104 (1939).

its fair and proper expenses for presenting its side to the Commission."[331] Paralleling this judicial authority, longstanding Commission practice in all sectors supports recovery of rate case expense. For instance, in D.12-04-009, the Commission allowed Suburban Water Systems to recover its rate case expense because "[r]easonable costs are allowable in rates for Suburban to participate in general rate cases and other regulatory proceedings."[332] Prior to the adoption of the 2015 rate case plan, the Commission consistently authorized the recovery of rate case expense for telephone companies. For example, in D.96-12-074, the Office of Ratepayer Advocates (the predecessor to Cal Advocates) determined that rate case expense was one of a number of "additional necessary items" that must be included in the Roseville Telephone Company's test year expenses, and adjusted its estimate of Roseville's expenses upwards "by including rate case costs."[333] Similarly, the Commission previously authorized the recovery of rate case expense for Cal-Ore and Calaveras amortized over a three-year period.[334] There is no legitimate legal or policy basis by which the Commission could depart from these precedents.

2. The FCC's Corporate Cap Methodology Does Not Account for Rate Case Expense.

Nothing in the FCC's Report and Order adopting the corporate cap, FCC-11-161, nor in the evidentiary and procedural record leading to its adoption, indicates that the FCC intended to – or did – account for rate case expense in the corporate cap. Indeed, the purpose of the corporate cap is to "allow carriers to receive support for corporate expenses based on typical expenses for companies of comparable size."[335] Rate case expenses are not "typical expenses" and the vast majority of rural telephone companies do not regularly experience such expenses. Companies incur rate case expense on a transactional basis during a fixed period of time, apart from their typical year-to-year operational expenses.[336] Therefore, carriers that have had rate cases are not "similarly situated" to the California companies, and these differences were not addressed by the cap. TURN's expert acknowledged this problem, noting that he was "not in

[331] *Id*. at 120-121.
[332] D.12-04-009 at 7 (finding it "reasonable to continue the current practice to amortize actual prior years' regulatory costs because we would otherwise have to 'catch up' for the unamortized years as well as include a future forecast in rates to avoid a gap in Suburban's recovery of reasonable costs.")
[333] D.96-12-074 at 12-13.
[334] Res. T-17133 at 9 (authorizing rate case expense of $61,000); Res. T-17184 at 11 (same); *see also* D.10-11-007, Att. 1 to App. A, Line 14.1 (authorizing recovery of Siskiyou's rate case expense); D.19-12-011 at 17 (authorizing recovery of Pinnacles' rate case expense).
[335] *See In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, *Fourteenth Report and Order*, FCC 01-157, ¶ 75 (rel. May 23, 2001).
[336] *See* LEC-2 (Duval Reply) at 33:19-28.

favor of a one size fits all solution for these companies because of their very significant differences in operational characteristics."[337]

3. Categorical Disallowance of Rate Case Expense Creates Impermissible Revenue Shortfalls and Impairs Companies' Abilities to Defend Themselves in Rate Cases.

A blanket denial of rate case expense through its inclusion in the corporation cap would deny Independent Small LECs a fair opportunity to recovery their "reasonable expenses," as Public Utilities Code Section 275.6(b)(5) requires.[338] This result would also violate their due process rights by stripping them of a property right without a fair opportunity to be heard.[339] The company witnesses testified to the significant expense they incurred as a result of being forced to litigate rate cases.[340] By denying recovery of rate case expense, the imposition of the corporate expense cap would compromise the companies' abilities to adequately defend themselves in future rate cases and, thus, deny them a reasonable opportunity to be heard.

C. Operating Expenses.

1. The Operating Expense Limitation Is a Reductive Methodology That Does Not Account for Critical California-Specific Costs.

The FCC's operating expense limitation is a simplistic methodology that cannot account for the legitimate expenses of providing service in rural California. The expense ceiling imposed by the formula was derived using a double log regression analysis, with the limitation established at one and a half standard deviations from the mean, which is derived from only two variables: (1) the total number of housing units in the study area; and (2) the density of those housing units in the study area.[341] Cal Advocates' expert admitted that the operating expense limitation only accounts for two variables and fails to measure numerous factors that impact costs.[342]

The Commission would reach erroneous ratemaking conclusions if it were to rely on the

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[337] RT at 1820:9-12 (Roycroft).
[338] Pub. Util. Code § 275.6(b)(5). As Cal Advocates has acknowledged, all reasonable expenses must be included in revenue requirement under Section 275.6. *See* RT at 2165:3-7 (Montero).
[339] Property rights are not limited to property physically possessed by a party, but also include the "legally enforceable right to receive a government benefit." *American Federation of Labor v. Employment*, 88 Cal.App.3d 811, 819 (1979), *citing Goldberg v. Kelly*, 397 U.S. 254, 261-262 (1970). Due process guarantees that a "person in jeopardy of a serious loss must be given notice of the case against him and an opportunity to meet it." *Mathews v. Eldridge*, 424 U.S. 319, 348 (1976), *citing Joint Anti-Fascist Comm. v. McGrath*, 341 U.S. 123, 171-172 (1951).
[340] *See* LEC-4 (Boos Opening) at 38:3-14; LEC-7 (Votaw Opening) at 21:20-24 and 22:19-24.
[341] The limitation applies to all operating expenses, including the items included in the corporate expense cap, but excluding depreciation, property taxes, and income taxes. *Rate of Return Reform Order*, *supra,* at ¶¶ 96, 98. The formula to is a simplistic two-variable regression model that relies only on "the number of housing units" and the "housing units per square mile" and in the study area. *Id*. at ¶ 99.
[342] RT at 2160:2-6, 2168:8-10 (Montero).

operating expense limitation. Use of these national metrics is understandable for the FCC, as it operates on a national scale. However, the FCC did not mandate that the states adopt the operating expense limitation and the California Commission must focus on what is reasonable for California. It would be illogical to set an expense cap in intrastate ratemaking using a national average that is significantly lower than the average cost to do business in California. The Independent Small LECs experience numerous California-specific expenses that rural telephone companies in other areas of the country do not face. Some of these are regulatory in nature, such as being subject to rate cases every five years or submitting annual filings to preserve high-cost support.[343] Other are economic, relating to the high cost of living in California. According to MIT's Living Wage Calculator, California has the highest cost of living of any state.[344] In addition, some California expense drivers are climate-related, such as PSPS events, wildfires, and extreme weather.[345] Cal Advocates' expense witness admitted that the operating expense limitation does not account for these expense factors, which makes the limitation ill-suited to capture the reasonable costs of doing business in California.[346]

Cal Advocates argues that adopting this limitation is "setting a standard to determine whether operating costs are reasonable" and "is consistent with the goals of the CHCF-A program," but neither statement is true.[347] Setting an expense cap that was created using nation-wide data obviously fails to properly account for the increased expense of operating in California.[348] Additionally, the unique regulatory environment in California, which involves significantly more regulatory scrutiny than the average nationwide, further demonstrates the unreasonableness of the limitation.[349] The goal of the CHCF-A program is not to force rural telecommunications providers to arbitrarily reduce their operating costs, but instead to ensure the delivery of safe, reliable, high-quality communications services in rural areas while allowing the providers to meet their rate-of-return revenue requirements.[350] Imposing the operating expense limitation would force the Independent Small LECs to earn profits at less than the authorized

[343] LEC-2 (Duval Reply) at 33:21-28.
[344] *Id*. at 34:3-5.
[345] Mr. Votaw and Mr. Boos confirmed that their companies' areas are prone to wildfires. LEC-7 (Votaw Opening) at 3:14-17; RT at 1503:25-1504:6 (Boos).
[346] RT at 2171:13-2172:8 (Montero).
[347] Reply Comments of the Public Advocates Office on the Assigned Commissioner's Fourth Amended Scoping Memo and Ruling ("Cal Advocates Reply Comments") at 7.
[348] LEC-1 (Duval Opening) at 40:2-5, 10-13 and 41:13-18.
[349] *Id*. at 40:14-18.
[350] Pub. Util. Code § 275.6(a).

level, or to decrease their expenses, which could impact the safety, reliability, and quality of their services. These results are counter to the intent of the CHCF-A program.[351]

2. Adopting the Operating Expense Limitation Without a Rebuttable Presumption Would Constitute Legal Error.

The operating expense limitation would be particularly unreasonable if it is adopted as a rigid cap and not a rebuttable presumption. To comply with its statutory mandate, the Commission must afford itself the flexibility to address California-specific and contemporary cost drivers that are not accounted for by the cap. Cal Advocates argues that an operating expense limitation should not be subject to a rebuttable presumption because the FCC "has already devoted considerable time in developing" the operating expense limitation.[352] However the formula does not measure any specific drivers of expense, let alone California-specific expenses. Under Public Utilities Code Section 275.6(b)(5), the Commission must approve an expense if it is "reasonable," and, without a rebuttable presumption, the Commission would be forced to reject reasonable expenses just because a company's overall expenses exceed the arbitrary operations cap[353] A rebuttable presumption is necessary to give the Commission a vehicle to properly measure the reasonable operating expenses needed to operate in California.

3. The Operating Expense Limitation Fails to Account for Critical Industry Developments That Drive Forward-Looking Expenses.

Removing the rebuttable presumption of reasonableness would be particularly poor public policy in this time of crisis, as the operating expense limitation does not account for the increased expenses of operating in post-COVID-19 world. The algorithm uses inputs from four years ago, so it cannot account for the altered operations, safety measures, and customer protections needed in the current environment. Similarly, the operating expense limitation fails to account for industry developments necessary to respond to other expense-generating events, such as PSPS events and the rise in fraudulent robocalls.[354] The expenses needed to address these developments could not have been incorporated into the historically-based algorithm, which is a fatal flaw that undermines its reasonableness in measuring future expenses.

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[351] LEC-1 (Duval Opening) at 42:12-19.
[352] *Cal Advocates Reply Comments on 4th Amended Scoping Memo* ("Cal Advocates Reply") at 7-8.
[353] Pub. Util. Code § 275.6(b)(5). As pointed out by Mr. Duval, the "rebuttable presumption allows the Commission to assess an individual case on its full merits." LEC-2 (Duval Reply) at 34:25-26.
[354] In particular, the operating expense limitation fails to account for the costs of implementing technological innovations such as SHAKEN/STIR. *In the Matter of Call Authentication Trust Anchor*, WC Docket Nos. 17-97, *Report and Order*, FCC 20-42 (rel. March 31, 2020) at ¶ 3, (ordering all voice providers to implement the STIR/SHAKEN caller ID authentication by June 30, 2021.).

4. NECA Inflation Figures Are Backward-Looking and Cannot Be a Basis for Applying the FCC Expense Caps to a Future Test Year.

If, notwithstanding their demonstrated flaws, the corporate expense cap and operating expense limitation are applied in intrastate ratemaking, appropriate inflation factors must be added to the "capped" expense thresholds so that they match the vintage of the future test year in a rate case. In applying both caps, Cal Advocates proposes to use a two-year-old NECA inflation factor that will systematically understate the expenses in the test year. Cal Advocates proposes to use inflation factors issued annually by NECA,[355] but these inflation factors only align the "caps" with the historical data, and the data is two years old.[356] Indeed, when confronted with an example, Cal Advocates' witness admitted that the numbers used to calculate the 2019 application of the expense cap were submitted in 2018 but actually based on data from 2017.[357] Although Ms. Montero initially claimed that these figures account for all necessary inflation,[358] she later agreed that the growth coefficient used was actually only adjusting the numbers from 2016 to 2017, so they were still two years out of date.[359] Cal Advocates' inflation methodology would not align with the future test years used in rate cases and would create a systematic shortfall in cost recovery, even if the FCC's expense caps are deemed reasonable.

VII. RATEMAKING TREATMENT OF INVESTMENTS. [SCOPING MEMO, ISSUES (2)(B)(I), (2)(B)(II), (2)(B)(IV)].

The Scoping Memo correctly concludes that "rate-of-return regulation is a prerequisite for CHCF-A eligibility," and it then seeks input on measures that can be implemented to "reduce costs," "increase efficiency, and "ensure that recovery of costs and investments is reasonable."[360] In response, Cal Advocates offers three proposals that would radically alter the manner in which the Commission measures the necessary level of investment needed in the rural communities served by the Independent Small LECs: (1) use historical rate base figures from NECA cost studies rather than measuring prospective community needs; (2) reject all new broadband-

[355] RT at 2193:20-2194:2 (Montero).
[356] *See* 47 C.F.R. §§ 54.1305 (information filed with NECA on July 31st of each year uses cost information from "the calendar year preceding each July 31st filing"); 54.1307 (NECA makes a filing each October 1 with the FCC that relies on information in the July 31st filings "provided to NECA . . . pursuant to § 54.1305"); 54.1308 (the "expense adjustment" applies the expense cap limitations to the historical data supplied pursuant to Section 54.1305); *see also* LEC-1 (Duval Opening) at 46:6-26 (explaining two-year time lag and need for inflation calculations to be grown beyond NECA figures)
[357] *Id*.
[358] *Id*. at 2204:3-17 (Montero).
[359] *Id*. at 2213:7-2215:9 (Montero).
[360] *Scoping Memo* at 5 (Issues (2)(b)(i), (2)(b)(ii)). Issue 2(b)(iv) also asks about "other measures."

capable investments unless a carrier can demonstrate that its ISP has achieved 87% adoption rates that Cal Advocates claims is the statewide average; and (3) deny all new broadband-capable investments unless a company can accurately document its deployment, apparently based on Cal Advocates' subjective judgment.[361]

These changes would be a material departure from longstanding Commission practice, and none would be permitted by the statutory framework. In small telephone company rate cases, the Commission uses a prospective test year, in which future plant additions are assessed based on whether they are reasonably necessary to serve customers and meet the forward-looking needs of the community.[362] Section 275.6 echoes this practice, defining rate base to include "the value of the telephone corporation's plant and equipment that is reasonably necessary to provide regulated voice services and access to advanced services."[363] Further, both the Legislature and the Commission have highlighted the importance of deploying "broadband-capable facilities" and fulfilling federal broadband capability mandates.[364] These standards are not in need of reform, and they certainly should not be impaired by historical investment figures, broadband adoption figures, or perceptions about broadband deployment reports.

A. Rate Base Cannot Be Limited to the Historical Data in NECA Cost Studies.

NECA cost studies are a useful reference in intrastate ratemaking, but they are not a reasonable measurement of rate base for a forward-looking test year. The NECA rate base figures are at least two years behind the test year in a typical rate case, so they cannot account for the prospective needs of rural communities.[365] Historical data are particularly unreliable in the current environment, in which reliance on telecommunications services is rapidly changing in response to the COVID-19 crisis.[366] As a matter of law and sound public policy, investments are

[361] Cal Adv-9 (Hoglund Reply) at 1-4:13-14; Cal Adv-4 (Parker Opening) at 1-2:3-11.
[362] *See, supra*, n. 38.
[363] Pub. Util. Code § 275.6(b)(2).
[364] *See* Pub. Util. Code § 275.6(c)(6); D.14-12-084 at 71 (acknowledging that "regulatory requirements" must be considered in assessing investments in broadband-capable facilities); *see also* LEC-19 (CD Staff Report Retail Communications services in California) at 6 (using the FCC benchmark for residential advanced services to mean fixed high-speed broadband services advertised at 25/3 Mbps); RT at 2116:23-25 (Hoglund) ("it is my recollection that I did recommend . . . the evaluating [of] projects to have 25/3").
[365] LEC-1 (Duval Opening) at 46:16-17 (the NECA "inflation factor is from two years prior; it is designed to update the expenses from three years prior to two years prior"); RT at 2142:17-20 (Hoglund) ("Depending on when the applications were filed, that most recent available rate base number from the cost study could be almost two years old"); s*ee also Id*. at 2262:21-26 (Hoglund) (agreeing that the function of the rate case is to "predict or forecast the net investments that would be needed in a future test year").
[366] *See* Res. M-4842 at 4 ("Having access to essential utility services [including communications] is critical to maintaining Californians' health and safety during the COVID-19 pandemic.").

judged by what is "reasonably necessary" to meet future demand and satisfy federal and state regulatory requirements, not by what happened two years ago.[367] Cal Advocates' proposal would also create a temporal disconnect between rate design and rate base, such that current customers are paying for returns on a historical rate base as opposed to the rate base that matches the timing of their new rates. This divergence could mean that customers – and CHCF-A contributors – are paying rates that are inconsistent with the value of the telephone company's deployment.[368] These problems can be avoided by retaining the status quo, which gives the Commission flexibility to make reasonableness determinations about company investments.

The NECA cost studies could only be a reasonable determinant of rate base if the future were consistently representative of the past, but recent experience shows that this premise is false. For example, in the recent Ducor rate case, the Commission approved significant increases in rate base from historical levels on the grounds that Ducor's planned fiber and "VDSL2" projects are "critical *forward-looking* projects" that will "ensure that Ducor['s] customers will have significantly more reliable service than is possible through the existing copper wire infrastructure."[369] The Foresthill rate case reflected similar dynamics, as the Commission concluded that broadband capable projects were necessary to meet future demand.[370]

Mr. Hoglund claims that the use of historical data is a reasonable proxy for future rate base calculations,[371] but the record shows otherwise. With reference to a series of charts depicting plant figures over a six-year period, he argues that "GRC recorded and proposed rate base and NECA cost studies Net Plant accounts indicated little to no growth on average."[372] However, the scale over which the dollar figures are distributed is extremely large, from $0 to $60 million. The large range in the "y" axis of the chart obscures material year-over-year differences. When the company-specific data from the NECA cost study are plotted over a proper scale that depicts each company's own range, as shown in LEC-37, the results are far different from what Mr. Hoglund describes.[373] The annual fluctuations are material, which

[367] Pub. Util. Code § 275.6(b)(2); *see also* D.19-06-025 at 10-11 *infra*.
[368] These disconnects could be enduring given that the rate case cycle is 5 years. D.15-06-048, App. A.
[369] D.19-06-025 at 10 (emphasis added).
[370] D.19-04-017 at 51-52 (rejecting Cal Advocates opposition and finding that "the projects are necessary to meet future demand" and that "the need for these fiber projects will only increase over time.")
[371] *See* Cal Adv-9 (Hoglund Reply) at 1-7:14-15 ("a reasonable forecast of the GRC Test Year rate base is the last year's NECA cost study rate base amount.")
[372] *Id.* at 1-7:12-13 (referencing Charts 1-1, 1-2, and 1-3).
[373] LEC-37 (Re-Scaled Chart 1-3).

undermines the notion that historical data could serve as a reliable indicator of future rate base.

B. Plant Disallowances Based on Internet Service Provider Subscription Levels Would Be Unlawful and Damaging to Consumers.

Disallowing investments in broadband-capable facilities based on ISP affiliate subscription levels would involve an inappropriate conflation of regulated and unregulated operations and an abdication of the Commission's duty to ensure that facilities deployment in rural areas is properly funded. Rate base calculations must be based on what is "reasonably necessary" to support "*telephone corporation*" operations, not adoption rates for information services provided by non-regulated ISPs.[374] Even if these legal barriers could be avoided, Cal Advocates' plant disallowance proposal would be counter-productive, as broadband adoption cannot occur if broadband-capable facilities do not exist. Further, the record contradicts Cal Advocates' assumption that threatening disallowances would spur broadband subscribership. ISPs already have every incentive to maximize their subscriber base,[375] and rural broadband providers face many obstacles to adoption that are beyond their control.[376] Blocking necessary facilities upgrades would only make it more challenging for ISPs to attract customers, not less.[377]

As the record reflects, there are also many problems with the 87% adoption threshold itself. While Cal Advocates presents this threshold as a reflection of statewide adoption, the source data confirms that the 87% it is systematically overstated.[378] Even if it were a legitimate

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[374] Pub. Util. Code § 275.6(b)(3); RT at 1269:25-1270:1 (Parker) (acknowledging that Section 275.6 "governs the extent to which investments would be placed in rate base in a rate case").
[375] RT at 1485:9-17 (Boos) (noting that Ponderosa Cablevision is free to "maximize their subscribership, broadband subscribership, and their profits.").
[376] LEC- 4 (Votaw Reply) at 8:27-9:6 ("Whether or not households in rural areas decide to subscribe to broadband implicates a complex web of different factors, including socio-economic, educational, cultural, and localized concerns. Computer literacy is a big factor, and that is an ongoing concern in Ducor's service territory. There are generational differences in terms of how much of life is lived 'online,' which often means that elderly individuals are less likely to pursue broadband connections. Some individuals are focused solely on low-level applications like email, and those people are likely to pursue whatever the lowest-cost option might be, even if the speed is lower than what most urban users consider to be 'standard.'"); *see also* LEC-2 (Duval Reply) at 28:8-10 (". . . 76% of rural adults report using the Internet on at least a daily basis, and 15% say they never access the Internet, while 86% of suburban adults and 83% of urban adults report accessing the Internet on a daily basis.").
[377] The problems caused by this disallowance policy would be compounded in areas with multiple unaffiliated ISPs, especially if such ISPs elect to use the NECA tariff to access Independent Small LEC customer locations. On cross-examination, Ms. Parker struggled to address these nuances. RT at 1261:8-10 (Parker) ("Q: What would happen under that scenario in your proposal? A: I don't know.") Ultimately, she was unwilling to make any exceptions or adjustments to her disallowance proposal in these circumstances, and she insisted that adoption levels from unaffiliated ISPs could be counted against the Independent Small LEC in measuring the 87% adoption figure. RT at 1264:6-7 ("yeah, the 87 percent would still apply.") This would lead to the perverse situation where a competitor could undermine Independent Small LEC investment opportunities by reporting lower adoption levels than 87%.
[378] According to the FCC source data, the 87% represents the number of total "residential fixed

statewide figure, there is no reason to believe that 87% would be a reasonable adoption target in rural areas. The witness who sponsored this proposal, Ms. Parker, did not analyze adoption statistics in rural areas,[379] instead relying on the alleged statewide percentage because rural data are included in the statewide figures.[380] This proposition ignores the unique consumer dynamics of rural areas, including demographic, cultural, and digital literacy factors that can complicate adoption.[381] As Ms. Parker recognized on cross-examination, 95% of California households are in urban or urbanized areas, so the adoption behavior of the "five percent" of rural households would "tend to be washed out by the 95% in the census data."[382] If a reasonable adoption target were established for rural areas, it could not be 87%.

Broadband adoption is an important issue, but a manipulation of the ratemaking process is not the way to address it. To promote the public interest and ensure equitable treatment of these small utilities, proposed plant additions should be evaluated on their own merits according to the established statutory reasonableness standard.

C. Plant Disallowances Based on Alleged Discrepancies in Broadband Deployment Reporting Would Be Unlawful and Counter-Productive.

Just as telephone company rate base cannot be determined based on arbitrary broadband deployment metrics, it cannot be influenced by subjective judgments about the sufficiency of broadband deployment reports. Ms. Parker's testimony suggests that there are discrepancies in the companies' deployment data, but these claims are unsubstantiated.[383] Even if her

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connections" from FCC Form 477 reports, divided by the total number of households in the state. *See* LEC-21 (FCC Internet Access Services Report) at 29 (Figure 32) (showing .87 figure on "California" line), 55 (confirming Form 477 source for the numerator), and 56 (identifying the denominator as the "estimated number of households" from census information). This methodology overstates the statewide subscribership percentage because the numerator counts all service connections at all potential locations, whereas the denominator is limited to "households," which are counted only once even if they have multiple service locations, such as vacation homes. This problem is acknowledged in the source data, and Ms. Parker admitted that, based on this definition of "household," it would tend to make the subscribership ratio "overstated." *See* LEC-21 at 56 (noting problems caused by disconnect between numerator and denominator), 9, n. 11 ("we continue to find estimates above 100% for the share of households with fixed Internet access connections"); RT at 1292:25-28 (Parker).

[379] RT at 1272:19-1273:10 (Parker) (Cal Advocates did not attempt to measure how Independent Small LEC ISP affiliate adoption rates compare to adoption in other rural areas).

[380] See RT at 1273:17-24 (Parker) (noting that her figures "capture the whole State of California," so rural adoption rates "are included in those numbers.")

[381] RT at 1701:27-1702:11 (Aron) (discussing her research and data analysis that show a number of demographic facts that affect broadband adoption, including computer literacy, income, family size, the presence of children in a household, and sociological research that she has cited and community effects, such as the extent one's peer group has access to broadband); RT at 1284:26-1285:15 (Parker) (Cal Advocates' witness did not account for rural adoption factors in proposing an 87% threshold).

[382] *See* LEC-20 (Census Data) (showing "95.0" percent urban households); RT at 1276:22-26 (Parker).

[383] *See* Cal Adv-4 (Parker Opening) at 1-2:16-31 (noting that the Commission should utilize the multiple

impressions were accurate, they would not justify a reduction in broadband investments, and the governing statute provides no mechanism for making such disallowances.[384] The Independent Small LECs are willing to work with the Commission and Cal Advocates to improve the precision and usefulness of deployment reporting, but the companies already comply with broadband reporting directives and the applicable ratemaking standards cannot be ignored.[385] A workshop would be an appropriate next step.

VIII. MODIFICATIONS TO THE RATE CASE PROCESS [SCOPING MEMO, ISSUES (2)(B)(I), (2)(B)(IV), (8)].

Based on the experience under the 2015 rate case plan, the rate case process is in dire need of reform. Of the 10 cases processed under the plan, only two were completed within the prescribed 14-month window, and some involved extreme delays.[386] As Mr. Votaw observed, "[t]he current rate case process is too long, too cumbersome, too intensive, and too inefficient to be a reasonable solution long-term."[387] In this proceeding, the Commission has an important opportunity to take stock of lessons learned and institute reforms that will make the process more transparent, efficient, and cost-effective.

The Independent Small LECs have made five discrete proposals for constructive improvements to the rate case process, each grounded in tangible evidence from the last rate case cycle and supported by testimony from Mr. Duval, an expert with decades of experience navigating telecommunications rate cases across the country.[388] Cal Advocates opposes these reforms with virtually no factual material and a witness who admitted she only has experience in one rate case.[389] Particularly given the Commission's resistance to reinstating the advice letter

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data sources the Independent Small LECs provided to determine deployment).

[384] *See* Pub. Util. Code § 275.6(b) ("rate base" must include plant and equipment that is reasonably necessary to provide regulated voice services and access to advanced services"); Pub. Util. Code § 275.6(d) (program criteria do not include broadband reporting compliance).

[385] The Independent Small LECs provide annual reports in response to D.16-12-025. *See also* LEC-1 (Duval Opening) at 76:22-77:9 (explaining FCC and Commission broadband deployment reporting requirements that Independent Small LECs meet); LEC-2-C (Duval Reply) at 32:2-26 (describing differences between FCC and Commission broadband deployment requirements and supporting workshop to develop reporting protocols); *see also* Pub. Util. Code § 275.6(b)(2).

[386] LEC-4 (Boos Opening) at 34:2-3, 15-23; *see also* D.19-12-011 (resolving Pinnacles rate case). Pinnacles' unopposed rate case application took 734 days to resolve, and Calaveras's rate case remained unresolved for more than a year after an all-party settlement was presented. The procedural timelines for these cases are discernible from the dockets of their application numbers. *See* A.17-12-004 (Pinnacles) and A.16-10-002 (Calaveras).

[387] LEC-7 (Votaw Opening) at 21:16-17.

[388] LEC-1 (Duval Opening) at 2:7-6, 4:7-11. Mr. Duval's experience with rate cases in California and in other states confirms that the Independent Small LECs' rate cases can be conducted in a more efficient and cost-effective manner. LEC-1 (Duval Opening) at 55:25-56:8, 56:24-57:1.

[389] RT at 2160:17-20, 2161:21-25 (Montero).

process for small telephone company rate cases, these measures to streamline the formal process are critical and should be adopted.[390]

A. Public Participation Hearings Should Take Place Once All Proposals From All Parties Are Known.

The Independent Small LECs strongly support the use of Public Participation Hearings ("PPH"), which provide an important opportunity for customers to express their views about how proposals in a rate case will affect them. However, PHHs are only useful if they occur after all proposals in a rate case are known. Unfortunately, in the rate cases under the rate case plan, the timing of PPHs was inconsistent. Contrary to the transparency goals of a PPH, Cal Advocates continued to push for these hearings to occur before their testimony, even though they proposed higher rate increases than the companies in every single case in which they participated.[391] This timing does a tremendous disservice to the public by misleading them into thinking that the company's proposal is the only potential impact of a rate case, only to discover that their ultimate rates increase more than the company's proposal due to advocacy from Cal Advocates.

The Commission should rectify this injustice by stating definitively that PHHs will take place after all testimony is provided. Indeed, the record shows that where the Commission has held the PPHs following Cal Advocates' testimony, the PPHs have been more fruitful and involved the participation of many customers. [392]

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[390] For decades, the Commission successfully relied on an informal rate case model for these companies, which produced generally timely results with dramatically reduced costs. *See Petition to Modify Rate Case Plan* (July 11, 2017), App. A. The Commission has taken the position that the 2015 rate case plan forecloses such submissions, and the Commission rejected the companies' petition to modify the rate case plan to clarify that the advice letter option is available. D.18-10-033 at 12.

[391] At the hearing, Cal Advocates' witness on local rates claimed that this was not true and that "[i]n some cases, we offer the same or propose the same rates as the small ILECs propose." RT at 2126:23-25 (Ahlstedt). Dr. Lehman's Table 1 shows that Mr. Ahlstedt's assertion is incorrect. While Ducor's and Cal Advocates' proposed basic residential voice and business rates did not differ, Cal Advocates proposed higher custom calling rates than Ducor. A.17-10-003, Ducor-1, Opening Testimony of Chad Duval on behalf of Ducor Telephone Company, October 2, 2017, at 45:1-9; A.17-10-003, ORA-24, *ORA Testimony Regarding Revenues and Rate Design*, May 14, 2018, at 18:10-19:8. *See also* LEC-12 (Lehman Reply) at 3:17-6:1 and Table 1.

[392] *See* LEC-4 (Boos Opening) at 40:8-11 ("Based on my experience in the Ponderosa rate case, where the PPH was held after Cal PA's testimony had been released, customers appreciated the opportunity to provide their input on all proposals, not just the company's proposal. Ponderosa's PPH was very well attended, with approximately 40 customers present and several who provided comments.").

B. Parties to Rate Cases Should Be Required to Submit to Mediation Prior to Proceeding with Evidentiary Hearings.

Mediation is an effective tool for conserving resources and expeditiously resolving disputes, but it is under-utilized in Commission proceedings. While some settlements were reached in the most recent cycle, many of these cases were contentious and protracted, even where settlement ultimately occurred. If mediation were a formal, mandatory event in the rate case plan, more cases would settle and settlement would happen earlier, greatly reducing the costs and burdens of the process. [393]

This step is appropriate because Cal Advocates has refused to participate in mediation on a voluntary basis. [394] Incorporating mandatory mediation into the rate case plan would also be consistent with the Commission's commitment to alternative dispute resolution and parallel litigation streamlining efforts that have taken place in the federal and state courts.[395] Cal Advocates opposes this proposal on the summary ground that mediation should be "limited to willing participants," but Cal Advocates' witness admitted that she had never participated in a mediation, so this judgment should be disregarded as lacking in any factual or experiential foundation.[396] This argument is also misplaced, as the premise of mediation is that even very entrenched litigants can be brought toward settlement by sitting face-to-face and participating in mediation with a skilled mediator.

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[393] LEC-7 (Votaw Opening) at 23:26-28 ("Ducor's rate case unfortunately proceeded to a full Commission decision, but I believe that mediation could have shortened the process and avoided the need for a full adjudication of the matter."); LEC-4 (Boos Opening) at 35:1-9 (explaining that conducting a mediation earlier in Ponderosa's case, which was eventually resolved via settlement, "could have saved both Cal Advocates and Ponderosa significant expenditures of resources."); *see also id.* at 36:4-12 (addressing benefits of mediation to help parties see strengths and weaknesses and achieve settlement).

[394] *See, e.g.*, LEC-7 (Votaw Opening) at 23:26-24:2 (in response to Ducor's motion seeking mediation, "Cal Advocates not only refused to participate, it sought sanctions against Ducor for asking that the Commission force the parties to the table.").

[395] *See* Res. ALJ-185 at 2, 5; D.82-07-086 ("If the parties cannot resolve their differences . . . they are urged to seek some form of relatively inexpensive and expeditious solution, such as mediation or arbitration by one or more persons of appropriate experience. Such prompt action should benefit all users . . . and might eliminate eventual costly litigation."); *see also* S.D. Cal. Civil Local Rule 16.1(c) (requiring "early neutral evaluation" within 45 days of filing an answer to attempt settlement); N.D. Cal. ADR Local Rules 1-2, 2-3; s*ee also* State Bar Guidelines of Civility and Professionalism, § 13.

[396] Cal Adv-8 (Montero Reply) at 1-2:28-31; RT at 2104:15-17 (Montero).

C. Parties Should Be Limited to 300 Data Requests Each in Rate Cases.

One of the most significant drivers of rate case expense is the discovery process, and the record from the recent rate case cycle shows that the number of data requests propounded is grossly disproportionate to the size of these companies and the scope of their applications.[397] The Commission should take reasonable steps to confine discovery practices within reasonable bounds by installing a 300-data request limit, while affording parties the ability to seek leave for more discovery from the assigned ALJ.

The Commission has ample authority to impose reasonable restrictions on discovery, and it has imposed certain limits in specific proceedings.[398] The record shows that that an unbridled use of the discovery process has led to excessive requests that have unnecessarily increased the expense of the process.[399] Under the rate case plan, the use of Minimum Data Requests ("MDRs") was intended to streamline the exchange of key information and avoid extensive post-filing discovery.[400] The reality has been otherwise,[401] and the Commission should take steps to circumscribe the discovery process, consistent with its original intent.

Cal Advocates opposes this reasonable discovery limit by citing to its generic statutory authority as a non-party under the Public Utilities Code.[402] However, these citations are

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[397] LEC-7 (Votaw Opening) at 22:3-6 ("Ducor received more than 540 data requests in its 2019 test year rate case, including sub-parts, which greatly increased the cost of the rate case."); *Id.* at 22:20-4; LEC-4 (Boos Opening) at 38:1-14 ("The number of data requests received has a direct impact on the expense of the process, and many of the data requests Ponderosa received in its rate case sought information on subjects that exceeded the scope of the cost of service and rate design issues . . . presented by the application. Including sub-parts, Ponderosa received 322 data requests, and the vast majority . . . required significant company data-gathering, confidentiality analysis, and review by Ponderosa's attorneys. . . .").

[398] *See* D.06-12-042 at 4-7 (denying applications for rehearing alleging that limitations imposed on discovery were legal error); A.17-10-004, *ALJ Ruling Denying Cal Advocates' Motion for Reconsideration* at 2 (Aug. 13, 2018) (imposing discovery cutoff); *see also* Code of Civ. Proc. § 2017.020(a); *People v. Sarpas*, 225 Cal.App.4th 1539, 1552-54 (2014) (limiting the number of interrogatories given that the "needs of the case did not warrant all of the interrogatories" and the volume was "unwarrantedly" oppressive, unduly burdensome and expensive).

[399] LEC-1 (Duval Opening) at 52:25-54:1 (explaining that the number of data requests propounded in rate cases in two other states have not generally exceeded 200 requests, and the resulting rate case expense incurred has been drastically lower than the expense incurred in California).

[400] *See* D.15-06-048 at 14.

[401] For example, in Ducor's rate case, Ducor provided comprehensive responses to 52 MDRs prior to filing its rate cases, yet the volume of discovery Ducor subsequently received was vastly disproportionate to the relief sought—an overall reduction in CHCF-A and a customer rate increase within the Commission's "range of reasonableness." LEC-7 (Votaw Opening) at 23:1-4. As Mr. Votaw noted: "[t]o put the burden in perspective, Cal PA's 540 data requests is more than one data request for every two of Ducor's customers." *Id.* at 23:5-6.

[402] Cal Adv-8 (Montero Reply) at 1-2:14-19. Cal Advocates cites to Public Utilities Code Sections 309.5 and 314, but neither of these sections forbids the Commission from establishing equitable limitations on parties to a Commission proceeding.

misplaced because Cal Advocates participates in rate cases as a party, and it must abide by the procedural rules that govern party participation, including Commission Rule 10.1 and other reasonable limits that may be imposed in specific proceedings or in a rate case plan. Cal Advocates' concerns about undue restrictions are also unfounded, as it would be able to exceed the 300-question limit if could show cause, just like any other party.

D. Parties Should Be Required to Meet and Confer Prior to Bringing Any Motion in a Rate Case.

To avoid unnecessary disputes and associated burdens on the parties and the Commission's resources, the Commission should require that "meet and confer" efforts be conducted prior to bringing any motion in a small telephone company rate case. The Commission already imposes this requirement on discovery motions, and many practitioners observe it as a matter of professionalism and basic civility.[403] A proactive "meet and confer" requirement was also adopted in the Ducor rate case to promote cooperation and discourage gamesmanship.[404] Cal Advocates claims that this proposal would "not support efficiency," but this assertion is manifestly incorrect.[405] Motion practice should not be used as a tool to surprise or strategically burden parties, nor should unnecessary motions be brought before an ALJ. A simple "meet and confer" requirement as to all motions in these cases will prevent abuse and conserve Commission resources.

E. Applicants in Rate Cases Should Have An Additional 30 Days for Submission of Rebuttal Testimony.

The rate case plan establishes milestones within each rate case on which certain procedural events should take place, including the submission of testimony. Experience in the recent rate case cycle shows that the time allotted for applicants' rebuttal testimony is insufficient, and an additional 30 days should be provided. Pursuant to the current rate case plan, Cal Advocates has 150 days from the date of an application to prepare its testimony, whereas the company has only 30 days to prepare rebuttal testimony.[406] In reality, Cal Advocates has had

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[403] *See* Rules 11.3(a), 11.6; *see State Bar Attorney Guidelines of Civility and Professionalism,* Intro, §10 ("An attorney should consider whether, before filing or pursuing a motion, to contact opposing counsel to attempt to informally resolve or limit the dispute.").
[404] LEC-7 (Votaw Opening) at 22:13-17, 25:19-23. The adoption of this requirement followed Cal Advocates' motion to shorten time on December 20, 2017 without any prior efforts to meet and confer with Ducor or its counsel. The strategic timing of Cal Advocates' motion forced Ducor to file a response on December 26, necessitating extensive work on Christmas Eve and Christmas Day and disrupting holiday plans. *Id.* at 25:7-18.
[405] Cal Adv-8 (Montero Reply) at 1-3:5.
[406] D.15-06-048, App. A at 2-3.

even more time due to delays in recent rate cases.[407]

This unequal treatment is especially harmful to the Independent Small LECs because Cal Advocates' testimony has been expansive and raised novel issues and new proposals beyond the limited ratemaking issues presented in the Independent Small LECs' application and opening testimony.[408] This has required the companies to retain additional experts to address the new proposals and the thirty-day time allotted for testimony has been insufficient.[409] The Commission should rectify this imbalanced and inequitable result, which can be easily done by shortening Cal Advocates' rebuttal testimony deadline by 30 days and providing the Independent Small LECs an additional 30 days for rebuttal so the overall schedule can be maintained.[410]

IX. BASIC SERVICE RATES AND OTHER END USER RATE PROPOSALS [SCOPING MEMO, ISSUE (4)].

The Scoping Memo seeks input regarding the standards for establishing basic service rates in Independent Small LEC territories and asks whether new "metrics" or "formula[s]" should be utilized.[411] The record shows that Independent Small LECs' rates are among the highest in the nation and that further increases would be inconsistent with the demographics and affordability indices in these rural areas.[412] TURN and the Independent Small LECs agree that significant rate increases beyond current levels cannot be justified and should not occur.[413] The Commission should continue to evaluate rate reasonableness in rate cases, but any increases should be capped at the inflation-adjusted value of current rates.[414]

A. The Record Evidence and Federal Universal Service Policy Militate Against Significant Increases in End User Rates for Rural Consumers.

The Commission should approach proposals to increase rural consumers' rates with

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[407] In Ducor's rate case, Cal Advocates was not required to submit testimony until 224 days after the application, yet Ducor only had 25 days for rebuttal. LEC-7 (Votaw Opening) at 24:16-20.
[408] *See, e.g.*, LEC-7 (Votaw Opening) at 22:9-12 ("The breadth of Cal PA's testimony in Ducor's case was overwhelming, as Cal PA addressed a number of issues that were not presented by Ducor's application and which I believe were beyond the scope of the proceeding. Nevertheless, Ducor had to address them, and it did not have enough time."); *id.* at 24:20-23 ("Cal PA's testimony turned out to be far more expansive than anticipated, and it presented a depreciation theory that was ultimately rejected in the final decision, but which required Ducor to devote extensive additional resources in rebuttal."); LEC-4 (Boos Opening) at 38:25-39:3 (Cal Advocates' testimony exceeded scope of the proceeding and the issues in the application and noting that "[b]ecause Cal PA's testimony included proposals affecting one of Ponderosa's affiliates, Ponderosa Cablevision, the affiliate had to seek to intervene in the case.").
[409] LEC-4 (Boos Opening) at 39:3-5; *see also* LEC-7 (Votaw Opening) at 24:22-24.
[410] *See* LEC-4 (Boos Opening) at 39:18-19; LEC-7 (Votaw Opening) at 24:24-25:4.
[411] *Scoping Memo* at 7 (Issues 4(a) and 4(b)).
[412] LEC-11 (Lehman Opening) at 19:2-4.
[413] *TURN Reply Comments on 4th Amended Scoping Memo* at 7; LEC-11 (Lehman Opening) at 20:17-24.
[414] *See* TURN-1 (Roycroft Opening) at 75:14; LEC-11 (Lehman Opening) at 20:17-18, 3:22-23.

heavy skepticism. By applying the "range of reasonableness" in the recent rate case cycle, the Commission adopted significant rate increases, and the companies' basic residential rates all exceed the FCC's "Residential Rate Ceiling," or "ARC benchmark," of $30.00, inclusive of specified fees and surcharges.[415] Further increases would be inconsistent with the income characteristics of these rural areas, and the Commission should avoid reliance on any models or benchmarks that would force rates higher and compromise the universal service and public safety benefits of basic voice service.

The record demonstrates that customers in the Independent Small LECs' territories are likely to be highly price-sensitive. Dr. Lehman provided unrebutted expert testimony showing that residents in these areas "are much more disadvantaged than the rest of the state."[416] This conclusion is backed by multiple independent measures of income and Dr. Lehman's observations from multiple rate cases in the last rate case cycle.[417] Consistent with these observations, Dr. Lehman produced compelling statistical evidence that the Independent Small LECs experienced higher than expected customer losses from the recent rate increases.[418] Dr. Lehman's expert findings also align with testimony from company witnesses, who describe their customer bases as predominantly low-income or middle-income.[419] These communities include many households with fixed or limited incomes, such as elderly individuals or migrant workers.[420] These are not the populations that should be asked to stomach further rate increases, especially given the current health crisis and the financial distress that it has engendered.

Current federal policy also discourages rate increases in rural areas. In 2019, the FCC eliminated its previously-escalating residential "rate floor," finding that "the rate floor creates a perverse incentive for carriers to raise local rates, harming consumers in rural areas and making telephone service less affordable."[421] Prior to its discontinuance, the rate floor was set at

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[415] *See* 47 C.F.R. § 51.915(b)(12); *see also* LEC-11 (Lehman Opening) at 7:22-14.
[416] *Id.* at 6:11-13.
[417] *Id.* at 7:21-8:20.
[418] Dr. Lehman used a time series model to estimate the impacts of the rate increases in the Independent Small LECs' rate cases under the rate case plan. His model shows that the actual residential line subscriptions have fallen short of the projected levels based on the historical pre-rate increase trends. *See* LEC-12 (Lehman Reply) at 8:5-11:14.
[419] *See* LEC-4 (Boos Opening) at 23:13; LEC-7 (Votaw Opening) at 3:8-9.
[420] LEC-11 (Lehman Opening) at 9:14-23 & ns. 7-8.
[421] *In the Matter of Connect America Fund*, WC Docket No. 10-90, *Report and Order*, FCC 19-32 (rel. Apr. 15, 2019) at ¶ 10 (noting that the rate floor has increased "the telephone rates of rural subscribers, who are often older Americans on fixed incomes, lower-income Americans, and individuals living on Tribal lands. These Americans are some of those least able to afford the needless rate increases caused by the rate floor."); *see also* LEC-11 (Lehman Opening) at 16:23-17:1.

$18.00,[422] far lower than any of the Independent Small LECs' current residential rates, so the FCC's observations provide a clear indictment of proposals to raise rates even higher. The Commission should defer to the FCC's sound judgment "based on an extensive and near-unanimous record," showing "that the rate floor is inconsistent with the direction of the Communications Act to advance universal service while ensuring that rates are just, reasonable, and affordable."[423] Additional rate increases would also be inconsistent with the FCC's policies surrounding the ARC, which rely on the previously-mentioned $30 "inclusive" rate ceiling and only permit ARC increases of 50 cents a year below the ceiling.[424]

B. End User Rates Should Not Be Modified Outside of Rate Cases.

Contrary to the weight of the evidence showing that additional rate increases would be inappropriate, Cal Advocates proposes an automatic rate increase mechanism by which *all* end-user rates would increase *every* year without Commission review. In addition to the sheer impropriety of this proposal for lower-income communities, it would be an unreasonable ratemaking practice that reduces transparency and enhances consumer dissatisfaction. First, this proposal would divorce rates from underlying costs, undermining the symmetry of test-year ratemaking principles and creating the perverse outcome that rates would increase even if costs of service decline.[425] Second, by implementing these automatic increases through the CHCF-A annual filing process, customers who be deprived of any opportunity to provide input on the increases.[426] Third, even if Cal Advocates regards these adjustments as automatic, the companies would still have to notify customers every year of price increases, creating the impression that rates are constantly increasing.[427] As Dr. Lehman explained, this is likely to cause customers to continually re-examine their subscription to landline telephone services and consider relying solely on wireless services, which does not provide reliable coverage in many of

[422] LEC-11 (Lehman Opening) at 16:17-21.
[423] *Id.* at ¶ 9.
[424] LEC-11 (Lehman Opening) at 17:16-18, 19:8-11; *see also USF/ICC Transformation Order* at ¶ 852.
[425] *See, e.g.*, *PT&T v. PUC*, 62 Cal.2d 634, 644-45 (1965) (under test year ratemaking, the rate base, revenues, costs and expenses and rates are calculated for the same year); RT at 2142:7-26 (Ahlstedt) (acknowledging disconnect between rates and costs, and falsely claiming that it exists today).
[426] LEC-4 (Boos Opening) at 33:8-10 (noting importance of customer input on rate issues).
[427] *See, e.g.*, LEC-4 (Boos Opening) at 32:12-16 ("Even if the rate increases are small, and even if they are based on inflationary metrics, sending a notice to customers on an annual basis is likely to create a misimpression that the company is constantly seeking to raise rates. In my experience as General Manager of Ponderosa, customers often react negatively to the fact that a rate increase is occurring even if the increase is small."); LEC-7 (Votaw Opening) at 19:5-9 ("If a customer perceives that he or she is going to be subject to an ever-increasing price for the same service, the mere fact of the compounding rate increases may cause the customer to investigate other service options.").

these areas.[428] Fourth, the proposed increases do not provide a vehicle to examine elasticity, a phenomenon that has been shown to be material on the record.[429] These problems are major, and they are amplified by Cal Advocates' inability to explain the mechanics of the proposal, which enhances the probability of more difficulties upon implementation.[430]

Perhaps the most concerning aspect of Cal Advocates' automatic rate increase proposal is that it would divest the Commission of any discretion with respect to end user rates, which is necessary for the Commission to fulfill its statutory mandate to ensure that the Independent Small LECs' rates "are just and reasonable and are reasonably comparable to rates charged to customers of urban telephone corporations."[431] This cannot and should not occur.

C. Basic Service Rates Established in Rate Cases Should Not Exceed the Inflation-Adjusted Value of Current Rates.

Rather than relying on the existing "range of reasonableness" or any alternative formula for measuring rate reasonableness, the Commission should rely on the reasonableness determinations already reached in the recent rate cases and cap any rate increases in the upcoming rate cases at the inflation-adjusted value of those same rates.[432] To be clear, this proposal is not a request for "price cap regulation," just a rate ceiling to guide future rate cases, where the Commission should determine the rates that are appropriate within those bounds.[433]

[428] LEC-11 (Lehman Opening) at 19:12-18; LEC-12 (Lehman Reply) at 6:18-7:4.
[429] Dr. Lehman's analysis shows that elasticity manifests differently in different service territories, further highlighting the need to examine these issues in rate cases. LEC-11 (Lehman Opening) at 11:8-9.
[430] Adopting Cal Advocates' proposal would raise due process concerns based on scant details provided about mechanics, which foreclosed detailed cross-examination. RT at 2145:2-15 (Ahlstedt) (claiming that the mechanics could be worked out later).
[431] Pub. Util. Code § 275.6(c)(3).
[432] *See* LEC-11 (Lehman Opening) at 3:22-23 ("Inflation should cap any further rate increases, but it should only serve as a cap, and not an automatic increase mechanism."); LEC-4 (Boos Opening) at 33:13-20 ("Rather than assuming that perpetual inflationary increases are appropriate, the Commission should review the issue in rate cases, and start with the premise that the current rates should not be increased beyond their current values, as adjusted by the Consumer Price Index."); *Independent Small LECs Opening Comments* at 19.
[433] TURN-2 (Roycroft Reply) at 53:16-20 (mischaracterizing rate proposal as a "price cap").

X. RATEMAKING TREATMENT OF MISCELLANEOUS REVENUES [SCOPING MEMO, ISSUE (5)].

The Scoping Memo seeks input on the "accounting treatment" of "miscellaneous revenues."[434] Miscellaneous revenues are not new, and existing accounting and ratemaking standards already address how to identify, record, and recognize these revenues.[435] These are regulated revenues defined according to 47 C.F.R. Section 32.5200.[436] To the extent that miscellaneous revenue sources have both intrastate and interstate components, the intrastate elements are identified according the FCC's established jurisdictional separations rules.[437] Nothing in the record suggests that changes are warranted to the treatment of these revenues.

A. License and Lease Revenues Are Already Properly Accounted for in Intrastate Ratemaking (Issue 5(a)).

The Scoping Memo poses specific questions about the "proper ratemaking treatment" of revenues "derived from the use of regulated utility property."[438] Established ratemaking practices already exist to account for these revenues, consistent with guidance from NECA.[439] As the FCC's administrator, NECA applies the FCC's rules to specific revenue classifications"[440] The proper treatment of "rental revenues" is outlined in NECA Reporting Guideline ("NRG") 8.3: Rent Revenues—Separations.[441] Based on this guideline, "rental revenues" includes all revenue derived from the use of regulated utility property, whether it takes the form of a lease, a license or another legal instrument.[442]

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[434] *See Scoping Memo* at 7 (Issue (5).)
[435] LEC-1 (Duval Opening) at 59:9-11 (noting common practice regarding incorporation of miscellaneous revenue into rate design). Each of the "Separated Results of Operations" tables in rural telephone company rate cases over the past 30 years have included miscellaneous revenues as part of cost recovery for intrastate revenue requirement. *See* n. 36, *supra*.
[436] This Part 32 account includes revenues from leasing or licensing regulated facilities, such as space on towers, poles, or buildings. *See* LEC-1 (Duval Opening) at 57:27-28 (noting assets that are licensed or leased). It also includes revenues for "billing and collection" services, directory listings, certain pooling activities, maintenance service "incident to" regulated telecommunications operations, and other "incidental regulated" revenue. 47 C.F.R. §§ 32.5200 (preamble), 32.5200(e), 32.5200(f), 32.5200(j); *see also* Res. T-17132 (Ponderosa) at 8 (noting inclusion of miscellaneous revenues amongst regulated revenue); D.19-06-025 (Ducor) at 12, n. 24 (acknowledging miscellaneous revenue as regulated).
[437] 47 C.F.R. §§ 36.1 (explaining overall function of Part 36 of FCC's rules); 36.215 (miscellaneous revenue is "apportioned on the basis of analysis"); LEC-1 (Duval Opening) at 57:23-24 (explaining use of Part 36 rules in jurisdictionalizing miscellaneous revenues); *see also* SB 379 (Fuller 2012) (confirming Legislative intent to "preserve" the FCC's "cost allocation and separation rules").
[438] *Scoping Memo* at 7-8.
[439] LEC-1 (Duval Opening) at 58:5-59:6.
[440] *Id.* (Duval Opening) at 58:7-10 (explaining NECA's role in providing guidance to participants in the cost pools). Each of the Independent Small LECs participate in the NECA cost pooling process. LEC-1 (Duval Opening) at 26:14-27:7.
[441] LEC-1 (Duval Opening) at 58:10-26 (presenting NRG 8.3).
[442] Mr. Duval explained that California's practice is to follow the NECA guidance with regard to

In NRG 8.3, NECA provides two options for how to incorporate the effects of lease or license agreements into ratemaking calculations: (1) the company can reduce its recoverable costs by removing the underlying asset from rate base; or (2) it can reduce its cost recovery by counting the revenue against its regulated expenses.[443] As Mr. Duval explained, "[t]hese methods have the same practical effect, which is to recognize the revenue provided for accessing the regulated facilities in the ratemaking process" and "ensure that the ratepayer is not subsidizing the cost of the 'rental . . . to others of telecommunications plant furnished apart from telecommunications services rendered by the company.'"[444] Continued adherence to these NECA procedures will ensure that "revenues" are "shared with ratepayers" through the ratemaking process, as the Scoping Memo suggests.[445]

B. No New Procedural Rules Are Needed to Address Miscellaneous Revenues (Issue 5(b)).

The Scoping Memo asks about the applicability of Public Utilities Code Section 851 and G.O. 69-C to the transactions or agreements that may generate miscellaneous revenues.[446] These are procedural requirements for all utilities governing the extent to which pre-approval is required before executing certain types of agreements.[447] The rules have no bearing on ratemaking or accounting determinations and they are not unique to the Independent Small LECs. Nothing in the record suggests changes would be needed to these mechanisms, and if changes were contemplated, they should be addressed across all utility sectors.

"Miscellaneous Revenues, including rental revenues." LEC-1 (Duval Opening) at 59:9-11.

[443] LEC-1 (Duval Opening) at 58:27-59:1 (". . . this NECA guidance provides companies with two options; they may remove the 'rented' plant and associated rental revenues, expense, and taxes from the regulated cost recovery, or they may offset regulated expenses with the rental revenue."). "Offsetting" regulated expenses with rental revenue can be achieved either through a reduction in expense calculations or by counting the revenue in the rate design as "miscellaneous revenue." The Commission has employed both methods, with the exact same numerical effect. *See, e.g.,*18-04-006 (Calaveras) at 13 ("[m]iscellaneous revenues were reported and equivalent expense amounts were recorded resulting in a zero net effect").

[444] LEC-1 (Duval Opening) at 59:1-6 (quoting 47 C.F.R. § 32.5000(a)). If the underlying asset is entirely excluded from rate base, it has no impact on regulated ratemaking calculations. As NECA recognizes, "'the apportionment of rent revenue'" should be "'consistent with the underlying plant being rented,'" such that if "'plant rented to other is not includable in a cost study for NECA settlement, the associated revenues are also excluded.'" LEC-1 (Duval Opening) at 13-14 (quoting NRG 8.3).

[445] *Scoping Memo* at 8. The term "sharing mechanism" is a misnomer in the context of ratemaking. The adjustments to rate design and revenue requirement to account for license and lease revenue do not result in a distribution of revenue to ratepayers; they just ensure that rate structures are set appropriately to recover only legitimate, intrastate regulated costs.

[446] *See Scoping Memo* at 8.

[447] If a company seeks to lease regulated assets, it must file either an application or an advice letter under Section 851 to obtain prior Commission approval. Pub. Util. Code § 851(a). If, alternatively, a company pursues a license that meets the specifications in G.O. 69-C, no approval is needed.

XI. CHCF-A ANNUAL FILING PROCESS [SCOPING MEMO, ISSUE (7)].

A. The CHCF-A Annual Filing Process Remains a Vital Part of the CHCF-A Program And it Should Not be Significantly Altered.

As explained in Section II(A)(4), above, the CHCF-A annual filing process has three principal components: (1) an adjustment procedure for "regulatory changes of industry-wide effect;" (2) the "means test;" and (3) the "waterfall" mechanism.[448] The Scoping Memo asks whether the Commission should "reevaluate" these "adjustments," but the record shows that each regulatory feature remains important to ensure stability and efficiency between rate cases.[449] No party has proposed substantive changes to these rules, and none should occur.

The adjustment mechanism for "regulatory changes of industry-wide effect" remains a critical tool for rebalancing companies' rate designs in response to annual fluctuations in federal funding and other revenue variations caused by changes in federal or state regulatory policy. The Commission envisioned this process to "provide relief" to rural telephone companies "for losses due to regulatory changes" and thereby "protect the availability of universal service."[450] The adjustments also served a pragmatic purpose; they were designed to avoid the potential burden of processing rate cases every time regulatory agencies change the rules of the road.[451]

These same imperatives exist today. Regulations continue to change, and revenues continue to fluctuate accordingly. In particular, federal support for intrastate operations can vary significantly from year-to-year, often deviating materially from the assumed level of funding in a rate case. The last 60 CHCF-A advice letters reflect 32 federal funding increases, 23 decreases, and five instances where it remained the same.[452] Contrary to Cal Advocates' characterizations, these adjustments do not produce "additional" funding beyond what is needed to fulfill revenue requirement.[453] As the Commission has previously clarified, the adjustments are revenue-

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[448] *See also* LEC-1 (Duval Opening) at 25:4-26:3
[449] *Scoping Memo* at 8-9.
[450] D.91-05-016 at 2; D.88-07-022, *supra,* 28 CPUC 2d at 476.
[451] *Id.* at 5 (citing D.88-07-022 at 210); *see also* LEC-1 (Duval Opening) at 71:10-14 ("These adjustments are necessary so that the Independent Small LECs are not required to file a new . . . rate case each time that the Commission or the FCC makes a change in regulations that impacts the assumptions used to project the net revenues that the regulated rate design will produce.").
[452] Res. T-17461 (2015); Res. T-17505 (2016); Res. T-17549 (2017); Res. T-17559 (2017); Res. T-17585 (2018), Res. T-17637 (2019); Res. T-17682 (2020). Most of these fluctuations exceed $100,000, and some exceed $1 million, so if revenue-neutral adjustments were not made to even out these variations, material shortfalls and windfalls would occur, leading to inequitable results for both ratepayers and the companies over time. *See id.*
[453] *See* LEC-1 (Duval Opening) at 74:3-6 ("it is not possible for the adjustments to produce a rate of return greater than authorized because the adjustments for regulatory changes of industry-wide effect are revenue-neutral and do not impact revenue requirements, revenue projections, or rates of return in the test

neutral; they "fill the gap between a reasonable revenue requirement and 'existing sources of revenue including interstate HCF assistance and basic exchange rates . . . .'"[454]

If an efficient mechanism did not exist to address these regulatory-induced fluctuations, it would create "significant shortfalls or windfalls in revenues" and compel companies to "file a new general rate case each time that the Commission or the FCC makes a change in regulations that impacts the assumptions used to project the net revenues that the regulated rate design will produce."[455] These adjustments therefore benefit ratepayers, the Commission, and companies by avoiding aberrational revenue variations that would otherwise require a formal rate case.

The "means test" and the "waterfall" elements of the CHCF-A annual filing process are also longstanding regulatory mechanisms, designed to disincentivize over-earning and encourage rate cases after a reasonable period of time. If applied as part of the overall CHCF-A annual filing apparatus, as set forth in D.91-09-042, these features also remain reasonable and the evidentiary record does not point to any reason to remove or materially revise them.[456]

B. The CHCF-A Rules Should Be Clarified in Two Limited Respects.

While there is no justification or record basis for overhauling the CHCF-A annual filing rules, two limited clarifications to the rules are appropriate. First, based on recent authority from the California Court of Appeal regarding the CHCF-A annual process, the Commission should clarify that the CHCF-A annual filings are the proper vehicle to address all "regulatory changes of industry-wide effect," regardless of whether a company is currently in a rate case or has recently completed a rate case.[457] The Commission had reached the contrary conclusion, arguing that that the adjustments were unavailable for companies who had recently completed rate cases. The Court of Appeal rejected this view, noting that "the CHCF-A implementing rules do not preclude such adjustments on that particular basis."[458] To avoid future confusion and incorporate this binding authority, the Commission should clarify that the pendency or timing of rate cases do not relate to the availability of these adjustments.

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year."); *see also Cal Advocates Opening Comments on 4th Amended Scoping Memo* at 23-24.
[454] D.88-07-022 at 209; *see also* LEC-1 (Duval Opening) at 25:7-16; 71:14-16.
[455] Phase 1 Exh. 4 (Duval Opening) at 26:15-21; LEC-1 (Duval Opening) at 71:10-14.
[456] The "means test" would not be reasonable if applied on a standalone basis, as it is fundamentally one-sided, reducing CHCF-A in response to over-earning, but providing no additional support if there is under-earning. It remains reasonable provided that the other elements of the annual process also remain.
[457] *See Calaveras Telephone Co., et al. v. Pub. Util. Comm'n*, 39 Cal.App.5th 972 (2019).
[458] *Id.* at 984; *see also* D.91-09-042, App. §§ B, D (adjustments for regulatory changes of industry-wide effect happen every year, including "in the years following a decision in the general rate proceeding.").

Second, the Commission clarify that the waterfall mechanism will operate as stated in D.91-09-042 during the next rate case cycle under the rate case plan. The decision adopting the rate case plan contains language that appears to undermine the flexibility of the waterfall, forcing companies to take a 100% waterfall if they do not file rate cases according to the schedule.[459] The Commission should return to the original functioning of the waterfall to ensure that the CHCF-A rules operate as intended.

XII. CONCLUSION.

The record strongly supports the procedural reforms and clarifications proposed by the companies, but neither the facts nor the law could justify the sweeping changes to the CHCF-A program and rate-of-return regulation that Cal Advocates and TURN have proposed. As former Commissioner Kennedy once observed, many radical ideas can be advanced under the mantle of "protecting consumers," but the Commission would be "wiser to . . . [s]low down, accept incremental change, and first of all do no harm."[460] This advice is especially applicable here, where many of the proposals will harm consumers, carriers, and the economy alike. The Commission should not reinvent a successful program; it should work to streamline its procedures to pave the way for continued success and prosperity for consumers in rural areas.

Respectfully submitted this April 21st, 2020.

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[459] *See* D.15-06-048 at 28 (O.P. 6) (companies have to wait until their next rate case application date to file a rate case, and be subjected to the waterfall in the meantime). This restriction would defeat the purpose of the waterfall, which is to give companies the option to forego rate cases at any point in the phase-down if they can accept the trade-off of reduced funding at any level of the waterfall. *See* D.91-09-042, App. § D (outlining waterfall provisions); *see also* LEC-1 (Duval Opening) at 25:24-26:3.
[460] D.04-05-057, Kennedy Dissent (decision later reversed in D.05-01-058, consistent with dissent).