

- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

)	DOCKET NO. 15-053-01
)	DPU Exhibit 4.0 SR
In the Matter of UBTA-UBET)	
Communications, Inc.'s (DBA Strata)	Surrebuttal Testimony of
Networks) Application for Utah)	Casey J. Coleman
Universal Service Fund Support)	
)	

DIVISION OF PUBLIC UTILITIES
DEPARTMENT OF COMMERCE

November 17, 2015

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1 **I. IDENTIFICATION OF WITNESS**

2 **Q. PLEASE STATE YOUR NAME, EMPLOYER, AND BUSINESS ADDRESS.**

3 A. My name is Casey J. Coleman. I am employed by the Division of Public
4 Utilities (“Division”) for the State of Utah. My business address is 160 East
5 300 South Salt Lake City, UT 84114.

6 **Q. HAVE YOU PREVIOUSLY FILED DIRECT TESTIMONY IN THIS**
7 **MATTER?**

8 A. Yes.

9 **Q. DESCRIBE THE PURPOSE OF YOUR TESTIMONY.**

10 A. The purpose of my testimony is to address issues discussed in rebuttal
11 testimonies provided by the Office of Consumer Services (“OCS”) and UBTA-
12 UBET Communications, Inc. dba Strata Networks (“UBTA”). In the rebuttal
13 testimony of Mr. David Brevitz (OCS) and Mr. Douglas Duncan Meredith
14 (UBTA), they argue why the proposed methodology and inputs calculated by
15 the Division of Public Utilities (“DPU”) should be modified or rejected. This
16 testimony clarifies the inputs used by the DPU and why the Public Service
17 Commission of Utah (“Commission”) should accept the DPU’s
18 recommendations.

19

II. INTERSTATE RATE OF RETURN

20 **Q. ARE THERE ANY CHANGES OR MODIFICATIONS YOU WOULD LIKE**
21 **TO MAKE REGARDING YOUR PREFILED DIRECT TESTIMONY?**

22 A. Yes. An updated NECA form 492 was filed with the FCC on September 24,
23 2015 showing the interstate rate of return of 9.51 percent. The Division agrees
24 this should be the new rate used for interstate when calculating the rate of
25 return.

26

III. CAPITAL ASSET PRICING MODEL

27 **Q. DO YOU BELIEVE THE DPU FOLLOWED THE CORRECT**
28 **METHODOLOGY TO DETERMINE THE COST OF CAPITAL FOR**
29 **UBTA?**

30 A. Yes.

31 **Q. BY USING THE CAPM HAS THE DIVISION CALCULATED A FAIR**
32 **AND REASONABLE RATE?**

33 A. Yes. In Docket No. 08-046-01 (Manti Telecom) the Commission faced many
34 of the similar issues and arguments as are being argued here. In reviewing
35 the details of Manti Telecom and UBTA I find nothing vastly different
36 between those two companies that would warrant using a different
37 methodology in this case. In public portions of the confidential report and

38 order issued by the Commission on December 28, 2012, page 21 the
39 Commission states as follows:

40 Considering the evidence presented regarding a reasonable
41 return on equity, i.e., the Division's use of the capital asset
42 pricing model, the Commission is persuaded the Division's
43 analysis produces a fair and reasonable result. We [the
44 Commission] therefore approve the Division's recommended
45 rate of return on equity.¹

46 The Commission has already found that the Division's method produces fair
47 and reasonable results in a relatively recent case. Using a CAPM model in
48 this case would similarly produce "fair and reasonable results."

49 The Commission should reject Mr. Meredith's suggestion to jettison the
50 CAPM unless there are adjustments to the standard approach of calculating
51 the cost of equity. The Commission has previously allowed that a basic
52 approach to calculating CAPM without modifications for size, liquidity, and
53 leveraged betas produces fair and reasonable results. Mr. Meredith's
54 arguments do not warrant departure.

55 The issues Mr. Meredith discusses are the same issues the Commission
56 considered in the Manti case. Because all of those issues were recently
57 considered, the Commission should not re-evaluate its recent decisions

¹ Even though this docket was confidential, the Division does not believe the above statement by the Commission is confidential. As a result we included the statement in the public version of the testimony.

58 without evidence that UBTA is vastly different than Manti or markets are
59 vastly different than they were then.

60 **Q. MR. MEREDITH USES YOUR ENDORSEMENT OF CAPM AS BEING**
61 **LUKEWARM AS SOME JUSTIFICATION FOR MODIFYING THE**
62 **CAPM CALCULATION. PLEASE RESPOND?**

63 A. Yes. I agree that, as Mr. Meredith explained in his rebuttal testimony, there
64 are some potential pitfalls in using a simple CAPM. I acknowledged as much
65 in my direct testimony. I refer the Commission to that discussion in my direct
66 testimony. As discussed in that testimony, with a small rural phone company
67 it is virtually impossible to arrive at a reasonable result using any other
68 method, such as a modified discounted cash flow, comparable companies, etc.
69 There is almost no publicly available information to determine a rate of
70 return that produces reasonable results. This stark fact is one germane
71 element of my reluctance to enthusiastically recommend the CAPM method
72 and it prevents my endorsement of any other method, including Mr.
73 Meredith's modifications.

74 **IV. ADJUSTMENTS TO CAPM**

75 **Q. WHY DO YOU THINK ADJUSTMENTS TO CAPM ARE**
76 **UNNECESSARY?**

77 A. In financial theory, small company premiums, adjusting for liquidity, and
78 others of the tools suggested make sense to consider on a macro level. No one
79 would argue that a large multi-national corporation like AT&T or Verizon
80 would have a harder time attracting capital than a small flower shop in
81 Roosevelt, Utah. Additionally, because AT&T or Verizon is traded daily on
82 the various stock exchanges, their stocks are more liquid than Alaska
83 Communications.

84 The challenge with the financial models is that the assumptions are for
85 publicly traded companies who are dealing with many of the same market
86 factors and constraints. The premise in investing is that the relationship
87 between risk and return is such that no investment will be made unless the
88 expected rate of return is high enough to compensate the investor for the
89 perceived risk of the investment. Investment risk is related to the probability
90 of actually earning less than the expected return—the greater the chance of
91 low or negative returns, the riskier the investment. To compensate for that
92 “higher risk” there is a risk premium to investors, which is the difference
93 between the expected rate of return on a given risky asset and that on a less
94 risky asset.

95 In lines 393 – 395 of Mr. Meredith’s rebuttal testimony he shows a graph that
96 illustrates some of the risks that are being evaluated in financial theory to

97 capture the correct “risk premium” for a given risky asset. For small stocks
98 it shows a small-stock premium, equity risk premium, bond horizon
99 premium, real riskless rate, and inflation. While these are generally
100 accepted adjustments in theory for most publicly traded stocks, the Division
101 does not believe they are applicable to UBTA.

102 When a company is subsidized by a government fund, it is incorrect to say
103 that it is as “risky” of an investment as a publicly traded company that does
104 not have the same safety net. As a general statement utilities are considered
105 a lower risk investment than most industries. Utilities often have an
106 inherent advantage of being a monopolistic provider of a basic service to a
107 captive customer base. Additionally, because subsidization stabilizes the
108 cash flows of a small rural Utah phone company, the risk of that security is
109 even lower than traditional utilities. Because UBTA receives money from
110 federal and state USFs its risk is much different from traditional “small
111 companies” and unsubsidized utilities. In part because of this decreased risk,
112 there is no need to adjust the CAPM.

113 Mr. Meredith argues otherwise in his rebuttal testimony in lines 272 – 275.
114 He states “[t]raditional methods of calculating a rate of equity for small
115 companies has a tendency to understate the lack of access to equity markets
116 and the corresponding return that is necessary to attract equity to remote

117 locations in Utah.” Mr. Meredith implies that using all the various financial
118 “tools” is necessary to ensure the cost of capital is adequate to attract capital
119 and fairly compensate investors for the opportunity cost that is the basic
120 principle of investing.

121 The Division disagrees because UBTA does not resemble such small
122 companies in either risk or access to capital. Because the financial theories
123 Mr. Meredith discusses deal with publicly traded companies who are
124 generally exposed to the same market risks and challenges, a CAPM, various
125 cash flow models, or even comparable companies apply reasonably well to
126 public companies. A small Utah rural phone company has access to capital
127 in different ways than most traditional publicly traded companies. UBTA has
128 some inherent advantages not available to companies being evaluated by the
129 model. These advantages make the small rural phone companies less risky
130 when looking at investment risk. This requires a lower return than other
131 more speculative and risky investments. Because of this fact, the CAPM
132 model is more likely to overstate than understate the appropriate cost of
133 equity for rural Utah phone companies. To adjust the rates for small
134 companies, as suggested in financial theory, would exacerbate the overstated
135 cost of equity and be less accurate.

136

V. COMPARABLE COMPANIES

137 **Q. MR. MEREDITH AND MR. BREVITZ MAKE A POINT THAT**
138 **CHOOSING THE CORRECT COMPANIES IS VITAL WHEN**
139 **DETERMING CAPM, DO YOU AGREE?**

140 A. Yes. For the CAPM model it is important to get comparable companies when
141 calculating a beta. The integrity of the model relies on the comparable
142 companies accurately reflecting the subject company to the extent possible.

143 **Q. CAN YOU EXPLAIN WHY YOU SELECTED THE COMPANIES YOU**
144 **DID FOR YOUR CAPM CALCULATION?**

145 A. Yes. The starting point was to use as many of the same companies as were
146 used in Docket No. 08-046-01 because the Commission found that the
147 Division's calculation produced fair and reasonable rates. Eight of the
148 companies listed were used in both Manti's and UBTA's cases. Those
149 companies are:

- 150 ▪ Alaska Communications
- 151 ▪ Consolidated Communications
- 152 ▪ Frontier Communications
- 153 ▪ IDT Corp
- 154 ▪ Hickory Tech Corp
- 155 ▪ Otelco
- 156 ▪ Shenandoah Telecom
- 157 ▪ Windstream Corp.

158 The different companies I added for this Docket were:

- 159 ▪ Atlantic Tele-Network, Inc.
- 160 ▪ Cincinnati Bell Inc.

- 161 ▪ Alteva, Inc
- 162 ▪ Earthlink Holdings Corp.
- 163 ▪ Fairpoint Communications, Inc.

164 I selected these additional companies to increase the number of companies to
165 calculate an average beta that would get reasonable results. I specifically
166 excluded large phone companies like AT&T, CenturyLink, and Verizon
167 because they were vastly different than rural phone companies in Utah.
168 Generally, I tried to find companies that had services and customers in some
169 parts of the United States that would be considered rural.

170 **Q. SO THE DIVISION HAS THEIR LIST, MR. MEREDITH HAS HIS**
171 **QUESTIONS WITH COMPANIES ON THE LIST, MR. BREVITZ ALSO**
172 **EXPRESSED A VARIETY OF RESERVATIONS. DISCUSS THEIR**
173 **CONCERNS?**

174 A. Each party that discusses the comparable companies agrees the peer group
175 is vital for effectively determining the appropriate risk premium.
176 Unfortunately, Mr. Meredith and Mr. Brevitz are silent on the most
177 important fact in dealing with the selected peer group: very few, if any of the
178 companies selected, have a state USF that will compensate those companies
179 for operating in high cost areas. As an example CenturyLink, as suggested
180 by Mr. Brevitz, offers service in at least 35 states in the country.
181 CenturyLink is eligible for state USF funds in some of those states like
182 Colorado, but does not qualify for any USF funds here in Utah.

183 A. The companies others use as comparable companies are “riskier”
184 investments because they do not have state USF funds to the same extent
185 Strata does. Because their chosen companies are riskier, the cost of equity
186 for rural phone companies in Utah should be adjusted down from their CAPM
187 calculations.

188 **VI. CONCLUSION**

189 **Q. WHAT IS THE DIVISION’S RECOMMENDATION FOR THIS PETITION?**

190 A. The Division recommends that the Commission use an allowed rate of return of
191 7.76 percent. The updated calculations are provided with my testimony as DPU
192 Exhibit 4.1 SR.

193 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

194 A. Yes it does.