

# **ATTACHMENT 4**

**STATE OF ALASKA**  
**THE REGULATORY COMMISSION OF ALASKA**

Before Commissioners

Mark K. Johnson, Chair  
Kate Giard  
Dave Harbour  
James S. Strandberg  
G. Nanette Thompson

In the Matter of the Petition by GCI  
COMMUNICATIONS CORP. d/b/a GENERAL  
COMMUNICATION, INC. and GCI for  
Arbitration Under Section 252 of the  
Telecommunications Act of 1996 with the  
MUNICIPALITY OF ANCHORAGE d/b/a ATU  
TELECOMMUNICATIONS a/k/a ATU  
TELECOMMUNICATIONS for the Purpose of  
Instituting Local Competition.

U-96-89

**PREFILED SURREBUTTAL TESTIMONY  
OF  
TERRY L. MURRAY**

**ON BEHALF OF  
GENERAL COMMUNICATION, INC. (GCI)**

**OCTOBER 13, 2003**

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EXHIBIT TLM-9: EXHIBITS FROM VIRGINIA ARBITRATION SHOWING  
VINTAGE OF BOND YIELDS

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EXHIBIT TLM-11: ACS DOCUMENTS FROM R-03-3

EXHIBIT TLM-12: UBS COST OF CAPITAL ESTIMATE FOR ALLTEL

1 I. **INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.**

3 A. My name is Terry L. Murray. I am President of the consulting firm Murray &  
4 Cratty, LLC. My business address is 8627 Thors Bay Road, El Cerrito, CA  
5 94530.

6 **Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS PROCEEDING?**

7 A. Yes, I filed direct and rebuttal testimony on behalf of General Communication,  
8 Inc., ("GCI"). Exhibit TLM-1 to my direct testimony provides a summary of my  
9 qualifications and experience.

10 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

11 A. The purpose of my surrebuttal testimony is to respond to the "opposition"  
12 testimonies of ACS-Anchorage ("ACS-AN") witnesses Mr. David C. Blessing<sup>1</sup> and  
13 Mr. Thomas R. Meade<sup>2</sup> on the cost of capital inputs to be used in a Total  
14 Element Long Run Incremental Cost ("TELRIC") study of unbundled network  
15 element ("UNE") costs.

16 Based on my review of their testimonies, I have reached the following  
17 conclusions:

- 18 • With the limited exception of Mr. Meade's objection to my "comparable"  
19 companies group (to which I respond below), ACS has *not* alleged that  
20 there are any errors in either the methodology that I used to estimate the  
21 various components of the cost of capital or in the data on which I based  
22 my analysis. To the contrary, Mr. Blessing acknowledges that I used

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<sup>1</sup> Prefiled Opposition Testimony of David C. Blessing on Behalf of ACS of Anchorage (hereinafter "Blessing Opposition").

<sup>2</sup> Prefiled Opposition Testimony of Thomas R. Meade on Behalf of ACS of Anchorage (hereinafter "Meade Opposition").

1 “standard methodologies” to develop my estimated weighted-average cost  
2 of capital.<sup>3</sup> And, although Mr. Blessing withholds specific agreement with  
3 the way that I developed the inputs used in my analysis,<sup>4</sup> he also does not  
4 claim that any of those inputs are incorrect.

5 • Instead, ACS’ “opposition” testimony relies almost exclusively on the claim  
6 that, because the *results* of my analysis are lower than the cost of capital  
7 adopted in the recent decision by the Wireline Competition Bureau of the  
8 Federal Communications Commission (“FCC”) in the Virginia arbitration  
9 proceeding,<sup>5</sup> my analysis must be wrong. To the contrary, it is ACS’  
10 comparison that is wrong because ACS failed to look behind the result of  
11 the *Virginia Arbitration Order* to understand the methodology underlying  
12 that result.

13 • ACS’ attempt to impeach my results reflects an apples-and-oranges  
14 comparison. My analysis reflected data current as of August 15, 2003; the  
15 *Virginia Arbitration Order* adopted results based on data current as of  
16 June 30, 2000—*i.e.*, data that are now over three years old.<sup>6</sup> As I  
17 demonstrated in my rebuttal testimony, application of the Bureau’s  
18 methodology to current data would produce a cost of capital estimate that  
19 is much closer to my own recommendation than to that of ACS.

20 • ACS witness Mr. Blessing is also incorrect in arguing that the correct risk-  
21 adjusted cost of capital is the (extremely stale) FCC-approved 11.25%  
22 cost of capital, adjusted upward for additional risk. Certain incumbent  
23 local exchange carriers (“ILECs”) advanced this argument before the FCC;

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<sup>3</sup> Blessing Opposition at 23, fn. 24.

<sup>4</sup> *Id.*

<sup>5</sup> Memorandum Opinion and Order, *In the Matter of In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc. and for Expedited Arbitration (CC Docket No. 00-218); In the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252 Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc. (CC Docket No. 00-251)*, DA 03-2738 (rel. August 29, 2003) (hereinafter “*Virginia Arbitration Order*”).

<sup>6</sup> In my rebuttal testimony, I noted that the data were over two years old, a conservative statement I based on the timing of the submission of testimony in that proceeding. Since filing my rebuttal, I have had an opportunity to review the exhibits relied on in the *Virginia Arbitration Order* and have verified that the government and U.S. Treasury bond yields used in the *Order*’s cost of capital calculations are the figures dated June 30, 2000, in the pertinent exhibits attached to Exhibit 5 in that proceeding, which was the testimony of AT&T/WorldCom witness Mr. Hirshleifer.

1           however, the FCC did not make any such finding in its *Triennial Review*  
2           *Order*.<sup>7</sup> Moreover, the cost of capital adopted in the *Virginia Arbitration*  
3           *Order* was not calculated with reference to that stale authorized return,  
4           contrary to the implication of Mr. Blessing’s testimony.

5           •     Mr. Blessing further errs in suggesting that the cost of capital for ACS-AN  
6           should exceed the cost of capital adopted for Verizon in the *Virginia*  
7           *Arbitration Order*. The relative levels of competition in the two companies’  
8           service territories are irrelevant because the *Virginia Arbitration Order*  
9           reflects the risk that Verizon would incur *if* it faced significant facilities-  
10          based competition, not the risk that Verizon faces today (or faced at the  
11          time of the data collection that underlies that *Order*). And, ACS’ higher  
12          degree of leverage is irrelevant because the *Virginia Arbitration Order*  
13          looks to an average industry capital structure, not a company-specific  
14          capital structure, to determine the weighted-average cost of capital.

15          •     Mr. Blessing also inappropriately compares my proposed cost of debt to  
16          the level of debt cost adopted in the *Virginia Arbitration Order* without  
17          making any adjustment for decreases in interest rates since June 30, 2000  
18          (which is the date of the underlying information used in that *Order* to  
19          establish the cost of debt). Had he compared my cost of debt to the  
20          *current* yield-to-maturity for Verizon’s debt, he would have observed that  
21          my proposed cost of debt is actually very reasonable. Verizon New  
22          England just issued new 10-year debt at a yield of 4.865%—well below  
23          the 5.84% cost of debt included in my recommended cost of capital for  
24          setting UNE prices in this arbitration.

25          •     Mr. Meade’s attack on my selection of “comparable” companies is  
26          misguided and factually erroneous, in part because he focuses only on the  
27          local telephone operations of my comparable companies and does not  
28          acknowledge that they are also subject to risk from other lines of business.  
29          Ironically, ACS elsewhere has chosen to “compare” itself to companies in  
30          my group that Mr. Meade now alleges to be inappropriate. Furthermore,  
31          the Commission can readily validate the appropriateness of my group by  
32          comparing the “beta” (or risk measure) that I derived using the group  
33          data—1.133—to the 1.0 beta that the *Virginia Arbitration Order* indicates is  
34          reasonable for a telecommunications company facing facilities-based

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<sup>7</sup> See FCC 03-36, *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking*, In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers (CC Docket No. 01-338); Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 (CC Docket No. 96-989); Deployment of Wireline Services Offering Advanced Telecommunications Capability (CC Docket No. 98-147), rel. August 21, 2003 (hereinafter, “*Triennial Review Order*”) at ¶ 678.

1 competition. If anything, my comparable group analysis incorporates a  
2 somewhat higher level of risk than the FCC's Wireline Competition Bureau  
3 found to be reasonable, given the guidance of the *Triennial Review Order*.

- 4 • As further corroboration that my analysis produces a cost of capital that  
5 reflects both current risk and current interest rates, I note that my 8.02%  
6 weighted-average cost of capital is very close to the 8.9% cost of capital  
7 that the independent investment advisory firm UBS Warburg has recently  
8 published for ALLTEL, one of the firms in my comparison group. Were it  
9 not for the high equity percentage in ALLTEL's capital structure (80%), the  
10 UBS Warburg estimate for ALLTEL would be even closer to mine. But,  
11 the UBS Warburg estimate is far lower than the cost of capital proposed  
12 by ACS or that estimated by Mr. Blessing.

13 The remainder of my testimony explains the basis for my conclusions and  
14 recommendations.

## 15 II. RESPONSE TO MR. BLESSING

16 **Q. MR. BLESSING CLAIMS THAT YOUR COST OF CAPITAL**  
17 **RECOMMENDATION IS INCONSISTENT WITH THE STANDARDS SET BY**  
18 **THE FCC.<sup>8</sup> IS THERE ANY MERIT TO HIS CLAIMS?**

19 A. No. Mr. Blessing's argument has two fundamental components, both of which  
20 are incorrect and one of which is not even tied to any "FCC" standard.

21 **Q. WHAT IS THE FIRST COMPONENT OF MR. BLESSING'S CLAIM?**

22 A. The first component of his claim is that my recommendation does not fulfill what  
23 he calls the "long-standing cost of capital legal requirement for regulated  
24 utilities."<sup>9</sup> Although he presents this claim as part of an answer concerning the  
25 standards set by the FCC, he does not attempt to tie it to any FCC ruling on  
26 TELRIC. Instead, he argues that Supreme Court precedent from early in the last

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<sup>8</sup> Blessing Opposition at 22.

<sup>9</sup> *Id.*

1 century requires that the cost of capital for a regulated utility must exceed the  
2 average cost of the utility's debt.

3 **Q. IS THIS ARGUMENT CORRECT?**

4 A. Not to the best of my understanding. I am not a lawyer (nor is Mr. Blessing,  
5 insofar as I can tell from the information he provided concerning his education  
6 and experience); hence, I will not presume to offer a legal opinion on Mr.  
7 Blessing's interpretation of those decades-old Supreme Court decisions.  
8 Nonetheless, based on my experience of how the Supreme Court decisions he  
9 references have been applied in actual regulatory settings, I believe that Mr.  
10 Blessing is completely off-base.

11 First, as I noted in my rebuttal to Mr. Blessing, the legal standards he  
12 references were developed in the context of rate-base, rate-of-return regulation.  
13 The Telecommunications Act of 1996 ("Act") specifically forbids setting UNE  
14 prices with reference to rate-base, rate-of-return regulation.<sup>10</sup> The Supreme  
15 Court, in upholding the TELRIC methodology, specifically discussed the history  
16 of such regulation, referencing the very series of decades-old Supreme Court  
17 decisions to which Mr. Blessing alludes. The Court observed: "The Act thus  
18 appears to be an explicit disavowal of the familiar public-utility model of rate  
19 regulation (whether in its fair-value or cost-of-service incarnations) presumably  
20 still being applied by many States for retail rates...."<sup>11</sup> Thus, it is unclear why the  
21 standards that Mr. Blessing cites would have any relevance in this context.

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<sup>10</sup> 47 U.S.C. § 252(d)(1)(A)(i).

<sup>11</sup> *Verizon v. FCC*, 535 U.S. 467, 489.

1           Second, the cost of capital used in a UNE cost study is simply one set of  
2 inputs among many that determine the prices for one line of business of ACS,  
3 and not for the entire firm. In my experience, the cost of capital legal  
4 requirements to which Mr. Blessing refers have been applied to test whether the  
5 firm has an opportunity to earn a reasonable return on its total prudent  
6 investment, not whether it has the opportunity to make a specific level of profit for  
7 any particular line of business. For example, regulators in many jurisdictions  
8 have targeted specific services (such as residential basic exchange service) to  
9 have a lower than average profit, or even to be provided below cost. Such rate  
10 designs have been widespread for decades, and have not automatically been  
11 ruled invalid simply because a particular service or services does not earn a  
12 return in excess of the firm's cost of debt.

13           Third, even if Mr. Blessing were otherwise entirely correct, the  
14 Commission would still be able to adopt my cost of capital recommendation. As I  
15 showed in Exhibit TLM-8 to my rebuttal testimony, my cost of capital  
16 recommendation would effectively allow ACS-AN an opportunity to earn a return  
17 on equity of 10.49% *after* covering its embedded debt cost of 10.33%. The  
18 apparent discrepancy between this result and my 8.02% weighted-average cost  
19 of capital recommendation occurs because my recommendation reflects a capital  
20 structure with much more equity (with its higher cost and tax consequences) than  
21 is the case for ACS' current capital structure. Therefore, the expected result of  
22 adopting my cost of capital recommendation would be an outcome that satisfies  
23 even Mr. Blessing's description of the relevant legal requirements.

24           I do not, however, concede the accuracy or relevance of those  
25 requirements, for all the reasons I just discussed above. The pertinent question  
26 is whether my cost of capital recommendation comports with the requirements of

1 the Act, as interpreted by the Supreme Court and the FCC. That question cannot  
2 be answered by referencing legal standards that applied to the prior rate-base,  
3 rate-of-return regime. Instead, that question must be answered by evaluating the  
4 second component of Mr. Blessing's claim.

5 **Q. WHAT IS THE SECOND COMPONENT OF MR. BLESSING'S CLAIM?**

6 A. The second component of his claim is that my recommendation is inconsistent  
7 with FCC requirements described variously in the *Triennial Review Order*, the  
8 Notice of Proposed Rulemaking ("NPRM") on UNE pricing<sup>12</sup> and *Virginia*  
9 *Arbitration Order*.<sup>13</sup> Although Mr. Blessing lists the *TELRIC NPRM* in this list, I  
10 did not see any subsequent reference to the *TELRIC NPRM* in his rebuttal to me,  
11 nor (as he mistakenly states) did I cite the *TELRIC NPRM* as authority in support  
12 of my cost of capital recommendation. In any case, it would be improper for the  
13 Commission to rely on any portion of the *TELRIC NPRM* describing proposed  
14 changes to the current TELRIC rules because those changes may never be  
15 adopted and are not currently the law of the land. Hence, I will focus my  
16 response on the other FCC orders that Mr. Blessing invoked.

17 **Q. THE FIRST SUCH ORDER THAT MR. BLESSING CITES IS THE 1996 LOCAL**  
18 **COMPETITION ORDER.<sup>14</sup> DO YOU AGREE WITH MR. BLESSING'S**  
19 **CHARACTERIZATION OF THAT FCC DECISION?**

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<sup>12</sup> WC Docket No. 03-173, *Notice of Proposed Rulemaking*, In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers, rel. September 15, 2003, (hereinafter, "*TELRIC NPRM*").

<sup>13</sup> Blessing Opposition at 23.

<sup>14</sup> Blessing Opposition at 24, citing to *First Report and Order*, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, 11 FCC Rcd. 15499 (hereinafter "*Local Competition Order*").

1 A. I agree in part and disagree in part. Mr. Blessing accurately quotes the *Local*  
2 *Competition Order's* provision for use of the then-currently-authorized state or  
3 federal cost of capital as a starting point for the determination of UNE prices,  
4 although he omits a significant statement that any party can demonstrate the  
5 required return to be higher *or lower*.<sup>15</sup> Moreover, he adds a statement about the  
6 11.25% federally authorized return that simply is not true. He claims that the  
7 federally authorized return is forward-looking and reflects investors' future  
8 expectations of risk.<sup>16</sup> This is an incredibly strong and implausible claim to make  
9 about an authorized return that was originally adopted in a 1990 represcription  
10 order.<sup>17</sup> The FCC's authorized return may reflect investors' expectations thirteen  
11 years ago, but it does not give this Commission useful insight into their  
12 expectations today. Indeed, in the same paragraph of the *Local Competition*  
13 *Order* that Mr. Blessing cites, the FCC observed that it was looking into whether  
14 the federally authorized return was *too high*, given what was the current  
15 marketplace cost of capital in 1996.<sup>18</sup> Interest rates are even lower today than  
16 they were in August 1996, giving particular force to the FCC's cautionary note  
17 about the 11.25% authorized return.<sup>19</sup>

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<sup>15</sup> *Local Competition Order*, ¶ 702.

<sup>16</sup> Blessing Opposition at 25.

<sup>17</sup> See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Order*, CC Docket No. 89-624, 5 FCC Rcd 7507, 7509 ¶ 13 (1990).

<sup>18</sup> *Local Competition Order*, ¶ 702.

<sup>19</sup> See my rebuttal testimony at pp. 47-49 for a detailed discussion of this point.

1 **Q. MR. BLESSING NEXT SUGGESTS THAT THE TRIENNIAL REVIEW ORDER**  
2 **REQUIRES AN UPWARD ADJUSTMENT TO THE FCC'S 11.25% RATE OF**  
3 **RETURN TO ACCOUNT FOR ADDITIONAL RISKS.<sup>20</sup> IS HE CORRECT?**

4 A. No. Verizon and other ILECs raised the same issue in the *Triennial Review*  
5 proceeding;<sup>21</sup> however, the FCC did not adopt their position. There is good  
6 reason for the FCC's hesitation. As I discussed above and in my rebuttal  
7 testimony, the 11.25% authorized return is out of line with current interest rates.  
8 Thus, only a quantitative analysis of current data such as the cost of capital study  
9 that I presented in my direct testimony can determine whether the decrease in  
10 the return on alternative investments outweighs the increase in business risk.  
11 The results of my quantitative analysis suggest that the decrease in interest rates  
12 does, in fact, outweigh the increase in business risk. It is not possible to refute  
13 such quantitative evidence using current data by applying *ad hoc* and subjective  
14 risk adjustments to a cost of capital that was originally adopted 13 years ago.

15 **Q. MR. BLESSING ATTEMPTS TO CORROBORATE HIS CONCLUSIONS BY**  
16 **NOTING THAT THE COST OF CAPITAL ADOPTED IN THE VIRGINIA**  
17 **ARBITRATION ORDER IS 170 BASIS POINTS HIGHER THAN THE 11.25%**  
18 **FCC-AUTHORIZED RETURN MENTIONED IN THE LOCAL COMPETITION**  
19 **ORDER.<sup>22</sup> DOES THIS COMPARISON PROVE ANYTHING?**

20 A. No. The *Virginia Arbitration Order* reflected the outcome of a record developed  
21 in 2001, using financial data primarily from 2000, without updated information. In  
22 particular, I have verified that the U.S. government bond yields used in the cost

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<sup>20</sup> Blessing Opposition at 25-26.

<sup>21</sup> *Triennial Review Order*, ¶ 678.

<sup>22</sup> Blessing Opposition at 25.

1 of equity calculation and the Verizon bond yields used in the cost of debt  
2 calculation both reflected data as of June 30, 2000.<sup>23</sup> As I explained in my  
3 rebuttal testimony, interest rates have declined significantly since that time.

4 Also, and contrary to Mr. Blessing's testimony, there is absolutely no  
5 reason that the cost of capital adopted in this arbitration should exceed the cost  
6 of capital adopted for Verizon in the *Virginia Arbitration Order*. The *Virginia*  
7 *Arbitration Order* did *not* adopt a cost of capital reflecting the actual competitive  
8 risk faced by Verizon in Virginia at that time; it adopted a cost of capital reflecting  
9 the risk that an efficient carrier in Verizon's position would face if it were subject  
10 to significant facilities-based competition.<sup>24</sup> Thus, any comparison between the  
11 level of competition that ACS and Verizon currently face is irrelevant to a  
12 comparison of the recommendations in this arbitration to the *Virginia Arbitration*  
13 *Order* adopted cost of capital.<sup>25</sup>

14 **Q. DOES THE VIRGINIA ARBITRATION ORDER PROVIDE ANY USEFUL**  
15 **GUIDANCE FOR THE DETERMINATION OF COST OF CAPITAL IN THIS**  
16 **ARBITRATION?**

17 A. Yes. The more appropriate benchmark, which is the one that I presented in my  
18 rebuttal testimony, is to compare the parties' cost of capital recommendations in

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<sup>23</sup> The *Virginia Arbitration Order* indicates that these inputs came from AT&T/WorldCom Exhibit 5 in that proceeding, which was the direct testimony of John Hirshleifer. A search of the exhibits to Mr. Hirshleifer's direct testimony reveals that the cost of debt figures were current as of June 30, 2000 (Hirshleifer Exhibit 3-c) and that the government bond yields used in the cost of equity calculation were also yields as of June 30, 2000 (Hirshleifer Exhibit 7). A copy of these exhibits to AT&T/WorldCom Exhibit 5 from the Virginia arbitration proceeding is attached as Exhibit TLM-9 to my surrebuttal testimony.

<sup>24</sup> *Virginia Arbitration Order*, ¶ 63.

<sup>25</sup> Also, the relevant form of competition considered in the *Virginia Arbitration Order* is *facilities-based* competition, not UNE-based competition. Mr. Blessing fails to make this distinction.

1 this proceeding to the result of the *Virginia Arbitration Order* methodology,  
2 applied to current data. For example, I showed in my rebuttal testimony that the  
3 *Virginia Arbitration Order* methodology produces a cost of equity of 10.91%, only  
4 slightly higher than the 10.33% that I estimated and substantially lower than  
5 either Mr. Blessing's 25.05% estimate or ACS' proposed 15.25% cost of equity. I  
6 also showed that the *Virginia Arbitration Order* requires the use of a "beta" of  
7 approximately 1.0<sup>26</sup>—slightly less than the 1.133 beta used in my analysis, but  
8 substantially below the 2.73 beta used in Mr. Blessing's calculations.

9 Furthermore, I explained that the discrepancy between my cost of equity  
10 recommendation and the outcome of the *Virginia Arbitration Order* methodology  
11 is primarily attributable to my use of a lower average equity risk premium, which I  
12 justified through references to the finance literature that were not considered in  
13 the Virginia arbitration proceeding. No ACS witness has disputed my statement  
14 that the forward-looking equity risk premium is lower than the historical average  
15 risk premium calculated by Ibbotson Associates.

16 **Q. MR. BLESSING CLAIMS THAT THE DIFFERENCE BETWEEN THE 7.86%**  
17 **COST OF DEBT ADOPTED IN THE VIRGINIA ARBITRATION ORDER AND**  
18 **THE 5.84% COST OF DEBT THAT YOU RECOMMEND HERE PROVES THAT**  
19 **YOUR COST OF DEBT ESTIMATE IS TOO LOW.<sup>27</sup> DO YOU AGREE?**

20 A. No. Once again, Mr. Blessing fails to account for the change in market interest  
21 rates since June 30, 2000, which is the date of the record information on Verizon  
22 bond yields used in the *Virginia Arbitration Order*. The current cost of debt for

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<sup>26</sup> *Virginia Arbitration Order*, ¶ 90.

<sup>27</sup> Blessing Opposition at 28-29.

1 the Verizon companies is much lower, as the Commission can readily verify.  
2 Verizon New England (one of the Verizon companies included in the cost of debt  
3 calculations underlying the *Virginia Arbitration Order*) issued \$300 million of new  
4 10-year debt on September 30, 2003. This 10-year debt corresponds closely to  
5 the maturity of ACS' debt. The cost to Verizon New England was only 4.865%,<sup>28</sup>  
6 which is substantially lower than the 5.84% cost of debt that I am recommending  
7 in this arbitration. Therefore, my recommendation does *not* assume that ACS (or  
8 rather, a hypothetical efficient carrier in ACS' position) is less risky than Verizon.  
9 It reflects the cost of debt for a company that is *more* risky.

10 **Q. MR. BLESSING NEXT SUGGESTS THAT THE COST OF EQUITY FOR A**  
11 **FIRM WITH MORE LEVERAGE (I.E., A HIGHER DEBT RATIO) THAN IS**  
12 **ASSUMED IN THE VIRGINIA ARBITRATION ORDER SHOULD BE HIGHER**  
13 **THAN THE COST OF EQUITY ADOPTED IN THAT DECISION.<sup>29</sup> IS THIS**  
14 **COMPARISON VALID?**

15 A. No. At the risk of repeating myself too often, I must point out that Mr. Blessing  
16 continues to fail to consider the change in market interest rates (and the drop in  
17 even the Ibbotson Associates measure of the equity risk premium) since the time  
18 of the data underlying the *Virginia Arbitration Order*. Comparing estimates of the  
19 cost of capital from two time periods with very different returns to alternative  
20 investments does not provide any useful information at all.

21 As I showed in my rebuttal testimony, my 8.02% proposed weighted-  
22 average cost of capital is quite close to the result that one would obtain by strictly

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<sup>28</sup> Reuters, "New Issue—Verizon New England sells \$300 mln notes," September 30, 2003. A copy of this article is included as Exhibit TLM-10.

<sup>29</sup> Blessing Opposition at 30.

1 applying the *Virginia Arbitration Order* methodology to current data. The few  
2 differences between my recommendation and the *Virginia Arbitration Order*  
3 results are easily explained by the differences between my approach to the  
4 equity risk premium and my use of a target capital structure. The *Virginia*  
5 *Arbitration Order* did not address either of these issues; hence, this Commission  
6 must decide for itself whether the evidence I have presented justifies the small  
7 differences between my results and those derived from the methodology adopted  
8 by the FCC's Wireline Competition Bureau.

9 **III. RESPONSE TO MR. MEADE**

10 **Q. MR. MEADE STATES THAT THE COMPANIES IN YOUR "COMPARABLE**  
11 **COMPANIES" GROUP DO NOT MEET YOUR CRITERION OF FACING**  
12 **FACILITIES-BASED COMPETITION.<sup>30</sup> IS HE CORRECT?**

13 A. No. Mr. Meade's rebuttal to me addresses the extent to which each of the  
14 companies faces *UNE-based* competition,<sup>31</sup> which is not the criterion identified in  
15 the *Triennial Review Order* and not the criterion I applied in my direct testimony.  
16 He presents absolutely no evidence to indicate that these companies face  
17 significantly less *facilities-based* competition than does ACS.

18 **Q. ARE THESE COMPANIES, IN FACT, LESS RISKY THAN IS ACS?**

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<sup>30</sup> Meade Opposition at 3 *et seq.*

<sup>31</sup> Furthermore, even his claims about UNE-based competition are not entirely accurate. For example, the arbitration between Roseville Telephone Company (the local exchange arm of SureWest) and Covad Communications Company was initially decided in California Public Utilities Commission D.00-06-080, issued in June of 2000. (Rehearing was subsequently granted.) Thus, it is simply not correct that SureWest is in the process of negotiating its first arbitration agreement, as Mr. Meade asserts on page 6 of his Opposition Testimony.

1 A. Not necessarily. As I explained in my direct testimony, the “unlevered beta” (*i.e.*,  
2 the beta after removing the effects of different company capital structures) is  
3 considered to be a useful measure of business risk. As shown on line 6 of the  
4 CAPM tab in Exhibit TLM-2 to my direct testimony (my electronic workpapers),  
5 ACS’ unlevered beta of .107 is actually *lower* than the unlevered betas for the  
6 other six companies included in my analysis.

7 Also, although I agree that ACS has higher-than-average financial risk  
8 because of its high debt ratio, it is not alone in that respect. As shown on line 4  
9 of the CAPM tab in Exhibit TLM-2, Cincinnati Bell is actually more leveraged than  
10 is ACS and Citizens also has high leverage.

11 The combined effect of business and financial risk appears in each  
12 company’s levered beta. As shown on line 3 of the CAPM tab in Exhibit TLM-2,  
13 ACS’ levered beta of .6 is actually *lower* than the levered betas for the other six  
14 companies in my study. Therefore, the inclusion of the other six companies in  
15 my analysis increased my estimated cost of equity compared to the estimate that  
16 I would have obtained using only ACS’ data.

17 **Q. HOW DO YOU EXPLAIN THE DISCREPANCY BETWEEN THESE**  
18 **OBJECTIVE, QUANTITATIVE MEASURES OF RISK AND MR. MEADE’S**  
19 **QUALITATIVE ASSESSMENT OF RISK?**

20 A. It is never possible to know exactly how qualitative assessments of risk relate to  
21 quantitative risk measures; however, I suspect that the discrepancy is largely  
22 explained by the differences between the holding company and local exchange  
23 operating company level of information.

24 As I explained in my direct testimony, the financial data used in standard  
25 cost of capital analyses are typically only available at the holding company level.

1 Therefore, my analysis reflects the risk of all of the lines of business of the  
2 companies included in my cost of capital study, not just the risk of their local  
3 exchange business. Many of these other lines of business are subject to far  
4 more competition than the limited UNE-based competition risk on which Mr.  
5 Meade focuses in his testimony. For example, ALLTEL has both long-distance  
6 and wireless operations, which are subject to true facilities-based competition.

7 Hence, even if Mr. Meade were correct in suggesting that the *local*  
8 *exchange* portion of each of these companies is less risky than is ACS'  
9 comparable line of business, that comparison does not show that the overall risk  
10 faced by the companies in my sample is less than either ACS' risk or (more  
11 pertinently) the risk of the hypothetical efficient carrier subject to facilities-based  
12 competition that is the focus of the *Triennial Review Order's* clarified cost of  
13 capital standard.

14 Again, looking just at the *Triennial Review Order's* standard, I note that the  
15 average re-levered beta that I obtained through my comparable company  
16 analysis is 1.133, which is *higher* than the beta measure of risk that the FCC's  
17 Wireline Competition Bureau indicated to be an appropriate measure of the risk  
18 of a firm subject to facilities-based competition. Thus, based on the benchmark  
19 to which Mr. Blessing referred constantly in his rebuttal, it is clear that my  
20 comparable companies group reflects sufficient risk to be suitable for use in this  
21 analysis.

22 **Q. IS THERE ANY OTHER FACTOR THE COMMISSION SHOULD TAKE INTO**  
23 **CONSIDERATION IN EVALUATING THE RELATIVE RISK OF ACS AND**  
24 **YOUR "COMPARABLE COMPANIES"?**

1 A. Yes. To the extent that ACS' competitive losses are its own making, whether  
2 because the acquisition price for the companies was too high or management's  
3 decision to raise retail rates simply increased the flight of customers to  
4 competitive alternatives, it is not obvious to me that a TELRIC study should  
5 reflect those losses. ACS has two primary competitors, one of which (AT&T) I  
6 understand to be strictly a reseller. Many other incumbents face more  
7 competitors, including facilities-based competitors. But, those companies have  
8 not lost as much retail market share to competition. Thus, the Commission  
9 should question whether an *efficient* competitor serving ACS' Anchorage service  
10 territory would have done as poorly. A TELRIC study should reflect the risks  
11 facing this efficient competitor, not the "actual" risk that ACS may have brought  
12 on itself.

13 **Q. MR. MEADE ALSO CRITICIZES YOUR "COMPARABLE COMPANIES"**  
14 **GROUP AS BEING FAR LARGER THAN ACS.<sup>32</sup> PLEASE RESPOND TO**  
15 **THIS CRITICISM.**

16 A. Although I agree with Mr. Meade that the companies in my group are not all as  
17 small as ACS, I disagree with any suggestion that this makes the group  
18 inappropriate as a comparison to ACS. Evidence that I discussed at length in my  
19 rebuttal testimony suggests that there may be no "size premium" whatsoever to  
20 the cost of equity. If that is correct, then there is no reason to limit the  
21 comparison to companies as small as ACS. Moreover, as I also noted in my  
22 rebuttal testimony, the exercise here is to determine the cost of capital for a

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<sup>32</sup> Meade Opposition at 7-8.

1 hypothetical efficient carrier, which might or might not be part of a company as  
2 small as ACS.

3 I chose to eliminate the very largest telephone companies from my  
4 comparables group as a measure of caution. But, Mr. Meade has failed to show  
5 that my inclusion of companies somewhat larger than ACS in any way distorted  
6 my estimate of the cost of capital.

7 **Q. HAS ACS TAKEN A CONSISTENT POSITION ON THE SELECTION OF**  
8 **COMPARISON COMPANIES?**

9 A. Not entirely. In Docket No. R-03-3, ACS has filed a chart comparing its  
10 Anchorage operations to those of a number of companies, including ALLTEL and  
11 CenturyTel, two of the six companies in my comparable companies group.<sup>33</sup> This  
12 chart was apparently produced to document a statement made on the hearing  
13 transcript by Mr. Moninski on behalf of ACS, who described the companies in  
14 question as being “other companies across the country similarly situated.”<sup>34</sup>

15 **Q. IF THE COMMISSION WERE TO ACCEPT ACS’ DESCRIPTION IN R-03-3 OF**  
16 **ALLTEL AS A “SIMILARLY SITUATED” COMPANY, WOULD THIS HAVE**  
17 **ANY IMPLICATIONS FOR THE COST OF CAPITAL IN THIS ARBITRATION?**

18 A. Yes. An independent investment advisory firm, UBS, recently issued its own  
19 estimate of ALLTEL’s weighted-average cost of capital. According to UBS, “We  
20 arrive at our target price of \$53 using a detailed discounted cash flow analysis

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<sup>33</sup> Alaska Communications System, *Notice of Filing Requested Information*, R-03-3, filed September 19, 2003. The chart is attached as Exhibit B. For the Commission’s convenience, a copy is attached as Exhibit TLM-11.

<sup>34</sup> R.03-3, Tr. 330:5-6. The relevant portion of the transcript was attached to ACS’ September 19<sup>th</sup> *Notice*.

1 (DCF). In our DCF, we use a weighted average cost of capital (WACC) of 8.9%,  
2 which incorporates a 10.25% cost of equity and a 20% debt ratio.”<sup>35</sup> Working  
3 backward from this information, I calculate that the UBS estimate of ALLTEL’s  
4 forward-looking debt cost is a mere 3.5%, far lower than the 5.84% debt cost that  
5 I have calculated for the more highly leveraged company assumed in my cost of  
6 capital analysis. I show the result of this calculation in the table below.

7 **UBS Estimate of ALLTEL Weighted-Average Cost of Capital**

<i>Component</i>	<i>Component Cost</i>	<i>% of Capitalization</i>	<i>Weighted-Cost</i>
Common equity	10.25%	80.00%	8.20%
Debt	3.50%	20.00%	0.70%
TOTAL		100.00%	8.90%

8  
9 Again, the UBS estimate of ALLTEL’s weighted-average cost of capital is  
10 far closer to my own 8.02% estimate than it is to either Mr. Blessing’s estimate or  
11 ACS’s proposed cost of capital.

12 **IV. CONCLUSION**

13 **Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY.**

14 A. My surrebuttal testimony demonstrates that ACS’s criticisms of my cost of capital  
15 analysis are invalid. ACS has not attempted to dispute any aspect of my  
16 methodology or data, other than the issues Mr. Meade raised concerning the

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<sup>35</sup> Colette Fleming, “ALLTEL: Raising Rating to Buy 1,” *UBS Investment Research: Telco Wake-Up Call*, September 26, 2003, at 3. A copy of this document is attached as Exhibit TLM-12.

1 selection of my comparable companies group. Instead, ACS witness Mr.  
2 Blessing focused almost entirely on an inappropriate comparison of my results  
3 (based on current data) to the FCC-authorized rate of return adopted 13 years  
4 ago and the *Virginia Arbitration Order* adopted cost of capital, based on data  
5 more than three years old. I have shown that the *Virginia Arbitration Order*  
6 actually validates my recommendation, when its methodology is applied to  
7 current data.

8 I have also shown that an independent estimate of the weighted-average  
9 cost of capital for ALLTEL, a firm that ACS has elsewhere described as being  
10 “similarly situated,” validates my recommendation. Finally, I have shown that  
11 inclusion of the companies in my comparable group does not understate the  
12 relevant risk-adjusted cost of capital and that those companies actually appear to  
13 be *more* risky than ACS based on objective, quantitative measures of risk that  
14 the FCC’s own Wireline Competition Bureau used in the *Virginia Arbitration*  
15 *Order* cited by ACS’ cost of capital witness.

16 For all of these reasons, as well as the reasons identified in my direct and  
17 rebuttal testimonies, I recommend that the Commission adopt GCI’s proposed  
18 cost of capital inputs.

19 **Q. DOES THAT CONCLUDE YOUR SURREBUTTAL TESTIMONY AT THIS**  
20 **TIME?**

21 A. Yes, it does.