BEFORE THE STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

In the matter of:	**)**
EnergyNorth Natural Gas, Inc. d/b/a National Grid NH	**)**
DG 08-009	**)**
Rate Filing	**)**

Brief of the Office of Consumer Advocate

Dated: **February 20, 2009**

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I. The partial settlement agreement resolves all issues required for the determination of new permanent delivery rates in a manner that is consistent with the public interest, except the allowed return on equity.

The OCA joined with the other parties in seeking PUC approval of a partial settlement agreement, Exhibit 41, which fixes all inputs to the revenue requirement formula except return on equity (ROE). The OCA believes that the terms of the partial settlement agreement are consistent with the public interest, and, if approved, will assist the PUC in determining the new permanent delivery rates for the Company. If the Commission approves the partial settlement agreement, it must determine the allowed return on equity (ROE) in order to set the Company's new rates pursuant to the partial settlement agreement.

Before turning to the issue of the PUC's determination of ROE, the OCA recognizes and thanks the parties for their efforts throughout the proceeding, and particularly during the settlement negotiations. The OCA also notes that it is particularly pleased that the rate design terms of the partial settlement flatten the Company's current residential rate design of quite significantly declining blocks. The OCA believes that this feature of the new rate design helps to send better price signals to encourage energy efficiency, which will reduce customers' energy usage, bills, and the environmental impact of their energy use. The OCA urges the PUC to approve the partial settlement agreement without modification, and asks the PUC to consider the following facts and law in making its determination of the Company's allowed ROE.

II. The allowed ROE must be determined in the context of the requirement that rates be just and reasonable, and by balancing the interests of the Company and its investors and with those of the customers.

The PUC heard testimony from two experts on the issue of ROE: Dr. Pradip Chattopadhyay (Staff expert) and Paul R. Moul (Company expert).[1] The testimony and evidence presented by both of these experts focused primarily on the specific methodologies and data used to derive the ROE. However, the PUC must consider and determine ROE within the broader context of its role as arbiter and the general ratemaking standards that require just and reasonable rates.

In setting rates, the PUC

> follows a process of identifying consumer and [utility investor] interests competing for recognition, with an ultimate goal of striking a fair balance or accommodation between them, to be reflected in the charges to customers that may be described as just and reasonable both to the customer and to the utility.[2]

In striking this balance, the PUC exercises its discretion and judgment.[3] When a utility seeks to increase its rates, it bears the burden of proof, and must sustain this burden by a preponderance of the evidence.[4] Just and reasonable rates satisfy a utility's revenue requirement.[5] The rate of

[1] On the issue of ROE, the Company also offered the testimony of Nicholas Stavropoulos, see Exhibit 40 and transcript of final hearing, Day 2 (Transcript Day 2), pp. 66-93. The PUC, however, should give little weight to Mr. Stavropoulos' testimony or qualifications as an expert on ROE. Mr. Stavropoulos did not conduct any independent technical analysis or calculations of the ROE, see Testimony of Nicholas Stavropoulos, Transcript Day 2, p. 74, line 21, through p. 75, line 9; and p. 82, lines 4-7, or any analysis of the market generally or the natural gas distribution company stock market. See Testimony of Nicholas Stavropoulos, Transcript Day 2, p. 76, line 14-19. Rather, for the technical aspects of ROE, Mr. Stavropoulos relied upon Mr. Moul's work. Transcript Day 2, p. 74, line 21, through p. 75, line 9.

[2] Appeal of Public Service Company of NH, 130 NH 748, 750 (1988); RSA 378:7, 378:28, and 363:17-a; see also Federal Power Commission v. Hope Natural Gas, 320 US 591, 603 (1944).

[3] See Appeal of Conservation Law Foundation, 127 NH 606, 634-36, 638 (1986) (citations omitted) (Court recognizes the role of the Commission's discretion and judgment in setting variables used in the revenue requirement calculation); see also Public Service Company of NH, 90 NH PUC 542, 559 (2005), *rehearing denied*, Public Service Company of NH, 91 NH PUC 49 (2006) (citations omitted).

[4] See RSA 378:8 and NH Code of Admin. Rules Puc 203.25.

return is one of the variables of the formula used by the PUC to calculate a utility's revenue requirement.[6]

A utility's rate of return compensates its investors "for the risks they assume when they lend to the company and buy its stock."[7] The PUC's determination of the rate of return is akin to its determination of rates in that it requires the exercise of judgment and discretion in balancing the competing interest of the company and its investors with those of the customers who must pay the rates to provide the revenue permitted.[8] "This general standard has been reflected over the years in the rule that a utility's threshold entitlement is to a rate of return equal to the cost of capital."[9]

"[A] composite figure,"[10] the rate of return "is a percentage applied to the rate base expressed as a dollar amount in order to produce interest on long-term debt, dividends on preferred stock, and earnings on common stock."[11] The partial settlement agreement in this case determined the figure to be used by the PUC for rate base,[12] as well as the capital structure, which does not include preferred stock, and the weighted average cost of debt.[13] Therefore, the only input to the calculation of the rate of return for the PUC to determine in this case is the allowed ROE on common equity.

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[5] See Appeal of Conservation Law Foundation, 127 NH at 633 (in defining the term "reasonable rate," the Court stated, "[t]he ratemaking process fixes rates that when charged to customers will satisfy a utility's revenue requirement.").
[6] See Id. at 633-34 (citations omitted) ("Reduced to its essentials, [the] revenue requirement may be expressed as a formula: R = O + (B x r), where R is the utility's allowed revenue requirement; O is its allowed operating expenses; B is its rate base …and r is the rate of return allowed on the rate base."); see also Appeal of Public Service Company of NH, 130 NH at 751 (citing RSA 378:27 and Appeal of Conservation Law Foundation, 127 NH at 633-34).
[7] Appeal of Public Service Company of NH, 130 NH at 751 (citations omitted).
[8] See Appeal of Conservation Law Foundation, 127 NH at 635.
[9] Appeal of Public Service Company of NH, 130 NH at 751 (citations omitted).
[10] Appeal of Conservation Law Foundation, 127 NH at 634 (citation and internal quotation omitted).
[11] Id. at 635 (citation and internal quotation omitted).
[12] See Exhibit 41, at p. 4, section II.B. ($140,239,771)
[13] See Exhibit 41, at p. 3, section II.A.1 (debt to equity ratio of 50:50 and weighted average cost of debt at 7.02%).

III. The allowed ROE must be reasonable.

The ROE is the measure of compensation allowed for the capital invested by the utility's common stockholders.[14] To establish the ROE, the PUC quantifies the risks for which a utility's investors require compensation by looking at "returns on investments in other enterprises having corresponding risks."[15] The allowed also ROE "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."[16]

Ultimately, the allowed ROE must fall "within a zone of reasonableness between the extremes of confiscating a utility's property, at one end, and exploiting customers for the utility's benefit, at the other."[17] "[T]he lower boundary of this zone … should be a rate that, at a minimum, is sufficient to yield the cost of the debt and equity capital necessary to provide the assets required for the company's responsibility."[18] Subject to limited exceptions, "the upper boundary is a rate sufficient to yield a return comparable to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[19]

A reasonable ROE is not intended to indemnify an investor, as "a regulated utility has no abstract constitutional right to make a profit."[20] Instead, "intrinsic to the determination of the allowed return is the need to avoid unnecessary wealth transfer from ratepayers to shareholders.

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[14] See Appeal of Public Service Co. of NH, 130 NH at 751 (citing Federal Power Comm. v. Hope Gas Co., 320 U.S. 591 (1944) (other citations omitted).
[15] Federal Power Commission v. Hope Natural Gas, 320 US at 603.
[16] Id.
[17] Appeal of Public Service Company of NH, 130 NH at 750-51 (citations omitted).
[18] Verizon NH, 89 NH PUC 17 (2004), *vacated on other grounds*, Verizon New England, Inc. v. NH Public Utilities Commission, 2005 WL 1984452 (DNH.), *citing*, Appeal of Conservation Law Foundation, 127 NH at 633 (internal quotations omitted).
[19] Verizon NH, 89 NH PUC 17 (2004) *citing*, Appeal of Conservation Law Foundation, 127 NH at 635 (internal quotations and citations omitted).
[20] Appeal of Public Service Company of NH, 130 NH at 755 (citations omitted).

To properly balance the interests of ratepayers and the financial viability of the utility, any approach to determine the cost of equity must reasonably target the need to encourage investment in the utility's equity at the least cost to its ratepayers."[21]

In fixing the return on equity "[t]he [PUC] is not compelled to accept the opinion evidence of any one witness or of any group of witnesses."[22] Instead, the PUC applies its own expertise to the evidence and "may reject even uncontradicted opinion testimony if its own expertise makes the testimony unpersuasive."[23] As the Company acknowledges, "[t]here's a considerable amount of judgment" that goes into the process.[24] This analysis should be undertaken with the goal of developing an ROE that attracts investment at the lowest cost to consumers.

To determine the allowed ROE in this case, the PUC should consider a number of issues. First, the PUC must consider which estimation methodology best captures investors' expectations of the risk associated with the Company's common equity. Next, the PUC must consider which proxy group of companies is most comparable to the Company in terms of risk. The PUC must also consider whether or not to adjust upward the results of the preferred estimation methodology for floatation costs and leverage risk, as recommended by the Company's expert. In addition, the PUC should consider what weight to give the Company's claims regarding volatility, as well as the ROE determinations made by other regulatory agencies in other jurisdictions. Each of these issues is addressed in turn below.

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[21] Staff expert's testimony (Exhibit 27), p. 7, lines 6-10.
[22] New England Tel. & Tel. Co. v. State, 104 NH 229, 236 (1962) (sustaining findings and conclusions of Commission but remanding for updating of test year).
[23] Verizon NH, 89 NH PUC 17 (2004), *citing*, Petition of Grim, 138 NH 42, 54 (1993).
[24] Testimony of Company's expert, transcript of final hearing, Day 1 (Transcript Day 1), p. 67, lines 1-2.

IV. The Discounted Cash Flow (DCF) methodology produces a reasonable ROE and is consistent with PUC precedent and the PUC's obligation to set just and reasonable rates. It should be the primary basis for the PUC's determination of the Company's allowed ROE, and other methods should be used to test the reasonableness of the DCF results.

To determine a rate of return on equity the PUC must select a methodology. The PUC heard testimony and received other evidence about several methodologies used to estimate ROE. Of these, the DCF method produces the most reasonable estimate of ROE. "The DCF approach is based on the premise that the market price of a particular stock equilibrates to the sum of the stream of returns expected in the future from the stock by investors, discounted by the market cost of equity."[25] "The two essential elements of this method are the dividend yield and the growth component."[26] Although the DCF methodology has some simplifying assumptions,[27] these can be accommodated by "giv[ing] weight[ ] to different ways of implementing it."[28]

Advantages of the DCF method are that it is "forward looking,"[29] and consistent with the "forward-looking concept [of] cost of equity."[30] The other methodologies relied upon by the Company's expert are not.[31] To the contrary, the Capital Asset Pricing Model (CAPM) and Risk

[25] Exhibit 27, p. 5, lines 8-10.
[26] Exhibit 27, p. 14, lines 4-5.
[27] Testimony of Staff expert, transcript of final hearing, Day 2 (Transcript Day 2), p. 130, line 23, through p. 134, line 20 (simplifying assumptions of DCF method), lines 7-9.
[28] See Testimony of Staff expert, Transcript Day 2, p. 134, line 20, through p. 135, line 14.
[29] Exhibit 27, p. 27, lines 19-20,
[30] Exhibit 27, p. 33, lines 18-19; see also Testimony of Staff's expert, Transcript of Day 2, p. 14, lines 15-16 (forward-looking DCF construct is "the preferred approach").
[31] See, e.g., Exhibit 27, p. 10, line 21 ("the other approaches are generally not forward looking"), and p. 34, lines 6-8 ("RPM is largely not forward-looking).

Premium Model (RPM) rely on historical data to estimate ROE.[32] Consequently, these other methods are less reliable.[33]

In light of this and other limitations of the CAPM and RPM methods,[34] the PUC's use of these methods should be limited to testing the reasonableness of the DCF result.[35] Using the DCF method primarily to calculate ROE, while using the other methods as tools to test the reasonableness of the DCF results is not only consistent with the position of Staff's expert, it is also consistent with the Company's recommendation to "look at a variety of models[,]"[36] and will provide "a superior foundation" to derive the Company's allowed ROE.[37]

When the market-to-book ratio is significantly higher than one, the DCF methodology also produces a better result,[38] and one that is more consistent than other methods with the rule that "a utility's threshold entitlement is to a rate of return equal to the cost of capital."[39] "When the

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[32] See Exhibit 27, p. 9, lines 5-7 (CAPM and RPM methods "predominantly use historical stock-price appreciation as the basis for measuring the expected return on common equity"); and Testimony of Staff's expert, Transcript Day 2, p. 55, lines 2-13 (CAPM and RPM methods use historical data).

[33] See, e.g., Exhibit 27, p. 27, lines 20-22 ("relying on a beta resulting from historical data and estimating a market risk premium that stresses historical data renders the cost of equity estimate quite suspect"); and p. 34, lines 7-8 (RPM's "reliance on historical data exposes the method to considerable subjective manipulation"); see also Testimony of Staff's expert, Transcript Day 2, p. 122, lines 1-14 (there is a tendency for the CAPM estimates to be not very accurate).

[34] See Exhibit 49 (Company's expert describes shortcomings of CAPM, Risk Premium and Comparable Earnings methods) and Testimony of Staff's expert, Transcript Day 2, p. 54, line 23, through p. 56, line 10 (concerning limitations of CAPM, Risk Premium and Comparable Earnings methods).

[35] See Exhibit 27, p. 10, line 12, through p. 11, line 2 (look at other methods of estimating cost of equity "good context" and "instructive"); and Testimony of Staff's expert, Transcript Day 2, p. 120, lines 1, through p. 121, line 5 (even though DCF approach is better, it is useful to look at other methods); see also, Public Service Company of NH, 90 NH PUC 230, 247, 250 (2005) (PUC acknowledged value in using ROE estimation methods other than DCF, and considered the CAPM results of Staff, OCA and Company experts to test the reasonableness of the DCF result), *on rehearing in part*, Public Service Company of NH, 90 NH PUC 542 (2005) (rehearing granted on other grounds), *rehearing denied*, Public Service Company of NH, 91 NH PUC 49 (2006).

[36] Testimony of Company's expert, Transcript Day 1, p. 66, lines 19-20.

[37] Company's direct testimony (Exhibit 9), bates p. 6, lines 15-16. See also, e.g., Testimony of Company's expert, Transcript Day 1, p. 68, lines 11-13 ("I would urge the Commission to consider the results of DCF, Risk Premium, and CAPM").

[38] See Exhibit 27, p. 9, lines 1-21,

[39] Appeal of Public Service Company of NH, 130 NH at 751 (citations omitted) (this rule reflects the general standard that "those who bear the risk must be compensated by a return on their investment that reflects the risk");

market-to-book ratio is significantly higher than one, it indicates that the expected return on equity, which is greatly influenced by the allowed rate of return for a regulated entity, exceeds the true opportunity cost of equity."[40] For some time this has been the case for the market-to-book ratio of the gas industry.[41] Therefore, methods like the CAPM and the RPM, which "largely rely on the appreciation in stock prices to determine the allowed return on equity[,]" tend to overestimate the true cost of equity.[42] Contrary to the required balance between shareholders and customers, "the resulting return would unreasonably benefit shareholders at the expense of ratepayers."[43]

The DCF method "better reflects investors' perception of a company's risk,"[44] and "is a well accepted way of explaining observed investor behavior."[45] The DCF method has been used in good and bad economic times,[46] and, in New Hampshire, the DCF model has been relied upon by PUC Staff in all cases concerning ROE in the last 10 years.[47] The DCF method has been "[t]he primary method used by [the PUC] to estimate the expected return on equity."[48] And this

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see also Exhibit 27, p. 7, lines 4-5 ("a fair and reasonable return on equity for a regulated utility would be the opportunity cost of equity").

[40] Exhibit 27, p. 4, lines 14-16.

[41] See Exhibit 27, p. 8, lines 6-7 (in the past ten years, "the average market-to-book-ratio of the gas industry has remained persistently above one").

[42] Exhibit 27, p. 4, lines 17-19.

[43] Exhibit 27, p. 8, lines 12-13.

[44] Exhibit 27, p. 27, lines 10-11,

[45] Exhibit 27, p. 5, line 11; see also Exhibit 27, p. 10, lines 3-5 (citation and internal quotation omitted) ("as far as techniques that are used to estimate the cost of equity are concerned, the [DCF] technique is one of the most popular of those currently in use"); and Testimony of Company's expert, Transcript Day 1, p. 110, lines 9-12 (DCF method is commonly applied in rate cases around the country).

[46] See Testimony of Company's expert, Transcript Day 1, p. 101, lines 7-11,

[47] See Exhibit 52.

[48] Public Service Company of NH, 90 NH PUC at 247 (2005), *citing* Verizon NH, 89 NH PUC 17 (2004); see Public Service Company of NH, 90 NH PUC 542 (2005) (affirming use of DCF consistent with "longstanding Commission precedent"); Pennichuck Water Works, Inc., 70 NH PUC 850 (1985) ("The Commission, in the past five years, has come to rely almost exclusively on the DCF method. Our knowledge of and experience with the other methodologies leads us to conclude that, in our judgment, DCF is the most reliable and consistent method in terms of its application and results."); and see also Testimony of Staff expert, Transcript Day 2, p. 111, lines 7-9.

past practice of using the DCF method is appropriate for the PUC to consider in determining the allowed ROE in this case.[49]

In this case, the Company's expert derived his recommend ROE by averaging the results of the DCF, CAPM and RPM methods, with equal weighting.[50] Although Staff's expert prefers the DCF construct, he calculated a revised range by using three point estimates: the average of the first three DCF estimates (9.33%); the average of the first three DCF estimates plus the market-to-book method (9.26%); and the average of the first three DCFs plus the market-to-book ratio method, plus the other two CAPM numbers (8.77%).[51] By using multiple ways of calculating the DCF, and giving weight to each, Staff accounted for the DCF's limitations,[52] and derived an ROE that primarily relies on the DCF construct, and produces a range of 8.77 – 9.33%.

The OCA supports Staff's methodology, as well as its recommendation that the PUC not diverge from its longstanding practice of calculating ROE.[53] Using the DCF methodology as the primary basis for determining ROE, and looking at the results of other methodologies to check the reasonableness of the DCF result, is consistent with the traditional rate of return regulation to obtain just and reasonable rates as set out in Hope and Bluefield, and will best serve the interests of the Company's shareholders and customers.

[49] See Testimony of Company's expert, transcript of final hearing, Day 1, p. 84, lines 18-22 (it is appropriate for the PUC to look at other decisions on ROE in assessing the reasonableness of the ROE recommendations in this case).
[50] See Exhibit 9, Attachment PRM-4.
[51] See Testimony of Staff's expert, Transcript Day 2, p. 217, lines 7-14. See also Exhibit 64, Attachment 2.
[52] See Testimony of Staff expert, Transcript Day 2, p. 11, lines 15-16; and p. 134, line 20, through p. 135, line 14; see also Exhibit 51, Attachments XI.
[53] See Exhibit 27, pp. 9-11; and p. 13, lines 9-10; see also Testimony of Staff expert, Transcript Day 2, pp. 11-14 (describing derivation of ROE range).

V. The proxy group recommended by Staff is most comparable to the Company, and the PUC should use Staff's proxy group to determine the Company's ROE.

"The first element in the DCF analysis to be considered is the selection of the appropriate proxy group."[54] "The challenge when selecting a proxy group is to narrow it sufficiently to reflect the risks faced by the company in question and at the same time find a large enough proxy group to bring confidence to the ultimate result by mitigating any distortion introduced by possible measurement error or vagaries in individual companies' market data."[55] The ROE experts in this case used many of the same criteria for choosing their proxy groups.[56] They differed on two criteria, however.

The Company's expert included in his proxy group companies having "a weather normalizing and/or decoupling feature to their tariff" and "at least 60% of their assets subject to utility regulation."[57] The Company's expert also identified certain financial risk measures that he used to compare the Company and those companies in his proxy group.[58]

The Staff's expert used 85% as the percentage of assets subject to state regulation, and did not use a weather normalizing or decoupling criteria to select companies for his proxy group.[59] In selecting his proxy, the Staff's expert also assessed for each proxy company and National Grid NH certain measures of financial risk, including some, if not all, of the measures that the

[54] Public Service Company of NH, 90 NH PUC at 247.
[55] Id. at 248.
[56] See Exhibit 27, p. 15, lines 11-6, and Exhibit 9, bates p. 5A, line 22, through bates p. 6, line 1.
[57] Exhibit 9, bates p. 5A, line 26, through bates p. 6, line 1; see also Exhibit 44 (Company expert's response to OCA 1-62 (c)).
[58] See Exhibit 9, pp. 12-16.
[59] Exhibit 27, p. 15, lines 13-14.

Company's expert identified.[60] Through this assessment, the Staff's expert confirmed that the financial risk of his proxy companies were comparable to the Company's financial risk.[61]

It is undisputed that 100% of the Company's assets are subject to state regulation.[62] Because the "assets screening criteria (the percentage of gas assets)…best describes the amount of capital that a firm devotes to each business segment[and it] is the potential return on that capital that represents the primary focus of investors when they value the securities of a firm,"[63] Staff's proxy group is more comparable to the Company.

By pointing to prior Staff testimony about ROE, the Company attempted unsuccessfully to portray the Staff expert's selection of 85% as arbitrary.[64] However, the Company's implication of arbitrariness was inapposite, as the prior testimonies used percentages of regulated <u>revenues</u> as opposed to regulated <u>assets</u>, which Staff's expert used in this case.[65] By moving from 60 percent of the regulated assets to 85 percent, when taken together with the comparable measures of financial risk, Staff's expert created a reasonable proxy for the Company.[66]

Staff's proxy group is more appropriate for another reason, too. Unlike those in the Company's proxy, the Company does not have a weather normalizing or decoupling feature to its tariff.[67] Without a weather normalizing or decoupling feature to their tariffs, the companies in

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[60] <u>See</u> Testimony of Staff's expert, Transcript Day 2, p. 169, line 20, through p. 170, line 13; and p. 171, lines 6-8.
[61] Id. at p. 170, line 16-19.
[62] Exhibit 27, p. 16, lines 3-4; <u>see also</u> Exhibit 46 (Company expert's response to OCA 2-23); and Testimony of Staff's expert, Transcript Day 2, p. 59, line 10, through p. 60, line 1 (100% of ENGI's assets are regulated).
[63] Exhibit 9, bates p. 1, lines 13-16.
[64] <u>See</u> Testimony of Staff's expert, Transcript Day 2, p. 161, line 24, through, p. 164, line 8.
[65] <u>See</u> Testimony of Staff's expert, Transcript Day 2, p. 164, line 9, through, p. 165, line 15.
[66] <u>See</u> Testimony of Staff's expert, Transcript Day 2, p. 170, lines 14-20. <u>See also</u> Testimony of Staff's expert, Transcript Day 2, p. 61, line 23, through p. 63, line 3.
[67] Exhibit 27, p. 15, lines 21-22.

the Staff's proxy group are more comparable to National Grid New Hampshire than those in the Company's proxy group with such tariff features.[68]

Moreover, the Company's revenues and income are 100% regulated. In contrast, the average regulated revenues and income for the Company's proxy are 66.26% and 69.47%, respectively.[69] The Company's proxy group includes three companies with regulated revenues and income below 60% and 67%, respectfully.[70] Staff's expert excluded these three companies from its proxy group.[71] The Staff's proxy companies also have averages of regulated revenues and income that are closer to the percentages of regulated revenues and income of the Company: 76% and 77.2%, respectively. See Exhibit 54. Because the percentages of regulated revenues and income for the Company's proxy group are lower than Staff's, and lower still than the Company's percentages of revenues and income, the Company's proxy group is "too dissimilar to use as a proxy" for the Company.[72]

VI. The Company did not sustain its burden of proving that leverage adjustment was required to produce a reasonable ROE. The PUC should therefore reject this proposed adjustment.

The Company proposes to adjust its ROE upward to account for the risk associated with the Company's leverage, or outstanding debt.[73] The Company posits that investors require additional compensation "for differences in risk when the book value capital structure contains

[68] See Testimony of Staff's expert, Transcript Day 2, p. 165, line 16, through p. 166, line 17; and p. 167, lines 6-11.
[69] See Exhibit 44.
[70] See Exhibit 44 (AGL Resources, Inc., 55.97% regulated revenues and 66.81% regulated income; New Jersey Resources Corp., 34.51% revenues and 60.10% regulated income; and South Jersey Industries, Inc., 55.70% regulated revenues and 55.70% regulated income). See also Exhibit 54.
[71] See, e.g., Exhibit 27, p. 16, lines 9-11.
[72] See, e.g., Public Service Company of NH, 90 NH PUC at 248 (proxy group used by PSNH's expert was "too dissimilar to use as a proxy for PSNH, in that the group contains some utilities with extremely low percentages of revenues derived from regulated electricity sales").
[73] See Exhibit 9, bates p. 23, lines 15-17.

more financial leverage than the market value capital structure."[74] Without the leverage adjustment, the Company contends that the DCF results compensate an investor only for a return on a capital structure of 100% equity.[75]

Staff opposes the proposed leverage adjustment on the grounds that it unfairly benefits the Company's investors at the expense of its customers.[76] Staff's expert also characterizes the leverage adjustment as an attempt by the Company's expert to increase the requested return on equity in a manner that is "inconsistent with the basics of finance and reasonable application of statistical concepts."[77] The OCA concurs with Staff.

The risk related to leverage is not atypical of the gas distribution industry as a whole, and is known to investors. For instance, investors are aware that gas utilities must continually invest in their infrastructure, and that the costs associated with these investments are not completely generated internally.[78] Investors are also aware of and take into consideration risks indicated by a company's capital structure, which includes a proportion of long-term debt as well as equity.[79] Consequently, leverage risk is captured in the stock price that forms the basis for the DCF calculation.[80] In other words, the risk associated with leverage should already be incorporated

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[74] See Exhibit 9, bates p. 23, lines 15-17; see also Company's rebuttal testimony (Exhibit 33), p. 22, lines 5-7.
[75] See Exhibit 9, bates p. 24, line 26, through bates p. 25, line 4; and bates p. 27, lines 5-7.
[76] See Exhibit 27, p. 4, lines 19-22 ("leverage adjustments as proposed by Mr. Moul would only further encourage the stock price to deviate away from the book value, at the expense of retail customers and to the advantage of investors"); and p. 11, lines 13-16 ("permitting an upward leverage adjustment to the … cost of equity estimate that already exceeds the market cost of equity …would further inappropriately increase the transfer of wealth from ratepayers to shareholders").
[77] Testimony of Company expert, Transcript Day 2, p. 21, lines 20-23.
[78] See Exhibit 9, bates p. 9, lines 11-12; bates p. 10, lines 7-11; and bates p. 15, lines 8-12 (infrastructure investment and ability of company to fund investment through internally generated funds are "qualitative" and "quantitative" factors considered by investors in determining risk); and Testimony of Stavropoulos, Transcript Day 2, p. 69, lines 21-23 (Company has doubled the size of rate base since the last rate case).
[79] See Exhibit 9, bates p. 13, lines 17-20, and bates p. 10, lines 7-11.
[80] See Pennichuck Water Works, Inc., 70 NH PUC at 863 (in denying a risk adjustment based upon smaller size and higher financial leverage, the PUC notes "[t]his risk has already been analyzed and accounted for by investors in the market price they are willing to pay for common stock).

into the DCF result.[81] Therefore, allowing an adjustment to ROE for leverage risk, as proposed by the Company, would amount to double recovery.

Moreover, in selecting the companies for his proxy group, the Company expert did not discriminate based on the actual capital structure of these companies.[82] A look, however, at the average capital structure for the Company's proxy group, reveals that it is not much different than the capital structure that will be used to set the Company's rates in this case (*i.e.*, 47.2%/52.4% debt to equity for proxy group; 50/50 for Company per Order 24,777 in DG 06-107).[83] Also, the five-year average common equity ratios, based on permanent capital, for the Company and the Company's proxy were not much different (*i.e.*, 56.9% v. 52.4%).[84] As the Company's expert observed, "[o]n balance, the [financial] risk factors [of the Company and the proxy group] average out."[85] Therefore, an adjustment to results of the DCF method to reflect different amounts of leverage is not appropriate.

Lastly, the Company agreed in a settlement agreement to the imputed capital structure in exchange for approval of the merger of Keyspan and National Grid.[86] The Company fully and actively participated in the merger proceedings, and benefited from the negotiated resolution approved by the PUC. It is unreasonable and unfair for the Company to now complain about the harms its shareholders will suffer if the PUC does not allow an upward adjustment due to the

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[81] See Exhibit 9, bates p. 7, lines 3-5 (DCF, as a "market measure[] of the cost of equity … reflect[s] fundamentals present in the stock and bond markets"); and bates p. 22, lines 13-14 (results of the DCF are based on the market price of the stock of the companies analyzed).
[82] See Exhibit 9, bates p. 5A, line 22, through bates p. 6, line 1.
[83] See Exhibit 9, Attachment PRM-12.
[84] See Exhibit 9, bates p. 13, line 22, through bates p. 14, line 1.
[85] Exhibit 9, bates p. 15A, lines 6-7.
[86] See National Grid plc, 92 NH PUC 279 (2007) (order approving settlement agreement filed by Companies, PUC Staff and OCA).

higher debt in the agreed-to capital structure. Consequently, for all of the reasons discussed above, the PUC should reject the proposed leverage adjustment.

VII. The Company did not sustain its burden of proving that the floatation adjustment was required to produce a reasonable ROE. The PUC should therefore reject this proposed adjustment.

The Company recommends that the PUC add an adjustment to the ROE for floatation costs.[87] Staff opposes the proposed floatation cost adjustment.[88] The OCA concurs with Staff.

Floatation costs typically relate to the issuance of new common equity.[89] Floatation costs are not actual expenses of the Company.[90] The PUC "has historically denied the inclusion of such an adjustment to the return on equity."[91] "Also, when the market-to-book ratio is significantly higher than one, [as is the case with gas utility stocks,] DCF and other methods produce sufficiently upward-biased estimates of the market cost of equity… that [the] dilution of stocks, which is the reason why flotation costs usually become relevant, is a non-issue."[92]

Notwithstanding the Company's assertions about Value Line forecasts and industry history concerning new equity issuances,[93] the Company has no plans to issue new common equity in the next few years, except to "satisfy its employee stock programs."[94] "[L]acking any evidence

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[87] Exhibit 9, bates p. 27, lines 21-22, and Attachment PRM-6.
[88] Exhibit 27, p. 12, line 16, through p. 13, line 4.
[89] See Public Service Company of NH, 90 NH PUC at 555.
[90] See, e.g., Public Service Company of NH, 90 NH PUC at 250 (In denying an adjustment for floatation costs advocated by the company, the PUC noted that Staff and OCA ROE experts argued that "issuance costs are not actual expenses of the Company. Instead, these costs are borne by the underwriter who recovers them by paying the issuing utility a price per share that is less than the offering price.").
[91] Id.; and see Public Service Company of NH, 90 NH PUC at 555 ("Consistent with the longstanding practice[,]" the PUC rejected an upward adjustment to ROE proposed by the Company to account for flotation costs).
[92] Exhibit 27, p. 12, line 21, through p. 13, line 1.
[93] See Exhibit 33, p. 18, lines 12-17.
[94] Exhibit 45 (Company expert's response to OCA 1-67); and Testimony of Nicholas Stavropoulos, Transcript Day 2, p. 81, lines 9-12.

of actual or planned [new equity] issuances," the PUC should not adjust upward the Company's allowed ROE to compensate it for floatation costs.[95] Therefore, the PUC should also deny the Company's request to adjust the allowed ROE upward for floatation costs.

VIII. The Company did not support its argument that the volatility in the market generally is reflective of the volatility of the proxy companies' stocks, or the Company's stocks. The PUC should therefore not adjust the allowed ROE for volatility.

The Company's expert painted a bleak picture of the market generally, and suggested that volatility of the market requires the PUC to set a higher allowed ROE for the Company.[96] However, there is no evidence in the record to suggest that the equity of the proxy companies has experienced similar volatility.[97] To the contrary, the evidence shows that during the recent period of economic instability, the common equity of the proxy companies has been much less volatile, to the point of being nearly stable, than the market generally.[98] Between January 2008

[95] Verizon NH, 89 NH PUC at 40 (2004), *citing* Pennichuck Water Works, Inc., 70 NH PUC at 862, 863.
[96] See Exhibit 33, pp. 3-4; and pp. 11-12; se also, Testimony of Company's expert, Transcript Day 1, p. 73, line 10 through p. 74, line 5.
[97] See Testimony of Company's expert, Transcript Day 1, p. 85, 3-13 (VIX index measures implied volatility of S&P 500 index options, which include public utilities only "to the extent that utilities are embedded in the 500"); p. 85, lines 15-18 (there are "no specific measures explicitly about the volatility of public utility equity"); p. 106, lines 3-7 (Company's expert did not look at whether volatility associated with the gas utilities was significantly different from the volatility present in the market as a whole); and Testimony of Staff expert, Transcript Day 2, p. 39, line 21, through p. 40, line 11 (issue is volatility of proxy companies, not market generally); and p. 41, lines 19-20 ("Company's expert did not provide any volatility estimates for the gas proxies").
[98] See Exhibits 65 and 67. See also Testimony of Company's expert, Transcript Day 1, p. 135, 21-23 ("Utilities certainly aren't being impacted to the same degree as other types of competitive, non-regulated companies in our economy."); and p. 136, lines 21-24 ("utilities can expect to realize higher profits during bad economic times perhaps that are better than other companies that are suffering during an economic crisis, such as we have today"); and Testimony of Staff's expert, Transcript Day 2, p. 50, line 5, through p. 51, line 6 (volatility associated with the gas proxies is not as high as the volatility associated with the market, proxies' stocks are more attractive in terms of being less risky now, Price Stability Index for proxy companies at highest level); and p. 206, lines 1-13 (stock prices of Staff's proxy companies have been "relatively stable").

and January 2009, while the Dow Jones Industrial Average declined 32%,[99] the companies in Staff's proxy group increased slightly.[100]

It is also undisputed that utilities have lower business risk than unregulated companies.[101] More specifically, we know that National Grid NH is "a very low risk business."[102] Consequently, the evidence in the record supports the conclusion that public utility stocks are among the destinations in investors' "flight to quality."[103]

For the sake of argument, even if it were not the case that the proxy companies stocks have experienced less volatility, to some extent, the market price reflects the volatility of the market, which is reflected in the results of the DCF.[104] Consequently, there is no reason to adjust upward the allowed ROE to account for volatility.[105]

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[99] See Exhibit 67. This exhibit also shows that the Dow Jones Utilities Average declined by 25% between January 2008 and January 2009. However, because the Dow Jones Utilities Average does not include any gas distribution companies, it is not a good indicator of the Company's risk. See Exhibit 66 (shows the "components" of the Dow Jones Utilities Average, and there are no gas utilities); and Transcript Day 2, p. 220, line 14-19.

[100] See Exhibit 65.

[101] See Testimony of Company's expert, Transcript Day 1, p. 111, lines 8-12; and Exhibit 51, Attachment XII (average beta of proxy companies is .69 compared to current median beta for Value Line companies of 1.11); see also Testimony of Staff's expert, Transcript Day 2, p. 62, line 4, through p. 63, line 1 (beta measures market risk); and p. 199, lines 19-24 (proposition that "utilities are lower risk than companies in the market generally" is not debated by economists).

[102] Testimony of Stavropoulos, Transcript Day 2, p. 72, line 16.

[103] See Testimony of Staff's expert, Transcript Day 2, p. 56, line 11, through p. 57, line 2 (utility stocks are "safe harbors" in volatile market); and p. 200, lines 1-8 (in difficult economic times, investors tend to gravitate toward public utility stocks).

[104] See Testimony of Company's expert, Transcript Day 1, p. 128, lines 1-24; and see Testimony of Staff's expert, Transcript Day 2, p. 40, line 18, through p. 41, line 13; p. 51, lines 9-13 (DCF includes investors' expectations about volatility); p. 108, lines 15-18 ("investors have all internalized a lot of factors in coming up with their sense of what the -- what the cost of equity is"); and p. 109, lines 7-10 ("DCF approach, that has in-built characteristics to it that really responds to what investors think the realities are and investors' expectations"). See also Exhibit 67.

[105] See Testimony of Staff's expert, Transcript Day 2, p. 20, lines 14-20 ("When the economy is in a downturn or recession, regulated stocks are more attractive relative to the market portfolio, and regulated stocks tend to attract interest at the expense of riskier investments. This relatively tends to put a downward pressure on the required return on regulated stocks."); and Exhibit 33, p. 6 (flight to quality translates into lower yields).

IX. The ROEs cited by the Company from other jurisdictions are not binding on the PUC or determinative of the allowed ROE of the Company.

The Company urged the PUC to consider, in making its determination of the Company's allowed ROE, numerous ROEs set by other regulatory agencies in other jurisdictions.[106] Such a "bald comparison" between the Company and these other companies is flawed.[107]
The ROEs set in other jurisdictions may combine with and reflect business, regulatory or financial risk differences of those other jurisdictions that do not apply to New Hampshire, or to utilities operating within New Hampshire. For instance, are these other jurisdictions like New Hampshire in its experience as a "leader in the national economy, perform[ing] well and not get[ting] hurt as much as the rest of the economy[?]"[108] There is also no evidence in the record as to whether ROE was litigated or the result of a settlement in the other jurisdictions.[109]
Presuming that it could consider an ROE from another jurisdiction without a circular effect, which is questionable,[110] the PUC would need additional information.[111] Therefore, without a complete picture of the companies cited by the Company and the cases in which the ROEs were decided, the rate of profit allowed these other utilities by regulatory agencies in other jurisdictions is simply not useful to PUC's determination of the Company's current cost of common equity.[112]

[106] Exhibit 9, bates p. 9; and Exhibit 55.
[107] Public Service Company of NH, 90 NH PUC at 556.
[108] Testimony of Stavropoulos, Transcript Day 2, p. 91, lines 17-22.
[109] See Exhibit 47.
[110] See Testimony of Staff's expert, Transcript Day 2, p. 219, lines 8-14 (reliance on ROE determinations in other jurisdiction results in circularity).
[111] See Testimony of Company's expert, Transcript Day 1, p. 94, line 18 through p. 95, line 11.
[112] See Public Service Company of NH, 90 NH PUC at 555 (internal quotations and citation omitted) ("[T]he evidence relating to rates elsewhere has no conclusive probative force…In other words, nothing in any of the applicable reported case law, and nothing in any of the various methodologies that we have applied, rules out the possibility that the ultimate answer will be different from the allowed returns of the companies in the proxy group."); and see also Testimony of Staff's expert, Transcript Day 2, p. 190, line 19, through p. 191, line 24.

X. The PUC should approve the "zone of reasonableness" recommended by Staff and select an allowed ROE within that range.

The Company originally recommended an allowed ROE of 11.5%.[113] In rebuttal testimony, however, the Company increased its recommendation to 12.25%.[114] The Company's recommendations include the proposed leverage and floatation cost adjustments,[115] which are not appropriate for the reasons discussed above. Without the leverage and floatation cost adjustments, the Company's revised DCF ROE is therefore 9.77%.[116]

With primary reliance on the DCF construct, the Staff recommends a range for the allowed ROE of 8.77 to 9.33%.[117] Unlike the Company's recommendation, Staff's recommendation does not include any upward adjustments for leverage or floatation costs,[118] and is also based upon more updated data than the Company's recommendation.[119] Staff's recommended range is also "conservative" if not on the "higher side."[120]

Because the rates resulting from the use of the approved ROE must be just and reasonable, it is appropriate for the PUC to look at the rate impacts at different ROE levels. There is no calculation in the record to show what the rate impact will be at the Staff's recommended ROE. However, there is some information from which the PUC can get a general sense of the impact.

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[113] See Exhibit 9, bates p. 4, lines 21-22.
[114] See Exhibit 33, p. 3, lines 7-8.
[115] See, e.g., Exhibit 33, Attachment PRM 21 (calculation of revised recommendation)
[116] Testimony of Company's expert, Transcript Day 1, p. 104, lines 21-22.
[117] Testimony of Staff expert, Transcript Day 2, p. 14, lines 10-13; and Exhibit 51, Attachment XI (Staff expert's updated DCF ROE Estimates).
[118] Testimony of Staff expert, Transcript Day, 2, pp. 19, lines 12-14.
[119] See, e.g., Testimony of Staff expert, Transcript Day 2, pp. 14-16 (Staff's data from December 2008 and January 2009); and Testimony of Company expert, Transcript Day 1, p. 90, lines 9-14 (Company expert's updated testimony date December 15, 2008 and uses data from September 2008).
[120] Testimony of Staff expert, Transcript Day 2, p. 20, lines 4-11; and see Testimony of Staff expert, Transcript Day 2, p. 21, lines 5-15 (the economic situation in New Hampshire indicates that the Company faces less risk than the companies in Staff's proxy group); p. 54, lines 8-9 (Staff's estimate is "definitely reasonably higher than the opportunity cost of equity"); p. 172, line 8, through p. 173, line 2 (explaining intent of the word "conservative" to describe ROE recommendation); and p. 209, lines 10-12 (Staff experts approach includes "building in slack" to the ROE to "ensure that investors stay interested in the business").

At the Company's recommended ROE of 12.25%, total bills for residential heating customers will increase by between 2.41% and 51.11% from the permanent rates last set for the Company.[121] At an ROE of 9.01%, which is 32 basis points lower than the upper point of Staff's recommended ROE range, residential heating customers' total bills will increase by between 0.29% and 39.27% from the permanent rates last set.[122] A look at the impact of these two ROEs, 9.01% and 12.25%, on the proposed customer charge shows an increase of 39.27% and 51.11%, respectively.[123]

In fulfilling its obligation to balance the interests of investors and ratepayers when determining the ROE, the PUC should also be mindful that the Company's expert and analysis are not objective and disinterested.[124] Unlike the Company's expert, Staff's expert considered the interests of shareholders and customers in calculating his recommended ROE.[125] In coming up with his recommendations, Staff's expert also consciously considered "not being overly restrictive or … penalizing the Company."[126] And, although Staff expert's "preferred approach

[121] Exhibit 43, pp. 3 and 4; and see Testimony of Ann Leary, Transcript Day 1, pp. 32-37 (explanation of Exhibits 42 and 43), and p. 44, lines 12-18 (defining "Present Rate" as used in Exhibits 42 and 43 as those rates in effect during the test year).

[122] Exhibit 42, pp. 3 and 4; and see Testimony of Ann Leary, Transcript Day 1, pp. 32-37 (explanation of Exhibits 42 and 43), and p. 44, lines 12-18 (defining "Present Rate" as used in Exhibits 42and 43 as those rates in effect during the test year).

[123] Exhibit 42, p. 3 (line 1, column 7) and 43, p.3 (line 1, column 7).

[124] See, e.g., Testimony of Company's expert, Transcript Day 1, p. 91, lines 11-17 (Company's expert works primarily for utilities).

[125] See, e.g., Exhibit 27, p. 7, lines 6-10 ("Intrinsic to the determination of the allowed return is the need to avoid unnecessary wealth transfer from ratepayers to shareholders. To properly balance the interests of ratepayers and the financial viability of the utility, any approach to determine the cost of equity must reasonably target the need to encourage investment in the utility's equity at the least cost to its ratepayers."); and Testimony of Staff expert, Transcript Day 2, p. 21, lines 15-18.

[126] Testimony of Staff's expert, Transcript Day 2, p. 114, lines 12-16.

is the one that uses only the DCF ROE estimates[,]"[127] he did give some weight to his CAPM results in coming up with a recommended range for ROE.[128]

The Company's last distribution rate case was more than 15 years ago.[129] There is no telling when the Company will come back to the PUC for another distribution rate case after the pending case concludes.[130] Although the OCA generally agrees with the Company that "the return on equity that's set should be realistic and fair, based upon circumstances that are in place today and for the foreseeable future,"[131] the ROE needs to be "reasonably durable[,]"[132] particularly in light of the uncertainty about how long it will apply and the fact that this is a "unique time in the market."[133]

Taking all of these considerations into account, in addition to approving the methodology used by the Staff's expert as well as its proxy group, the PUC should approve the ROE range recommended by Staff and select an allowed ROE from within that range.

XI. Conclusion

For the reasons set forth above, the OCA respectfully requests that the Commission approve the partial settlement agreement, and adopt Staff's recommendation in setting the Company's ROE.

[127] See Testimony of Staff expert, Transcript Day 2, p. 125, lines 23-24,
[128] See, e.g., Testimony of Staff expert, Transcript Day 2, p. 126, lines 14-18.
[129] Testimony of Stavropoulos, Transcript Day 2, p. 88, lines 9-15.
[130] See, e.g., Testimony of Stavropoulos, Transcript Day 2, p. 88, lines 17-18 ("it varies"); and p. 89, lines 9-10 ("we're not a company that constantly files for increases").
[131] Testimony of Stavropoulos, Transcript Day 2, p. 89, lines 1-3.
[132] Question of Commissioner Below, transcript of final hearing, Day 2, p. 88, lines 19-24.
[133] Testimony of Company's expert, Transcript Day 2, p. 90, lines 12-13.

Respectfully submitted,
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Date: February 20, 2009

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