In the Matter of an Audit of Twin Valley Telephone, Inc. to Determine its Cost-Based Kansas Universal Service Fund Support Pursuant to K.S.A. 66-2008	))))	**DOCKET NO.** **15-TWVT-213-AUD**

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 the 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 115 proceedings. I have also filed cost of capital testimony before the Federal Energy Regulatory Commission in natural gas pipeline and electric transmission dockets.

Q What is the purpose of your testimony?

A The purpose of my testimony is to provide the Commission with an estimate of Twin Valley Telephone Company, Inc.'s (Twin Valley) required rate of return (ROR). To do so, I reviewed Twin Valley's Application, the Direct Testimony of Tim J. Morrissey, Twin Valley's Audited Financial Report and that of its parent company, as well as numerous sources of data from the capital markets.

Q Do you agree with Twin Valley's requested ROR in this Docket?

A Yes, I agree with the ROR proposed by Twin Valley. The methodology underlying Twin Valley's proposed ROR is consistent with the methodology advocated by Staff and accepted by the Commission in past dockets. Furthermore, through a careful evaluation of Twin Valley's Application and supporting documents, I conclude that the 7.26% ROR provides Twin Valley with sufficient revenue to service its debt and provides an opportunity for its owners to earn a return commensurate with returns available on comparable investments.

Q Please summarize Twin Valley's rate of return request.

A The following table provides the components of Twin Valley's 7.26% ROR requested in its Application filed on April 15, 2015.

Rate of Return
Requested By Twin Valley Telephone
& Accepted By Staff

	1 Capital Ratio	2 Cost of Capital	3 Weighted Cost
Long-term Debt	52.19%	4.97%	2.59%
Common Equity	47.81%	9.75%	4.66%
		Rate of Return	7.26%

Source: Application, Section 7

Q Please discuss your review of Twin Valley's proposed ROR?

A I verified that the cost of debt is traceable back to Twin Valley's financial statements and reflects Twin Valley's borrowing costs. Likewise, I have no adjustments to Twin Valley's proposed capital structure; it accurately reflects the consolidated capital structure of the parent company that owns and finances Twin Valley. Unlike the cost of debt and the capital structure, the cost of equity does not lend itself to being traced back to an accounting document. The cost of equity is a discount rate that investors apply in their valuation of investment opportunities. That discount rate or required return on equity changes as conditions in the economy and capital market change.

Q How did Twin Valley arrive at a 9.75% ROE?

A In recent KUSF audits, I have advocated for a 9.75% ROE for Kansas rural local exchange carriers (RLEC). Twin Valley has adopted that ROE.[1] As you can see in the next table, Staff has advocated for a 9.75% ROE in May of 2013 and continuing through the last four KUSF Dockets, the latest being in January of 2015. In each of those Dockets, Staff provided evidence that 9.75% was a reasonable ROE at each discrete point in time.

Q In your opinion, is 9.75% a reasonable ROE for Twin Valley?

A Yes, a 9.75% ROE is reasonable for Twin Valley because the underlying economic conditions that influence returns available in the capital markets are the same as they were during those recent KUSF dockets. Most notable is that, throughout this time period since May of 2013 to the present, the U.S. economy has consistently exhibited slow economic growth; low inflation; and low interest rates across the

[1] Direct Testimony of Tim J. Morrissey, Twin Valley Telephone, Inc.; 15-TWVT-213-AUD; pp14-15.

entire spectrum of fixed income vehicles. Of course, Staff's position in this Docket should not be taken to mean that a 9.75% ROE is appropriate for all RLECs in future KUSF Dockets. The cost of equity capital changes with the economy and capital markets, thus an ROE of 9.75% that has been appropriate in the past and that is appropriate at this juncture, may not be the correct return to use in the future. The key decisions on rate of return issued by the U.S. Supreme Court emphasize this very point.[2]

Staff Positions in Recent KUSF Dockets

Testimony Date	Equity Ratio	Staff ROE	Baa/BBB Yields*	Company	Docket
10/18/2012	29.69%	10.50%	4.27%	Gorham Telephone Company	12-GRHT-633-KSF
12/19/2012	90.00%	10.00%	4.33%	LaHarpe Telephone Company	12-LHPT-875-AUD
3/13/2013	60.00%	10.00%	4.48%	Craw-Kan Telephone Cooperative, Inc.	13-CRKT-268-KSF
5/17/2013	Confidential	10.00%	4.42%	Zenda Telephone Company, Inc.	13-ZENT-065-AUD
5/23/2013	46.50%	9.75%	4.52%	J.B.N. Telephone Company, Inc.	13-JBNT-437-KSF
9/24/2013	55.83%	9.75%	5.19%	Peoples Telecommunications, LLC	13-PLTT-678-KSF
2/5/2014	61.43%	9.75%	4.78%	Wamego Telecommunications Co.	14-WTCT-142-KSF
9/25/2014	54.86%	9.75%	4.45%	S&T Telephone Cooperative, Inc.	14-S&TT-525-KSF
1/20/2015	Confidential	9.75%	3.91%	Moundridge Telephone Co.	15-MRGT-097-KSF

* Yield on Baa/BBB Utility Bonds reported by Value-Line Investment Survey

Q How did you ascertain that 9.75% continues to be a reasonable ROE?

A I reviewed the capital markets from several perspectives for the time period of May 2013 to the present to ascertain whether there have been measurable changes in investors' required returns. For this time period, I reviewed: 1) the interest rates on public utility bonds; 2) the forecasted returns published by asset management firms;

[2] Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, 692-3 (1923). Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603 (1944).

and 3) the returns set by public utility commissions. Each of these views of the capital markets provides us with an indication of investors' required returns. As you will see in the following tables the expected returns on common stocks and allowed returns granted by utility commissions indicate that capital costs have declined since the Commission adopted the 9.75% return on equity in 2013. However, other data such as interest rates did not follow that downward trend. In my opinion these three views of the capital markets taken as a whole support continuing the 9.75% return on equity for this docket. In future KUSF dockets, Staff will evaluate capital market data to determine if a change upward or downward is necessary

Q Please discuss your observations of interest rates on public utility debt over the past three years?

A Since May of 2013, the yield on public utility bonds has ranged from 3.91% to 5.19% (see the previous table). There does not appear to be a discernable trend in those data points, but those data points establish a range for bond investors' required return for us to use as a yardstick to compare to current interest rates. In August of 2015, Value-Line reported the yield on Baa/BBB Utility Bonds was 4.63%. Thus, the current yield on public utility debt is within the range seen during that time period. Interest rates on public utility debt and the cost of equity move in the same direction, although not in lock-step with one another. Current interest rates are within the range seen in past dockets, which is an indication that there has not been a significant change in the cost of capital from 2013 to the present.

Q Please discuss the second measure, expected returns on common stocks as forecasted and published by asset management companies.

A For another perspective of the capital markets, I reviewed returns expected on common stocks over the next 10 to 15 years. Staff is aware of two asset management firms that publish long-run forecasts for returns on a host of financial assets such as common stock and corporate bonds. These two firms directly manage billions of dollars of assets making their forecasts an important indicator of the expectations of sophisticated, institutional investment advisors. In the last three years, both firms maintained relatively low expected returns on common stocks and corporate bonds. This information is an indication that sophisticated institutional investors continue to expect low returns on investments into the future, and that has been their expectation for each of the last three years.

The following table shows the 10 to 15 year projected returns published by J.P. Morgan Asset Management[3] (JPMAM) for each of the previous three years; the

[3] Long-Term Capital Market Return Assumptions, (2015 Edition, U.S.); J.P. Morgan Asset Management; https://am.jpmorgan.com/us/institutional/ltcmra J.P. Morgan Asset Management provides its expected annual returns on 46 different domestic and international asset classes for the 10 to 15 year horizon. J.P. Morgan describes its LTCMRA publication with the following paragraph:

same time period that Staff has advocated the 9.75% ROE for RLECs. A similar report is published by BNY-Mellon Investment Management[4] whose forecasted returns are comparable to JPMAM's forecasts for equity and fixed income investments.

Long-Term Capital Market Return Assumptions
Published by J.P. Morgan Asset Management
10 to 15 Year Expected Annual Arithmetic Returns

	*** Equities ***		U.S. Corporate
	Large-Cap	Mid-Cap	Long-Bond
2013	8.71%	10.23%	4.80%
2014	8.49%	9.17%	5.67%
2015	7.60%	8.34%	4.95%

Source: LTCMRA reports for each year; published by J.P. Morgan Asset Management
https://am.jpmorgan.com/us/institutional/home

Q **Please discuss the last measure of capital costs, the returns granted by public utility commissions?**

A Last of all, we can review the actions of regulatory agencies that set allowed returns for natural gas and electric utilities. There is ample information on the allowed

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J.P. MORGAN ASSET MANAGEMENT LONG-TERM CAPITAL MARKET RETURN ASSUMPTIONS are developed each year by our Assumptions Committee, a multi-asset class team of senior investors from across the firm. The Committee relies on the input and expertise of a range of portfolio managers and product specialists, striving to ensure that the analysis is consistent across asset classes. The final step in the process is a rigorous review of the proposed assumptions and their underlying rationale with the senior management of J.P. Morgan Asset Management.

Our capital market assumptions are used widely by institutional investors – including pension plans, insurance companies, endowments and foundations – to ensure that investment policies and decisions are based on real-world, consistent views and can be tested under a variety of market scenarios.

[4] http://us.bnymellonam.com/core/library/documents/knowledge/market_commentary/2015_ten_year_capital_market_assumptions.pdf

returns granted to gas and electric utilities. Unfortunately there is virtually no reporting of the returns granted to local exchange carriers across the nation. This comparison to other rate-of-return regulated industries is helpful as allowed returns on other rate of return regulated industries have moved in parallel with this Commission's findings in KUSF Dockets. The next table shows median observation for returns granted from each quarter; the median as a measure of central tendency reduces the effects of any outliers. For the time period in this table, rate case activity has been brisk; there were 156 observations. Thus, there have been many opportunities for regulatory commissions to evaluate evidence on investors' required returns. From this data, it is apparent that regulatory commissions concluded that capital costs have remained low; there is no sign that we have left the territory of sub-10.00% returns or that required returns have dropped dramatically further to the 9.00% range.

Quarterly Rate Case Statistics
Median Return on Equity Granted

	Electric	Gas Distribution
03/2013	9.78	9.60
06/2013	9.84	9.34
09/2013	10.20	9.60
12/2013	9.95	9.84
03/2014	9.86	9.60
06/2014	9.70	9.95
09/2014	9.78	9.33
12/2014	9.80	10.20
03/2015	9.83	9.05
06/2015	9.60	9.50

Source: Regulatory Research Associates/SNL
https://www2.snl.com/interactivex/RRAHome.aspx

Q Did Staff evaluate whether a 7.26% rate of return produces sufficient

revenues for Twin Valley to maintain financial health?

A Yes, Staff Schedule D-1 contains a TIER calculation. TIER stands for times-interest-earned-ratio which conveys sufficiency of revenues to cover interest and principal payments. Staff's revenue requirement produces a TIER in excess of five times interest and principal coverage; by rational standards, this is a healthy level of coverage over and above its annual debt service.

Q Does this conclude your testimony?

A Yes.

CERTIFICATE OF SERVICE

15-TWVT-213-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 4th day of September, 2015, to the following:

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