Exhibit OCS 2S-3

2012.12.19 09:32:32
Kansas Corporation Commission
/S/ Patrice Petersen-Klein

In the Matter of Staff's Motion Requesting The	)	
Commission Order LaHarpe Telephone	)	
Company to Submit to an Audit for Purposes of	)	DOCKET NO.
Determining its Cost-Based Kansas Universal	)	12-LHPT-875-AUD
Service Support, Pursuant to K.S.A. 66-2008	)	

Received
on

DEC 19 2012

by
State Corporation Commission
of Kansas

DIRECT TESTIMONY

OF

ADAM H. GATEWOOD

ON BEHALF OF

THE KANSAS CORPORATION COMMISSION

OF THE STATE OF KANSAS

Q Please state your name and business address.

A Adam H. Gatewood, 1500 Arrowhead Road, Topeka, Kansas 66604.

Q Who is your employer and what is your title?

A I am Managing Financial Analyst for the Kansas Corporation Commission (Commission).

Q What is your educational and professional background?

A I graduated from Washburn University with a B.A. in Economics in 1987 and a Masters of Business Administration in 1996. I have filed testimony on cost of capital, capital structure, and related issues before the Commission in more than 110 proceedings and before the Federal Energy Regulatory Commission.

Q What is the purpose of your testimony?

A My testimony provides the Commission with an estimate of LaHarpe Telephone Company's (LaHarpe) cost of equity, cost of debt, and its overall rate of return that Staff used in setting LaHarpe's revenue requirement and ultimately determines the support payment from the Kansas Universal Service Fund (KUSF). In doing so, I evaluated LaHarpe's requested cost of capital presented in its Application.

Q Please summarize your findings and recommendations.

A I am recommending a 9.27% rate of return (ROR) for LaHarpe based on the elements of capital shown in the following table.

Rate of Return for LaHarpe Telephone Co.
Proposed by Staff

	1 Capitalization Ratio	2 Cost of Capital	3 Weighted Cost
Long-term Debt	9.68%	2.50%	0.24%
Common Equity	90.32%	10.00%	9.03%
		Rate of Return	9.27%

1) Sec 7
2) Staff's recommended cost of capital
3) column 1 x column 2

Source: Application Section 7 & Direct Testimony of Adam H. Gatewood filed October 18, 2012, in Docket 12-GRHT-633-KSF

Q Please describe LaHarpe's ROR request.

A LaHarpe calculated its revenue requirement using an ROR of 11.53% as detailed in the table below.

Rate of Return
Proposed by LaHarpe Telephone Co.

	1 Capitalization Ratio	2 Cost of Capital	3 Weighted Cost
Long-term Debt	9.68%	2.50%	0.24%
Common Equity	90.32%	12.50%	11.29%
	100.00%	Rate of Return	11.53%

Source: Application, Section 7

The 12.50% return on equity (ROE) LaHarpe is requesting is not supported by any study or analysis that is filed in this Docket. It is unclear on how the Applicant supports a 12.50% cost of equity in the current capital markets.

Q Explain the root of the difference between Staff and LaHarpe's rate of return?

A The only difference is the return on equity used in the rate of return calculation. Staff accepts LaHarpe's cost of debt and capital structure shown in Section 7 of the Application.

Q How did you arrive at your conclusions for LaHarpe's cost of equity?

A I relied on the cost of equity analysis that I produced and filed on October 18, 2012, in Docket 12-GRHT-633-KSF (Gorham ROE Analysis).

Q Why do you believe it is reasonable to rely on a previously filed analysis?

A First, it is reasonable because I have verified that the Gorham ROE Analysis continues to accurately reflect the cost of equity in the capital markets. That is, the inputs to the cost of equity models that I relied on in the Gorham ROE Analysis have not changed significantly. Second, relying on the Gorham ROE Analysis reduces the number of Staff hours billed to this Docket without reducing the accuracy of Staff's analysis. I request that the testimony I filed in Docket 12-GRHT-633-KSF be incorporated into this Docket.

Q What were the results of your Gorham ROE Analysis?

A In the Gorham Analysis, I recommended a 10.50% return on equity for Gorham Telephone based on its actual capital structure of 70% debt and 30% equity.

Staff's Cost of Equity Estimates
Filed in 12-GRHT-633-KSF
on October 18, 2012

Discounted Cash Flow Analysis based on nGDP growth of 4.56%			
Mean	12.26%		
with a range of 7.43%	to	14.73%	
Capital Asset Pricing Model	10.43%		
Staff's recommendation is at the low-end of this range for Gorham Telephone Company			**10.50%**

Q **Would you recommend the same return on equity for LaHarpe?**

A No, I recommend slightly lower allowed return on equity capital for LaHarpe to reflect the fact that LaHarp's capital structure contains considerably more equity than the proxy group used in the Gorham ROE Analysis, or Gorham Telephone itself for that matter. LaHarpe's higher equity ratio is indicative of lower financial risk. The precise adjustment to investors' required return on equity given a different level of financial risk is always inexact; I believe it is reasonable to use an estimate at the lower end of the range bounded by the results shown in the previous table. Thus, 10.00% is a reasonable estimate as it is at the lower end of the range observed in the Gorham ROE Analysis.

Capital Structure

Q **Does Staff have adjustments to LaHarpe's capital structure?**

A No, the capital structure in LaHarpe's Application is consistent with what is reported in its financial statements. LaHarpe's capital structure does contain considerably more equity than the capital structures found in the proxy group, therefore, LaHarpe has less financial risk than the proxy group, and that reduced risk is accounted for in Staff's cost of equity used in the rate of return.

Cost of Debt

Q What cost of debt are you using for LaHarpe's revenue requirement?

A Staff's rate of return includes the cost of debt contained in LaHarpe's Application; 2.50%.

Standards for Evaluating a Fair Rate of Return

Q Please discuss legal standards used to evaluate a utility's allowed return on equity capital and allowed rate of return.

A I discuss these standards in Appendix A of my Gorham ROE Analysis. Appendix A discusses key rulings by the United States Supreme Court that financial analysts and policy makers rely on for guidance. My recommendation is consistent with the decisions from the United States Supreme Court in that I have based my recommendation on current data from the securities market and relied on data of publicly held companies in the rural local exchange segment of the telephony industry. The cost of debt and capital structure is LaHarpe's actual cost of debt; therefore, the Commission can be certain that LaHarpe is recovering its embedded cost of debt.

Q How does this Docket, in which the Commission is setting the level of KUSF support for LaHarpe, differ from a typical rate case?

A In a general rate case, the revenue requirement is only collected from its customers. In determining a rural local exchange carrier's (RLEC) KUSF support, the Commission is not setting a revenue requirement to determine rates paid by the customers. The support is coming from all Kansans who contribute to the KUSF. Thus, we are transferring money from users of telecommunications services in Kansas to the owners of LaHarpe Telephone.

Q In authorizing an ROR in recent cases, has the Commission set forth any factors it relies on to guide its decisions?

A Yes. In Docket No. 10-KCPE-415-RTS, the Commission stated in its Order (415 Order), "The return on equity we authorize should: 1) fairly compensate the utility for its invested capital; 2) enable the utility to compete for new capital on equal terms with other businesses in the same geographic area having similar risks; and 3) maintain the utility's financial integrity."[1]

In the 415 Order, the Commission also recognized its responsibility to balance the interests of investors seeking to earn a return on the capital they supply to the utility with the prices charged to utility consumers.[2] In that Order, the Commission explicitly noted that consumers' interests must be included in that balancing of

[1] Order, Docket No. 10-KCPE-415-RTS at p.41 (Nov. 22, 2010).
[2] Order, Docket No. 10-KCPE-415-RTS at p.37 (Nov. 22, 2010).

interests, particularly in times of economic hardships.[3]

Q Do those principles apply to the RLECs subject to these KUSF audits?

A Yes, these principles apply equally to KUSF audits where we are determining a revenue requirement on a rate of return regulated service as they do for setting revenue requirements for any other rate regulated industry where a regulatory agency has to balance the interests of a regulated entity and the consumer. In this instance, consumers' interests encompass all who contribute to the KUSF support mechanism.

Q Does your recommendation in this Docket meet the standards discussed in the 415 Order?

A Yes, my recommendation balances the competing interests of consumers and LaHarpe's owners. The ROR I recommend satisfies investors' required returns by including the actual cost of debt incurred by LaHarpe, so there is no doubt by LaHarpe's lenders that Staff's revenue requirement includes the interest expense necessary to compensate them, but no more than what is absolutely required by the market.

My ROR also relies on LaHarpe's actual mix of debt and equity as of the end of the test-year. Debt and equity capital possess unique risks and, as a result, investors have different required returns on the two forms of capital. Using a capital structure

[3] Order, Docket No. 10-KCPE-415-RTS at p.39 (Nov. 22, 2010).

different than the actual may enrich one of the interests at the expense of the other.

Staff's proposed ROE for LaHarpe is the result of a balanced, analytical review of the current capital markets. The ROE range I recommend to the Commission is based on investors' required returns observed in the current capital markets on investments of similar risks, namely publicly traded telecommunications companies serving rural areas. My recommendation balances consumers' interests and investors' interests by explicitly including forecasts of long-term growth rates for the broad economy, thus recognizing the realities of the current economy.

Q Does this conclude your testimony?

A Yes.

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CERTIFICATE OF SERVICE

12-LHPT-875-AUD

I, the undersigned, hereby certify that a true and correct copy of the above and foregoing Direct Testimony was served by electronic service on this 19th day of December, 2012, to the following parties who have waived receipt of follow-up hard copies.

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