COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF HIGHLAND TELEPHONE COOPERATIVE, INC. FOR AN ADJUSTMENT OF RATES	)))	CASE NO. 2010-00227

ORDER

This matter is before the Commission on the application of Highland Telephone Cooperative Inc. ("Highland") to increase the local exchange service rates for residential and business customers. The Commission, having heard the testimony, reviewed the record, exhibits and applicable law, and being otherwise sufficiently advised, finds that the rate requests should be granted. The Commission's findings in this matter are outlined as follows:

BACKGROUND

Highland is an incumbent local exchange carrier, providing local telephone service to McCreary County, Kentucky. Highland serves approximately 5,319 residential and 1,041 business customers in Kentucky. Highland also has approximately 12,258 residential customers and 3,718 business customers in Tennessee.[1] Approximately 72 percent of its customer access lines are located in Tennessee; however, Tennessee does not regulate any of its cooperative utilities. Although Highland operates within two different states, the cooperative operates in a

[1] Notification of Adjustment in Existing Rates at Exhibit F ("Application").

consolidated manner wherein all end-user rates are uniform between all service areas. Highland has already increased rates in Tennessee and seeks those same changes in Kentucky.[2]

Pursuant to KRS 278.192(1), Highland submitted its rate application based on a historical test period of calendar year 2009. Highland last filed a rate case with the Commission in 1983, wherein its current rates were set by Commission Order.[3] During the last 25 years, the telecommunications industry has undergone massive technological and regulatory changes. Under Kentucky law, non-basic services provided by telecommunications utilities are primarily de-regulated from Commission oversight. However, the Commission retains jurisdiction over the rates for basic local exchange service and switched access.[4] During the last 5 to 10 years, competition from wireless, cable television providers and internet service providers have each drawn customer demand away from public switch networks, thereby placing pressure on the traditional retail service revenues for many small telephone companies, such as Highland.

In Case No. 2010-00341,[5] Highland has requested a Certificate of Convenience and Necessity for the Construction of a Fiber-to-the-Home ("FTTH") network in

---

[2] Pre-Filed Testimony of Steve Armes, CPA, at p. 3.

[3] Case No. 8997, Notice of Adjustment of Rates and Charges of Highland Telephone Coop. Corp., Inc. to be Effective September 1, 1984 and Application of Highland Telephone Inc. for Order Permitting Adjustment of Rates (Ky. PSC Nov. 20, 1984).

[4] KRS 278.512 and KRS 278.543.

[5] Case No. 2010-00341, Application of Highland Telephone Cooperative, Inc. for a Certificate of Public Convenience and Necessity for Construction of Fiber-To-The-Home in McCreary County, Kentucky, filed June 24, 2011.

McCreary County, Kentucky. The FTTH network will also be constructed throughout Highland's Tennessee operating territory. The proposed construction of the FTTH Network will be funded by a $16.6 million Rural Utilities Services ("RUS") Loan and a $49.9 million grant. The FTTH construction will enable Highland to provide enhanced broadband services and video services along with traditional telephone service. Highland states in its application that the RUS advised Highland that unless revenues were replaced, it would not be eligible to apply for the stimulus funds or loans being made for the continued upgrading and expansion of its telecommunications services.[6] Highland stated that the replacement of revenues that enabled it to be eligible for the loan and grant was accomplished by implementing the rate increase to the Tennessee Customers.[7]

Highland provided notice to its customers as to the pending rate request, as required under 807 KAR 5:001, Section 10. No intervenors or correspondence from any customers of Highland have been received by the Commission. The Attorney General declined to intervene in this matter.

Highland submitted pre-filed testimony from two witnesses to address its current financial condition, the potential effect of the rate increases and the competitive nature of the telecommunications industry. The witnesses were Mr. Steve Armes, CPA, Accounting Manager of Highland, and Mr. Gentry Underhill, CPA, an outside auditor. The Commission, by Order issued on September 27, 2010, suspended Highland's proposed rates for a period of five months, ending March 25, 2011.

---

[6] Application at 2.

[7] Responses to Commission Staff's First Request For Information at 1.

The Commission did not complete its review of Highland's application by March 25, 2011. On March 24, 2011, Highland notified the Commission that it intended to implement its proposed rates for service provided after March 26, 2011, subject to refund. The Commission issued an order on March 28, 2011, recognizing Highland's intent to implement the rate change and directing Highland to maintain its records in such a manner as to allow for a refund if necessary. On April 22, 2011, Commission staff propounded data requests on Highland to gather additional information related to the requested rate change. On June 9, 2011, the Commission staff held an informal conference to discuss the matters in this case. On June 16, 2011, the Commission held a formal hearing in this matter. Prior to the hearing, Highland moved to allow one additional witness, Mr. Fred Terry, Manager of Highland, to testify during the hearing. At the hearing, the Commission granted Highland's motion and allowed Mr. Terry to testify. Mr. Underhill and Mr. Armes also testified and supplemented their pre-filed testimony.

RATE REQUEST AND REVENUE REQUIREMENTS

Highland selected the calendar year 2009 as the test period for this case. Highland made one adjustment to the test period to remove a one-time expense for loss on obsolete inventory of $706,485 and the Commission has not made any additional adjustments to the test period. Highland's operating revenues for the test year were $17,235,638. Highland states that its revenue requirement to cover its expenses with no component of rate of return for the base period would be $17,621,087, an increase of $385,449.[8] Highland has proposed to increase its charges for residential and

[8] Pre-Filed Testimony of Gentry Underhill, Jr., CPA, at pp. 3-5.

business basic local exchange service by $5 and $8 respectively. The following table provides a breakdown of the proposed revenue increase:

	Residential	**Business**	**Annualized**
KY Access Lines	5,319	1,041	
TN Access Lines	12,258	3,718	
Current Rates	$9.73	$15.98	
Rate Increase	$5.00	$8.00	
Proposed Rates	$14.73	$23.98	
Additional Revenue	$1,054,620.00	$456,864.00	$1,511,484.00

Approximately 85 percent of Highland's revenues are from local service and access charges. In response to a data request from Commission staff, Highland explained that, in Kentucky, it has had a cumulative loss of $523,966.32 in local service and access revenue over the past five years.[9] At the hearing, Highland stated that the total company loss of revenue over the past five years has been approximately $2 million.[10] Highland also stated in response to a data request from Commission staff that it had instituted several cost-cutting measures to help offset declining revenue over the past three years. Those measures include: renegotiating its collective bargaining agreement with its union employees, obtaining a three-year wage freeze; and no increase in any employee benefits. Additionally, all management staff wages were frozen in 2008. Highland reduced its advertising budget by 50 percent in 2010 and obtained reductions in insurance premiums for medical coverage and workers

---

[9] Responses to Commission Staff's Second Request For Information at 20.

[10] Hearing Video Transcript at 10:18, Armes Testimony.

compensation. Highland has reduced its workforce by 13 employees since 2008. Highland has also evaluated and reduced legal expenses and expense related to travel.[11] Highland also stated at the hearing that, due to legislation passed in Tennessee, it anticipates that it will lose $1.5 million in access revenue per year in Tennessee.[12]

Highland primarily receives capital from its members and debt obtained from the RUS. RUS requires its borrowers to meet and maintain certain financial conditions. In 1991, RUS directed Highland to maintain a minimum times interest earned ratio ("TIER") of 1.25 through April 3, 1989 and a minimum TIER of at least 1.50 thereafter.[13] RUS includes in its calculation for the TIER the non-regulated income of the company. In 2008, Highland had a TIER of 2.65 and in 2009 Highland had a TIER of negative 1.84 as calculated by RUS.[14] Highland's TIER in 2010 was 1.11.[15]

Highland did not propose a certain TIER level, but proposed only dollar-specific rate increases. Highland explained that it looked at several factors in determining the basis and amount of the requested rate increase. Highland had not had a general rate increase since 1983. It calculated that, if its rates had increased by the rate of inflation since 1983, the rates for residential service and business service would be $21.30 and $34.99 respectively. Highland also reviewed its future revenue requirements to make

---

[11] Responses to Commission Staff's Second Request For Information at 17.

[12] Hearing Video Transcript at 10:18–19, Armes Testimony.

[13] Responses to Commission Staff's First Request For Information at 2.

[14] Id. at 3.

[15] Responses to Commission Staff's Second Request For Information at 2.

certain that the requested rate increase would be sufficient to avoid another rate increase in the near future. Highland also reviewed the rates charged by other similarly situated cooperatives. When compared to the rates charged by these companies, Highland's proposed rates were within one dollar of the other companies' rates.[16] The proposed rate increases will improve Highland's financial position and enable Highland to maintain a TIER level that will not put it in default of its lending requirements.

OTHER SERVICE RATES

Highland has not proposed any adjustments to its access service rates in its application. As to the issue of non-basic services, Highland has not increased rates for non-basic services, including Caller ID, Call Waiting, Non-published/Non-listed numbers and Directory Assistance.[17] Highland explained that the rates charged for these services are comparable to other providers. Also, rates for digital subscriber line ("DSL") provided by its subsidiary are limited by competitive providers. Highland only provides video service, through a subsidiary, to a very limited portion of its service territory which is also subject to competition and the rate increase would produce a very limited revenue increase.[18]

CAPITAL CREDITS

As a membership cooperative, Highland is obligated to return to its members any excess profits earned by the cooperative by paying capital credits. The Board of Directors makes the determination of when and how many capital credits to pay back to

[16] Responses to Commission Staff's Second Request For Information at 6.

[17] Responses to Commission Staff's First Request For Information at 5.

[18] Responses to Commission Staff's Second Request For Information at 23.

its membership as long as the redemption will not impair the financial integrity of the cooperative. Highland has not paid any capital credits to its membership since 2009 due to the financial condition of the cooperative.[19]

CONCLUSION

Having reviewed the record, testimony, pleadings, applicable law and being otherwise sufficiently advised, the Commission hereby finds that Highland's request to increase the basic local service rates for residential and business customers is reasonable.

IT IS THEREFORE ORDERED that:

1. Highland's request to increase its basic local exchange service rates for residential and business customers is granted.

2. The motion submitted June 14, 2011 for leave to submit additional testimony at the hearing is granted.

By the Commission

ENTERED
JUL 0 7 2011
KENTUCKY PUBLIC SERVICE COMMISSION

ATTEST:

Aaron D. Greenwell for
Executive Director

[19] Responses to Commission Staff's First Request For Information at 6.

Jeffrey J Yost
Jackson Kelly PLLC
175 East Main Street
Suite 500, P. O. Box 2150
Lexington, KENTUCKY 40595-0000