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April 11, 2011

Mr. Mike Isbell  
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OKLAHOMA TAX COMMISSION  
AD VALOREM DIV.

RE: Comments Concerning the Draft Capitalization Rate Study April 2011

Dear Mr. Isbell:

Thank you for the opportunity to provide input related to the 2011 Draft Study. I will provide the calculations of the cost of capital completed by Duff and Phelps for the mid-cap telecommunications companies under separate cover. Their determination of the cost of capital for mid-cap telecommunications companies such as Southwestern Bell Telephone Company was 11.5%.

As I reviewed the Ad Valorem Division's 2011 study with regard to the Telecommunications Industry I noted that it was essentially consistent with the methodology that was used in 2010. The only notable change I observed was that there are now two industry segments, i.e. Telecommunications Utility and Telecommunications Services. However the basic methodology within the each category is consistent with 2010. That being the case I reviewed the comments submitted last year and found them to be applicable to this year's study as well.

It is still problematic to me that the 2011 cost of capital is lower than the Ad Valorem Division's estimate of the cost of capital prior to the financial crisis in 2008. The financial markets still have not recovered, and capital is still hard to obtain for all but the most credit worthy companies. Moreover, the traditional wire line telephone companies are far from the most credit worthy. The incumbent local exchange carriers and long distance carriers such as Southwestern Bell Telephone and AT&T Communications are companies that have lost a substantial portion of their customer base and are experiencing aggressive competitors on virtually all aspects of there business.

The capital structure issue is still very relevant in that the Divisions proportion of debt still reflects significantly more debt than was found to be appropriate in 2008 prior to the

financial crisis. The debt components in the 2011 study are 28.42% and 40.02% for Telecommunications Services and Telecommunications Utility categories respectively as compared to 18.82% in 2008. Again, debt was more generally more difficult to obtain in January 2011, and this was particularly true of the wire line telephone companies.

In addition, the issue of the size premium should be recognized in the estimates of the cost of equity. There is wide agreement among virtually all experts in the area of finance that there is a relationship with the cost of capital and size. Some suggest that the size premium is related to liquidity. In any case, this issue is widely acknowledged among valuation practitioners. SWBT would fit the size criteria of a mid-size company. As such, the estimated cost of equity should be adjusted based on size. Moreover, this would in part recognize the liquidity issue that has been raised by Dr. Heaton the last several years. The criteria with which to make the appropriate size adjustments can be found in the Morningstar Valuation Yearbook, which is indicated as a source of information that is used within the study.

Finally, if you simply look across the various industries for which you have estimated the cost of capital, the conclusions as to the cost of capital reflect in the Ad Valorem Division's study suggest that the wire line telecommunications industry segments are among the least risky, which suggests the predictability of future cash flows is far more certain than that of the Railroad Industry, Fluid Pipelines, Gas Transmission, and Pipeline MLPs. That is simply not the case. How many of those industries are impacted by intense competition to the degree that wire line telecommunications is from technology substitution, the cable TV industry, Google, Skype, Vonage, and many others. The local exchange segment is bleeding access lines at an unprecedented rate of more than 11% annually and cumulatively they have lost roughly 50% since the year 2000. The long distance segment is so competitive that it loses hundreds of millions of dollars annually with little hope of recovery in the near term if at all. The cost of capital is a measure of risk, and at this time the wire line telecommunications industry is far more like the airlines than it is the electric companies or the water companies.

I don't want to simply repeat the comments that were provided last year. Therefore I am going to attach last year's comments as being relevant this year as well.

Again, I appreciate the opportunity to provide input.

Best regards,



Attachments



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April 14, 2010

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RE: Comments Concerning the Draft Capitalization Rate Study April 2010

Dear Mr. Isbell:

Thank you for the opportunity to provide input related to the 2010 Draft Study. In that regard I asked Dr. Heaton to review the study and provide his input. I have also included a thorough discussion of floatation cost written by Tom Tegarden as an additional attachment.

Before we get into to Dr. Heaton's comments I want to make a couple of observations:

- If you simply compare the Oklahoma 2008 capitalization rate study to the Draft 2010 study the implications are that the cost of capital in January of 2010 is substantially less than in January 2008 when the economy and wireline telecommunications companies were much healthier. It simply doesn't make sense that the cost of capital is some 98 basis points, or 9%, lower in 2010 as compared to 2008.
- The 2010 Draft suggests that the optimal debt component in the capital structure is 32.4% while the 2008 debt component was 18.89%. This difference is primarily attributable to the dramatic fall in equity prices over the previous 15 months, not the market's perception that the telecommunications is less risky and therefore investors would be comfortable with a greater amount of debt. In point of fact, in the case of AT&T it is in the process of paying down its debt level over the next few years to bring it back in line with the historical norm. Finally, optimal capital structures do not swing wildly from year to year. There may be factors that causes the near term market of equity to swing, but over time companies will bring the debt/equity ratio back to more normal levels either through growing equity or paying down debt. Given the valuation models used in

Oklahoma it is the long term optimal capital that is relevant, and a debt ratio of roughly 20% would be more indicative of the long run capital structure.

- The cost of capital to be estimated is that of the specific subject property. It is not the holding companies that issue stock and have various business segments with different patterns of future cash flows. The risk profiles of the holding companies are often far different than those of the operating segments that are the subject of ad valorem taxation by the Public Service Section. As currently reflected in the Draft the cost of capital estimate is far more indicative of the parent holding companies than the operating properties that are the subject of valuation.
- I find it troubling that in the third year of the process Oklahoma has not adequately addressed the floatation cost issue. To simply dismiss the issue with a statement in the Executive Summary of the study indicating "companies do not typically issue new common equity as a matter of common practice" is simply inadequate. Moreover, at the end of this letter I provide specific examples that in the case of the major AT&T acquisitions new securities were issued in each instance. Finally, it is not practical to deduct the floatation expenses from the income stream because in the telecommunications industry they are typically incurred at the holding company level for the benefit of all of the divisions. Therefore, it is not practical associate them with a particular operating segment.
- It is obvious that Dr Heaton's comments during the capitalization rate presentation were simply ignored. This is unfortunate considering his level of expertise on the subject of cost of capital. He has far more knowledge and experience in this area than anyone else that provided input during the hearings, or anyone in the Public Service Section of the Ad Valorem Division. He is in fact one of the leading experts in the country. To simply dismiss his comments out of hand is a disservice to the entire process.

Dr. Heaton's specific comments related to the 2010 Draft are reflected below. In addition, following Dr Heaton's discussion I have included some additional comments concerning the need to add floatation costs:

**Dr. Heaton's Comments:**

## Comments on the 2010 Oklahoma Capitalization Rate Study

I have reviewed the Oklahoma 2010 Capitalization Rate study and have some concerns about the approaches they used. The state has selected comparables that reflect a wide variety of businesses of which the declining landline business is only a part and then extracted information from their liquid, traded securities to determine a discount rate. The inclusion of growing businesses severely biases the discount rate for the landline business and extracting discount rates from securities and then applying those rates to illiquid property violates fundamental appraisal principles.

The cataclysmic events of late 2008 and early 2009 underscored the difference between investments that could be bought and sold easily and the *property* that is the subject of the state's assessment. Property is highly illiquid. At the same levels of risk, property that cannot be converted into cash easily must offer higher returns than investments that can. Nowhere has the state accounted for this critical difference.

The state has made no attempt to adjust for this key difference. Fundamental appraisal principles indicate that an appraiser must make adjustments for known differences between the investments chosen as comparable and the subject property being valued. The state's failure to account for this difference represents a basic appraisal error.

Another key problem with the state's study is the fact that it is landline property that is being assessed, not AT&T or other telecommunications companies as a whole. The sharp drop in AT&T's landline market indicates that its risk is critically different from that of AT&T and the aggregate corporate assets of the other companies chosen as comparable. Inasmuch as the number of landlines is falling over time at an increasing rate, one would anticipate steadily declining values for this business.

I will first offer some criticisms of some of the approaches in the capitalization rate study and then offer some recommendations.

### Criticisms

The capital structure used in the Oklahoma Capitalization Rate Study had increased debt levels compared to the 2009 and 2008 study (32.4% debt in 2010, 27% debt in 2009 and 18% debt in 2008). This stemmed entirely from the dramatic fall in stock prices since 2008. Fair market value reflects the price between a willing buyer and a willing seller. The levels of debt reflected in the state's study do not reflect the amount of debt available to a potential buyer in January 2010. The use of elevated debt levels reduces the cost of capital estimate despite substantial market evidence that debt was *less* available in early 2010. During 2009 the amount of lending had dropped more than any year in several decades. Although large diversified corporations could raise debt, properties such as the landline business of SWBT with declining future revenues would face severe restrictions on the amount of debt it could raise. That percentage of debt would likely be less than prior years, not more.

The Ex Post and Ex Ante Capital Asset Pricing Model (CAPM) approaches are both biased dramatically too low due to reliance on betas and risk premiums that were not reflective of conditions in early 2010. Betas were calculated based on five years of

weekly data. The drop in the market and elevated debt levels only happened in the last year or so of data used to calculate the betas. As a result, the betas do not reflect those elevated debt levels prevailing on January 2010. The effect of using five years of data during most of which time debt levels were much lower would serve to bias the betas lower than the debt/equity levels in early 2010 would warrant. In addition, the dramatic fall in the market would reduce the ex post equity risk premium due to the huge negative return that would be included in the historical average. In reality, the fall in the market reflects higher levels of risk, not lower.

In addition the CAPM estimates are biased low by Treasury rates that were extraordinarily low due to liquidity needs. Market participants were purchasing U. S. Treasuries as a place to put funds that could be sold quickly and easily when the need for cash arose. Market participants, particularly foreign central banks, needed dollar-denominated investments that were very liquid and did not bear credit risk. As a result of this unusual demand, Treasury bond prices were driven high and Treasury interest rates low. Properties subject to property tax are very illiquid, so discount rates based on highly liquid instruments would be too low for use in valuing illiquid property without some adjustment.

The DCF (Dividend) Equity Rate would be biased low by historical data which reflected a shift for the last several years away from dividend payments to share repurchases as a means to get cash to shareholders. Share repurchases have substantial advantages over dividends in that (1) they are discretionary and can be cancelled when cash is needed, (2) provide choice to a shareholder as compared to a dividend that will be received whether cash is needed or not, and (3) if shares are sold the return is primarily taxed as a capital gain rather than at ordinary income tax rates that apply to dividends (except for a brief period under the Bush tax cut). As a result, companies paid less dividends than otherwise and began increasing share repurchases. This would lead to the growth rate and the yield in the DCF (Dividend) Equity Rate being biased low. At the very least, the yields in the DCF model should reflect both dividend yields and share repurchases as a percent of equity market capitalization. Using only dividends paid to calculate yields biases this indicator severely too low.

Another key issue with all of the approaches is that the discount rates fail to recognize the illiquidity of the property being valued. Investors will require higher returns on equally-risky assets that take time, money and effort to sell. The California Assessors Handbook (502) explicitly recognizes the need to adjust estimated value:

California State Board of Equalization, *Assessors' Handbook*, Section 502, Advanced Appraisal, p. 63.

"Most financial assets are liquid. Real estate and most business assets, however, are relatively illiquid, and real estate investors must be compensated for this reduced liquidity."

California State Board of Equalization, *Assessors' Handbook*, Section 502, Advanced Appraisal, pp. 183-184.

"The argument based on lack of liquidity is a much stronger one. There is no question that financial assets are significantly more liquid than real estate assets. ... An adjustment for lack of liquidity can be made in two ways: (1) consider lack of liquidity as an added risk factor and add a

premium for it to the cost of equity estimated by the CAPM; or (2) value the real estate asset using the CAPM/WACC without any liquidity adjustment, and then apply a liquidity discount to the estimated value.”

All of the approaches in the Oklahoma Capitalization Rate Study rely on data from highly liquid stocks and bonds. As a result, the estimated discount rates reflect rates that only apply to investments that can be sold quickly, easily and at low cost; they do not reflect the illiquidity of the telecommunications property being valued.

### **Recommendation**

The two rates in the Oklahoma Capitalization Rate Study that reflected the short term conditions in early 2010 were the DCF (Earnings) Equity Rate and the Earnings Price Ratio. The fallen stock prices are immediately reflected in that the stock price shows up in the yield portion of the DCF (Earnings) Equity Rate and also in the Earnings Price Ratio.

I recommend that the yield in the DCF model be increased by average share repurchases over the prior years and then greater weight be placed on this adjusted DCF (Earnings) Equity Rate and the Earnings Price Ratio due to their better reflection of actual market conditions. Less weight should be placed on the Ex Post CAPM, Ex Ante CAPM and DCF (Dividend) Equity Rate inasmuch as they were all biased low (as per the explanations above) and were definitely not reflective of actual market conditions in early 2010. Alternatively, the beta used in these models should be adjusted upward by 30% or more to reflect the difference between the companies selected as comparable and the high risk, declining landline property which is the subject of the assessment.

Finally, to at least partially adjust for the illiquidity of the property being valued, a minimum of 1% should be added to the discount rates. The study I presented on March 25 indicated at least a 1% difference between required returns on property and the WACC as calculated using the state's techniques. This 1% must be added to avoid the fundamental appraisal error of using noncomparable liquid stocks and bonds to value the landline *property* of the assessment.

Please feel free to contact me if you have further questions.

Hal Heaton

### **Additional Comments on Floatation Costs**

Floatation costs, and/or deal costs are a part of every transaction. There are always financing costs associated with issuing debt and equity that a purchaser/owner recognizes in measuring his required return. This premise is widely accepted by experts as well as financial reference sources such as text books and other treatises on the cost of capital (See Tegarden whitepaper attached for a number of references). Moreover, given the holding company corporate structure of the major telecommunications companies the only practical way to recognize the issuance cost associated with securities is in the cost of capital.

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The comment in the Draft's Executive Summary concerning floatation cost is as follows: "Financial theory suggests and evidence supports that firms do not typically issue new common equity as a matter of common practice. Therefore in determining a capitalization rate, no adjustment will be made in the capitalization rate or the income stream for hypothetical floatation cost. Floatation costs actually incurred may be accounted for in the income stream." Unless a much larger company is purchasing a smaller company new equity is typically issued in the case of the telecommunications industry. For example, when SBC acquired AT&T Corp it issued 632M new shares of stock. In addition, when AT&T purchased Bell South it issued 2.4B shares of stock. New shares were issued in conjunction with both of these deals and others in the industry. The matter is most recently discussed in the 2008 AT&T Annual Report on Page 41 in the explanation of the year over year increase in dividends. There are also more complete discussions in the 2005 and 2006 AT&T Annual Reports.

However, whether new debt and equity is issued in conjunction with a purchase is not necessarily the critical issue. The point is that even in a steady state utilities issue new securities and pay various issuing costs on an ongoing basis that must be recognized. As Dr. Roger Morin points out in his book *Utilities Cost of Capital*, PP 102-112. "A typical utility is continuously issuing stock through its dividend reinvestment plan and employee stock option plan, or sells new shares to the public on a regular basis in order to maintain its construction program and meet its mandated service requirements. The costs of issuing securities are just as real as operating and maintenance expenses or the cost to build utility plants, and fair regulatory treatment must permit the recovery of these costs."..... "If investors were to expect continuing confiscation of their equity investment with each new stock issue, the utility's cost of capital would reach unacceptably high levels"

The problem of course is that such costs are not reflected in the expenses on a company's income statement. They are simply deducted from the proceeds provided by the securities. Moreover, in the case of the telecommunications industry the debt and equity are routinely issued by the parent holding company. Accordingly, it is not clear exactly what businesses are being financed by a specific securities issuance. Therefore, the preferable way to address the problem is to include the cost of issuing the securities in the cost of capital calculation as do most of the recognized experts in the field.

Tom Tegarden's discussion of floatation is included as another attachment. It reflects a very thorough analysis of the floatation adjustment issue with a number of authoritative references. A similar paper was published in the *Journal of Property Tax Assessment and Administration*, Volume 5, Issue 1\* 2008.

I urge you to strongly consider adjusting the 2010 Oklahoma Capitalization Rate for floatation costs. The matter has been thoroughly vetted and there is agreement among the foremost experts in finance that it is a necessary adjustment. Moreover, this would be at least a nominal step to take in recognizing the liquidity issue that has become an important consideration in today's marketplace.

Letter to Mr. Isbell continued

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Thank you for the opportunity to provide input. I look forward to the final 2010 Oklahoma Capitalization Rate Study.

Best regards,

Gary

Attachment