

with the DCF method, after which I consider the RP, CAPM and CE methods. I believe that these other methods are more reliable indicators of the cost of common equity in the present environment. In fact, if one looks at the results of the four methodologies, it is apparent that the DCF model produces a result that is significantly different than the other methodologies. The relationship of the DCF results to the other methods should raise questions about the reliability of the DCF method in this environment and the emphasis that should be placed on it in selecting an allowed rate of return on common equity in this case.

9 **Q. In your opinion, what factors should the Commission consider when**  
10 **determining the Company's cost of capital in this proceeding?**

11 A. The Commission should consider the ratesetting principles that I have set forth in  
12 Attachment PRM-2. In this regard, the Commission's rate of return allowance must  
13 be set to cover the Company's interest and dividend payments, provide a  
14 reasonable level of earnings retention, produce an adequate level of internally  
15 generated funds to meet capital requirements, be commensurate with the risk to  
16 which the Company's capital is exposed, support reasonable credit quality, and  
17 allow the Company to raise capital on reasonable terms.

18 **Q. What factors have you considered in measuring the cost of equity in this**  
19 **case?**

20 A. The models that I used to measure the cost of common equity for the Company  
21 were applied with market and financial data developed for my proxy group of seven  
22 natural gas companies. The proxy group consists of companies that: (i) are  
23 engaged in the natural gas distribution business, (ii) have publicly-traded common  
24 stock, (iii) are contained in The Value Line Investment Survey, (iv) have not  
25 recently cut or omitted their dividend, (v) are not currently the target of a merger or  
26 acquisition, (vi) operate with a weather normalization and/or decoupling feature to

1 several important aspects, principally related to its smaller size, its more variable  
2 earned returns, and its weaker interest coverages, the Company's risk is higher  
3 than that of the Gas Group. Its common equity ratio for ratesetting purposes,  
4 operating ratios, quality of earnings, and IGF to construction are fairly similar to the  
5 Gas Group. Overall, some risk indicators suggest higher risk for National Grid NH,  
6 while others indicate about the same risk. On balance, the risk factors average  
7 out, indicating that the cost of equity for the Gas Group would provide a reasonable  
8 basis for measuring the Company's cost of equity for this case.

#### 9 COST OF EQUITY – GENERAL APPROACH

10 **Q. Please describe the process you employed to determine the cost of equity**  
11 **for the Company.**

12 **A. Although my fundamental financial analysis provides the required framework to**  
13 **establish the risk relationships between National Grid, the Gas Group and the S&P**  
14 **Public Utilities, the cost of equity must be measured by standard financial models**  
15 **that I describe in Attachment PRM-4. Differences in risk traits, such as size,**  
16 **business diversification, geographical diversity, regulatory policy, financial**  
17 **leverage, and bond ratings must be considered when analyzing the cost of equity**  
18 **indicated by the models.**

19 It also is important to reiterate that no one method or model of the cost of  
20 equity can be applied in an isolated manner given the constraints associated with  
21 each method/model (see Attachment PRM-4). Rather, informed judgment must be  
22 used to take into consideration the relative risk traits of the firm. It is for this reason  
23 that I have used more than one method to measure the Company's cost of equity,  
24 and that I favor considering the results from a variety of methods. In this regard, I  
25 applied each of the methods with data taken from the Gas Group and have arrived  
26 at a cost of equity of 11.50% for National Grid NH.