Witness OCS – 3S Brevitz

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

	)	
	)	Docket No. 15-053-01
	)	
In the Matter of Strata Inc.	)	Surrebuttal Testimony
Application for an Increase in	)	of David Brevitz, C.F.A.
Utah Universal Service Fund Support	)	For the Office of
	)	Consumer Services
	)	

NONCONFIDENTIAL VERSION

November 17, 2015

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is David Brevitz. My business address is Brevitz Consulting Services, 3623 SW Woodvalley Terrace, Topeka, KS, 66614.

Q. HAVE YOU PREVIOUSLY FILED DIRECT TESTIMONY AND REBUTTAL TESTIMONY IN THIS MATTER ON BEHALF OF THE OFFICE OF CONSUMER SERVICES ("OCS")?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS SURREBUTTAL TESTIMONY?

A. The purpose of this rebuttal is to respond to various positions taken in the rebuttal testimony of Douglas Meredith on behalf of Strata regarding rate of return, and to relate those positions to my direct testimony on those issues. I have read Mr. Meredith's testimony and exhibits thoroughly and while it is somewhat voluminous, the Commission should give it little weight for the reasons described in this surrebuttal testimony. The material presented by Mr. Meredith regarding the "small company premium" is the perhaps unintended product of "data mining" permitted by advances in databases and computer technologies, which mistakes correlation for causation, and overlooks the nature of and problems with the data that is being mined. The "small company premium" hinges on existence of market inefficiencies and is an alleged measure of one market inefficiency. Since this conflicts with the established and widely held view that financial markets are efficient, the proof that the Commission should require to demonstrate the existence of the "small company premium" is that there are actual investors identifying this market inefficiency and profiting from it. Mr. Meredith provides no such evidence. I urge the Commission to adopt the rate of return recommendations contained in my Direct Testimony.

RATE OF RETURN ISSUES

Q. PLEASE IDENTIFY THE RATE OF RETURN ISSUES, AND DESCRIBE THE OVERALL BALANCE OF MR. MEREDITH'S TESTIMONY ON THOSE ISSUES IN THIS CASE.

A. In my Direct Testimony, I addressed two important elements in the computation of rate of return under the Commission's rules in this matter – the appropriate state rate of return on equity to be used, and the appropriate interstate overall rate of return to be used. Mr. Meredith devotes the great majority of his testimony and exhibits to only one of those elements – which certainly is important on its own – the state rate of return on equity. Of the thirteen pages that comprise Mr. Meredith's rate of return testimony, only one question and brief answer is provided for the appropriate interstate rate of return.

Q. IS THE OFFICE TAKING POSITIONS "UNREASONABLY DESIGNED TO SIMPLY PRODUCE A LOW RATE OF RETURN FOR STRATA" AS

ALLEGED BY MR. MEREDITH AT LINE 123 OF HIS REBUTTAL TESTIMONY?

A. Absolutely not. Each of the recommendations in my Direct and Rebuttal testimonies on rate of return has firm foundation in the Commission's rules, regulatory policy, financial management and modern portfolio theory. Furthermore, Mr. Meredith's testimony quite clearly suffers from the very weakness that he accuses (without support) my testimony of having. Mr. Meredith appears to have taken many opportunities – which are not supported by financial or regulatory practice or modern portfolio theory – in a scattershot approach to create additive factors to increase his recommended return on equity. Here I am referring to Mr. Meredith's rejection of the DCF methodology and "various premia" he seeks to add to intrastate return on equity for liquidity, small size, and leverage, as well as flawed calculation of "leveraged beta".

Q. MR. MEREDITH'S TESTIMONY CONTAINS SPECULATION AND CONJECTURE CLAIMING TO KNOW WHY THE FCC HAS NOT YET ACTED ON THE FCC STAFF REPORT ON RATE OF RETURN. SHOULD THE COMMISSION GIVE THIS SPECULATION AND CONJECTURE ANY WEIGHT?

A. No. Mr. Meredith makes the following statements in an attempt to rebut my reference to the rate of return recommendation contained in the FCC Staff Report:

- Line 217, "the rebuttals of the [FCC] staff report provided by NTCA and the Rural Broadband Alliance leveled a broadside against the staff findings to the extent that the FCC has let the issue remain dormant for two years and no action has been taken."
- Line 228, "from the FCC's docket we have one staff report that was thoroughly rebutted."
- Line 231, "in light of the evidence, the FCC has let the issue remain idle"

The Commission should not accept Mr. Meredith's speculation and conjecture regarding what is on the minds of the FCC commissioners regarding this report, or why the FCC has not yet acted on the Staff Report. Mr. Meredith has not provided any basis to support that he knows why the FCC is doing what it is doing regarding the Staff Report. As this Commission no doubt can well appreciate given its own responsibility to manage its own docket schedule, the FCC sets its own schedule of when it takes matters up and when it doesn't. It is my experience that commissions do not allow parties to make any conclusions on facts or policy from circumstances and timing of when a commission does or doesn't take a matter up for consideration. The Commission should give no weight to Mr. Meredith's speculation and conjecture that because time has elapsed since the FCC Staff Report was filed, and rural local exchange company groups filed comments opposing the conclusions contained in the Report, that in fact the FCC has rejected the Report and its conclusions. In fact, as described below, the American Cable Association filed a Request for Reconsideration on use of the FCC staff return in the cost modeling to determine Connect America Fund Phase II support levels, stating that the FCC staff return was "too high". The FCC denied this reconsideration request and found that the FCC staff return was in fact reasonable.[1] Mr. Meredith's speculation and conjecture would be equally applicable to infer that because the FCC has not yet acted, the FCC agrees with those commenters that the FCC Staff Report provides a rate of return that is <u>too high</u>.

The Commission should also note that one of the "rebuttals" to the FCC Staff Report that Mr. Meredith states "levels a broadside" against that Report is the Exhibit 4 authored by Mr. Vincent Wiemer who, as explained below, the Kansas Corporation Commission found not to be a credible witness on rate of return issues. This should cause the Commission to carefully scrutinize the merit of Mr. Meredith's Exhibit 4.

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[1] Memorandum Opinion and Order; In the Matter of Connect America Fund and High Cost Universal Service Support; WC Docket Nos. 10-90 and 05-337; FCC 14-180; Released November 12, 2014. This Order is attached as Exhibit OCS 3S-1.

Q. AT LINE 216 MR. MEREDITH STATES "WHAT SHOULD INFORM THE COMMISSION IN THIS PROCEEDING IS THE FACT THAT THE FCC DID NOT ACCEPT THE CONCLUSIONS OF THE STAFF REPORT" (EMPHASIS IN ORGINAL). IS THIS ACCURATE?

A. No. While the FCC has not yet acted on the FCC staff Report on Rate of Return for reasons known only to the FCC itself, the FCC has directly employed the FCC staff recommended rate of return to determine support amounts for Phase II of the Connect America Fund or "CAF II" funding. Specifically in the cost model used to determine CAF II support amounts, the FCC staff used an 8.5% rate of return as a model input, based on the mid-point of the rate of return range contained in the FCC Staff Report on Rate of Return: 7.84% to 9.20%. The FCC addressed the application for review of this model input by the American Cable Association and specifically upheld the 8.5% rate of return from the FCC Staff report stating: "we are not persuaded by ACA's argument that the cost of money selected by the Bureau is unreasonably high"; and, "we find the Bureau's selection of the input values for the cost of money and the subscription rate to be reasonable, clearly reflecting the Bureau's consideration of the record before it, its own analysis, and its predictive judgment of future conditions."[2] The midpoint of the rate of return range established by the FCC Staff Report on Rate

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[2] Id, at page 3.

of Return – 8.5% -- is in use today to determine CAF II support amounts from the federal Universal Service Fund.

RATE OF RETURN FOR INTERSTATE SERVICES

Q. DOES MR. MEREDITH DIRECTLY ADDRESS THE RECOMMENDATION IN YOUR DIRECT TESTIMONY THAT THE COMMISSION USE THE 9.40% OVERALL RATE OF RETURN FROM THE FCC FORM 492 REPORT?

A. No. Mr. Meredith's testimony on the interstate rate of return to be used is provided at lines 436 – 441. There he advocates for use of a more recent (2015) Form 492 and states "this is not the 2014 version proposed by Messrs. Brevitz and Coleman." Mr. Meredith is completely incorrect to state that I proposed use of this Form 492 from 2014 – the Company proposed it via Mr. Searle's Direct Testimony, as I made clear in my Direct Testimony at footnote 2.[3] I accepted use of the Company – proposed Form 492 from 2014 but made clear that Mr. Searle had selected the wrong return on the form to use – 11.45% versus 9.40% -- which I explained was the correct interstate rate of return to use. I have thoroughly explained why the 9.40% rate of return is the correct return to use in this case in my Direct Testimony at lines 171 – 239. The Commission should find that 9.40%

[3] Mr. Meredith also completely glosses over the fact that he has changed more than just which year of the Form 492 to use. In this case Mr. Meredith changes from Mr. Searle's recommended use of the Common Line pool return of 11.45% to the total interstate rate of return for all services of 9.51%. Mr. Meredith makes this change in the company position without any explanation whatsoever.

is the correct interstate rate of return for use in this case under the Commission's rule. However, in the alternative, I do not object to use of the more recent return of 9.47%/9.51% which is the more recent total interstate return.

"COMPARABLE OR PEER COMPANIES"

Q. MR. MEREDITH DISCUSSES THE "PEER GROUP" OF COMPANIES SELECTED BY MR. COLEMAN AT LINES 281 – 315 OF HIS TESTIMONY, AND IDENTIFIES A SIGNIFICANTLY DIFFERENT "PEER GROUP". SHOULD THE COMMISSION ACCEPT HIS PEER GROUP?

A. No. Selection of "comparable companies" for rate of return analysis is necessary and required. The rate of return analyst must rely on public information associated with publicly traded companies in order to perform calculations necessary to determine the cost of capital elements of capital structure and return on equity. There is no public market data for Utah telecommunications companies since these companies are not publicly held with stocks and bonds that trade in public financial markets. If there were publicly traded telecommunications companies in Utah, those companies could be considered for reasonableness for inclusion as "comparable companies" for rate of return analysis purposes. Since there are no such companies, other telecommunications companies which are publicly traded must be reviewed for inclusion in the pool of "comparable companies" for this analysis – recognizing that it is not possible to assemble a pool of companies that are direct analogs to Strata.[4] Mr. Meredith takes issue with the comparable companies Mr. Coleman used, and accepts my testimony in other cases to exclude HickoryTech, Alteva, Atlantic Tele Network, Earthlink, and IDT. However, Mr. Meredith does not exclude Cincinnati Bell or FairPoint, and in fact includes them in his "levered beta" table. I am very familiar with FairPoint Communications (FRP) from many years of working in other states on various FairPoint cases and dockets, including the acquisition case in which FairPoint acquired Verizon's Northern New England operations, and the subsequent bankruptcy case less than two years later. FairPoint does not pay a dividend and is owned by a variety of entities that acquired ownership as a result of the bankruptcy proceeding, and subsequent "distressed capital" (or "vulture fund") investors. FairPoint has yet to earn a profit on a full-year basis. For these reasons I would not include FairPoint as a comparable company.

Oddly, Mr. Meredith states at line 310 "as noted by Dr. Billingsley, some of these companies are distressed or are in bankruptcy, thereby affecting their beta value" and refers to "FTR", which is Frontier Communications. Frontier is not distressed or in bankruptcy and in fact has recently concluded over $10 billion in financing to fund its acquisition of Verizon landline operations in California,

[4] Mr. Meredith notes that "there are only 14 publicly traded ILEC peers in the nation" within "1,101 small company study areas in the nation". Meredith Rebuttal, at line 349.

Florida and Texas. This erroneous statement carries through to Mr. Meredith's "levered beta" table at line 378. Mr. Meredith also puts in AT&T and Verizon as "peers" to Strata without any substantive explanation. This is illogical and inconsistent with his claim elsewhere that a "small company premium" is necessary. It makes no sense to include the two companies which are most demonstrably not comparable to Strata in the peer group. Mr. Coleman and I appropriately did not include AT&T and Verizon.

It is reasonable for the Commission to rely on the comparable companies selected by Mr. Coleman and me, as adjusted above.

STATE RETURN ON EQUITY

Q. AT LINES 87 – 95 MR. MEREDITH DISCOUNTS THE EXTENSIVE CASE CITATIONS IN YOUR DIRECT TESTIMONY TO RURAL LOCAL EXCHANGE COMPANY RATE OF RETURN DETERMINATIONS BY THE KANSAS CORPORATION COMMISSION (KCC) STATING "WE SIMPLY DON'T HAVE ANY INFORMATION THAT THE RATE USED FOR RETURN ON EQUITY WAS FULLY EXAMINED IN THE CITED KANSAS CASES". IS THIS CRITICISM WARRANTED OR REASONABLE?

A. No. Every document in every case cited is publicly available on the KCC's website. Each company filing, company witness testimony, staff witness testimony, pleading, stipulation, and final Commission order is available on the website for each case. Only limited information is deemed confidential and not publicly available. In footnotes 10 and 11 of my direct testimony I included the link to the KCC website and stated that "each of these testimonies is public record" and "each of the Commission decisions is public record" on the KCC website. The cost basis for individual rural local exchange company KUSF funding has been reviewed by the KCC on a rotating basis since 1997. So at this point there is an established base of precedent from cases that have gone to hearing, and now in most cases stipulations are reached to generally accept the KCC staff-recommended revenue requirement based on KCC staff-recommended ROR as illustrated by the table at line 252 of my Direct Testimony. I cannot explain why Mr. Meredith did not use the link provided in my Direct Testimony to review these stipulations and orders himself to seek to verify that in fact rate of return was fully examined by the parties and the Commission in each case. The only appropriate criticism here is that Mr. Meredith failed to review these public documents as he easily could have done before writing the testimony he wrote.

Q. MR. MEREDITH'S REBUTTAL STATED "ESPECIALLY ABSENT IS ANY REFERENCE OR CITATION FROM THE COMMISSION ABOUT ITS EVALUATION AND DETERMINATION OF THE RATE OF EQUITY [SIC] IN THE LAHARPE CASE." IS THIS CRITICISM WARRANTED?

A. No. As noted above, this decision by the KCC is publicly available on its website and is attached as Exhibit OCS 3S-1. Review of this KCC Order makes clear that the Commission did thoroughly review rate of return determination, and the Commission's analysis of the rate of return position expressed by the Company's consultant is scathing:

> 22. As part of the Commission's analysis of the extensive evidentiary record, the Commission also assesses witness credibility. In this proceeding, the Commission finds a substantial credibility gap between the two ROR witnesses. Staff's witness, Mr. Gatewood, incorporated his own comprehensive updated cost of equity analysis and consistently recommended this analysis as a reasonable and appropriate approach.
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> 23. LaHarpe's witness, Mr. Wiemer, incorporated another witness's testimony in his pre-filed direct testimony to recommend a 12.5% ROE. Then, in his supplemental rebuttal testimony, Mr. Wiemer, abandoned his initial recommendation. Instead, he opted to use Mr. Gatewood's analysis and add premia in an apparent effort to reach the highest possible ROE figure. There was no mention of his previous recommendation, and the Commission was left to ponder its application. Mr. Wiemer was certainly free to adjust his testimony as the proceeding progressed; however, wholesale abandonment of one position without reasonable explanation does have an effect on witness credibility.[5]

As noted in my Direct Testimony at line 497, the Commission adopted the 10% return on equity recommended by KCC staff's "comprehensive updated cost of equity analysis".[6] The KCC clearly fully and carefully vetted the rate of return

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[5] Order; State Corporation Commission of the State of Kansas; *In the Matter of Staff's Motion Requesting The Commission Order LaHarpe Telephone Company, Inc. to Submit to an Audit for Purposes of Determining its Cost-Based Kansas Universal Service Fund Support, Pursuant to K.S.A. 66-2008;* Docket No. 12-LHPT-875-AUD; June 26, 2013, at page 7 – 8. [Exhibit OCS 3S-1; or the "LaHarpe Order"]

[6] *Id*., at page 7.

analysis before it. This KCC Order was (and is) publicly available on the website cited in my testimony for Mr. Meredith's review.

Q. IS THE COMPANY WITNESS IN THE LAHARPE PROCEEDING ABOVE THE SAME MR. WIEMER THAT IS INDICATED TO HAVE AUTHORED THE DOCUMENT MR. MEREDITH ATTACHES AS HIS EXHIBIT 4?

A. Yes. Vincent H. Wiemer, CPA, Alexicon Consulting is indicated on the cover page of Meredith Exhibit 4 to be the author of those comments to the FCC on the FCC Staff Rate of Return report. The KCC's finding of Mr. Wiemer's lack of credibility on rate of return issues should cause this Commission to carefully scrutinize the merit of this Exhibit and Mr. Meredith's related testimony.

Q. MR. MEREDITH STATES AT LINE 413 THAT YOU "FAIL TO INDICATE THE METHOD USED TO CALCULATE THE PROPOSED STAFF RETURNS ON EQUITY IN KANSAS". IS THIS CRITICISM WARRANTED OR REASONABLE?

A. No. At line 500 of my Direct Testimony I indicate that the DCF and CAPM methods are used. Also as indicated above, all the filings, pleadings, testimonies, stipulations and orders are publicly available on the KCC website. Review of each publicly available KCC staff testimony on rate of return will show that each case contains a "comprehensive updated cost of equity analysis"[7] and that the comprehensive analysis performed includes both Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) estimations which are used to create a holistic return on equity recommendation to the Commission.

Q. MR. MEREDITH APPEARS TO IGNORE USE OF THE DISCOUNTED CASH FLOW METHOD OF DETERMINING RETURN ON EQUITY, AND FOCUSES ONLY ON THE CAPITAL ASSET PRICING MODEL (CAPM). IS THIS A SIGNIFICANT SHORTCOMING IN HIS TESTIMONY AND PRESENTATION?

A. Yes. Mr. Meredith's testimony contains no discounted cash flow analysis for determining return on equity, or reference to such analysis. Further, there is no explanation of why Mr. Meredith has excluded the DCF methodology from his testimony. My experience is that return on equity analysis before state utility commissions will include estimations using both the DCF and CAPM methodologies. This is done for purposes of producing a robust analysis, which has an inherent cross-check between the methods to ensure reasonableness. Notably, the return on equity estimations contained in the table in my Direct Testimony at line 488 are derived from averages of the estimations from application of both the DCF and CAPM methodologies. There is thus an

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[7] Exhibit OCS 3S-1; LaHarpe Order; at page 7.

inherent cross check for reasonableness in my recommendation that is lacking in Mr. Meredith's testimony.

Q. AT LINE 120 MR. MEREDITH STATES "A SMALL COMPANY ADJUSTMENT OR MORE SPECIFICALLY A SIZE ADJUSTMENT IS A COMMON ADJUSTMENT THAT IS USED WHEN EXAMINING SMALL COMPANIES". HAS MR. MEREDITH PROVIDED ANY CITATIONS WHERE THIS ADJUSTMENT WHICH HE CLAIMS IS "COMMON" HAS BEEN ACCEPTED BY A STATE COMMISSION?

A. No. Mr. Meredith provides no evidence of the acceptance of a small company adjustment in any state USF funding proceeding, or in any other proceeding where determination of rate of return is required. I am not aware of any case where a state commission has accepted and used a "small company adjustment" in its rate of return findings for state USF funding. In fact, this Commission has rejected the request for a small company size adjustment of return on equity in the Questar Gas Company rate case in Docket No. 13-057-05.[8] Also, the Minnesota Public Utilities Commission has recently rejected the application of a

[8] Report and Order, In the Matter of the Application of Questar Gas Company to Increase Distribution Rates and Charges and Make Tariff Modification; Docket No. 13-057-05; Issued by the Public Service Commission of Utah, February 21, 2014, at pages 20, 32-33.

small size adjustment of return on equity. The pages from the MPUC's Order relevant to cost of equity are attached as Exhibit OCS 3S-2.

Mr. Meredith's testimony contains generalizations and assertions on the subject of the "small size" adjustment, but no real specifics on how "size" is measured, or where are the breakpoints between "small size" and larger size. Perhaps it may be presumed that size is measured by the firm's level of capitalization. In any event, the proffered small size adjustment is completely contrary to rate of return estimation concepts in public utility proceedings before state utility commissions. Furthermore, the bare existence of a "small company premium" is disputed in the finance field, and there is strong evidence that such a premium does not in fact exist. My Direct Testimony explains this at lines 305 – 431.

Q. AT LINE 98 MR. MEREDITH DEFINES "A SMALL COMPANY PREMIUM [AS] AN ADJUSTMENT TO THE CALCULATED RATE OF EQUITY [SIC] AND IS DESIGNED TO ACCOUNT FOR THE FACT THAT ACCESS TO EQUITY IS MORE CONSTRAINED AS COMPANIES GET SMALLER. THUS, DUE TO VARIOUS FACTORS, ACCESS TO CAPITAL REQUIRES A PREMIUM OVER A RETURN ON EQUITY FOR MUCH LARGER COMPANIES." PLEASE RESPOND.

A. Mr. Meredith provides no evidence whatsoever that Strata's access to capital is at all constrained. In fact, Strata's Annual Report data shows its equity has grown substantially enough to permit rapid accumulation of profits and capital credits, all while it is financing a substantial construction program for Fiber to the Home, and buying various buildings and other assets.

[**BEGIN CONFIDENTIAL**]

[redacted]

[**END CONFIDENTIAL**]

This is not the profile of an entity that is "capital constrained". The purported need for a "premium" would be pure profit subsidy from ratepayers statewide to Strata's members.

Q. AT LINE 347, MR. MEREDITH STATES "STRATA IS CHALLENGED IN THE NATIONAL EQUITY MARKETS". DOES MR. MEREDITH PROVIDE ANY SUPPORT FOR THIS CONTENTION?

A. Mr. Meredith provides no evidence whatsoever that Strata is challenged in the equity markets. Further undermining Mr. Meredith's claims is the fact that Strata does not participate in public equity markets. It therefore is unclear what "equity market" Mr. Meredith is referring to. The nature of the "challenge" is not described by Mr. Meredith and the nature of any such "challenge" is very difficult to perceive when Strata has accumulated substantial capital credit balances, all while funding substantial construction and asset acquisition. It begs the question of how much more equity does Strata need when it has substantial member-provided equity, and is funding a substantial Fiber to the Home construction program and asset acquisition while continuing to accumulate substantial capital credits (equity) for its members.

Q. AT LINE 228 MR. MEREDITH REFERENCES A RURAL BROADBAND ALLIANCE ESTIMATE OF 6 PERCENT FOR A "SMALL COMPANY ADJUSTMENT". IS SUCH AN ADJUSTMENT WARRANTED OR SUPPORTABLE?

A. No. This "estimate" is drawn from Mr. Meredith's Exhibit 4, which the cover page indicates are comments before the FCC authored by Mr. Vincent Wiemer. This is the same Mr. Wiemer that the Kansas Corporation Commission found had no credibility as a rate of return expert in the LaHarpe case. Also, the very size of the suggested "premium" indicates its inappropriateness. It is egregious to recommend that 6% be added on top of any return on equity determined by DCF or CAPM using market data which by definition includes a market assessed risk/return relationship.

Q. AT LINE 361 MR. MEREDITH INDICATES "ADJUSTING THE BETA" FOR LEVERAGE IS "ANOTHER STANDARD TOOL". IS THIS IN FACT "STANDARD" IN DETERMINATION OF RETURN ON EQUITY BEFORE STATE UTILITY COMMISSIONS?

A. This is an unsupported assertion by Mr. Meredith, which the Commission should not accept. He offers no citation to state commission decisions that have adopted this "standard" adjustment, including to decisions of the Utah PSC. I am unaware of any Commission decision in any jurisdiction where this "standard" adjustment is applied in determination of return on equity.

Q. BEGINNING AT LINE 368 OF HIS TESTIMONY MR. MEREDITH PROPOSES THE USE OF A "LEVERED BETA" TO CALCULATE REQUIRED RETURN ON EQUITY. DOES MR. MEREDITH PROVIDE ANY SUPPORT FOR THE USE OF "LEVERED BETA" IN CALCULATING RETURN ON EQUITY IN A REGULATORY PROCEEDING?

A. No. Mr. Meredith provides no citation to any regulatory proceeding where a commission has used "levered beta" as he presents it to calculate a required or allowed return on equity. I am not aware of any instance where a state utility commission has accepted or used "levered beta" as presented by Mr. Meredith in its determinations on rate of return, despite his unsupported claim at line 362 that it "is another standard tool when using CAPM". I have reviewed the various finance and investment texts in my possession[9] and while there are extensive chapters on CAPM, beta, and related concepts and practices, there is no mention whatsoever of "levered beta" or any equivalent. The standard usage of "levered beta" I believe is for capital budgeting decisions – i.e., whether to undertake a specific capital project, or not – not for valuation estimations such as rate of return. Use of levered beta in state regulatory ROE determinations appears to be uncommon at best.

Q. PLEASE ADDRESS MR. MEREDITH'S TABLE 2 (AT LINE 374), WHICH PRESENTS "LEVERED BETA" AND "ADJUSTED CAPM".

A. The levered beta/adjusted CAPM table appears flawed for a number of reasons. Mr. Meredith provides no source or calculation documentation. It can perhaps be assumed from prior statement that the "October 27th Spot Beta" is from Yahoo Finance, but that and other data in the table is unattributed and unsourced. Mr. Meredith states he "gathered the data to produce a levered beta" but provides no more insight into the data sources and calculations for "CAPM unadjusted" or the tax or debt%/equity% figures. Critically, Mr. Meredith's "Spot beta" point of beginning—if it is from Yahoo Finance, or potentially other sources—would already include leverage and tax considerations. The same as other betas, the

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[9] These include: Managerial Finance, J. Fred Weston and Eugene F. Brigham; Financial Management and Policy, James C. Van Horne; Investments, Frank K. Reilly; Managing Investment Portfolios: A Dynamic Process, John L. Maginn and Donald L. Tuttle, eds.

Yahoo Finance beta is based on stock trading prices for the individual stock relative to the S&P 500 stock index. The stocks trade based on earnings, which includes leverage and tax effects. Mr. Meredith's levered beta/Adjusted CAPM Table 2 is unsupported, potentially incorrect on its face, and unusable by the Commission. Importantly, the "levered beta" presentation assumes the return on equity from CAPM requires adjustment – which it does not for reasons described in my testimony. The Commission should disregard Mr. Meredith's "levered beta" discussion and calculations for these reasons.

Q. AT LINE 422 MR. MEREDITH REFERS TO A NEW NTCA-SPONSORED RATE OF RETURN METHOD. SHOULD THE COMMISSION GIVE ANY WEIGHT TO THIS TESTIMONY?

A. No. Mr. Meredith does not provide any citation to where this new methodology has been used and vetted. Furthermore, the new method requires a substantial new variable – "value" – which by its nature is bound to be controversial. There will be competing estimations of "value" and it does not simplify or streamline the rate of return determination process to add a controversial new variable that must be calculated.

Q. AT LINE 387 OF MR. MEREDITH'S TESTIMONY A GRAPH IS PRESENTED DRAWN FROM AN ARTICLE IN THE <u>INVESTMENT MANAGEMENT REVIEW</u>, WITH THE CLAIM THAT THE GRAPH "SHOWS THE VARIOUS

PREMIA REQUIRED TO CALCULATE RETURNS ACROSS FINANCIAL INSTRUMENTS". DOES MR. MEREDITH PROVIDE SUCH A CALCULATION OR INDICATE WHERE STATE UTILITY COMMISSIONS ARE USING SUCH A CALCULATION TO DETERMINE RETURN ON EQUITY?

A. No. Mr. Meredith presents this graph but never provides any proposed data or calculations, or more importantly never provides any data sources from which the calculation could be made. Full assessment of this graph is impeded since the title of the graph is not provided, nor is the article from which it is drawn attached as an exhibit. Mr. Meredith is not consistent in that he states that "they [the various premia] are required to calculate a rate of return" but he does not provide a rate of return estimation which estimates and sums each of these "various premia". The Commission should give no weight to this graph because it is not tied to a real calculation of required return on equity and is otherwise inconsistent with other parts of Mr. Meredith's testimony. Immediately following this graph which shows "various premia", Mr. Meredith finds another even more important premium which is not contained on the graph. "It is claimed that 'the liquidity premium is perhaps as important as any of the risk premiums'". Yet this most important premium is not included in the various premia listed immediately before, from the same author. The Commission should rely upon required return on equity estimations that are clearly based upon the standard formulation of the real risk free rate of return plus expected inflation plus the risk premium – DCF and CAPM, rather than the scattershot, inconsistent and unapplied citations from Mr. Meredith.

Q. MR. MEREDITH INDICATES MR. COLEMAN'S CAPM MUST BE ADJUSTED IN "RECOGNITION OF A LIQUIDITY PREMIUM" (LINE 355) AND STATES "THE LIQUIDITY PREMIUM IS PERHAPS AS IMPORTANT AS ANY OF THE RISK PREMIUMS" (LINE 392). PLEASE RESPOND.

A. "Liquidity" is defined as "the ability to buy or sell an asset quickly with reasonably small price changes assuming no new information has entered the market".[10] Liquidity is irrelevant to the Commission's determinations in this case regarding Strata. Strata is a cooperative. There is no indication whatsoever that the cooperative is going to be sold. From a member perspective, under Strata's bylaws membership interests in Strata are non-transferrable, so by definition liquidity is not relevant. The Commission should not accept Mr. Meredith's proposal to recognize and include a "liquidity premium" among the various premia which he seeks to have added to the computation of return on equity. Mr. Meredith admits at lines 408 – 410 that he is not able to calculate such a "liquidity premium" in the first place.

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[10] Investments, Frank K. Reilly, The Dryden Press, 1982, at page 673.

Q. PLEASE SUMMARIZE HOW AND WHY MR. MEREDITH'S TESTIMONY CONTRADICTS WELL ACCEPTED PRINCIPLES OF FINANCE AND THEREFORE YIELDS RATE OF RETURN ESTIMATIONS WHICH ARE ESSENTIALLY MEANINGLESS AND WITHOUT PROPER FOUNDATION.

A. Mr. Meredith's testimony obfuscates basic principles of finance and rate of return determination in regulatory cases, and is otherwise internally inconsistent. The Commission should find that a return on equity and overall rate of return of the magnitude sought by Strata is unwarranted and unnecessary in today's capital markets, and is imbalanced against the wireline and wireless services consumers that pay into the UUSF to provide funds for individual local exchange companies like Strata. Strata's original requested intrastate rate of return on equity is approximately 14.00%, and the requested overall rate of return is 9.50%. Mr. Meredith offers a variety of recommendations and observations, including that "there is more than enough data to support the 9.50 percent rate of return" (line 204); "the median value [for the NECA calculated rate of return] was at least 11.75 percent" (line 427); the levered beta/adjusted CAPM "results in an intrastate cost of equity of 16.76 percent" using "a very conservative value of 3 percent for the small company premium" (line 369). Mr. Meredith's potpourri is disconnected from the methods of rate of return analysis regularly used by state utility commissions – Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) – and violates fundamental principles in finance by which risk and return are related, and under which investors are compensated <u>only</u> for systematic risk as calculated in the "beta" associated with each security. Mr. Meredith's testimony begs the question of what does he believe specifically is an appropriate rate of return, and lends itself to an interpretation such "specific" rate of return would <u>simply be the highest return</u> the Commission can be persuaded to accept.

Mr. Meredith's disconnection from methods of rate of return analysis regularly used by state utility commissions is illustrated by his testimony which:

- Without serious explanation or consideration discards use of DCF, which is <u>the</u> fundamental method for asset valuation;
- Provides no evidence whatsoever that the company's access to equity or capital is at all constrained;
- Advocates calculation and use of "levered beta", which is not used or recognized for rate of return analysis by state utility commissions, and is instead oriented toward internal capital budgeting decisions of firms;
- Advocates use of "various premia" layered on top of determined rate of returns, which premia are not used or recognized for rate of return analysis by state utility commissions;
- Advocates use of "various premia", the very existence of which is inconsistent with efficient markets principles of finance and capital markets,

and whose existence would necessarily imply profitable exploitable investment strategies – using which professional investors have "yet to make a nickel";

- Advocates use of "various premia" as an additive to reflect purported additional risks, without consideration of substantial offsetting additional benefits which pertain to incumbent local exchange companies;
- Advocates use of "various premia", which researchers have found may very well not exist, whose apparent existence may be the result of "data mining", which may be indicative of correlation but not causation, and may ultimately stem from "survivor" bias in the small company database as well as being driven by a very small fraction of outliers in the data;
- Advocates use of "various premia", which is entirely inconsistent with modern portfolio theory under which investors are compensated only for systematic risk (expressed via the "beta") within an efficient portfolio, but not for unsystematic risk; and,
- Contains inappropriate and unfounded speculation and conjecture regarding why the FCC may or may not have acted on its staff report.

The Commission should adopt the overall rate of return of 7.50% based on a 10% intrastate return on equity which is recommended in my Direct Testimony. This recommendation has a demonstrable, solid foundation in regulatory practices for rate of return determination, and finance theory and practices. This recommendation reflects a proper balance for those Utah statewide consumers that pay monthly charges through their wireless and wireline services provider bills to fund the UUSF, and those individual incumbent companies that seek to draw from the UUSF. Finally, this recommendation is very consistent with rates of return on equity recently granted by the Commission.

Q. DOES THIS COMPLETE YOUR PREFILED SURREBUTTAL TESTIMONY?

A. Yes.