Section 1: CBT's Cost Studies

B. CBT's Model Assumptions and Methodology

3. CBT's Excessive Cost of Capital Estimate

Q. Would you now discuss the third major flaw in the Company's modeling assumptions--regarding cost of capital?

A. Yes. According to CBT witness Dr. James H. Vander Weide, CBT assumes that its overall cost of money will be 11.35%, based upon a cost of equity estimate of 13.6%, and a debt/equity ratio of 38.99%/61.01%. [Vander Weide Direct Testimony, pp. 36-7.] While the proposed capital structure is reasonable, the estimated cost of equity is too high and should be rejected. The Commission should not include unnecessarily high capital costs in the cost estimates developed in this proceeding, since this would force CBT's competitors to pay excessive rates. Long-run economic cost estimates should be based on the most efficient and cost effective way of doing business.

Q. Dr. Vander Weide defends this cost of equity estimate by pointing to certain competitive risks to which CBT is exposed. Do you agree with his reasoning?

A. No, I do not. According to Dr. Vander Weide, "CBT has a number of disadvantages in its efforts to compete in a fully competitive local exchange market." [Id., p. 20.] Among these disadvantages Dr. Vander Weide singles out the Company's carrier-of-last-resort (COLR) obligations, but he also mentions the handicaps imposed by regulation and recent regulatory and technological changes, and high operating leverage. In my opinion, each of these risk factors is largely or completely offset by other factors and advantages accruing to the Company as the local exchange monopoly in the area. I will examine these risk claims one by one.

First, the subject of universal service support is being addressed in the federal jurisdiction and will undoubtedly also be addressed by this Commission if the federal solution is not sufficient to meet the state's needs. There is every reasonable expectation that explicit and targeted support to carriers serving low-income customers and high-cost areas will be in place by the time competitors begin to make substantial inroads into CBT's market share.

Second, while changing technology always raises the possibility of stranded investment, the current position of CBT as the dominant provider of local loops is unlikely to be seriously eroded for some years. And there has been no showing that the Company's installed base of copper cable will become economically obsolete prior to the end of its currently authorized depreciation schedule. While fiber optic cable and the associated electronics continue to decline in cost, and while fiber holds the potential for handling video dial tone, broadband data services, and other offerings that require an enormous expansion of bandwidth, that does not mean the existing copper cable is an albatross hanging around the Company's neck. To the contrary, manufacturers are working aggressively on Asynchronous Digital Subscriber Line (ADSL), Hybrid Digital Subscriber Line (HDSL) and other new technologies that hold the potential for offering higher bandwidth services over ordinary copper wires. Nor is the specter of future low cost wireless competition particularly frightening in a service territory as compact and densely populated as CBT's.

Third, in response to Dr. Vander Weide's claim that CBT lacks the ability to compete on the same terms as its competitors [Id., p. 21], I would observe that while this may be residually true (and the residue shrinks almost daily), any remaining regulatory handicap is more than offset by CBT's enormously valuable market presence, including its standing as THE telephone company, its long-established network, its established customer base and its unmatched knowledge of the market. Competitors have a steep uphill fight to enter its service area and win market share.

Finally, while it is true that investment in LECs involves high operating leverage, this will be equally true of any facilities-based competitor, and that competitor faces the even more

daunting problem of predicting what share of the market it will gain, and thus what size network to install.

Q. What cost of capital do you recommend be used in this proceeding?

A. Dr. Vander Weide's equity cost estimate is clearly too high. OCC witness Pultz recommends a range of the 10.95% to 12.37%. The Staff recommends a range of 11.38% to 12.39%. In preparing the studies included in my exhibit, I have used an equity cost of 12%. This falls within both of these recommended ranges, and is roughly equal to the midpoint of Staff's range (11.89%). I do not dispute Staff's analysis of CBT's capital structure (33.37% debt and 66.63% common equity), nor Staff's estimate of the Company's embedded cost of debt (7.78%). However, I have used slightly different assumptions, which are consistent with a forward looking, long run economic cost study: I used a mixture of 40% debt and 60% equity, and a long run cost of debt of 8%. These assumptions translate into an overall cost rate of 10.4%, which falls within the Staff's total cost of capital range of 10.18% to 10.85%. My 10.4% figure is just slightly below the midpoint of the Staff range (10.52%) and is just slightly higher than the 10.37% overall cost of capital recommended by Mr. Pultz on behalf of OCC.

Q. How does this recommended cost of capital compare with the Commission's recently set cost of capital for Ameritech - Ohio?

A. It is slightly higher. In its *Opinion and Order* in Case No. 96-922-UNC et al, issued June 19, 1997, PUCO set Ameritech's cost of capital at 9.74%, based upon a cost of equity of 11.33%. [pp. 18, 22.] The 10.52% and 11.89% midpoints of the ranges of the Staff's respective cost of capital and cost of equity estimates are also higher than this recent finding by the Commission concerning Ameritech.