

**Exhibit No. \_\_\_\_ HCT (RTA-1HCT)**  
**Docket UT-081393**  
**Witness: Rick Applegate**  
**REDACTED VERSION**

**BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**Verizon Select Services, Inc.; MCImetro  
Access Transmission Services, LLC; MCI  
Communications Services, Inc.;  
Teleconnect Long Distance Services and  
Systems Co. d/b/a Telecom USA; and TTI  
National, Inc.,**

**Complainants,**

**v.**

**United Telephone Co. of the Northwest,**

**Respondent.**

**DOCKET UT-081393**

**TESTIMONY**

**OF**

**Rick Applegate**

**STAFF OF  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION**

**June 5, 2009**

**HIGHLY CONFIDENTIAL PER PROTECTIVE ORDER**

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## **LIST OF EXHIBITS**

Exhibit No. \_\_\_\_ HC (RTA-2HC):    Cost of Capital Comparison

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**I. INTRODUCTION**

**Q. Please state your name and business address.**

A. My name is Rick Applegate. My business address is the Richard Hemstad Building,  
1300 S. Evergreen Park Drive SW, P.O. Box 47250, Olympia, WA 98504. My e-mail  
address is [rapplega@utc.wa.gov](mailto:rapplega@utc.wa.gov).

**Q. By whom are you employed and in what capacity?**

A. I am employed by the Washington Utilities and Transportation Commission  
(Commission) as a Regulatory Analyst in the Telecommunications Section.

**Q. How long have you been employed by the Commission?**

A. I have been employed with the Commission since August 2008.

**Q. Please state your educational and professional background.**

A. I graduated from the University of Montana in 2001 receiving a degree in Business  
Administration with an emphasis in Finance. In 2005, I received a J.D. from the  
Willamette University College of Law and an M.B.A. from the Atkinson Graduate  
School of Management.

My current responsibilities at the Commission include analysis of interconnection  
agreements, affiliated interest transactions, contracts, and other commercial filings. I am  
also responsible for reviewing the Qwest performance assurance plan (QPAP) and  
providing analysis to Staff members for contested cases. I participated as a Staff analyst  
in Docket UT-082119, the joint application of Embarq Corporation and CenturyTel, Inc.,

1 for approval of transfer of control of United Telephone Company of the Northwest d/b/a  
2 Embarq and Embarq Communications, Inc..

3 Prior to joining the Commission, I worked for various employers in the legal, real  
4 estate, and financial services industries.

5  
6 **Q. Please describe the scope of your testimony.**

7 A. My testimony addresses the cost of capital assumptions used in the economic cost model  
8 (ECM) presented by United Telephone Company of the Northwest (United).

9  
10 **II. SUMMARY OF TESTIMONY**

11  
12 **Q. Please summarize your testimony.**

13 A. My testimony will support Staff's position advanced primarily in the policy testimony of  
14 Glenn Blackmon. I have studied the United ECM as well as supporting documentation  
15 and I will testify that it uses an excessive cost of capital.

16  
17 **III. DISCUSSION**

18  
19 **Q. What is the nature of the access charge complaint?**

20 A. Verizon and intervenor AT&T allege that United charges unlawfully high rates for the  
21 service of connecting intrastate long distance calls to United's customers. Accordingly,  
22 they seek a reduction in these access charge rates. United asserts that its current access  
23 rates are lawful and cost based.

1 **Q. What is the purpose of the ECM?**

2 A. According to United, “[t]he purpose of the study is to develop the Total Service Long  
3 Run Incremental Cost (TSLRIC) plus common cost of End Office switching, Tandem  
4 switching and Switching Costs per R1, B1 Access Line.” In more general terms, United  
5 provided the ECM to show that the cost of building and maintaining United’s telephone  
6 network justifies access charges at current levels.  
7

8 **Q. What is the significance of the characterization by United of the ECM results as**  
9 **TSLRIC results?**

10 A. As a purportedly TSLRIC study, the ECM results should measure incremental costs at the  
11 service level. In other words, the study should measure the costs that are incurred in  
12 order to provide the specific service and should not include any costs that would be  
13 incurred even if the specific service were not provided. In addition, as a TSLRIC study,  
14 the ECM should measure costs on a forward looking basis. This means that the costs  
15 reflect what United would pay today to build and operate local exchange network  
16 including loops, switches and transport facilities. It is not based on United’s embedded  
17 costs and investment or what United has paid and invested historically.  
18

19 **Q. How does United’s cost of capital affect the ECM?**

20 A. The cost of capital represents the value United’s owners and creditors require for using  
21 their money to invest in United’s network. In the ECM, United uses a weighted average  
22 cost of capital equal to [REDACTED]. This value assumes that United is financed with [REDACTED]  
23 [REDACTED] equity at a cost of [REDACTED] and [REDACTED] debt at a cost of [REDACTED].

1 **Q. Does Staff agree with the cost of capital advocated by United?**

2 A. No. Please see Exhibit No. \_\_\_\_ HC (RTA-2HC). Staff believes 7.93 percent should be  
3 used as the cost of capital in the ECM. This is a value [REDACTED] less than the [REDACTED]  
4 [REDACTED] proposed by United.

5  
6 **Q. Does Staff agree that the cost of equity should be [REDACTED]?**

7 A. Staff believes that [REDACTED] is reasonable. In Order No. 10 of UT-980311, the  
8 Commission allowed United a 12.25 percent cost of equity. The order was part of a rule  
9 making proceeding and it addressed cost-related matters necessary to produce reliable  
10 cost estimates for a Commission report to the Legislature on the funding of  
11 telecommunications services in “high cost” locations. The Commission has recently  
12 authorized rates as high as 10.2 percent for Avista Corporation in UE-080416 and UG-  
13 080417.

14 Staff agrees with the method United used to develop its cost of equity. According  
15 to United’s Highly Confidential Cost of Capital work paper, “[REDACTED]  
16 [REDACTED]  
17 [REDACTED]”

18  
19 **Q. Does Staff agree that the company should be financed by [REDACTED] debt?**

20 A. No. This is a lower level of debt than Embarras has actually maintained over the past two  
21 years. Staff recommends allocations of [REDACTED] to current liabilities, [REDACTED] to  
22 long-term debt, and [REDACTED] to other liabilities because these levels represent the

1 average balances maintained by the company over the past two years. Accordingly, Staff  
2 advocates a total debt percentage of [REDACTED].

3  
4 **Q. Do you agree that the cost of debt should be [REDACTED]?**

5 **A.** No. Staff believes the cost is unreasonable for the following reasons:

- 6 1. The value is greater than the proposed cost of equity, which implies that United's  
7 creditors would expect higher levels of investment risk than United's owner,  
8 Embarq Corp. (Embarq).
- 9 2. The value substantially exceeds Embarq's effective interest rate on long-term debt  
10 for 2007, which was 7.2 percent. See FORM 10-K, Annual report pursuant to  
11 section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year  
12 ended December 13, 2007, Page 46. It also exceeds the total return provided by  
13 the Wall Street Journal on May 20, 2009 for triple-B-rated bonds, which is 7.78  
14 percent. Embarq currently maintains a triple-B rating with Standard & Poor's and  
15 an investment grade rating with the other two major rating agencies. Allowing  
16 United a cost of debt significantly higher than that of Embarq would afford the  
17 companies with an exploitable arbitrage opportunity because United receives debt  
18 financing from Embarq. United's proposal would provide a windfall to the parent  
19 company by allowing it to charge the operating company [REDACTED] for  
20 financing that costs substantially less.
- 21 3. The value assumes that 100 percent of forward-looking financing would come  
22 from the issuance of a ten-year note and it omits the cost savings that can be  
23 achieved from using other sources, such as short-term arrangements. In Exhibit



1 No. \_\_\_\_ HC (RTA-2HC) Cost of Capital Comparison, Staff has included a line  
2 titled "Other Liabilities and Deferred Credits" to highlight the extent to which  
3 United has used, and Staff believes would continue to use, other substantial  
4 sources of financing such as net noncurrent deferred operating federal income tax,  
5 other long-term liabilities, and other deferred credits.  
6

7 **Q. Why does Staff advocate a [REDACTED] cost for current liabilities?**

8 A. According to the Embarq Corporation Affiliated Interest Report for 2007, [REDACTED]  
9 [REDACTED]  
10 [REDACTED]  
11 [REDACTED]  
12 [REDACTED]. See confidential  
13 version of Initial Filing on Behalf of United Telephone Company of the Northwest from  
14 Barbara C. Young, UT-080930. [REDACTED]  
15 [REDACTED]  
16 [REDACTED]  
17

18 **Q. Why does Staff advocate a 8.77 percent cost of long-term debt?**

19 A. In response to UTC Staff Data Request No. 4, United identified long-term debt  
20 outstanding in the amount of \$29,000,000, issued August 1, 1992, maturing August 1,  
21 2017, with an interest rate of 8.77 percent. Staff accepts this embedded cost of debt  
22 despite concerns about it exceeding the 7.2 and 7.78 percent benchmarks for long-term  
23 debt that are discussed above.

1 **Q. Why do you advocate a [REDACTED] cost for other liabilities and deferred credits?**

2 A. [REDACTED] represents the value calculated when United's 2008 interest expense is  
3 divided by the average of the company's total liabilities at the end of 2007 and 2008.  
4 Staff offers this value as an estimate for the varied and potentially costless capital sources  
5 that are attributable to this category of liabilities, which includes noncurrent deferred  
6 operating federal income tax, other long-term liabilities, and other deferred credits.  
7 Under ideal circumstances, the cost of each source would be known and appear as part of  
8 the weighting calculation; sources with zero cost would offset the company's plant and  
9 rate base investment levels and would not appear as part of the cost weighting  
10 calculation. However, Staff advocates this costing approach because it balances the need  
11 to assign a significantly lower cost than United's long-term cost of debt with the risk of  
12 assuming a blanket value of zero.

13  
14 **IV. CONCLUSION**  
15

16 **Q. Please summarize your conclusions.**

17 A. Having examined the ECM cost of capital, Staff believes the ECM overstates United's  
18 cost of service. Dr. Blackmon's testimony identifies other ways in which the ECM  
19 overstates United's cost of service and explains why Staff believes United has failed to  
20 justify its current access charge levels with its model.

21  
22 **Q. Does this complete your testimony?**

23 A. Yes, it does.