

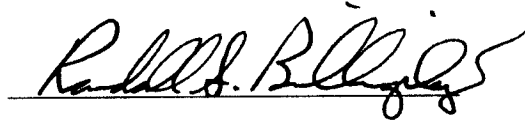
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STATE OF VIRGINIA

COUNTY OF MONTGOMERY

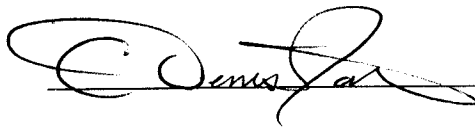
BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared Randall S. Billingsley, who, being by me first duly sworn deposed and said that:

He is appearing as a witness before the Kentucky Public Service Commission in Case No. 2003-00379, Review of Federal Communications Commission's Triennial Review Order Regarding Unbundling Requirements for Individual Network Elements, and if present before the Commission and duly sworn, his surrebuttal testimony would be set forth in the annexed testimony consisting of 10 pages and 0 exhibits.



Randall S. Billingsley

SWORN TO AND SUBSCRIBED BEFORE ME  
THIS 6<sup>th</sup> DAY OF APRIL, 2004



Notary Public

Commission Expires 8/31/05

1 **BELLSOUTH TELECOMMUNICATIONS INC.**  
2 **BEFORE THE**  
3 **KENTUCKY PUBLIC SERVICE COMMISSION**  
4 **DOCKET NO. 2003-00379**  
5 **SURREBUTTAL TESTIMONY OF**  
6 **DR. RANDALL S. BILLINGSLEY, CFA**  
7 **APRIL 13, 2004**

8  
9 **I. INTRODUCTION**

10  
11 **Q. Please state your name, occupation, and business address.**

12  
13 A. My name is Randall S. Billingsley. I am a finance professor at Virginia Polytechnic  
14 Institute and State University. I also act as a financial consultant in the areas of cost of  
15 capital analysis, financial security analysis, and valuation. My business address is:  
16 Department of Finance, Pamplin College of Business, Virginia Polytechnic Institute and  
17 State University, Blacksburg, Virginia 24061-0221.

18  
19 This surrebuttal testimony presents my independent professional opinions and is not  
20 presented by me as a representative of Virginia Polytechnic Institute and State  
21 University.

1 **Q. Have you previously submitted testimony in this proceeding on behalf of BellSouth**  
2 **Telecommunications Corporation (BST)?**

3

4 A. Yes.

5

6 **II. PURPOSE OF SURREBUTTAL TESTIMONY AND SUMMARY OF**  
7 **CONCLUSIONS**

8 **A. PURPOSE OF SURREBUTTAL TESTIMONY**

9

10 **Q. What is the purpose of your testimony in this proceeding?**

11

12 A. My purpose is to critically evaluate the cost of capital-related portions of Mr. Don J.  
13 Wood's rebuttal testimony filed on behalf of AT&T Communications of the Southern  
14 States, L.L.C. (AT&T), which is dated March 31, 2004. I show that his rebuttal testimony  
15 provides no insight into the current capital costs faced by competing local exchange  
16 companies (CLECs) in general or any specific insight into the appropriate discount rate to  
17 be used in the BellSouth Analysis of CLEC Entry (BACE) model. Below I summarize my  
18 analysis of Mr. Wood's rebuttal testimony.

19

20 **B. SUMMARY OF SURREBUTTAL OF MR. DON J. WOOD'S**  
21 **REBUTTAL TESTIMONY ON BEHALF OF AT&T**  
22 **COMMUNICATIONS OF THE SOUTHERN STATES, L.L.C.**

23

1 **Q. What issues does your surrebuttal focus on in Mr. Wood’s rebuttal testimony**  
2 **concerning the CLEC industry’s capital costs?**

3  
4 A. My surrebuttal shows that most of Mr. Wood’s testimony provides nothing more than  
5 unsupported speculations concerning CLEC capital costs and the rest presents inconsistent  
6 and incorrect arguments that leave us with no evidence on current CLEC capital costs.  
7 Importantly, Mr. Wood provides *absolutely no estimates* of CLEC capital costs. I identify  
8 numerous examples of his unsupported personal opinions in my surrebuttal. Further, I focus  
9 on Mr. Wood’s inconsistent and incorrect argument that currently operating CLECs possess  
10 inefficient, sub-optimal capital structures and yet at the same time somehow are  
11 economically efficient. This contradictory argument dramatizes his misunderstanding of the  
12 information provided by currently operating, market-traded CLECs concerning their capital  
13 costs. I also evaluate Mr. Wood’s misguided projection that past CLEC infrastructure  
14 investments and associated bankruptcies will necessarily be repeated in the future. In  
15 summary, Mr. Wood’s unsupported and incorrect observations tell us nothing meaningful  
16 about the appropriate discount rate that should be used in the BACE model.

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18 **III. ANALYSIS OF MR. DON J. WOOD’S REBUTTAL TESTIMONY ON**  
19 **BEHALF OF AT&T**  
20 **A. QUALIFICATIONS AS A COST OF CAPITAL EXPERT**

21  
22 **Q. Are you familiar with Mr. Wood’s testimony as a cost of capital expert in other**  
23 **regulatory proceedings?**

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A. No. While I have read and rebutted Mr. Wood’s testimony in other regulatory proceedings, in my experience he has always simply summarized the cost of capital recommendations made by the cost of capital expert(s) working in the given case. I am not familiar with any independent work done by Mr. Wood as a cost of capital expert. I am consequently surprised that he appears to consider himself a cost of capital expert in the current proceeding and I know of no basis for doing so.

**B. EVIDENCE CONTRADICTING MR. WOOD’S ASSUMPTION OF CLEC INEFFICIENCY**

**Q. Do you agree with Mr. Wood’s position that CLECs are currently operating efficiently?**

A. No, I believe that the evidence contradicts Mr. Wood’s position. He incorrectly argues that: ... the fact that a significant number of CLECs have gone bankrupt suggests that competitive market constraints have winnowed the field and those CLECs that currently are operating do have efficient operations. In order to make reasonable assumptions about efficient CLEC costs, it is logical to look at currently operating CLECs (Rebuttal Testimony, p. 50, lines 4 - 9).

Mr. Wood’s argument reduces to unsupported speculation that CLECs that did not go bankrupt are, by definition, necessarily operating efficiently. As shown in my direct

1 testimony in this proceeding, the average bond rating for a sample of market-traded CLECs  
2 is CCC+/CCC (see Billingsley Exhibit No. RSB-6). This is a speculative-grade bond rating  
3 that is associated with firms in financial distress. Consider the following definition of the  
4 CCC-level rating:

5  
6 An obligation rated ‘CCC’ is currently vulnerable to nonpayment, and is  
7 dependent upon favorable business, financial, and economic conditions for the  
8 obligor to meet its financial commitment on the obligation. In the event of  
9 adverse business, financial, or economic conditions, the obligor is not likely to  
10 have the capacity to meet its financial commitment on the obligation (*Standard*  
11 *& Poor’s Bond Guide*, October 2003, p. 4).

12  
13 It is absolutely amazing that Mr. Wood argues that such firms should be used “... to make  
14 reasonable assumptions about efficient CLEC costs.” The evidence obviously contradicts  
15 this. Further, Mr. Wood’s reliance on unadjusted data drawn from inefficient CLECs is  
16 inconsistent with the Federal Communication Commission’s (FCC’s) assertion that the cost  
17 of capital should reflect a forward-looking, efficient network (see Triennial Review Order,  
18 In Re Review of the Section 251, Unbundling Obligations of Incumbent Local Exchange  
19 Carriers, First Report and Order on Remand and Further Notice of Proposed Rulemaking,  
20 FCC 03-36, released August, 21, 2003, pp. 419 - 420, §682).

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22 **C. INCONSISTENT ARGUMENT THAT CLEC CAPITAL STRUCTURES**  
23 **ARE NOT EFFICIENT**

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**Q. After arguing that CLECs are currently operating efficiently, does Mr. Wood also argue that current CLEC capital structures are not efficient, target capital structures?**

A. Yes. Mr. Wood states:

This structure is clearly not the target capital structure of these companies, but has arisen in large part because of the precipitous drop in the companies' stock prices (Rebuttal Testimony, p. 57, lines 18 - 20).

Mr. Wood is inconsistent. On one hand he argues that CLECs are efficient and a reasonable source of representative capital costs. Yet on the other hand he argues that their current capital structure is not equal to their target, optimal capital structure. His only explanation for this contradictory speculation concerning current CLEC capital structures is that they are the result of the "precipitous drop in the companies' stock prices." Mr. Wood's contradictory, inconsistent argument does not make sense. The truth that must be faced is that CLECs are not currently efficient in a comprehensive sense. It is consequently reasonable to use the averaging process that I do to produce a representative bounded estimate of representative CLEC capital costs. It is eminently appropriate to bound current CLEC costs on the downside with the S&P 500 and on the upside with capital costs produced by a CLEC sample, which is obviously in an inefficient condition.

1                   **D. MR. WOOD’S SPECULATIONS CONCERNING CLEC FUTURE**  
2                   **INFRASTRUCTURE INVESTMENTS**

3  
4   **Q. What speculation does Mr. Wood make concerning future CLEC infrastructure**  
5   **investments based on history?**

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7   A. The gist of Mr. Wood’s speculation is that CLECs have no capacity to understand or to  
8   avoid their past mistakes. He states that:

9  
10           ... CLECs invested in network infrastructure (large fixed costs) based on an  
11           anticipation of future revenues that would make their market entry economic.  
12           Their assumptions regarding whether entry in this manner would be economic,  
13           now clearly flawed, are very similar to the assumptions that BellSouth is now  
14           inviting CLECs to make through the results of its business case analysis (and is  
15           asking the Commission to conclude that the CLEC’s should accept the  
16           invitation). ... CLECs face a decision of whether or not to invest in network  
17           infrastructure (in this case a local circuit switch, whose cost characteristics cause  
18           it to represent a large fixed cost). BellSouth argues that they could rationally do  
19           so ... (Rebuttal Testimony, p. 54, line 27 - p. 55, line 10).

20  
21           Thus, Mr. Wood attributes the CLECs past woes to network infrastructure investments with  
22           “large fixed costs” and predicts that CLECs will necessarily experience the same troubles  
23           again in the future. However, I do not share Mr. Wood’s uncomplimentary view of the



1 CLECs' ability to learn from past challenges. The future is not necessarily a simple  
2 extension of the past and learning is possible.

3  
4 **E. RELATIVE RISK OF CLECS AND ILECS**

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6 **Q. Does Mr. Wood provide any evidence to support his position that CLECs face higher**  
7 **risks than incumbent local exchange companies (ILEC's)?**

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9 A. No. Mr. Wood offers no evidence on the relative riskiness of CLECs and ILECs. He only  
10 expresses his unsupported opinion as follows:

11  
12 There is a fundamental difference in the risk incurred by a former monopoly  
13 provider, with existing network facilities and an existing base of customers, and  
14 the risk incurred by a new entrant to enter the market by making a large fixed  
15 investment without the customer base needed to recover the cost of that  
16 investment (Rebuttal Testimony, p. 53, lines 1 - 5).

17  
18 He then speculates that "... a CLEC continues to face, for the reasons described above,  
19 much higher risk than an ILEC" (Rebuttal Testimony, p. 54, lines 9 - 11).

20  
21 While CLECs may well be riskier than ILECs, any possible difference should be  
22 *demonstrated* using empirical evidence rather than *assumed*. Mr. Wood *speculates* about  
23 the relative risks of ILECs and CLECs when evidence is needed, not his opinion.

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**IV. SUMMARY OF COST OF CAPITAL ANALYSIS FOR BACE MODEL**

**Q. Please summarize your recommendation concerning the appropriate pre-tax overall cost of capital that should be used to calculate the NPV in the BACE model.**

A. As presented in my previously filed direct testimony in this proceeding, my cost of capital estimation approach adapts to the data problems resulting from the current troubled environment facing the CLEC industry. I essentially provide “ceiling” and “floor” estimates of the industry’s capital costs. Thus, I use two surrogates to measure the representative CLEC’s capital costs. I use the S&P 500 as a lower-bound or minimum estimate of the representative CLEC’s cost of capital and I also use a sample of publicly-traded CLECs that provides an upper-bound or maximum estimate of the representative CLEC’s cost of capital. I then provide a reasonable estimate of the industry’s overall capital costs by averaging the results of my two approaches.

My analysis indicates that a forward-looking cost of equity estimate for the representative CLEC is an average of 17.55%. I also find evidence that the cost of debt of the representative CLEC is an average of 9.92%. The average market value-based capital structure of firms is 58.50% debt and 41.50% equity. Combining this average capital structure with the above average costs of debt and equity produces an average pre-tax overall cost of capital for the representative CLEC of 13.09%. This bounded averaging approach provides the most reasonable estimate of efficient CLEC capital costs in the

1 current environment.

2

3 In summary, I recommend that the Kentucky Public Service Commission use a *before-tax*  
4 overall cost of capital of 13.09% as an input in the BACE business case model. This cost of  
5 capital should be adjusted to reflect the effect of taxes before using it to discount the after-  
6 tax cash flows generated by the BACE model.

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8 **Q. Does this conclude your surrebuttal testimony?**

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10 A. Yes, it does.

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