Before the

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Review of: Unbundled Loop and Switching Rates; the Deaveraged Zone Rate Structure; and Unbundled Network Elements, Transport, and Termination (Recurring Costs)	**Docket No. UT-023003**

Surrebuttal Testimony

of

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on behalf of

AT&T Communications of the Pacific Northwest, Inc.

REDACTED VERSION

May 12, 2004

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SURREBUTTAL TESTIMONY

Introduction

Q. Please state your name, position and business address.

A. My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Boston, Massachusetts 02108.

Q. Have you previously submitted testimony in this proceeding?

A. Yes, I submitted direct testimony on behalf of AT&T Communications of the Pacific Northwest, Inc., on April 20, 2004.

Q. What is the purpose of your testimony at this time?

A. I address and respond to Dr. Vander Weide's contention that his proposed 13.95% cost of equity "reflects the competitive, technology, and regulatory risks that Verizon NW faces in making network investments under the TELRIC standard." I also comment upon Mr. Spinks's suggestion, despite his (correct) conclusion that Dr. Vander Weide's cost of equity DCF model uses firms that "are not an appropriate comparable group to use for determining Verizon's cost of equity," that Dr. Vander Weide's 13.95% figure may nevertheless be used as an "upper limit" for the cost of equity,

Summary of testimony

Q. Please summarize your responses to both witnesses.

A. Dr. Vander Weide bases his cost of equity calculations upon a proxy group of competitive industrial companies *none of which are in the business of providing regulated local exchange telephone services* – the precise business in which Verizon Northwest is engaged. The effect of this extrapolation from a collection of patently noncomparable companies is to grossly overstate the cost of equity confronting Verizon Northwest with respect to unbundled network elements (UNEs) being provided under conditions of facilities-based competition. The DCF model being relied upon by Dr. Vander Weide imputes dividend growth rates to Verizon that are multiples of that actually being experienced by, and being predicted by analysts for, the telecommunications industry.[1]

While Mr. Spinks correctly recognizes that Dr. Vander Weide's cost of equity DCF model uses firms that "are not an appropriate comparable group to use for determining Verizon's cost of equity,"[2] he nonetheless adopts Dr. Vander Weide's proposed cost of equity of

1. I/B/E/S, a collection of consensus growth rates, predicts the telecommunications industry will grow as 6.47%.

2. *Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure,* WUTC Docket No. UT-023003, Response Testimony of Thomas L. Spinks on behalf of the WUTC Staff, April 20, 2004 ("*Spinks (WUTC Staff) Response Testimony*), at 15.

13.95% as an "upper limit."[3] Inasmuch as the basis for Dr. Vander Weide's calculation is fatally flawed, there is no rationale for accepting his figure as an "upper limit" or for any other purpose.

Because the data set upon which it relies specifically excludes all four of the RBOCs and all other telecommunications firms, Dr. Vander Weide's DCF model teaches nothing about the cost of equity confronting Verizon with respect to the provision of UNEs or for any other purpose.

Q. Dr. Vander Weide suggests that his proposed 13.95% cost of equity "reflects the competitive, technology, and regulatory risks that Verizon NW faces in making network investments under the TELRIC standard."[4] Do you agree?

A. No. Dr. Vander Weide's analysis actually reflects the significantly greater risks confronting a group of industrial companies *none of which are in the business of providing local telecommunications services or unbundled network elements*.

Q, In what way does the cost of equity for the average industrial company in Dr. Vander Weide's "sample" differ from that of telecommunications companies in particular?

3. *Id*., at 15.

4. *Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure*, WUTC Docket No. UT-023003, Reply Testimony of Dr. James Vander Weide on behalf of Verizon Northwest, April 20, 2004 ("*Vander Weide Reply Testimony*"), at 14.

A. In short, the average industrial company in Dr. Vander Weide's hand-picked sample faces significantly higher levels of risk leading to a higher cost of equity than is currently being exhibited by telecommunications firms.

Q. How does Dr. Vander Weide measure the cost of equity?

A. Dr. Vander Weide uses a one-stage perpetual-growth discounted cash flow (DCF) model. According to this version of the DCF, the cost of equity (r) is expressed as;

$$r = (D/P) + g$$

where P = the original price of equity
D = the dividend payout (D)
g = the dividend growth rate

As is evident from this equation, the calculated cost of equity is particularly sensitive to the dividend growth rate that is supplied to the calculation. The dividend growth rates that Dr. Vander Weide has supplied to his calculation – whose market cap-weighted average is 11.9% – grossly exceeds the far more modest dividend growth typical of telecommunications firms in general and of RBOCs in particular. According to the Institutional Brokers Estimate System (I/B/E/S), a well accepted source that collects analysts' predicted earnings

growth for companies[5] and that has been specifically relied upon by Dr. Vander Weide as the basis for his dividend growth rate projection, the I/B/E/S consensus estimate of the average long-term earnings growth rate for Verizon is 3.7% per year. Indeed, the I/B/E/S consensus projections for the other RBOCs and for most other telecommunications firms are not very different (see Table 1 below). The projected long term earnings growth rate for SBC is 4.0%, 3.9% for BellSouth, and 0.0% for Qwest. Moreover, the weighted average growth rate being projected for all telecommunications firms (which includes pure wireless carriers and IXCs along with other ILECs and the RBOCs) is only 6.47%. Since Dr. Vander Weide's calculation assumes dividend growth rates that are nearly double those for telecom firms generally and roughly triple those for the RBOCs, his model necessarily calculates a grossly excessive estimate of the cost of equity for an ILEC providing UNEs in a competitive environment.

5. *Institutional Brokers Estimate System* (I/B/E/S), Long Term Earnings Growth as of 4/2004.

Table 1

I/B/E/S Long Term Earnings Growth Rate Projections
April 2004

Company	Market Capitalization	I/B/E/S Long Term Earnings Growth
ALLTEL	$15.2	5.40%
AT&T	$15.4	-13.80%
AT&T Wireless	$36.6	27.10%
BellSouth	$48.3	3.90%
CenturyTel	$3.8	4.30%
Citizens	$3.6	8.20%
Qwest	$7.1	0.00%
SBC	$78.4	4.00%
Sprint Corp.	$24.1	15.50%
Verizon	$99.8	3.70%
Average RBOC (VZ, BSC, SBC, Qwest)		3.73%
Average ILEC (RBOCs+ALLTEL, CenturyTel, Citizens and Sprint)		4.90%
Average for all Telecom firms		6.47%
Average for Vander Weide Sample Industrial Firms used in VZ Cost of Capital Model		11.90%

Q. Does Dr. Vander Weide acknowledge the fact that projections of earnings growth rates for Verizon and the other RBOCs are so much below the "average" of the industrial companies that he had selected for his sample?

A. No. Dr. Vander Weide does not discuss the RBOCs' low growth rates, which in turn result in costs of equity that are correspondingly lower than the "average" for all of the industrial firms in his proxy. Importantly, Dr. Vander Weide does not even mention that the RBOCs

(and all other telecom companies) have been excluded from his proxy of industrial firms *precisely because their costs of equity are so low*.

Despite Dr. Vander Weide's assurance that the "cost of capital [he] recommend in [his] direct testimony ... fully reflects the competitive, technology, and regulatory risks that Verizon NW faces in making network investments under the TELRIC standard,"[6] he offers no specific facts or evidence as a basis for such assurance. Moreover, Dr. Vander Weide's cost of equity in no way reflects the risks of *any* telecommunications carrier – a point that the Wireline Competition Bureau in the *Virginia Arbitration Order* specifically found to be necessary.[7] Instead, Dr. Vander Weide's cost of equity uses a proxy of competitive *non-telecommunications* industrial companies that exclude all four of the RBOCs and that has an average long-term earnings growth rate of 11.9%.

Q. What rationale did Dr. Vander Weide offer as the basis to exclude the RBOCs from his proxy of industrial firms?

A. Dr. Vander Weide offered no specific rationale, but he does describe a certain amount of pre-processing that was conducted on the full S&P data set prior to its use in his cost of equity calculations. Dr. Vander Weide excluded firms whose cost of equity fell below the

6. *Vander Weide (Verizon NW) Reply Testimony*, at 14.

7. *Petition of Worldcom and AT&T for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia*, CC Docket Nos. 00-218 and 00-251, *Memorandum Opinion and Order*, 18 FCC Rcd 17722 (2003) ("*Virginia Arbitration Order*"), at para. 67.

current yield on Moody's A-rated industrial bonds (6.26%) or was above 20%, excluded firms with negative earnings growth rates and firms that did not pay dividends, excluded the highest and lowest quartile of firms with respect to their projected earnings growth rates, and used only the remaining middle two quartiles to calculate his weighted-average cost of equity for an industrial firm. Dr. Vander Weide does, however, advance a basis for using "the S&P industrial group" rather than specifically focusing upon telecommunications firms. Essentially, he concludes that since no current company provides UNEs against a ubiquitous facilities-based competitor, a proxy of industrial firms would best represent this risk. Of course, having methodically *excluded* all four of the RBOCs and, for that matter, all other telecom firms in the S&P industrials, Dr. Vander Weide has created a "sample" of companies *not a single one of which provides any "unbundled network elements in a competitive market"* or, for that matter, any unbundled network elements at all!

Q. Is there any basis for Dr. Vander Weide's theory that the risks of providing UNEs are better represented by a proxy of competitive industrial firms than by the firms that actually provide UNEs or other telecommunication services?

A. No. Apparently, Dr. Vander Weide believes that an entirely hypothetical "UNE-only company" would confront significantly different – and greater – risks than other telecommunication service providers. Incredibly, when expressed in terms of the DCF model used by Dr. Vander Weide, this implicitly assumes that this hypothetical UNE-only provider would experience earnings growth rates roughly triple those of Verizon and the other RBOCs. There is, of course, absolutely no theoretical basis for this notion, nor does

Dr. Vander Weide even attempt to suggest one. UNEs do not represent a new or unique market – they are used principally to provide local voice-grade telephone service. Therefore, an estimate of the cost of equity for a hypothetical UNE-only company must consider the current growth rates of companies that provide UNEs (the BOCs) or at the very least the growth rates of all companies that provide local telecommunications service. Even under the most extreme set of assumptions – specifically, one in which each of the existing BOCs is assumed to be structurally separated into a wholesale "UNE-only" company and a retail company that purchases UNEs from the wholesale company for 100% of its retail services (something that Verizon has strenuously resisted) – there is no basis to believe that the earnings growth of the wholesale entity would exceed that for the integrated BOC. Indeed, to the extent that demand growth for the wireline local network components that are required to be offered as UNEs – principally subscriber loops and, perhaps, switch ports – may actually decline in the coming years due to intermodal competition from wireless and broadband services, precisely the opposite condition may obtain – i.e., the earnings growth in a bifurcated BOC UNE-only entity could well be less than that for the BOC as a whole.

Q. If you were to apply the current cost of equity, dividends, and growth rate for telecommunications carriers to Dr. Vander Weide's one-stage DCF model, what would the resulting cost of equity be for the RBOCs and for other telecommunication providers?

A. Applying Dr. Vander Weide's one-stage continuous-growth DCF model, the cost of equity confronting Verizon would be 7.78%. For the average RBOC or the average ILEC, the cost of equity would be 8.36% and 9.20% respectively (see Table 2 below). These values are

obviously well below the 13.95% cost of equity that has been proposed by Dr. Vander Weide.

Table 2

Adjusted DCF Cost of Equity Analyses
April 2004

Company	Market Capitalization	I/B/E/S Long Term Earnings Growth	Current Price of Equity	Current Dividend	Cost of Equity
ALLTEL	$15.2	5.40%	$50.34	$1.42	8.22%
AT&T	$15.4	-13.80%	$17.15	$0.85	-8.84%
AT&T Wireless	$36.6	27.10%	$13.81	na	na
BellSouth	$48.3	3.90%	$25.81	$0.92	7.46%
CenturyTel	$3.8	4.30%	$28.88	$0.22	5.06%
Citizens Communications	$3.6	8.20%	$13.04	na	na
Qwest Communications	$7.1	0.00%	$4.02	na	na
SBC	$78.4	4.00%	$24.90	$1.41	9.66%
Sprint Corp.	$24.1	15.50%	$17.89	$0.50	18.29%
Verizon	$99.8	3.70%	$37.74	$1.54	7.78%
Average RBOC (VZ, BSC, SBC, Qwest)		3.73%			8.36%
Average ILEC (RBOCs+ALLTEL, CenturyTel, Citizens and Sprint)		4.90%			9.20%
Average for all Telecom firms		6.47%			8.22%
Avg for Vander Weide Sample Industrial Firms used in VZ Cost of Capital Model		11.90%			13.95%

Q. Are you suggesting that the Commission adopt a cost of equity based upon a proxy of RBOCs or ILECs, as you have calculated here?

A. It would certainly make more sense to do that rather than to accept Dr. Vander Weide's figure, which is unambiguously derived from a proxy of industrial firms from which all RBOCs and other telecommunications firms have been specifically excluded. However, I am not recommending that the Commission adopt one of these telecom DCF-based cost of equity results. In my direct testimony, I showed that a cost of equity of 8.51% best represents the risks of a UNE provider facing facilities based competition. The analysis was based upon the capital asset pricing model (CAPM) and I stand by that result.[8] These secondary calculations, however, corroborate my prior findings and calculation, since the CAPM result – 8.51% – falls between the DCF-based cost of equity for a proxy of RBOCs (8.36%) and a proxy of ILECs (9.20%). Moreover, both my original findings and these secondary findings show that Dr. Vander Weide's 13.95% represents a gross exaggeration of the cost of equity and risks that Verizon actually confronts.

The internal, project-specific "hurdle rate" used by AT&T or other local market entrants to evaluate individual investment decisions has no bearing upon the cost of capital confronting Verizon.

Q. Citing an AT&T response to a Verizon NW data request, Dr. Vander Weide seeks to buttress his contention that a UNE provider confronting facilities-based competition would incur a cost of capital in excess of Verizon NW's currently authorized rate of return by observing that "[t]he equivalent before-tax weighted average cost of capital associated with AT&T's

8. *Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure,* WUTC Docket No. UT-023003, Direct Testimony of Dr. Lee L. Selwyn on behalf of AT&T Communications of the Pacific Northwest, April 20, 2004, at 28.

[**BEGIN AT&T PROPRIETARY**] % [**END AT&T PROPRIETARY**] after-tax cost of capital is [**BEGIN AT&T PROPRIETARY**] % [**END AT&T PROPRIETARY**]."[9] Has Dr. Vander Weide accurately characterized AT&T's response?

A. No. AT&T's Compelled Supplemental Response to Verizon Data Request No. 4-1 provided the following information:

> AT&T Corp., AT&T's parent corporation, currently uses a weighted average cost of capital of [**BEGIN AT&T PROPRIETARY**] % **[END AT&T PROPRIETARY**] (after tax) *as the hurdle rate for determining whether to offer a particular local service*. Note that this AT&T Corp. figure is an internal "hurdle rate," and therefore is not completely comparable to an overall business rate-of-return.

Emphasis supplied. What Dr. Vander Weide here characterizes as AT&T's "cost of capital" is, as AT&T has stated in its response, a "hurdle rate for determining whether to offer a particular local service." A "hurdle rate" is a target rate of return on a *specific* investment initiative, establishing the minimum *projected* return that a company would accept before allocating capital funds to any one *specific* project.

Q. How is that different from a company's overall cost of capital?

A. The cost of capital and its components, cost of debt and cost of equity, reflect the *portfolio risk* associated with the totality of the enterprise. Risk issues aside, it would obviously make no sense for a firm to invest in a project that merely returned the firm's overall cost of

9. Vander Weide (Verizon NW), reply testimony, at 12.

capital, so all firms routinely establish higher objective earnings levels for individual undertakings. In its response to a similar, although somewhat more detailed, data request from Verizon earlier this year in the UNE case in New Jersey, NJBPU Docket No. TO00060356 (a case in which Dr. Vander Weide also appeared as a witness for Verizon), AT&T provided the following additional information:

> These figures reflected the judgment of AT&T management about the extremely high risks facing AT&T as a niche entrant in the local exchange business. For markets where AT&T considered itself to be better established, AT&T adopted lower hurdle rates. For example, for business and consumer long distance voice and data services, AT&T adopted a hurdle rate of **[BEGIN AT&T PROPRIETARY]**
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>
> AT&T emphasizes that the assumptions underlying these hurdle rates differ in several respects from the assumptions appropriate in setting a cost of capital for UNE pricing. Apart from the differences in risk discussed above, these hurdle rates were deliberately set on the conservative side (e.g., by adopting a historic equity market premium rather than a forward-looking premium) to offset the tendency of project proponents to overoptimism about the anticipated returns from particular investment projects. This conservative bias is inappropriate in determining the cost of capital set by regulators for pricing UNEs. Moreover, interest rates and capital costs have fallen since these hurdle rates were set. The average yield to maturity on 10-year Treasury instruments, for example, is now only 4.16 percent.
>
> Adjusting the above hurdle rates to reflect these differences would produce a cost of capital figure for the wholesale UNE business of a firm as well entrenched as Verizon NJ or its corporate parent, Verizon Communications, in the range of seven or eight percent.[10]

10. NJBPU Docket No. TO00060356, AT&T response to Verizon New Jersey Data Request VNJ-ATT-7, February 3, 2004, at 3-4.

Even with respect to portfolio risk, AT&T and other CLECs confront enormously greater risk when investing in local network facilities than would a dominant ILEC such as Verizon NW. Indeed, it is the very presence of such elevated levels of risk (relative to those confronting a dominant ILEC) that help to produce the economic efficiencies associated with CLECs' use of ILEC network elements rather than engaging in duplicative overbuilds of the ILEC's infrastructure. The comparison that Dr. Vander Weide seeks to draw as between an internal project-specific hurdle rate applicable to a niche entrant in the local market and the cost of capital confronting Verizon NW overall, as the dominant incumbent with a near-100% facilities-based market share, is patently inapposite and irrelevant, and has no bearing upon the appropriate cost of capital to be used in *Verizon* TELRIC studies.

Mr. Spinks's reliance upon Dr. Vander Weide's results as an "upper limit" is misplaced.

Q. Does Mr. Spinks agree with Dr. Vander Weide's approach to estimating Verizon NW's cost of capital applicable to the pricing of UNEs?

A. No, he does not. Mr. Spinks takes issue with Dr. Vander Weide's recommended capital structure, his "risk premium" calculation, and with his use of a proxy of industrial firms rather than telecom firms as the basis for calculating the cost of equity in the DCF model.

Q. Is there any aspect of Mr. Spinks's testimony with which you disagree?

A. Yes, in one limited area. Mr. Spinks has correctly concluded that Dr. Vander Weide's proxy "is not an appropriate selection of comparable companies because those companies do not operate in the relevant industry (i.e., telecommunications) and are not of similar size or similar revenue bases."[11] Indeed, by using this unrepresentative hand-picked sample of non-telecom firms, Dr. Vander Weide has proposed a cost of equity that is 67% higher than the cost of equity for the average RBOC and 52% greater than the cost of equity for the average ILEC. However, having reached the correct conclusion as to Dr. Vander Weide's calculation, Mr. Spinks nevertheless suggests that the 13.95% result may be considered by the Commission as some sort of "upper limit" of an acceptable cost of equity. I disagree. There is no basis for the 13.95% result, which grossly exceeds and exaggerates the cost of equity that Verizon confronts and that it would confront as a hypothetical UNE-only company, and thus falls well outside of any possible reasonable range of results.

Q. Does this conclude your testimony at this time?

A. Yes, it does.

11. *Spinks (WUTC Staff) Response Testimony*, at 12.