ORIGINAL

0000033973

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED 30 NF

2001 MAY -3 P 12: 00

AZ CORP COMMISSION DOCUMENT CONTROL

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE, INC. FOR AUTHORITY TO INCREASE RATES AND FOR DISBURSEMENTS FROM THE ARIZONA UNIVERSAL SERVICE FUND.

DOCKET NO. T-02532A-00-0512

STAFF'S NOTICE OF FILING SURREBUTTAL TESTIMONY

The Arizona Corporation Commission Staff ("Staff") hereby files the Surrebuttal Testimony of Darron W. Carlson, Al Buckalew and Joel M. Reiker.

RESPECTFULLY SUBMITTED this 3rd day of May, 2001.

By: Jennifer M. Williams for
Maureen A. Scott
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
Telephone: (602) 542-6022
Facsimile: (602) 542-4870
e-mail: maureenscott@cc.state.az.us

Arizona Corporation Commission
DOCKETED
MAY 03 2001
DOCKETED BY VV

The Original and Ten Copies of the Foregoing were filed this 3rd day of May, 2001 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing were mailed/hand-delivered the 3rd day of May, 2001 to:

Conley E. Ward
GIVENS, PURSLEY LLP
277 N. 6th Street, Suite 200
P.O. Box 2720
Boise, Idaho 83701
Attorneys for Midvale Telephone Exchange, Inc.

Tamara S. Herrera
RYLEY, CARLOCK & APPLEWHITE
101 North 1st Avenue, Suite 2700
Phoenix, Arizona 85003-1973
Attorneys for Midvale Telephone Exchange, Inc.

Timothy Berg
FENNEMORE CRAIG
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012
Attorneys for Qwest Corporation

Michael M. Grant
Todd C. Wiley
GALLAGHER & KENNEDY, P.A.
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for Citizens Communications Companies

Curt Huttsell, Ph.D.
Director, State Government Affairs
Citizens Communications Company
9672 South 700 East, Suite 101
Sandy, Utah 84070-3555

By:______________________
Assistant to Maureen A. Scott

\\S\LEGAL\MAI\MAUREEN\PLEADING\00-512-NOFDT.doc

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED

2001 MAY -3 P 12:00

AZ CORP COMMISSION
DOCUMENT CONTROL

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR MARKET VALUE OF THE COMPANY FOR RATE MAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH A RETURN AND TO CONSIDER THE REQUEST TO EXTEND THE COMPANY'S CERTIFICATE OF CONVENIENCE AND NECESSITY TO INCLUDE NEW SERVICE AREAS

DOCKET NO. T-02532A-00-0512

SURREBUTTAL

TESTIMONY

OF

DARRON W. CARLSON

SENIOR RATE ANALYST

UTILITIES DIVISION

MAY 3, 2001

Jbc136t

TABLE OF CONTENTS

EXECUTIVE SUMMARY
OF THE
SURREBUTTAL TESTIMONY
OF
STAFF WITNESS
DARRON W. CARLSON
REGARDING
MIDVALE TELEPHONE EXCHANGE
DOCKET NO. T-02532A-00-0512

The surrebuttal testimony of Staff witness, Darron W. Carlson, addresses the following issues in the rebuttal testimonies of the Company's witnesses:

- Miscellaneous Interest Expense
- Staff's application of the known and measurable standard and
- Rate Case Expense.

<u>Miscellaneous Interest Expense</u> – Staff recommends excluding all interest expense from operating expenses because interest expense is a non-operating (below-the-line) expense. Pro forma interest expense relating to projected debt for funds to be used in the unserved areas is not known and measurable and should not be included in the calculation of the revenue requirement. Staff witness, Mr. Joel Reiker, is providing testimony regarding the effects of interest expense on the cost of capital.

<u>Known and Measurable Standard</u> – For purposes of determining the Company's revenue requirement in the rate case, pro forma adjustments should be limited to known and measurable changes to the historical test year amounts for revenues, expenses, and rate base. On the contrary, by necessity, rates for areas covered by a new Certificate of Convenience and Necessity ("CC&N") must be established based on projected information since no historical information exists.

<u>Rate Case Expense</u> – The Company has not refuted Staff's position that a major portion of the costs included in Company's claimed rate case expense are costs related to the CC&N extension that should be capitalized. The Company's proposed rate case expense is much greater than the amount the Commission typically recognizes for recovery in similar cases. Staff recommends that the Commission allow a more typical amount ($60,000 to be amortized over three years at $20,000 per year).

Staff continues to recommend the same intrastate operating revenue as reflected in Staff's direct testimony and schedules.

INTRODUCTION

Q. Please state your name and business address.

A. My name is Darron W. Carlson. My business address is 1200 West Washington, Phoenix, Arizona 85007.

Q. Are you the same Darron W. Carlson who previously filed direct testimony in this case?

A. Yes, I am. I filed my direct testimony on March 15, 2001.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to provide a portion of Staff's response to the rebuttal testimony filed by Midvale Telephone Exchange ("Midvale" or "Company") witnesses, Dr. Don C. Reading and Mr. Lane Williams, on April 12, 2001. The Company's rebuttal testimony is in response to Staff's direct testimony filed on March 15, 2001. I am only addressing the issues that pertain to my direct testimony. Staff witnesses, Mr. Allen G. Buckalew and Mr. Joel Reiker, are addressing rebuttal comments pertaining to issues in their direct testimonies.

Q. How is your surrebuttal testimony organized?

A. My surrebuttal testimony follows the same sequence as that of the Company's rebuttal testimony. My surrebuttal testimony begins by addressing the issues of miscellaneous interest expense and the "known and measurable" standard raised by Company witness, Dr. Don C. Reading. My surrebuttal testimony then addresses the issue of rate case expense raised by Company witness, Mr. Lane Williams.

. . .

. . .

. . .

. . .

. . .

Q. Is Staff accepting the Company's position on any issues not addressed in surrebuttal testimony?

A. No. Staff's lack of response to any issue in this surrebuttal testimony should not be construed as agreement with the Company's rebuttal testimony, rather, where there is no response, Staff relies on its original direct testimony.

MISCELLANEOUS INTEREST EXPENSE

Q. Have you reviewed the Company's rebuttal testimony regarding the miscellaneous interest expense?

A. Yes, I have.

Q. What is the Company's position?

A. The Company's position is that the calculation of the weighted average cost of capital and the capital structure should be consistent with Staff's disallowance of interest expense as an operating expense.

Q. What else did you find in your review?

A. The Company claims that recalculating the weighted cost of capital to reflect the disallowance of Test Year and pro forma interest expense increases the weighted cost of capital from 11.2 percent to 11.3 percent.

Q. Do you agree with the Company's conclusion?

R. No. As explained in the surrebuttal testimony of Staff witness, Mr. Joel Reiker, Staff's calculation of the weighted average cost of capital correctly reflects existing loans and interest expense and excluded pro forma amounts related to the unserved areas.

. . .

. . .

. . .

KNOWN AND MEASURABLE STANDARD

Q. Please respond to the rebuttal testimony of the Company's witness, Dr. Don C. Reading (Page 8, Line 10), that you and Mr. Buckalew have inconsistently applied the known and measurable standard for recognizing items for ratemaking purposes.

A. Mr. Buckalew and I have treated the known and measurable standard in a manner that is appropriate to the different circumstances. I have applied the known and measurable standard to the existing service area. Mr. Buckalew's testimony pertains to a new unserved service area where there are no known and measurable revenues, expenses, or rate base. By necessity, revenues and costs for the new service area must be projected. Mr. Buckalew's treatment is consistent with the Arizona Corporation Commission's ("Commission") normal recognition of estimates as the basis for establishing initial rates for a utility.

Q. Then the recommendations of Mr. Buckalew and you are the same as they would have been had the Company filed the rate case and request for an extension of its Certificate of Convenience and Necessity ("CC&N") separately, is that correct?

A. Yes. For purposes of the rate case, I have applied the known and measurable standard for recognizing revenue, expenses, and rate base components in the same manner as if the rate case had been filed separately from the CC&N application. Mr. Buckalew recognized projected costs in his analysis of the new service area in the same manner that CC&N applications are normally evaluated. Had the Company not filed a combined rate case and CC&N application the apparent confusion regarding consistency in the application of the known and measurable standard would have been avoided.

. . .

. . .

. . .

. . .

. . .

Q. Why did the Company file a combined three-part permanent rate, Extended Area Service ("EAS") and CC&N extension case?

A. The Commission's rules require that any EAS consideration must be done under the auspices of a rate case filing. Therefore, the Company was required to file its EAS request as part of this rate case.

However, the rules are not the same for CC&N extensions. Staff asked the Company to separate the CC&N extension from the rest of the rate case to simplify both filings. The Company refused to separate or allow bifurcation of any of the components of this case.

Q. Why would the Company refuse to remove the CC&N extension from the rest of the rate case filing?

A. The Commission's current rules only allow consideration for Arizona Universal Service Funds ("AUSF") under the auspices of a rate case filing. The Company believes that AUSF funding is necessary prior to serving customers to make the CC&N extension viable. However, these same current rules also indicate that a utility must provide embedded costs for the potential support area and since there are no embedded costs in the unserved areas, Staff believes the rules do not allow any AUSF funding for the new unserved areas.

In conclusion, Staff has properly applied the known and measurable standard in each of the different aspects of this filing.

RATE CASE EXPENSE

Q. Have you reviewed the Company's rebuttal testimony regarding the rate case expense?

A. Yes, I have.

. . .

. . .

Q. What did you find in your review?

A. The Company objects to Staff's reductions out of hand because the Company has estimated that it will expend in excess of $150,000 on this entire proceeding. In Staff's direct testimony, Staff noted that $41,610 of the rate case expense was for engineering costs directly related to the CC&N extension – not the rate case. Staff recommended that this amount be capitalized in the plant costs for the new unserved areas, if and when, any funds are expended for plant. Additionally, a large portion of the remaining $108,390 is also attributable to the CC&N extension. The Company has not refuted Staff classification of these costs.

The typical level for rate case expense approved by this Commission for small telephone utility rate cases has been in the $60,000 range and amortized over three years. Staff believes that this amount fairly represents the Company's approximate costs, excluding all the costs attributable to the CC&N extension, that will be expended in the rate case portion of this proceeding.

The Company also complained that this proceeding was far more expensive than it anticipated and complained that Staff caused a great deal of the excess expenditure. Staff cooperated with the Company's efforts to reduce rate case expense, including sending a Staff auditor to the Company's office in Idaho for a week.

The Company also complained that the largest cost was suffered from responding to Staff's discovery requests. The Company states that it responded to more than 115 questions. The number of data requests by Staff is typical and does not justify the amount of rate case expense proposed by the Company.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE
ARIZONA CORPORATION COMMISSION

In the Matter of the Midvale Telephone Exchange, Inc.'s Application for Authority To Increase Rates and for Disbursements from the Arizona USF.	)	DOCKET NO. T-02532A-00-0512

SURREBUTTAL TESTIMONY OF

ALLEN G. BUCKALEW

ON BEHALF OF

THE ARIZONA CORPORATION COMMISSION

MAY 3, 2001

Executive Summary
of the Surrebuttal Testimony
of Allen G. Buckalew

Under the current Commission's rules, drawing from the AUSF is not allowed without plant in service and a cost study for the support area. I have suggested that the Company seek Federal high cost support to bring service to Millsite and Silver Bell. I have proposed an initial exchange rate of $24.00 per month for customers in these unserved areas. This rate was developed based on Midvale's current revenue experience and its estimated cost of serving these new customers.

My analysis has assumed that the Company received less support per line from the Federal USF than it currently does. In calculating my hypothetical initial rate of $24.00 per month for the 278 expected customers, I included an annual support in the amount of $71,651. This amount, which represents one-half the current level of Interstate USF revenue, more than likely understates future revenues.

Q. ARE YOU THE SAME ALLEN G. BUCKALEW THAT FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. This testimony corrects the interpretation made by the Company of my analysis filed in this case about Midvale's intentions to provide service to the unserved areas of Millsite and Silver Bell. In addition, there a couple of areas related to Midvale's certificate of convenience and necessity expansion that need some further clarification.

Q. WHAT NEEDS TO BE CLARIFIED ON MIDVALE'S REQUEST FOR EXPANSION OF ITS CERTIFICATE?

A. In its testimony Staff recommends that Midvale's certificate of convenience and necessity to include the unserved areas of Millsite and Silver Bell be approved. Since then it has been brought to my attention that the Company's request for service in Section 33 (see Sheet 2 of 2 of the Company's application of the proposed Henderson Valley Service Boundaries) is already included in Qwest's service area. Therefore, it should be removed from the Company's request. I would also like to point out that Qwest exchanges surround, or are near, many of the areas requested by Midvale. For example, the Rio Verde area, an area that

Midvale is requesting to serve, is surrounded on three sides by Qwest service areas. Therefore, although Staff is recommending approval, we would like to alert the Commission to some potential future problems. For example, once Midvale serves the Rio Verde area, customers will have a different area code and local calling area than the surrounding customers. In effect, Rio Verde is a hole (no service area) in Qwest's service area that Staff agrees must be served. However, the Commission may want to consider further analysis of areas like Rio Verde to determine whether Midvale or Qwest is the best provider of service. Midvale does not propose including Rio Verde in the Phoenix calling area, therefore, not only will neighbors have different area codes, but toll calls will also be necessary to call across the street. The Staff expects that as soon as Midvale provides service, it will, and should, request some form of EAS for these customers with appropriate supporting cost and demand data.

Q. COULD YOU BRIEFLY RESTATE YOUR ANALYSIS OF THE UNSERVED AREAS?

A. Yes. My analysis starts from the fact that the Commission's rules do not allow drawing from AUSF without actual plant in service and a cost study for the support area. Therefore, other alternatives need to be examined. For example, I suggested that the Company seek Federal high cost support to bring service to these unserved areas (Direct Testimony, page 14, lines 9-17). I also constructed a hypothetical cost and revenue analysis using the Company's own analysis. The purpose of that analysis was to provide the Company with an initial local exchange rate that Staff would support to initiate service.

In that analysis I assumed that the Company received less support from the Federal USF than it currently receives for its existing customers. I used 50% of the existing level of Federal USF support revenues and assumed that toll and access revenues would be similar to the Company's existing customers' revenues. My analysis suggested a local exchange rate of $24 per month for Millsite and Silver Bell. This rate exceeded what I had determined as the average residential local exchange rate for existing customers, but reflected the higher cost of servicing these new customers.

Q. HOW DID MIDVALE INTERPRETE YOUR ANALYSIS?

A. The main concern of Midvale's Witness, Dr. Reading, is based on his claim that I included $164,437 as Federal support for Millsite and Silver Bell. I did not include $164,437 as Federal USF support for Millsite and Silver Bell. I did use $164,437, which is one-half of the existing level of support for existing customers, to calculate an average non-local exchange revenue for existing customers. The average non-local exchange revenue for existing customers was used to estimate non-local exchange revenue for new customers in the unserved areas and to develop a local exchange rate of $24 per month per customer in the unserved areas.

Q. HOW DID YOU CALCULATE A RESIDENTIAL RATE OF $24.00 FOR THE UNSERVED AREAS?

As I was quoted in Mr. Reading's rebuttal testimony, I assumed that "if the Millsite and Silver Bell customers have about the same toll, other service usage, access charges and Federal Revenues as Midvale's existing exchanges, the local exchange rate would have to be about $24 per month in order to cover all expenses for providing services to these areas" (Reading Rebuttal Testimony, page 7, lines 20-26).

In my estimated residential rate of $24 for Millsite and Silver Bell, I used the Company's existing level of revenues from services other than local exchange to estimate the level that is likely to exist in Millsite and Silver Bell once plant is built. As shown in Exhibit AGB-1 in footnote no. 2, I used the Company's existing Network Access Service Revenue of $206,624, plus one-half the Interstate USF Revenue of $328,874, which is $164,437, plus Directory Revenue of $1,759, plus Miscellaneous Revenue of $22,081, plus Uncollectible Revenue of ($1,279). This results in Total Revenue (without exchange revenues) of $393,622. I then divided that total revenue by the number of existing lines, 638, to get an average non-exchange revenue per line of $617 per year for existing customers. I used the $617 per year per line to determine the total other revenue (excluding local exchange service) for the unserved areas. In other words, I assumed the same revenue patterns of Midvale's 638 current customers, however, I included only 50% of the current Federal USF revenue.

The average revenue from Interstate USF assuming 50% of the existing level is: $164,437 divided by the number of existing customers of 638, or $257.74 per customer. I used this level to estimate Interstate USF for the unserved areas. That is, 278 expected customers in the unserved areas times $257.74 for a total of $71,651. The annual USF support I included for Millsite and Silver Bell was only $71,651.

Once these other revenues were estimated as described above, they were subtracted from the costs and the difference was used to estimate the local exchange rate of $24 per month in the unserved areas. Of course, this estimate is hypothetical because the plant has not been built and costs have not been incurred. My thought here was to provide Midvale with an initial rate.

Q. THE COMPANY'S CLAIM THAT YOU ASSUMED $164,437 OF FEDERAL SUPPORT IS WRONG, CORRECT?

A. Yes. Dr. Reading states in his rebuttal that my estimated Federal USF amount is

$164,437, and that Midvale would lose more than $328,874 during the first 2 years of providing service. This is simply wrong. First, Dr. Reading assumed no support for two years. Midvale can seek a waiver of the FCC rules as it has done in the past. The FCC's primary directive is universal service. Second, if Midvale received no Interstate USF, then the two-year loss would be $143,302 (or two times $71,651), not $328,874. Remember that I assumed only one-half the existing level of support per customer. Assuming half the current level of Federal USF for these high cost unserved areas is extremely conservative.

Q. COULD YOU SUMMARIZE YOUR REBUTTAL TESTIMONY?

A. Under the current Commission's rules, drawing from the AUSF is not allowed without plant in service and a cost study. I have proposed an initial exchange rate of $24.00 per month for customers in Millsite and Silver Bell. This rate was developed based on Midvale's current revenue experience and its estimated cost of serving these new customers. The use of one-half the current level of Interstate USF revenue more than likely understates future revenues.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes; it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF MIDVALE TELEPHONE EXCHANGE, INC., FOR AUTHORITY TO INCREASE RATES AND FOR DISBURSEMENTS FROM THE ARIZONA USF	))))))	DOCKET NO. T-02532A-00-0512

SURREBUTTAL

TESTIMONY

OF

JOEL M. REIKER

SENIOR RATE ANALYST

UTILITIES DIVISION

MAY 3, 2001

Jbc137t

TABLE OF CONTENTS

EXECUTIVE SUMMARY
OF THE
SURREBUTTAL TESTIMONY
OF
STAFF WITNESS
JOEL M. REIKER
REGARDING
MIDVALE TELEPHONE EXCHANGE, INC.
DOCKET NO. T-02532A-00-0512 ET AL

The surrebuttal testimony of Staff witness, Joel M. Reiker, addresses the following issues in the rebuttal testimony of the Company's witness, Don C. Reading, Ph.D:

<u>Miscellaneous Interest Expense</u> – Staff rejects the Company's claim that an adjustment needs to be made to the capital structure if interest expense is excluded from operating expenses. The capital structure recommended by Staff already includes the appropriate amount of debt and interest expense.

<u>Comparable Earnings Analysis</u> – The comparable earnings analysis was not used to derive Staff's recommended cost of equity because the analysis produced results that were unreasonable, and a significant portion of the revenues of the comparable companies comes from competitive operations.

<u>Capital Asset Pricing Model ("CAPM")</u> – The beta reported by Value Line for the comparable companies reflects the entirety of their operations, which includes unregulated competitive sectors currently in the growth stage of the business life cycle. Accordingly, Staff has adjusted the beta used in its CAPM calculation to more accurately reflect the risks associated with regulated operations.

<u>Discounted Cash Flow ("DCF") Method</u> – The basis of Staff's recommended 11.50 percent cost of equity recommendation is the DCF earnings growth result of 11.80 percent. The 11.80 percent was adjusted downward to account for the Company's equity-rich capital structure and the business make-up of the comparable companies.

<u>Risk Adjustment</u> – The Company's capital structure, cost of debt, and concentration in the local telephone industry contributes to a lower cost of equity than the comparable companies.

<u>Unregulated Services</u> – The rate of return set by the Commission should reflect the risk associated with the Company's regulated local telephone operations, not its unregulated subsidiaries.

<u>Interpretation of Analyses</u> – Staff's analyses and the analyses of the Company's witness both support Staff's recommended cost of equity of 11.50 percent.

Staff continues to recommend the same cost of capital as reflected in Staff's direct testimony and schedules.

INTRODUCTION

Q. Please state your name and business address.

A. My name is Joel M. Reiker. My business address is 1200 West Washington, Phoenix, Arizona 85007.

Q. Are you the same Joel M. Reiker who previously filed direct testimony in this proceeding?

A. Yes.

Q. Are there any changes or corrections to your Direct Testimony that you wish to make at this time?

A. No.

Q. Have you reviewed the rebuttal testimony of the Company's witness, Don C. Reading, Ph.D., concerning your direct testimony?

A. Yes, I have.

Q. What is the purpose of your surrebuttal testimony?

A. I am responding to criticisms of my direct testimony contained in the rebuttal testimony of Dr. Reading. I will also address the issue of miscellaneous interest expense.

Miscellaneous Interest Expense

Q. What is the Company's rebuttal position regarding the treatment of interest expense?

A. According to Dr. Reading's rebuttal testimony (Page 6, Lines 12 through 20), the Company will accept the adjustment made by Staff witness, Mr. Darron Carlson, to exclude interest expense from operating expenses providing that a corresponding adjustment is made to the capital structure. The Company claims that a corresponding change to the capital structure would result in an increase in the weighted cost of capital from 11.2 percent to 11.3 percent.

Q. Does a change in interest expense change the capital structure?

A. No. The capital structure is composed of equity and debt obligations, not interest expense.

Q. Did Dr. Reading provide supporting calculations to show how he derived an increase in the proposed cost of capital?

A. No.

Q. What would cause the cost of capital to increase as suggested by Dr. Reading?

A. Including additional interest expense without recognizing the corresponding debt would cause a calculation of the cost of capital to increase.

Q. Is it appropriate to recognize interest expense without recognizing the corresponding debt in a cost of capital calculation?

A. No. Recognizing interest expense without also recognizing the corresponding debt creates a mismatch that results in an incorrect calculation of the cost of capital.

Q. What amounts of interest should be included in the calculation of the cost of capital?

A. As shown in the Company's response to Staff data request JMR-6-105, the Company's total proposed interest expense for the year ending December 31, 1999, was $25,107. The $25,107 pertains to the existing loans and is known and measurable. Therefore, only interest expense of $25,107 should be included in the cost of capital calculation.

Q. What amount of debt obligations should be included in the calculation of the cost of capital?

A. As discussed previously in this testimony, the amount of debt included in the calculation should be consistent with the amount of interest recognized. Thus, only the existing debt should be included in the cost of capital calculation.

Q. What amounts of interest and debt are included in your recommended cost of capital?

A. According to the Company's application, the stated interest rates on the Company's RUS and RTFC loans are 5.00 percent and 6.10 percent, respectively. Using these interest rates, I calculated the Company's weighted-average cost of debt of 5.47 percent. The effective cost of debt, calculated by dividing test year interest expense by the principal amount outstanding ($25,107 ÷ $469,217), was 5.40 percent. My recommended cost of debt correctly includes only the $25,107 in interest expense related to existing loans. Therefore, the cost of capital as stated in my direct testimony is correct.

Comparable Earnings Analysis

Q. Please summarize Dr. Reading's rebuttal to your comparable earnings analysis.

A. By using selective quotations from my direct testimony, Dr. Reading implies that I disregarded the results of the comparable earnings analysis because the results are skewed by U S WEST's reported return on equity ("ROE") of 199.7 percent and 130.8 percent in 1998 and 1999, respectively. Dr. Reading further states that my comparable earnings analysis would still have produced results in excess of the 13 percent requested by Midvale had U S. WEST been eliminated from the analysis.

Q. Does Dr. Reading's rebuttal accurately reflect your reasons for not relying upon your comparable earnings analysis?

A. No. I have disregarded the results of my comparable earnings analysis because I believe they are unreasonably high for use in determining the cost of equity for regulated telephone operations, not because the results are skewed by U S WEST's reported ROE.

Q. Is Dr. Reading's assertion correct that your comparable earnings analysis would have produced results in excess of 13 percent even if U S WEST had been eliminated from the analysis?

A. Yes, however, he failed to recognize that a significant portion of the revenues of the comparable companies came from competitive operations. It is a dubious assumption that the 20 to 30 percent equity returns reported in Value Line for the comparable companies are entirely attributable to regulated local telephone operations. Historically, regulated utilities have not shown the ability to sustain long-term 20 to 30 percent equity returns.

Capital Asset Pricing Model ("CAPM")

Q. Is Dr. Reading's statement that you have simply disregarded the objective results of your comparable earnings and CAPM analyses, and substituted your own judgement correct?

A. No. I have disregarded the results of my comparable earnings analysis for the appropriate reasons stated above. All of the sample companies used in my analysis are involved to some degree in data, Internet, and wireless operations. These sectors are currently in the growth stage of their life cycle. High earnings and increased risk are a characteristic of an industry in the growth stage. To the contrary, regulated local telephone service is a mature industry. Earnings and risk in mature industries are normally less than those for growth industries. Because the sample companies report financial information on a consolidated basis, Value Line's beta reflects the entirety of their operations, not just their regulated local telephone operations. To account for the reduced risk of regulated local telephone companies, I have adjusted the beta used in my CAPM analysis.

Q. How have you adjusted the beta used in your CAPM study to account for this risk differential?

A. Rather than simply adjusting the beta downward to account for decreased risk, I employed a beta that is representative of regulated operations. Of all the industries followed by Value Line, the water utility industry most closely fits this profile. As of November 3, 2000, Value Line's beta for water utility companies ranged from .45 to .60, with an average of .55. I used a beta of .60, which is at the upper limit of that range. Value Line has since revised its beta estimate for the water utility companies it tracks. Value Line's revised beta estimates now range from .55 to .65, with an average of .61. Thus, my beta of .60 closely represents the midpoint for regulated utilities.

Discounted Cash Flow Method ("DCF")

Q. Have you simply disregarded the results of your Discounted Cash Flow ("DCF") analysis and relied on your own judgment, as Dr. Reading claims?

A. No. The basis of my 11.50 percent cost of equity recommendation is the DCF result of 11.80 percent based on earnings growth. The 11.80 percent result was adjusted downward to account for Midvale's equity-rich capital structure and the business make-up of the sample companies.

Q. Dr. Reading characterizes your recommended ROE as an adjustment downward from the results of your DCF analyses using sustainable earnings on average and spot stock prices. Is his characterization accurate?

. . .

. . .

A. No. My recommended ROE of 11.50 percent is no more a downward adjustment from the results of my sustainable earnings analyses than it is an upward adjustment from the 4.6 percent results of my dividend growth analyses.

The results of my DCF analysis using sustainable earnings with the average and spot stock price were both 16.5 percent. As Dr. Reading acknowledged, these results are unreasonably high due to U S WEST's reported ROE of 199.7 percent and 130.8 percent in 1998 and 1999, respectively. However, even if U S WEST were removed from the study, these results would be unreasonable expectations for sustainable earnings. Because sustainable earnings growth is the product of the retention ratio and ROE (sustainable growth = retention ratio x ROE), a ROE that is not truly reflective of regulated local telephone operations is problematic in its determination. Therefore, I would dismiss these results for the same reasons I have dismissed the results of my comparable earnings analysis.

The results of my DCF analysis using dividend growth with the average and spot stock price were both 4.6 percent. As I stated in my direct testimony, this is well below the Company's cost of debt, as well as the current prime rate. I ignored these results when estimating Midvale's cost of equity because large diversified telecommunications companies, like the ones used in my sample, have been foregoing dividend increases consistent with rises in earnings in order to invest in high-growth competitive operations.

Risk Adjustment

Q. Please respond to Dr. Reading's assertions that Midvale should receive a higher return on equity than the comparable companies, and that companies like BellSouth are less risky than Midvale.

. . .

A. Midvale's capital structure, cost of debt, and concentration in the local telephone industry contribute to a lower cost of equity than the comparable companies.

Q. How is Midvale's relative cost of equity affected by its capital structure?

A. Midvale's rate making capital structure for this proceeding is over 75 percent equity. The average capital structure of the sample companies used in my analysis is only 51 percent equity. A difference of this magnitude warrants an adjustment for financial risk.

Q. How does the amount of equity in a company's capital structure affect financial risk?

A. Financial risk is the risk to shareholders resulting from the use of debt. As I stated in my direct testimony, equity financing is generally more expensive than debt financing. Therefore, a firm that carries a large amount of equity in its capital structure will have a higher overall cost of capital, but lower financial risk. Increasing the amount of debt in the capital structure increases financial risk. In turn, equity investors will demand a higher rate of return on their investment to account for the increased financial risk.

As I mentioned above, Midvale's ratemaking capital structure in this proceeding consists of over 75 percent equity. The capital structures of each of the comparable companies used in my analysis contain substantially less equity and more debt than that used by Midvale in this proceeding, thus exhibiting greater financial risk. Greater financial risk for the comparable companies versus Midvale places an upward influence on equity investors' earnings expectations for those companies.

. . .

. . .

. . .

Q. Have you examined Midvale's cost of debt compared to the comparable companies used in your analysis?

A. Yes. Midvale's cost of debt in this proceeding is 5.47 percent, compared to a debt cost of approximately 7 percent for the companies in my analysis. In his direct testimony, Dr. Reading claims that:

> Small, closely held firms like Midvale must obtain the equity portion of new investment solely from profits, and the debt portion from loans that may carry above-average interest rates.

Midvale isn't borrowing at above-average interest rates. In fact, I have analyzed several financing applications of small, closely held utilities like Midvale, and found their cost of debt is generally below average. Midvale's low cost of debt reduces its financial risk and cost of equity.

Q. How is Midvale's relative cost of equity affected by operating characteristics?

A. As Dr. Reading has acknowledged, a significant portion of the comparable companies' earnings are derived from unregulated, competitive operations. Dr. Reading cites BellSouth as having revenues of $26,200,000. However, only $11,200,000 of BellSouth's revenues are from local service. The remaining revenues come from unregulated, competitive operations that are more risky than regulated local telephone operations. BellSouth for example, has interests in wireless operations in 10 Latin American countries; this type of operation surely bares greater risk than Midvale's regulated local telephone service.

The larger comparable companies are also experiencing competition in local telephone service lines. For example, Qwest is currently facing limited competition in some parts of the Phoenix metropolitan area. Cox Communications is currently offering basic local service in several residential areas in direct competition with Qwest. In downtown Phoenix and Tucson, there are several telecommunications services providers who are seeking to provide service to business customers. Midvale experiences none of this competition. Thus, Dr. Reading's claim that Midvale not only has its own unique problems but also experiences the same problems as larger carriers is inaccurate. Midvale benefits significantly from the absence of existing direct competition.

Unregulated Services

Q. Dr. Reading has implied that Midvale's risk is similar to the comparable companies in your analysis because Midvale is attempting to develop unregulated, competitive subsidiaries, just as the comparable companies have established. Are the risks related to unregulated, competitive services directly relevant to the determination of Midvale's cost of capital?

A. No. The purpose of this proceeding is to set rates for Midvale's regulated local telephone operations. The rate of return set by the Commission should reflect the risk associated with Midvale's regulated local telephone operations, not its unregulated services or subsidiaries. The risks and costs of unregulated activities should not be reflected in regulated rates.

Interpretation of Analyses

Q. Do you agree with Dr. Reading's assertion that your own studies confirm that a 13.00 percent ROE is reasonable for Midvale?

A. No. After eliminating my comparable earnings results, which ranged from 20 to 30 percent, the average of all of my historical DCF and unadjusted CAPM analyses is exactly 11.80 percent. In fact, Dr. Reading's studies suggest a cost of equity very close to what I have recommended. In his direct testimony, Dr. Reading recommends that the Commission concentrate on the mid-range of his estimates; 10.9 percent to 12.25 percent for the DCF method, 11.0 percent to 12.25 percent for his risk premium calculation, and 12.0 to 14.0 percent for the comparable earnings approach. As I stated in my direct testimony, I believe Dr. Reading's comparable earnings analysis is flawed and results in excessive cost of equity results for Midvale because it relies solely on unregulated industrial and manufacturing firms. The mid-range of his DCF and risk premium approaches is 11.58 percent and 11.63 percent, respectively.

The Company's request for a 13.00 percent cost of equity is excessive. This Commission has consistently accepted the results of the DCF methodology as used by Staff. As my own DCF analysis and the DCF analysis of the Company's witness show an 11.50 percent cost of equity is fair and reasonable for Midvale.

Q. Does this conclude your testimony?

A. Yes, it does.