

1 SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY  
2 REBUTTAL TESTIMONY OF DR. RANDALL S. BILLINGSLEY  
3 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

4 DOCKET NO. 920260-TL

5 DECEMBER 18, 1992

ORIGINAL  
FILE COPY

6  
7 I. INTRODUCTION

8  
9 Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS  
10 ADDRESS.

11  
12 A. MY NAME IS RANDALL S. BILLINGSLEY. I AM ASSOCIATE  
13 PROFESSOR OF FINANCE AT VIRGINIA POLYTECHNIC  
14 INSTITUTE AND STATE UNIVERSITY. I AM ALSO A  
15 FINANCIAL CONSULTANT IN THE AREAS OF COST OF  
16 CAPITAL ANALYSIS, SECURITY ANALYSIS AND VALUATION,  
17 AND INVESTMENT ANALYSIS. MY BUSINESS ADDRESS IS:  
18 DEPARTMENT OF FINANCE, THE R. B. PAMPLIN COLLEGE OF  
19 BUSINESS, VIRGINIA POLYTECHNIC INSTITUTE AND STATE  
20 UNIVERSITY, BLACKSBURG, VIRGINIA 24061-0221.

21  
22 Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS  
23 PROCEEDING ON BEHALF OF SOUTHERN BELL TELEPHONE AND  
24 TELEGRAPH COMPANY (SOUTHERN BELL)?

25

1 A. YES, I HAVE.

2

3 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

4

5 A. I HAVE BEEN ASKED BY SOUTHERN BELL TO REVIEW THE  
6 TESTIMONIES OF MR. JAMES A. ROTHSCHILD AND MR. MARK  
7 A. CICCHETTI WITH RESPECT TO THEIR DETERMINATION OF  
8 SOUTHERN BELL'S REQUIRED RATE OF RETURN ON EQUITY  
9 CAPITAL. FURTHER, I WILL REVIEW MR. CHARLES W.  
10 KING'S TESTIMONY CONCERNING THE APPROPRIATE RATE OF  
11 RETURN "TRIGGER" FOR THE COMMISSION'S  
12 RECONSIDERATION OF THE APPROPRIATE RATE OF RETURN  
13 SHARING BAND BETWEEN SOUTHERN BELL AND RATEPAYERS.

14

15 Q. HOW IS YOUR TESTIMONY ORGANIZED?

16

17 A. FIRST, I PROVIDE A REBUTTAL OF MR. CICCHETTI'S  
18 TESTIMONY ON BEHALF OF THE FLORIDA CABLE TELEVISION  
19 ASSOCIATION WHEREIN HE ERRONEOUSLY ESTIMATES A COST  
20 OF EQUITY CAPITAL OF 11.20% FOR SOUTHERN BELL. I  
21 EXPLAIN THE REASONS FOR MR. CICCHETTI'S  
22 UNDERESTIMATION OF THE COST OF EQUITY CAPITAL.

23

24 SECOND, I PROVIDE A REBUTTAL OF MR. ROTHSCHILD'S  
25 TESTIMONY ON BEHALF OF THE CITIZENS OF THE STATE OF

1 FLORIDA WHEREIN HE INCORRECTLY ESTIMATES A COST OF  
2 EQUITY CAPITAL OF 11.00% FOR SOUTHERN BELL. I  
3 DEMONSTRATE THAT THE UNDERLYING ASSUMPTIONS OF HIS  
4 ANALYSIS ARE INCORRECT AND THAT THE APPLICATION OF  
5 HIS METHODOLOGICAL APPROACHES IS INHERENTLY FLAWED.  
6 THUS, HIS COST OF EQUITY CAPITAL ESTIMATE IS SHOWN  
7 TO BE SIGNIFICANTLY BIASED DOWNWARD.

8  
9 LAST, I REBUT MR. CHARLES W. KING'S TESTIMONY ON  
10 BEHALF OF THE DEPARTMENT OF DEFENSE AND ALL OTHER  
11 FEDERAL EXECUTIVE AGENCIES IN WHICH HE INCORRECTLY  
12 RECOMMENDS THAT THE COMMISSION RECONSIDER THE RATE  
13 OF RETURN SHARING BANDS WHENEVER THE YIELDS ON  
14 10-YEAR TREASURY BONDS CHANGE BY MORE THAN 150  
15 BASIS POINTS FROM THEIR LEVEL WHEN THE SHARING  
16 BANDS WERE LAST ESTABLISHED. I SHOW THAT HIS  
17 RECOMMENDED TRIGGER IS CONTRADICTED BY CURRENT  
18 RESEARCH FINDINGS WITH REGARD TO RISK PREMIUMS AND  
19 THE TRIGGER IS INCONSISTENT WITH THE COMMISSION'S  
20 PRIOR STANDARD FOR EVALUATING CHANGES IN THE COST  
21 OF EQUITY CAPITAL.

22

23 II. SUMMARY OF REBUTTAL TESTIMONY

24

25 Q. PLEASE SUMMARIZE YOUR REBUTTAL OF MR. CICHETTI'S

1 TESTIMONY.  
2  
3 A. MY EVALUATION OF MR. CICCHETTI'S DIRECT TESTIMONY  
4 DISCUSSES HIS INCORRECT ASSUMPTIONS AND THE FLAWED  
5 APPLICATION OF HIS COST OF EQUITY CAPITAL  
6 ESTIMATION METHODOLOGIES. HIS MOST PROMINENT  
7 ERRORS FALL INTO THREE CATEGORIES: A) AN INCORRECT  
8 AND HIGHLY SUBJECTIVE APPLICATION OF THE  
9 MULTI-STAGE VERSION OF THE DISCOUNTED CASH FLOW  
10 (DCF) MODEL; B) THE USE OF A GROUP OF FIRMS IN HIS  
11 RISK PREMIUM ANALYSIS THAT ARE NOT COMPARABLE IN  
12 RISK TO SOUTHERN BELL, AND C) A FAILURE TO  
13 RECOGNIZE THE IMPLICATIONS OF THE INCREASINGLY  
14 COMPETITIVE ENVIRONMENT FACED BY ALL OF THE  
15 REGIONAL BELL HOLDING COMPANIES (RBHCS) IN GENERAL  
16 AND SOUTHERN BELL IN PARTICULAR. I WILL SHOW HOW  
17 MR. CICCHETTI'S ERRORS HAVE RESULTED IN AN  
18 UNREALISTICALLY LOW ESTIMATE OF SOUTHERN BELL'S  
19 COST OF EQUITY CAPITAL. FURTHER, I WILL RESPOND TO  
20 MR. CICCHETTI'S SPECIFIC CRITICISMS OF MY  
21 APPROACHES TO ESTIMATING THE COST OF EQUITY  
22 AND SHOW THAT THEY ARE BASED ON HIS INCORRECT  
23 ASSUMPTIONS AND HIS INCOMPLETE UNDERSTANDING OF HOW  
24 THESE APPROACHES SHOULD BE IMPLEMENTED.  
25

1 Q. WHAT ISSUES DOES YOUR REBUTTAL FOCUS ON IN MR.  
2 ROTHSCHILD'S DIRECT TESTIMONY?  
3  
4 A. MY REBUTTAL FOCUSES ON FOUR PRIMARY ERRORS AND/OR  
5 MISCONCEPTIONS IN MR. ROTHSCHILD'S APPROACHES TO  
6 ESTIMATING THE COST OF EQUITY FOR SOUTHERN BELL.  
7 THESE ERRORS INCLUDE: A) NUMEROUS MISTAKES IN  
8 APPLYING THE DCF MODEL; B) INAPPROPRIATE RELIANCE  
9 ON THE DOW JONES INDUSTRIAL AVERAGE INDEX AS A  
10 REASONABLENESS CHECK IN EVALUATING THE RISKINESS OF  
11 SOUTHERN BELL; C) INCORRECT DEPENDENCE ON THE  
12 CRITERION THAT THE EQUITY PRICE-TO-BOOK RATIO OF A  
13 REGULATED UTILITY SHOULD BE EQUAL TO ONE UNDER  
14 EFFICIENT REGULATION, AND D) MISUNDERSTANDING OF  
15 THE EFFECT OF QUARTERLY DIVIDENDS ON STOCK PRICES.  
16 FURTHER, I WILL RESPOND TO MR. ROTHSCHILD'S  
17 INACCURATE CRITICISMS OF THE RESULTS PRESENTED IN  
18 MY DIRECT TESTIMONY. I WILL ALSO POINT OUT THE  
19 AREAS OF MR. ROTHSCHILD'S TESTIMONY THAT HAVE  
20 ERRONEOUSLY BEEN INCLUDED FROM ANOTHER CASE,  
21 MATERIAL THAT SHOULD CONSEQUENTLY BE DISCARDED BY  
22 THIS COMMISSION AS IRRELEVANT. MY REBUTTAL WILL  
23 SHOW THAT MR. ROTHSCHILD'S ERRORS AND  
24 MISCONCEPTIONS EXPLAIN HIS SIGNIFICANT  
25 UNDERESTIMATION OF SOUTHERN BELL'S COST OF EQUITY

1 CAPITAL.

2

3 Q. WHAT ELEMENTS DO YOU CONCENTRATE ON IN YOUR

4 REBUTTAL OF MR. KING'S DIRECT TESTIMONY?

5

6 A. MY REBUTTAL OF MR. KING'S TESTIMONY EVALUATES THE

7 FLAWED RATE OF RETURN TRIGGER MECHANISM THAT HE

8 RECOMMENDS THE COMMISSION USE IN DECIDING WHEN TO

9 RECONSIDER THE BANDS ESTABLISHED FOR THE SHARING OF

10 RETURNS BETWEEN SOUTHERN BELL AND RATEPAYERS. MR.

11 KING HAS MADE SEVERAL IMPORTANT ERRORS THAT

12 INCLUDE: A) INCORRECTLY USING THE RETURNS ON

13 10-YEAR TREASURY BONDS AS THE INTEREST RATE INDEX;

14 B) MAKING INCORRECT IMPLICIT ASSUMPTIONS CONCERNING

15 THE RELATIONSHIP BETWEEN CHANGES IN THE COST OF

16 EQUITY AND CHANGES IN THE COST OF DEBT SECURITIES;

17 C) INCORRECTLY CONCLUDING THAT A 150 BASIS POINT

18 CHANGE IN THE RETURN ON 10-YEAR TREASURY BOND

19 IMPLIES A SIGNIFICANT CHANGE IN THE COST OF EQUITY,

20 AND D) RECOMMENDING A CRITERION FOR IDENTIFYING

21 SIGNIFICANT CHANGES IN EQUITY COSTS THAT IS

22 INCONSISTENT WITH THE COMMISSION'S PRIOR STANDARD.

23 MY REBUTTAL CITES EVIDENCE FROM THE CAPITAL MARKETS

24 THAT SHOWS THAT MR. KING'S RECOMMENDED TRIGGER

25 MECHANISM IS INCORRECT.

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III. REBUTTAL OF MR. CICHETTI'S DIRECT TESTIMONY

A. INCORRECT APPLICATION OF THE DCF MODEL

Q. WHAT SPECIFIC ERRORS DOES MR. CICHETTI MAKE IN APPLYING A MULTI-STAGE DCF MODEL THAT RESULT IN THE UNDERESTIMATION OF SOUTHERN BELL'S COST OF EQUITY CAPITAL?

A. MR. CICHETTI'S ERRORS INCLUDE: 1) EXCLUSIVE RELIANCE ON VALUE LINE FOR GROWTH RATE FORECASTS' 2) INCORRECT FOCUS ON THE EXPECTED GROWTH IN DIVIDENDS RATHER THAN IN EARNINGS; 3) INCORRECT USE OF THE B X R GROWTH RATE FORECAST APPROACH; 4) ABSENCE OF ANY JUSTIFICATION FOR USING A MULTI-STAGE MODEL; 5) INCORRECT USE OF THE ANNUAL FORM OF THE DCF MODEL EVEN THOUGH THE FIRMS IN HIS SAMPLE ALL PAY DIVIDENDS QUARTERLY; 6) INCORRECT ASSERTION THAT THE EFFECTIVE RATE OF RETURN UNDER A QUARTERLY DCF MODEL SHOULD BE CONVERTED INTO A NOMINAL RATE OF RETURN; 7) USE OF A FLOTATION COST ESTIMATE THAT IS CONTRADICTED BY PUBLISHED EMPIRICAL EVIDENCE, AND 8) INAPPROPRIATE DEPENDENCE ON THE GROUP OF RBHCS, WHICH ARE NOT RELEVANT RISK

1 PROXIES FOR SOUTHERN BELL.  
2  
3 Q. WOULD YOU PLEASE ELABORATE ON THE NATURE AND  
4 SIGNIFICANCE OF MR. CICCHETTI'S ERRORS IN  
5 ESTIMATING FUTURE GROWTH?  
6  
7 A. YES. MR. CICCHETTI OBTAINS ALL OF HIS GROWTH RATE  
8 FORECASTS FROM VALUE LINE. WHILE IT IS TRUE THAT  
9 THIS PUBLICATION IS FREQUENTLY RELIED ON BY  
10 INVESTORS, IT IS NOT THE MOST OBJECTIVE AND  
11 BROAD-BASED SOURCE OF INVESTORS' EXPECTATIONS.  
12 VALUE LINE PUBLISHES ITS OWN FORECAST OF A  
13 COMPANY'S GROWTH. IN CONTRAST, THE INSTITUTIONAL  
14 BROKERS ESTIMATE SYSTEM (IBES) OFFERS AN AVERAGE OF  
15 SECURITY ANALYSTS' FORECASTED GROWTH RATES ON A  
16 COMPANY-BY-COMPANY BASIS. AS SUCH, IBES PROVIDES A  
17 MORE BROAD-BASED FORECAST OF GROWTH THAN DOES VALUE  
18 LINE. CONSEQUENTLY, MY USE OF IBES IN ESTIMATING  
19 EXPECTED GROWTH PROVIDES A MORE REPRESENTATIVE  
20 MEASURE OF INVESTORS' EXPECTATIONS THAN DOES MR.  
21 CICCHETTI'S RELIANCE ON A SINGLE ESTIMATE SUCH AS  
22 VALUE LINE.  
23  
24 Q. MR. CICCHETTI ARGUES ON PAGE 54, LINES 11-14, OF  
25 HIS DIRECT TESTIMONY THAT "THE EXPECTED GROWTH IN



1 EARNINGS IS NOT A VALID PROXY FOR THE EXPECTED  
2 GROWTH IN DIVIDENDS BECAUSE ALL EARNINGS ARE NOT  
3 PAID OUT AS DIVIDENDS WHEN THEY ARE EARNED." DO  
4 YOU AGREE WITH HIS POSITION ON THE IMPORTANCE OF  
5 DIVIDENDS?

6  
7 A. NO, I DO NOT AGREE WITH HIS POSITION. WHILE IT IS  
8 TRUE THAT THE DCF MODEL FOCUSES ON DIVIDENDS, THE  
9 RELATIONSHIP BETWEEN DIVIDENDS AND EARNINGS OVER  
10 THE LONG-RUN MAKES THE EXPECTED RATE OF GROWTH IN  
11 EARNINGS OF KEY IMPORTANCE IN COST OF EQUITY  
12 ESTIMATION. EARNINGS ARE THE SOURCE OF DIVIDENDS  
13 PAID TO INVESTORS. ANY EARNINGS THAT ARE NOT PAID  
14 OUT AS DIVIDENDS ARE REINVESTED IN THE FIRM AND  
15 SHOULD CONTRIBUTE TO AN INVESTOR'S RETURN THROUGH  
16 THE APPRECIATION OF THE STOCK'S PRICE THAT RESULTS  
17 FROM SUCH REINVESTMENT.

18  
19 IT IS IMPORTANT IN COST OF EQUITY ANALYSIS TO RELY  
20 ON THE MOST OBJECTIVE DATA AVAILABLE. MOST ALL  
21 ANALYSTS' GROWTH FORECASTS ARE IN TERMS OF EARNINGS  
22 RATHER THAN DIVIDENDS. THUS, THE MOST RELIABLE AND  
23 OBJECTIVE FORECASTS ARE FOR FUTURE EARNINGS.

24  
25 MR. CICCHETTI'S APPROACH IS TOO SIMPLISTIC IN

1 REQUIRING THAT THE DCF MODEL FOCUS EXCLUSIVELY ON  
2 DIVIDENDS RATHER THAN ON THEIR SOURCE, EARNINGS.  
3 HIS RELIANCE ON IMPLICIT DIVIDEND FORECASTS  
4 INTRODUCES ADDITIONAL ESTIMATION BIAS BY USING A  
5 DIVIDEND PAYOUT RATIO FORECAST TO DERIVE A DIVIDEND  
6 GROWTH RATE FROM VALUE LINE'S EARNINGS FORECASTS.  
7 THE BEST AND MOST WIDELY AVAILABLE DATA IN THE  
8 INVESTMENT COMMUNITY IS FOR EXPECTED EARNINGS, NOT  
9 EXPECTED DIVIDENDS.  
10  
11 Q. WHAT IS YOUR OPINION OF MR. CICHETTI'S USE OF THE  
12 SO-CALLED B X R APPROACH TO ESTIMATING GROWTH?  
13  
14 A. THE B X R APPROACH TO ESTIMATING GROWTH DOES NOT  
15 PRODUCE THE MOST OBJECTIVE, REPRESENTATIVE MEASURE  
16 OF INVESTORS' LONG-TERM GROWTH EXPECTATIONS. THE  
17 OBSERVATION THAT GROWTH IS EQUAL TO A FIRM'S  
18 RETENTION RATE (B) TIMES ITS RETURN ON BOOK EQUITY  
19 (R) IS AN ACCOUNTING DEFINITION THAT HOLDS AFTER  
20 THE FACT. INDEED, ANALYSTS MAY EVEN USE THIS  
21 APPROACH TO FORECAST GROWTH. HOWEVER, THE EVIDENCE  
22 INDICATES THAT INVESTORS USE ANALYSTS' OVERALL  
23 GROWTH RATE FORECASTS IN VALUING EQUITY SECURITIES  
24 AND THAT A SURVEY OF ANALYSTS PRODUCES THE MOST  
25 OBJECTIVE ASSESSMENT OF SUCH EXPECTATIONS.

1 RELIANCE ON B X R FORECASTS BY ONLY A SINGLE  
2 FORECASTING ENTITY LIKE VALUE LINE REDUCES THE  
3 RELIABILITY OF SUCH FORECASTS BY INCLUDING THE  
4 ESTIMATION OF TWO VARIABLES (B AND R) INSTEAD OF  
5 ONE (G) AND BY DEPENDING ON A SINGLE FORECAST  
6 RATHER THAN A BROAD SURVEY SERVICE SUCH AS IBES.

7  
8 Q. IS MR. CICHETTI'S ESTIMATED COST OF EQUITY CAPITAL  
9 OF 11.20% FOR SOUTHERN BELL CONSISTENT WITH HIS B X  
10 R APPROACH TO MEASURING INVESTORS' GROWTH  
11 EXPECTATIONS?

12  
13 A. NO, IT IS NOT. MR. CICHETTI DEPENDS ON VALUE  
14 LINE'S IMPLICIT AVERAGE LONG-TERM GROWTH FORECAST  
15 FOR THE RBHCS OF 5.98% USING A PROJECTED RETURN ON  
16 BOOK EQUITY OF 16.79% IN THE FINAL STAGE OF HIS DCF  
17 MODEL. IT IS IMPORTANT TO EMPHASIZE THAT THE  
18 FINAL OR LONG-TERM STAGE OF HIS DCF MODEL IS BY FAR  
19 THE MORE INFLUENTIAL OF HIS MULTIPLE STAGES. YET  
20 CONSIDER THE FUNDAMENTAL INCONSISTENCY IN HIS  
21 ANALYSIS. MR. CICHETTI ARGUES THAT SOUTHERN  
22 BELL'S COST OF EQUITY IS 11.20% BUT HE ALSO DEPENDS  
23 ON VALUE LINE'S ESTIMATE OF LONG-TERM RETURN ON  
24 BOOK EQUITY OF 16.79%. IT IS UNCLEAR HOW MR.  
25 CICHETTI VIEWS THE RELATIONSHIP BETWEEN THE COST

1 OF EQUITY AND THE RETURN ON BOOK EQUITY. THERE IS  
2 A BASIC INCONSISTENCY IN HIS USE OF THE B X R  
3 APPROACH TO ESTIMATE EXPECTED GROWTH. THUS, BY  
4 IMPLICATION HIS ESTIMATE OF SOUTHERN BELL'S COST OF  
5 EQUITY CAPITAL IS BIASED.

6

7 Q. WHAT JUSTIFICATION DOES MR. CICCHETTI OFFER FOR  
8 USING THE MULTI-STAGE VERSION OF THE DCF MODEL?

9

10 A. NO JUSTIFICATION IS OFFERED. IT APPEARS THAT MR.  
11 CICCHETTI'S RELIANCE ON VALUE LINE AS A CONVENIENT,  
12 ALTHOUGH LIMITED, SOURCE OF DATA FORCED HIM TO USE  
13 A MULTI-STAGE APPROACH. INDEED, THE ESTIMATION OF  
14 MULTIPLE GROWTH RATES INTRODUCES GREATER  
15 SUBJECTIVITY INTO COST OF EQUITY ESTIMATION,  
16 ESPECIALLY WHEN THE FORECASTS RELY ONLY ON A SINGLE  
17 FORECASTING ENTITY SUCH AS VALUE LINE. FOR THESE  
18 REASONS I BELIEVE THAT MR. CICCHETTI'S MULTI-STAGE  
19 DCF MODEL IS NOT SUFFICIENTLY OBJECTIVE OR ACCURATE  
20 TO BE CONSIDERED SERIOUSLY BY THIS COMMISSION IN  
21 DETERMINING SOUTHERN BELL'S COST OF EQUITY CAPITAL.

22

23 Q. IS MR. CICCHETTI'S DCF MODEL CONSISTENT WITH  
24 INVESTORS' PERSPECTIVE ON VALUING EQUITY  
25 SECURITIES?

1  
2 A. NO, IT IS NOT. MR. CICCHETTI USES THE ANNUAL FORM  
3 OF THE DCF MODEL EVEN THOUGH THE RBHCS IN HIS GROUP  
4 OF COMPARABLE FIRMS PAY DIVIDENDS ON A QUARTERLY  
5 BASIS. INVESTORS VALUE EQUITY SECURITIES IN LIGHT  
6 OF NOT ONLY WHAT THEY EXPECT TO GET (I.E.,  
7 DIVIDENDS AND/OR FUTURE PRICE), BUT ALSO IN LIGHT  
8 OF WHEN THEY EXPECT TO GET IT. OTHER THINGS BEING  
9 EQUAL, INVESTORS WILL PAY A HIGHER PRICE FOR A  
10 STOCK THAT PAYS DIVIDENDS QUARTERLY THAN FOR A  
11 STOCK THAT PAYS DIVIDENDS ANNUALLY. THIS IS DUE TO  
12 INVESTORS' ABILITY TO EARN A HIGHER RETURN WITH  
13 QUARTERLY DIVIDENDS THROUGH THE MORE FREQUENT  
14 OPPORTUNITY TO REINVEST DIVIDENDS THAN IS THE CASE  
15 WITH THE ANNUAL PAYMENT OF DIVIDENDS. THUS, MR.  
16 CICCHETTI'S USE OF THE ANNUAL FORM OF THE DCF MODEL  
17 DOES NOT ACCURATELY PORTRAY INVESTORS' PERSPECTIVE  
18 AND CONSEQUENTLY SIGNIFICANTLY UNDERESTIMATES  
19 SOUTHERN BELL'S COST OF EQUITY CAPITAL. THE  
20 IMPORTANCE OF THIS ERROR IS DRAMATIZED BY LINKE AND  
21 ZUMWALT'S PUBLISHED (FINANCIAL MANAGEMENT, AUTUMN,  
22 1984, PP. 15 - 20) ESTIMATE THAT FAILURE TO ADJUST  
23 FOR THE QUARTERLY PAYMENT OF DIVIDENDS CAN  
24 UNDERESTIMATE A UTILITY'S COST OF EQUITY CAPITAL BY  
25 50 TO OVER 200 BASIS POINTS.

1

2 Q. ON PAGES 58-59 OF HIS DIRECT TESTIMONY, MR.  
3 CICCHETTI ARGUES THAT NOT CONVERTING THE EFFECTIVE  
4 RETURN PRODUCED BY A QUARTERLY DCF MODEL INTO A  
5 NOMINAL RETURN IS "INCONSISTENT AND UNFAIR TO  
6 RATEPAYERS." WHAT IS HIS ESSENTIAL POINT AND WHY  
7 IS IT INCORRECT?

8

9 A. MR. CICCHETTI'S ESSENTIAL POINT IS THAT THE  
10 OPPORTUNITY TO REINVEST DIVIDENDS QUARTERLY IMPLIES  
11 AN EFFECTIVE OR AN ECONOMICALLY MEANINGFUL RATE OF  
12 RETURN THAT IS IN EXCESS OF THE STATED OR NOMINAL  
13 RATE OF RETURN THAT MUST BE EARNED PERIODICALLY IN  
14 ORDER FOR THE EFFECTIVE RATE OF RETURN TO BE  
15 REALIZED. THUS, MR. CICCHETTI ARGUES THAT GRANTING  
16 A UTILITY THE EFFECTIVE ANNUAL RATE OF RETURN THAT  
17 IS RELEVANT TO INVESTORS OVERSTATES THE APPROPRIATE  
18 NOMINAL RATE OF RETURN THAT ALLOWS INVESTORS TO  
19 EARN THE GIVEN EFFECTIVE RATE OF RETURN. HIS  
20 RECOMMENDATION IS INCORRECT DUE TO THE WAY IN WHICH  
21 UTILITIES ARE REGULATED.

22

23 MR. CICCHETTI'S RECOMMENDED ADJUSTMENT WOULD BE  
24 CORRECT IF THE REGULATORY PROCESS REFLECTED THE  
25 ASSUMPTIONS NECESSARY FOR HIS ADJUSTMENT TO BE

1       REQUIRED. MR. CICHETTI STATES ON PAGES 58 - 59 OF  
2       HIS DIRECT TESTIMONY THAT THE COMPANY'S ACCRUAL OF  
3       EARNINGS ON RATEPAYERS' MONTHLY PAYMENT OF BILLS IS  
4       REFLECTED IN THE 12-MONTH AVERAGE EQUITY BALANCE.  
5       HE THUS ARGUES THAT THE EFFECTIVE RATE OF RETURN  
6       PRODUCED BY THE QUARTERLY DCF MODEL MUST BE REDUCED  
7       IN RECOGNITION OF THE COMPANY'S EARNINGS ON THE  
8       MONTHLY RECEIPT OF CUSTOMERS' BILLS. YET THIS  
9       POSITION IS INCORRECT BECAUSE MR. CICHETTI HAS  
10      FAILED TO CONSIDER THAT SOUTHERN BELL'S CAPITAL  
11      STRUCTURE AND DEBT COSTS ARE HISTORICAL, NOT  
12      PROSPECTIVE. AS SHOWN IN THE LINKE AND ZUMWALT  
13      ARTICLE CITED BY MR. CICHETTI, THE USE OF A  
14      HISTORICAL FINANCIAL STRUCTURE REQUIRES AN UPWARD  
15      ADJUSTMENT TO THE QUARTERLY DCF RESULT.

16  
17      I HAVE USED THE QUARTERLY DCF MODEL BECAUSE IT  
18      REFLECTS THE INVESTOR'S PERSPECTIVE MORE  
19      REALISTICALLY THAN DOES MR. CICHETTI'S ANNUAL FORM  
20      OF THE DCF. MOST FIRMS DO NOT PAY DIVIDENDS  
21      ANNUALLY AND THE APPROPRIATE FORM OF THE DCF MODEL  
22      MUST BE CONSISTENT WITH THE ACTUAL TIMING OF THE  
23      DIVIDEND STREAM RECEIVED BY INVESTORS. MR.  
24      CICHETTI'S RECOMMENDED ADJUSTMENT IS INCORRECT  
25      SINCE SOUTHERN BELL IS NOT REGULATED IN THE MANNER

1 NECESSARY FOR THIS ADJUSTMENT TO BE REQUIRED AS SET  
2 FORTH IN THE LINKE AND ZUMWALT ARTICLE. CONTRARY  
3 TO MR. CICHETTI'S POSITION IN HIS TESTIMONY, IT  
4 WOULD BE "INCORRECT AND UNFAIR TO RATEPAYERS" TO  
5 MAKE SUCH AN ADJUSTMENT SINCE IT WOULD  
6 UNDERESTIMATE A UTILITY'S COST OF EQUITY CAPITAL  
7 AND THEREBY IMPAIR ITS ABILITY TO ATTRACT CAPITAL  
8 ON REASONABLE TERMS. FURTHERMORE, IF THE  
9 COMMISSION WERE TO ADOPT MR. CICHETTI'S ADJUSTMENT  
10 TO THE ALLOWED RATE OF RETURN, INVESTORS WILL  
11 DEMAND A HIGHER RETURN TO OFFSET THE COST OF THIS  
12 ADJUSTMENT.

13

14 Q. WHAT JUSTIFICATION DOES MR. CICHETTI OFFER FOR THE  
15 3% FLOTATION COST ESTIMATE USED IN HIS DCF MODEL  
16 ANALYSIS?

17

18 A. NO EVIDENCE IS PROVIDED TO SUPPORT THE  
19 REASONABLENESS OF THE 3% COST USED IN HIS ANALYSIS.

20

21 Q. DO YOU HAVE REASON TO BELIEVE THAT THE 3% ESTIMATE  
22 PROVIDES EQUITY INVESTORS WITH ADEQUATE  
23 COMPENSATION FOR THE COST OF SELLING STOCK?

24

25 A. NO, I BELIEVE THAT 3% IS UNREALISTICALLY LOW AND



1 THAT THE USE OF THIS FIGURE CONTRIBUTES TO MR.  
2 CICCHETTI'S UNDERESTIMATION OF SOUTHERN BELL'S COST  
3 OF EQUITY CAPITAL. TWO EMPIRICAL STUDIES INDICATE  
4 THAT A 5% FLOTATION COST IS REALISTIC. RESEARCH BY  
5 SMITH (JOURNAL OF FINANCIAL ECONOMICS, 1977, PP.  
6 273-307) FINDS THAT EXPLICIT FLOTATION COSTS AMOUNT  
7 TO BETWEEN 4% AND 5% OF THE AMOUNT OF AN EQUITY  
8 ISSUE. FOCUSING ON THE UTILITY INDUSTRY, RESEARCH  
9 BY PETTWAY (PUBLIC UTILITY FORTNIGHTLY, MAY 10,  
10 1984, PP. 35-39) FINDS THAT THE SALE OF EQUITY  
11 SECURITIES GENERALLY ALSO INVOLVES IMPLICIT  
12 FLOTATION COSTS IN THE FORM OF A 2% TO 3% DECLINE  
13 IN THE PRICE OF THE STOCK THAT RESULTS FROM MARKET  
14 PRESSURE. THUS, A TOTAL FLOTATION COST OF 5% IS A  
15 CONSERVATIVE ESTIMATE. MR. CICCHETTI'S 3% ESTIMATE  
16 IS LOW IN LIGHT OF THE AVAILABLE EVIDENCE.

17

18 Q. WHAT JUSTIFICATION DOES MR. CICCHETTI PROVIDE FOR  
19 USING THE RBHCS AS PROXIES FOR SOUTHERN BELL IN  
20 ESTIMATING ITS COST OF EQUITY CAPITAL?

21

22 A. NO JUSTIFICATION IS PROVIDED.

23

24 Q. DO YOU BELIEVE THAT THE RBHCS ARE RELEVANT  
25 BENCHMARKS FOR ESTIMATING SOUTHERN BELL'S COST OF

1 EQUITY CAPITAL?  
2  
3 A. NO, I DO NOT. MR. CICCHETTI DOES NOT  
4 SYSTEMATICALLY COMPARE THE RISK CHARACTERISTICS OF  
5 SOUTHERN BELL AND ANY OF THE RBHCS. IT IS EASY TO  
6 FALL INTO THE TRAP OF ASSUMING THAT THE RISK OF A  
7 SUBSIDIARY MUST BE COMPARABLE TO THE RISK OF ITS  
8 PARENT COMPANY. YET A MAJOR LESSON OF MODERN  
9 PORTFOLIO THEORY IS THAT THE RISK OF AN INDIVIDUAL  
10 INVESTMENT CANNOT SAFELY BE USED TO MAKE  
11 GENERALIZATIONS ABOUT THE RISK OF THE ENTIRE  
12 PORTFOLIO. THE RISK OF ANY GIVEN MEMBER OF A  
13 PORTFOLIO CAN BE HIGHER OR LOWER THAN THAT OF THE  
14 OVERALL PORTFOLIO. SINCE SOUTHERN BELL DOES NOT  
15 HAVE MARKET-TRADED EQUITY, ALL COST OF CAPITAL  
16 EXPERTS IN THIS PROCEEDING AGREE THAT IT IS  
17 NECESSARY TO USE OTHER FIRMS WITH SUCH EQUITY AS  
18 PROXIES FOR SOUTHERN BELL. I HAVE USED GENERALLY  
19 ACCEPTED MEASURES OF INVESTMENT RISK TO COMPOSE A  
20 GROUP OF 20 FIRMS COMPARABLE IN RISK TO SOUTHERN  
21 BELL RATHER THAN SIMPLY ASSUMING THAT THE RBHCS ARE  
22 COMPARABLE IN RISK.  
23  
24  
25

1 B. INCORRECT RISK PREMIUM ANALYSIS

2

3 Q. DO YOU AGREE WITH MR. CICCHETTI'S USE OF MOODY'S  
4 NATURAL GAS DISTRIBUTION INDEX AS A REPRESENTATIVE  
5 PROXY FOR THE INVESTMENT RISK OF SOUTHERN BELL?

6

7 A. NO. MR. CICCHETTI DOES NOT PROVIDE ANY CONVINCING  
8 EVIDENCE THAT NATURAL GAS DISTRIBUTION COMPANIES  
9 ARE COMPARABLE IN RISK TO SOUTHERN BELL.  
10 INTERESTINGLY, MR. CICCHETTI'S USE OF THIS INDEX  
11 CONTRADICTS HIS USE OF THE RBHCS AS COMPARABLE IN  
12 RISK TO SOUTHERN BELL. SCHEDULE 6 OF HIS DIRECT  
13 TESTIMONY INDICATES THAT THE AVERAGE SYSTEMATIC  
14 RISK (BETA) OF HIS INDEX OF GAS DISTRIBUTION  
15 COMPANIES IS .63 WHILE SCHEDULE 3 INDICATES THAT  
16 THE AVERAGE BETA FOR THE RBHCS IS .82. OBVIOUSLY  
17 HIS INDEX AND THE RBHCS ARE NOT COMPARABLE IN TERMS  
18 OF SYSTEMATIC RISK. YET BOTH ARE BEING OFFERED BY  
19 MR. CICCHETTI AS COMPARABLE IN RISK TO SOUTHERN  
20 BELL. CONSEQUENTLY, THERE IS A SIGNIFICANT  
21 INTERNAL INCONSISTENCY IN MR. CICCHETTI'S APPROACH  
22 TO ESTIMATING SOUTHERN BELL'S COST OF EQUITY  
23 CAPITAL. THE INDEX OF GAS DISTRIBUTION COMPANIES  
24 AND THE RBHCS ARE NOT COMPARABLE TO EACH OTHER AND  
25 CONSEQUENTLY CANNOT BOTH BE COMPARABLE IN RISK TO

1 SOUTHERN BELL.

2

3 Q. MR. CICCHETTI'S RISK PREMIUM ANALYSIS USES A DCF  
4 MODEL TO ESTIMATE THE COST OF EQUITY CAPITAL FOR  
5 THE INDEX OF GAS DISTRIBUTION COMPANIES. WHAT IS  
6 YOUR ASSESSMENT OF MR. CICCHETTI'S APPLICATION OF  
7 THE DCF METHODOLOGY IN THIS CONTEXT?

8

9 A. MR. CICCHETTI'S RISK PREMIUM ANALYSIS IS FLAWED BY  
10 THE INCORRECT APPLICATION OF THE DCF MODEL. ALL OF  
11 THE MISTAKES MADE IN HIS MULTI-STAGE DCF MODEL ARE  
12 REPEATED IN THE APPLICATION OF THE DCF MODEL TO THE  
13 RISK PREMIUM ANALYSIS. THUS, MR. CICCHETTI MAKES  
14 NUMEROUS ERRORS IN ESTIMATING EXPECTED GROWTH, USES  
15 A LOW FLOTATION COST ESTIMATE, AND FAILS TO  
16 RECOGNIZE THE QUARTERLY PAYMENT OF DIVIDENDS.

17

18 C. MISINTERPRETATION OF  
19 THE COMPETITIVE ENVIRONMENT

20

21 Q. ON PAGE 34, LINES 10-13, OF HIS DIRECT TESTIMONY  
22 MR. CICCHETTI OFFERS HIS OPINION THAT  
23 "...MEANINGFUL COMPETITION WITHIN THE LOCAL LOOP IS  
24 STILL UNCERTAIN AND IS YEARS AWAY AT BEST." DO YOU  
25 AGREE WITH MR. CICCHETTI'S INTERPRETATION OF

1       COMPETITIVE ENVIRONMENT FACED BY LOCAL EXCHANGE  
2       COMPANIES?

3  
4 A.   NO.   AS A COST OF EQUITY ANALYST I CONCERN MYSELF  
5       ONLY WITH THE OPINIONS OF INVESTORS CONCERNING THE  
6       IMPACT OF COMPETITION ON THE VALUATION OF EQUITY  
7       SECURITIES.   THE INVESTMENT COMMUNITY DOES NOT  
8       AGREE WITH MR. CICCHETTI'S CASUAL APPRAISAL OF  
9       COMPETITION IN THE LOCAL LOOP.   FOR EXAMPLE, A  
10      RECENT EQUITY RESEARCH STUDY DONE BY SALOMON  
11      BROTHERS ("THE BELL REGIONAL HOLDING COMPANIES --  
12      PUTTING COMPETITION IN PERSPECTIVE," S. GEORGES,  
13      JUNE 1992) INDICATES THAT INVESTORS HAVE BECOME  
14      FIXATED ON "...THE INCREASING THREAT OF COMPETITION  
15      IN THE BASIC LOCAL TELEPHONE BUSINESS" (P.1).

16  
17      FURTHER, MR. CICCHETTI IGNORES THE IMPLICATIONS OF  
18      AT&T'S RECENT EFFORTS TO ACQUIRE ABOUT A THIRD OF  
19      MCCAW CELLULAR COMMUNICATIONS FOR ABOUT \$3.73  
20      BILLION.   THIS DEVELOPMENT DRAMATIZES HOW IMMINENT  
21      IS DIRECT COMPETITION BETWEEN THE RBHCS AND AT&T.  
22      MCCAW IS THE DOMINANT PROVIDER OF WIRELESS SERVICES  
23      IN A NUMBER OF METROPOLITAN AREAS.   THIS  
24      TRANSACTION CONSEQUENTLY WILL BRING AT&T INTO  
25      SIGNIFICANT COMPETITION WITH THE RBHCS IN THE AREA

1 OF WIRELESS SERVICES. INDEED, ACCORDING TO A  
2 RECENT WALL STREET JOURNAL ARTICLE ("AT&T SEEKING  
3 TO ENTER THE CELLULAR ERA," NOVEMBER 5, 1992,  
4 P.A3), AT&T CHAIRMAN ROBERT E. ALLEN HAS REPEATEDLY  
5 SPOKEN OF THE GROWTH OPPORTUNITIES IN LOCAL  
6 SERVICES. THUS, THE EVIDENCE CONTRADICTS MR.  
7 CICCHETTI'S ASSERTION THAT "...MEANINGFUL  
8 COMPETITION WITHIN THE LOCAL LOOP IS STILL  
9 UNCERTAIN AND IS YEARS AWAY AT BEST." THE  
10 INVESTMENT COMMUNITY AND AT&T HAVE A DIFFERENT  
11 OPINION THAN MR. CICCHETTI.

12

13 D. RESPONSES TO MR. CICCHETTI'S  
14 CRITICISMS OF MR. BILLINGSLEY'S  
15 DIRECT TESTIMONY

16

17 Q. WHAT ARE MR. CICCHETTI'S CRITICISMS OF YOUR  
18 APPLICATION OF THE DCF MODEL TO ESTIMATE THE COST  
19 OF EQUITY CAPITAL FOR SOUTHERN BELL?

20

21 A. MR. CICCHETTI ARGUES ON PAGE 53, LINES 1-13, OF HIS  
22 DIRECT TESTIMONY THAT I: 1) INCORRECTLY RELIED ON  
23 ESTIMATES OF EARNINGS GROWTH INSTEAD OF DIVIDEND  
24 GROWTH; 2) PERFORMED MY DCF ANALYSIS ON COMPANIES  
25 THAT ARE NOT COMPARABLE IN RISK TO SOUTHERN BELL,

1 AND 3) RELIED ON A QUARTERLY DCF MODEL THAT  
2 PRODUCED AN EFFECTIVE COST OF EQUITY ESTIMATE THAT  
3 SHOULD HAVE BEEN CONVERTED INTO A NOMINAL RATE.

4

5 Q. HOW DO YOU RESPOND TO THESE CRITICISMS?

6

7 A. MY REBUTTAL TESTIMONY HAS ALREADY EXPLAINED WHY IT  
8 IS APPROPRIATE AND DESIRABLE TO USE ESTIMATES OF  
9 EXPECTED EARNINGS GROWTH RATHER THAN EXPECTED  
10 DIVIDEND GROWTH AND HAS DISCUSSED WHY CURRENT  
11 REGULATORY PRACTICES RENDER THE  
12 EFFECTIVE-TO-NOMINAL RATE CONVERSION UNNECESSARY.  
13 THUS, I WILL FOCUS MY RESPONSE ON MR. CICHETTI'S  
14 CRITICISM OF MY GROUP OF FIRMS COMPARABLE IN RISK  
15 TO SOUTHERN BELL.

16

17 MR. CICHETTI'S PRIMARY OBJECTION TO THE GROUP OF  
18 FIRMS USED IN MY DCF ANALYSIS IS THAT BECAUSE THEY  
19 "...ARE NON-REGULATED INDICATES THE FIRMS ARE NOT  
20 "CLOSE ENOUGH" TO BE COMPARABLE TO SOUTHERN BELL"  
21 (DIRECT TESTIMONY, P.55, LINES 16-18). YET MR.  
22 CICHETTI PROVIDES NO EVIDENCE THAT THE GROUP OF  
23 FIRMS ARE NOT COMPARABLE TO SOUTHERN BELL. MR.  
24 CICHETTI FAILS TO APPRECIATE THAT MY CLUSTER OF  
25 FIRMS WAS IDENTIFIED FROM A BROAD LIST OF FIRMS

1 THAT WERE BOTH REGULATED AND UNREGULATED. THE  
2 COMPREHENSIVE SET OF RISK CRITERIA GROUPED FIRMS OF  
3 COMPARABLE RISK WITHOUT PURPOSELY INCLUDING OR  
4 EXCLUDING REGULATED FIRMS. THUS, FIRMS WERE  
5 IDENTIFIED WITHOUT ANY PRECONCEIVED ASSUMPTIONS OR  
6 BIASES CONCERNING THE RELATIVE RISKINESS OF  
7 REGULATED VS. UNREGULATED FIRMS. I LET THE DATA  
8 DETERMINE COMPARABILITY USING GENERALLY ACCEPTED  
9 MEASURES OF RISK RATHER THAN DEPEND UNCRITICALLY ON  
10 CONVENTIONAL WISDOM TO ESTABLISH A GROUP OF  
11 SUPPOSEDLY COMPARABLE FIRMS. OBJECTIVITY DEMANDS  
12 NOTHING LESS.

13

14 Q. WHAT IS MR. CICHETTI'S CRITICISM OF YOUR RISK  
15 PREMIUM ANALYSIS?

16

17 A. MR. CICHETTI'S CRITICISM IS ESSENTIALLY THE SAME  
18 AS THAT AIMED AT MY DCF ANALYSIS. HE CRITICIZES MY  
19 USE OF THE S&P 500 INDEX ON THE GROUNDS THAT  
20 "INDUSTRIAL COMPANIES IN GENERAL, AND THE COMPANIES  
21 THAT COMPRISE THE S&P 500 IN PARTICULAR, ARE  
22 RISKIER THAN SOUTHERN BELL" (DIRECT TESTIMONY,  
23 P.55, LINES 19-21). YET NO EVIDENCE IS PROVIDED TO  
24 SUPPORT THIS SPECULATION. I BELIEVE THAT THE  
25 EXPECTATIONAL RISK PREMIUM OF THE S&P 500 OVER



1 AAA-RATED UTILITY BOND YIELDS PROVIDES A USEFUL  
2 TEST FOR ASSESSING THE REASONABLENESS OF MY DCF  
3 COST OF EQUITY ESTIMATE FOR SOUTHERN BELL.

4

5 IV. REBUTTAL OF MR. ROTHSCHILD'S DIRECT TESTIMONY

6

7 A. INCORRECT APPLICATION OF THE DCF MODEL

8

9 Q. DO YOU AGREE WITH THE WAY IN WHICH MR. ROTHSCHILD  
10 APPLIED THE DCF MODEL TO ESTIMATE THE COST OF  
11 EQUITY CAPITAL FOR SOUTHERN BELL?

12

13 A. NO. MR. ROTHSCHILD MAKES NUMEROUS CONCEPTUAL  
14 ERRORS IN HIS APPLICATION OF THE DCF MODEL. THESE  
15 ERRORS CONTRIBUTE TO HIS SIGNIFICANT  
16 UNDERESTIMATION OF SOUTHERN BELL'S COST OF EQUITY  
17 CAPITAL.

18

19 Q. WHAT ERRORS DOES MR. ROTHSCHILD MAKE IN HIS DCF  
20 ANALYSIS?

21

22 A. MR. ROTHSCHILD MAKES FIVE TYPES OF MAJOR CONCEPTUAL  
23 ERRORS IN HIS DCF ANALYSIS. THESE ERRORS INCLUDE:  
24 1) MISTAKES IN ESTIMATING EXPECTED GROWTH; 2)  
25 INCORRECT USE OF THE ANNUAL FORM OF THE DCF MODEL

1 IN THE PRESENCE OF QUARTERLY DIVIDEND PAYMENTS; 3)  
2 IMPROPER RELIANCE OF THE RBHCS AND BELLSOUTH AS  
3 COMPARABLE IN RISK TO SOUTHERN BELL; 4) INCORRECT  
4 ASSERTION THAT HIS COMPLEX DCF MODEL ACCURATELY  
5 EVALUATES THE RBHCS, AND 5) NO ALLOWANCE FOR EQUITY  
6 FLOTATION COSTS.

7

8 Q. HOW DOES MR. ROTHSCHILD ESTIMATE THE EXPECTED  
9 GROWTH RATE USED IN HIS SIMPLE AND COMPLEX  
10 APPLICATIONS OF THE DCF MODEL?

11

12 A. IN HIS SIMPLE DCF MODEL HE USES THE B X R METHOD  
13 UNDER THE ASSUMPTION THAT IS IT "...THE ONLY PROPER  
14 WAY TO DETERMINE GROWTH FOR USE IN THE SIMPLIFIED  
15 DCF MODEL" (DIRECT TESTIMONY, P.21, LINES 9-10).  
16 THE PROJECTED R OR RETURN ON BOOK EQUITY IS  
17 OBTAINED FROM VALUE LINE AND IS ALSO INFERRED FROM  
18 DATA PROVIDED BY ZACK'S RESEARCH. THE DECISION TO  
19 USE ZACK'S ESTIMATED GROWTH RATE INDIRECTLY IS  
20 BASED ON THE ASSUMPTION THAT SUCH RATES "...ARE NOT  
21 INTENDED TO BE SUSTAINABLE GROWTH RATES" (DIRECT  
22 TESTIMONY, P. 28, LINES 4-5). FURTHER, MR.  
23 ROTHSCHILD CONTENDS THAT THE FORMATION OF ANALYSTS'  
24 FORECASTS DURING AN "ATYPICALLY GOOD OR ATYPICALLY  
25 BAD YEAR" WOULD PRODUCE ATYPICAL FORECASTS. THUS,

1 HE ARGUES THAT THE FORECASTS CANNOT BE USED  
2 DIRECTLY. FUTURE RETURNS ON BOOK EQUITY IN THE  
3 COMPLEX DCF MODEL ARE ALSO DETERMINED USING THE B X  
4 R APPROACH. THE PROJECTED RETENTION RATE (B) IN  
5 BOTH THE SIMPLE AND THE COMPLEX DCF MODELS IS THE  
6 CURRENT AVERAGE RATE FOR THE RBHCS.

7  
8 Q. DO YOU AGREE WITH MR. ROTHSCHILD'S RELIANCE ON THE  
9 B X R APPROACH FOR ESTIMATING THE EXPECTED RATE OF  
10 EARNINGS GROWTH?

11  
12 A. NO, I DO NOT. AS ELABORATED ON IN MY REBUTTAL OF  
13 MR. CICHETTI'S DIRECT TESTIMONY, THE B X R  
14 APPROACH DOES NOT PRODUCE THE MOST OBJECTIVE,  
15 REPRESENTATIVE MEASURE OF INVESTORS' LONG-TERM  
16 GROWTH EXPECTATIONS. MR. ROTHSCHILD'S USE OF VALUE  
17 LINE'S B AND R FORECASTS SUFFERS FROM ALL OF THE  
18 SHORTCOMINGS NOTED PREVIOUSLY. VALUE LINE DOES NOT  
19 PROVIDE THE MOST OBJECTIVE, BROAD-BASED MEASURE OF  
20 INVESTORS' EXPECTATIONS.

21  
22 ADDITIONALLY, MR. ROTHSCHILD'S USE OF ZACK'S  
23 EARNINGS FORECASTS IS INCONSISTENT WITH HIS  
24 ARGUMENT THAT ANALYSTS' FORECASTS CANNOT BE USED  
25 BECAUSE THEY REFLECT ANY "ATYPICAL" CONDITIONS

1 PRESENT AT THE TIME THE FORECAST IS MADE. THE FACT  
2 THAT MR. ROTHSCHILD USES ZACK'S GROWTH FORECASTS  
3 INDIRECTLY DOES NOT FREE HIM FROM HIS OWN  
4 CRITICISM.

5  
6 Q. ABSTRACTING FROM MR. ROTHSCHILD'S INCONSISTENT  
7 DEPENDENCE ON ZACK'S EARNINGS FORECASTS, DO YOU  
8 AGREE THAT SUCH FORECASTS CANNOT BE USED BECAUSE  
9 THEY CAN REFLECT ATYPICAL CONDITIONS THAT  
10 INVALIDATE THEIR USE AS A LONG-TERM, STEADY-STATE  
11 RATE OF EARNINGS GROWTH?

12  
13 A. ABSOLUTELY NOT. IT IS COMMON PRACTICE FOR SECURITY  
14 ANALYSTS TO NORMALIZE BASE YEAR EARNINGS IF THOSE  
15 EARNINGS DEPART FROM THE "NORM". INDEED, THE IBES  
16 SURVEY OF ANALYSTS' EARNINGS FORECASTS EXPLICITLY  
17 REQUESTS A LONG-TERM NORMALIZED ANNUAL GROWTH RATE.  
18 SIMILARLY, WHILE NOT A SURVEY OF ANALYSTS'  
19 EXPECTATIONS, VALUE LINE INDICATES THAT IT TOO  
20 NORMALIZES THE EARNINGS THAT ARE RELIED ON IN ITS  
21 LONG-TERM GROWTH FORECASTS. THUS, IT IS DIFFICULT  
22 TO UNDERSTAND HOW MR. ROTHSCHILD CAN ARGUE THAT  
23 ANALYSTS' GROWTH RATE FORECASTS REFLECT ANY CURRENT  
24 ATYPICAL CONDITIONS WHEN THE GENERAL, DOCUMENTED  
25 PRACTICE IS TO NORMALIZE BASE YEAR EARNINGS TO

1 REMOVE ANY SUCH ATYPICAL EFFECTS.  
2  
3 Q. APART FROM YOUR CONCERNS ABOUT MR. ROTHSCHILD'S  
4 MISESTIMATION OF GROWTH, DO YOU AGREE WITH THE WAY  
5 IN WHICH THE GROWTH RATE IS USED IN THE DCF MODEL?  
6  
7 A. NO. MR. ROTHSCHILD MULTIPLIES THE FIRST DIVIDEND BY  
8  $(1 + .5G)$  RATHER THAN BY THE MORE CONVENTIONAL  $(1 +$   
9  $G)$ , WHERE G IS THE EXPECTED RATE OF GROWTH IN  
10 EARNINGS. THIS APPROACH SYSTEMATICALLY  
11 UNDERESTIMATES THE RESULTING COST OF EQUITY  
12 CAPITAL. THE COMMON ANNUAL FORM OF THE DCF MODEL  
13 IS  $K = [D(1 + G)/P] + G$ , WHERE D IS THE MOST RECENT  
14 ANNUAL DIVIDEND AND P IS THE MARKET PRICE OF THE  
15 EQUITY SECURITY. THUS, USING ONLY ONE-HALF OF G IN  
16 THE FIRST PART OF THE EQUATION CLEARLY BIASES THE  
17 ESTIMATED COST OF EQUITY FOR SOUTHERN BELL  
18 DOWNWARD.  
19  
20 Q. WHAT IS MR. ROTHSCHILD'S JUSTIFICATION FOR USING  
21 THE ANNUAL FORM OF THE DCF MODEL IN BOTH HIS SIMPLE  
22 AND HIS COMPLEX ANALYSIS?  
23  
24 A. NO JUSTIFICATION IS GIVEN IN HIS DIRECT TESTIMONY.  
25

1 Q. UNDER WHAT CIRCUMSTANCES WOULD IT BE APPROPRIATE TO  
2 USE THE ANNUAL FORM OF THE DCF MODEL?  
3

4 A. ONLY WHEN THE FIRM OR FIRMS BEING EVALUATED PAY  
5 DIVIDENDS ANNUALLY. THUS, MR. ROTHSCHILD'S  
6 ANALYSIS IS FLAWED SINCE THE FIRMS USED IN HIS COST  
7 OF CAPITAL ESTIMATION PROCESS PAY DIVIDENDS ON A  
8 QUARTERLY BASIS. CONSISTENT WITH MY OBSERVATIONS  
9 CONCERNING MR. CICHETTI'S MISTAKES IN THIS AREA,  
10 THE USE OF THE ANNUAL DCF MODEL IN THE PRESENCE OF  
11 THE QUARTERLY PAYMENT OF DIVIDENDS SERIOUSLY  
12 UNDERESTIMATES THE COST OF EQUITY CAPITAL. THIS,  
13 IN PART, EXPLAINS MR. ROTHSCHILD'S UNREASONABLY LOW  
14 ESTIMATE OF SOUTHERN BELL'S COST OF EQUITY CAPITAL.  
15

16 Q. WHAT REASONS DOES MR. ROTHSCHILD GIVE FOR APPLYING  
17 HIS DCF ANALYSES TO THE RBHCS AND TO BELLSOUTH AS  
18 FIRMS OF COMPARABLE RISK TO SOUTHERN BELL?  
19

20 A. NO CLEAR RATIONALE IS OFFERED IN HIS DIRECT  
21 TESTIMONY. THE ONLY JUSTIFICATION GIVEN FOR USING  
22 THE RBHCS AND BELLSOUTH IS THAT "...THEIR BUSINESS  
23 CONSISTS PRIMARILY OF REGULATED PUBLIC UTILITIES  
24 THAT OBTAIN MOST OF THEIR INCOME BY PROVIDING  
25 REGULATED TELEPHONE SERVICE" (DIRECT TESTIMONY, P.

1 7, LINES 12-14). THUS, AS IN MR. CICCHETTI'S  
2 FLAWED ANALYSIS, NO EFFORT IS MADE TO  
3 SYSTEMATICALLY COMPARE SOUTHERN BELL WITH EITHER  
4 THE RBHCS OR WITH BELLSOUTH TO EMPIRICALLY DOCUMENT  
5 THE ASSUMED COMPARABILITY. MR. ROTHSCHILD ONLY  
6 CASUALLY NOTES THAT "ALL COMPANIES HAVE CERTAIN  
7 UNIQUE CHARACTERISTICS THAT MAKE THEM, IN ONE WAY  
8 OR ANOTHER, DIFFERENT FROM SOUTHERN BELL" (DIRECT  
9 TESTIMONY, P. 7, LINES 10-11).  
10  
11 OBJECTIVE COST OF CAPITAL ANALYSIS DEMANDS MORE  
12 THAN UNDOCUMENTED SPECULATION THAT THE MARKET VIEWS  
13 THE RBHCS, BELLSOUTH AND SOUTHERN BELL AS  
14 COMPARABLE IN RISK SIMPLY BECAUSE THEY ARE ALL IN  
15 THE SAME GENERAL INDUSTRY. MR. ROTHSCHILD'S  
16 ANALYSIS DEFIES COMMON SENSE BY IMPLICITLY ARGUING  
17 THAT ALL OF THE FIRMS IN A GIVEN INDUSTRY ARE OF  
18 COMPARABLE RISK SIMPLY BY VIRTUE OF THEIR  
19 MEMBERSHIP IN THAT COMMON INDUSTRY.  
20  
21 Q. ARE THERE ANY REASONS WHY THE RBHCS AND BELLSOUTH  
22 SHOULD NOT BE USED IN ESTIMATING SOUTHERN BELL'S  
23 COST OF EQUITY CAPITAL USING THE DCF METHOD?  
24  
25 A. YES. AS DISCUSSED IN MY DIRECT TESTIMONY (PP.

1 31-32), THE RBHCS POSSESS CHARACTERISTICS THAT ARE  
2 INCONSISTENT WITH THE ASSUMPTIONS UNDERLYING THE  
3 CONSTANT GROWTH DCF MODEL. THE RBHCS ARE INVOLVED  
4 IN A WIDE VARIETY OF UNREGULATED ACTIVITIES. OF  
5 PARTICULAR RELEVANCE IS THEIR SIGNIFICANT  
6 INVESTMENT IN CELLULAR SERVICES. WHILE THIS  
7 INVESTMENT IN AN INFANT TECHNOLOGY IS CURRENTLY  
8 GENERATING LITTLE INCOME, IT IS WIDELY EXPECTED TO  
9 CONTRIBUTE SIGNIFICANTLY OVER THE LONG-RUN. AS  
10 SUCH, MANY ANALYSTS HAVE TRIED TO ESTIMATE THE  
11 PORTION OF A RBHC'S STOCK PRICE THAT IS  
12 ATTRIBUTABLE TO THE MARKET'S EXPECTATIONS  
13 CONCERNING THE FUTURE PROFITS TO BE CONTRIBUTED BY  
14 CELLULAR SERVICES. HOWEVER, THE GROWTH PROSPECTS  
15 OF EARNINGS FROM CELLULAR SERVICES ARE THOUGHT TO  
16 EXTEND BEYOND THE TIME HORIZON THAT IS EXPLICITLY  
17 IDENTIFIED IN PUBLISHED LONG-TERM GROWTH FORECASTS.  
18 THUS, THE PRICE AND THE EXPECTED GROWTH RATE USED  
19 IN THE DCF MODEL ARE MISMATCHED AND THE IMPLIED  
20 COST OF EQUITY IS UNDERSTATED DUE TO THE VIOLATION  
21 OF THE CONSTANT GROWTH RATE ASSUMPTION INHERENT IN  
22 THE DCF MODEL.

23

24 Q. DOES THE USE OF MR. ROTHSCHILD'S COMPLEX DCF MODEL  
25 MAKE IT ACCEPTABLE TO ANALYZE THE RBHCS AND



1 BELLSOUTH EVEN IN LIGHT OF THE PROBLEMS THAT YOU  
2 HAVE IDENTIFIED?  
3  
4 A. NO. WHILE MR. ROTHSCHILD'S COMPLEX MODEL FORECASTS  
5 EARNINGS, DIVIDENDS, AND BOOK VALUES FOR THE NEXT  
6 40 YEARS, IT IS STILL TIED TO THE SAME B X R  
7 APPROACH USED IN HIS SIMPLIFIED DCF MODEL. THE  
8 ONLY SIGNIFICANT DISTINCTION IS IN APPEARING TO  
9 ACCOMMODATE INITIAL ATYPICAL CONDITIONS BY ALLOWING  
10 BOOK VALUE TO GROW AT A DIFFERENT RATE FROM THAT OF  
11 EARNINGS AND DIVIDENDS. HOWEVER, THE B X R  
12 ANALYSIS STILL INDIRECTLY RELIES ON ANALYSTS'  
13 FORECASTS (ZACK'S) AND VALUE LINE AND THUS  
14 CONTINUES TO VIOLATE THE ASSUMPTIONS OF THE DCF  
15 MODEL.  
16  
17 Q. DO YOU AGREE THAT MR. ROTHSCHILD'S COMPLEX DCF  
18 MODEL SERVES AS A CHECK ON THE VALIDITY OF THE  
19 SIMPLE DCF MODEL?  
20  
21 A. NO, I DO NOT. I DISAGREE WITH MR. ROTHSCHILD'S  
22 ASSERTION THAT HIS "...COMPLEX DCF MODEL BOTH SHOWS  
23 THAT THE GROWTH RATE I HAVE USED IN MY SIMPLIFIED  
24 DCF IS A SUSTAINABLE GROWTH RATE, AND IT PROVIDES A  
25 MECHANISM TO KEEP THE RESULTS OF THE DCF MODEL

1 VALID..." (DIRECT TESTIMONY, P.34, LINES 8-10).  
2 SINCE BOTH THE SIMPLE AND THE COMPLEX DCF MODELS  
3 ULTIMATELY MAKE THE SAME UNDERLYING ASSUMPTIONS,  
4 AND BOTH ARE APPLIED TO THE RBHCS AND TO BELLSOUTH,  
5 THE COMPLEX DCF IS INVALID FOR THE SAME REASONS AS  
6 HIS SIMPLE DCF MODEL. AS SUCH, MR. ROTHSCHILD'S  
7 COMPLEX MODEL DOES NOT SERVE AS AN INDEPENDENT  
8 CHECK ON THE VALIDITY OF HIS SIMPLE DCF MODEL.  
9 UNFORTUNATELY, NEITHER OF MR. ROTHSCHILD'S DCF  
10 MODELS PROVIDE AN ACCURATE ESTIMATE OF SOUTHERN  
11 BELL'S COST OF EQUITY CAPITAL.

12

13 Q. WHAT ADJUSTMENT DOES MR. ROTHSCHILD MAKE IN HIS DCF  
14 ANALYSIS FOR THE IMPACT OF FLOTATION COSTS ON THE  
15 COST OF SOUTHERN BELL'S COST OF EQUITY CAPITAL?

16

17 A. NO ADJUSTMENT IS MADE.

18

19 Q. WHAT EFFECT DOES MR. ROTHSCHILD'S OMISSION HAVE ON  
20 HIS ESTIMATE OF SOUTHERN BELL'S COST OF EQUITY  
21 CAPITAL?

22

23 A. CONSISTENT WITH THE OBSERVATIONS IN MY DIRECT  
24 TESTIMONY (PP. 24-26), MR. ROTHSCHILD'S FAILURE TO  
25 ADJUST FOR FLOTATION COSTS IS ONE REASON THAT HE

1 UNDERESTIMATES SOUTHERN BELL'S COST OF EQUITY  
2 CAPITAL.

3

4 Q. WHAT JUSTIFICATION IS PROVIDED FOR IGNORING  
5 FLOTATION COSTS?

6

7 A. NO JUSTIFICATION IS PROVIDED. THIS IS ESPECIALLY  
8 CURIOUS GIVEN MR. ROTHSCHILD'S EXPLICIT ADJUSTMENT  
9 FOR FLOTATION COSTS IN HIS ESTIMATE OF SOUTHERN  
10 BELL'S COST OF EQUITY CAPITAL IN DOCKET NO.  
11 880069-TL (DIRECT TESTIMONY, JANUARY 16, 1992, PP.  
12 43-44 AND SCHEDULE 7). I DO NOT UNDERSTAND WHY MR.  
13 ROTHSCHILD RECOGNIZED FLOTATION COSTS IN HIS PRIOR  
14 ANALYSIS OF SOUTHERN BELL BUT IGNORES THEM IN THE  
15 CURRENT PROCEEDING. HIS CURRENT APPROACH TO  
16 ESTIMATING THE COST OF EQUITY CAPITAL IS  
17 INCONSISTENT WITH HIS PRIOR APPROACH.

18

19 B. INAPPROPRIATE RELIANCE ON THE  
20 DOW JONES INDUSTRIAL AVERAGE

21

22 Q. WHAT INSIGHTS DO MR. ROTHSCHILD'S "COMPARABLE  
23 EARNINGS OBSERVATIONS" CONCERNING THE HISTORICAL  
24 RETURNS ON THE DOW JONES INDUSTRIAL AVERAGE (DJIA)  
25 YIELD INTO THE COST OF EQUITY CAPITAL OF SOUTHERN

1 BELL?

2

3 A. THE COMPARATIVE ANALYSIS PROVIDES NO RELIABLE  
4 INSIGHTS INTO THE COST OF EQUITY CAPITAL FOR  
5 SOUTHERN BELL. MR. ROTHSCHILD COMPARES THE 10-YEAR  
6 MOVING AVERAGE OF THE ACTUAL EARNED RETURN ON BOOK  
7 EQUITY FOR THE DJIA FROM 1929 TO 1991 TO HIS  
8 ESTIMATED 11% DCF COST OF EQUITY FOR SOUTHERN BELL  
9 (DIRECT TESTIMONY, SCHEDULE 6, P.1, AND PP. 54-56).  
10 AFTER OBSERVING THAT THE 10-YEAR AVERAGE BOOK  
11 RETURN FOR THE DJIA HAS BEEN "BETWEEN 10% AND 12%  
12 SINCE THE LATE 1950'S," MR. ROTHSCHILD CONCLUDES  
13 THAT "...MY RECOMMENDED COST OF EQUITY IN THIS CASE  
14 IS WELL WITHIN THAT RANGE" (DIRECT TESTIMONY, P.54,  
15 LINE 25- P.55, LINE 1). THE INCORRECT IMPLICATION  
16 IS THAT THE EARNED RETURNS ON THE DJIA ARE  
17 SUPPOSEDLY A RELEVANT BENCHMARK FOR EVALUATING THE  
18 COST OF EQUITY CAPITAL OF SOUTHERN BELL.

19

20 FURTHER, EARNED OR HISTORICAL RETURNS ARE NOT WHAT  
21 THE MARKET FOCUSES ON IN DETERMINING THE  
22 COMPARABILITY OF FIRMS' RISKINESS. ONLY EXPECTED  
23 OR PROSPECTIVE RETURNS ARE COMPARABLE FOR FIRMS OF  
24 COMPARABLE RISK. THUS, MR. ROTHSCHILD'S  
25 OBSERVATIONS ON THE DJIA'S HISTORICAL RETURNS ARE

1 IRRELEVANT TO THE ESTIMATION OF SOUTHERN BELL'S  
2 COST OF EQUITY CAPITAL BECAUSE THE RETURNS ARE  
3 EXCLUSIVELY HISTORICAL AND BECAUSE SOUTHERN BELL IS  
4 NOT COMPARABLE TO THE FIRMS CONSTITUTING THE DJIA.

5

6 C. IMPROPER RELIANCE ON THE PRICE-TO-BOOK  
7 EQUAL TO ONE CRITERION

8

9 Q. DO YOU AGREE WITH MR. ROTHSCHILD'S ARGUMENT THAT A  
10 PRICE-TO-BOOK RATIO OF ONE INDICATES THAT A  
11 REGULATED UTILITY IS EARNING A RETURN ON BOOK  
12 EQUITY THAT IS EQUAL TO ITS COST OF EQUITY?

13

14 A. NO. THE USEFULNESS OF THE MARKET-TO-BOOK RATIO  
15 DEPENDS ON A UTILITY BEING FULLY AND PERFECTLY  
16 REGULATED. HOWEVER, WHEN ALL OF A UTILITY'S  
17 ACTIVITIES ARE NOT COMPLETELY AND PERFECTLY  
18 REGULATED, ITS STOCK PRICE WILL REFLECT THE  
19 ANTICIPATED RETURNS ON BOTH REGULATED AND  
20 UNREGULATED BUSINESS VENTURES. FURTHER, THE BOOK  
21 VALUE OF EQUITY IS AN ACCOUNTING MEASURE THAT NEED  
22 NOT BEAR MUCH RESEMBLANCE TO THE ECONOMIC OR MARKET  
23 VALUE OF THAT EQUITY. THUS, THE MARKET-TO-BOOK  
24 RATIO CANNOT BE RELIABLY USED TO DRAW INFERENCES  
25 CONCERNING THE RELATIONSHIP BETWEEN A UTILITY'S

1 COST OF EQUITY AND ITS RETURN ON EQUITY.

2

3 MR. ROTHSCHILD'S CONFUSION CONCERNING THE  
4 IRRELEVANCE OF THE PRICE-TO-BOOK RATIO IS REVEALED  
5 BY HIS ASSERTION THAT "THE EARNED RETURN ON BOOK  
6 EQUITY IS NOT THE COST OF EQUITY. IT IS , HOWEVER,  
7 THE EARNED RETURN ON BOOK EQUITY THAT WILL BE THE  
8 END RESULT OF THE RATES ALLOWED FROM THESE  
9 PROCEEDINGS" (DIRECT TESTIMONY, P. 55, LINES 5-7).  
10 IN THE ABSENCE OF A FULLY AND PERFECTLY REGULATED  
11 UTILITY, THE ALLOWED RETURN ON EQUITY SHOULD SIMPLY  
12 BE SET EQUAL TO THE MARKET-DETERMINED COST OF  
13 EQUITY.

14

15 D. MISUNDERSTANDING OF THE TIME  
16 VALUE OF MONEY: STOCK PRICES  
17 AND QUARTERLY DIVIDENDS

18

19 Q. DO YOU AGREE WITH MR. ROTHSCHILD'S OPINION THAT  
20 "...THE IMPACT OF THE PAYMENT OF QUARTERLY  
21 DIVIDENDS IS TO CAUSE THE DCF MODEL TO OVERSTATE,  
22 NOT UNDERSTATE THE RETURN ON BOOK EQUITY WHICH  
23 SHOULD BE ALLOWED TO PUBLIC UTILITIES" (DIRECT  
24 TESTIMONY, P. 66, LINES 11-13)?

25

1 A. NO. MOST SURPRISINGLY, MR. ROTHSCHILD REVEALS A  
2 MISUNDERSTANDING OF THE TIME VALUE OF MONEY WHEN HE  
3 ARGUES THAT "BECAUSE DIVIDENDS ARE PAID QUARTERLY,  
4 THE AVERAGE COMMON STOCK PRICE FOR ANY COMPANY IS  
5 LOWER THAN IT WOULD BE IF THE DIVIDEND WERE PAID  
6 ANNUALLY" (DIRECT TESTIMONY, P. 64, LINES 12-14).  
7 INVESTORS ARE WILLING TO PAY HIGHER, NOT LOWER  
8 PRICES FOR STOCKS THAT PAY DIVIDENDS QUARTERLY  
9 RATHER THAN ANNUALLY. THIS IS DUE TO INVESTORS'  
10 IMPROVED REINVESTMENT OPPORTUNITIES UNDER QUARTERLY  
11 COMPOUNDING. MR. ROTHSCHILD IS ARGUING THAT THE  
12 OPPOSITE HOLDS: INVESTORS WILL PENALIZE STOCKS THAT  
13 PAY DIVIDENDS QUARTERLY. IF THAT STRANGE RESULT  
14 WERE TO OCCUR, THEN THE LOWER PRICE WOULD BE  
15 ASSOCIATED WITH A HIGHER COST OF EQUITY TO THE  
16 AFFECTED FIRM. HOWEVER, INVESTORS DO NOT LIVE IN  
17 SUCH A WORLD.

18

19 E. RESPONSES TO MR. ROTHSCHILD'S CRITICISMS  
20 OF DR. BILLINGSLEY'S DIRECT TESTIMONY

21

22 Q. WHAT ARE MR. ROTHSCHILD'S SPECIFIC CRITICISMS OF  
23 YOUR APPROACHES TO ESTIMATING SOUTHERN BELL'S COST  
24 OF EQUITY?

25

1 A. MR. ROTHSCHILD INCORRECTLY ARGUES ON PAGES 11-13 OF  
2 HIS DIRECT TESTIMONY THAT: 1) THE EXPECTED GROWTH  
3 RATES USED IN MY DCF ANALYSIS ARE NOT SUSTAINABLE  
4 BECAUSE THEY ARE ALLEGEDLY "ATYPICALLY LOW DUE TO  
5 THE RECESSION"; 2) THE USE OF THE QUARTERLY DCF  
6 MODEL OVERSTATES DIVIDEND YIELDS, AND 3) MY RISK  
7 PREMIUM METHOD IS LIMITED BY ITS USE OF MY DCF  
8 METHODOLOGY AND BY THE RISK ADJUSTMENT PROCEDURE.

9  
10 I WILL SHOW THAT EACH OF THESE CRITICISMS ARE  
11 INVALID AND MERELY REFLECT MR. ROTHSCHILD'S  
12 MISCONCEPTIONS AND ERRORS IN ESTIMATING THE COST OF  
13 EQUITY CAPITAL.

14

15 Q. THE RECENT RECESSION HAS CERTAINLY BROUGHT  
16 ATYPICALLY BAD ECONOMIC CONDITIONS. WHAT ARE YOUR  
17 REASONS FOR BELIEVING THAT THE EXPECTED EARNINGS  
18 GROWTH RATES EMPLOYED IN YOUR DCF MODEL ARE  
19 SUSTAINABLE OVER THE LONG-TERM AND THAT THE  
20 RECESSION HAS NOT PRODUCED AN ATYPICALLY LOW  
21 EARNINGS BASE THAT DRAWS INTO QUESTION THE CONSTANT  
22 GROWTH ASSUMPTION OF THE DCF MODEL?

23

24 A. AS NOTED ABOVE, THE IBES MEASURES OF ANALYSTS'  
25 EARNINGS FORECASTS USED IN MY DCF ANALYSIS ARE



1       BASED ON SURVEYS THAT EXPLICITLY REQUEST ANALYSTS  
2       TO NORMALIZE THEIR EARNINGS DATA IN LIGHT OF  
3       CURRENT ECONOMIC CONDITIONS.  THUS, THERE IS NO  
4       REASON TO BELIEVE THAT THE ATYPICAL CONDITIONS HAVE  
5       BIASED THESE EARNINGS FORECASTS.  FURTHER, MY GROUP  
6       OF 20 FIRMS COMPARABLE IN RISK TO SOUTHERN BELL  
7       OFFER NO REASON TO EXPECT THAT CURRENT ANALYSTS'  
8       LONG-TERM GROWTH RATE FORECASTS WILL NOT BE  
9       SUSTAINABLE.

10

11 Q.  HOW DOES YOUR APPLICATION OF THE QUARTERLY DCF  
12       MODEL PREVENT THE OVERESTIMATION OF THE COST OF  
13       CAPITAL THAT MR. ROTHSCHILD CONTENDS?

14

15 A.  AS PREVIOUSLY DISCUSSED, MR. ROTHSCHILD IS  
16       OPERATING UNDER THE SERIOUS MISCONCEPTION THAT  
17       STOCKS THAT PAY DIVIDENDS QUARTERLY COMMAND LOWER  
18       PRICES THAN STOCKS PAYING DIVIDENDS ANNUALLY.  I  
19       PRESENT A QUARTERLY DCF MODEL BECAUSE IT MORE  
20       ACCURATELY PORTRAYS THE CASH FLOW PROFILE  
21       ENCOUNTERED BY INVESTORS.  AS STOCKS PAY DIVIDENDS  
22       MORE FREQUENTLY, THERE IS NOT A NEGATIVE RESPONSE  
23       BY STOCKHOLDERS.  THE DIVIDEND YIELDS USED IN MY  
24       DCF MODEL ARE REPRESENTATIVE OF ECONOMIC REALITY.  
25       CONSEQUENTLY, MR. ROTHSCHILD'S ARGUMENT THAT MY DCF

1 MODEL IS FLAWED DUE TO THE LACK OF ADJUSTMENT FOR  
2 THIS NON-EXISTENT EFFECT IF FALLACIOUS.

3

4 Q. MR. ROTHSCHILD ARGUES THAT YOUR RISK PREMIUM  
5 ANALYSIS IS INCORRECT BECAUSE IT RELIES ON "...THE  
6 SAME FLAWED DCF METHODOLOGY TO QUANTIFY THE COST OF  
7 EQUITY FOR THE S&P 500 AS THE METHOD HE USED TO  
8 QUANTIFY THE COST OF EQUITY FOR HIS 20 "CLUSTER"  
9 COMPANIES" (DIRECT TESTIMONY, P. 67, LINES 16-18).  
10 HOW DO YOU RESPOND TO THIS CRITICISM?

11

12 A. MY REBUTTAL OF MR. ROTHSCHILD'S METHODOLOGICAL  
13 APPROACHES HAS DEMONSTRATED THAT MY DCF MODEL IS  
14 CORRECT AND ACCURATE IN THE CONTEXT OF MY RISK  
15 PREMIUM ANALYSIS. HIS INCORRECT CRITICISMS  
16 CONTEND THAT I HAVE OVERSTATED THE DIVIDEND YIELD  
17 DUE TO A INCORRECT HANDLING OF THE QUARTERLY  
18 DIVIDEND EFFECT AND THAT I HAVE USED GROWTH RATES  
19 THAT ARE UNREPRESENTATIVE OF LONG-TERM  
20 EXPECTATIONS. YET MY REBUTTAL TESTIMONY HAS SHOWN  
21 THAT MR. ROTHSCHILD MISUNDERSTANDS THE EFFECT OF  
22 QUARTERLY DIVIDEND PAYMENTS BECAUSE HE INCORRECTLY  
23 BELIEVES THAT STOCKHOLDERS PENALIZE FIRMS THAT  
24 CHOOSE TO PAY DIVIDENDS QUARTERLY RATHER THAN  
25 ANNUALLY. FURTHER, I HAVE EXPLAINED THAT THE IBES

1 GROWTH RATES RELIED ON IN MY DCF AND RISK PREMIUM  
2 ANALYSES ARE FORMED USING NORMALIZED EARNINGS THAT  
3 INVALIDATE MR. ROTHSCHILD'S CRITICISMS CONCERNING  
4 THE EFFECTS OF THE RECESSION ON THE USEFULNESS OF  
5 SUCH FORECASTS. MR. ROTHSCHILD'S CRITICISMS OF THE  
6 DCF ASPECT OF MY RISK PREMIUM ANALYSIS ARE AS  
7 INCORRECT IN THIS CONTEXT AS THEY WERE IN  
8 CRITICIZING MY CLUSTER-BASED DCF ANALYSIS.

9  
10 Q. ON PAGE 68 OF HIS DIRECT TESTIMONY MR. ROTHSCHILD  
11 CRITICIZES YOUR USE OF THE S&P 500 AS A BASE IN  
12 YOUR RISK PREMIUM ANALYSIS. OF WHAT RELEVANCE IS  
13 THE S&P 500 IN YOUR ANALYSIS?

14  
15 A. THE S&P 500 IS A BROAD MEASURE OF THE OVERALL STOCK  
16 MARKET AND CONSEQUENTLY PROVIDES A RELIABLE  
17 INDICATION OF THE OVERALL RISK/RETURN TRADE-OFF  
18 THAT PREVAILS IN THE MARKET. MY RISK PREMIUM IS  
19 DEFINED USING AAA-RATED UTILITY BONDS TO RELATE IT  
20 TO THE RELEVANT CONTEXT OF UTILITIES. THUS, IT  
21 SERVES AS A VALUABLE INDICATION OF THE  
22 REASONABLENESS OF MY DCF ANALYSIS OF FIRMS  
23 COMPARABLE IN RISK TO SOUTHERN BELL.

24  
25 Q. MR. ROTHSCHILD INDICATES THAT YOU PERFORMED A

1 HISTORICAL RISK PREMIUM ANALYSIS OF THE S&P 500'S  
2 ACHIEVED RETURNS RELATIVE TO UTILITY BOND RETURNS  
3 FROM 1937 TO 1991. IT IS ALSO INDICATED THAT YOU  
4 CONDUCTED SIMILAR ANALYSIS USING THE S&P UTILITIES  
5 INDEX. IS THIS AN ACCURATE REPRESENTATION OF THE  
6 APPROACH THAT YOU IMPLEMENTED?

7

8 A. NO. MY RISK PREMIUM ANALYSIS DID NOT USE  
9 HISTORICAL (ACHIEVED) RETURNS ON THE S&P 500 OR THE  
10 S&P UTILITIES INDEX. APPARENTLY MR. ROTHSCHILD HAS  
11 INADVERTENTLY INCLUDED SOME "OLD" TESTIMONY THAT  
12 APPLIES TO ANOTHER WITNESS IN ANOTHER PROCEEDING.  
13 HIS OBSERVATIONS IN THIS AREA ARE INACCURATE AND  
14 SHOULD BE DISCARDED BY THIS COMMISSION IN THEIR  
15 EVALUATION OF SOUTHERN BELL'S COST OF EQUITY  
16 CAPITAL. THIS ERROR, IN COMBINATION WITH HIS OTHER  
17 SIGNIFICANT CONCEPTUAL ERRORS AND MISCONCEPTIONS,  
18 EXPLAINS WHY HE HAS UNDERESTIMATED SOUTHERN BELL'S  
19 COST OF EQUITY CAPITAL SO SEVERELY.

20

21 V. REBUTTAL OF MR. KING'S DIRECT TESTIMONY

22

23 A. INAPPROPRIATE INTEREST RATE INDEX

24

25 Q. WHAT MECHANISM DOES MR. KING RECOMMEND THAT THIS

1 COMMISSION USE IN DETERMINING WHEN IT IS  
2 APPROPRIATE TO RECONSIDER THE BANDS ESTABLISHED FOR  
3 SHARING EARNED RETURNS BETWEEN SOUTHERN BELL AND  
4 RATEPAYERS?

5

6 A. MR. KING RECOMMENDS THAT "...THE YIELDS ON 10-YEAR  
7 TREASURY BONDS BE USED AS A TRIGGER FOR THE  
8 COMMISSION'S RECONSIDERATION OF THE RATE OF RETURN  
9 BANDS" (DIRECT TESTIMONY, P. 11, LINES 6-7).  
10 FURTHER, HE ARGUES THAT "...IF THOSE YIELDS CHANGE  
11 BY MORE THAN 150 BASIS POINTS (1.5 PERCENTAGE  
12 POINTS) SINCE THE SHARING BANDS WERE LAST  
13 DETERMINED, THE COMMISSION SHOULD INITIATE AN  
14 INVESTIGATION TO DETERMINE WHETHER THERE SHOULD BE  
15 AN ADJUSTMENT IN THE SHARING BANDS" (DIRECT  
16 TESTIMONY, P. 11, LINES 7-10).

17

18 Q. HOW DOES MR. KING JUSTIFY THE USE OF THE RETURNS ON  
19 10-YEAR TREASURY BONDS AS AN INTEREST RATE INDEX  
20 THAT INDICATES WHEN THE COST OF EQUITY CAPITAL HAS  
21 CHANGED SIGNIFICANTLY?

22

23 A. NO JUSTIFICATION IS PROVIDED. MR. KING ONLY  
24 PRESENTS A CHART THAT DISPLAYS THE YIELDS ON  
25 MOODY'S AA-RATED PUBLIC UTILITY BONDS AND 10-YEAR

1       TREASURY BONDS FROM JULY OF 1988 TO SEPTEMBER OF  
2       1992 (DIRECT TESTIMONY, ATTACHMENT C). ON THE  
3       BASIS OF THIS CHART ALONE HE INCORRECTLY IMPLIES  
4       THAT SINCE THE YIELDS ON BOTH OF THESE TYPES OF  
5       SECURITIES HAVE FALLEN BY ABOUT 200 BASIS POINTS,  
6       SOUTHERN BELL'S COST OF EQUITY CAPITAL MUST HAVE  
7       FALLEN BY A COMPARABLE AMOUNT. FURTHER, WITHOUT  
8       ANY EXPLANATION, HE CONCLUDES THAT THE APPROPRIATE  
9       INTEREST RATE INDEX FOR COST OF EQUITY ANALYSIS IS  
10      THE YIELD ON 10-YEAR TREASURIES. ONE CAN ONLY  
11      PRESUME THAT MR. KING MAKES THIS CHOICE BECAUSE HIS  
12      CHART APPEARS TO SHOW SOME POSITIVE RELATIONSHIP  
13      BETWEEN YIELDS ON AA-RATED UTILITIES AND 10-YEAR  
14      TREASURIES.

15

16 Q. DO YOU AGREE WITH MR. KING'S USE OF THE YIELD ON  
17      10-YEAR TREASURIES AS A RELEVANT BENCHMARK IN  
18      EVALUATING CHANGES IN SOUTHERN BELL'S COST OF  
19      EQUITY?

20

21 A. NO. MR. KING'S CHOICE OF THE YIELDS ON 10-YEAR  
22      TREASURIES IS ARBITRARY AND INCORRECT. TWO  
23      STANDARDS DEFINE AN APPROPRIATE BENCHMARK FOR  
24      EVALUATING CHANGES IN A GIVEN TARGET COST OF  
25      FINANCING: 1) THE BENCHMARK SHOULD APPROXIMATE THE

1 MATURITY OF THE TARGET CAPITAL MARKET COST AS  
2 CLOSELY AS POSSIBLE, AND 2) THE BENCHMARK SHOULD BE  
3 OF COMPARABLE RISK TO THE TARGET CAPITAL MARKET  
4 INSTRUMENT.

5

6 Q. IS MR. KING'S CHOSEN INTEREST RATE INDEX CONSISTENT  
7 WITH THE STANDARDS FOR CHOOSING AN APPROPRIATE  
8 BENCHMARK THAT YOU HAVE IDENTIFIED?

9

10 A. NO. THEY ARE NOT. FIRST, MR. KING RECOMMENDS A  
11 TREASURY YIELD BENCHMARK WITH A 10-YEAR MATURITY  
12 WHILE THE TARGET'S (SOUTHERN BELL'S) COST OF EQUITY  
13 CAPITAL IS OF INFINITE (I.E., VERY LONG-TERM)  
14 MATURITY. AT THE VERY LEAST, HE SHOULD HAVE USED  
15 30-YEAR MATURITY TREASURY BONDS.

16

17 SECOND, TREASURIES ARE DEBT SECURITIES THAT MAKE  
18 CONTRACTUALLY PREDETERMINED COUPON PAYMENTS THAT  
19 ARE GUARANTEED BY THE U.S. GOVERNMENT. IN  
20 CONTRAST, FIRMS HAVE NO CONTRACTUAL OBLIGATION TO  
21 PAY DIVIDENDS ON EQUITIES. THUS, EVEN THOUGH  
22 EQUITIES ARE WIDELY RECOGNIZED AS RISKIER THAN DEBT  
23 SECURITIES, MR. KING MAKES NO ADJUSTMENT FOR THIS  
24 DIFFERENCE WHEN DRAWING INFERENCES ABOUT EQUITY  
25 COSTS BASED ON DEBT COSTS.

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LASTLY, MR. KING'S COMPARISON OF THE YIELDS ON  
AA-RATED UTILITIES AND 10-YEAR TREASURIES IMPLIES  
THAT HE VIEWS AA-RATED UTILITY DEBT AS COMPARABLE  
TO THE DEBT OF SOUTHERN BELL. YET THIS IS NOT  
TRUE. SOUTHERN BELL'S DEBT SECURITIES ARE RATED  
AAA, NOT AA.

B. INCORRECT CRITERION FOR IDENTIFYING  
SIGNIFICANT CHANGES IN THE COST OF EQUITY

Q. DOES MR. KING RECOGNIZE THAT IT IS INAPPROPRIATE TO  
USE CHANGES IN DEBT COSTS DIRECTLY TO ESTIMATE  
CHANGES IN EQUITY COSTS?

A. YES. IN DISCUSSING THE RECENT REDUCTION IN 10-YEAR  
TREASURY BOND YIELDS HE OBSERVES THAT "WHILE IT MAY  
BE INAPPROPRIATE TO TRANSLATE THIS 200 BASIS POINT  
REDUCTION IN DEBT COSTS TO EQUITY, THERE CAN BE  
LITTLE DOUBT THAT THE ENVIRONMENT OF THE CAPITAL  
MARKETS HAS CHANGED SIGNIFICANTLY DURING THIS FOUR  
YEAR INTERVAL" (DIRECT TESTIMONY, P.3, LINE 26-  
P.4, LINE 2). HE THEREFORE CONCLUDES THAT SOUTHERN  
BELL'S APPROPRIATE RETURN SHOULD BE RECALIBRATED.



1 Q. DO YOU AGREE WITH MR. KING'S OPINION THAT RECENT  
2 CHANGES IN THE CAPITAL MARKETS HAVE CHANGED  
3 SOUTHERN BELL'S COST OF EQUITY CAPITAL  
4 SIGNIFICANTLY ENOUGH TO REQUIRE RECALIBRATION?

5

6 A. NO. I ACCEPT MR. KING'S PREMISE THAT A 200 BASIS  
7 POINT REDUCTION IN DEBT COSTS CANNOT BE USED  
8 DIRECTLY TO ESTIMATE AN ASSOCIATED CHANGE IN THE  
9 COST OF EQUITY CAPITAL. HOWEVER, MR. KING DOES NOT  
10 ACT ON HIS OWN PREMISE AND FAILS TO ALLOW FOR THE  
11 DIFFERENCE IN THE VARIABILITY OF DEBT AND EQUITY  
12 COSTS. CONSEQUENTLY, THERE IS NO EVIDENCE TO  
13 SUPPORT HIS CONCLUSION THAT SOUTHERN BELL'S COST OF  
14 CAPITAL HAS DECLINED SIGNIFICANTLY.

15

16 C. INAPPROPRIATENESS OF THE  
17 150 BASIS POINT TRIGGER

18

19 Q. DO YOU ACCEPT MR. KING'S 150 BASIS POINT VARIATION  
20 IN 10-YEAR TREASURY YIELDS AS AN APPROPRIATE  
21 CRITERION FOR IDENTIFYING SIGNIFICANT CHANGES IN  
22 THE COST OF EQUITY CAPITAL?

23

24 A. NO, I DO NOT. AS I OBSERVED ABOVE, THERE IS  
25 CAPITAL MARKET EVIDENCE THAT CHANGES IN DEBT COSTS

1 ARE NOT ACCOMPANIED BY EQUIVALENT CHANGES IN EQUITY  
2 COSTS. IN THE CONTEXT OF MR. KING'S TESTIMONY, HIS  
3 OBSERVED 200 BASIS POINT DECLINE IN DEBT COSTS IS  
4 NOT ACCOMPANIED BY A 200 BASIS POINT DECLINE IN  
5 EQUITY COSTS. AS DISCUSSED IN MY DIRECT TESTIMONY  
6 (P. 37, LINES 14-21), HARRIS (FINANCIAL MANAGEMENT,  
7 1986) FINDS EVIDENCE THAT THE EQUITY RISK PREMIUM  
8 TENDS TO MOVE AN AVERAGE OF  $-.51$  OF CONTEMPORANEOUS  
9 CHANGES IN THE RETURN ON A BENCHMARK DEBT SECURITY.  
10 THAT IS, IF INTEREST RATES DECLINE BY 200 BASIS  
11 POINTS, THE EQUITY RISK PREMIUM INCREASES BY 102  
12 BASIS POINTS. THE PRACTICAL IMPLICATION IS THAT  
13 EQUITY COSTS SHOULD HAVE FALLEN BY ABOUT HALF (OR  
14 ABOUT 98 BASIS POINTS) OF THE OBSERVED DECLINE IN  
15 THE RETURN ON A BENCHMARK DEBT SECURITY. IT IS  
16 IMPORTANT TO NOTE THAT THE MAGNITUDE OF THIS  
17 RELATIONSHIP IS CONSERVATIVE IN LIGHT OF RECENT  
18 RESEARCH BY HARRIS AND MARSTON (FINANCIAL  
19 MANAGEMENT, 1992). THEIR WORK PROVIDES EVIDENCE  
20 THAT EQUITY COSTS MAY FALL BY EVEN LESS THAN HALF  
21 OF A GIVEN DECLINE IN DEBT COSTS.  
22  
23 MR. KING'S USE OF A 150 BASIS POINT VARIATION IN  
24 THE YIELD ON 10-YEAR TREASURIES AS AN INDICATION  
25 THAT EQUITY COSTS HAVE CHANGE SIGNIFICANTLY IS

1           CONTRADICTED BY PUBLISHED EVIDENCE ON THE MAGNITUDE  
2           OF THE RELATIONSHIP BETWEEN CHANGES IN THE COSTS OF  
3           DEBT AND EQUITY. THE EVIDENCE SHOWS THAT A 150  
4           BASIS POINT CHANGE IN THE COST OF DEBT IS  
5           ASSOCIATED AT MOST WITH ABOUT A 75 BASIS POINT  
6           CHANGE IN THE COST OF EQUITY. SUCH A CHANGE IS NOT  
7           SIGNIFICANT ENOUGH TO WARRANT THE RECONSIDERATION  
8           OF THE SHARING BANDS PREVIOUSLY ESTABLISHED BY THE  
9           COMMISSION.

10

11                           D. APPLICATION OF TRIGGER MECHANISM  
12   TO SOUTHERN BELL

13

14 Q.   HOW SHOULD THIS TRIGGER BE APPLIED TO SOUTHERN  
15       BELL?

16

17 A.   I AM A FINANCIAL ECONOMIST, NOT AN EXPERT IN  
18       REGULATORY POLICY. I HAVE OBSERVED, HOWEVER, THAT  
19       THIS COMMISSION IN PREVIOUS DECISIONS HAS RELIED ON  
20       A COST OF EQUITY BAND OF 100 BASIS POINTS OVER AND  
21       UNDER THE AUTHORIZED RETURN ON EQUITY. THIS WOULD  
22       IMPLY A BAND OF ABOUT 200 BASIS POINTS ON AAA-RATED  
23       DEBT YIELDS BEFORE ACTION WOULD BE NEEDED TO BE  
24       CONSIDERED BY THIS COMMISSION.

25

1 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

2

3 A. YES, IT DOES.

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