1 BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION

2 COMMISSION

3 In the Matter of the Petition)
)
4 of GTE NORTHWEST INCORPORATED) HEARING NO. UT-931591
)
5 for Review of its Authorized) VOLUME 3
Rate of Return.) PAGES 16 - 164
6 -----------------------------)

7 A hearing in the above matter was held

8 on June 20, 1994 at 9:30 a.m. at 1300 South

9 Evergreen Park Drive Southwest, Olympia, Washington,

10 98504 before Chairman SHARON NELSON, Commissioner

11 RICHARD HEMSTAD and Administrative Law Judge HEATHER

12 BALLASH.

13

14 The parties were present as follows:

15 GTE NORTHWEST, INC., by THOMAS R. PARKER,
Attorney at Law, GTE Tel. Ops., 600 Hidden Ridge, (HGE
16 0353), Irving, Texas 75038.

17 WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION STAFF, by STEVEN W. SMITH, Assistant
18 Attorney General, 1400 South Evergreen Park Drive
Southwest, Olympia, Washington 98504.
19
PUBLIC, by DONALD T. TROTTER, Assistant
20 Attorney General, 900 Fourth Avenue, Suite 2000,
Seattle, Washington 98164.
21

22

23

24
Cheryl Macdonald, CSR
25 Court Reporter

1 I N D E X

2

WITNESS:	DIRECT	CROSS	REDIRECT	RECROSS	EXAM
S. SANCHEZ	19	21			
F. HANLEY	24	29	146	158	131

EXHIBIT	MARKED	ADMITTED
T-1		21
T-2		28
3		28
4	33	35

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1 P R O C E E D I N G S
2 JUDGE BALLASH: Let's be on the record.
3 The hearing will please come to order. The Washington
4 Utilities and Transportation Commission has set for
5 hearing at this time and place docket No. UT-931591,
6 which is entitled in the matter of the petition of GTE
7 Northwest Incorporated for review of its authorized
8 rate of return. Today's date is June 20, 1994. The
9 hearing is being held in the Commission's hearing room
10 in Olympia, Washington before Chairman Nelson and
11 Commissioner Hemstad. Presiding is Heather Ballash of
12 the Office of Administrative Hearings. At this time I
13 will take the appearances of ther parties beginning
14 with the company.
15 MR. PARKER: Thomas R. Parker, 600 Hidden
16 Ridge, Irving, Texas. Also appearing with me here
17 today is Richard E. Potter, 1800 41st Street, Everett,
18 Washington 98201, on behalf of GTE Northwest
19 Incorporated.
20 JUDGE BALLASH: Commission staff.
21 MR. SMITH: Steven W. Smith, Assistant
22 Attorney General, South 1300 Evergreen Park Drive
23 Southwest, Olympia, Washington 98504.
24 MR. TROTTER: For the public counsel
25 section of the Attorney General's office, Don Trotter,

1 Assistant Attorney General, 900 Fourth Avenue,
2 Seattle, Washington, Suite 2000. Zip code is 98164.
3 JUDGE BALLASH: Thank you. Is there
4 anything that we need to -- that needs to be presented
5 before the first witness? Mr. Parker.
6 MR. PARKER: Not on behalf of the company,
7 Your Honor.
8 JUDGE BALLASH: Call your first witness.
9 MR. PARKER: We would call Mr. Sanchez to
10 the stand.
11 Whereupon,
12 STEVEN SANCHEZ,
13 having been first duly sworn, was called as a witness
14 herein and was examined and testified as follows:
15
16 DIRECT EXAMINATION
17 BY MR. PARKER:
18 Q. State your name for the record, please.
19 A. My name is Steven P. Sanchez, S A N C H E
20 Z.
21 Q. By whom are you employed, Mr. Sanchez?
22 A. GTE Northwest Incorporated.
23 Q. Business address?
24 A. 1800 - 41st Street, Everett, Washington
25 98203.

1 Q. What is your position with the company?
2 A. Manager of regulatory planning and
3 management for the Northwest company.
4 Q. Do you have before you, Mr. Sanchez, an
5 exhibit which was premarked at the pre-hearing
6 conference as T-1 consisting of some six pages of
7 prefiled testimony?
8 A. Yes, I do.
9 Q. And was that exhibit prepared by you or
10 under your direct supervision?
11 A. Yes, it was.
12 Q. Are there any corrections, additions or
13 deletions that need to be made to Exhibit T-1 at this
14 time?
15 A. No, there are not.
16 Q. And if I were to ask you those same
17 questions today, would your answers be the same?
18 A. Yes, they would.
19 Q. And are the answers contained therein true
20 and correct to the best of your belief and knowledge?
21 A. Yes, they are.
22 MR. PARKER: I would offer Exhibit T-1 at
23 this time.
24 JUDGE BALLASH: Any objection?
25 MR. SMITH: No objection.

1 JUDGE BALLASH: Exhibit T-1 will be
2 admitted into the record.
3 (Admitted Exhibit T-1.)
4 MR. PARKER: Your Honor, does the
5 Commission wish to hear summaries of testimony or do
6 you just want the witness tendered for
7 cross-examination?
8 JUDGE BALLASH: I think we can proceed
9 without a summary. It's fairly short.
10 MR. PARKER: Mr. Sanchez is available.
11 JUDGE BALLASH: Mr. Smith.
12 MR. SMITH: I have no questions for Mr.
13 Sanchez.
14 MR. TROTTER: Just a couple.
15
16 CROSS-EXAMINATION
17 BY MR. TROTTER:
18 Q. Mr. Sanchez, you're not offering an
19 independent opinion on rate of return for GTE
20 Northwest, are you?
21 A. I personally am not, no.
22 Q. LineS 9 to 11 you say with respect to this
23 case there will be no impact on the company because it
24 is not requesting any rate increases or decreases. Do
25 you see that?

1 A. Yes, I do.
2 Q. Was your answer there limited to rate
3 increases or decreases with respect to impact or are
4 there other impacts other than increases or decreases
5 that will result from this filing?
6 A. There are no other impacts that I can think
7 of that will result from this filing.
8 Q. The company from time to time files for new
9 services or changes to existing services, does it not?
10 A. Yes, it does.
11 Q. And supports those filings with cost
12 studies from time to time, does it not?
13 A. Yes, it does.
14 Q. And it uses a rate of return in those cost
15 studies, does it not?
16 A. It employs a return to develop the cost
17 studies, yes.
18 Q. Is it anticipated that the company will use
19 the rate of return that results from this proceeding
20 in such filings in the future?
21 A. We would employ a new rate of return that
22 would result from this proceeding in cost studies that
23 we would file, yes.
24 Q. So there will be an impact on the company
25 as a result of this filing; is that correct?

1 A. There will be an impact on the costs that
2 are developed from the rate of return, but the impact
3 -- there may be an impact if prices develop from that
4 cost study were to be different than they would
5 otherwise.
6 Q. So there will be an impact on costs but
7 there may or may not be an impact on rates?
8 A. That's correct.
9 Q. But there may be an impact on rates?
10 A. There may be an impact on rates.
11 MR. TROTTER: Thank you. Nothing further.
12 JUDGE BALLASH: Questions from the
13 Commission?
14 CHAIRMAN NELSON: No.
15 COMMISSIONER HEMSTAD: I have none.
16 JUDGE BALLASH: Redirect.
17 MR. PARKER: None.
18 JUDGE BALLASH: Thank you for your
19 testimony, sir. You may step down.
20 MR. PARKER: Call Mr. Hanley to the stand.
21 Whereupon,
22 FRANK HANLEY,
23 having been first duly sworn, was called as a witness
24 herein and was examined and testified as follows:
25

1 DIRECT EXAMINATION
2 BY MR. PARKER:
3 Q. State your name for the record, please.
4 A. Frank J. Hanley, H A N L E Y.
5 Q. And what is your business address, Mr.
6 Hanley?
7 A. My business address is Post Office Box
8 1050, Moorestown, M O O R E S T O W N, New Jersey
9 08057.
10 Q. And by whom are you employed, Mr. Hanley?
11 A. I am employed by AUS Consultants. I'm
12 president of its utility services group.
13 Q. Mr. Hanley, do you have before you two
14 exhibits, one Exhibit T-2 which contains your revised
15 direct testimony and Exhibit 3 which contains the
16 schedules to that testimony?
17 A. Yes, sir, I do.
18 Q. And were both of those exhibits prepared by
19 you or under your direct supervision?
20 A. Yes.
21 Q. Turning your attention first to Exhibit
22 T-2, are there any additions, corrections or deletions
23 that need to be made to that document at this time?
24 A. Two very minor corrections.
25 Q. And would the first correction appear on

1 page 13, line 19?
2 A. That's correct.
3 Q. And could you state for the record what
4 that correction is, please.
5 A. Yes. After the word "those" should be
6 inserted the word "domestic." It was inadvertently
7 omitted.
8 Q. So line 19 should read "consists of those
9 domestic companies contained in the S & P" and then
10 the sentence goes on.
11 MR. TROTTER: Excuse me. Is that line 17?
12 THE WITNESS: Line 19.
13 MR. TROTTER: Page 13. Are we on the
14 revised copy or what?
15 MR. PARKER: It is the revised testimony of
16 Frank J. Hanley, April 27, 1994.
17 CHAIRMAN NELSON: I don't have it either.
18 COMMISSIONER HEMSTAD: I have it.
19 JUDGE BALLASH: Let's be off the record for
20 a moment.
21 (Recess.)
22 JUDGE BALLASH: Let's be back on the
23 record. While we were off the record we discussed the
24 fact that two separate copies of the testimony has
25 been distributed. One was revised testimony without

1 legislative format and one was with legislative
2 format. For the record the legislative format version
3 is the one that will be in the record as the original
4 exhibit. For clarification today counsel will refer
5 to both versions so we can find the changes.
6 Q. Prior to going off the record, Mr. Hanley,
7 when we were identifying the change on page 13, was
8 that to the revised testimony in non-legislative
9 format?
10 A. Yes.
11 MR. PARKER: I would state for the record,
12 Your Honor, in the legislative format testimony that
13 that change appears on page 13, line 17.
14 JUDGE BALLASH: Thank you, Mr. Parker.
15 Q. Mr. Hanley, what copy of the testimony do
16 you have before you?
17 A. Actually, I'm one of the fortunate ones in
18 the room. I have both, but tell me which one you
19 want to look at first and I will do so.
20 Q. Just to be consistent, turning your
21 attention again to the revised testimony in the
22 nonlegislative format, is there a change that appears
23 on page 42, line 17?
24 A. Yes. Yes, there is.
25 Q. And on that page would the words

1 "historical and" appear before "projected growth
2 rates" appearing on that line?
3 A. That's correct, yes.
4 MR. PARKER: And I would state for the
5 record, Your Honor, that same change in the
6 legislative format testimony appears on page 43, line
7 18, so that that line should read, "historical and
8 projected growth rates in BR plus SV by company and
9 proxy group," and then the sentence goes on.
10 JUDGE BALLASH: Thank you.
11 Q. Are there any other corrections, additions
12 or deletions that need to be made to Exhibit T-2?
13 A. Only in the legislative format, not in the
14 revised, and that is truly minor, but on page 19 of
15 the legislative format, the very beginning of that
16 line there is reference to a bond rating and it is
17 just AA, two capital A's and a parentheses. After the
18 second A there should be a minus sign or a dash, to
19 indicate AA minus and then the parenthetical.
20 COMMISSIONER HEMSTAD: Which line is that?
21 THE WITNESS: That is line 7 of the page 19
22 of the legislative format.
23 Q. With those corrections noted, Mr. Hanley,
24 if I were to ask you the same questions today, would
25 your answers be the same?

1 A. Yes.
2 Q. And are they true and correct to the best
3 of your belief and knowledge?
4 A. Yes, they are.
5 Q. Are there any changes that need to be made
6 to Exhibit No. 3 which contains your exhibits to the
7 testimony?
8 A. No.
9 MR. PARKER: Your Honor, I would offer
10 Exhibits T-2 and Exhibit 3 at this time.
11 JUDGE BALLASH: Any objection.
12 Exhibits T-2 and 3 will be admitted into
13 the record.
14 (Admitted Exhibits T-2 and 3.)
15 MR. PARKER: Does the Bench desire to hear
16 a summary from Mr. Hanley over his testimony?
17 JUDGE BALLASH: I don't think that will be
18 necessary, Mr. Parker.
19 MR. PARKER: Mr. Hanley is available for
20 cross-examination.
21 JUDGE BALLASH: Let's be off the record for
22 a moment.
23 (Discussion off the record.)
24 JUDGE BALLASH: Let's be back on the
25 record. Commission staff.

1 MR. SMITH: I'm not sure the exhibits were
2 admitted.
3 JUDGE BALLASH: I believe I just admitted
4 them.
5
6 CROSS-EXAMINATION
7 BY MR. SMITH:
8 Q. Mr. Hanley, the purpose of your testimony
9 is to offer a current estimate of GTE Northwest's cost
10 of capital; is that correct?
11 A. Yes.
12 Q. When you speak of the company's cost of
13 capital you're referring to its weighted average cost
14 of capital including long-term debt, short-term debt,
15 preferred stock and common equity; is that correct?
16 A. Yes.
17 Q. And in computing the company's cost of
18 capital you didn't actually include any cost of
19 short-term debt; is that correct?
20 A. It's technically correct simply because
21 they're on an actual and proforma basis, which is the
22 capital structure that I recommend. The actual
23 outstanding short-term debt was permanently funded
24 with long-term capital, so on an actual and proforma
25 basis there is no short-term debt.

1 Q. And can you tell us when the short-term
2 debt was funded by long-term debt?
3 A. Well, I don't know if it occurred in
4 piecemeal but certainly it would have happened prior
5 to on or about May 3.
6 Q. Of 1994?
7 A. 1994, yes, sir.
8 Q. On your schedule 1, page 1, you show the
9 short-term debt ratio of zero, and that is imported
10 from schedule 6, page 1; is that correct?
11 JUDGE BALLASH: For clarification of the
12 record, all references to schedules are part of
13 Exhibit No. 3.
14 MR. SMITH: That's correct, Your Honor.
15 A. Yes, sir, that is correct.
16 Q. And there on schedule 6, page 1, you show a
17 December 31st 1993 amount of outstanding short-term
18 debt as zero; is that correct?
19 A. Yes.
20 Q. On schedule 6, note 5, which is on page
21 2, indicates that someone in the company provided you
22 the year ending 1993 short-term debt balance; is that
23 correct?
24 A. That is correct, yes.
25 Q. And did you inquire as to whether the

1 company expected to use short-term debt in the future?
2 A. I did not. Frankly, it's a reasonable
3 assumption that it would from time to time use
4 short-term debt and that at various intervals the
5 short-term debt would be permanently funded and was my
6 -- was and is my understanding that we were to work
7 with the December 31, 1993 capital structure and I
8 encouraged use of it on an actual and proforma basis
9 to reflect significant changes to the capital
10 structure that would be occurring imminently
11 subsequent to the end of calendar 1993. Those changes
12 have occurred.
13 Q. And is it your understanding that the
14 company in fact had a balance for short-term debt in
15 its capital structure on December 31, 1993?
16 A. Looking at the data on schedule 6 and
17 trying to refresh my memory, the indication is that it
18 did not.
19 Q. Were you provided data by the company or
20 did you request any data showing whether or not, and
21 if so, to what extent the company has had short-term
22 debt balances in recent periods of time?
23 A. I did inquire and there is -- I don't
24 recall the exact figure. It was a verbal inquiry, but
25 in the overall scheme of things is diminimus.

1 Currently I believe -- Mr. Sanchez can verify it, but I
2 think it's something in the magnitude of $30 million
3 at this moment.
4 Q. And short-term debt is the lowest form of
5 capital, lowest cost form of capital available to the
6 company; is that correct?
7 A. Generally speaking, that's true, yes. And
8 it is true at this point in time.
9 Q. And you show that cost rate in your
10 schedule 1, Exhibit page 1; is that correct?
11 A. Yes.
12 Q. And is that cost rate developed on page 1
13 of your schedule 7?
14 A. That's correct.
15 Q. And, as I understand it, the cost rate for
16 short-term debt was provided to you by the company; is
17 that correct?
18 A. Yes.
19 Q. And do you recall who within the company
20 provided you with that information?
21 A. Well, my direct interface, it came through
22 Mr. Sanchez.
23 Q. And if the company -- is it fair to say
24 that if hypothetically there were a balance of
25 short-term debt in the company's capital structure

1 that its overall cost of capital would be lower?
2 A. Well, hypothetically speaking, but with the
3 use of funds from the permanent financing it would
4 have been paid out, that the $200 million of long-term
5 debt was actually issued, I believe, May 3.
6 Q. And I believe you indicated earlier that it
7 was reasonable to assume that the company would
8 generally have some balance of short-term debt in its
9 capital structure pending the refinancing; is that
10 correct?
11 A. At various intervals that's true. I think
12 that's true of almost any entity from time to time
13 will need to use short-term debt. That doesn't mean
14 that it always has short-term debt outstanding,
15 however.
16 MR. SMITH: I have a document I would like
17 to have marked for identification.
18 JUDGE BALLASH: Been handed a two-page
19 document entitled GTE Northwest Incorporated with the
20 docket No. UTC data request No. 8. That document
21 will be marked as Exhibit No. 4 for identification.
22 (Marked Exhibit 4.)
23 Q. Mr. Hanley, do you have before you what's
24 been marked for identification as Exhibit No. 4?
25 A. Yes. Actually you handed me two copies so

1 if someone has need for another --
2 Q. Yes, that would be me. And have you ever
3 seen that document before?
4 A. I believe so.
5 Q. And do you recognize it or will you accept
6 subject to check that it is the company's response to
7 staff data request No. 8?
8 A. Yes.
9 Q. And in that data request the staff asks the
10 company to provide end of month short-term debt
11 balances for GTE Northwest for the preceding 36
12 months. And attachment, which was provided by the
13 company, shows a short-term debt balance on December
14 31st, 1993 of $188,298,895. Do you see that?
15 A. I do.
16 Q. Does attachment A also indicate that for
17 each month from 1990 through 1993 the company had a
18 short-term debt balance?
19 A. From 1990 through 1993 it does show that;
20 not so in 1989, however, but yes.
21 Q. And attachment A also indicates for each
22 month of 1994 that that is shown that the company's
23 actual or estimated short-term debt balance is in a
24 positive amount?
25 A. That's correct.

1 Q. And down at the last line it shows a fourth
2 quarter cost rate of 3.497 percent; is that correct?
3 A. That's correct.
4 Q. And that's the same rate the company
5 provided to you for your schedule 1?
6 A. Yes.
7 MR. SMITH: Your Honor, I would move for
8 admission of Exhibit No. 4.
9 JUDGE BALLASH: Any objection?
10 MR. PARKER: None.
11 JUDGE BALLASH: Exhibit No. 4 will be
12 admitted into the record.
13 (Admitted Exhibit 4.)
14 Q. Mr. Hanley, do you calculate the cost of
15 long-term debt and preferred stock shown in your
16 schedule 7 and 8 or did the company provide those
17 calculations?
18 A. Company provided the information. I made
19 the calculations.
20 Q. And on your schedule 1, you indicate that
21 the company's equity ratio is 59.296 percent; is that
22 correct?
23 A. Yes.
24 Q. And the equity ratio and the other
25 capitalization ratios are developed in your schedule

1 6; is that correct?
2 A. Yes.
3 Q. Let me ask you whether you agree with the
4 following statement: If a parent corporation issues
5 its own debt and is wholly owned -- and if a wholly
6 owned subsidiary also builds debt over the base of
7 equity invested by the parent leveraging takes place
8 twice on the single layer of the parent's publicly
9 held equity.
10 MR. PARKER: Will you identify, for the
11 record, Counsel, where that statement comes from?
12 MR. SMITH: It comes from the page 295 of
13 the Morin book cited by Mr. Hanley -- 294, I'm sorry.
14 A. Do we have some reference in the testimony,
15 please, where I cited that.
16 Q. You cited him as an authority, not on this
17 particular point, just in general.
18 A. Well, in order to respond -- I'm a little
19 confused. I interpreted your comment just a moment
20 ago that the question -- the genesis of the question
21 had to do with something in Morin's book. Did I
22 misunderstand?
23 Q. The question is from Morin's book. I'm
24 asking if you agree with it or not. Would you like me
25 to read it again?

1 A. Would you please.
2 Q. Sure. The statement is as follows: If a
3 parent corporation issues its own debt and if a wholly
4 owned subsidiary also builds debt over the base of
5 equity invested by the parent, leveraging takes place
6 twice on a single layer of the parent's publicly held
7 equity.
8 A. Subject to check I would agree that that
9 statement is undoubtedly in Dr. Morin's book. It
10 probably is in there in the context of acknowledging
11 that that concept is imposed in some instances by some
12 regulatory bodies. I don't think it is and don't
13 believe it is a relevant concept simply because it is
14 a discriminatory concept. I suspect, if I were to get
15 Morin's book and read well prior to that statement and
16 perhaps subsequent to it, that there would be some
17 discussion to the effect of what I have just
18 suggested, so to acknowledge its existence, for
19 example, I acknowledge that genocide goes on in the
20 world. Do I agree with it, no, and I think that's
21 pretty much Morin's characterization of it as well.
22 Q. And GTE Northwest is a wholly owned
23 subsidiary of GTE Corporation; is that correct?
24 A. Yes, it is.
25 Q. And GTE Corporation owns all the stock of

1 GTE Northwest; is that correct?
2 A. Yes.
3 Q. And GTE Corp has its own stock that is
4 publicly issued; is that correct?
5 A. It does, yes.
6 Q. And GTE Northwest has its own debt; is that
7 correct?
8 A. It does.
9 Q. And all of the debt you show in schedule 1
10 and your other schedules is the debt of GTE Northwest;
11 am I correct?
12 A. You are.
13 Q. And is it also correct that GTE Corp issues
14 debt in its own name?
15 A. Yes.
16 Q. And I just want to confirm that in this
17 case you have analyzed GTE Northwest cost of capital
18 using its own capital structure and cost rates without
19 regard to the parent subsidiary relationship between
20 GTE Corp and GTE Northwest?
21 A. That's correct.
22 Q. And is it correct that your methodology
23 rests on the basic premise that the required return on
24 an investment in GTE Northwest depends just on its
25 risk and not the parent's financing costs?

1 A. Yes. And the reason concisely that I say
2 that is that if tomorrow GTE Northwest were to be sold
3 and suddenly owned by a thousand or 10,000 individual
4 shareholders, the risk inherent in the capital
5 invested in that rate base and of providing service
6 hasn't changed one iota. All that's changed is the
7 name on the stock certificates.
8 Q. So in your analysis, at least the DCF
9 portion, you reviewed GTE Northwest as an independent
10 operating company and then inferred its cost of equity
11 as that of comparable risk firms; is that correct?
12 A. Yes, which I believe is consistent with the
13 legal precedents from the famous and often cited Hope
14 and Bluefield cases.
15 Q. And in your analysis you formed two proxy
16 groups of telephone utilities that you believe are of
17 comparable risk to GTE Northwest; is that correct?
18 A. Generally, that's correct. However, I
19 believe that the group of the four independent LECs is
20 more comparable and is the one that should be relied
21 upon.
22 Q. And that group of four independent LECs
23 includes ALLTEL Corporation, Cincinnati Bell,
24 Rochester Telephone and Southern New England
25 Telecommunications Corporation; is that correct?

1 A. Yes.
2 Q. Are any of those four independent operating
3 companies subsidiaries of a holding company?
4 A. No. I think that's why we call them
5 independent.
6 Q. Second group you indicated consists of the
7 seven regional Bell holding companies. None of those
8 seven are subsidiaries of another holding company, are
9 they?
10 A. No, but they themselves are holding
11 companies and have operating subsidiaries.
12 Q. Now, the use of the DCF model requires
13 knowledge of a company's current price per share for
14 their stock; is that correct?
15 A. There has to be one, yes.
16 Q. There has to be one and you have to be
17 aware of it for your model; is that correct?
18 A. Yes.
19 Q. And in the DCF formula the stock price is
20 designated as P sub zero, the price at time zero; is
21 that correct?
22 A. A current price, that's correct.
23 Q. And the standard formula requires an
24 estimate of the next dividend relative to the time
25 when the DCF analysis is being performed; is that

1 correct?
2 A. Yes, or representative, if you will, over
3 the ensuing 12-month period.
4 Q. Is it frequently the case that the estimate
5 of the next dividend is determined as a function of
6 the current dividend adjusted by an estimated growth
7 rate?
8 A. Yes.
9 Q. And using the DCF model, a rate of return
10 analyst requires an estimate of the rate of growth of
11 dividends; is that correct?
12 A. That's correct.
13 Q. And that's represented by the letter small
14 G in the formulation; is that correct?
15 A. Yes, although the G component need not be,
16 I don't believe, in the literature identical to the
17 adjusted or the adjustment made to the dividend. They
18 need not be identical.
19 Q. In your testimony at page 23, follow up on
20 what you just said, line 11 you define the G as the
21 constant dividend growth rate proxy. Why is the word
22 proxy used there?
23 A. Simply because we don't know what it is.
24 We're going to assume that it represents the growth
25 that investors require when in reality we don't know.

1 We formulate an opinion based upon various accounting
2 measures of growth, some combination of historical
3 and/or projected growth, and dividends, which is
4 dependent upon growth in earnings which is influenced
5 by the regulatory process. So in some sense of the
6 word not only are we crudely estimating but there's a
7 degree of circularity in the whole process because of
8 the regulatory influence.
9 Q. I'm not sure I understood you. The term
10 proxy there, is that used in part to indicate that the
11 proxy is the growth of earnings as the proxy for the
12 growth in dividends?
13 A. No. It means that whatever the analyst
14 applying the model chooses as the proxy as the
15 estimate of growth, and it's a proxy in the sense that
16 no one knows with any degree of certainty what it is
17 that investors in the aggregate formulation of the
18 market actually require, because they don't really
19 look at the things necessarily that the analyst in a
20 regulatory process is forced to look at. For example,
21 the model doesn't take into account changes in
22 price/earnings multiples, and there's a good
23 indication for the telecommunications industry
24 currently and prospectively, for example, that that's
25 going to be a much larger role in investors' decisions

1 as to how they will gain or capture their capital
2 appreciation. That's not reflected in the model.
3 Q. Getting back to the model itself. From all
4 the information about current stock price, current
5 dividend rate, and an estimate of dividend growth, one
6 may infer the discount rate that investors use in
7 making investment decisions; is that correct?
8 A. Yes.
9 Q. And the discount rate is designated by the
10 letter K in the model; is that correct?
11 A. It is.
12 Q. And finance theory says that the discount
13 rate is the investors' current cost of equity capital;
14 is that correct?
15 A. It's presumed to be, that's correct.
16 Q. Well, that's the point of the DCF analysis,
17 is it not, to estimate investors' cost of equity?
18 A. It is. It's the purpose of every cost of
19 equity model.
20 Q. You mentioned a minute ago in response to a
21 question that there's a number of things that
22 investors consider in making their investment
23 decisions. Do investors regard their own and other's
24 expectations of future inflation as relevant to their
25 investment decisions?

1 A. Oh, I think it's safe to say that investors
2 have some degree of concern about inflation.
3 Q. And are those expectations of inflation
4 built into the price of the stock?
5 A. Under the efficient market hypothesis upon
6 which virtually all the models are predicated,
7 including the DCF, there would be the assumption that
8 all information, historical and all public information
9 that is available -- and that presumably comes from
10 the most learned economists, U.S. Government, Federal
11 Reserve and so on -- is in their minds and if it's in
12 their minds it's reflected in their pocketbooks when
13 they pay the price. So I think the answer has to be
14 under the assumptions that the model is predicated
15 upon, yes.
16 Q. Do investors regard their own and other's
17 expectations of the future earnings performance of
18 alternative investments as relevant to investment
19 decisions?
20 A. Would you please repeat the question.
21 Q. Do investors consider their own
22 expectations and the expectations of others regarding
23 the potential future earnings of other investments in
24 making a decision to invest in a particular stock?
25 A. I understand the question except for the

1 part, "and the expectations of others." I don't know
2 that I can respond to that, but I think it's safe to
3 say with the question in general, other than that
4 portion of it, that clearly they form their own
5 expectations of the return that they require and that
6 that return is based upon the price that they pay and
7 it will -- whether that expectation is realized or not
8 will depend upon the market price upon which they sell
9 the stock at some point in time in the future in large
10 measure.
11 Q. And do investors take into consideration
12 expectations of geopolitical events in making
13 investment decisions?
14 A. I think we have to say that in a very macro
15 sense of the word those things affect prices, and
16 due to the general nature of your question, they would
17 probably be the systematic kinds of market movements
18 in prices which are not diversifiable, nobody can
19 protect themselves against, but the market does react
20 to many things that have no apparent direct bearing on
21 a given company or a given industry.
22 Q. And under the efficient market theory that
23 you just mentioned, isn't it fair to say that any
24 information that investors can get which may be
25 relevant to their investment decision is captured in

1 prices they are willing to pay for security?
2 A. Oh, I think that is a fairly reasonable
3 assumption. The only thing that I believe is that
4 when an analyst attempts to measure to get that K that
5 we have spoken about, calculating the yield part is
6 pretty easy, but it's trying to measure that growth is
7 the real problem.
8 Q. And investors must anticipate higher
9 returns as an inducement to make riskier investments.
10 Is that generally fair to say?
11 A. Higher than what?
12 Q. Higher than a less risky investment.
13 A. There is an aversion to risk. The more
14 risk the greater the desired or expected return,
15 that's correct.
16 Q. And in your testimony you indicate that
17 risk encompasses both the risk of -- let me start
18 over. Broadly speaking risk encompasses both the risk
19 of possible insolvency and the variability of earnings
20 available to common stockholders; is that correct?
21 A. Almost anything you can think of, including
22 those, would be relevant and have a bearing, yes.
23 Q. And I take it from your testimony you would
24 agree that the total uncertainty associated with an
25 investor's return and company's common stock is

1 comprised of business risk and financial risk?
2 A. That's the diversifiable risk and then
3 there's the nondiversifiable systematic risk.
4 Q. And as the firm increases the proportion of
5 its debt lease financing and preferred stock in its
6 capital structure the fixed charges increase; isn't
7 that correct?
8 A. Just stands to reason the more fixed
9 capital you issue the more fixed charges you will have
10 all else equal.
11 Q. As a result the probability of cash
12 insolvency increases; is that correct?
13 A. All else equal, that is correct.
14 Q. And would you agree that that's the essence
15 of financial risk faced by shareholders?
16 A. It is the essence. That's what the concern
17 is, yes.
18 Q. And business risk on the other hand
19 involves the variation over time of operating income;
20 is that correct?
21 A. Well, I have a problem with the question
22 when you say it involves. Business risk is a
23 catch-all term for all of the other operating risks of
24 an enterprise. Anything you can think of other than
25 the nondiversifiable systematic risk and other than

1 financial risk represents the operating or business
2 risks of an enterprise.
3 Q. To the extent that operating revenues or
4 expenses are uncertain the firm is said to be subject
5 to more or less business risk; is that correct?
6 A. Yes.
7 Q. In terms of business and financial risk,
8 can you say whether an investment in GTE Corporation
9 is more or less risky than an investment in GTE
10 Northwest?
11 A. Would you repeat the question again,
12 please, especially the beginning part of it.
13 Q. In terms of business and financial risk, do
14 you have an opinion as to whether an investment in GTE
15 Corp is more or less risky than an investment in GTE
16 Northwest?
17 A. Offhand I haven't made an analysis, and I
18 really wouldn't care to speculate. I will just say
19 this to try and give you some indication of why I
20 choose not to speculate and the answer isn't apparent
21 to me without an analysis, which I didn't make, and
22 that is that on the surface a variety of different
23 businesses, a multiplicity of businesses, would seem
24 to be more risky, many various and sundry unregulated
25 kinds of endeavors, totally unregulated, but there is

1 such a thing as a portfolio effect. You can diversify
2 a portfolio of assets, different kinds of --
3 investments in different kinds of enterprises and
4 actually have a risk reduction. Sometimes that kind
5 of diversification works successfully and that goal is
6 accomplished and other times it doesn't. So in the
7 absence of a study, your specific question, I don't
8 know. I didn't make an analysis, and I cannot
9 speculate.
10 Q. And in your testimony you indicated that
11 you did not use GTE Corp as a proxy for GTE Northwest
12 because of the diversity of its nonutility businesses;
13 is that correct?
14 A. It is. It seems apparent to me at least,
15 and I think should be fairly evident on the surface,
16 that a company that has telephone operations in 33
17 different states with in excess of 17 million access
18 lines, that is in effect a portfolio itself. A large
19 risk in a regulated enterprise, you have -- as I hate
20 to say it with the commissioners sitting here -- is
21 regulatory risk, and if you can spread the regulatory
22 risk over 33 jurisdictions, in effect you have to a
23 large degree -- goes with the whole concept of
24 diversification -- a balanced portfolio in terms of
25 the risk of providing a telephone. It's the old case

1 of not having all your eggs in one basket.
2 Q. Well, you're not saying -- as you indicate
3 you haven't done a study. You're not saying
4 definitively that GTE Corporation is less risky than
5 GTE Northwest, are you?
6 A. Definitively I said I have no idea. I
7 didn't make a study and I choose not to speculate.
8 But what I have suggested in my immediate response to
9 your last question was that I don't believe
10 nonetheless that GTE Corp is a suitable proxy for GTE
11 Northwest in finding a rate of return, an overall cost
12 of capital if you will, that's applicable to the risk
13 of GTE Northwest's rate base and specifically within
14 the Washington jurisdiction.
15 Q. And that's the reason you did not include
16 or look at the -- or consider the cost of equity for
17 GTE Corporation?
18 A. I considered it. I rejected its use.
19 Q. The two proxy groups you use are intended
20 to be comparable to GTE Northwest to some extent; is
21 that fair to say?
22 A. With emphasis on the "to some extent," yes.
23 As I said before, I believe that the group of the four
24 independent LECs are significantly more comparable.
25 Q. And for the comparison to be appropriate,

1 the risk of the proxy companies must be comparable to
2 GTE Northwest; is that correct?
3 A. Well, as close as one can get. The truth
4 is, and I think that should be also evident to a
5 rational person, is there is no such thing as an
6 absolute perfect mirror or proxy. We try to do the
7 best we can with what's available and there is limited
8 available in the telecommunications area.
9 Q. But the kinds of factors we've been talking
10 about as determining a firm's overall risk should be
11 comparable between GTE Northwest and the companies in
12 your proxy sample; is that correct?
13 A. They should be relatively comparable, that
14 is correct.
15 Q. I want to for a minute look at how you
16 selected your two proxy groups, and this is on page
17 13. I don't know that you will need to refer to it.
18 You state that you chose as the universe of possible
19 companies to include in your samples the companies in
20 the Standard & Poor's telecommunications Compustat II
21 database; is that correct?
22 A. Yes.
23 Q. Now, was this choice made because your DCF
24 analysis requires certain data which is reported in
25 some standard form and because the Compustat II

1 telecommunications database is likely the broadest
2 from which one can select telecommunications company
3 data?
4 A. Yes to both parts.
5 Q. And you state that you limited your sample
6 to those companies who have actively traded stock; is
7 that correct?
8 A. Yes. Those domestic companies.
9 Q. And the Compustat II telecommunications
10 database includes companies with different ranges of
11 risk; is that correct?
12 A. I think it's safe to say, without many
13 companies, yes.
14 Q. And this limitation to companies in the
15 common database is necessary because an analysis such
16 as yours requires consistently reported data; is that
17 correct?
18 A. Yes.
19 Q. And it's necessary that there be an active
20 market for the stock in order to have confidence
21 the price reported is a true equilibrium price; is
22 that correct?
23 A. Yes, at least consistent with the theory
24 it's presumed.
25 Q. Now, could you tell us how many of the 108

1 firms in the database were eliminated from
2 consideration because they did not have actively
3 traded common stock?
4 A. Well, I can count them if you like me to,
5 but we did respond to your data request No. 14 and
6 attachment 1 related thereto. It's shown by company.
7 I haven't actually made a count of the number of them.
8 Would you like me to sit here and do that?
9 Q. That won't be necessary. Line 20 at page
10 13 you state that you also limited your sample to
11 companies which are the subject of Value Line
12 investment survey reports. Is that correct?
13 A. Yes.
14 Q. And do you know how many of the Compustat
15 database companies with actively and publicly traded
16 stock were eliminated because they are not the subject
17 of Value Line reports?
18 A. Well, I have a two-part response to the
19 question. First is that that's also shown in response
20 to your data request No. 14. Secondly, even if you
21 count the noes in that column, it's a step-by-step
22 screening process. If it didn't pass the actively
23 traded test it was immediately eliminated. If it then
24 did not pass the domestic test it was then --
25 companies were then eliminated so that what's shown in

1 that column under data request really relates only to
2 those companies that made it through that level of
3 screening.
4 Q. I understand that, but referring to the
5 Value Line criterion itself, that screen was necessary
6 because every company in the sample had to have
7 consistently reported data. Is that accurate?
8 A. With regard to the Value Line requirement?
9 Q. Yes.
10 A. No. The Value Line requirement is in there
11 really for two reasons, one that it's in there because
12 there's a Value Line beta available, and two because
13 the Value Line forecasts, as well as historical
14 information, forecasts for growth rate purposes.
15 Q. Does the Value Line investment survey
16 report on a variety of companies with the range of
17 risks?
18 A. I don't know what you mean by a range
19 of risks but there are reports -- there are Value Line
20 reports for a universe, not just telecommunications,
21 of approximately 1700 companies.
22 Q. Another criterion you had is that your
23 sample companies had to exhibit a continuous pattern
24 of dividend payouts; is that correct?
25 A. Yes.

1 Q. In fact, to satisfy the assumption of the
2 DCF model a company cannot have an erratic dividend
3 history; is that correct?
4 A. I'm going to answer the question by saying
5 no, it's not correct, because as long as there is a
6 dividend and an expected dividend, one could make a
7 DCF calculation. However, from a regulatory viewpoint
8 if a company has had to cut or omit dividends in the
9 recent past, to me that's an indication that the
10 company is in trouble. It's not a healthy proxy, and
11 unless regulation wants to close its eyes to the
12 process, you don't look to, in effect, sick companies
13 to try and determine what is an appropriate cost of
14 equity. If I wanted to find out what a healthy person
15 looks like I wouldn't go in a ward for the terminally
16 ill. So I think in the regulatory process you
17 appropriately should exclude companies that are
18 troubled. Companies do not cut or omit dividends
19 unless they're in trouble.
20 Q. There are two other screens you relied upon
21 in getting your sample groups. First, you eliminated
22 any company from your sample that had less than
23 600,000 access lines, is that correct, in 1992?
24 A. Yes.
25 Q. And do you know how many companies -- well,

1 I guess strike that question.
2 Is the number of access lines a company has
3 a reflection of the riskiness of the company's common
4 stock?
5 A. I think it's a pretty good indication
6 because I think there is virtually universal agreement
7 in the financial literature that there is a direct
8 correlation between -- I don't mean necessarily
9 statistical sense but a general relationship across a
10 spectrum of size. In other words, smaller companies
11 have greater risk. As you go up the spectrum the
12 larger and larger companies they become -- all else
13 equal obviously there is lesser risk and that goes
14 across the universe of size and there is a decided
15 relationship between number of access lines and size.
16 You can measure that size by book value of common
17 equity and/or market value of common equity or by
18 total capital. There are a number of ways that one
19 can do that, but the number of access lines for the
20 group of four LECs, for example, is in rounded numbers
21 on average, the average company, 1.3 million, which
22 is almost identical to GTE Northwest in contrast to
23 something like 16 million for the average regional
24 Bell holding company.
25 Q. But as I understand the screen, you just

1 looked at the number of access lines as a screening
2 device without regard to any revenues associated with
3 those access lines?
4 A. I used it as a screening device in the
5 order of the screen as we've been discussing them,
6 that's correct.
7 Q. I'm not sure you answered my question. In
8 the screen you weren't looking at the revenues from
9 those access lines, were you? You were simply looking
10 at the number of access lines itself?
11 A. That's right.
12 Q. Finally, you state that your sample
13 companies had to have received less than 30 percent of
14 their total 1992 revenues from long distance
15 operations. Is the proportion of revenue received
16 from long distance operations a measure of the risk of
17 an investment in a company's common stock?
18 A. I think it is, yes. I mean it is just
19 that. It is a measure. There are many elements, as
20 we've discussed and I've alluded to, that comprise the
21 aggregate risk but it is one for sure.
22 Q. Were the four screens on -- five screens on
23 page 13 applied to just the four independent LECs or
24 was it also applied to the seven Bell regional holding
25 companies?

1 A. Actually the screens were applied to all
2 companies in the S & P Compustat database and what we
3 wound up with in effect were two subsets.
4 Q. Because of the diversity of their nonlocal
5 exchange and nonutility businesses, are the regional
6 holding companies less suitable proxies than the four
7 independents?
8 A. I believe so, but I also believe that they
9 are so much larger that they're not suitable proxies
10 as well. For example, at December of 1993 the market
11 value of the average RBHC's common equity was just
12 under 20 billion dollars, 19.973 billion. You compare
13 that to the comparably sized average of the four
14 independents, which is very, very similar to GTE
15 Northwest, was just about 2.3 billion compared to
16 almost 20 billion for the average RBHC.
17 Q. Would the operating companies of the
18 holding companies be a better proxy then?
19 A. Well, there may be an individual one, but
20 unfortunately, they don't have stock that's traded
21 either. They're wholly owned subsidiaries. I guess
22 we couldn't do the DCF then, could we?
23 Q. If I can refer you to your schedule 4.
24 JUDGE BALLASH: Mr. Smith, is this a good
25 time to take our break?

1 MR. SMITH: No time is better than another
2 so it's fine.
3 JUDGE BALLASH: Let's take a 10-minute
4 break and be back at at five minutes to 11.
5 (Recess.)
6 JUDGE BALLASH: Let's be back on the record
7 after our morning break.
8 Q. Mr. Hanley, do you know the number of
9 utility companies -- not necessarily
10 telecommunications companies -- that have cut
11 dividends in the last three years in response to a
12 lower authorized rate of return or in response to
13 capital market conditions?
14 A. I couldn't answer that. I haven't made
15 such an analysis.
16 Q. Turn to your schedule 4 on your exhibit.
17 There you show selected capitalization and financial
18 statistics for your proxy group of four independent
19 operating companies. Are these statistics indicators
20 of the financial risk faced by these companies?
21 A. No. The financial risk indicated by the
22 company I think is pretty much determined by the
23 single section of ratios, capital structure ratios.
24 There are a number of other statistics on there some
25 of which reflect the impact of it, but I don't know

1 that you could say that they measure or indicate
2 risk by themselves in any way.
3 Q. So the coverages -- are the coverages
4 indicators of the risk of these companies at all?
5 A. Of these risks plural? Did you just say of
6 these risks?
7 Q. Of risks for these companies -- do the
8 coverage ratios shown on page 1, are those indicators
9 of the risk of the four operating companies?
10 A. Over time they would reflect all the risks,
11 the results of operation, the results of all the
12 operating risks, as well as the financial risk.
13 Q. Now, you did not form your sample of
14 companies by reference to these indicators, did you?
15 Rather you compiled the averages after you had formed
16 the sample using the tests described on page 13 of
17 your testimony; is that correct?
18 A. Yes.
19 Q. And the statistics shown on page 1 of
20 schedule 4 are averages of the four independent
21 companies; is that correct?
22 A. That's correct.
23 Q. And is it accurate to say that there is
24 considerable variation in these statistics as reported
25 for each of the companies within the sample?

1 A. Each company will be different, that's
2 right. It's the profile of the group, and that's the
3 purpose of putting a group together rather than
4 relying upon a single company.
5 Q. Would you accept subject to your check that
6 the most recently reported common equity ratio,
7 excluding short-term debt, for the four independents
8 range from a high of 56.5 percent for Cincinnati Bell
9 to a low of 49.5 percent for Rochester Telephone
10 Corporation?
11 A. They sound reasonable, yes. I would accept
12 those as approximations.
13 Q. And on your schedule 1, page 2, the common
14 equity ratio excluding short-term debt for GTE
15 Northwest was 57.119 percent; is that correct?
16 A. No.
17 Q. In 1992?
18 A. No. It's not correct. You said excluding?
19 It's including.
20 Q. With that change.
21 A. If you say including I agree, yes, sir.
22 Q. On schedule 1, page 1, shows that by 1993
23 the common equity ratio excluding short-term debt in
24 this case for GTE Northwest was 59.296 percent; is
25 that correct?

1 A. That's correct, but what I think is
2 important to note that despite this seemingly high
3 equity ratio, which I think is fair to characterize
4 the line of questioning, is that it's important to say
5 that the equity ratio needs to reflect the level of
6 business risk that the enterprise is faced with, and
7 notwithstanding the equity ratios that we were just
8 referring to for GTE Northwest, its bonds have been
9 downgraded by all the major rating agencies including
10 most recently by Standard & Poor's on April 25, and
11 they were downgraded from AA minus to an A plus, and
12 Standard & Poor's basically said the downgrading
13 reflects the erosion in financial measures of credit
14 protection and the company's rising exposure to
15 competitive pressure. "The company's rate structures
16 and revenue mix place the company at a disadvantage and
17 an operating environment that is becoming increasingly
18 competitive." So it would seem to me in my
19 professional expert opinion that in this bond rating
20 process, despite the moving up, as is appropriate, of
21 the equity ratio to reflect increasing business risk
22 environment, apparently still hasn't moved enough to
23 preserve the double A minus bond rating.
24 Q. Increasingly competitive market is a factor
25 for all telephone local exchange companies; is that

1 correct?

2 A. As a general proposition, yes, but however,

3 certain companies are affected more greatly than

4 others due to regulatory policies and other

5 competitive factors.

6 Q. If we compare the common equity ratios for

7 GTE Northwest that you show on schedule 3, page 1,

8 with the average common equity ratios for the four

9 independents, the GTE Northwest ratio is higher in

10 each of the five years shown; is that correct?

11 A. Yes, it is, and during that historical

12 period of time, however, the average bond rating for

13 the four LECs and GTE Northwest was the same, AA

14 minus. No longer the same. GTE Northwest is lower.

15 It's been downgraded to A plus.

16 Q. And the common equity ratios for the four

17 other LECs are shown on schedule 4; is that correct?

18 A. Yes.

19 Q. Now, if we also compared the coverage

20 ratios shown on schedules 3 and 4 after 1988, the

21 ratios for GTE Northwest are superior to those of the

22 independents, is that correct, after 1988?

23 A. Well, that's true, but by that measure

24 alone that obviously wasn't enough to preserve the

25 bond rating.

1 Q. And if we compared the common equity ratios
2 for GTE Northwest shown on schedule 3 with the average
3 common equity ratios for the Bell regional holding
4 companies on schedule 5, GTE Northwest's ratio is
5 higher in each of the five years shown there; is that
6 correct?
7 A. Yes, but with all of these -- it's
8 important I think to recognize that with all of these
9 ratios the rating agencies, and particularly Standard
10 & Poor's, who basically tells you and gives you some
11 tangible parameters of financial benchmarks that they
12 consider -- unlike Moody's and Duff & Phelps who are
13 in some sense more secretive about it. However, they
14 say consistently that they don't look at a given point
15 in time. They're interested in trends and what the
16 prospects are. It's interesting to note that the
17 trends, which can be gleaned from Value Line
18 projections of all of these companies -- and while
19 they differ between groups -- the trends in the common
20 equity ratio are expected to continue to increase.
21 For example, albeit based on permanent
22 capital without short-term debt the average common
23 equity ratio for the four independents is expected to
24 be on average during the 1997 to 1999 period 61.8
25 percent. Now, that's without regard to short-term

1 debt which would probably take a couple of percentage
2 points off of that. And for the seven regional Bell
3 holding companies the average permanent capital common
4 equity ratio is expected to be 63.4 percent on average
5 during that same period of time, rising to meet and
6 offset hopefully the increasing at an accelerating
7 rate business competition.
8 Q. But for the comparison I asked you to make
9 between GTE Northwest and the seven Bell holding
10 companies for the five-year period, in each year the
11 GTE Northwest had a higher common equity ratio; is
12 that correct?
13 A. Well, yes, that is correct, but again, I
14 would point out the average bond rating for the
15 average regional Bell holding companies is a solid AA,
16 not even AA minus, compared to GTE Northwest's A plus.
17 So when you look at one you've got to look at the
18 other. You put the sum together, that's what adds the
19 composite risk.
20 Q. If we made a similar comparison of the
21 coverage ratios shown between GTE Northwest and the
22 Bell holding companies, after 1988 the average ratios
23 for GTE Northwest are superior to those of the Bell
24 companies, is that correct, as shown on schedule 5 for
25 the Bell holding companies?

1 A. Just bear with me a moment, please. That
2 is correct, but again, to demonstrate the fact that
3 that these things are not to be taken in a vacuum, if
4 you look on schedule 2.
5 MR. SMITH: Your Honor, I am going to
6 object at this point. Counsel can fill in the blanks
7 on redirect if he wants. I've got the answer to my
8 question. Now we're going well beyond it for the
9 second or third time.
10 JUDGE BALLASH: I will sustain the
11 objection. Please keep that in mind, Mr. Hanley.
12 Q. Mr. Hanley, in your testimony, you
13 presented a number of different applications of the
14 DCF model. For each of the two proxy groups we've
15 been discussing you estimated the dividend growth rate
16 four different ways; is that correct?
17 A. Yes.
18 Q. And on schedule 16, page 1, you recap your
19 DCF analyses and the average indicated cost of equity
20 for the four independents is 12.1 percent and the
21 figure for the holding companies is 10.4 percent; is
22 that correct?
23 A. Yes.
24 Q. And those are averages of the four
25 applications; is that accurate?

1 A. Yes.
2 Q. Then if I want to follow the numbers in
3 schedule 1, page 3, where you show the derivation of
4 your estimate, you include the 12.1 percent DCF result
5 where you average it with your CAPM and the risk
6 premium model, all of which yields your recommended
7 equity cost rate of 13.2 percent; is that correct?
8 A. It is, yes.
9 Q. And in that averaging you give equal rate
10 to DCF, CAPM and risk premium; is that correct?
11 A. Yes.
12 Q. Although you analyzed similar results for
13 the seven Bell holding companies, those results are
14 not a factor in the 13.2 percent figure. Am I
15 accurate about that?
16 A. Yes, you are.
17 Q. So that other than a general check your
18 analysis of the Bell holding companies did not
19 influence your recommended 3.2 percent return on
20 equity; is that correct?
21 A. That's correct. I did not rely upon it as
22 a group for the reasons that I've stated. It has a
23 much stronger bond rating on average, solid AA, and
24 they are, as I've noted earlier, substantially, very
25 substantially, larger companies.

1 Q. Now, you indicated earlier that in the DCF
2 model the problem is really calculating the growth
3 piece, and in your four different applications, you in
4 fact center on the calculation of growth; is that
5 correct?
6 A. Well, I don't know that. You say I center
7 upon, but I used four different methods because I
8 think it's reasonable to believe that investors would
9 use a variety of techniques rather than just pick
10 unilaterally some single proxy for growth, yes.
11 Q. In your analysis you were concerned with
12 the growth element not so much the yield?
13 A. Yes. That's true, but I'm also concerned
14 that the -- even having done that I'm also concerned
15 that the proxy for growth that is used is not really
16 what investors expect simply because we are forced to
17 look, as I've mentioned before, at accounting measures
18 of growth and I don't believe that that's what
19 investors do. Investors are going to be looking to,
20 among other things, yes, growth in earnings but also
21 changes in price/earnings multiples to get their
22 return rates, and the model as used, standard
23 regulatory DCF model, does not take those changes into
24 account, and they are and are expected to continue to
25 be significant particularly in the telecommunications

1 area.

2 Q. I appreciate your explanation, but the
3 point I wanted to make was only that your four
4 applications of the DCF model were involved with
5 estimating the growth rather than the market price or
6 the dividend.?

7 A. That's true.

8 Q. First method for estimating growth that you
9 employ consists of using five years of historical data
10 and five years of projected data; is that correct?

11 A. Yes.

12 Q. So although the time horizon implicit in
13 the DCF model is infinite, your first method uses an
14 estimate based on ten years worth of data; is that
15 correct?

16 A. I wouldn't word it like that, no. Because
17 that could be misleading especially somebody later
18 reading the record. It uses five years historical
19 data as well as projected data which happens to be
20 five years, and in the absence of any empirical
21 evidence to indicate that investors completely
22 disregard the historical past, that is at least one
23 reasonable approach to look at.

24 Q. Do you have an expert opinion as to the
25 expected long term growth rate of the U.S. economy?

1 A. Personally?
2 Q. Yes.
3 A. No. If I wanted to get some idea of that I
4 would look to econometric organizations, perhaps Chase
5 Econometric, Wharton's Econometrics, perhaps even
6 Value Line's results of its hypothesized economic
7 environment three to five years hence.
8 Q. Schedule 18, page 1, under your first
9 method five years historical and five years projected
10 data for estimating growth, ALLTEL shows a growth rate
11 of 8.2 percent in column 12; is that correct?
12 A. Yes.
13 Q. And I am going to ask you to assume for
14 purposes of a hypothetical question that the expected
15 long term growth rate for the U.S. economy is 7
16 percent. With that hypothetical in mind, if ALLTEL's
17 earnings grew at a rate of 8.2 percent for infinite
18 while the U.S. economy grew at an average rate of 7
19 percent, wouldn't ALLTEL eventually dominate and
20 become virtually the entire U.S. economy which would
21 grow at a rate of 8.2 percent?
22 A. I don't know the answer to that, frankly.
23 I'm not good at estimating infinite and that's the
24 problem with the model, it assumes an infinite
25 horizon, but we're pretty much limited to five years

1 in the future, and you've got the inevitable mismatch
2 of taking price that's presumed in the model to
3 recognize an infinite stream of dividends when in fact
4 all we can do and all the estimates we have are pretty
5 much limited to five years in the future. That's why
6 we should not have relied exclusively on the DCF
7 model.
8 Q. Turn to your second method for estimating
9 dividends growth rates. That's based solely on
10 projected data; is that right?
11 A. Yes.
12 Q. Referring to schedule 19, page 1, column 8,
13 using this method for estimating growth you found a
14 growth rate of 7.9 percent for ALLTEL Corporation; is
15 that correct?
16 A. I'm sorry. You went just a little too fast
17 for me. Can I have your reference, please.
18 Q. Schedule 19, page 1.
19 A. I'm there so please give me the question.
20 Q. This schedule covered your second method
21 of projecting growth, and you found a growth rate of
22 7.9 percent for ALLTEL under this method, is that
23 correct, column 8?
24 A. Yes.
25 Q. And you estimate a growth rate of 8.2

1 percent for Rochester Telephone; is that correct?
2 A. Yes.
3 Q. In the DCF model, the assumption is that
4 these growth rates will continue forever; is that
5 right?
6 A. Unfortunately, that's right, yes. And at a
7 constant rate which is also unfortunate.
8 Q. The figures shown in schedule 19 are based
9 on Value Line and IBES projections of about five
10 years; is that correct?
11 A. Of about five years -- they're the
12 projected rates of growth for five-year period into
13 the future.
14 Q. Turning to your third method for estimating
15 growth, that is based on a combination of internal and
16 external growth rates; is that correct?
17 A. Yes, it is.
18 Q. And that's based on historical and
19 projected data; is that correct?
20 A. Yes.
21 Q. And your fourth method for estimating
22 growth is similar to the method except it relies on
23 only projected data; is that correct?
24 A. That's correct.
25 Q. We look at schedule 20, page 1, column 5,

1 we see your calculations of growth for your third
2 method; is that correct?
3 A. Yes.
4 Q. For ALLTEL it is 14.3 percent. For
5 Cincinnati Bell it is 7.2 percent, for Rochester
6 Telephone it is 8.5 percent and for Southern New
7 England Telecommunications it's 6.2 percent; is that
8 correct?
9 A. Yes.
10 Q. And the average of these four is shown as
11 9.1 percent; is that correct?
12 A. Yes.
13 Q. The DCF model, using method 3 for
14 calculating growth, takes a dividend growth rate of
15 9.1 percent for an indefinite period; is that
16 accurate?
17 A. That is presumed to be the case, yes.
18 Q. Now, if I compare the growth rates shown on
19 schedule 21, page 1, column 2, if I compare those with
20 those shown on schedule 20, page 1, column 2, those
21 are the same growth rates, are they not?
22 A. Yes.
23 Q. And in essence what you have done is to
24 give double weight to the projected data; is that
25 correct?

1 A. No.
2 Q. You average the four DCF methods in your
3 DCF analysis, do you not?
4 A. That's correct.
5 Q. In your methods 3 and 4 for estimating
6 growth, the growth rate is a function of the growth
7 rate of common shares outstanding; is that correct?
8 A. The external growth rate is.
9 Q. Could you please refer to schedule 20, page
10 4, column 2. And column 2 is headed with the letter S
11 and S represents the growth rate in common shares, as
12 I understand it?
13 A. That's right.
14 Q. And column 2 shows the historical data for
15 growth rate in common shares for the four independent
16 companies in your proxy group; is that correct?
17 A. Yes.
18 Q. For ALLTEL you show a growth rate in common
19 shares of 13.7 percent?
20 A. Correct.
21 Q. And have you made an investigation of
22 ALLTEL to determine whether it plans to continue to
23 issue new shares at this rate into the future?
24 A. No. I think it's apparent that the rate is
25 going to decline somewhat by comparison to the same

1 calculation on a projected basis. Schedule 20, page
2 4, is the historical calculation.
3 Q. But it's not likely that ALLTEL is going to
4 be issuing new common equity at that rate ten years
5 into the future, is it?
6 A. I don't know. That's the problem. There
7 are no forecasts out ten years into the future, much
8 less infinite.
9 Q. Well, at that rate of 13.7 percent, how
10 long would it take before ALLTEL became a bigger
11 company than NYNEX which you show with a growth rate
12 of 1.3 percent?
13 A. I don't know. I haven't made the
14 calculation, and besides, next year NYNEX's financial
15 plans could change and so could ALLTEL's. All of
16 these data, whether I use or another analyst uses and
17 ultimately whatever the Commission relies upon, all
18 come from some type of analytical forecasts and those
19 analytical forecasts change all the time. So it not
20 only presumes some constant rate of growth on an
21 infinite basis into the future but that infinite
22 may be quite different or that view of infinite may be
23 quite different three or six or twelve months from
24 now.
25 Q. Same page you show the number of shares of

1 Cincinnati Bell decreased by .6 percent per year for
2 the period of time you looked at; is that correct?
3 A. Yes.
4 Q. And if that continued for an indefinite
5 period of time, Cincinnati Bell's common shares
6 outstanding would approach zero; is that correct?
7 A. That's right, and I think that's no more
8 likely to happen than a growth rate picked now would
9 in fact remain that rate on a constant basis in
10 infinity. These things change all the time.
11 Q. I just have a few more questions on risk
12 premium analysis. Your schedule 22. In formulating
13 your risk premium analysis, did you conclude that
14 investors require 5.7 percent and a 5.3 percent
15 additional return respectively to hold common stock of
16 the four independent LECs and the seven holding
17 companies as compared to a single A public utility
18 bond?
19 A. That's almost quite right. However, I
20 made the adjustments to reflect the average bond
21 rating of each of the two groups which was AA minus
22 and AA. That's why on line 2, page 1, schedule 22, I
23 made a downward adjustment to reflect the prospective
24 costs at the time I prepared this of AA minus and AA
25 respectively.

1 Q. Your conclusion was based on two sources of
2 information as I read your schedule here. One being
3 the beta approach shown on page 7 of schedule 22 and
4 the other being two studies shown on page 8 as
5 schedule 22; is that correct?
6 A. That's correct.
7 Q. Now, if we turn to the beta approach on
8 page 7 of this schedule, am I correct that the only
9 difference between your beta approach here and the
10 CAPM is that in the CAPM the debt security used is
11 supposed to be a risk-free security and you use a
12 bond?
13 A. That's correct, although it is, I believe,
14 a significant difference because if --
15 Q. I'm sorry, did you say significant?
16 A. It is a very significant difference because
17 I think it becomes apparent that the bond rating
18 process is all encompassing and does reflect all
19 elements of diversifiable business and financial risk,
20 so it is significantly more pertinent in that regard
21 than the CAPM which of course reflects none of that
22 and relies only on level of systematic risk.
23 Q. In financial theory, isn't it true that
24 when beta is used as a component of the cost of
25 capital determination that the debt rate costs should

1 be risk free?

2 A. No. I know of nowhere of that. In fact,

3 while it's true I cited Morin you also cited him during

4 this cross-examination, and in his text he gives some

5 examples of using beta as a measure to capture relative

6 risk from the market, and that's precisely what I do is

7 to look at the total return rates on the market as a

8 whole and adjust that for beta in order to get the

9 level of equity risk premium, so I think it's

10 appropriate and consistent with the beta concept.

11 Q. On page 7, schedule 22, your risk premium

12 analysis depends on the value chosen for total return;

13 is that correct?

14 A. You said page 7 of schedule 22?

15 Q. Yes.

16 A. Could you repeat it. I'm sorry for the

17 distraction but I lost my place.

18 Q. Sure. Your risk premium analysis depends

19 on the value chosen for total return; is that correct?

20 A. Well, of course, yes.

21 Q. And does that refer to the overall stock

22 market return?

23 A. It does.

24 Q. And the total return rate of 12.4 percent,

25 is that from Ibbotsen?

1 A. It is, and it's the long term historical
2 average as indicated on line 1 for the Standard &
3 Poor's 500 composite index.
4 Q. Can you tell me what percentage of the
5 Standard and Poor's 500 companies are LECs?
6 A. Well, hopefully it's very small and I think
7 it is very small. I wouldn't want to adjust and
8 contaminate the average but I don't care so much about
9 that, but as it is a broad-based indicator and
10 generally accepted by virtually the entire financial
11 community as the proxy for the market.
12 Q. Is the mean total rate of return of 12.4
13 percent an arithmetic mean return?
14 A. It is, yes.
15 Q. Would your equity risk premium be lower if
16 instead you used a geometric mean return for the same
17 period?
18 A. Not only would it be lower but it would
19 also be incorrect in trying to make an estimate of the
20 forward cost of capital, because the geometric mean
21 return is only appropriately used when measuring
22 portfolio performance on an historic basis.
23 Q. Again, on schedule 22, but on page 8, the
24 AUS Consultants utility service group study was
25 prepared by your firm; is that correct?

1 A. Yes.
2 Q. And the database is the S & P public
3 utility index; is that correct?
4 A. That's correct.
5 Q. Can you tell me what percentage of that
6 index is local exchange telecommunications companies?
7 A. I would have to say I would have to check
8 on that. I just don't recall at the moment so I can't
9 answer that.
10 Q. You would anticipate that it would be a
11 small percentage?
12 A. Yes, if any. And hopefully that's right.
13 It would be very small or perhaps none, but I don't
14 know any precise number.
15 Q. On your 5.1 percent risk premium from your
16 firm's study, was that based on an arithmetic average
17 also?
18 A. Yes.
19 MR. SMITH: Thank you. Those are all my
20 questions.
21 JUDGE BALLASH: Mr. Trotter.
22 MR. TROTTER: Thank you.
23
24 CROSS-EXAMINATION
25 BY MR. TROTTER:

1 Q. You cited, just to cover a couple of
2 questions Mr. Smith asked you, you gave some 1996
3 through 1999 projected equity ratios for the Bell
4 holding companies. What was the source of that quote?
5 A. Value Line.
6 Q. Is it from your exhibits, the Value Line
7 sheets in your exhibits?
8 A. It's from the more recent Value Line which
9 would be April -- I don't have the exact date in my
10 head here.
11 Q. Value Lines?
12 A. In my support -- it would be in the April
13 edition. In the exhibit is the January which was the
14 latest at the time that this was prepared.
15 Q. But Value Line in any event?
16 A. Value Line, yes, sir.
17 Q. Turn to page 7 of your testimony. And here
18 and on subsequent pages you talk about competitive
19 access providers attracting both large local customers
20 and high volume national customers. Do you see that?
21 A. Yes.
22 Q. You have not provided a schedule which
23 shows the dollar impact of that kind of competition on
24 GTE Northwest in Washington; is that right?
25 A. That's correct. And then also at page 7

1 you refer to competition from interexchange carriers
2 as well as wireless and cable TV as, "continues to
3 evolve for both intrastate and interstate
4 communications." And likewise you have not provided a
5 schedule that details the current or projected dollar
6 amount of that type of competition in GTE's -- GTE
7 Northwest's Washington service territory; is that
8 right?
9 A. Well, I have not but with regard to that
10 portion of my testimony, Mr. Sanchez responded to your
11 data request No. 23 and indicated essentially specific
12 studies in that regard have not been prepared but he
13 did refer you to response provided to your data
14 request No. 33 and also my response to your No. 10, so
15 they would be our official replies, if you will.
16 Q. And included in that were some certain FCC
17 study documents; is that right?
18 A. Yes.
19 Q. Did you review those prior to your
20 preparing your testimony in this proceeding?
21 A. Prior to preparing my testimony, I did not,
22 no.
23 Q. Did you review those subsequent to
24 preparing your testimony?
25 A. Yes.

1 Q. And those were GTE Northwest's estimate of
2 Washington bypass; is that right?
3 A. Yes.
4 Q. Is that total state or Washington
5 intrastate only?
6 A. Let me just check. I believe it to be the
7 Washington state.
8 Q. So that would include intra and interstate
9 Washington?
10 A. Yes.
11 Q. And the FCC ceased requiring filing of
12 bypass reports in 1992; is that right?
13 A. Yes, sir.
14 Q. And were the reports that GTE filed ever
15 reviewed by the FCC in any formal way, tested in any
16 formal way or were they simply filed?
17 A. I cannot respond to that. I don't know.
18 Q. Did you do an independent evaluation of
19 those reports?
20 A. I did not.
21 Q. In your opinion, is cellular telephone a
22 competition for GTE Northwest?
23 A. Yes.
24 Q. Did you provide any schedules which
25 quantified the dollar impact of cellular telephone

1 competition on GTE Northwest's revenue?
2 A. No.
3 Q. Which GTE subsidiaries offer cellular
4 service in Washington or subsidiaries of GTE
5 Northwest?
6 A. At this time there is none offered to the
7 best of my knowledge.
8 Q. Are you familiar with GTE Mobilnet and
9 Contel Cellular?
10 A. Well, I don't know how you define familiar,
11 but I am aware of them, yes.
12 Q. And neither of those -- well, what is the
13 relationship between those two companies and GTE or
14 GTE Northwest?
15 A. Well, they are subsidiaries of GTE and in
16 some sense they're affiliates and Contel, of course,
17 is since the merger.
18 Q. And neither of those companies are offering
19 cellular services in GTE Northwest's territory?
20 A. That is my understanding, yes, sir.
21 Q. On page 8 of your testimony around line 21,
22 you discuss -- in addition to the alternative local
23 transport companies you also mention cable TV,
24 cellular and other wireless services such as PCS; is
25 that right?

1 A. Yes.
2 Q. And you have not provided an exhibit that
3 projects the dollar impact of those services on the
4 income stream of GTE in the northwest in the future,
5 have you?
6 A. No, I haven't, but as we indicated in
7 response to several of your data requests, nor have I
8 made any attempt to adjust the recommended equity cost
9 rate to reflect that. These are risks that are there
10 in a general sense prospectively facing the industry.
11 Q. Well, to the extent investors reflect them
12 in the prices paid for commodities, they're reflected
13 by you, are they not?
14 A. Well, if you accept the notion that
15 investors are all knowing, but investors unfortunately
16 aren't all knowing. Something that is so nebulous
17 can hardly be reflected in any measurable sense of the
18 word because they have yet to know what the impact
19 will be. It's there, it's a contingent fear. They're
20 don't know if they're going to be shot by a .22 or a
21 .44 magnum so they can't know prospectively.
22 Q. In your review of GTE's filings with the
23 FCC on the bypass report, did you consider those
24 reports to be nebulous?
25 A. No. To that extent they were specific, and

1 to that extent I gleaned that on an annualized basis,
2 at that point in time, anyway, that a full 6 percent
3 of Washington operation revenues have been affected.
4 That's -- that's not tremendous. It's not
5 inordinately significant but it's not insignificant
6 either, and probably my intuitive sense is that with
7 the promotion of competition to the extent that it
8 exists in the state that that's going to be a very
9 growing number.
10 Q. Do you agree that GTE has developed -- is
11 developing facilities as effective deterrent to any
12 erosion in its major customer base?
13 A. That I don't know and I honestly have to
14 say, however, humbling I think that type of analysis
15 would go beyond the scope of my expertise.
16 Q. So you did not consider it a part of your
17 assignment to analyze how GTE NW is or is -- is and
18 will be responding to competition in the future?
19 A. No. And moreover it's pretty much I
20 believe proprietary, and even if I had, I doubt if
21 they would let me sit up here and let me have my mouth
22 in motion on it.
23 Q. Would you agree subject to check that in
24 GTE Northwest's 1993 annual report they informed
25 investors, "We continue to actively develop our fiber

1 rings (such as those in Portland and Puget Sound
2 metropolitan areas) as an effective deterrent to any
3 erosion in our major customer base." Would you accept
4 that?
5 A. I recall that specifically, yes.
6 Q. On page 8 beginning on line 6 you talk
7 about competitive pricing and pricing by competitors
8 and you say "because they are not burdened by the
9 obligation to serve as are the LEC's." What is the
10 source of your opinion that they are not burdened by
11 the obligation to serve?
12 A. General information, knowledge and belief
13 and my vast reading of a lot of material on the
14 industry.
15 Q. Does that include Washington statutes?
16 A. I can't address Washington statutes. That
17 would be something for counsel. If I am in error on
18 that, then the legal part of it I assure will
19 supersede me. I am not an attorney.
20 Q. On page 12 of your testimony, line 15, you
21 acknowledge that GTE Northwest's access lines has
22 grown -- have grown steadily within the last five
23 years to approximately 1.3 million by year end 1993;
24 is that right?
25 A. Yes.

1 MR. TROTTER: Your Honor, this might be an
2 appropriate point to break. I can continue.
3 JUDGE BALLASH: Why don't we break at this
4 time. Let's be off the record and be back at 1:30
5 p.m.
6 (Lunch recess.)
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1 A F T E R N O O N S E S S I O N
2 1:30 p.m.
3 JUDGE BALLASH: Let's be back on the record
4 after our lunch break. Mr. Trotter.
5 BY MR. TROTTER:
6 Q. Mr. Hanley, your cost of capital estimate
7 is valid for approximately three years; is that
8 correct?
9 A. Yes. Up to three years.
10 Q. Turn to page 14 of your testimony. This is
11 in the area beginning on page 13 where you talk about
12 your proxy groups, and on line 18 you say you did not
13 include GTE as a suitable proxy for GTE Northwest
14 because of the diversity of its nonlocal exchange and
15 nonutility businesses, and a couple of pages earlier
16 you identified those businesses in general terms; is
17 that right?
18 A. Yes.
19 Q. Now, you testified earlier that you
20 couldn't speculate as to whether GTE was more risky
21 than GTE Northwest, so if that is the case, why is
22 your testimony on lines 18 through 20 relevant?
23 A. Well, it's relevant basically for the
24 reasons given. One is the diversity of the local
25 exchange businesses I mentioned this morning, I think

1 in response to Mr. Smith's questions. And also while
2 I did not make an analysis on the surface, one should
3 try and use companies that at least for sure on the
4 surface seem to be in a generally similar business
5 environment, and for example, I note today in today's
6 papers there's an announcement that GTE has created a
7 new company called Interactive Media and is going to
8 get into the video games software business in a very
9 large way, and I think that this simply demonstrates
10 that this kind of a holding company and the diversity
11 and the completely unrelated kinds of activities make
12 it not a suitable proxy.
13 Q. Let me ask it this way. If GTE was of
14 comparable risk to GTE Northwest, would it be
15 appropriate to use it as a proxy?
16 A. It would be appropriate to consider it as a
17 proxy, but certainly by no means the proxy for sure
18 because under any circumstances one should look to
19 other groups, proxy groups, to avoid circularity.
20 Q. And the other proxy groups that you're
21 relying on -- and I use that term relying on carefully
22 because you're not relying on the RBOCs, are you?
23 A. No. That's correct. I reviewed their
24 results. I considered them but did not rely on them.
25 Q. And so the proxy group consists of four

1 nonBell publicly traded telephone companies; is that
2 right?
3 A. Yes.
4 Q. Now, assume hypothetically, if you will,
5 that, say, two of those four companies are merged with
6 a Bell operating company or AT&T or some other large
7 telephone company. Would two -- the two remaining
8 local exchange companies be sufficient for a proxy
9 group, in your opinion?
10 A. Well, it wouldn't be ideal, but if out of
11 the universe that that's all that was available, it
12 would certainly be preferable to pick two companies
13 that were more nearly like the company in question
14 than to pick a larger group of companies that clearly
15 are not comparable to the company in question.
16 Q. And if there were none, if all of these
17 were merged into regional Bell holding companies, what
18 would your approach be?
19 A. Well, then I think the process becomes more
20 difficult. Then you would have to rely upon what was
21 available and to make an adjustment for the risk
22 differential however difficult that may be to
23 quantify.
24 Q. On page 13 you discuss in your criteria
25 first --

1 A. Did you say 13?
2 Q. Yes, of your testimony. You added today
3 the word domestic company to your characterization.
4 Is that a sixth criteria? Did you weed out companies
5 that were not domestic as part of your sifting
6 process?
7 A. I weeded out nondomestic companies, yes.
8 I corrected the inadvertent omission of the word
9 here, but if you look carefully in my exhibit you
10 will see that it is in the exhibit. So I didn't add
11 it today. I simply corrected the prior omission.
12 Q. But in terms of the numbered criteria, we
13 could add an additional number for domestic versus
14 nondomestic?
15 A. I'm sorry. I do not understand your
16 question.
17 Q. On lines 19 through 23 of page 13 of your
18 testimony, you identify the criteria that you used to
19 sift companies to get to your proxy groups?
20 A. Yes.
21 Q. Nowhere in those five enumerated criteria
22 is there a sift for domestic versus nondomestic; is
23 that correct? Or is it there but I don't see it?
24 A. Well, it's corrected by the correction
25 today on -- that I made on line 17 consists of those

1 domestic companies, so by implication if they were not
2 domestic they weren't considered.
3 Q. So you had an initial shift -- sift -- of
4 getting just domestic companies and then you applied
5 the five criteria to it?
6 A. Yes.
7 Q. And one of your criteria was that they had
8 less than 30 percent of total 1992 revenues derived
9 from long distance operations, and by long distance
10 operations do you mean interLATA long distance?
11 A. No, just total long distance because
12 they're not always that clear on the information
13 available. Whatever is categorized as long distance
14 revenues, intra or inter.
15 Q. The operating risk of interexchange
16 carriers is generally greater than that of local
17 exchange carriers. Would you agree with that?
18 A. Yes.
19 Q. So by limiting your sample group companies
20 to those which had revenues from long distance
21 operations below 30 percent of total revenues, you
22 wanted to insure that your proxy group's operating
23 risk wasn't unnecessarily high. Is that true?
24 A. That's true.
25 Q. Now, GTE Northwest had no Washington

1 revenues associated with interLATA long distance, did
2 it?
3 A. Did not, correct.
4 Q. And do you know what percentage it had of
5 long distance in 1992?
6 A. In 1992, not off the top of my head, no,
7 sir. I'm sure I have the information but I just don't
8 recall it at the moment.
9 Q. If you could provide that as a response to
10 record requisition 1.
11 (Record Requisition 1.)
12 Q. This would be the percentage of GTE
13 Northwest long distance for 1992.
14 JUDGE BALLASH: 1992?
15 MR. TROTTER: Yes, total 1992.
16 JUDGE BALLASH: That will be record
17 requisition No. 1.
18 Q. Now, one parameter you elected not to
19 consider in selecting your sample group was the
20 percentage of revenues derived from unregulated
21 competitive operations; is that correct?
22 A. Could you repeat the question, please.
23 Q. One parameter you elected not to consider
24 in selecting your sample group was the percentage of
25 revenues derived from unregulated competitive services

1 or operations; is that correct?
2 A. Well, I guess you could say that by
3 inference I chose those parameters that I believed
4 were relevant and meaningful in picking my group. Now
5 the way you worded the question would imply that
6 that I considered that and rejected it. That I don't
7 think is the case. I picked those measures that I
8 believed to be good and meaningful screens.
9 Q. Would you turn to your Exhibit 3, schedule
10 18, page 4. This is the Value Line sheet for ALLTEL
11 Corporation one of your proxy companies. I would like
12 to focus on just below the middle of the page in the
13 finer fine print under the category business. Do you
14 see that?
15 A. Yes.
16 Q. And in that section, it indicates that
17 ALLTEL has cellular operations, does it not?
18 A. Yes.
19 Q. And I asked you earlier whether GTE NW had
20 any cellular operations in Washington, and your
21 response was that you --
22 A. My response was to the best of my knowledge
23 they do not in Washington. I believe that they may
24 have on a limited basis through Mobilnet in the
25 Portland area at one location.

1 Q. Is there anything preventing GTE Northwest
2 from going into the cellular business?
3 A. I don't know. I don't know. That may even
4 have a legal implication. I don't know.
5 Q. Now, Value Line also notes -- first of all,
6 just for the record Portland is not in the Washington
7 jurisdiction, correct?
8 A. Correct.
9 Q. Also, it indicates that ALLTEL is involved
10 in telecommunications supplied distribution 18 percent
11 of 1992 revenues. Do you see that?
12 A. Yes.
13 Q. What is GTE Northwest's percentage of
14 revenues devoted to that function?
15 A. Off the top of my head I don't recall
16 without looking in the work papers.
17 Q. And is this an unregulated or regulated
18 function?
19 A. I would take it with regard to ALLTEL to be
20 an unregulated function.
21 Q. And it also indicates that ALLTEL has data
22 processing management 28 percent of 1992 revenues. Do
23 you see that?
24 A. Yes.
25 Q. Do you know what percentage of GTE

1 Northwest's Washington revenues for '92 were derived
2 from data processing management?
3 A. I do not know.
4 Q. Is that something you analyzed?
5 A. Specifically, no, because what I
6 concentrated on was the characterization of the
7 companies and number of access lines and those other
8 elements. In other words, these companies are thought
9 of primarily based on their SEC readings and whatnot
10 as telephone communications, and to that extent all of
11 the companies are considered comparable.
12 Q. Let's go to the next item there in the
13 finer fine print. Telephone division 45 percent of
14 1992 revenues. Do you see that?
15 A. Yes.
16 Q. Just based on your review of this detail or
17 based on your knowledge, does that mean that 45
18 percent of ALLTEL's revenues are subject to regulation
19 by regulators?
20 A. Yes.
21 Q. Let's go to page 5 of schedule 18, the
22 Value Line sheet for Cincinnati Bell. And in the same
23 portion, the business portion of that sheet, it shows
24 for the 1992 revenue breakdown telephone operations,
25 52 percent. Do you see that?

1 A. Yes.
2 Q. And it also indicates unregulated
3 operations are mainly in information services,
4 software related to telecommunications, CBIS, and
5 telemarketing services, matrixx marketing. Did I read
6 that correctly?
7 A. Yes.
8 Q. Does GTE Northwest have either a
9 telecommunications software or a telemarketing
10 subsidiary?
11 A. No.
12 Q. Now, back on page 16 of your testimony, you
13 were asked some questions about this earlier regarding
14 capital structure, and I take it that you have used
15 the -- what you call the actual and proforma capital
16 structure as of December 31, 1993; is that right?
17 A. Yes.
18 Q. Now, I learned an awful lot from
19 accountants in my day and they always made a
20 distinction between actual and proforma, you can't
21 have both, so let me ask you this. When you say
22 actual and proforma, that means you started with
23 actual and then made proforma adjustments to it?
24 A. Yes.
25 Q. And so the result is a proforma capital

1 structure although it's based on actuals at the
2 starting point?
3 A. Right. The distinction, just for
4 clarification so no one is confused, is that sometimes
5 -- and especially in some jurisdictions -- one works
6 towards an estimated capital structure to which
7 adjustments are made, and then if the timing of the
8 proceedings warrant it can then be updated for the
9 actual and reflecting proforma adjustments, and since
10 this was prepared at least initially prior -- well,
11 the first version, as you know, was prepared prior to
12 December 31, and so I wanted to make that
13 clarification on the update.
14 Q. Let's go back to schedule 6, page 1, and I
15 take it one of the things that was established earlier
16 was that the short-term debt at December 1993 was
17 considerably greater than zero on an actual basis; is
18 that right?
19 A. Yes, but has been refunded from the
20 permanent financing.
21 Q. And that's at footnote 5, attempts to
22 explain it, but you amplified on that explanation; is
23 that right?
24 A. Yes.
25 Q. Let's go down the page then. I would like

1 to focus on common equity. You show retained earnings
2 of $466.3 million and total common equity of $972
3 million; is that right?
4 A. Yes.
5 Q. And you have a footnote 8 related to the
6 amount of common stock and additional paid-in capital;
7 is that right?
8 A. Yes.
9 Q. Now, in looking at GTE Northwest's 1993
10 annual report, it showed for shareholders' equity
11 897.4 million in total common equity, and retained
12 earnings, or reinvested earnings, of $391.7 million.
13 Would you accept those two figures subject to check?
14 A. Yes.
15 Q. And it did not appear to us that the
16 difference between those two figures and the figures
17 you show on schedule 6 were justified entirely by the
18 footnote 8 explanation. Appeared to be about a $75
19 million difference. Could you enlighten us on that?
20 A. I think so, I hope so. I think this is
21 attributable to the re-engineering costs that GTE Corp
22 booked and was in essence allocated or distributed to
23 the subsidiaries in 1993. The expense charges are
24 below the line, which is where I would think they
25 should be because there's going to be some degree of

1 benefit over a prospective period of time resulting
2 from those costs. The charge was taken from an
3 accounting viewpoint against retained earnings in 1993
4 for rate making purposes. I believe my assessment of
5 it is, is that it is appropriate to disregard that
6 charge for rate making purposes against the capital
7 structure for several reasons. One, by virtue of that
8 accounting concept, there is no change at that moment
9 in time in the rate base either on a company-wide or a
10 jurisdictional basis. And therefore it would be
11 inappropriate to, based on an accounting adjustment,
12 to presume, which would be the inevitable fall-out of
13 reflecting the lower level of retained earnings, that
14 suddenly there is considerably more debt financing the
15 investment than was the case prior to putting the ink,
16 so to speak, in a figurative sense on a piece of
17 paper.
18 The second reason is that the benefits, to
19 the extent that they will accrue as expected, are
20 going to occur over a prospective period of time which
21 will result, hopefully, if it goes according to plan,
22 a greater level or degree of earnings, hence a greater
23 acceleration than would have been the case otherwise,
24 all else equal, in the accumulation of retained
25 earnings. So for these reasons I believe it is

1 appropriate to exclude that as though that accounting
2 function did not occur for rate making purposes.
3 Q. The accounting event that you referred to,
4 is that a restructuring related to restructuring
5 costs?
6 A. Yes.
7 Q. Now, how come that change is not footnoted
8 on page 2 of your exhibit schedule 6?
9 A. Well, probably because it's an omission on
10 my part which I apologize for. I probably should have
11 had an explanatory notation on there and I didn't. I
12 apologize for the confusion.
13 Q. The annual report for 1993 reports a
14 restructuring cost of $106.4 million, but the
15 difference we see on these figures is not 106.4
16 million. Can you track that for me?
17 A. What was your reference to the -- you just
18 held a document in your hand. What was that?
19 Q. Xerox sheet from the '93 annual report.
20 A. Northwest?
21 Q. Yeah.
22 A. Yeah. I believe it's probably the tax
23 effect.
24 Q. Let's just do it this way. As response to
25 record requisition 2, could you just please explain

1 all changes from book total common equity to your
2 proforma total common equity shown on schedule 6, page
3 1.
4 JUDGE BALLASH: That will be record
5 requisition No. 2.
6 (Record Requistion 2.)
7 Q. Would you accept subject to your check that
8 if we just looked at the December 31, 1993 annual
9 report, which would include the short-term debt and
10 the shareholders' equity as reported, that you would
11 have a common equity ratio at year end for GTE
12 Northwest of 51.18 percent; preferred stock .23
13 percent; long-term debt 37.83 percent; and short-term
14 debt of 10 and three quarters percent?
15 A. I will accept those subject to check. If I
16 disagree we'll let you know.
17 Q. Turn to your schedule 4, page 1, and this
18 is your proxy group of the four independents, and the
19 five-year average common equity ratio shown in the
20 right-hand column was 50.5 percent for those
21 companies; is that right?
22 A. Yes.
23 Q. And it's your testimony that these
24 independent companies are the most comparable to GTE
25 Northwest of any that you studied?

1 A. Yes.
2 Q. Turn to schedule 6, page 4, and this shows
3 the capital structure of your proxy group consisting
4 of the Bell holding companies; is that right?
5 A. Yes.
6 Q. And then down at the very bottom you show
7 the proxy group average and the average common equity
8 ratio for that group as of 1992 was 52.83 percent?
9 A. Well, I would consider it to be 52.95. I
10 would include the minority interest for comparative
11 purposes.
12 Q. Okay, thank you. So the average debt ratio
13 for those companies would be 47.05 percent?
14 A. Yes, including short term.
15 Q. Turn to page -- turn to schedule 22, page
16 3, and this shows bond ratings for your proxy groups
17 and for the Bell companies. The average -- it's on
18 the very bottom line before the notes -- average for
19 the group -- meaning the Bell holding company group --
20 is AA; is that right?
21 A. Yes.
22 Q. Now, in your testimony you testified that
23 Standard & Poor's maximum total debt ratio for a
24 AA-rated utility is 42 percent. Could you explain how
25 the regional Bell holding companies can have an

1 average total debt ratio of 47 -- over 47 percent and
2 have an AA bond rating?
3 A. I believe so, yes. These Standard & Poor's
4 financial benchmark or financial ratio guidelines, as
5 they're actually called, which are summarized on
6 schedule 2, page 4 of Exhibit 3, are just that. They
7 are guidelines. They are not rigid parameters that
8 must be adhered to at all times. Standard & Poor's
9 has in a number of its publications indicated clearly
10 that while they are important they aren't the be-all
11 end-all and that they look at trends as will be
12 affected in the future. So if they believe that the
13 trend is going in the proper direction to attain and
14 maintain within those financial guidelines over a
15 prospective average period of time in the future, they
16 will tend to preserve the bond rating. And the same
17 thing is true not only for the debt equity ratios but
18 also for the other guidelines which would include the
19 pre-tax coverage of interest charges.
20 Q. Does that complete your answer?
21 A. Yes.
22 Q. Turn to schedule 6, page 4, again the
23 capital structures for the proxy Bell holding
24 companies. Let's just take a look at Ameritech. From
25 1988 to 1992, the equity ratio declined from over 61

1 percent to just over 51 percent; is that right?
2 A. Yes, sir.
3 Q. And U S WEST declined from about 51 percent
4 to 48 percent; is that right?
5 A. Yes, but I wouldn't say there's by any
6 means a steady trend. As you can see looking across
7 laterally for U S WEST, the same thing is true for
8 most of the companies. In fact, that you can see a
9 trend, it changes. For example, U S WEST in 1989 was
10 48.25 percent, but in 1990 was 50.66 percent.
11 Q. Would this five-year trend as shown on this
12 schedule have been generally forecast in 1988? Put
13 another way, would Standard & Poor's have understood
14 that this trend in 1988 --
15 A. I think it's been clear that there has been
16 a need and a trend for increasing equity ratios
17 responding to increased business risk. Whether they
18 anticipated the difficulties or the degree of -- or
19 the level of effort that it would take to attain
20 that within a certain period of time, I don't know. I
21 don't know what was in their minds, in what period of
22 time they anticipated it would occur, but to the
23 extent that as a group they've been managing to hold
24 on to the AA bond rating, despite the fact that their
25 debt ratios would indicate looking at them in a

1 vacuum, if you will, that they ought not be AA as a
2 group, tells me that they do expect the ratios to
3 increase and they are optimistic that they will be at
4 least at a level commensurate with the degree of
5 business risk which they face and are expected to
6 face.
7 Q. Does it also tell you that Standard and
8 Poor's looks at a lot of other factors other than
9 equity ratio?
10 A. For sure. Very, very much so, but,
11 however, in the final analysis, since it is a credit
12 rating that they give, they're interested in the
13 security of their bond holders and they want to make
14 sure it is an extremely important indicator that the
15 equity underlying that is commensurate so that it
16 doesn't jeopardize the bond holders which is their
17 primary concern.
18 Q. Let's turn to page 27 of your testimony,
19 and here you're talking about how, in your view, a
20 change in price/earnings multiples influences a
21 DCF-derived common equity cost rate; is that right?
22 A. Yes.
23 Q. And that narrative and your schedule 12
24 shows a case where the P/E ratio increases and in that
25 instance you state that the DCF produces a result, 14

1 percent, which understates what you call the "true
2 cost of equity" of 15.6 percent; is that right?
3 A. In that example, yes, sir.
4 Q. On page 28, lines 15 to 16, you state that
5 the converse situation is also likely.
6 A. Yes.
7 Q. The converse of P/E ratios increasing is
8 P/E ratios decreasing; is that right?
9 A. That's right.
10 Q. And the converse of the DCF understating
11 the "true cost of equity" is DCF overstating the true
12 cost of equity; is that right?
13 A. No. It could -- this is a hypothetical
14 example, and it is as though in a vacuum. My only
15 point with regard to that whole discussion is that P/E
16 multiples can and do change and that the standard
17 regulatory version of the model does not take it into
18 account. And by "it" I mean specifically expected
19 changes in price/earnings multiples. It counts on
20 picking a proxy for future dividend growth over an
21 infinite horizon in the future.
22 Q. Well, let me ask it this way. Your
23 schedule 12 contains an illustration of the impact on
24 DCF-derived common equity of assumed -- of an assumed
25 increase in the P/E multiple; is that right?

1 A. Yes.
2 Q. Now, if you did an illustration of the
3 impact on DCF-derived common equity of an expected
4 decrease in the P/E multiple, which is the converse,
5 would the result be that the DCF would overstate the
6 true cost of equity in that circumstance?
7 A. It would only to the extent that everything
8 else is perfectly forecast, nothing else changes,
9 which is of course an unrealistic situation, and that
10 the only change, the only difference between what you
11 would expect or as an analyst you decided upon in
12 formulating your DCF result applying the model. Only
13 under those circumstances would that be true. Of
14 course that's an unrealistic assumption in itself.
15 The main point of the demonstration and the discussion
16 at pages 27 through top of page 29 is to focus on the
17 fact that the standard regulatory model does not take
18 those changes into account. And it's important, I
19 think, to recognize, accept in the telecommunications
20 area that it's beginning to be recognized, for
21 example.
22 MR. TROTTER: Your Honor, just for the
23 record this question started out as being whether the
24 converse applied, and he said it didn't, and now we're
25 getting I don't know what, but I am unable to

1 cross-examine because it's been going on for so long.
2 MR. PARKER: Well, I think it's a fair
3 response. He asked if the converse was true, and Mr.
4 Hanley, if I understood your testimony, said it was if,
5 and now is explaining what the if's are.
6 MR. TROTTER: He said if everything else
7 was constant.
8 JUDGE BALLASH: If you want to explore this
9 further, Mr. Parker, on redirect you may do so.
10 Q. Let me ask you this. On schedule 12 did
11 you assume all else was constant?
12 A. For this illustration, yes.
13 Q. Did you assume that nothing else changed
14 except the P/E ratio?
15 A. Yes.
16 Q. Now, the Value Line pages that we looked at
17 earlier -- and let's just go back to ALLTEL, schedule
18 18, page 4. Value Line reports the price/earnings
19 ratio on a projected basis, does it not?
20 A. Yes.
21 Q. And could you just point to us where on
22 that sheet it does so?
23 A. Well, in this particular sheet it's in the
24 extreme right-hand column towards about one third of
25 the way down the page.

1 Q. Average annual P/E ratio of it looks like
2 18?
3 A. Yes.
4 Q. And that's projected for the 1996 to 1998
5 period; is that right?
6 A. Yes.
7 Q. And if we look at this data for your proxy
8 companies, compared to each company's 1993 P/E ratio,
9 would we find that P/E ratios are expected to increase
10 for this group or are they expected to decrease?
11 A. I think you will find they're expected to
12 decrease.
13 Q. Did you take that fact into account in --
14 let me put it this way. You did not provide testimony
15 on that particular factor in Exhibit T-2, did you?
16 A. I don't understand your question because in
17 response to the prior questions, which is the point I
18 was trying to make was, the main focus of the point is
19 that the model does not take into account -- the DCF
20 model does not take into account relative changes
21 among other things in price/earnings multiples.
22 Q. So let me ask you this. Did you take into
23 account changes in price/earnings multiples on a
24 projected basis for each of your comparable companies
25 in making your DCF or any other cost of capital

1 determination in this proceeding?
2 A. No, I didn't, but I recognize the fact that
3 no model, including the DCF, is so inherently correct
4 based on its assumptions that it could be relied upon
5 exclusively. That is the theme that I've maintained
6 over many years in many jurisdictions.
7 Q. And virtually all jurisdictions continue to
8 use DCF, do they not?
9 A. As a principal tool, but the majority do
10 not rely upon it exclusively.
11 Q. On page 32 of your testimony, line 11
12 through 15 you indicate that a market-based DCF cost
13 rate applied to the book value of common stock could
14 either overstate the common equity cost rate when the
15 market value was much less than book or understate it
16 when the market value was above book. Is this a fair
17 paraphrasing?
18 A. Yes.
19 Q. Now, you've been testifying in rate cases
20 since the late 1970s; is that right?
21 A. Well, I wish it were but I'm a little older
22 than that. Since the early 1970s.
23 Q. And in the last part of the 70s and the
24 early 1980's -- before I ask that -- and you testified
25 not just in telephone but also in energy, electric and

1 natural gas proceedings?
2 A. Yes.
3 Q. And in the late 1970s and early 1980's the
4 market prices of utilities, certain utilities at
5 least, were generally below book value, were they not?
6 A. Yes.
7 Q. And so you have testified on behalf of such
8 utilities when their market price was below booked; is
9 that right?
10 A. Yes.
11 Q. Have you ever made the statement in any
12 testimony you have submitted anywhere that your DCF
13 result overstated the cost of equity because the
14 market price of the utility for whom you were
15 testifying was below book value?
16 A. Well, you see, I didn't have to then
17 because I didn't rely exclusively on the DCF. I did
18 then what I do now. I use a number of models and so
19 when the DCF -- when the market values were
20 substantially below book values, and the cost rates
21 resulting from the application of the DCF were in that
22 16, 18, 19 percent area, my recommendations weren't
23 based on DCF. They were ameliorated downward, and my
24 recommendations were lower. The reason I point out
25 about the understatement now is because with the

1 changes of the times, it's only since those times that
2 there's been such a love affair with between many
3 regulators and the DCF, but the concept hasn't
4 changed. I have not relied exclusively on the DCF
5 then and I don't now. Had I done so then, my
6 recommendations would have been higher.
7 Q. Now, in this case you are testifying that a
8 market-based DCF cost rate applied to book value could
9 overstate or understate the cost rate when market
10 value is less or above book respectively?
11 A. Yes.
12 Q. Did you give that testimony in your prior
13 proceedings when you were testifying for utilities
14 that were selling below book?
15 A. No, I didn't because I didn't feel I have
16 to mainly because most of the jurisdictions then
17 weren't relying, or if they were, not so heavily on
18 DCF. I made my recommendation -- the purpose of
19 making it now, frankly, in cases is to make the appeal
20 and the argument that the DCF, it is a very good
21 academic model but other models are academically good
22 and sound. The DCF is not superior to other models.
23 It has a lot of invalid assumptions that aren't
24 reflected in application. No one model should be
25 relied upon exclusively.

1 Q. It's your testimony that in the past most
2 Commissions were not relying on DCF?
3 A. Not to the extent that they have been in
4 the last 12, 15 years, no, sir.
5 Q. What's your proof of that?
6 A. My experience.
7 Q. Now, you have in a data response
8 subsequently given us a NARUC survey of states that
9 use DCF or whatever common equity estimating tool is
10 used. Do you recall that response?
11 A. Yes.
12 Q. And are you relying on any similar survey
13 from the prior period to support your experience?
14 A. No. In fact I don't know that there was
15 such surveys back then and if there was I was probably
16 unaware of them.
17 Q. Turn to page 33 of your testimony, and here
18 beginning on line 18 you're referring us to a Wall
19 Street Journal article which you include in your
20 schedule 15. And that is the reports on a study
21 which finds no clear link between stock prices,
22 earnings and interest rates. Is that correct?
23 A. Yes.
24 Q. And you're relying on this article, which
25 relies on a study, as another reason not to rely on

1 DCF; is that right?

2 A. Not quite. I would only clarify the last

3 part -- and for your information I do have the study

4 and I read the study, so I am aware of all that's in

5 the study. When you say to not rely upon, if you add

6 the word exclusively then yes. I have relied upon

7 the DCF and I think I've given it the weight it

8 deserves as a meaningful model along with other

9 meaningful models but have not given exclusive weight,

10 have not relied upon it solely.

11 Q. Now, the article that you provide in

12 schedule 15 and the underlying study is not a study of

13 DCF specifically at all, is it? It's about market

14 behavior; is that right?

15 A. That's right.

16 Q. And so the criticism -- well, it's

17 basically a criticism of the efficient market

18 hypotheses; is that right?

19 A. Well, yes, you can say that, but as far as

20 specifically the inferences to or the relationship to

21 the DCF model is, is that the model assumes that the

22 return is based only on the income derived from

23 dividends and dividends are derived from earnings, and

24 this study confirms I think what a lot of people

25 know by common sense is that the market is driven by

1 many other nebulous and intangible things, not just
2 earnings, and earnings and interest rates are
3 extremely important to utilities that are
4 capital-intensive and interest rate driven.
5 Q. I would like to focus on the efficient rate
6 market hypothesis. It's your testimony that the market
7 may not be efficient at all and certainly is not
8 efficient in the short run as confirmed by the schedule
9 15 referenced study?
10 A. Yes.
11 Q. Refer you to your --
12 A. Yes. Although I subscribe -- and
13 notwithstanding that all the models employed are at
14 least dependent upon the semistrong version of the
15 efficient market hypothesis, that it presumes that
16 investors have knowledge of historical events and all
17 public information that is available, and that those
18 things are impounded in market dealing.
19 Q. To the extent that the market may be
20 efficient at all would be a criticism of risk premium
21 and CAPM as well; is that right?
22 A. Yes, but I think to a significantly lesser
23 degree for the reasons indicated in my testimony --
24 Q. And yet you gave DCF equal weight with
25 your other methods, did you not?

1 A. I did.
2 Q. Mr. Hanley, if I was or if one of your
3 clients was about to invest $500 in either a telephone
4 utility or a gas distribution utility both which have
5 a beta coefficient of .8, which of those two firms
6 would you tell her has more investment risk?
7 A. Not to answer the question -- hopefully I
8 will answer it but I would like to answer it this way
9 if I may. I would tell her first if that's all she
10 has to invest is $500 to put it into a mutual fund and
11 kind of diversify her investment and don't put it all
12 into a single stock. That's the first thing I would
13 tell her. If she was adamant and chose not to listen
14 and said, no, just tell me one or the other, I would
15 say that over time if she made the investment and that
16 there are studies that indicate this that it probably
17 wouldn't make a whole lot of difference if they could
18 hang in for the longer run. But in the short run it
19 would require a lot more analysis than just telling me
20 one is in one industry and the other is in another.
21 Q. So would you agree that firms that have
22 the same beta may have a different level of investment
23 risk?
24 A. The diversifiable risk, yes.
25 Q. So there's more to investment risk than is

1 captured in a beta coefficient; is that right?
2 A. Well, that's right, although it would
3 certainly seem that the capital asset pricing model
4 works and beta works a lot better than some studies
5 that came out several years ago indicated. There have
6 been a lot of responses that indicate that beta as an
7 investment device is still quite alive and well.
8 While the answer is yes it appears that there are some
9 things other than systematic risk, apparently
10 systematic risk is a large factor in influencing
11 investment decisions.
12 Q. If we were to invest dollars in either the
13 equity of a telephone utility or a gas distribution
14 utility both of which have bond ratings of A minus,
15 which do you believe is a more risky investment?
16 A. The common stock investment, is that what
17 your question is?
18 Q. They were common stock investments in
19 either utility but those utilities have a bond rating
20 of A minus.
21 A. Well, I would look on a comparative basis
22 and try and get some insight from the bond rating
23 process and look at the financial ratio guidelines
24 for that rating for each company in the different
25 industry.

1 Q. So there is more to investment risk than is
2 captured in bond ratings. Would that be true?
3 A. There is more to common stock investment
4 than is reflected just in bond rating, because, as
5 I've said in my testimony, there is no perfect proxy
6 for common stock risk, but the bond rating process is
7 very comprehensive and takes into account all of the
8 diversifiable business and financial risks of a
9 specific enterprise.
10 Q. Now, you went through your four growth rate
11 analyses with staff this morning for your DCF, and one
12 of the four methods you used was the BR plus SV growth
13 rate formula; is that right?
14 A. Yes.
15 Q. And that formula or analysis originated
16 with the work of professor Myron Gordon; is that
17 right?
18 A. Yes.
19 Q. And am I correct that you began using this
20 methodology only last year?
21 A. No.
22 MR. TROTTER: Can I approach the witness,
23 Your Honor?
24 JUDGE BALLASH: Yes.
25 Q. Did you submit the testimony in an Arizona

1 Commission docket involving Southwest Gas Corporation?
2 A. Yes.
3 Q. Like to refer you to a request No. SH-29
4 that requested "At what point in time did witness
5 Hanley begin to utilize the BR plus SV growth rate
6 methodology in his cost of equity testimony and why."
7 Could you first of all see if you recognize that
8 response and then read it.
9 A. Okay. This response --
10 Q. First, do you recognize that as your
11 response?
12 A. Yes, I do.
13 Q. Could you just read it and then you can
14 explain. Read it into the record.
15 A. "Mr. Hanley began utilizing the BR plus SV
16 growth rate methodology in his cost of common equity
17 testimony in early 1993. By that time the degree of
18 understatement by the DCF model of investors' required
19 cost rate of common equity was more pronounced. Mr.
20 Hanley then used a number of measures of growth for
21 use in the DCF model in hope of ameliorating, at least
22 in part, the gross disparity attributable to applying
23 a market cost rate based on a market value
24 substantially greater than book value to book value
25 (refer to pages 32 and 33 of Mr. Hanley's direct

1 testimony)."
2 Now, when I said no, I said it for two
3 reasons. You said in the last year. Early 1993 was
4 more than a year, I was thinking at least several
5 years, but in addition the "no" meant I have used it
6 in specific instances. For example, I used it a
7 number of times in a New York jurisdiction going well
8 back into perhaps even the early but for sure at least
9 the mid 1980s. This response goes more to as a
10 general inclusion in almost every case, so with those
11 two clarifications.
12 Q. Let me ask you this. Have you ever
13 testified that the use of BR plus SV growth rate
14 methodology was inappropriate?
15 A. I have testified that it was inappropriate
16 to rely upon exclusively, particularly the way in the
17 past the staff of the New York Commission had used it
18 where essentially they arbitrarily picked a retention
19 ratio and the they arbitrarily picked the expected
20 return on equity, so that application became pretty
21 much a self-fulfilling prophecy.
22 Q. Is New York the only example you recall?
23 A. No. If someone relied upon it exclusively,
24 I'm sure I did criticize it and say that they
25 neglected to take into account earnings growth and/or

1 dividend growth. I've done that many times.
2 Q. Now, you are using the CAPM, capital asset
3 price modeling model, as one of your estimating
4 methods; is that right?
5 A. Yes.
6 Q. And you haven't used the CAPM in your
7 testimony, have you?
8 A. Not always, no.
9 Q. When did you begin using CAPM?
10 A. I don't recall. It's been quite a while.
11 Q. Have you ever argued against the use of
12 CAPM in a utility regulatory proceeding?
13 A. On an exclusive use basis I'm sure that I
14 probably have.
15 Q. Do you recall testifying in a case
16 involving West Virginia Public Service -- before the
17 West Virginia Public Service Commission involving
18 Mountaineer Gas Company?
19 A. Well, I have done that several times over a
20 number of years for Mountaineer.
21 Q. I would like to provide you an excerpt of
22 testimony you provided in a 1987 case involving
23 Mountaineer Gas. I wonder if you could recognize that
24 as an excerpt of your testimony. I would like you to
25 -- first of all, do you recognize that as the

1 excerpt of testimony you presented or would you accept
2 that subject to your check?
3 A. Well, yeah. I mean, it looks like mine.
4 I'm just trying to get familiar with it. If you say
5 it's 1987 that's seven years ago. Obviously it didn't
6 -- I need a moment to peruse it.
7 Okay.
8 Q. I would like to refer you to page 19 of
9 your testimony in that docket which was docket
10 86-604-G-42T. Page 19, you were asked the question,
11 "Before you begin your critique of the specific
12 applications of CAPM utilized by witnesses Stewart and
13 Hill, would you please comment upon the CAPM approach,
14 generally." Would you please read your response?
15 A. Yes. To the best of my knowledge -- the
16 whole thing?
17 Q. Yeah. It's just a couple of paragraphs.
18 A. "To the best of my knowledge, there is only
19 one regulatory agency in the country which has used
20 CAPM as a principal method of arriving at the cost
21 rate for common equity capital in a public utility
22 rate case and has specifically stated that it was used
23 in a rate order. Generally speaking, the use of CAPM
24 has been rejected by regulatory bodies and public
25 utility rate making. The CAPM has been subject to

1 much academic criticism and there is little evidence
2 that the model is used in the investment community.
3 "The CAPM theory states that the expected
4 rate of return on a security is equal to the risk free
5 rate of return plus a risk premium which is
6 proportional to the nondiversifiable systematic risk
7 of a security. The beta coefficient is a statistical
8 measure which attempts to quantify the systematic risk
9 of an individual security. Both witnesses Stewart and
10 Hill utilized Value Line betas (Value line publishes
11 adjusted betas). Unfortunately, neither witness
12 mentioned the fact that the R squared, or coefficients
13 of determination for the Value Line published betas
14 were only .12 for Mr. Stewart's barometer group and
15 .05 for Mr. Hill's barometer group. The R squared is
16 a statistic that tells what percentage of the
17 movement in the price of the common stock used to
18 develop the beta is attributable to systematic risk or
19 general movement the market. In other words, the
20 betas do not account for 88 percent and 95 percent
21 respectively of the price movement of the common
22 stocks used to develop the group average betas.
23 Thus, the overwhelming portion of the total risk is
24 unexplained because it is company-specific
25 (nonsystematic) risk which is not captured in beta.

1 In short, use of the beta in the CAPM model limits the
2 usefulness of any results determined because the
3 overwhelming percentage of total risk to the
4 enterprise is not explained by the model and that risk
5 is nonsystematic or, in other words, company-specific."
6 JUDGE BALLASH: Mr. Trotter, can that be
7 provided to the court reporter?
8 MR. TROTTER: Yes.
9 Q. In your testimony in that docket, in
10 calculating your own CAPM cost of equity, you used
11 three-year treasury notes as the risk-free rate; is
12 that right? And I just refer you to page 22 of the
13 excerpt.
14 A. Yes.
15 Q. And in this proceeding before this
16 Commission today you are recommending the use of a
17 30-year T bond for the risk-free rate; is that
18 correct?
19 A. I am because of analyses that I've made
20 that in recent years the 30-year T bond most closely
21 approximates the changes measured by standard
22 deviation and the utility's cost of capital and that's
23 measured I think best by the A rated utility bond.
24 The yield on the three-year treasuries or any other
25 90-day T bills and all the shorter measures are

1 extremely much more volatile and not indicative of the
2 long-term cost of capital for a public utility.
3 Q. Volatility was one of your concerns in your
4 1987 testimony, was it not, in arguing against the use
5 of the 30- or 90-day security?
6 A. Compared to the 90-day security, 90-day T
7 bills, yes, and at that point in time the three or
8 five-year T bond was a very good approximation of
9 relative change in volatility in the cost of utility
10 capital as measured by changes in time of utility bond
11 rates. That's no longer true.
12 Q. What changed?
13 A. Well, I suspect what changed is that the
14 market's assessment and the degree of influence by the
15 Federal Reserve and related actions of the Treasury,
16 but one thing is clear that the shorter term bills and
17 treasury notes and bonds have become much more
18 volatile vis-a-vis changes in utility bond yields.
19 Q. As a response to record requisition 3 could
20 you provide us the study that you produced that
21 supported your change from a three year to a 30-year
22 T-bill or treasury note?
23 A. Yes.
24 (Record Requisition 3.)
25 Q. Would you accept subject to your check that

1 currently three-year treasury notes are yielding
2 around 6 percent while 30-year T bonds are around 7
3 and a quarter?
4 A. That's the general area, yes.
5 Q. And just wrapping this up, if you could go
6 to schedule 22, page 7, on your equity risk premium
7 analysis --
8 A. Give me the reference again.
9 Q. Schedule 22, page 7. And the line 1, your
10 arithmetic mean total return on the S & P 500 is over
11 the period 1926 to 1992 as reported by Ibbotsen; is
12 that right?
13 A. Yes.
14 Q. And that period includes the Great
15 Depression, does it not?
16 A. Right. It includes a lot of events
17 including the stock market crash of October 1987, which
18 blew the bubble in how efficient the market is from
19 one day to the next, but yeah, Ibbotsen says that it
20 is appropriate to use the long-term averages because
21 I think he points out what happened in 1987. They
22 thought from 1929 something like that couldn't happen
23 again but it did, so that to avoid the bias of a
24 shorter term historical average selected arbitrarily,
25 the use of the long term average is appropriate.

1 Q. The question was simply whether the Great
2 Depression was included in there but I appreciate your
3 answer. And it would also include World War II?
4 A. Korea, Vietnam.
5 Q. Do you have an opinion as to the
6 probability of the Great Depression-type event
7 occurring during the next three years?
8 A. No, I don't, but when you've got that long
9 a period of time and all those events are averaged out
10 over time, that's the point is that the likelihood of
11 the average of all of those events is quite possible.
12 Q. But if we assume that the Depression lasted
13 for four years, that would be four out of 70 years or
14 nearly 6 to 7 percent of the data points. Would that
15 be correct?
16 A. Yes.
17 Q. Do you believe there's a 6 to 7 percent
18 chance that we're going to have a Great Depression in
19 the next three years? Do you have an opinion on that?
20 A. No, I don't think anybody is forecasting a
21 Great Depression in the next three years, but again,
22 there weren't many people forecasting the stock market
23 crash of 1987, either.
24 Q. Do you think this Commission should take
25 into account a 5 to 6 percent chance there could be a

1 Great Depression in setting a rate of return in this
2 case?
3 A. I don't think that's what they would be
4 taking into account by looking at a long-term
5 historical average.
6 Q. Did you do any analysis of selecting
7 shorter periods of time, taking two years out of this
8 70-year sample or four years or whatever, to see how
9 that changed the arithmetic mean total return rate?
10 A. No. That's the very thing that Ibbotsen
11 suggests against because that would be imparting a
12 bias into the data.
13 Q. And just so I'm correct, is 1926 the first
14 year that S & P did a 500 composite that the data was
15 available?
16 A. I think it's the -- I believe it's the
17 first year from which data was able to be compiled on
18 an historical basis.
19 Q. And if the data was not available for the
20 Great Depression, for example, the figure you show on
21 line 1 would be substantially less, would it not?
22 A. I can't answer that without a little
23 research, but I can do that at a break or before I
24 come back on for redirect, if you like.
25 Q. Let's make it record requisition No. 4.

1 Just remove the data from the Great Depression from
2 the arithmetic mean total return rate and provide the
3 result.
4 (Record Requistion 4.)
5 JUDGE BALLASH: That would be record
6 requisition No. 4. Mr. Trotter, how much more do you
7 have?
8 MR. TROTTER: I think I'm done.
9 Nothing further. Thank you.
10
11 EXAMINATION
12 BY CHAIRMAN NELSON:
13 Q. Good afternoon, Mr. Hanley.
14 A. Good afternoon, Your Honor.
15 Q. I would just like to explore with you for a
16 second business risk. At pages 7 and 8 of your
17 testimony you talk about the situation with respect to
18 competition and actually at page 8 note that at the
19 second line there the SEC's collocation order. My
20 question is, in the last week a couple of judicial
21 opinions have been rendered which seem to me to change
22 the nature of the industry, one being Seattle Federal
23 Judge Barbara Rothstein's decision to hold the cable
24 telco cross ownership ban invalid for carriers that
25 were parties to that suit, including, as I understand

1 it, the Washington Independent Telephone Association
2 of which GTE is a member, and another case in the
3 District of Columbia Court of Appeals invalidated the
4 FCC's collocation order. Do you have an opinion on
5 how either one of those judical orders might affect
6 the riskiness of this telephone company's business?
7 A. I must say I was not aware of the former
8 that you suggested by Judge -- what was her name --
9 Rothstein --
10 Q. Yes.
11 A. -- but I certainly have been aware of the
12 District of Columbia Court of Appeals with regard to
13 the collocation, but let me say that I don't believe
14 that in a general sense, going forward over the long
15 run, that either one of those things is going to
16 really do much in the way of reducing the momentum,
17 which is towards continued competition, and
18 competition is healthy and it's good, but in the
19 process when that occurs, it does tend to create more
20 of a business risk environment, which of course those
21 that were not as accustomed to business risk
22 environment have to adapt themselves pretty readily to
23 deal with it, but I think in terms of the trend, I
24 don't think -- my personal opinion -- I can't answer
25 obviously from a legal point of view, but my personal

1 opinion is I don't think they're going to do anything
2 serious in any big way to deter that snowball of
3 increasing competition.
4 Q. I guess what I'm trying to get at, it seems
5 to me that we spend a lot of time, especially in
6 proceedings just such as this one, talking about
7 regulatory risk, and for this industry 1994/1995, I
8 see a lot of uncertainty caused by judicial and
9 legislative events, and they're just very difficult to
10 predict. Do you agree with me or disagree with me or
11 do you have any comment on that observation? We have
12 Congress ready to act or maybe not act, and if it does
13 or if it doesn't something will happen, and we have
14 lots of cases in the pipeline that could affect this
15 business it seems to me far more than any state
16 regulatory agency does, and yet investors and analysts
17 spending all this time examining regulatory risk.
18 Have you ever heard of an analyst evaluating judicial
19 or legislative-type risks?
20 A. Well, at least acknowledging them. For
21 example -- and I suspect, Your Honor, and I certainly
22 don't mean to insult you -- I suspect you're probably
23 more familiar than I with probably some of these
24 telecommunications reports, but for example Standard &
25 Poor's has quite a discussion in its June 2 industry

1 survey on telecommunications industry, and there is a
2 fair amount of under the broad caption beginning at
3 page T-18 an "industry at the crossroads." There's
4 considerable discussion here about the various
5 legislative bills, the Senate bill and the Markee
6 Fields bill mandate, so forth and so on. So I suspect
7 to some degree your point is well taken, so when we
8 say regulatory risk, unfortunately in some sense of
9 the word that kind of filters down, they do
10 legislative things and eventually it hits the
11 regulatory funnel and we tend to use the catch-all --
12 I shouldn't say we -- I guess I do -- use the catch-
13 all phrase of "regulatory risk," but I think your
14 point is well taken. There is a degree of uncertainty
15 relating from a lot of pending legislation as well.
16 Q. Last year we had -- do you by any chance
17 know Dr. Charles Olson?
18 A. I do, yes.
19 Q. He testified on behalf of Puget Power in
20 their recently concluded general rate case. He and I
21 had a quite interesting colloquy -- I thought it
22 was interesting -- because his prefiled testimony had
23 made the observation that he thought perhaps the
24 market was irrational, and that's quite a statement
25 for someone in his position to say because we all do

1 rely on the at least common understanding of the term
2 "rational investor." That is whose behavior we're
3 trying to assess here. Do you think the market is
4 irrational or investors are irrational these days or
5 is that why -- is that perhaps why you're including --
6 you're diversifying your portfolio and including all
7 of those models by which to assess investor
8 expectation?
9 A. Your Honor, I don't believe the market is
10 irrational and I don't really take a great deal of
11 umbrage with the academic concept of efficient market
12 hypothesis and so on. But it would seem to me that
13 the problem lies in this that all of the models
14 have some problems underlying them. If there were
15 such a thing as a perfect model we all, regulators,
16 those appealing to regulators in expert witness
17 capacity, staff members, everyone, we would all have
18 seized upon it and said this is the perfect deal, and
19 there would be unanimity of agreement.
20 There are problems with the capital
21 asset pricing model. There are problems with the risk
22 premium model. There are problems with the DCF model.
23 They all have their problems. The thing that
24 has gotten out of hand, though, is that as market
25 values have escalated to substantially above their

1 booked values -- there was a time when they were
2 substantially below -- I think at least some have lost
3 sight of the fact that investors are getting their
4 return requirements from market value, and changes in
5 the market value, so if we take for a discussion
6 purpose that an investor, you or I, aren't really
7 interested in infinity because we don't even know what
8 infinity is, we can raise something to the highest
9 number we know and still have no concept of what
10 infinity is, but we're only concerned about some
11 shorter finite investment arising and we want to get a
12 return, we hope to sell our stock at a return or at a
13 value greater than what we paid.
14 Now, two things cause that value to change.
15 One is increasing earnings so that even if the
16 multiple of price and earnings remained the same the
17 absolute value would be higher, but in addition there
18 are other factors, and I think that's clear from
19 studies that have been made and what's going on, there
20 are other things driving price other than just
21 earnings and dividends however nebulous they may be;
22 that investors expect to get more capital appreciation
23 than we are able to get and capture in the model by
24 looking at these proxies for dividend growth,
25 earnings, dividends, whether it's BR plus SV or what

1 have you.

2 One of the major constraints is that
3 invariably we're limited to a short run horizon. We
4 look at analyst forecasts of five years into the
5 future. If we accept efficient market hypothesis that
6 those investors do have a long run horizon and
7 expectation, perhaps not infinite, although the model
8 calls for infinity, but something a lot longer than
9 five years, then we've got a problem of -- we've got a
10 price from which we get the dividend yield portion of
11 the model that reflects a much longer run expectation
12 of increase or growth in value, that growth rate, but
13 we're matching it up with a lower level of growth for
14 the much shorter more finite horizon of time so we've
15 got a mismatch.

16 Then we take that market value, that K
17 derived from the market values, and apply it to a much
18 lower book value, and when you subtract the actual
19 dividends that the company is actually paying or
20 expected to pay over the next 12-month period of time,
21 there was an implicit in the market model based on
22 market values, so much left in dollars and cents for
23 growth, but when you apply it to this much lower book
24 value and take out the dividends the opportunity,
25 because of the original cost concept in the book value

1 rate making, that opportunity really isn't there. So
2 they never have the chance to really achieve what it is
3 investors are looking for because that's related to a
4 market value that's substantially above the book value.
5 So the problem is not so much with, in my
6 mind, with whether investors have this cognizance or
7 that I don't believe they're a bunch of just lunatics
8 that just want to just throw money around out there.
9 I don't believe that for a moment, but I do think that
10 there are mechanical problems that are unavoidable.
11 It's no one's fault, but it just is and that -- so the
12 model is good. It's a meaningful and useful model,
13 but shouldn't be relied upon exclusively, the same
14 thing with the capital asset pricing model.
15 Q. I think you do agree with him and he said
16 it just made our jobs all that much more difficult.
17 A. Well, I do agree with that.
18 Q. Thank you.
19 CHAIRMAN NELSON: That's all I have.
20 JUDGE BALLASH: Commissioner Hemstad.
21
22 EXAMINATION
23 BY COMMISSIONER HEMSTAD:
24 Q. I believe you testified this morning with
25 regard to your proposed financial structure does not

1 include any structure in debt. Would you explain to
2 me why you did not account for short-term debt in view
3 of the history of its use by the company.
4 A. Well, it's my understanding that we were to
5 or I was to look at a given point in time and that
6 there was considerable amount, some I think 188
7 million approximately, of short-term debt at the end
8 of calendar 1993. However, it was planned that from
9 the proceeds of the sale of long-term debt in an
10 amount of 200 million all of that would be repaid and
11 that we were looking at a picture, a moment at a point
12 in time, albeit on a proforma basis.
13 Q. But if you had done a proforma basis,
14 wouldn't that have to take into account short-term
15 debt?
16 A. In my mind at least only if it were an
17 average capital structure. We could say that -- I
18 could then say, well, rather than at a given moment in
19 time over a 12-month period what is perhaps an average
20 level of short-term debt likely to be outstanding.
21 Q. And your conclusion was that that would be
22 a very low figure or --
23 A. Well, for instance, in staff Exhibit 4,
24 which I think is now identified for the record, the
25 estimate was for June of roughly 21 and a half

1 million. I wouldn't consider that to be terribly
2 significant given the overall capital structure of the
3 company.
4 Q. But since 1990, with the exception of one
5 month, that's the lowest short-term debt month, in
6 over something like four and a half years.
7 A. Well, that's because we just had the
8 permanent take-out. Now, I have no evidence to
9 indicate that there's going to be any time real soon
10 levels like that. That was an accumulation, it seems
11 to me, over a fair period of time that's just been
12 permanently funded, and then if we were to assume some
13 arbitrary level of short-term debt then we've got to
14 be really careful about having capital structure --
15 dollars of capital presumed to be financing the rate
16 base perhaps larger than a jurisdictional rate base,
17 if in fact there is an actual rate case proceeding.
18 Q. Well, so your structure was based upon a
19 snapshot in time. Then do you have an opinion as to
20 whether short-term debt over the next several years
21 will be used in any meaningful amount or -- I will ask
22 my question there. Do you have an opinion as to
23 whether short-term debt will be a measurable amount in
24 the reasonably near future?
25 A. I don't know. The only information that I

1 would have available would be this type of information
2 that was prepared by Mr. Dieter. I think he's in
3 Texas. I have no forecast nor did I have a reason to
4 request one, Your Honor.
5 Q. Well, should this Commission be attempting
6 to forecast that as we come to a conclusion as to what
7 ought to be the overall rate of return?
8 A. Well, I would say no and for this reason,
9 that despite the seemingly high -- and I use that word
10 guardedly, but I think it's been implied from some of
11 the questions that have been fired up -- not from Your
12 Honors but from counsel -- compared to the proxy group
13 companies that perhaps the equity ratio is higher than
14 maybe it ought or should be, and I would suggest that
15 that isn't the case, and notwithstanding the fact that
16 it is what it is, the bonds have just been downgraded
17 so that they're lower in bond rating than either the
18 average mean of the four independent LECs that I
19 relied upon or indeed even the seven RBHCs. And since
20 the level of debt and equity in the capital structures
21 is, while it's certainly not the only means by any
22 stretch of the imagination the be-all end-all for
23 bond rating, it is certainly an important
24 consideration and notwithstanding the seemingly -- put
25 that in quotes I guess -- high equity ratio, the

1 downgrading of GTE Northwest's bonds did occur and
2 all of the major rating agencies -- and they all have
3 downgradings within a fairly compact short period of
4 time and all -- prior to the May 3 issuance of the new
5 long-term debt, all referred to the problems ensuing
6 from an increasingly competitive environment. Now, as
7 business risk is greater there needs to be I think a
8 corresponding increase in equity and the equity ratio
9 should be greater to compensate or offset that
10 increasing level of business risk.
11 Q. Would GTE Incorporated, the holding
12 company, and its shareholders be better off in that
13 its interest it would have to pay on debt would be
14 lower if it issued bonds at the holding company level
15 rather than at the subsidiary level, or let me phrase
16 it another way. Why don't the GTE Incorporated issue
17 the debt rather than the subsidiaries?
18 A. I don't know the answer to that, Your
19 Honor. I know that many holding companies, the
20 operating subsidiaries tend to finance the fixed
21 capital on their own. There are others, however,
22 where the parent raises the capital, and I am not sure
23 I can answer your specific question here. I just
24 don't know.
25 Q. Well, with a company as diversified as GTE

1 Incorporated is, wouldn't the market value that debt
2 as a lower risk for taking into account the parent
3 company's broad diversification?
4 A. I don't know because I don't know
5 whether the market would conclude that it would be
6 less risky because of its diversification. That's one
7 of the things I said that was a possibility but I
8 really don't know that it is so.
9 Q. Now, the regional Bell companies, how do
10 they issue their debt? At the holding company level
11 or at the subsidiary level?
12 A. The operating companies tend to issue their
13 own fixed capital securities.
14 Q. So it would be comparable then between GTE
15 and the Bells?
16 A. Yes, sir.
17 Q. Your testimony goes on at considerable
18 length in describing the deficiency of the discounted
19 cash flow model. I am trying to recall the name of
20 the University of Chicago professor who developed a
21 beta theory. Do you recall his name?
22 A. Well, there's Sharpe and Lintner were the
23 first two that debated the CAPM theory. You may be
24 thinking about the paper that was written that
25 suggested that beta was no longer an appropriate

1 measure by Fama and French. Eugene Fama is with the
2 University of Chicago.
3 Q. Fama. Well, he was supposedly the father
4 of that theory of risk analysis, I thought, but now
5 his conclusion is that it provides no -- as I
6 understand it, it provides no persuasiveness in risk
7 analysis, if that's a fair -- do you agree with the
8 summary of his paper?
9 A. Well, I think that's a fair summary of his
10 paper, and I should point out Fischer Black in
11 particular responded to Fama's article and basically
12 criticized it and said that it had a lot of
13 statistical noise, their high-powered statisticians
14 called it, and he drew erroneous conclusions.
15 And in addition I've just come into
16 possession of a paper, and if you bear with me a
17 moment, Your Honor, you may find it interesting. I
18 would like to just give you the citation if I may.
19 Let me give you the paper that I was referring to.
20 There's another paper that's expected to be published
21 in the Journal of Finance. I have a copy of the
22 latest working paper copy of it by Kothari, K O T H A
23 R I, Shanken, S H A N K E N, and Sloan, S L O A N
24 entitled "Another Look at the Cross-Section of
25 Expected Stock Returns," and they also take

1 considerable umbrage with Fama and French and the
2 conclusions drawn in their 1992 article. And it's
3 interesting because their paper along with Fischer
4 Black's papers were both reviewed by, among others,
5 Eugene Fama and Kenneth French. They were asked to
6 comment on those papers before getting them published.
7 So there seems to be by those equally qualified with
8 Fama and French that disagree significantly with the
9 conclusions drawn, and so what that tells me is that
10 what I have known all along that capital asset pricing
11 model has lots of problems involved with it. Risk
12 premium model has lots of problems with it. The
13 discounted cash flow model has lots of problems
14 involved with it, but they're all used, they're all
15 useful and none should be rejected because all the
16 models have imperfections. They necessarily do and my
17 appeal to this Commission is even if you still choose
18 to give principal reliance to it at least consider
19 that it isn't the perfect be-all end-all that it's
20 purported to be in the academic literature.
21 Q. In your group of four LECs, as your
22 comparison group, how are their betas determined?
23 A. The betas of all the companies are
24 determined by Value Line in the same method that the
25 stock price for the individual companies are regressed

1 against the market as a whole over a period of 60
2 months.
3 Q. So that's the Value Line --
4 A. Yes.
5 Q. -- beta estimate?
6 A. Yes.
7 Q. In the December 31, 1993 construction of
8 yours with the company capital ratios, did that take
9 into account the consolidation of Contel?
10 A. It did, yes.
11 COMMISSIONER HEMSTAD: That's all I have.
12 JUDGE BALLASH: Just before we go off the
13 record, could you spell Fama, please?
14 THE WITNESS: F A M A.
15 JUDGE BALLASH: Why don't we take our
16 afternoon break at this time. Let's be back at 3:30.
17 (Recess.)
18 JUDGE BALLASH: Let's be back on the record
19 after our afternoon break. Redirect.
20
21 REDIRECT EXAMINATION
22 BY MR. PARKER:
23 Q. Mr. Hanley, let's start at the end and go
24 backwards. Do you still have before you, Mr. Hanley,
25 the excerpt of West Virginia testimony that Mr.

1 Trotter gave you in case No. 86-604 G-42T?
2 A. I do, yes, sir.
3 Q. Now, to answer the obvious, Mr. Hanley, how
4 long ago in terms of years was this testimony given?
5 A. Seven years ago.
6 Q. And am I correct in looking at this excerpt
7 of testimony that you provided a CAPM analysis in this
8 case?
9 A. I did, yes.
10 Q. Now, could I turn your attention to
11 schedule 9 of Exhibit 3. Now, directing your
12 attention to page 2 of 3, would you tell me what the
13 fourth column from the right entitled Capital Asset
14 Pricing Model, would you tell me what that vertical
15 column is supposed to indicate?
16 A. Well, that's supposed to indicate that
17 where those X's are is that that is a model that is
18 explicitly considered by those regulatory Commissions.
19 Q. And looking at the fourth column from the
20 left, could you tell me what that column represents,
21 and that column is entitled "No One Method, All Are
22 Considered"?
23 A. Yes. Essentially that means I think
24 that what they're responding to in the surveys they're
25 saying is that even if they tend to favor one method

1 over another they don't rely necessarily upon a single
2 model but they consider the results of all the models.
3 Q. So looking at schedule 9 there are
4 approximately ten Commissions that put primary
5 reliance on the capital asset model, and then there
6 are numerous Commissions that consider it as a group
7 of models; is that correct?
8 A. Apparently, yes, sir. It says all are
9 considered.
10 Q. And again the date of this study is what?
11 A. This was 1992/93 so I suspect that by now
12 it's probably a year old from the time of when it was
13 published.
14 Q. Turning your attention back to the excerpt
15 of the West Virginia testimony, Mr. Hanley. On page
16 19 of that handout, line 9, the statement appears,
17 "The CAPM has been subject to much academic
18 criticism." Could you give the Commission an update
19 as to what is the status of that academic criticism in
20 the passage of the last seven years?
21 A. Well, many -- at that point in time this
22 was, as I say seven years ago -- many have criticized
23 the capital asset pricing models by saying it was
24 inappropriate simply because the R squareds or the
25 coefficient of determination derived from the

1 regression analyses from which the betas are derived
2 reflect so much market systematic risk and so little
3 company-specific risk. But I think it's apparent now
4 in studies in more recent analysis that apparently a
5 lot more of those nonspecific factors -- the general
6 systematic risk element apparently plays a much larger
7 role in returns. Certainly that seems to be indicated
8 by the Goldman Sachs study of Wigmore he conducted of
9 the results during the 1980s.
10 And in addition in response to Commissioner
11 Hemstad's couple of his questions, I made reference --
12 and I would like to as part of this response just
13 clarify that. I made reference to a Fischer Black.
14 That's F I S C H E R which is his first name. His
15 response to the Fama and French findings was published
16 in the Journal of Portfolio Management the fall of
17 1993 at pages 8 through 18 of that issue and if I may
18 just quickly state the conclusions. There's a lot
19 more detail in it as to why he arrives at his
20 conclusions but they would speak for themselves, but
21 he concluded by saying, "Announcements of the death of
22 beta seem premature. The evidence that prompts such
23 statements implies more uses for beta than ever.
24 Rational investors who can borrow freely whether
25 individuals or firms should continue to use the CAPM

1 and beta to value investments and to choose portfolio
2 strategy." So I think it's certainly not clear at
3 all, that beta is dead. Beta is as available to
4 investors as are forecasts of earnings and other
5 information consistent with the use of other models,
6 and there's no reason to believe that investors cannot
7 and would not and do not use a variety of methods
8 including these notwithstanding the imperfections of
9 any specific model including the capital asset pricing
10 model.
11 Q. Now, changing gears on you if a moment, Mr.
12 Hanley. As I understand your testimony you used
13 multiple models due to the problems associated with
14 each individual model; is that correct?
15 A. Yes.
16 Q. Is that an accepted technique in this area?
17 A. Well, yes, I believe it is. I believe that
18 first of all, as I've indicated in looking at schedule
19 9, page 2 of Exhibit 3, at least a goodly number if
20 not the majority of Commissions don't seem to rely --
21 at least they say that they consider a number of
22 models and don't preclude useful information.
23 Moreover, their academicians -- one of whom to the
24 best of my knowledge doesn't appear as a cost of
25 capital witness in a purest sense of word, has no ax

1 to grind -- is Professor Stuart Myers and he's a
2 coauthor of I think rather popular finance textbook
3 published by Brealey and Myers. He refers to in his
4 corporate finance textbook that he says the constant
5 growth formula -- referring to the DCF -- and the
6 capital asset pricing model are two different ways of
7 getting a handle on the same problem. Then he goes
8 on to say, use more than one model and you can,
9 because estimating the opportunity cost of capital is
10 difficult. "Only a fool throws away useful
11 information." And there are others, other academicians
12 in textbooks that encourage the use of multiple
13 models.
14 Q. Who is Eugene F. Brigham?
15 A. Dr. Brigham -- well, he's several things.
16 He's a prominent academician who has authored and
17 coauthored quite a number of finance and managerial
18 finance textbooks that are in wide use in universities
19 around the country and he also happens to be a rate of
20 return expert witness.
21 Q. Does Dr. Brigham utilize multiple models?
22 A. He does in his textbooks. He encourages
23 the use of multiple models.
24 Q. Who is Roger A. Morin?
25 A. Dr. Morin is also a professor. His

1 university escapes me but it's in Georgia. It's
2 either Emory or University of Georgia, someplace down
3 there I think, and has written at least two textbooks
4 that I know of, utilities cost of capital in 1984 and
5 regulatory finance utilities cost of capital in 1994.
6 Q. Dr. Dr. Morin uses multiple models?
7 A. He encourages the use of multiple models
8 because of the imperfections in all of the models.
9 Q. Let me switch gears. In response to a
10 question from Mr. Trotter I believe you stated that
11 the return that you were recommending in this case was
12 good for three years. Do you recall that?
13 A. Yes.
14 Q. Could you tell me what meaning you put on
15 the words "good for" in the question that Mr. Trotter
16 asked when you answered it?
17 A. Yes. My meaning I think is consistent with
18 response to one of public counsel's data request and
19 that means maybe good to be in effect for a period of
20 up to three years, but as we all know cost of capital
21 can and does change and may be different a couple of
22 months from now, next year from now if one were to
23 recalculate and look again, but it's my judgment of a
24 typical maximum period of time that in the traditional
25 not quite so competitive environment where sometimes

1 it doesn't make a difference if you're allowed to
2 charge a higher rate and you cannot. But in the
3 traditional concept oftentimes rates were put into
4 effect for an average period of time for many
5 utilities for periods of up to three years before they
6 had to change them through a new rate proceeding, and
7 also where there is alternative rate mechanisms in
8 place a period for sometime up to three years seems to
9 be a popular time frame for review again.
10 Q. At the beginning of Mr. Trotter's
11 cross-examination I believe there was a discussion of
12 the various aspects of business risk and whether you
13 did any analysis into how GTE Northwest Incorporated
14 was responding to the competitive environment, and I
15 believe you stated that you had no expertise in that
16 area. Do you recall that?
17 A. I do.
18 Q. Could you tell the Commission what you meant
19 when you said that you had no expertise in the area?
20 A. When I said I had no expertise in the area,
21 I meant I have no technical expertise in being able to
22 determine whether a given strategy or the
23 implementation of a certain technology is the best
24 alternative way to deal with the problem of
25 competitors as opposed to some other choice. I am not

1 an engineer and I am certainly not a detailed rate
2 expert in what it would take to -- rates in the sense
3 of rates, specific rates, charged to customers for a
4 given class of service to deal with competition. So
5 that's specifically what I meant when I said I had no
6 expertise in that area.
7 Q. One final area, Mr. Hanley. During Mr.
8 Smith's cross-examination, I believe there was some
9 discussion about leveraging between the parent and the
10 subsidiary. Do you recall that?
11 A. Yes, I do.
12 Q. And do you recall that a quote was read to
13 you from Roger Morin's book regarding double leverage.
14 Do you recall that?
15 A. Yes.
16 Q. Could you explain to the Commission what
17 double leverage is.
18 A. Well, double leverage is the presumption
19 that because a corporate parent company has the
20 ability to -- simplify it and say -- issue debt
21 capital at a lower cost than equity capital and then
22 make an investment in the equity of a subsidiary.
23 When they do that they can think that to be double
24 leveraging, and that's essentially what it means, as
25 I think I alluded to, or at least tried to, to some

1 myth that that is wrong I think because it's
2 discriminatory, and I didn't have the opportunity to go
3 on, but I suspected, however, that Dr. Morin was not
4 endorsing the double leverage concept.
5 Q. Does finance theory recognize double
6 leverage as affecting the market-required return?
7 A. No. Finance theory basically says that the
8 market-required return is commensurate with the risk
9 to where you place the capital, not the cost of the
10 capital or the source from which it is derived.
11 Q. Could you point out to the Commission
12 briefly what the major flaws are associated with
13 double leverage.
14 A. Well, the major flaw is, first of all,
15 it's discriminatory because it's not imposed in
16 situations where there is not a corporate sole
17 shareholder. If there were numerous individual
18 shareholders it would not be, indeed practically could
19 not be, but I suspect even more importantly the outrage
20 of individuals would surpass anything that regulators
21 may have seen when it suddenly would become important
22 where you got your money to invest in the stock, how
23 much it cost, who did you borrow it from, or indeed
24 whether you got the stock for free and it cost you
25 nothing. And if you have a situation where you have a

1 minority interest and you have a number of individual
2 shareholders it flies in the face of economic theory,
3 and financial theory, to suggest that there would be
4 two cost rates for common equity investment in the same
5 assets, one for the corporate shareholder and another
6 for the individual shareholders. So the way it is
7 typically applied, as far as I am concerned, is at odds
8 with economic and financial theory and it's clearly
9 discriminatory.
10 MR. PARKER: Can I approach the witness,
11 Your Honor?
12 JUDGE BALLASH: Yes.
13 Q. Let me hand to you Dr. Morin's book which I
14 believe Mr. Smith took his quote out of, and if you
15 just take a look at that and read in the paragraph
16 that appears at the top of page 299 as Dr. Morin's
17 opinion of what double leverage is.
18 A. Yes. It appears under a section entitled
19 Theoretical Issues and it says, "The double leverage
20 approach contradicts the core of the cost of capital
21 concept. Financial theory clearly establishes that
22 the cost of equity is the risk-adjusted opportunity
23 cost to the investors, and not the cost of the
24 specific capital sources employed by investors. The
25 true cost of capital depends on the use to which the

1 capital is put and not on its source. What the Hope
2 and Bluefield doctrines have made clear is that the
3 relevant considerations in calculating a company's
4 cost of capital are the alternatives available to
5 investors and the returns and risks associated with
6 those alternatives. The specific source of funding an
7 investment and the cost of the funds to the investor
8 are irrelevant considerations."
9 Q. I neglected to do something, Mr. Hanley.
10 Could you read the name of that book and when it was
11 published?
12 A. Yes. This is entitled Utilities
13 -- plural -- Cost of Capital by Roger A. Morin, PhD,
14 Public Utilities Reports Incorporated, Arlington,
15 Virginia, 1984.
16 Q. Does Dr. Morin have a new book out?
17 A. He does.
18 Q. Have you read that book?
19 A. I have, yes.
20 Q. Has Dr. Morin changed his mind about the
21 defects associated with double leverage?
22 A. No. I would say the conclusions -- the
23 words are slightly different but the essence of it is
24 exactly the same.
25 MR. PARKER: I have nothing further. Thank

1 you, Your Honor.
2 JUDGE BALLASH: Recross from staff?
3 MR. SMITH: Two questions.
4
5 RECROSS-EXAMINATION
6 BY MR. SMITH:
7 Q. Mr. Hanley, Mr. Trotter asked you questions
8 about the percentage of GTE Northwest revenues from
9 long distance operations for 1992. Do you recall that
10 question?
11 A. Yes. As I recall if it's the same one
12 you're talking about it's a data request item No. 1.
13 Q. That's correct. Now, GTE Northwest is in
14 the process of becoming a toll carrier, primary toll
15 carrier, in this state. Will that affect the
16 percentage of the company's long distance -- revenues
17 from long distance operations?
18 A. It will. I suspect it will or at least
19 hopefully will get them to be at a level a little
20 closer to some of the proxy companies that have been
21 able to be the primary, unless somebody dials the
22 10 XXX first.
23 Q. And Commissioner Hemstad asked you some
24 questions regarding Exhibit 4 which shows short-term
25 debt issued in the company's capital structure of the

1 last few years. And isn't it correct that
2 periodically within the last four-year period
3 take-outs of short-term debt have occurred and then
4 the balance went back up in subsequent years?
5 A. Well, when you say take-outs, it's true
6 that the balance has varied. It has been a steady
7 progression upward. I haven't gone back to
8 historically track, but there can be repayments on
9 short-term debt from internally generated funds and
10 the like without permanent financing. In this
11 instance we proformaed out the short-term debt of
12 approximately 188 million which were to be repaid
13 among other uses of the proceeds from the sale of the
14 $200 million of long-term debt in early May.
15 Q. And you proformaed it out to show a zero
16 balance of short-term debt; is that correct?
17 A. As of December 193, yes, sir.
18 MR. SMITH: That's all I have.
19 JUDGE BALLASH: Mr. Trotter.
20
21 RECROSS-EXAMINATION
22 BY MR. TROTTER:
23 Q. Regarding the double leverage approach, in
24 which jurisdictions have state regulatory Commissions
25 applied the double leverage approach to GTE -- to a

1 GTE operating company?
2 A. Well, haven't made really an analysis of
3 that across all the 33 states that are involved. I
4 know of personal knowledge of only two.
5 Q. And which are those?
6 A. Missouri and Oregon.
7 Q. Texas doesn't ring a bell with you?
8 A. Not of my personal knowledge. I would have
9 to research and I haven't really done that.
10 Q. Are you aware of any state supreme court
11 decisions that have affirmed Commissions that have
12 used such an approach as to GTE operating
13 subsidiaries?
14 A. I personally am not, no.
15 Q. You haven't taken a look at that issue,
16 those facts?
17 A. No, because I wouldn't have had any
18 interest in those other jurisdictions.
19 Q. Are you familiar with any state court
20 decision involving any utility company where the state
21 supreme court has approved the double leverage
22 technique?
23 A. Personally, no. Most of the states I think
24 in recent years don't employ double leverage. I
25 haven't really had occasion to look into it.

1 Q. Have you been advised that double leverage
2 violates the Hope and Bluefield doctrines, as you
3 understood them? Have you been given specific advice
4 on that topic?
5 A. Legal advice?
6 Q. Yes.
7 A. I have not been given specific legal
8 advice, no.
9 Q. Now, with respect to the NARUC survey, did
10 you conduct any independent check to see when any
11 particular Commission last used any particular rate of
12 return methodology listed in that chart?
13 A. No. It's an initial publication of NARUC
14 and my feeling is that I assume NARUC knows what it's
15 doing and however it does what it does and I accept it
16 at face value. I have no reason to probe or inquire
17 or call Mr. Rogers or any of his staff down there and
18 say how do you do this and why do you do it. I accept
19 it for what it says.
20 Q. And does it say when the last order was
21 issued or last time a particular method was used, does
22 it?
23 A. Beg your pardon?
24 Q. This doesn't say when any particular
25 Commission last used a particular methodology?

1 A. No, it does not say that but this is an
2 annual survey and at the time this was prepared this
3 was the most recent one.
4 Q. And did you review prior surveys?
5 A. Yes, and they pretty much have been the
6 same in the sense that the majority of Commissions are
7 in the column entitled "No One Method, All Are
8 Considered." There may be a little fluctuation from
9 time to time, but the majority of X's are in that
10 column.
11 Q. And you didn't go back behind to see how
12 the agencies actually employed the No One Method All
13 Are Considered category?
14 A. No.
15 Q. Did you review the questionnaire that gave
16 rise to this statement?
17 A. I don't even have access to it. This is
18 published in an official NARUC publication that we
19 paid to get and it is a table in it.
20 Q. You were referred to a Mr. Brigham and a
21 Mr. Morin. Do those witnesses testify for utility
22 Commissions, to your knowledge?
23 A. They're expert rate of return witnesses.
24 Q. And I'm just saying on whose behalf do they
25 testify?

1 A. I must say I don't follow their careers
2 that intently. I'm not even sure who their clients
3 are, but I know that they're -- and I must say I don't
4 personally know either one. I don't think I've ever
5 either individually met either gentleman.
6 Q. Have you ever reviewed any of their
7 testimony?
8 A. No. Well, let me stand corrected. I think
9 I've seen a year or two ago testimony of Dr. Morin's,
10 but I frankly don't even recall on whose behalf it was
11 prepared.
12 Q. Do you recall the substance of the
13 testimony?
14 A. Yes. I recall that the substance of the
15 testimony was the use of a number of different models.
16 Q. Do you still have a copy of that testimony?
17 A. I am not sure.
18 Q. Do you recall the jurisdiction?
19 A. I only got it -- stumbled across it by
20 accident and I had no particular special interest. It
21 was kind of passed on to me.
22 Q. Do you recall the jurisdiction?
23 A. I do not, unfortunately.
24 MR. TROTTER: Nothing further. Thank you.
25 JUDGE BALLASH: Any other questions from

1 the Commission?

2 CHAIRMAN NELSON: No.

3 COMMISSIONER HEMSTAD: No.

4 JUDGE BALLASH: If there's nothing further

5 we will stand in recess until August 22nd. Let's be

6 off the record.

7 (Hearing adjourned at 4:00 p.m.)

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