

3. *Cost of Capital*

Q. Let's turn to the third section of your testimony, concerning the Cost of Capital. Would you briefly discuss the importance of the cost of capital in this proceeding?

A. Yes. The cost of capital, the rate at which the firm is able to raise funds for capital investment, is a key element in estimating the economic cost of providing unbundled network elements. Together with the depreciation rate, it is used to convert the total investment amounts to annual or monthly costs. The cost of capital consists of two components--the cost of equity and the cost of debt; these components are weighted or blended together based upon the debt/equity ratio.

Q. Is Ameritech-Indiana's current cost of capital the appropriate cost to use in this proceeding?

A. No. For purposes of performing a TELRIC analysis, the appropriate focus is on the long run cost of capital.

Q. What has the FCC said regarding the appropriate cost of capital?

A. In its August 8, 1996, *Implementation Order*, the FCC stated as follows:

706. Based on the current record, we conclude that the currently authorized rate of return at the federal or state level is a reasonable starting point for TELRIC calculations, and incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-adjusted cost of capital or depreciation rate. These elements generally are bottleneck, monopoly services that do not now face significant competition.... States may adjust the cost of capital if a party demonstrates to a state commission that either a higher or lower level of cost of capital is warranted, without that commission conducting a "rate-of-return or other rate based proceeding."

The FCC noted that it had already instituted a proceeding to determine "whether the currently authorized federal 11.25 percent rate of return is too high given the current marketplace cost of equity and debt." [Id., ¶ 702.]

Q. What capital costs has Mr. Domagola recommended?

A. Mr. Domagola has recommended a range from 10.6% to 14.0%, with a midpoint of 12.30%. [MJD-11.] He has estimated the cost of debt to be 7.00% and used an assumed debt ratio of 25.3% [Id.] Mr. Domagola's CAPM and DCF analyses resulted in equity costs of 15.9% and 11.5%, respectively. [Id., pp. 12-13]. He then adjusted these upward to 16.36% and 11.8% to account for flotation costs, which he estimates to be between 4% and 5%. [Id.].

Q. Has Ameritech used Mr. Domagola's cost estimates in its price models?

A. Apparently not. According to Mr. Palmer, Ameritech assumes that its cost of money will range from *****Ameritech PROPRIETARY BEGINS***** *****Ameritech PROPRIETARY ENDS*****, depending upon the density zone. These costs are based upon equity costs which range from *****Ameritech PROPRIETARY BEGINS***** *****Ameritech PROPRIETARY ENDS*****

Q. Do you feel that a capital structure of only 18.6% debt is appropriate for this proceeding?

A. No, I do not. The use of an 18.6% debt ratio would not only ignore the large amounts of low-cost debt financing that are being used to support Ameritech and its subsidiaries, but it would also assume the use of more equity than is necessary or cost effective. In other words, an 18.6% equity ratio conflicts with both reality and theory. Despite any claims to the contrary, the underlying business risk associated with providing unbundled network elements is not high enough to justify such a low level of debt leveraging

Although there are numerous considerations involved in the choice of a debt/equity ratio, it is clear that within limits, a lower cost of capital can be achieved by maximizing the use of the debt component and minimizing the equity component. Since the cost of equity is generally higher than the cost of debt, and since interest is deductible for federal income tax purposes while the return on equity is not, it makes economic sense, all other things being equal,

to maintain a relatively high debt level and a relatively low equity level. Of course, debt leveraging should not be so extreme that interest coverage deteriorates below an acceptable level and lenders become unwilling to provide debt capital to the firm.

For purposes of this proceeding it is important for the Commission to use a reasonable estimate of the cost of capital, consistent with long-run cost-minimization assumptions. Long-run economic cost estimates should be based on the most efficient and cost-effective way of doing business. Any higher cost estimate would force the Company's competitors to pay excessive rates for unbundled elements.

If we are to calculate the long-run cost of a cost-efficient network, the annual or monthly cost estimates should be based upon a economical and efficient capital structure. Since carriers can raise debt capital at a cost substantially below their cost of equity, with the resulting interest expense deducted from state and federal income taxes, it isn't appropriate to assume a high equity ratio—one that translates into unnecessarily high costs.

In determining the most reasonable capital structure for use in this proceeding, I have relied in part on industry comparisons. I examined the historical capital structures for the Regional Bell Operating Companies (RBOCs) and a group of 11 other telecommunication carriers, for the years 1990 to 1995. As shown on schedule 3, these firms have successfully operated with equity ratios significantly lower than the 81.4% proposed by the Company. In fact, as a group the long-term debt ratios for the RBOCs averaged 41.9 percent from 1990 to 1994 and 44.0 percent for the period 1991 to 1995. Similarly, the long-term debt ratios for the group of 11 other phone companies averaged 40.5 percent from 1990 to 1994 and 39.4 percent for the period 1991 to 1995. I therefore recommend a capital structure consisting of 60% equity and 40% debt, which is consistent with the industry data and is significantly more cost effective than the ratio proposed by the Company.

Q. What debt cost do you recommend using in this proceeding?

A. To arrive at an overall cost of capital, I recommend using cost of debt of 8.00%.

Q. How did you arrive at this cost of debt?

A. I reviewed historical yields from 1990 through February, 1997 for Moody's Aaa and Baa rated corporate bonds, as reported by the Federal Reserve. These data are shown on schedule 4. Aaa rated corporate bond yields averaged 9.32 in 1990, declining to an average of 7.37 in 1996. Similarly, Baa rated corporate bond yields declined from an average of 10.36 in 1990 to an average of 8.05 in 1996. More recently, Aaa and Baa corporate bonds have averaged yields of 7.31 and 7.94 percent, respectively.

Q. Your recommended cost of debt is slightly higher than the most recent interest-rate data. Could you explain this?

A. Yes. My recommended cost of debt is about the same as, or slightly higher than, the recent average level of Baa yields. This is appropriate for three reasons. First, I am assuming more aggressive leveraging than would be consistent with an Aaa bond rate. The 40% debt ratio I have used is generally consistent with an A or a Baa bond rate, depending upon other characteristics of the carrier in question (e.g, management). Hence, it is appropriate to use a cost rate that is close to the Baa level

Second, I do not recommend focusing exclusively on the most recent spot rate. Instead, I suggest looking at the overall pattern of yields, as indicated by the average reported over the past six months or so. Third, the cost of newly issued debt to a hypothetical carrier would be slightly higher than the reported yield to investors. Among other reasons, there are costs of issuance which increase the cost incurred by the carrier above the rate earned by bond holders.