

PENNSYLVANIA-AMERICAN WATER COMPANY

Northeast Wastewater Division

Docket No. R-2010-2166214

Direct Testimony

Of

Paul R. Moul, Managing Consultant
P. Moul & Associates

Concerning

Cost of Equity

Date: April 23, 2010

PENNSYLVANIA-AMERICAN WATER COMPANY

Northeast Wastewater Division

Direct Testimony of Paul R. Moul

Table of Contents

	<u>Page No.</u>
INTRODUCTION AND SUMMARY OF RECOMMENDATION	1
FUNDAMENTAL RISK ANALYSIS	5
COST OF EQUITY – GENERAL APPROACH	11
DISCOUNTED CASH FLOW ANALYSIS	12
RISK PREMIUM ANALYSIS	26
CAPITAL ASSET PRICING MODEL	31
COMPARABLE EARNINGS APPROACH	36
CONCLUSION ON COST OF EQUITY	39
Appendix A - Educational Background, Business Experience and Qualifications	
Appendix B - Ratesetting Principles	
Appendix C - Evaluation of Risk	
Appendix D - Cost of Equity - General Approach	
Appendix E - Discounted Cash Flow Analysis	
Appendix F – Interest Rates	
Appendix G - Risk Premium Analysis	
Appendix H - Capital Asset Pricing Model	
Appendix I - Comparable Earnings Approach	

GLOSSARY OF ACRONYMS AND DEFINED TERMS

ACRONYM	DEFINED TERM
AFUDC	Allowance for Funds Used During Construction
AWCC	American Water Capital Corporation
AWW	American Water Works Company, Inc.
b	Represents the retention rate that consists of the fraction of earnings that are not paid out as dividends
β	Beta
b x r	Represents internal growth
CAPM	Capital Asset Pricing Model
CCR	Corporate Credit Rating
CE	Comparable Earnings
DCF	Discounted Cash Flow
EPA	Environmental Protection Agency
FOMC	Federal Open Market Committee
g	Growth rate
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IGF	Internally generated funds
lev.	Leverage modification
M&A	Merger and Acquisition
PAWC	Pennsylvania-American Water Company
PEDFA	Pennsylvania Economic Development Financing Authority
PUC	Public Utility Commission
r	Represents the expected rate of return on common equity
Rf	Risk-free rate of return
Rm	Market risk premium
RP	Risk Premium
s	Represents the new common shares expected to be issued by a firm

DIRECT TESTIMONY OF PAUL R. MOUL

INTRODUCTION AND SUMMARY OF RECOMMENDATION

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

2 A. My name is Paul Ronald Moul. My business address is 251 Hopkins Road,
3 Haddonfield, New Jersey 08033-3062. I am Managing Consultant at the firm P.
4 Moul & Associates, an independent financial and regulatory consulting firm. My
5 educational background, business experience, and qualifications are provided in
6 Appendix A that follows my direct testimony.

7 **Q. What is the purpose of your testimony?**

8 A. My testimony presents evidence, analysis and a recommendation concerning the
9 appropriate rate of return on common equity that the Pennsylvania Public Utility
10 Commission ("PUC" or the "Commission") should recognize in the determination of
11 the revenues that Pennsylvania-American Water Company ("PAWC" or the
12 "Company") should realize as a result of this proceeding. My analysis and
13 recommendation are supported by the detailed financial data contained in Exhibit
14 No. 9-A, which is a multi-page document divided into eleven (11) schedules.
15 Additional evidence, in the form of appendices, follows my direct testimony. The
16 items covered in these appendices provide additional detailed information
17 concerning the explanation and application of the various financial models upon
18 which I rely.

19 **Q. Based upon your analysis, what is your conclusion concerning the cost of
20 common equity and overall rate of return for the Company in this case?**

21 A. My conclusion is that the Company's cost of common equity is 11.75%. For the
22 purpose of this proceeding, the Company has selected an 11.50% cost of equity in
23 calculating its requested overall rate of return in order to minimize the impact of the
24 proposed increase on customer rates. As shown on Schedule 1, the Company has

DIRECT TESTIMONY OF PAUL R. MOUL

1 proposed a 8.85% overall rate of return that includes the lower equity return. The
2 calculation of the weighted average cost of capital requires the selection of
3 appropriate capital structure ratios and a determination of the cost rate for each
4 capital component. The Company's capital structure ratios and embedded costs of
5 long-term debt and preferred stock are taken from the direct testimony of Mr. Rod
6 Nevirauskas, the Company's Director of Rates and Regulation. The resulting 8.85%
7 overall rate of return, when applied to the Company's rate base, will provide a
8 compensatory level of return for the use of capital and, if achieved, will provide the
9 Company with the ability to attract capital on reasonable terms.

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

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

19 **Q. Please briefly describe the Company.**

20 A. PAWC is a wholly owned subsidiary of American Water Works Company, Inc.,
21 ("AWW"), the nation's largest water utility holding company. AWW has 25 water
22 utility subsidiaries that operate in 23 states. On November 24, 2009, RWE AG
23 completed the divestiture of its interest in AWW. AWW is now an entirely
24 independent publicly-traded company.

25 At year-end 2009, PAWC provided wastewater service to 3,911 customers in

DIRECT TESTIMONY OF PAUL R. MOUL

1 its Northeast region.

2 **Q. How have you determined the cost of equity for the Company?**

3 A. My recommended cost of equity is established using capital market and financial
4 data relied upon by investors when assessing the relative risk, and hence cost of
5 equity, for a water utility, such as PAWC. In analyzing the Company's cost of
6 equity, I have relied on four well-recognized measures: the Discounted Cash Flow
7 ("DCF") model, the Risk Premium ("RP") analysis, the Capital Asset Pricing Model
8 ("CAPM"), and the Comparable Earnings ("CE") approach. By considering the
9 results of a variety of approaches, my analysis is consistent with well-recognized
10 principles for determining a fair rate of return.

11 I have measured the cost of equity for the Company using data from a proxy
12 group of seven water companies that are identified on page 2 of Schedule 3. I have
13 used water utilities to measure the cost of equity for the Northeast wastewater
14 division because there are insufficient data for wastewater utilities with traded stock
15 that could be used in an analysis such as this. Moreover, of all utility types, the
16 water utilities are probably most similar to the wastewater utilities. The group of
17 water utilities that I have assembled have the following common characteristics: (i)
18 they are listed in the "Water Utility Industry" section (basic and expanded editions) of
19 The Value Line Investment Survey, (ii) their stock is publicly traded, and (iii) they are
20 not currently the target of a publicly-announced merger or acquisition. I will refer to
21 my proxy group of seven water companies as the "Water Group." In assembling my
22 Water Group, I specifically excluded Southwest Water Company. As a preliminary
23 matter, Southwest Water Company should be excluded because it reduced its
24 quarterly dividend payment in the first quarter of 2009, which is an unusual
25 occurrence for a water company. Further, Southwest Water should not be included

DIRECT TESTIMONY OF PAUL R. MOUL

1 in a barometer group because on March 2, 2010, it announced that it had agreed to
2 be acquired by a group of institutional investors, thereby taking the company private.
3 Upon completion of the acquisition, the common stock of Southwest Water will stop
4 trading. Indeed, it would be inappropriate to include a company that is a target of a
5 takeover in a proxy group because the stock price of that company usually
6 disconnects from its underlying fundamentals.

7 **Q. Please summarize the basis for your cost of equity recommendation in this**
8 **proceeding.**

9 A. My recommendation is derived from the results of the four methods/models
10 previously identified. In general, the use of more than one approach provides a
11 superior foundation to arrive at the cost of equity. At any point in time, any single
12 method can provide an incomplete measure of the cost of equity depending upon
13 extraneous factors which may influence market sentiment. The specific application
14 of these methods/models will be described later in my testimony.

15 The following table provides a summary of the indicated costs of equity using
16 each of these approaches.

DIRECT TESTIMONY OF PAUL R. MOUL

	<u>Water Group</u>
DCF	11.71%
Risk Premium	11.50%
CAPM	12.01%
Comparable Earnings	12.60%
Average	11.96%
Median	11.86%
Mid-point	12.05%

1 Focusing upon the DCF, RP and CAPM results (i.e., the market-based models), a
2 reasonable cost of common equity is 11.75% (i.e., $11.71\% + 11.50\% + 12.01\% =$
3 $35.22\% \div 3 = 11.74\%$). My recommended cost of equity makes no provision for the
4 prospect that the rate of return may not be achieved due to unforeseen events, such
5 as unexpected spikes in expenses, abrupt changes in customer usage, and
6 abnormal weather events. Furthermore, general inflationary pressures can produce
7 cost increases that will negatively impact the Company's return unless provision for
8 them is recognized in the ratesetting process.

FUNDAMENTAL RISK ANALYSIS

10 **Q. Is it necessary to conduct a fundamental risk analysis to provide a framework**
11 **for a determination of a utility's cost of equity?**

12 A. Yes. It is necessary to establish a company's relative risk position within its industry
13 through a fundamental analysis of various quantitative and qualitative factors that
14 bear upon investors' assessment of overall risk. The items that influence investors'

DIRECT TESTIMONY OF PAUL R. MOUL

1 evaluation of risk and their required returns are described in Appendix C. For this
2 purpose, I have compared the Company to the S&P Public Utilities, an industry-wide
3 proxy consisting of various public utility endeavors, and the Water Group.

4 **Q. What are the components of the S&P Public Utilities?**

5 A. The S&P Public Utilities is a widely recognized index which is comprised of electric
6 power and natural gas companies. These companies are identified on page 3 of
7 Schedule 4.

8 **Q. Is knowledge of a utility's bond rating an important factor in assessing its risk
9 and cost of capital?**

10 A. Yes. Knowledge of a company's credit quality rating is important because the cost
11 of each type of capital is directly related to the associated risk of the firm. So while
12 a company's credit quality risk is shown directly by the rating and yield on its bonds,
13 these relative risk assessments also bear upon the cost of equity. This is because a
14 firm's cost of equity is represented by its borrowing cost plus compensation to
15 recognize the higher risk of an equity investment compared to debt.

16 **Q. How do the bond ratings compare for the Company, the Water Group and the
17 S&P Public Utilities?**

18 A. On February 17, 2009, PAWC obtained an A3 credit quality rating from Moody's
19 Investors Service and a BBB+ rating from Standard & Poor's Corporation. This
20 rating was obtained in connection with the Company's issuance of debt through the
21 Pennsylvania Economic Development Financing Authority ("PEDFA"). The average
22 credit quality rating for the Water Group is an A from S&P and A2 from Moody's.
23 For the S&P Public Utilities, the average composite rating is BBB+ by S&P and
24 Baa1 by Moody's. Many of the financial indicators that I will subsequently discuss
25 are considered during the rating process.

DIRECT TESTIMONY OF PAUL R. MOUL

1 Q. How do the financial data compare for PAWC, the Water Group, and the S&P
2 Public Utilities?

3 A. The broad categories of financial data that I will discuss are shown on Schedules 2,
4 3 and 4. The data cover the five-year period 2004-2008. The S&P Utility
5 Compustat database that I used as a source of the schedules has not been fully
6 updated with 2009 annual data. The important categories of relative risk may be
7 summarized as follows:

8 Size. In terms of capitalization, PAWC is larger than the average size of the
9 Water Group. The average S&P Public Utility is many times the size of PAWC and
10 the average Water Group company. All other things being equal, a smaller
11 company is riskier than a larger company because a given change in revenue and
12 expense has a proportionately greater impact on a small firm. As I will demonstrate
13 later, the size of a firm can impact its cost of equity.

14 Market Ratios. Market-based financial ratios, such as earnings/price ratios
15 and dividend yields, provide a partial measure of the investor-required cost of
16 equity. If all other factors are equal, investors will require a higher return on equity
17 for companies that exhibit greater risk as compensation for that risk. That is to say,
18 a firm that investors perceive to have higher risks will experience a lower price per
19 share in relation to expected earnings.¹

20 There are no market ratios available for PAWC because its stock is owned
21 by AWW. The average price-earnings multiple was higher for the Water Group as
22 compared to the S&P Public Utilities. The average dividend yield was lower for the

¹ For example, two otherwise similarly situated firms each reporting \$1.00 in earnings per share would have different market prices at varying levels of risk (i.e., the firm with a higher level of risk will have a lower share value, while the firm with a lower risk profile will have a higher share value).

DIRECT TESTIMONY OF PAUL R. MOUL

1 Water Group than for the S&P Public Utilities. On average, the historical market-to-
2 book ratios were higher for the Water Group than for the S&P Public Utilities.

3 Common Equity Ratio. The level of financial risk is measured by the
4 proportion of long-term debt and other senior capital that is contained in a
5 company's capitalization. Financial risk is also analyzed by comparing common
6 equity ratios (the complement of the ratio of debt and other senior capital). That is
7 to say, a firm with a high common equity ratio has low financial risk, while a firm with
8 a low common equity ratio has high financial risk. The five-year average common
9 equity ratios, based on permanent capital, were 47.0% for the Company, 50.9% for
10 the Water Group, and 45.0% for the S&P Public Utilities. From a financial risk
11 perspective, the S&P Public Utilities show the highest financial risk, followed by
12 PAWC and then by the Water Group.

13 Return on Book Equity. Greater variability (i.e., uncertainty) of a firm's
14 earned returns signifies relative levels of risk, as shown by the coefficient of
15 variation (standard deviation ÷ mean) of the rate of return on book common equity.
16 The higher the coefficient of variation, the greater degree of variability. For the five-
17 year period, the coefficients of variation were 0.080 (0.7% ÷ 8.7%) for the Company,
18 0.071 (0.7% ÷ 9.8%) for the Water Group, and 0.068 (0.8% ÷ 11.8%) for the S&P
19 Public Utilities. The earnings variability was somewhat higher for PAWC as
20 compared to the Water Group. Also, the Company's historic returns on book
21 common equity are lower than the Water Group and S&P Public Utilities.

22 Operating Ratios. I have also compared operating ratios (the percentage of
23 revenues consumed by operating expense, depreciation and taxes other than

DIRECT TESTIMONY OF PAUL R. MOUL

1 income).² The five-year average operating ratios were 60.4% for the Company,
2 72.0% for the Water Group, and 84.3% for the S&P Public Utilities. The Company's
3 lower operating ratio can be traced to its high capital intensity because a larger
4 operating margin (i.e., the complement of the operating ratio) derives from the
5 income taxes and return associated with a larger capital investment per dollar of
6 revenue. Indeed, the Company's investment in net plant is 4.90 times its revenue in
7 2009. This is to say, PAWC must invest \$4.90 in new or replacement plant to
8 produce \$1.00 of additional revenue. This compares to the Water Group's
9 investment in net plant which is 3.52 times its revenue in 2009. No direct conclusion
10 should be drawn from the operating ratio comparison for the reason stated above.

11 Coverage. The level of fixed charge coverage (i.e., the multiple by which
12 available earnings cover fixed charges, such as interest expense and preferred
13 stock dividends) provides an indication of the earnings protection for creditors.
14 Higher levels of coverage, and hence earnings protection for fixed charges, are
15 usually associated with superior grades of creditworthiness. The five-year average
16 pre-tax interest coverage (excluding AFUDC) was 3.03 times for the Company, 3.50
17 times for the Water Group, and 3.34 times for the S&P Public Utilities. Creditor
18 protection, as shown by the interest coverage was somewhat weaker for PAWC as
19 compared to the Water Group.

20 Quality of Earnings. Measures of earnings quality are usually revealed by
21 the percentage of Allowance for Funds Used During Construction ("AFUDC") related
22 to income available for common equity, the effective income tax rate, and other cost
23 deferrals. These measures of earnings quality usually influence a firm's internally

² The complement of the operating ratio is the operating margin which provides a measure of profitability. The higher the operating ratio, the lower the operating margin.

DIRECT TESTIMONY OF PAUL R. MOUL

1 generated funds because poor quality of earnings would not generate high levels of
2 cash flow. Quality of earnings has not been a significant concern for the Company,
3 the Water Group and the S&P Utilities in recent years.

4 Internally Generated Funds. Internally generated funds ("IGF") provide an
5 important source of new investment capital for a utility and represent a key measure
6 of credit strength. Historically, the five-year average percentage of IGF to capital
7 expenditures was 69.8% for the Company, 52.4% for the Water Group, and 95.0%
8 for the S&P Public Utilities.

9 The Company is engaged in a continuing capital expenditure program
10 necessary to meet the needs of its customers and to comply with various
11 regulations. Over the period 2002-2009, \$5.5 million has been invested in the
12 Northeast wastewater division. For the future test year in this case, the Company
13 expects another \$3.0 million of capital expenditures net of contributions. In total, the
14 Company expects that \$5.6 million will be invested in the completed cost of the new
15 wastewater treatment plant.

16 Betas. The financial data I have been discussing relate primarily to
17 company-specific risks. Market risk for firms with traded stock is measured by beta
18 coefficients. Beta coefficients attempt to identify systematic risk, i.e., the risk
19 associated with changes in the overall market for common equities.³ Value Line
20 publishes such a statistical measure of a stock's relative historical volatility to the
21 rest of the market. A comparison of market risk is shown by the average betas of
22 .77 for the Water Group (see page 2 of Schedule 3), and .77 for the S&P Public

³The procedure used to calculate the beta coefficient published by Value Line is described in Appendix H. A common stock that has a beta less than 1.0 is considered to have less systematic risk than the market as a whole and would be expected to rise and fall more slowly than the rest of the market. A stock with a beta above 1.0 would have more systematic risk.

DIRECT TESTIMONY OF PAUL R. MOUL

1 Utilities (see page 4 of Schedule 4).

2 **Q. Please summarize your risk evaluation of the Company and the Water Group.**

3 A. In certain respects, the Company has higher risk than the Water Group. For
4 example, its credit quality rating is lower, the variability of its returns are higher and
5 its achieved returns have been lower, its capital intensity is higher than the Water
6 Group, its common equity is lower thereby displaying more financial risk, and its
7 interest coverage has been lower. Overall, the fundamental risk factors indicate that
8 the Water Group provides a conservative basis for measuring the Company's cost
9 of equity.

10 COST OF EQUITY – GENERAL APPROACH

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

13 A. Although my fundamental financial analysis provides the required framework to
14 establish the risk relationships among PAWC, the Water Group, and the S&P Public
15 Utilities, the cost of equity must be measured by standard financial models that I
16 describe in Appendix D. Differences in risk traits, such as size, business
17 diversification, geographical diversity, regulatory policy, financial leverage, and bond
18 ratings must be considered when analyzing the cost of equity.

19 It is also important to reiterate that no one method or model of the cost of
20 equity can be applied in an isolated manner. Rather, informed judgment must be
21 used to take into consideration the relative risk traits of the firm. It is for this reason
22 that I have used more than one method to measure the Company's cost of equity.
23 As noted in Appendix D, and elsewhere in my direct testimony, each of the methods
24 used to measure the cost of equity contains certain incomplete and/or overly
25 restrictive assumptions and constraints that are not optimal. Therefore, I favor

DIRECT TESTIMONY OF PAUL R. MOUL

1 considering the results from a variety of methods. In this regard, I applied each of
2 the methods with data taken from the Water Group and have arrived at a cost of
3 equity of 11.75% for PAWC.

DISCOUNTED CASH FLOW ANALYSIS

4
5 **Q. Please describe your use of the Discounted Cash Flow approach to determine**
6 **the cost of equity.**

7 A. The details of my use of the DCF approach and the calculations and evidence in
8 support of my conclusions are set forth in Appendix E. I will summarize them here.
9 The DCF model seeks to explain the value of an asset as the present value of future
10 expected cash flows discounted at the appropriate risk-adjusted rate of return. In its
11 simplest form, the DCF return on common stock consists of a current cash
12 (dividend) yield and future price appreciation (growth) of the investment.

13 Among other limitations of the model, there is a certain element of circularity
14 in the DCF method when applied in rate cases. This is because investors'
15 expectations for the future depend upon regulatory decisions. In turn, when
16 regulators depend upon the DCF model to set the cost of equity, they rely upon
17 investor expectations that include an assessment of how regulators will decide rate
18 cases. Due to this circularity, the DCF model may not fully reflect the true risk of a
19 utility.

20 As I describe in Appendix E, the DCF approach has other limitations that
21 diminish its usefulness in the ratesetting process where, as in this case, the firm's
22 market capitalization diverges significantly from the book value capitalization. When
23 this situation exists, the DCF method will lead to a misspecified cost of equity when
24 it is applied to a book value capital structure.

25 **Q. Please explain the dividend yield component of a DCF analysis.**

DIRECT TESTIMONY OF PAUL R. MOUL

1 A. The DCF methodology requires the use of an expected dividend yield to establish
2 the investor-required cost of equity. For the twelve months ended March 2010, the
3 monthly dividend yields of the Water Group are shown graphically on Schedule 5.
4 The monthly dividend yields shown on Schedule 5 reflect an adjustment to the
5 month-end prices to reflect the buildup of the dividend in the price that has occurred
6 since the last ex-dividend date (i.e., the date by which a shareholder must own the
7 shares to be entitled to the dividend payment – usually about two to three weeks
8 prior to the actual payment). An explanation of this adjustment is provided in
9 Appendix E.

10 For the twelve months ended March 2010, the average dividend yield was
11 3.53% for the Water Group based upon a calculation using annualized dividend
12 payments and adjusted month-end stock prices. The dividend yields for the more
13 recent six- and three- month periods were 3.55% and 3.55%, respectively. I have
14 used, for the purpose of my direct testimony, the six-month average dividend yield
15 of 3.55% for the Water Group. The use of this dividend yield will reflect current
16 capital costs, while avoiding spot yields. For the purpose of a DCF calculation, the
17 average dividend yield must be adjusted to reflect the prospective nature of the
18 dividend payments i.e., the higher expected dividends for the future. Recall that the
19 DCF is an expectational model that must reflect investor anticipated cash flows for
20 the Water Group. I have adjusted the six-month average dividend yield in three
21 different, but generally accepted manners, and used the average of the three
22 adjusted values as calculated in Appendix E. That adjusted dividend yield is 3.68%
23 for the Water Group.

24 **Q. Please explain the underlying factors that influence investor's growth**
25 **expectations.**

DIRECT TESTIMONY OF PAUL R. MOUL

1 A. As noted previously, investors are interested principally in the future growth of their
2 investment (i.e., the price per share of the stock). As I explain in Appendix E, future
3 earnings per share growth represent the DCF model's primary focus because under
4 the constant price-earnings multiple assumption of the model, the price per share of
5 stock will grow at the same rate as earnings per share. In conducting a growth rate
6 analysis, a wide variety of variables can be considered when reaching a consensus
7 of prospective growth, including: earnings, dividends, book value, and cash flow
8 stated on a per share basis. Historical values for these variables can be
9 considered, as well as analysts' forecasts that are widely available to investors. A
10 fundamental growth rate analysis also can be formulated, which consists of internal
11 growth ("b x r"), where "r" represents the expected rate of return on common equity
12 and "b" is the retention rate that consists of the fraction of earnings that are not paid
13 out as dividends. The internal growth rate can be modified to account for sales of
14 new common stock -- this is called external growth ("s x v"), where "s" represents
15 the new common shares expected to be issued by a firm and "v" represents the
16 value that accrues to existing shareholders from selling stock at a price different
17 from book value. Fundamental growth, which combines internal and external
18 growth, provides an explanation of the factors that cause book value per share to
19 grow over time.

20 Growth also can be expressed in multiple stages. This expression of growth
21 consists of an initial "growth" stage where a firm enjoys rapidly expanding markets,
22 high profit margins, and abnormally high growth in earnings per share. Thereafter, a
23 firm enters a "transition" stage where fewer technological advances and increased
24 product saturation begin to reduce the growth rate and profit margins come under
25 pressure. During the "transition" phase, investment opportunities begin to mature,

DIRECT TESTIMONY OF PAUL R. MOUL

1 capital requirements decline, and a firm begins to pay out a larger percentage of
2 earnings to shareholders. Finally, the mature or "steady-state" stage is reached
3 when a firm's earnings growth, payout ratio, and return on equity stabilizes at levels
4 where they remain for the life of a firm. The three stages of growth assume a step-
5 down of high initial growth to lower sustainable growth. Even if these three stages
6 of growth can be envisioned for a firm, the third "steady-state" growth stage, which
7 is assumed to remain fixed in perpetuity, represents an unrealistic expectation
8 because the three stages of growth can be repeated. That is to say, the stages can
9 be repeated where growth for a firm ramps-up and ramps-down in cycles over time.

10 **Q. What investor-expected growth rate is appropriate in a DCF calculation?**

11 A. Investors consider both company-specific variables and overall market sentiment
12 (i.e., level of inflation rates, interest rates, economic conditions, etc.) when balancing
13 their capital gains expectations with their dividend yield requirements. I follow an
14 approach that is not rigidly formatted because investors are not influenced by a
15 single set of company-specific variables weighted in a formulaic manner. Therefore,
16 in my opinion, all relevant growth rate indicators using a variety of techniques must
17 be evaluated when formulating a judgment of investor-expected growth.

18 **Q. What data for the proxy group have you considered in your growth rate
19 analysis?**

20 A. I have considered the growth in the financial variables shown on Schedule 6 and 7.
21 The bar graph provided on Schedule 6 shows the historical growth rates in earnings
22 per share, dividends per share, book value per share, and cash flow per share for
23 the Water Group. The historical growth rates were taken from the Value Line
24 publication that provides these data. As shown on Schedule 6, the historical growth
25 of earnings per share was in the range of 4.71% to 5.50% for the Water Group.

DIRECT TESTIMONY OF PAUL R. MOUL

1 Schedule 7 provides projected earnings per share growth rates taken from
2 analysts' forecasts compiled by IBES/First Call and Zacks and from the Value Line
3 publication. IBES/First Call and Zacks represent reliable authorities of projected
4 growth upon which investors rely. The IBES/First Call and Zacks forecasts are
5 limited to earnings per share growth, while Value Line makes projections of other
6 financial variables. The Value Line forecasts of dividends per share, book value per
7 share, and cash flow per share have also been included on Schedule 7 for the
8 Water Group.

9 Although five-year forecasts usually receive the most attention in the growth
10 analysis for DCF purposes, current market performance is strongly influenced by
11 short-term earnings forecasts. Each of the major publications provides earnings
12 forecasts for the current and subsequent year. These short-term earnings forecasts
13 receive prominent coverage and, indeed, they dominate these publications.

14 **Q. Is a five-year investment horizon associated with the analysts' forecasts**
15 **consistent with the DCF model?**

16 A. Yes. Rather than viewing the DCF in the context of an endless stream of growing
17 dividends (e.g., a century of cash flows), the growth in the share value (i.e., capital
18 appreciation, or capital gains yield) is most relevant to investors' total return
19 expectations. Hence, the sale price of a stock can be viewed as a liquidating
20 dividend that can be discounted along with the annual dividend receipts during the
21 investment-holding period to arrive at the investor-expected return. The growth in
22 the price per share will equal the growth in earnings per share absent any change in
23 price-earnings ("P-E") multiple -- a necessary assumption of the DCF. As such, my
24 company-specific growth analysis, which focuses principally upon five-year
25 forecasts of earnings per share growth, is consistent with the type of analysis that

DIRECT TESTIMONY OF PAUL R. MOUL

1 influences the total return expectation of investors. Moreover, academic research
2 focuses on five-year growth rates as they influence stock prices. Indeed, if investors
3 really required forecasts which extended beyond five years in order to properly
4 value common stocks, then I am sure that some investment advisory service would
5 begin publishing that information for individual stocks in order to meet the demands
6 of investors. The absence of such a publication signals that investors do not require
7 infinite forecasts in order to purchase and sell stocks in the marketplace.

8 **Q. What specific evidence have you considered in the DCF growth analysis?**

9 A. As to the five-year forecast growth rates, Schedule 7 indicates that the projected
10 earnings per share growth rates for the Water Group are 8.19% by IBES/First Call,
11 6.18% by Zacks, and 8.92% by Value Line. The Value Line projections indicate that
12 earnings per share for the Water Group will grow prospectively at a more rapid rate
13 (i.e., 8.92%) than the dividends per share (i.e., 4.17%), which translates into a
14 declining dividend payout ratio for the future. As noted earlier, and in Appendix E,
15 with the constant price-earnings multiple assumption of the DCF model, growth for
16 these companies will occur at the higher earnings per share growth rate, thus
17 producing the capital gains yield expected by investors.

18 **Q. What conclusion have you drawn from these data regarding the applicable
19 growth rate to be used in the DCF model?**

20 A. A variety of factors should be examined to reach a conclusion on the DCF growth
21 rate. However, certain growth rate variables should be emphasized when reaching
22 a conclusion on an appropriate growth rate. First, historical and projected earnings
23 per share, dividends per share, book value per share, cash flow per share, and
24 retention growth represent indicators that could be used to provide an assessment
25 of investor growth expectations for a firm. However, although history cannot be

DIRECT TESTIMONY OF PAUL R. MOUL

1 ignored, it cannot receive primary emphasis. This is because an analyst, when
2 developing a forecast of future earnings growth, would first apprise himself/herself of
3 the historical performance of a company. Hence, there is no need to count historical
4 growth rates separately, because historical performance already is reflected in
5 analysts' forecasts. Second, from the various alternative measures of growth
6 identified above, earnings per share should receive greatest emphasis. Earnings
7 per share growth are the primary determinant of investor expectations regarding
8 their total returns in the stock market. This is because the capital gains yield (i.e.,
9 price appreciation) will track earnings growth with a constant price earnings multiple
10 (a key assumption of the DCF model). Moreover, earnings per share (derived from
11 net income) are the source of dividend payments, and are the primary driver of
12 retention growth and its surrogate, i.e. book value per share growth. As such, under
13 these circumstances, greater emphasis must be placed upon projected earnings per
14 share growth. In this regard, it is worthwhile to note that Professor Myron Gordon,
15 the foremost proponent of the DCF model in rate cases, concluded that the best
16 measure of growth in the DCF model is a forecast of earnings per share growth.⁴
17 Hence, to follow Professor Gordon's findings, projections of earnings per share
18 growth, such as those published by IBES/First Call, Zacks, and Value Line,
19 represent a reasonable assessment of investor expectations.

20 It is appropriate to consider all forecasts of earnings growth rates that are
21 available to investors. In this regard, I have considered the forecasts from
22 IBES/First Call, Zacks, and Value Line. The IBES/First Call and Zacks growth rates
23 are consensus forecasts taken from a survey of analysts that make projections of

⁴ "Choice Among Methods of Estimating Share Yield," The Journal of Portfolio Management, spring 1989 by Gordon, Gordon & Gould.

DIRECT TESTIMONY OF PAUL R. MOUL

1 growth for these companies. The IBES/First Call and Zacks estimates are obtained
2 from the Internet and are widely available to investors free-of-charge. First Call
3 probably is quoted most frequently in the financial press when reporting on earnings
4 forecasts. The Value Line forecasts also are widely available to investors and can
5 be obtained by subscription or free-of-charge at most public and collegiate libraries.

6 The forecasts of earnings per share growth, as shown on Schedule 7,
7 provide a range of growth rates of 6.18% to 8.92%. Although the DCF growth rates
8 cannot be established solely with a mathematical formulation, it is my opinion that
9 an investor-expected growth rate of 7.00% is within the array of earnings per share
10 growth rates shown by the analysts' forecasts. The Value Line forecast of dividend
11 per share growth is inadequate in this regard due to the forecasted decline in the
12 dividend payout ratio. Moreover, the restructuring and consolidation now taking
13 place in the utility industry will provide additional risks and opportunities as the utility
14 industry successfully adapts to the new business environment. These changes in
15 growth fundamentals will undoubtedly develop beyond the next five years typically
16 considered in the analysts' forecasts, and will enhance the growth prospects for the
17 future. In my opinion, a 7.00% growth rate will accommodate all these factors.

18 **Q. Are the dividend yield and growth components of the DCF adequate to explain**
19 **the rate of return on common equity when it is used in the calculation of the**
20 **weighted average cost of capital?**

21 A. Only if the capital structure ratios are measured with the market value of debt and
22 equity. If book values are used to compute the capital structure ratios, then an
23 adjustment is required.

24 **Q. Please explain why.**

25 A. If regulators use the results of the DCF (which are based on the market price of the

DIRECT TESTIMONY OF PAUL R. MOUL

1 stock of the companies analyzed) to compute the weighted average cost of capital
2 with a book value capital structure used for ratesetting purposes, those results will
3 not reflect the higher level of financial risk associated with the book value capital
4 structure. Where, as here, a stock's market price diverges from a utility's book
5 value, the potential exists for a financial risk difference, because the capitalization of
6 a utility measured at its market value contains more equity, less debt and, therefore,
7 less risk than the capitalization measured at its book value.

8 It must be recognized that in order to make the DCF results relevant to the
9 capitalization measured at book value (as is done for ratesetting purposes), the
10 market-derived cost rate cannot be used without modification. As I will explain later
11 in my testimony, the results of the DCF model can be adjusted to account for
12 differences in risk when the book-value capital structure contains more financial
13 leverage than the market-value capital structure.

14 **Q. Is your leverage adjustment dependent upon the market valuation or book**
15 **valuation from an investor's perspective?**

16 A. The only perspective that is important to investors is the return that they can realize
17 on the market value of their investment. As I have measured the DCF, the simple
18 yield (D/P) plus growth (g) provides a return applicable strictly to the price (P) that
19 an investor is willing to pay for a share of stock. The DCF formula is derived from
20 the standard valuation model: $P = D/(k-g)$, where P = price, D = dividend, k = the
21 cost of equity, and g = growth in cash flows. By rearranging the terms, we obtain
22 the familiar DCF equation: $k = D/P + g$. All of the terms in the DCF equation
23 represent investors' assessment of expected future cash flows that they will receive
24 in relation to the value that they set for a share of stock (P). The need for the
25 leverage adjustment arises when the results of the DCF model (k) are to be applied

DIRECT TESTIMONY OF PAUL R. MOUL

1 to a capital structure that is different than indicated by the market price (P). From
2 the market perspective, the financial risk of the Water Group is accurately measured
3 by the capital structure ratios calculated from the market capitalization of a firm. If
4 the ratesetting process utilized the market capitalization ratios, then no additional
5 analysis or adjustment would be required, and the simple yield (D/P) plus growth (g)
6 components of the DCF would satisfy the financial risk associated with the market
7 value of the equity capitalization. Because the ratesetting process uses a different
8 set of ratios calculated from the book value capitalization, then further analysis is
9 required to synchronize the financial risk of the book capitalization with the required
10 return on the book value of the equity. This adjustment is developed through
11 precise mathematical calculations, using well recognized analytical procedures that
12 are widely accepted in the financial literature. To arrive at that return, the rate of
13 return on common equity is the unleveraged cost of capital (or equity return at 100%
14 equity) plus one or more terms reflecting the increase in financial risk resulting from
15 the use of leverage in the capital structure. Multiple terms are used in the case of
16 debt and preferred stock.

17 **Q. Is your leverage adjustment based on a factor designed to transform the**
18 **return into one that is designed to produce a particular market-to-book ratio?**

19 A. No. The adjustment that I label as a "leverage adjustment" is merely a convenient
20 way to incorporate into the result of the simple DCF model (i.e., $D/P + g$), when it is
21 applied to the capital structure used in ratesetting, which is computed with book
22 value weights rather than market value weights. I specify a separate factor, which I
23 call the leverage adjustment, but there is no need to do so other than providing
24 identification for this factor. If I expressed my return solely in the context of the book
25 value weights that are used to calculate the weighted average cost of capital, and

DIRECT TESTIMONY OF PAUL R. MOUL

1 ignore the familiar $D/P + g$ expression entirely, then there would be no separate
2 element to reflect the financial leverage change from market value to book value
3 capitalization. This is because the equity return applicable to the book value
4 common equity ratio is equal to 9.39%, which is the return for the Water Group
5 applicable to its equity with no debt in its capital structure (i.e., the cost of capital is
6 equal to the cost of equity with a 100% equity ratio) plus 2.30% compensation for
7 having a 49.19% debt ratio, plus 0.02% for having a 0.23% preferred stock ratio
8 (see pages E-12 and E-13 of Appendix E). The sum of the parts is 11.71% (9.39%
9 + 2.30% + 0.02%) and there is no need to even address the cost of equity in terms
10 of $D/P + g$. To express this same return in the context of the familiar DCF model, I
11 summed the 3.68% dividend yield, the 7.00% growth rate, and the 1.03% for the
12 leverage adjustment in order to arrive at the same 11.71% (3.68% + 7.00% + 1.03%)
13 return. I know of no means to mathematically solve for the 1.03% leverage
14 adjustment by expressing it in the terms of any particular relationship of market price
15 to book value. The 1.03% adjustment is merely a convenient way to compare the
16 11.71% return computed directly with the Modigliani & Miller formulas to the 10.68%
17 return generated by the DCF model based on a market-value capital structure. My
18 point is that when a market-determined cost of equity developed from the DCF
19 model is used, it reflects a level of financial risk that is different (in this case, lower)
20 from the capital structure stated at book value. This process has nothing to do with
21 targeting any particular market-to-book ratio.

22 **Q. Are there specific factors that influence market-to-book ratios that determine**
23 **whether the leverage adjustment should be made?**

24 A. No. The leverage adjustment is not intended, nor was it designed, to address the
25 reasons that stock prices vary from book value. Hence, any observations regarding

DIRECT TESTIMONY OF PAUL R. MOUL

1 market prices relative to book are not on point. The leverage adjustment deals with
2 the issue of financial risk and is not intended to transform the DCF result to a book
3 value return through a market-to-book adjustment. Again, the leverage adjustment
4 that I propose is based on the fundamental financial precept that the cost of equity is
5 equal to the rate of return for an unleveraged firm (i.e., where the overall rate of
6 return equates to the cost of equity with a capital structure that contains 100%
7 equity) plus the additional return required for introducing debt and/or preferred stock
8 leverage into the capital structure.

9 Further, as noted previously, the high market prices of utility stocks cannot
10 be attributed solely to the notion that these companies are expected to earn a return
11 on equity that differs from its cost of equity. Stock prices above book value are
12 common for utility stocks and, indeed, the stock prices of non-regulated companies
13 exceed book values by even greater margins. In this regard, according to the
14 Barron's issue of April 5, 2010, the major market indices' market-to-book ratios are
15 well above unity. The Dow Jones Utility index traded at a multiple of 1.60 times
16 book value, which is below the market multiple of other indices. For example, the
17 S&P Industrial index was at 3.25 times book value, and the Dow Jones Industrial
18 index was at 4.84 times book value. It is difficult to accept that the vast majority of
19 all firms operating in our economy are generating returns far in excess of its cost of
20 capital. Certainly, in our free-market economy, competition should contain such
21 "excesses" if they indeed exist.

22 Finally, the leverage adjustment adds stability to the final DCF cost rate.
23 That is to say, as the market capitalization increases relative to its book value, the
24 leverage adjustment increases while the simple yield (D/P) plus growth (g) result
25 declines. The reverse also is true that when the market capitalization declines, the

DIRECT TESTIMONY OF PAUL R. MOUL

1 leverage adjustment also declines as the simple yield (D/P) plus growth (g) result
2 increases.

3 **Q. What are the implications of a DCF derived return that is related to market**
4 **value when the results are applied to the book value of a utility's**
5 **capitalization?**

6 A. The capital structure ratios measured at the utility's book value show more financial
7 leverage, and higher risk, than the capitalization measured at its market value.
8 Please refer to page E-12 of Appendix E for the comparison. This means that a
9 market-derived cost of equity, using models such as DCF and CAPM, reflects a
10 level of financial risk that is different -- in this instance, much lower -- from that
11 shown by the book value capitalization. Hence, it is necessary to develop a cost of
12 equity that reflects the higher financial risk related to the book value capitalization
13 used for ratesetting purposes. Failure to make this modification would result in a
14 mismatch of the lower financial risk related to market value used to measure the
15 cost of equity and the higher financial risk of the book value capital structure used in
16 the ratesetting process. That is to say, the cost of equity for the Water Group that is
17 related to the 50.58% common equity ratio using book value has higher financial risk
18 than the 64.91% common equity ratio using market values. Because the ratesetting
19 process utilizes the book value capitalization, it is necessary to adjust the market-
20 determined cost of equity for the higher financial risk related to the book value of the
21 capitalization.

22 **Q. How is the DCF-determined cost of equity adjusted for the financial risk**
23 **associated with the book value of the capitalization?**

24 A. In pioneering work, Nobel laureates Modigliani and Miller developed several
25 theories about the role of leverage in a firm's capital structure. As part of that work,

DIRECT TESTIMONY OF PAUL R. MOUL

1 Modigliani and Miller established that, as the borrowing of a firm increases, the
2 expected return on stockholders' equity also increases.⁵ This principle is
3 incorporated into my leverage adjustment which recognizes that the expected return
4 on equity increases to reflect the increased risk associated with the higher financial
5 leverage shown by the book value capital structure, as compared to the market
6 value capital structure that contains lower financial risk. Modigliani and Miller
7 proposed several approaches to quantify the equity return associated with various
8 degrees of debt leverage in a firm's capital structure. These formulas point toward
9 an increase in the equity return associated with the higher financial risk of the book
10 value capital structure. Simply stated, the leverage adjustment contains no factor
11 for a particular market-to-book ratio. It merely expresses the cost of equity as the
12 unleveraged return plus compensation for the additional risk of introducing debt
13 and/or preferred stock into the capital structure. There can be no dispute that a
14 firm's financial risk varies with the relative amount of leverage contained in its capital
15 structure. As detailed in Appendix E, the Modigliani and Miller theory when applied
16 to the Water Group shows that the cost of equity increases by 1.03% (11.71% -
17 10.68%) when the book value of equity, rather than the market value of equity, is
18 used for ratesetting purposes.

19 **Q. Please provide the DCF return based upon your preceding discussion of**
20 **dividend yield, growth, and leverage.**

21 A. As explained previously, I have utilized a six-month average dividend yield (" D_1 / P_0 ")
22 adjusted in a forward-looking manner for my DCF calculation. This dividend yield is
23 used in conjunction with the growth rate (" g ") previously developed. The DCF also

⁵ Modigliani, F. and Miller, M.H. "The Cost of Capital, Corporation Finance, and the Theory of Investments." American Economic Review, June 1958, 261-297. Modigliani, F. and Miller, M. H. "Taxes and the Cost of Capital: A Correction." American Economic Review, June 1963, 433-443.

DIRECT TESTIMONY OF PAUL R. MOUL

1 includes the leverage modification ("lev.") required when the book value equity ratio
2 is used in determining the weighted average cost of capital in the ratesetting
3 process rather than the market value equity ratio related to the price of stock.

$$D_1/P_0 + g + lev. = k$$

$$\text{Water Group } 3.68\% + 7.00\% + 1.03\% = 11.71\%$$

4 The DCF result shown above represents the simplified (i.e., Gordon) form of the
5 model that contains a constant growth assumption. I should reiterate, however, that
6 the DCF-indicated cost rate provides an explanation of the rate of return on common
7 stock market prices without regard to the prospect of a change in the price-earnings
8 multiple. An assumption that there will be no change in the price-earnings multiple
9 is not supported by the realities of the equity market, because price-earnings
10 multiples do not remain constant. This is one of the constraints of this model that
11 makes it important to consider other model results when determining a company's
12 cost of equity. For this reason, the DCF cost rate I have developed likely
13 understates the cost of equity.

RISK PREMIUM ANALYSIS

14
15 **Q. Please describe your use of the risk premium approach to determine the cost
16 of equity.**

17 A. The details of my use of the Risk Premium approach and the evidence in support of
18 my conclusions are set forth in Appendix G. I will summarize them here. With this
19 method, the cost of equity capital is determined by corporate bond yields plus a
20 premium to account for the fact that common equity is exposed to greater
21 investment risk than debt capital. As with other models used to determine the cost
22 of equity, the Risk Premium approach has its limitations, including potential

DIRECT TESTIMONY OF PAUL R. MOUL

1 imprecision in the assessment of the future cost of corporate debt and the
2 measurement of the risk-adjusted common equity premium.

3 **Q. What long-term public utility debt cost rate did you use in your risk premium**
4 **analysis?**

5 A. In my opinion, a 6.00% yield represents a reasonable estimate of the prospective
6 yield on long-term A-rated public utility bonds. The Moody's index and the Blue
7 Chip forecasts support this figure. The historical yields for long-term public utility
8 debt are shown graphically on page 1 of Schedule 8. For the twelve months ended
9 March 2010, the average monthly yield on Moody's A-rated index of public utility
10 bonds was 5.90%. For the six and three-month periods ended March 2010, the
11 yields were 5.74% and 5.83%, respectively. During the twelve-months ended
12 February 2010, the range of the yields on A-rated public utility bonds was 5.53% to
13 6.49%.

14 **Q. What forecasts of interest rates have you considered in your analysis?**

15 A. I have determined the prospective yield on A-rated public utility debt by using the
16 Blue Chip Financial Forecasts ("Blue Chip") along with the spread in the yields that I
17 describe above and in Appendix F. The Blue Chip is a reliable authority and
18 contains consensus forecasts of a variety of interest rates compiled from a panel of
19 banking, brokerage, and investment advisory services. In early 1999, Blue Chip
20 stopped publishing forecasts of yields on A-rated public utility bonds because the
21 Federal Reserve deleted these yields from its Statistical Release H.15. To
22 independently project a forecast of the yields on A-rated public utility bonds, I have
23 combined the forecast yields on long-term Treasury bonds published on April 1
24 2010, and a yield spread of 1.25%. As shown on page 5 of Schedule 8, the yields
25 on A-rated public utility bonds have exceeded those on Treasury bonds by 1.60%

DIRECT TESTIMONY OF PAUL R. MOUL

1 on a twelve-month average basis, 1.37% on a six-month average basis, and 1.34%
 2 on a the three-month average basis. From these averages, 1.25% represents a
 3 reasonable spread for the yield on A-rated public utility bonds over Treasury bonds.
 4 For comparative purposes, I also have shown the Blue Chip forecasts of Aaa-rated
 5 and Baa-rated corporate bonds. These forecasts are:

<u>Blue Chip Financial Forecasts</u>						
<u>Year</u>	<u>Quarter</u>	<u>Corporate</u>		<u>30-Year</u>	<u>A-rated Public Utility</u>	
		<u>Aaa-rated</u>	<u>Baa-rated</u>	<u>Treasury</u>	<u>Spread</u>	<u>Yield</u>
2010	2nd	5.3%	6.3%	4.6%	1.25%	5.85%
2010	3rd	5.5%	6.5%	4.8%	1.25%	6.05%
2010	4th	5.6%	6.7%	4.9%	1.25%	6.15%
2011	1st	5.7%	6.8%	5.0%	1.25%	6.25%
2011	2nd	5.9%	6.9%	5.2%	1.25%	6.45%
2011	3rd	6.1%	7.1%	5.3%	1.25%	6.55%

6 **Q. Are there additional forecasts of interest rates that extend beyond those**
 7 **shown above?**

8 A. Yes. Twice yearly, Blue Chip provides long-term forecasts of interest rates. In its
 9 December 1, 2009 publication, Blue Chip published forecasts of interest rates as
 10 follows:

<u>Blue Chip Financial Forecasts</u>			
<u>Averages</u>	<u>Corporate</u>		<u>30-Year</u>
	<u>Aaa-rated</u>	<u>Baa-rated</u>	<u>Treasury</u>
2011-15	6.4%	7.5%	5.6%
2016-20	6.8%	7.8%	5.9%

11 Given these forecasted interest rates, a 6.00% yield on A-rated public utility bonds
 12 represents a reasonable expectation.

13 **Q. What equity risk premium have you determined for public utilities?**

14 A. Appendix G provides a discussion of the financial returns that I relied upon to

DIRECT TESTIMONY OF PAUL R. MOUL

1 develop the appropriate equity risk premium for the S&P Public Utilities. I have
2 calculated the equity risk premium by comparing the market returns on utility stocks
3 and the market returns on utility bonds. I chose the S&P Public Utility index for the
4 purpose of measuring the market returns for utility stocks. The S&P Public Utility
5 index is reflective of the risk associated with regulated utilities, rather than some
6 broader market indexes, such as the S&P 500 Composite index. The S&P Public
7 Utility index is a subset of the overall S&P 500 Composite index. Use of the S&P
8 Public Utility index reduces the role of judgment in establishing the risk premium for
9 public utilities. With the equity risk premiums developed for the S&P Public Utilities
10 as a base, I derived the equity risk premium for the Water Group.

11 **Q. What equity risk premium for the S&P Public Utilities have you determined for**
12 **this case?**

13 A. To develop an appropriate risk premium, I analyzed the results for the S&P Public
14 Utilities by averaging (i) the midpoint of the range shown by the geometric mean and
15 median and (ii) the arithmetic mean. This procedure has been employed to provide
16 a comprehensive way of measuring the central tendency of the historical returns.
17 As shown by the values set forth on page 2 of Schedule 9, the indicated risk
18 premiums for the various time periods analyzed are 5.51% (1928-2007), 6.58%
19 (1952-2007), 6.08% (1974-2007), and 6.37% (1979-2007). The selection of the
20 shorter periods taken from the entire historical series is designed to provide a risk
21 premium that conforms more nearly to present investment fundamentals, and
22 removes some of the more distant data from the analysis.

23 **Q. Do you have further support for the selection of the time periods used in your**
24 **equity risk premium determination?**

25 A. Yes. First, the terminal year of my analysis presented in Schedule 9 represents the

DIRECT TESTIMONY OF PAUL R. MOUL

1 returns realized through 2007. An update to 2008 has not been prepared because
2 of the difficulty in obtaining the return on public utility bonds from Lehman Brothers,
3 which is in bankruptcy. Second, the selection of the initial year of each period was
4 based upon the financial market defining events that I note here and describe in
5 Appendix G. These events were fixed in history and cannot be manipulated as later
6 financial data becomes available. That is to say, using the Treasury-Federal
7 Reserve Accord as a defining event, the year 1952 is fixed as the beginning point
8 for the measurement period regardless of the financial results that subsequently
9 occurred. Likewise, 1974 represented a benchmark year because it followed the
10 1973 Arab Oil embargo. Also, the year 1979 was chosen because it began the
11 deregulation of the financial markets. I consistently use these periods in my work,
12 and additional data are merely added to the earlier results when they become
13 available. The periods chosen are, therefore, not driven by the desired results of
14 the study.

15 **Q. What conclusions have you drawn from these data?**

16 A. Using the summary values provided on page 2 of Schedule 9, the 1928-2007 period
17 provides the lowest indicated risk premium, while the 1952-2007 period provides the
18 highest risk premium for the S&P Public Utilities. Within these bounds, a common
19 equity risk premium of 6.23% ($6.08\% + 6.37\% = 12.45\% \div 2$) is derived by
20 averaging data covering the periods 1974-2007 and 1979-2007. Therefore, 6.23%
21 represents a reasonable risk premium for the S&P Public Utilities in this case.

22 As noted earlier in my fundamental risk analysis, differences in risk
23 characteristics must be taken into account when applying the results for the S&P
24 Public Utilities to the Water Group. I recognized these differences in the
25 development of the equity risk premium in this case. I previously enumerated

DIRECT TESTIMONY OF PAUL R. MOUL

1 various differences in fundamentals between the Water Group and the S&P Public
2 Utilities, including size, market ratios, common equity ratio, return on book equity,
3 operating ratios, coverage, quality of earnings, internally generated funds, and
4 betas. In my opinion, these differences indicate that 5.50% represents a reasonable
5 common equity risk premium in this case. This represents approximately 88%
6 (5.50% ÷ 6.23% = 0.88) of the risk premium of the S&P Public Utilities, and is
7 reflective of the risk of the Water Group compared to the S&P Public Utilities.

8 **Q. What common equity cost rate did you determine based on your risk premium
9 analysis?**

10 A. The cost of equity (i.e., "k") is represented by the sum of the prospective yield for
11 long-term public utility debt (i.e., "i"), and the equity risk premium (i.e., "RP"). The
12 Risk Premium approach provides a cost of equity of:

$$i + RP = k$$

Water Group 6.00% + 5.50% = 11.50%

13 CAPITAL ASSET PRICING MODEL

14 **Q. Have you used the Capital Asset Pricing Model to measure the cost of equity
15 in this case?**

16 A. Yes. As with other models of the cost of equity, the CAPM contains a variety of
17 assumptions and shortcomings that I discuss in Appendix H. Therefore, this method
18 should be used with other methods to measure the cost of equity, as each will
19 complement the other and will provide a result that will help reduce the unavoidable
20 defects found in each method.

21 **Q. What are the features of the CAPM as you have used it?**

22 A. The CAPM uses the yield on a risk-free interest bearing obligation plus a rate of

DIRECT TESTIMONY OF PAUL R. MOUL

1 return premium that is proportional to the systematic risk of an investment. The
2 details of my use of the CAPM and evidence in support of my conclusions are set
3 forth in Appendix H. To compute the cost of equity with the CAPM, three
4 components are necessary: a risk-free rate of return ("Rf"), the beta measure of
5 systematic risk (" β "), and the market risk premium ("Rm-Rf") derived from the total
6 return on the market of equities reduced by the risk-free rate of return. The CAPM
7 specifically accounts for differences in systematic risk (i.e., market risk as measured
8 by the beta) between an individual firm or group of firms and the entire market of
9 equities. As such, to calculate the CAPM, it is necessary to employ firms with
10 traded stocks. In this regard, I performed a CAPM calculation for the Water Group.
11 In contrast, my Risk Premium approach also considers industry- and company-
12 specific factors, because it is not limited to measuring just systematic risk. As a
13 consequence, the Risk Premium approach is more comprehensive than the CAPM.
14 In addition, the Risk Premium approach provides a better measure of the cost of
15 equity, because it is founded upon the yields on corporate bonds rather than
16 Treasury bonds.

17 **Q. What betas have you considered in the CAPM?**

18 A. For my CAPM analysis, I initially considered the Value Line betas. As shown on
19 page 1 of Schedule 10, the average beta is 0.77 for the Water Group.

20 **Q. What betas have you used in the CAPM determined cost of equity?**

21 A. The betas must be reflective of the financial risk associated with the ratesetting
22 capital structure that is measured at book value. Therefore, Value Line betas
23 cannot be used directly in the CAPM, unless those betas are applied to a capital
24 structure measured with market values. To develop a CAPM cost rate applicable to
25 a book-value capital structure, the Value Line (market value) betas have been

DIRECT TESTIMONY OF PAUL R. MOUL

1 unleveraged and releveraged for the book value common equity ratios using the
2 Hamada formula,⁶ as follows:

$$\beta_l = \beta_u [1 + (1 - t) D/E + P/E]$$

3
4 where β_l = the leveraged beta, β_u = the unleveraged beta, t = income tax rate, D =
5 debt ratio, P = preferred stock ratio, and E = common equity ratio. The betas
6 published by Value Line have been calculated with the market price of stock and,
7 therefore, are related to the market value capitalization. By using the formula shown
8 above and the capital structure ratios measured at market value, the beta would
9 become 0.57 for the Water Group if it employed no leverage and was 100% equity
10 financed. With the unleveraged beta as a base, I calculated the leveraged beta of
11 0.93 for the book value capital structure of the Water Group. The betas and
12 corresponding common equity ratios are:

<u>Market Values</u>		<u>Book Values</u>	
<u>Beta</u>	<u>Common Equity Ratio</u>	<u>Beta</u>	<u>Common Equity Ratio</u>
0.77	64.91%	0.93	50.58%

13 The book value leveraged beta that I will employ in the CAPM cost of equity is 0.93
14 for the Water Group.

15 **Q. What risk-free rate have you used in the CAPM?**

16 A. For the reasons explained in Appendix F, I have employed the yields on 20-year
17 Treasury bonds using historical data. For forecasts, I have used the yields on 30-
18 year Treasury bonds that are published by Blue Chip. The reason that I used the
19 20-year Treasury yield in my historical analysis relates to the interruption in the 30-

⁶Robert S. Hamada, "The Effects of the Firm's Capital Structure on the Systematic Risk of Common Stocks" *The Journal of Finance* Vol. 27, No. 2, Papers and Proceedings of the Thirtieth Annual Meeting of the American Finance Association, New Orleans, Louisiana, December 27-29, 1971. (May 1972), pp.435-452

DIRECT TESTIMONY OF PAUL R. MOUL

1 year series, which had no data reported for the months of March 2002 to January
2 2006. That is to say, 48-months of data were missing from the 60-months that I
3 used for my five-year historical analysis shown on page 2 of Schedule 10. As
4 shown on pages 2 and 3 of Schedule 10, I provided the historical yields on Treasury
5 notes and bonds. For the twelve months ended March 2010, the average yield was
6 4.31%, as shown on page 3 of that schedule. For the six- and three-months ended
7 March 2010, the yields on 20-year Treasury bonds averaged 4.38% and 4.49%,
8 respectively. During the twelve-months ended March 2010, the range of the yields
9 on 20-year Treasury bonds was 3.84% to 4.51%. As shown on page 4 of Schedule
10 10, forecasts published by Blue Chip on April 1, 2010 indicate that the yields on
11 long-term Treasury bonds are expected to be in the range of 4.6% to 5.3% during
12 the next six quarters. The longer term forecasts described previously (see Blue
13 Chip Financial Forecast presented earlier) show that the yields on 30-year Treasury
14 bonds will average 5.6% from 2011 through 2015 and 5.9% for 2016 to 2020. For
15 the reasons explained previously, forecasts of interest rates should be emphasized
16 at this time in selecting the risk-free rate of return in CAPM. Hence, I have used a
17 4.75% risk-free rate of return for CAPM purposes, which considers not only the Blue
18 Chip forecasts, but also the recent trend in the yields on long-term Treasury bonds.

19 **Q. What market premium have you used in the CAPM?**

20 A. As shown in Appendix H, the market premium is derived from the SBBi Classic
21 Yearbook (i.e., 6.05%) and the Value Line and S&P 500 returns (i.e., 7.55%). For
22 the historically based market premium, I have used the arithmetic mean. The
23 market premium as averaged from these sources equals 6.80% ($6.05\% + 7.55\% =$
24 $13.60\% \div 2$).

25 **Q. Are there adjustments to the CAPM results that are necessary to fully reflect**

DIRECT TESTIMONY OF PAUL R. MOUL

1 **the rate of return on common equity?**

2 A. Yes. The technical literature supports an adjustment relating to the size of the
3 company or portfolio for which the calculation is performed. As the size of a firm
4 decreases, its risk and hence its required return, increases. Moreover, in his
5 discussion of the cost of capital, Professor Brigham has indicated that smaller firms
6 have higher capital costs than otherwise similar larger firms (see Fundamentals of
7 Financial Management, fifth edition, page 623). Also, the Fama/French study (see
8 "The Cross-Section of Expected Stock Returns"; The Journal of Finance, June
9 1992) established that the size of a firm helps explain stock returns. In an October
10 15, 1995 article in Public Utility Fortnightly, entitled "Equity and the Small-Stock
11 Effect," it was demonstrated that the CAPM could understate the cost of equity
12 significantly according to a company's size. Indeed, it was demonstrated in the
13 SBBI Yearbook that the returns for stocks in lower deciles (i.e., smaller stocks) had
14 returns in excess of those shown by the simple CAPM. In this regard, the Water
15 Group has a market-based average equity capitalization of \$694 million. For my
16 CAPM analysis, I have adopted a mid-cap adjustment of 0.94%.

17 **Q. What CAPM result have you determined?**

18 A. Using the 4.75% risk-free rate of return, the leverage adjusted beta of 0.93 for the
19 Water Group, the 6.80% market premium, and the 0.94% size adjustment, I derived
20 the following CAPM-indicated cost of equity:

$$R_f + \beta \times (R_m - R_f) + size = k$$

$$\text{Water Group } 4.75\% + 0.93 \times (6.80\%) + 0.94\% = 12.01\%$$

DIRECT TESTIMONY OF PAUL R. MOUL

COMPARABLE EARNINGS APPROACH

1

2 **Q. How have you applied the Comparable Earnings approach in this case?**

3 A. The technical aspects of the Comparable Earnings approach are set forth in
4 Appendix I. Because regulation is a substitute for competitively determined prices,
5 the returns realized by non-regulated firms with comparable risks to a public utility
6 provide useful insight into a fair rate of return. In order to identify the appropriate
7 return, it is necessary to analyze returns earned (or realized) by other firms within
8 the context of the Comparable Earnings standard. The firms selected for the
9 Comparable Earnings approach should be companies whose prices are not subject
10 to cost-based price ceilings (i.e., non-regulated firms) so that circularity is avoided.
11 There are two avenues available to implement the Comparable Earnings approach.
12 One method would involve the selection of another industry (or industries) with
13 comparable risks to the public utility in question, and the results for all companies
14 within that industry would serve as a benchmark. The second approach requires
15 the selection of parameters that represent similar risk traits for the public utility and
16 the comparable risk companies. Using this approach, the business lines of the
17 comparable companies become unimportant. The latter approach is preferable with
18 the further qualification that the comparable risk companies exclude regulated firms
19 in order to avoid the circular reasoning implicit in the use of the achieved
20 earnings/book ratios of other regulated firms. The United States Supreme Court
21 has held that:

22 A public utility is entitled to such rates as will permit it to earn a
23 return on the value of the property which it employs for the
24 convenience of the public equal to that generally being made at
25 the same time and in the same general part of the country on
26 investments in other business undertakings which are attended by
27 corresponding risks and uncertainties.... The return should be
28 reasonably sufficient to assure confidence in the financial

DIRECT TESTIMONY OF PAUL R. MOUL

1 soundness of the utility and should be adequate, under efficient
2 and economical management, to maintain and support its credit
3 and enable it to raise the money necessary for the proper
4 discharge of its public duties. Bluefield Water Works vs. Public
5 Service Commission, 262 U.S. 668 (1923).
6

7 Therefore, it is important to identify the returns earned by firms that compete for
8 capital with a public utility. This can be accomplished by analyzing the returns of
9 non-regulated firms that are subject to the competitive forces of the marketplace.

10 **Q. How have you implemented the Comparable Earnings approach?**

11 A. In order to implement the Comparable Earnings approach, non-regulated
12 companies were selected from the Value Line Investment Survey for Windows that
13 have six categories (see Appendix I for definitions) of comparability designed to
14 reflect the risk of the Water Group. These screening criteria were based upon the
15 range as defined by the rankings of the companies in the Water Group. The items
16 considered were: Timeliness Rank, Safety Rank, Financial Strength, Price Stability,
17 Value Line betas, and Technical Rank. The identities of the companies comprising
18 the Comparable Earnings group and their associated rankings within the ranges are
19 identified on page 1 of Schedule 11.

20 Value Line data was relied upon because it provides a comprehensive basis
21 for evaluating the risks of the comparable firms. As to the returns calculated by
22 Value Line for these companies, there is some downward bias in the figures shown
23 on page 2 of Schedule 11, because Value Line computes the returns on year-end
24 rather than average book value. If average book values had been employed, the
25 rates of return would have been slightly higher. Nevertheless, these are the returns
26 considered by investors when taking positions in these stocks. Because many of
27 the comparability factors, as well as the published returns, are used by investors in
28 selecting stocks, and to the extent that investors rely on the Value Line service to

DIRECT TESTIMONY OF PAUL R. MOUL

1 gauge returns, it is, therefore, an appropriate database for measuring comparable
2 return opportunities.

3 **Q. What data have you used in your Comparable Earnings analysis?**

4 A. I have used both historical realized returns and forecasted returns for non-utility
5 companies. As noted previously, I have not used returns for utility companies in
6 order to avoid the circularity that arises from using regulatory-influenced returns to
7 determine a regulated return. It is appropriate to consider a relatively long
8 measurement period in the Comparable Earnings approach in order to cover
9 conditions over an entire business cycle. A ten-year period (5 historical years and 5
10 projected years) is sufficient to cover an average business cycle. Unlike the DCF
11 and CAPM, the results of the Comparable Earnings method can be applied directly
12 to the book value capitalization. In other words, the Comparable Earnings approach
13 does not contain the potential misspecification contained in market models when the
14 market capitalization and book value capitalization diverge significantly. The
15 historical rate of return on book common equity was 12.3% as shown on page 2 of
16 Schedule 11. The forecast rate of return, as published by Value Line, approximates
17 12.9%, as indicated on page 2 of Schedule 11.

18 **Q. What rate of return on common equity have you determined in this case using**
19 **the Comparable Earnings approach?**

20 A. The average of the historical and forecast median rates of return is:

	<u>Historical</u>	<u>Forecast</u>	<u>Average</u>
Comparable Earnings Group	12.3%	12.9%	12.60%

21 As noted previously, I have used the results from the Comparable Earnings method
22 to confirm the results of the market-based models.

DIRECT TESTIMONY OF PAUL R. MOUL

1

CONCLUSION ON COST OF EQUITY

2 **Q. What is your conclusion regarding the Companies' cost of common equity?**

3 A. Based upon the application of the variety of methods and models described
4 previously, I recommend that the Commission set the Company's rate of return on
5 common equity at 11.75%. My cost of equity recommendation should be
6 considered in the context of the Company's higher risk characteristics. It is
7 essential that the Commission employ a variety of techniques to measure the
8 Company's cost of equity because of the limitations/infirmities that are inherent in
9 each method. My cost of equity recommendation makes no provision for the
10 prospect that the rate of return may not be achieved due to regulatory lag, attrition
11 and/or other unforeseen events.

12 **Q. Does this conclude your direct testimony at this time?**

13 A. Yes, it does.

PENNSYLVANIA-AMERICAN WATER COMPANY

Northeast Wastewater Division

Docket No. R-2010-2166214

Exhibit

To Accompany the

Direct Testimony

Of

Paul R. Moul, Managing Consultant
P. Moul & Associates

Concerning

Cost of Equity

Pennsylvania-American Water Company

Northeast Wastewater Division

Index of Schedules

	<u>Schedule</u>
Summary Cost of Capital	1
Pennsylvania-American Water Company Historical Capitalization and Financial Statistics	2
Water Group Historical Capitalization and Financial Statistics	3
Standard & Poor's Public Utilities Historical Capitalization and Financial Statistics	4
Dividend Yields	5
Historical Growth Rates	6
Projected Growth Rates	7
Interest Rates for Investment Grade Public Utility Bonds	8
Long-Term, Year-by-Year Total Returns for the S&P Composite Index, S&P Public Utility Index, and Long-Term Corporate Bonds and Public Utility Bonds	9
Component Inputs for the Capital Market Pricing Model	10
Comparable Earnings Approach	11

Pennsylvania-American Water Company
Summary Cost of Capital for Northeast Wastewater
Estimated at December 31, 2010

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rate</u>	<u>Weighted Cost Rate</u>
Long-Term Debt	49.21%	6.16%	3.03%
Preferred Stock	0.72%	8.11%	0.06%
Common Equity	<u>50.07%</u>	11.50%	<u>5.76%</u>
Total	<u>100.00%</u>		<u>8.85%</u>

Indicated levels of fixed charge coverage assuming that the Company could actually achieve its overall cost of capital:

Pre-tax coverage of interest expense based upon a 41.4935% composite federal and state income tax rate (12.88% ÷ 3.03%)	4.25 x
Post-tax coverage of interest expense (8.85% ÷ 3.03%)	2.92 x
Post-tax coverage of interest expense and preferred stock dividends (8.85% ÷ 3.09%)	2.86 x

Pennsylvania-American Water Company
Capitalization and Financial Statistics
2004-2008, Inclusive

	2008	2007	2006	2005	2004	
	(Millions of Dollars)					
Amount of Capital Employed						
Permanent Capital	\$ 1,805.9	\$ 1,677.6	\$ 1,499.6	\$ 1,590.2	\$ 1,597.2	
Short-Term Debt	\$ 90.6	\$ 80.1	\$ 180.9	\$ 12.4	\$ 11.7	
Total Capital	<u>\$ 1,896.5</u>	<u>\$ 1,757.7</u>	<u>\$ 1,680.5</u>	<u>\$ 1,602.7</u>	<u>\$ 1,608.9</u>	
Capital Structure Ratios						
Based on Permanent Capital:						Average
Long-Term Debt	51.1%	50.6%	47.8%	53.9%	57.0%	52.1%
Preferred Stock	0.8%	0.8%	0.9%	0.9%	0.9%	0.9%
Common Equity ⁽¹⁾	48.1%	48.5%	51.2%	45.2%	42.1%	47.0%
	<u>100.0%</u>	<u>99.9%</u>	<u>99.9%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	53.5%	52.9%	53.5%	54.3%	57.3%	54.3%
Preferred Stock	0.7%	0.8%	0.8%	0.9%	0.9%	0.8%
Common Equity ⁽¹⁾	45.8%	46.3%	45.7%	44.8%	41.8%	44.9%
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity ⁽¹⁾	9.0%	7.8%	8.4%	9.6%	8.9%	8.7%
Operating Ratio ⁽²⁾	59.2%	62.1%	61.2%	59.3%	60.1%	60.4%
Coverage incl. AFUDC ⁽³⁾						
Pre-tax: All Interest Charges	3.28 x	2.83 x	2.94 x	3.07 x	3.05 x	3.03 x
Post-tax: All Interest Charges	2.35 x	2.10 x	2.16 x	2.25 x	2.22 x	2.22 x
Overall Coverage: All Int. & Pfd. Div.	2.35 x	2.09 x	2.16 x	2.25 x	2.17 x	2.20 x
Coverage excl. AFUDC ⁽³⁾						
Pre-tax: All Interest Charges	3.26 x	2.83 x	2.94 x	3.07 x	3.05 x	3.03 x
Post-tax: All Interest Charges	2.33 x	2.09 x	2.16 x	2.25 x	2.22 x	2.21 x
Overall Coverage: All Int. & Pfd. Div.	2.32 x	2.09 x	2.16 x	2.25 x	2.17 x	2.20 x
Quality of Earnings & Cash Flow						
AFC/Income Avail. for Common Equity	1.6%	0.2%	0.3%	0.0%	0.2%	0.5%
Effective Income Tax Rate	40.8%	40.1%	40.1%	39.4%	40.5%	40.2%
Internal Cash Generation/Construction ⁽⁴⁾	62.9%	55.5%	71.8%	71.9%	87.1%	69.8%
Gross Cash Flow/ Avg. Total Debt ⁽⁵⁾	18.9%	14.9%	16.4%	16.3%	17.2%	16.7%
Gross Cash Flow Interest Coverage ⁽⁶⁾	4.24 x	3.38 x	3.70 x	3.71 x	4.08 x	3.82 x
Common Dividend Coverage ⁽⁷⁾	3.36 x	2.83 x	3.40 x	2.85 x	3.19 x	3.13 x

See Page 2 for Notes.

Pennsylvania-American Water Company
Capitalization and Financial Statistics
2004-2008, Inclusive

Notes:

- (1) Excluding Accumulated Other Comprehensive Income ("OCI") from the equity account.
- (2) Total operating expenses, maintenance, depreciation and taxes other than income taxes as a percent of operating revenues.
- (3) Coverage calculations represent the number of times available earnings, both including and excluding AFUDC (allowance for funds used during construction) as reported in its entirety, cover fixed charges.
- (4) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally-generated funds from operations after payment of all cash dividends divided by gross construction expenditures.
- (5) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) plus interest charges, divided by interest charges.
- (6) Gross Cash Flow plus interest charges divided by interest charges.
- (7) Common dividend coverage is the relationship of internally-generated funds from operations after payment of preferred stock dividends to common dividends paid.

Source of Information: Certified Annual Reports

Water Group
Capitalization and Financial Statistics ⁽¹⁾
2004-2008, Inclusive

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	
	(Millions of Dollars)					
Amount of Capital Employed						
Permanent Capital	\$ 667.1	\$ 644.5	\$ 582.7	\$ 524.6	\$ 489.2	
Short-Term Debt	\$ 36.8	\$ 16.4	\$ 24.6	\$ 25.9	\$ 21.0	
Total Capital	<u>\$ 703.9</u>	<u>\$ 660.9</u>	<u>\$ 607.3</u>	<u>\$ 550.5</u>	<u>\$ 510.2</u>	
Market-Based Financial Ratios						
Earnings/Price Ratio	22 x	27 x	27 x	25 x	22 x	<u>Average</u> 25 x
Market/Book Ratio	195.1%	246.4%	267.1%	255.8%	232.3%	239.3%
Dividend Yield	3.4%	2.6%	2.7%	2.8%	3.2%	2.9%
Dividend Payout Ratio	72.6%	72.0%	73.0%	71.3%	70.2%	71.8%
Capital Structure Ratios						
Based on Permanent Capital:						
Long-Term Debt	48.8%	49.1%	47.2%	49.5%	49.0%	48.7%
Preferred Stock	0.2%	0.4%	0.4%	0.4%	0.5%	0.4%
Common Equity ⁽²⁾	<u>51.0%</u>	<u>50.6%</u>	<u>52.4%</u>	<u>50.1%</u>	<u>50.5%</u>	<u>50.9%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	51.9%	50.3%	48.6%	51.2%	50.6%	50.5%
Preferred Stock	0.2%	0.3%	0.4%	0.4%	0.4%	0.4%
Common Equity ⁽²⁾	<u>47.8%</u>	<u>49.3%</u>	<u>51.1%</u>	<u>48.5%</u>	<u>49.0%</u>	<u>49.1%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity ⁽²⁾	9.1%	9.1%	10.3%	10.2%	10.5%	9.8%
Operating Ratio ⁽³⁾	72.2%	72.1%	72.6%	70.8%	72.2%	72.0%
Coverage incl. AFUDC ⁽⁴⁾						
Pre-tax: All Interest Charges	3.40 x	3.51 x	3.59 x	3.80 x	3.55 x	3.57 x
Post-tax: All Interest Charges	2.53 x	2.58 x	2.67 x	2.72 x	2.65 x	2.63 x
Overall Coverage: All Int. & Pfd. Div.	2.51 x	2.56 x	2.65 x	2.70 x	2.63 x	2.61 x
Coverage excl. AFUDC ⁽⁴⁾						
Pre-tax: All Interest Charges	3.33 x	3.46 x	3.51 x	3.74 x	3.45 x	3.50 x
Post-tax: All Interest Charges	2.46 x	2.52 x	2.59 x	2.66 x	2.56 x	2.56 x
Overall Coverage: All Int. & Pfd. Div.	2.43 x	2.50 x	2.58 x	2.64 x	2.54 x	2.54 x
Quality of Earnings & Cash Flow						
AFC/Income Avail. for Common Equity	4.6%	3.3%	5.2%	3.8%	5.7%	4.5%
Effective Income Tax Rate	36.4%	37.5%	32.9%	37.9%	35.5%	36.0%
Internal Cash Generation/Construction ⁽⁵⁾	52.7%	49.8%	49.9%	49.7%	60.0%	52.4%
Gross Cash Flow/ Avg. Total Debt ⁽⁶⁾	19.6%	17.6%	21.0%	19.7%	21.4%	19.9%
Gross Cash Flow Interest Coverage ⁽⁷⁾	4.24 x	3.89 x	4.19 x	4.38 x	4.37 x	4.21 x
Common Dividend Coverage ⁽⁸⁾	3.20 x	2.72 x	3.28 x	3.00 x	3.23 x	3.09 x

See Page 2 for Notes.

Water Group
Capitalization and Financial Statistics
2004-2008, Inclusive

Notes:

- (1) All capitalization and financial statistics for the group are the arithmetic average of the achieved results for each individual company in the group.
- (2) Excluding Accumulated Other Comprehensive Income ("OCI") from the equity account.
- (3) Total operating expenses, maintenance, depreciation and taxes other than income taxes as a percent of operating revenues.
- (4) Coverage calculations represent the number of times available earnings, both including and excluding AFUDC (allowance for funds used during construction) as reported in its entirety, cover fixed charges.
- (5) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally-generated funds from operations after payment of all cash dividends divided by gross construction expenditures.
- (6) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) plus interest charges, divided by interest charges.
- (7) Gross Cash Flow plus interest charges divided by interest charges.
- (8) Common dividend coverage is the relationship of internally-generated funds from operations after payment of preferred stock dividends to common dividends paid.

Basis of Selection:

The Water Group companies have the following common characteristics: (i) they are listed in the "Water Utility Industry" section (basic and expanded editions) of The Value Line Investment Survey, (ii) their stock is publicly traded, and (iii) they are not currently the target of a publicly-announced merger or acquisition.

Ticker	Company	Corporate Credit Ratings		Stock Traded	S&P Stock Ranking	Value Line Beta
		Moody's	S&P			
AWR	American States Water	A2	A	NYSE	B+	0.80
WTR	Aqua America, Inc.	-	A+	NYSE	A-	0.65
CWT	California Water Serv. Grp.	A2	A+	NYSE	B+	0.75
CTWS	Connecticut Water Services	-	A	NASDAQ	A-	0.80
MSEX	Middlesex Water Company	-	A-	NASDAQ	B+	0.80
SJW	SJW Corporation	-	-	AMER	B+	0.95
YORW	York Water Company	-	A-	-	-	0.65
Average		<u>A2</u>	<u>A</u>		<u>B+</u>	<u>0.77</u>

Note: Ratings are those of utility subsidiaries

Source of Information: Utility COMPUSTAT
Moody's Investors Service
Standard & Poor's Corporation
S&P Stock Guide

Standard & Poor's Public Utilities
Capitalization and Financial Statistics ⁽¹⁾
2004-2008, Inclusive

	2008	2007	2006	2005	2004	
	(Millions of Dollars)					
Amount of Capital Employed						
Permanent Capital	\$ 15,307.2	\$ 13,978.1	\$ 14,025.4	\$ 13,213.3	\$ 13,102.2	
Short-Term Debt	\$ 746.9	\$ 578.0	\$ 478.8	\$ 436.5	\$ 261.0	
Total Capital	<u>\$ 16,054.1</u>	<u>\$ 14,556.1</u>	<u>\$ 14,504.2</u>	<u>\$ 13,649.8</u>	<u>\$ 13,363.2</u>	
Market-Based Financial Ratios						<u>Average</u>
Price-Earnings Multiple	15 x	16 x	17 x	16 x	16 x	16 x
Market/Book Ratio	184.8%	228.7%	217.3%	211.3%	173.3%	203.1%
Dividend Yield	4.1%	3.3%	3.4%	3.5%	3.7%	3.6%
Dividend Payout Ratio	60.6%	53.3%	57.9%	55.7%	58.7%	57.2%
Capital Structure Ratios						
Based on Permanent Capital:						
Long-Term Debt	53.7%	51.8%	53.0%	54.5%	56.2%	53.8%
Preferred Stock	1.0%	1.1%	1.2%	1.3%	1.4%	1.2%
Common Equity ⁽²⁾	<u>45.4%</u>	<u>47.1%</u>	<u>45.9%</u>	<u>44.2%</u>	<u>42.4%</u>	<u>45.0%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Based on Total Capital:						
Total Debt incl. Short Term	56.6%	54.5%	55.1%	56.8%	58.0%	56.2%
Preferred Stock	1.0%	1.1%	1.1%	1.2%	1.4%	1.2%
Common Equity ⁽²⁾	<u>42.5%</u>	<u>44.5%</u>	<u>43.8%</u>	<u>41.9%</u>	<u>40.6%</u>	<u>42.6%</u>
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Rate of Return on Book Common Equity ⁽²⁾	11.2%	13.1%	12.1%	11.2%	11.6%	11.8%
Operating Ratio ⁽³⁾	82.1%	84.3%	84.6%	86.0%	84.6%	84.3%
Coverage incl. AFUDC ⁽⁴⁾						
Pre-tax: All Interest Charges	3.42 x	3.81 x	3.38 x	3.23 x	3.15 x	3.40 x
Post-tax: All Interest Charges	2.58 x	2.87 x	2.62 x	2.57 x	2.50 x	2.63 x
Overall Coverage: All Int. & Pfd. Div.	2.55 x	2.84 x	2.59 x	2.53 x	2.46 x	2.59 x
Coverage excl. AFUDC ⁽⁴⁾						
Pre-tax: All Interest Charges	3.32 x	3.73 x	3.33 x	3.19 x	3.11 x	3.34 x
Post-tax: All Interest Charges	2.48 x	2.79 x	2.57 x	2.53 x	2.46 x	2.57 x
Overall Coverage: All Int. & Pfd. Div.	2.45 x	2.75 x	2.54 x	2.49 x	2.42 x	2.53 x
Quality of Earnings & Cash Flow						
AFC/Income Avail. for Common Equity	7.1%	5.0%	3.5%	1.0%	3.1%	3.9%
Effective Income Tax Rate	32.3%	34.1%	26.8%	29.4%	27.0%	29.9%
Internal Cash Generation/Construction ⁽⁵⁾	78.6%	82.3%	88.5%	101.9%	123.6%	95.0%
Gross Cash Flow/ Avg. Total Debt ⁽⁶⁾	24.7%	24.6%	22.6%	20.8%	21.6%	22.9%
Gross Cash Flow Interest Coverage ⁽⁷⁾	5.14 x	4.94 x	4.49 x	4.40 x	4.54 x	4.70 x
Common Dividend Coverage ⁽⁸⁾	5.31 x	5.84 x	4.31 x	4.40 x	4.84 x	4.94 x

See Page 2 for Notes.

Standard & Poor's Public Utilities
Capitalization and Financial Statistics
2004-2008, Inclusive

Notes:

- (1) All capitalization and financial statistics for the group are the arithmetic average of the achieved results for each individual company in the group.
- (2) Excluding Accumulated Other Comprehensive Income ("OCI") from the equity account
- (3) Total operating expenses, maintenance, depreciation and taxes other than income taxes as a percent of operating revenues.
- (4) Coverage calculations represent the number of times available earnings, both including and excluding AFUDC (allowance for funds used during construction) as reported in its entirety, cover fixed charges.
- (5) Internal cash generation/gross construction is the percentage of gross construction expenditures provided by internally-generated funds from operations after payment of all cash dividends divided by gross construction expenditures.
- (6) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) as a percentage of average total debt.
- (7) Gross Cash Flow (sum of net income, depreciation, amortization, net deferred income taxes and investment tax credits, less total AFUDC) plus interest charges, divided by interest charges.
- (8) Common dividend coverage is the relationship of internally-generated funds from operations after payment of preferred stock dividends to common dividends paid.

Source of Information: Annual Reports to Shareholders
Utility COMPUSTAT

Standard & Poor's Public Utilities

Company Identities ⁽¹⁾

	Ticker	Credit Rating ⁽²⁾		Common Stock Traded	S&P Stock Ranking	Value Line Beta
		Moody's	S&P			
Allegheny Energy	AYE	Baa3	BBB-	NYSE	B	1.00
Ameren Corporation	AEE	Baa2	BBB-	NYSE	B+	0.80
American Electric Power	AEP	Baa2	BBB	NYSE	B	0.70
CMS Energy	CMS	Baa2	BBB-	NYSE	B	0.80
CenterPoint Energy	CNP	Baa3	BBB	NYSE	B	0.80
Consolidated Edison	ED	A3	A-	NYSE	B+	0.65
Constellation Energy Group	CEG	Baa2	BBB	NYSE	B	0.80
DTE Energy Co.	DTE	Baa1	BBB	NYSE	B	0.75
Dominion Resources	D	Baa1	A-	NYSE	B+	0.70
Duke Energy	DUK	A3	A-	NYSE	B	0.65
Edison Int'l	EIX	A3	BBB+	NYSE	B	0.80
Entergy Corp.	ETR	Baa2	BBB	NYSE	A	0.70
EQT Corp.	EQT	Baa1	BBB	NYSE	B+	1.15
Exelon Corp.	EXC	A3	BBB	NYSE	B+	0.85
FPL Group	FPL	A1	A	NYSE	A	0.75
FirstEnergy Corp.	FE	Baa2	BBB	NYSE	A-	0.80
Integrus Energy Group	TEG	A2	A-	NYSE	B+	0.95
NICOR Inc.	GAS	A2	AA	NYSE	B	0.70
NiSource Inc.	NI	Baa2	BBB-	NYSE	B	0.85
Northeast Utilities	NU	Baa1	BBB	NYSE	B	0.70
PEPCO Holdings, Inc.	POM	Baa2	BBB	NYSE	B	0.80
PG&E Corp.	PCG	A3	BBB+	NYSE	B	0.55
PPL Corp.	PPL	Baa1	A-	NYSE	B+	0.70
Pinnacle West Capital	PNW	Baa2	BBB-	NYSE	B	0.75
Progress Energy, Inc.	PGN	A3	BBB+	NYSE	B	0.65
Public Serv. Enterprise Inc.	PEG	Baa1	BBB	NYSE	B+	0.80
Questar Corp.	STR	A3	BBB+	NYSE	A	1.20
SCANA Corp.	SCG	Baa1	BBB+	NYSE	B	0.65
Sempra Energy	SRE	A2	A	NYSE	B+	0.85
Southern Co.	SO	A2	A	NYSE	A-	0.55
TECO Energy	TE	Baa1	BBB	NYSE	B	0.85
Wisconsin Energy Corp.	WEC	A1	A-	NYSE	B+	0.65
Xcel Energy Inc	XEL	A3	A-	NYSE	B	0.65
Average for S&P Utilities		<u>Baa1</u>	<u>BBB+</u>		<u>B+</u>	<u>0.77</u>

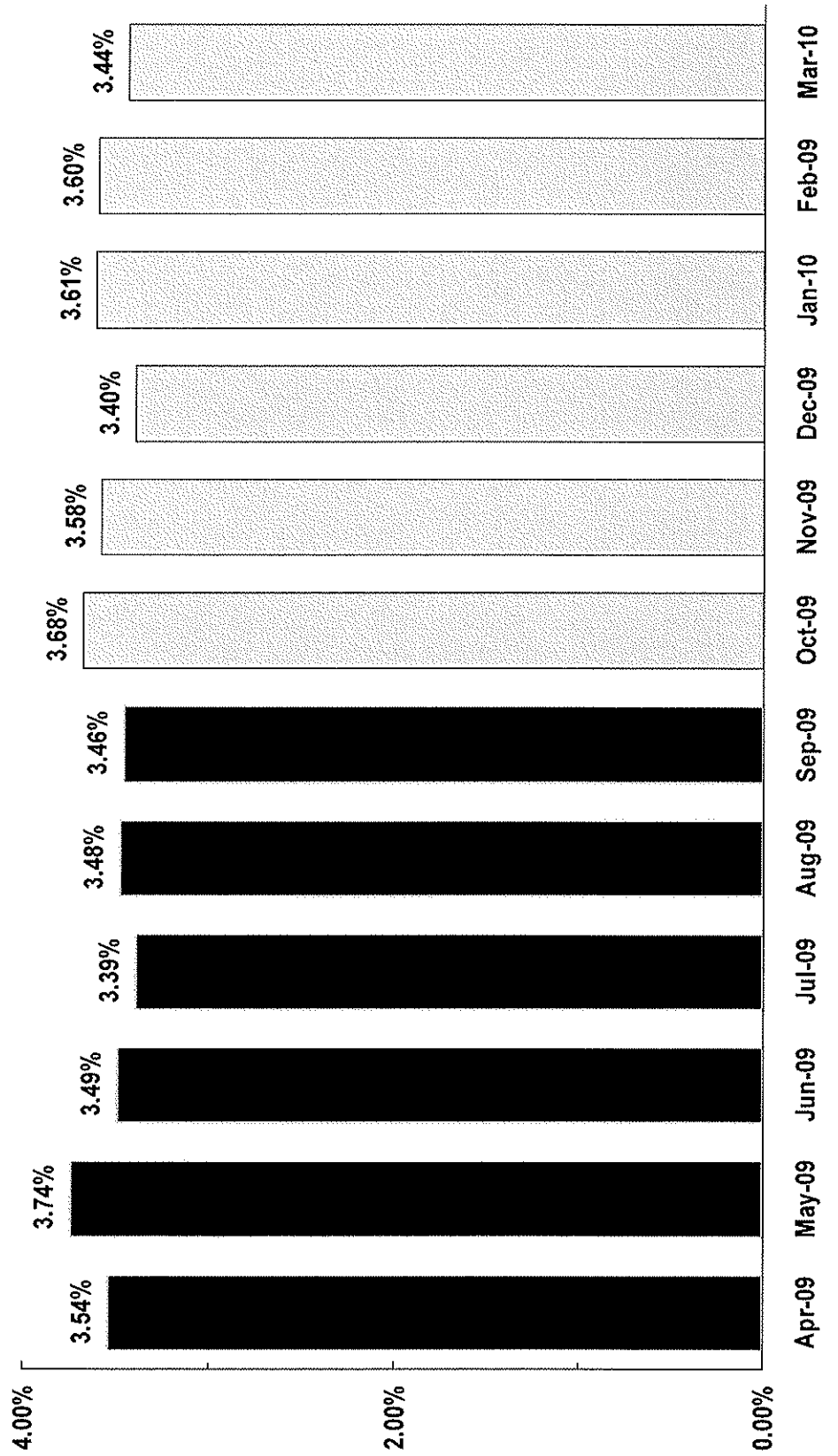
Note: ⁽¹⁾ Includes companies contained in S&P Utility Compustat. AES Corp. and Dynegy, Inc. are not included.

⁽²⁾ Ratings are those of utility subsidiaries

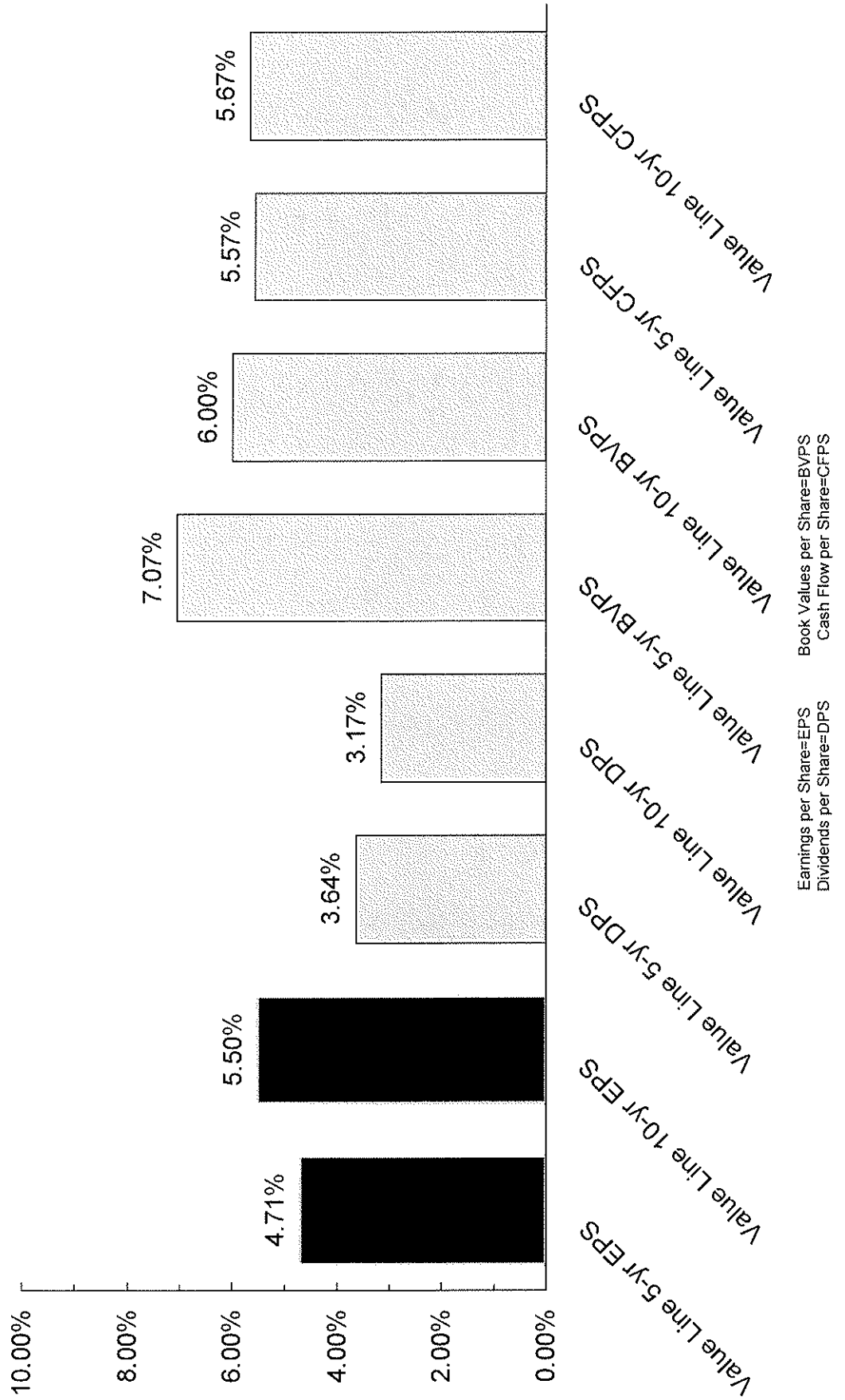
Source of Information: Moody's Investors Service
Standard & Poor's Corporation
Standard & Poor's Stock Guide
Value Line Investment Survey for Windows

Water Group

Monthly Dividend Yields

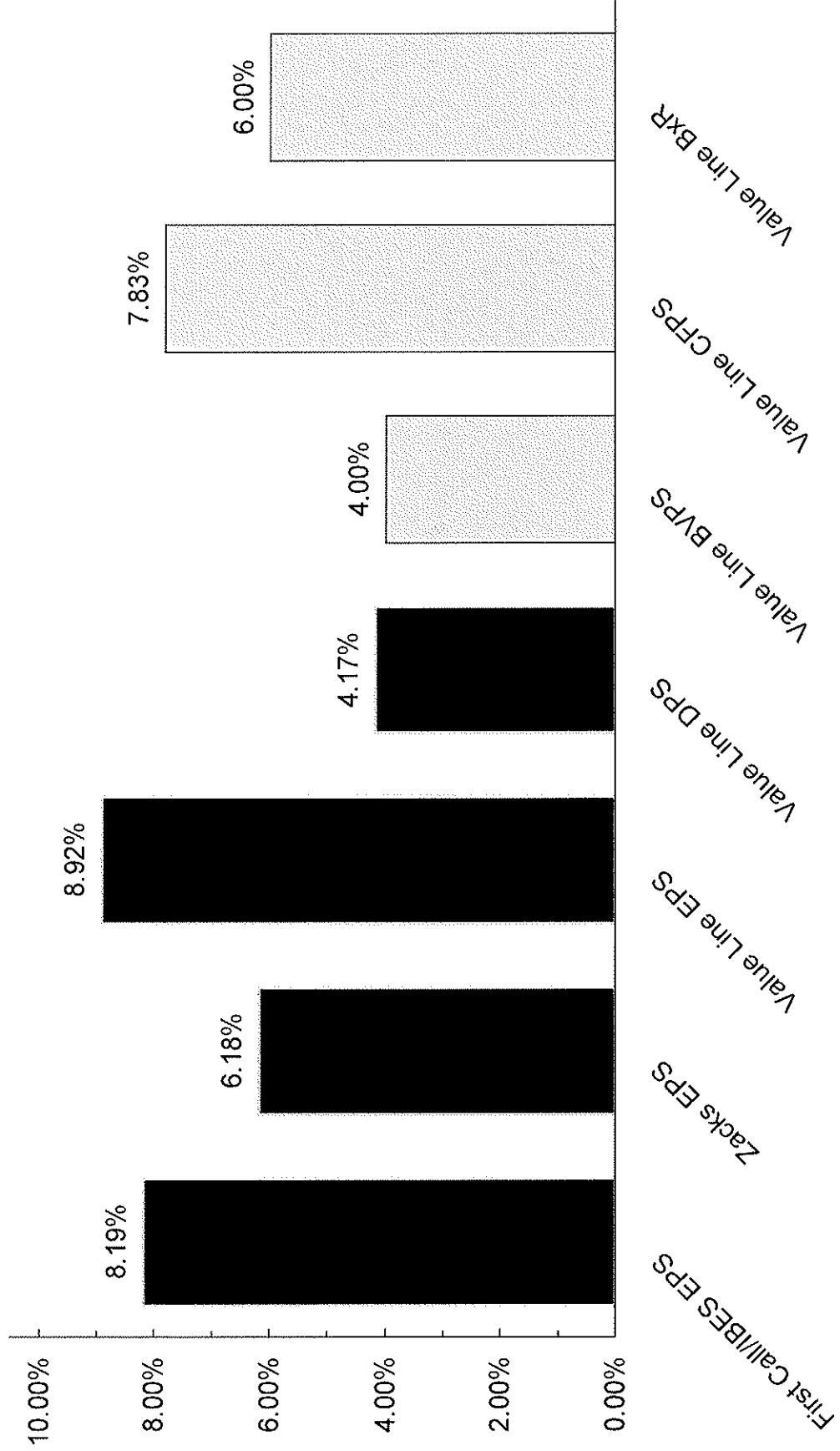


Water Group Historical Growth Rates



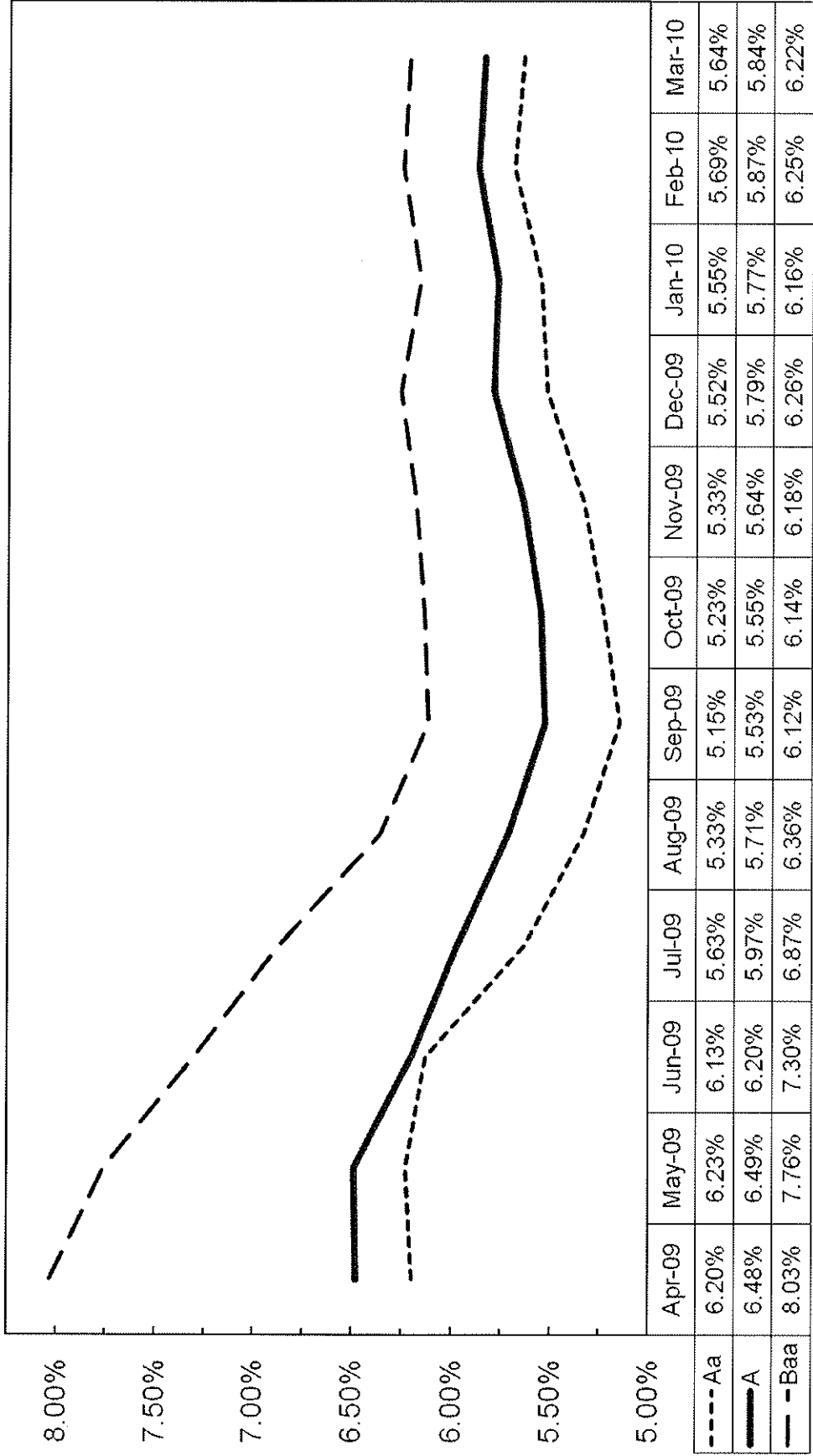
Water Group

Five-Year Projected Growth Rates



Earnings per Share=EPS Book Values per Share=BVPS
 Dividends per Share=DPS Cash Flow per Share=CFPS
 Percent Retained to Common Equity=BxR

**Interest Rates for
Investment Grade Public Utility Bonds**

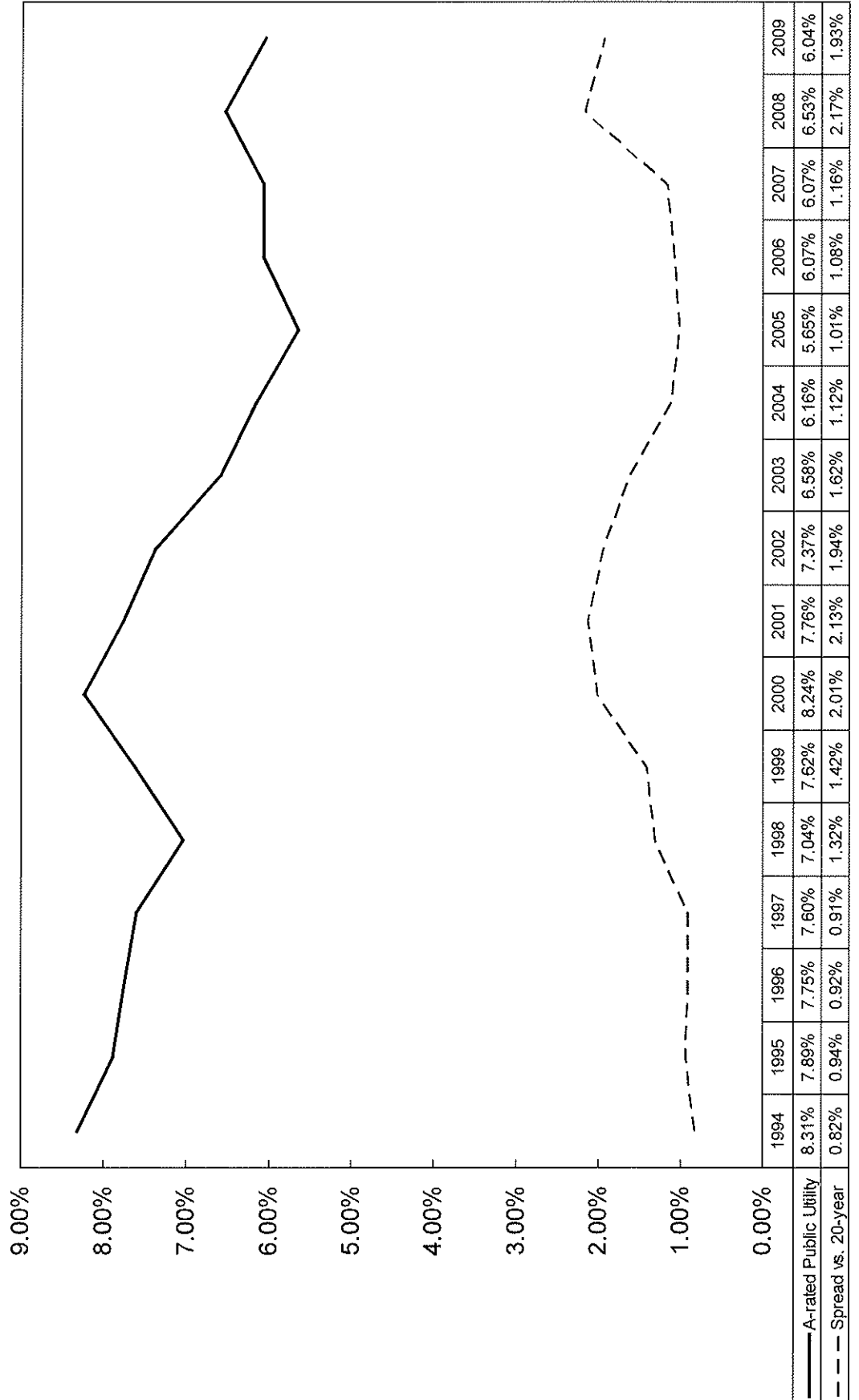


**Interest Rates for Investment Grade Public Utility Bonds
Yearly for 2004-2008 and 2009
and the Twelve Months Ended March 2010**

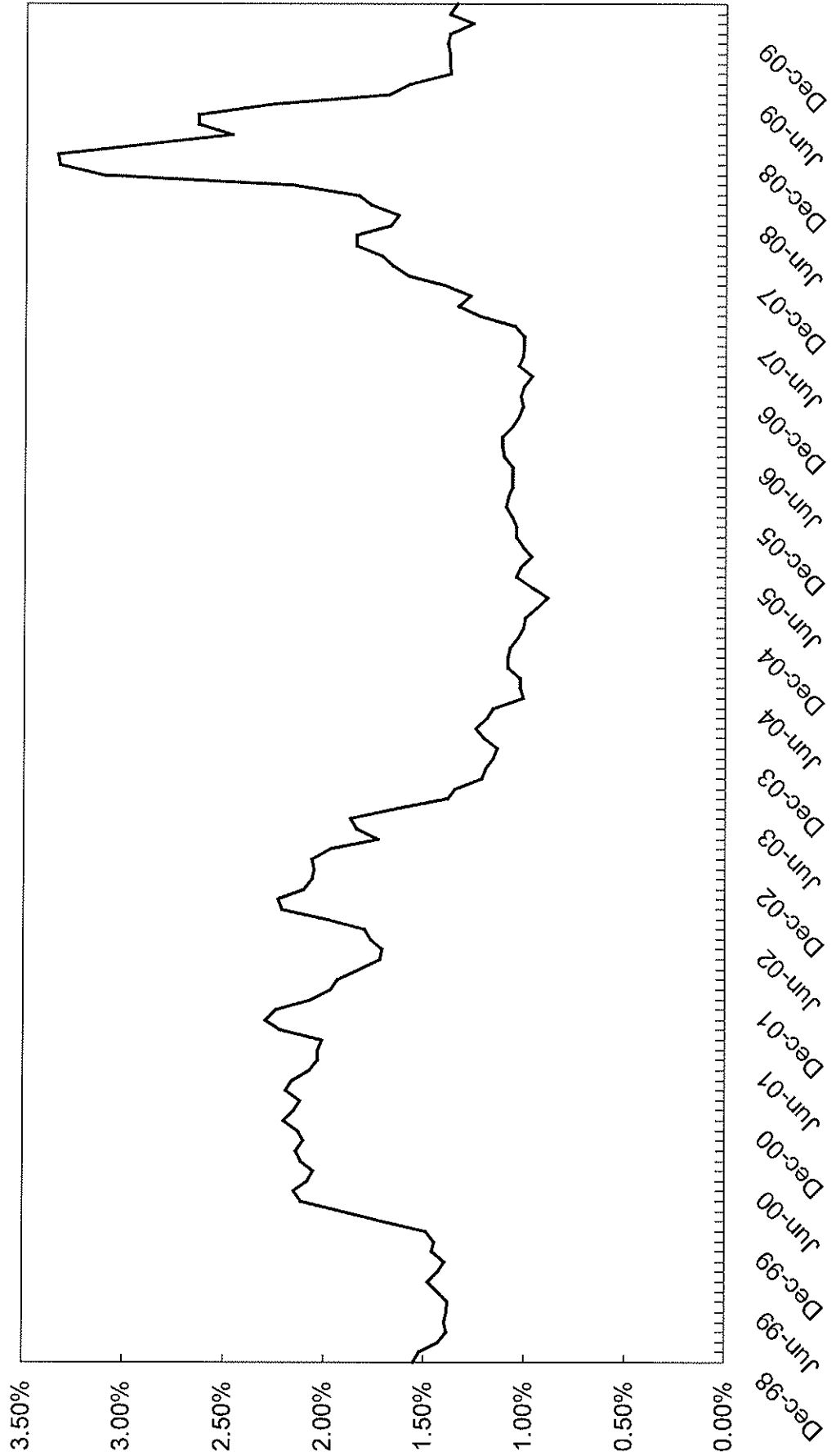
<u>Years</u>	<u>Aa Rated</u>	<u>A Rated</u>	<u>Baa Rated</u>	<u>Average</u>
2004	6.04%	6.16%	6.40%	6.20%
2005	5.44%	5.65%	5.93%	5.67%
2006	5.84%	6.07%	6.32%	6.08%
2007	5.94%	6.07%	6.33%	6.11%
2008	6.18%	6.53%	7.24%	6.65%
Five-Year Average	<u>5.89%</u>	<u>6.10%</u>	<u>6.44%</u>	<u>6.14%</u>
2009	5.75%	6.04%	7.06%	6.28%
<u>Months</u>				
Apr-09	6.20%	6.48%	8.03%	6.90%
May-09	6.23%	6.49%	7.76%	6.83%
Jun-09	6.13%	6.20%	7.30%	6.54%
Jul-09	5.63%	5.97%	6.87%	6.15%
Aug-09	5.33%	5.71%	6.36%	5.80%
Sep-09	5.15%	5.53%	6.12%	5.60%
Oct-09	5.23%	5.55%	6.14%	5.64%
Nov-09	5.33%	5.64%	6.18%	5.71%
Dec-09	5.52%	5.79%	6.26%	5.86%
Jan-10	5.55%	5.77%	6.16%	5.83%
Feb-10	5.69%	5.87%	6.25%	5.94%
Mar-10	5.64%	5.84%	6.22%	5.90%
Twelve-Month Average	<u>5.64%</u>	<u>5.90%</u>	<u>6.64%</u>	<u>6.06%</u>
Six-Month Average	<u>5.49%</u>	<u>5.74%</u>	<u>6.20%</u>	<u>5.81%</u>
Three-Month Average	<u>5.63%</u>	<u>5.83%</u>	<u>6.21%</u>	<u>5.89%</u>

Source: Mergent Bond Record

Yields on A-rated Public Utility Bonds and Spreads over 20-Year Treasuries



Interest Rate Spreads A-rated Public Utility Bonds over 20-Year Treasuries



A rated Public Utility Bonds over 20-Year Treasuries

Year	A-rated Public Utility	20-Year Treasuries		Year	A-rated Public Utility	20-Year Treasuries		Year	A-rated Public Utility	20-Year Treasuries	
		Yield	Spread			Yield	Spread			Yield	Spread
Dec-98	6.91%	5.36%	1.55%								
Jan-99	6.97%	5.45%	1.52%	Jan-03	7.07%	5.02%	2.05%	Jan-07	5.96%	4.95%	1.01%
Feb-99	7.09%	5.66%	1.43%	Feb-03	6.93%	4.87%	2.06%	Feb-07	5.90%	4.93%	0.97%
Mar-99	7.26%	5.87%	1.39%	Mar-03	6.79%	4.82%	1.97%	Mar-07	5.85%	4.81%	1.04%
Apr-99	7.22%	5.82%	1.40%	Apr-03	6.64%	4.91%	1.73%	Apr-07	5.97%	4.95%	1.02%
May-99	7.47%	6.08%	1.39%	May-03	6.36%	4.52%	1.84%	May-07	5.99%	4.96%	1.01%
Jun-99	7.74%	6.36%	1.38%	Jun-03	6.21%	4.34%	1.87%	Jun-07	6.30%	5.29%	1.01%
Jul-99	7.71%	6.28%	1.43%	Jul-03	6.57%	4.92%	1.65%	Jul-07	6.25%	5.19%	1.06%
Aug-99	7.91%	6.43%	1.48%	Aug-03	6.78%	5.39%	1.39%	Aug-07	6.24%	5.00%	1.24%
Sep-99	7.93%	6.50%	1.43%	Sep-03	6.56%	5.21%	1.35%	Sep-07	6.18%	4.84%	1.34%
Oct-99	8.06%	6.66%	1.40%	Oct-03	6.43%	5.21%	1.22%	Oct-07	6.11%	4.83%	1.28%
Nov-99	7.94%	6.48%	1.46%	Nov-03	6.37%	5.17%	1.20%	Nov-07	5.97%	4.56%	1.41%
Dec-99	8.14%	6.69%	1.45%	Dec-03	6.27%	5.11%	1.16%	Dec-07	6.16%	4.57%	1.59%
Jan-00	8.35%	6.86%	1.49%	Jan-04	6.15%	5.01%	1.14%	Jan-08	6.02%	4.35%	1.67%
Feb-00	8.25%	6.54%	1.71%	Feb-04	6.15%	4.94%	1.21%	Feb-08	6.21%	4.49%	1.72%
Mar-00	8.28%	6.38%	1.90%	Mar-04	5.97%	4.72%	1.25%	Mar-08	6.21%	4.36%	1.85%
Apr-00	8.29%	6.18%	2.11%	Apr-04	6.35%	5.16%	1.19%	Apr-08	6.29%	4.44%	1.85%
May-00	8.70%	6.55%	2.15%	May-04	6.62%	5.46%	1.16%	May-08	6.28%	4.60%	1.66%
Jun-00	8.36%	6.28%	2.08%	Jun-04	6.46%	5.45%	1.01%	Jun-08	6.36%	4.74%	1.64%
Jul-00	8.25%	6.20%	2.05%	Jul-04	6.27%	5.24%	1.03%	Jul-08	6.40%	4.62%	1.78%
Aug-00	8.13%	6.02%	2.11%	Aug-04	6.14%	5.07%	1.07%	Aug-08	6.37%	4.53%	1.84%
Sep-00	8.23%	6.09%	2.14%	Sep-04	5.98%	4.89%	1.09%	Sep-08	6.49%	4.32%	2.17%
Oct-00	8.14%	6.04%	2.10%	Oct-04	5.94%	4.85%	1.09%	Oct-08	7.56%	4.45%	3.11%
Nov-00	8.11%	5.98%	2.13%	Nov-04	5.97%	4.89%	1.08%	Nov-08	7.60%	4.27%	3.33%
Dec-00	7.84%	5.64%	2.20%	Dec-04	5.92%	4.88%	1.04%	Dec-08	6.52%	3.16%	3.34%
Jan-01	7.80%	5.65%	2.15%	Jan-05	5.78%	4.77%	1.01%	Jan-09	6.39%	3.46%	2.93%
Feb-01	7.74%	5.62%	2.12%	Feb-05	5.61%	4.61%	1.00%	Feb-09	6.30%	3.83%	2.47%
Mar-01	7.68%	5.49%	2.19%	Mar-05	5.83%	4.89%	0.94%	Mar-09	6.42%	3.78%	2.64%
Apr-01	7.94%	5.78%	2.16%	Apr-05	5.64%	4.75%	0.89%	Apr-09	6.48%	3.84%	2.64%
May-01	7.99%	5.92%	2.07%	May-05	5.53%	4.56%	0.97%	May-09	6.49%	4.22%	2.27%
Jun-01	7.85%	5.82%	2.03%	Jun-05	5.40%	4.35%	1.05%	Jun-09	6.20%	4.51%	1.69%
Jul-01	7.78%	5.75%	2.03%	Jul-05	5.51%	4.48%	1.03%	Jul-09	5.97%	4.38%	1.59%
Aug-01	7.59%	5.58%	2.01%	Aug-05	5.50%	4.53%	0.97%	Aug-09	5.71%	4.33%	1.38%
Sep-01	7.75%	5.53%	2.22%	Sep-05	5.52%	4.51%	1.01%	Sep-09	5.53%	4.14%	1.39%
Oct-01	7.63%	5.34%	2.29%	Oct-05	5.79%	4.74%	1.05%	Oct-09	5.55%	4.16%	1.39%
Nov-01	7.57%	5.33%	2.24%	Nov-05	5.88%	4.83%	1.05%	Nov-09	5.64%	4.24%	1.40%
Dec-01	7.83%	5.76%	2.07%	Dec-05	5.80%	4.73%	1.07%	Dec-09	5.79%	4.40%	1.39%
Jan-02	7.66%	5.69%	1.97%	Jan-06	5.75%	4.65%	1.10%	Jan-10	5.77%	4.50%	1.27%
Feb-02	7.54%	5.61%	1.93%	Feb-06	5.82%	4.73%	1.09%	Feb-10	5.87%	4.48%	1.39%
Mar-02	7.76%	5.93%	1.83%	Mar-06	5.98%	4.91%	1.07%	Mar-10	5.84%	4.49%	1.35%
Apr-02	7.57%	5.85%	1.72%	Apr-06	6.29%	5.22%	1.07%				
May-02	7.52%	5.81%	1.71%	May-06	6.42%	5.35%	1.07%				
Jun-02	7.42%	5.65%	1.77%	Jun-06	6.40%	5.29%	1.11%	Average:			
Jul-02	7.31%	5.51%	1.80%	Jul-06	6.37%	5.25%	1.12%	12-months			1.60%
Aug-02	7.17%	5.19%	1.98%	Aug-06	6.20%	5.08%	1.12%	6-months			1.37%
Sep-02	7.08%	4.87%	2.21%	Sep-06	6.00%	4.93%	1.07%	3-months			1.34%
Oct-02	7.23%	5.00%	2.23%	Oct-06	5.98%	4.94%	1.04%				
Nov-02	7.14%	5.04%	2.10%	Nov-06	5.80%	4.78%	1.02%				
Dec-02	7.07%	5.01%	2.06%	Dec-06	5.81%	4.78%	1.03%				

S&P Composite Index and S&P Public Utility Index
Long-Term Corporate and Public Utility Bonds
Yearly Total Returns
1928-2007

Year	S & P Composite Index	S & P Public Utility Index	Long Term Corporate Bonds	Public Utility Bonds
1928	43.61%	57.47%	2.84%	3.08%
1929	-8.42%	11.02%	3.27%	2.34%
1930	-24.90%	-21.96%	7.98%	4.74%
1931	-43.34%	-35.90%	-1.85%	-11.11%
1932	-8.19%	-0.54%	10.82%	7.25%
1933	53.99%	-21.87%	10.38%	-3.82%
1934	-1.44%	-20.41%	13.84%	22.61%
1935	47.67%	76.63%	9.61%	16.03%
1936	33.92%	20.69%	6.74%	8.30%
1937	-35.03%	-37.04%	2.75%	-4.05%
1938	31.12%	22.45%	6.13%	8.11%
1939	-0.41%	11.26%	3.97%	6.76%
1940	-9.78%	-17.15%	3.39%	4.45%
1941	-11.59%	-31.57%	2.73%	2.15%
1942	20.34%	15.39%	2.60%	3.81%
1943	25.90%	46.07%	2.83%	7.04%
1944	19.75%	18.03%	4.73%	3.29%
1945	36.44%	53.33%	4.08%	5.92%
1946	-8.07%	1.26%	1.72%	2.98%
1947	5.71%	-13.16%	-2.34%	-2.19%
1948	5.50%	4.01%	4.14%	2.65%
1949	18.79%	31.39%	3.31%	7.16%
1950	31.71%	3.25%	2.12%	2.01%
1951	24.02%	18.63%	-2.69%	-2.77%
1952	18.37%	19.25%	3.52%	2.99%
1953	-0.99%	7.85%	3.41%	2.08%
1954	52.62%	24.72%	5.39%	7.57%
1955	31.56%	11.26%	0.48%	0.12%
1956	6.56%	5.06%	-8.81%	-6.25%
1957	-10.78%	6.36%	6.71%	3.58%
1958	43.36%	40.70%	-2.22%	0.18%
1959	11.96%	7.49%	-0.97%	-2.29%
1960	0.47%	20.26%	9.07%	9.01%
1961	26.89%	29.33%	4.82%	4.65%
1962	-8.73%	-2.44%	7.95%	6.55%
1963	22.80%	12.36%	2.19%	3.44%
1964	16.48%	15.91%	4.77%	4.94%
1965	12.45%	4.67%	-0.46%	0.50%
1966	-10.06%	-4.48%	0.20%	-3.45%
1967	23.98%	-0.63%	-4.95%	-3.63%
1968	11.06%	10.32%	2.57%	1.87%
1969	-8.50%	-15.42%	-8.09%	-6.66%
1970	4.01%	16.56%	18.37%	15.90%
1971	14.31%	2.41%	11.01%	11.59%
1972	18.98%	8.15%	7.26%	7.19%
1973	-14.66%	-18.07%	1.14%	2.42%
1974	-26.47%	-21.55%	-3.06%	-5.26%
1975	37.20%	44.49%	14.64%	15.50%
1976	23.84%	31.81%	18.65%	19.04%
1977	-7.18%	8.64%	1.71%	5.22%
1978	6.56%	-3.71%	-0.07%	-0.98%
1979	18.44%	13.58%	-4.18%	-2.75%
1980	32.42%	15.08%	-2.76%	-0.23%
1981	-4.91%	11.74%	-1.24%	4.27%
1982	21.41%	26.52%	42.56%	33.52%
1983	22.51%	20.01%	6.26%	10.33%
1984	6.27%	26.04%	16.86%	14.82%
1985	32.16%	33.05%	30.09%	26.48%
1986	18.47%	28.53%	19.85%	18.16%
1987	5.23%	-2.92%	-0.27%	3.02%
1988	16.81%	18.27%	10.70%	10.19%
1989	31.49%	47.80%	16.23%	15.61%
1990	-3.17%	-2.57%	6.78%	8.13%
1991	30.55%	14.61%	19.89%	19.25%
1992	7.67%	8.10%	9.39%	8.65%
1993	9.99%	14.41%	13.19%	10.59%
1994	1.31%	-7.94%	-5.76%	-4.72%
1995	37.43%	42.15%	27.20%	22.81%
1996	23.07%	3.14%	1.40%	3.04%
1997	33.36%	24.69%	12.95%	11.39%
1998	28.58%	14.82%	10.76%	9.44%
1999	21.04%	-8.85%	-7.45%	-1.69%
2000	-9.11%	59.70%	12.87%	9.45%
2001	-11.88%	-30.41%	10.65%	5.85%
2002	-22.10%	-30.04%	16.33%	1.63%
2003	28.70%	26.11%	5.27%	10.01%
2004	10.87%	24.22%	8.72%	6.03%
2005	4.91%	16.79%	5.87%	3.02%
2006	15.80%	20.95%	3.24%	3.94%
2007	5.49%	19.39%	2.60%	5.20%
Geometric Mean	10.04%	8.92%	5.81%	5.45%
Arithmetic Mean	11.95%	11.24%	6.13%	5.72%
Standard Deviation	20.02%	22.43%	8.52%	7.84%
Median	13.38%	12.05%	4.11%	4.55%

**Tabulation of Risk Rate Differentials for
S&P Public Utility Index and Public Utility Bonds
For the Years 1928-2007, 1952-2007, 1974-2007, and 1979-2007**

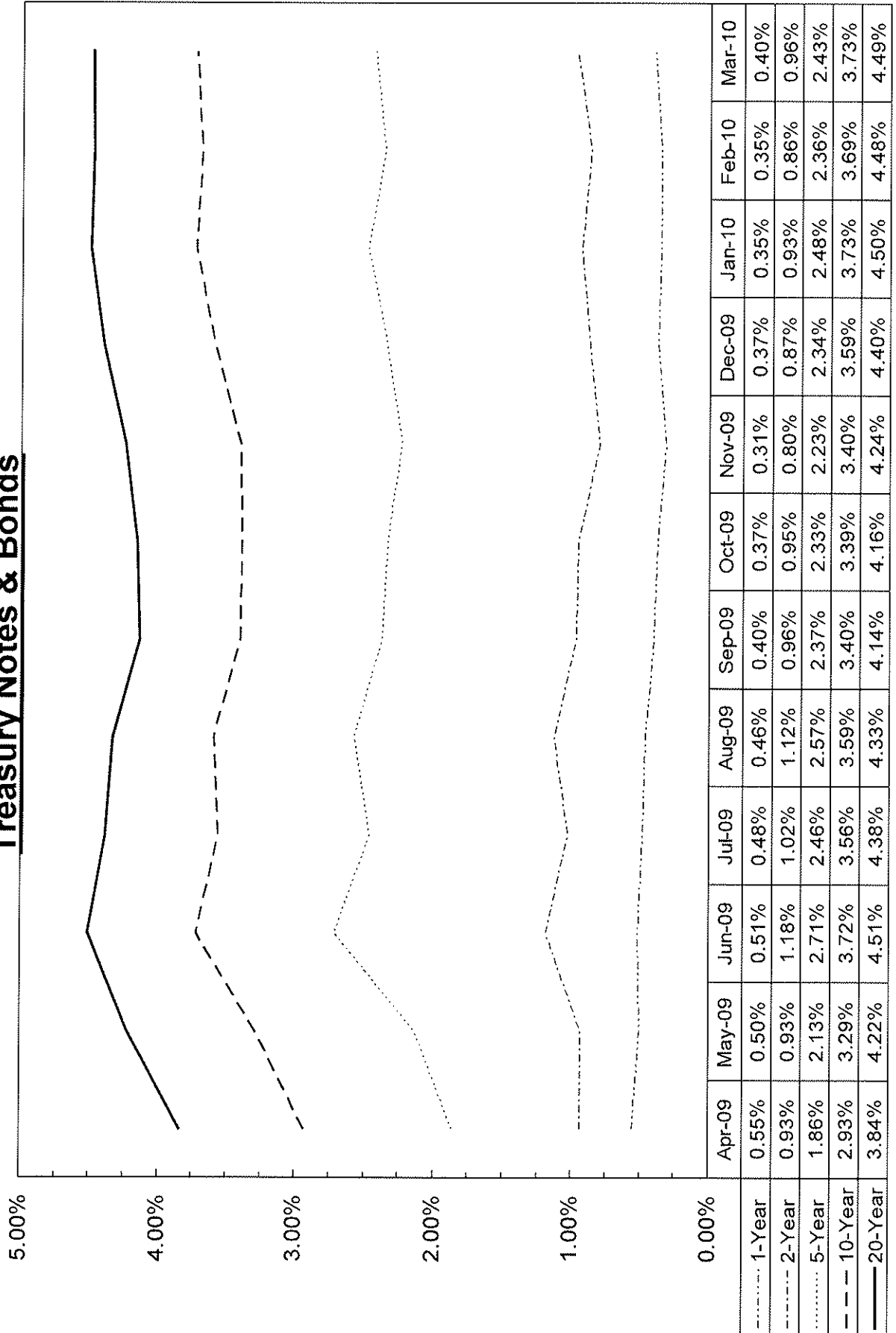
Total Returns	<u>Range</u>		<u>Midpoint</u>	<u>Point Estimate</u>	<u>Average of the Midpoint of Range and Point Estimate</u>
	<u>Geometric Mean</u>	<u>Median</u>		<u>Arithmetic Mean</u>	
<u>1928-2007</u>					
S&P Public Utility Index	8.92%	12.05%		11.24%	
Public Utility Bonds	<u>5.45%</u>	<u>4.55%</u>		<u>5.72%</u>	
Risk Differential	<u>3.47%</u>	<u>7.50%</u>	<u>5.49%</u>	<u>5.52%</u>	<u>5.51%</u>
<u>1952-2007</u>					
S&P Public Utility Index	11.14%	14.00%		12.65%	
Public Utility Bonds	<u>6.15%</u>	<u>5.07%</u>		<u>6.45%</u>	
Risk Differential	<u>4.99%</u>	<u>8.93%</u>	<u>6.96%</u>	<u>6.20%</u>	<u>6.58%</u>
<u>1974-2007</u>					
S&P Public Utility Index	12.98%	15.94%		14.90%	
Public Utility Bonds	<u>8.45%</u>	<u>8.39%</u>		<u>8.79%</u>	
Risk Differential	<u>4.53%</u>	<u>7.55%</u>	<u>6.04%</u>	<u>6.11%</u>	<u>6.08%</u>
<u>1979-2007</u>					
S&P Public Utility Index	13.62%	16.79%		15.41%	
Public Utility Bonds	<u>8.83%</u>	<u>8.65%</u>		<u>9.15%</u>	
Risk Differential	<u>4.79%</u>	<u>8.14%</u>	<u>6.47%</u>	<u>6.26%</u>	<u>6.37%</u>

Value Line Betas

Water Group	Beta
American States Water	0.80
Aqua America, Inc.	0.65
California Water Serv. Grp.	0.75
Connecticut Water Services	0.80
Middlesex Water Company	0.80
SJW Corporation	0.95
York Water Company	0.65
Average	0.77

Source of Information:
The Value Line Investment Survey
January 22, 2010

Yields on Treasury Notes & Bonds



**Yields for Treasury Constant Maturities
Yearly for 2004-2008 and 2009
and the Twelve Months Ended March 2010**

<u>Years</u>	<u>1-Year</u>	<u>2-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>7-Year</u>	<u>10-Year</u>	<u>20-Year</u>
2004	1.89%	2.38%	2.78%	3.43%	3.87%	4.27%	5.04%
2005	3.62%	3.85%	3.93%	4.05%	4.15%	4.29%	4.64%
2006	4.93%	4.82%	4.77%	4.75%	4.76%	4.79%	4.99%
2007	4.52%	4.36%	4.34%	4.43%	4.50%	4.63%	4.91%
2008	1.82%	2.00%	2.24%	2.80%	3.17%	3.67%	4.36%
Five-Year Average	<u>3.36%</u>	<u>3.48%</u>	<u>3.61%</u>	<u>3.89%</u>	<u>4.09%</u>	<u>4.33%</u>	<u>4.79%</u>
2009	0.47%	0.96%	1.43%	2.19%	2.81%	3.26%	4.11%
Months							
Apr-09	0.55%	0.93%	1.32%	1.86%	2.47%	2.93%	3.84%
May-09	0.50%	0.93%	1.39%	2.13%	2.81%	3.29%	4.22%
Jun-09	0.51%	1.18%	1.76%	2.71%	3.37%	3.72%	4.51%
Jul-09	0.48%	1.02%	1.55%	2.46%	3.14%	3.56%	4.38%
Aug-09	0.46%	1.12%	1.65%	2.57%	3.21%	3.59%	4.33%
Sep-09	0.40%	0.96%	1.48%	2.37%	3.02%	3.40%	4.14%
Oct-09	0.37%	0.95%	1.46%	2.33%	2.96%	3.39%	4.16%
Nov-09	0.31%	0.80%	1.32%	2.23%	2.92%	3.40%	4.24%
Dec-09	0.37%	0.87%	1.38%	2.34%	3.07%	3.59%	4.40%
Jan-10	0.35%	0.93%	1.49%	2.48%	3.21%	3.73%	4.50%
Feb-10	0.35%	0.86%	1.40%	2.36%	3.12%	3.69%	4.48%
Mar-10	0.40%	0.96%	1.51%	2.43%	3.16%	3.73%	4.49%
Twelve-Month Average	<u>0.42%</u>	<u>0.96%</u>	<u>1.48%</u>	<u>2.36%</u>	<u>3.04%</u>	<u>3.50%</u>	<u>4.31%</u>
Six-Month Average	<u>0.36%</u>	<u>0.90%</u>	<u>1.43%</u>	<u>2.36%</u>	<u>3.07%</u>	<u>3.59%</u>	<u>4.38%</u>
Three-Month Average	<u>0.37%</u>	<u>0.92%</u>	<u>1.47%</u>	<u>2.42%</u>	<u>3.16%</u>	<u>3.72%</u>	<u>4.49%</u>

Source: Federal Reserve statistical release H.15

Measures of the Risk-Free Rate

The forecast of Treasury yields
per the consensus of nearly 50 economists
reported in the Blue Chip Financial Forecasts dated April 1, 2010

<u>Year</u>	<u>Quarter</u>	<u>1-Year Treasury Bill</u>	<u>2-Year Treasury Note</u>	<u>5-Year Treasury Note</u>	<u>10-Year Treasury Note</u>	<u>30-Year Treasury Bond</u>
2010	Second	0.5%	1.1%	2.5%	3.8%	4.6%
2010	Third	0.7%	1.3%	2.7%	3.9%	4.8%
2010	Fourth	1.0%	1.7%	3.0%	4.1%	4.9%
2011	First	1.4%	2.0%	3.2%	4.3%	5.0%
2011	Second	1.8%	2.3%	3.4%	4.4%	5.2%
2011	Third	2.2%	2.7%	3.7%	4.6%	5.3%

April 2, 2010

TABLE OF SUMMARY & INDEX CONTENTS		Summary & Index Page Number	
Industries, in alphabetical order		1	
Stocks, in alphabetical order		2-23	
Noteworthy Rank Changes		24	
SCREENS			
Industries, in order of Timeliness Rank	24	Stocks with Lowest P/Es	35
Timely Stocks in Timely Industries	25-26	Stocks with Highest P/Es	35
Timely Stocks (1 & 2 for Performance)	27-29	Stocks with Highest Annual Total Returns	36
Conservative Stocks (1 & 2 for Safety)	30-31	Stocks with Highest 3- to 5-year Dividend Yield	36
Highest Dividend Yielding Stocks	32	High Returns Earned on Total Capital	37
Stocks with Highest 3- to 5-year Price Potential	32	Bargain Basement Stocks	37
Biggest "Free Flow" Cash Generators	33	Untimely Stocks (5 for Performance)	38
Best Performing Stocks last 13 Weeks	33	Highest Dividend Yielding Non-utility Stocks	38
Worst Performing Stocks last 13 Weeks	33	Highest Growth Stocks	39
Widest Discounts from Book Value	34		

The Median of Estimated
PRICE-EARNINGS RATIOS
of all stocks with earnings

17.9

26 Weeks Ago	Market Low	Market High
17.5	3-9-09 10.3	7-13-07 19.7

The Median of Estimated
DIVIDEND YIELDS
(next 12 months) of all dividend
paying stocks under review

1.9%

26 Weeks Ago	Market Low	Market High
2.1%	3-9-09 4.0%	7-13-07 1.6%

The Estimated Median Price
APPRECIATION POTENTIAL
of all 1700 stocks in the hypothesized
economic environment 3 to 5 years hence

50%

26 Weeks Ago	Market Low	Market High
55%	3-9-09 185%	7-13-07 35%

ANALYSES OF INDUSTRIES IN ALPHABETICAL ORDER WITH PAGE NUMBER
Numeral in parenthesis after the industry is rank for probable performance (next 12 months).

PAGE		PAGE		PAGE		PAGE	
Advertising (56)	2369	Electric Util. (Central) (55)	901	Machinery (65)	1701	R.E.I.T. (60)	1512
Aerospace/Defense (38)	543	Electric Utility (East) (89)	148	Manuf. Housing/RV (-)	1972	Recreation (46)	2301
Air Transport (32)	245	Electric Utility (West) (67)	2231	Maritime (80)	271	Reinsurance (20)	2026
Apparel (8)	2101	Electronics (25)	1320	Medical Services (7)	628	Restaurant (12)	287
Auto & Truck (70)	101	Entertainment (13)	2319	Medical Supplies (10)	169	Retail Automotive (51)	2118
Auto Parts (14)	995	Entertainment Tech (90)	2008	Metal Fabricating (82)	570	*Retail Building Supply (63)	1133
Bank (87)	2501	Environmental (76)	346	Metals & Mining (Div.) (44)	1562	Retail (Special Lines) (17)	2162
Bank (Canadian) (49)	1984	Financial Svcs. (Div.) (50)	2528	Natural Gas Utility (78)	445	Retail Store (22)	2130
Bank (Midwest) (88)	611	Food Processing (23)	1901	Natural Gas (Div.) (53)	426	Retail/Wholesale Food (75)	1941
Beverage (9)	1957	Foreign Electronics (79)	1976	Newspaper (19)	2360	Securities Brokerage (86)	1797
Biotechnology (73)	662	Funeral Services (84)	1830	Office Equip./Supplies (72)	1427	Semiconductor (35)	1347
*Building Materials (95)	1101	*Furn/Home Furnishings (33)	1140	Oil/Gas Distribution (31)	519	Semiconductor Equip (40)	1385
Cable TV (3)	1030	Healthcare Information (64)	654	Oilfield Svcs/Equip. (68)	2390	Shoe (1)	2150
Canadian Energy (94)	415	*Heavy Construction (91)	1228	*Packaging & Container (66)	1167	Steel (General) (85)	580
Chemical (Basic) (28)	1573	*Homebuilding (71)	1120	*Paper/Forest Products (45)	1156	Steel (Integrated) (47)	1785
Chemical (Diversified) (29)	2416	Hotel/Gaming (81)	2333	Petroleum (Integrated) (97)	397	Telecom. Equipment (54)	958
Chemical (Specialty) (42)	458	*Household Products (26)	1182	Petroleum (Producing) (57)	2379	Telecom. Services (77)	922
Coal (21)	508	Human Resources (83)	1627	Pharmacy Services (5)	986	Thrift (58)	1501
Computers/Peripherals (27)	1400	Industrial Services (59)	319	*Power (92)	1211	Tobacco (18)	1991
Computer Software/Svcs (24)	2566	Information Services (41)	374	Precious Metals (37)	1552	Toiletries/Cosmetics (2)	1020
Diversified Co. (69)	1753	Insurance (Life) (11)	1538	Precision Instrument (34)	115	Trucking (96)	261
Drug (15)	1585	Insurance (Prop/Cas.) (52)	589	Property Management (62)	1041	Water Utility (93)	1791
E-Commerce (4)	1813	Internet (30)	2613	Public/Private Equity (61)	2633	Wireless Networking (74)	487
Educational Services (16)	1998	*Investment Co. (48)	1198	Publishing (6)	2350		
Electrical Equipment (43)	1301	Investment Co.(Foreign) (39)	359	Railroad (36)	279		

*Reviewed in this week's issue.

In three parts: This is Part 1, the Summary & Index. Part 2 is Selection & Opinion. Part 3 is Ratings & Reports. Volume LXV, No. 32.

Published weekly by VALUE LINE PUBLISHING, INC. 220 East 42nd Street, New York, N.Y. 10017-5891

© 2010, Value Line Publishing, Inc. All rights reserved. Factual material is obtained from sources believed to be reliable and is provided without warranties of any kind. THE PUBLISHER IS NOT RESPONSIBLE FOR ANY ERRORS OR OMISSIONS HEREIN. This publication is strictly for each subscriber's own, non-commercial, internal use. No part of this publication may be reproduced, resold, stored or transmitted in any printed, electronic or other form, or used for generating or marketing any printed or electronic publication, service or product. See back cover for important disclosures.

Table 2-1: Basic Series: Summary Statistics of Annual Total Returns

Series	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)	Distribution (%)
Large Company Stocks	9.6	11.7	20.6	
Small Company Stocks*	11.7	16.4	33.0	
Long-Term Corporate Bonds	5.9	6.2	8.4	
Long-Term Government Bonds	5.7	6.1	9.4	
Intermediate-Term Government Bonds	5.4	5.6	5.7	
U.S. Treasury Bills	3.7	3.8	3.1	
Inflation	3.0	3.1	4.2	

Data from 1926–2008 * The 1933 Small Company Stocks Total Return was 142.9 percent.

Table 10-1: Building Blocks for Expected Return Construction

	Value (%)
Yields (Riskless Rates)¹	
Long-Term (20-year) U.S. Treasury Coupon Bond Yield	3.0
Intermediate-Term (5-year) U.S. Treasury Coupon Note Yield	1.3
Short-Term (30-day) U.S. Treasury Bill Yield	0.1
Fixed Income Risk Premia^{1, 2}	
Expected default premium: <i>long-term corporate bond total returns minus long-term government bond total returns</i>	0.1
Expected long-term horizon premium: <i>long-term government bond income returns minus U.S. Treasury bill total returns*</i>	1.4
Expected intermediate-term horizon premium: <i>intermediate-term government bond income returns minus U.S. Treasury bill total returns*</i>	1.0
Equity Risk Premia²	
Long-horizon expected equity risk premium: <i>large company stock total returns minus long-term government bond income returns</i>	6.5
Intermediate-horizon expected equity risk premium: <i>large company stock total returns minus intermediate-term government bond income returns</i>	6.9
Short-horizon expected equity risk premium: <i>large company stock total returns minus U.S. Treasury bill total returns*</i>	7.9
Small Stock Premium: <i>small company stock total return minus large company stock total return</i>	4.8

¹ As of December 31, 2008. Maturities are approximate. Expected risk premia for fixed income and equities are based on the differences of historical arithmetic mean returns from 1926–2008.

² We would prefer to use the 1970–2008 time range for calculating fixed income premia to reflect that bond volatility has increased over time. However, abnormal returns in 2008 make using a short time frame for forward-looking expectations unrealistic.

*For U.S. Treasury bills, the income return and total return are the same.

Comparable Earnings Approach

Using Non-Utility Companies with
Timeliness of 3 & 4; Safety Rank of 2 & 3; Financial Strength of B+ & B++;
Price Stability of 70 to 95; Betas of .65 to .95; and Technical Rank of 3

Company	Industry	Timeliness Rank	Safety Rank	Financial Strength	Price Stability	Beta	Technical Rank
ADTRAN Inc.	TELEQUIP	3	3	B++	75	0.85	3
Alliant Techsystems	DEFENSE	3	3	B+	95	0.80	3
AptarGroup	PACKAGE	3	3	B+	90	0.90	3
Archer Daniels Midl'd	FOODPROC	4	3	B++	70	0.90	3
Avon Products	COSMETIC	3	3	B++	75	0.95	3
BOK Financial	BANKMID	3	2	B++	85	0.95	3
Berkley (W.R.)	INSPRPTY	4	3	B+	90	0.75	3
CACI Int'l	SOFTWARE	3	3	B++	80	0.75	3
CLARCOR Inc.	PACKAGE	4	3	B++	80	0.90	3
CSG Systems Int'l	INDUSRV	3	3	B+	80	0.70	3
Capitol Fed. Fin'l	THRIFT	3	2	B++	95	0.65	3
Chemed Corp.	DIVERSIF	3	3	B+	70	0.80	3
Cincinnati Financial	INSPRPTY	4	2	B++	85	0.95	3
Cintas Corp.	INDUSRV	4	2	B++	90	0.90	3
Citrix Sys.	SOFTWARE	3	3	B++	70	0.95	3
Coherent Inc.	INSTRMNT	3	3	B+	80	0.90	3
Columbia Sportswear	APPAREL	4	3	B++	75	0.90	3
Cullen/Frost Bankers	BANK	4	2	B++	90	0.85	3
Dionex Corp.	INSTRMNT	3	3	B++	80	0.90	3
Equifax Inc.	INFOSER	3	2	B++	90	0.90	3
Forrester Research	INFOSER	3	3	B+	80	0.85	3
Gen-Probe	BIOTECH	3	3	B++	80	0.85	3
Genzyme Corp.	DRUG	4	3	B+	85	0.65	3
Greatbatch Inc.	ELECTRNX	4	3	B+	70	0.75	3
HCC Insurance Hldgs.	INSPRPTY	3	3	B+	90	0.85	3
Haemonetics Corp.	MEDSUPPL	3	2	B++	95	0.65	3
Hain Celestial Group	FOODPROC	3	3	B+	75	0.95	3
Hanover Insurance	INSPRPTY	3	2	B++	90	0.85	3
Hershey Co.	FOODPROC	3	2	B++	95	0.65	3
Hudson City Bancorp	THRIFT	3	3	B+	90	0.80	3
Ingram Micro 'A'	COMPUTER	3	3	B+	85	0.95	3
Int'l Speedway 'A'	RECREATE	4	3	B+	85	0.90	3
Interactive Data	INFOSER	3	2	B++	90	0.85	3
J&J Snack Foods	FOODPROC	3	2	B++	90	0.75	3
Linear Technology	SEMICOND	4	3	B++	85	0.90	3
MAXIMUS Inc.	INDUSRV	3	2	B++	90	0.80	3
MTS Systems	INSTRMNT	4	3	B+	70	0.85	3
ManTech Int'l 'A'	SOFTWARE	3	3	B+	70	0.80	3
Mattel Inc.	RECREATE	3	3	B++	80	0.85	3
Matthews Int'l	FUNL SVC	3	3	B+	90	0.85	3
McAfee Inc.	SOFTWARE	3	3	B++	70	0.95	3
National Instruments	INSTRMNT	3	3	B++	80	0.90	3
Omnicom Group	ADVERT	3	2	B++	90	0.95	3
PetSmart Inc.	RETAILSP	3	3	B+	75	0.80	3
Pharmac. Product	DRUG	4	3	B++	70	0.85	3
Progressive (Ohio)	INSPRPTY	3	3	B+	80	0.95	3
QLogic Corp.	SEMICOND	3	3	B++	70	0.95	3
RLI Corp.	INSPRPTY	3	2	B++	90	0.80	3
Safeway Inc.	GROCERY	4	2	B++	95	0.70	3
Sensient Techn.	FOODPROC	3	3	B+	90	0.85	3
Silgan Holdings	PACKAGE	3	3	B+	90	0.80	3
Stericycle Inc.	ENVIRONM	3	3	B+	90	0.70	3
Synopsys Inc.	SOFTWARE	4	3	B++	90	0.85	3
Total System Svcs.	FINSERV	3	3	B++	85	0.90	3
Valspar Corp.	CHEMSPEC	3	3	B+	85	0.95	3
WD-40 Co.	HOUSEPRD	3	2	B++	85	0.75	3
Werner Enterprises	TRUCKING	4	3	B++	75	0.90	3
West Pharmac. Svcs.	MEDSUPPL	3	3	B+	80	0.80	3
Yum! Brands	RESTRNT	3	2	B++	85	0.95	3
Average		<u>3</u>	<u>3</u>	<u>B+</u>	<u>83</u>	<u>0.84</u>	<u>3</u>
Water Group	Average	<u>3</u>	<u>3</u>	<u>B+</u>	<u>85</u>	<u>0.77</u>	<u>3</u>

Source of Information: Value Line Investment Survey for Windows, January 2010

Comparable Earnings Approach
Five -Year Average Historical Earned Returns
for Years 2004-2008 and
Projected 3-5 Year Returns

Company	2004	2005	2006	2007	2008	Average	Projected 2012-14
ADTRAN Inc.	16.1%	18.7%	18.0%	20.2%	20.9%	18.8%	14.0%
Alliant Techsystems	22.4%	24.5%	31.9%	30.5%	42.9%	30.4%	16.5%
AptarGroup	10.7%	12.3%	10.9%	12.5%	13.6%	12.0%	13.0%
Archer Daniels Mid'l'd	9.7%	10.9%	13.4%	13.9%	13.6%	12.3%	11.0%
Avon Products	89.0%	NMF	60.4%	74.6%	NMF	74.7%	63.0%
BOK Financial	12.8%	13.1%	12.4%	11.6%	8.3%	11.6%	11.0%
Berkley (W.R.)	19.5%	20.7%	20.8%	20.6%	16.5%	19.6%	17.0%
CACI Int'l	12.8%	13.9%	11.4%	9.6%	9.1%	11.4%	10.5%
CLARCOR Inc.	14.9%	15.8%	15.4%	16.3%	14.7%	15.4%	11.0%
CSG Systems Int'l	16.7%	18.9%	19.7%	72.9%	37.9%	33.2%	46.5%
Capitol Fed. Fin'l	4.8%	7.5%	5.6%	3.7%	5.8%	5.5%	7.5%
Chemed Corp.	5.8%	13.3%	13.7%	20.9%	19.2%	14.6%	14.0%
Cincinnati Financial	8.4%	9.2%	7.3%	10.3%	8.2%	8.7%	8.5%
Cintas Corp.	14.4%	15.7%	15.4%	14.9%	11.8%	14.4%	12.0%
Citrix Sys.	17.6%	17.3%	12.5%	11.7%	9.3%	13.7%	10.0%
Coherent Inc.	3.0%	5.8%	6.9%	2.1%	5.7%	4.7%	6.0%
Columbia Sportswear	17.8%	17.6%	14.8%	14.9%	11.2%	15.3%	12.5%
Cullen/Frost Bankers	17.2%	16.8%	14.1%	14.4%	11.8%	14.9%	10.0%
Dionex Corp.	22.6%	24.9%	19.3%	24.4%	26.8%	23.6%	21.0%
Equifax Inc.	41.2%	29.1%	31.1%	22.0%	24.6%	29.6%	16.5%
Forrester Research	6.4%	7.4%	6.6%	6.9%	9.6%	7.4%	9.5%
Gen-Probe	15.1%	13.4%	10.4%	10.2%	13.1%	12.4%	14.0%
Genzyme Corp.	3.3%	8.6%	NMF	7.3%	5.8%	6.3%	13.0%
Greatbatch Inc.	7.1%	3.8%	5.4%	10.1%	9.4%	7.2%	9.0%
HCC Insurance Hldgs.	11.8%	11.4%	16.8%	15.6%	12.0%	13.5%	12.0%
Haemonetics Corp.	11.2%	11.8%	10.5%	11.4%	11.9%	11.4%	13.0%
Hain Celestial Group	5.4%	6.0%	6.5%	6.8%	7.9%	6.5%	9.0%
Hanover Insurance	6.0%	3.6%	9.7%	10.2%	9.7%	7.8%	10.5%
Hershey Co.	48.6%	55.6%	81.8%	81.3%	135.3%	80.5%	42.5%
Hudson City Bancorp	17.1%	5.3%	5.9%	6.4%	9.0%	8.7%	10.5%
Ingram Micro 'A'	7.2%	10.1%	9.1%	8.1%	10.0%	8.9%	10.0%
Int'l Speedway 'A'	14.7%	15.3%	15.0%	13.1%	12.2%	14.1%	9.5%
Interactive Data	9.4%	11.0%	10.2%	13.1%	14.9%	11.7%	14.0%
J&J Snack Foods	10.8%	11.1%	11.2%	10.9%	8.8%	10.6%	12.5%
Linear Technology	18.1%	21.6%	20.4%	NMF	NMF	20.0%	NMF
MAXIMUS Inc.	10.4%	8.9%	0.6%	4.9%	11.1%	7.2%	14.5%
MTS Systems	16.9%	19.4%	23.0%	22.1%	23.0%	20.9%	16.0%
ManTech Int'l 'A'	7.7%	14.1%	12.1%	12.2%	13.3%	11.9%	13.5%
Mattel Inc.	21.3%	23.1%	22.6%	26.0%	17.9%	22.2%	20.0%
Matthews Int'l	18.0%	17.9%	16.6%	16.1%	17.9%	17.3%	15.5%
McAfee Inc.	8.3%	12.8%	11.7%	11.5%	11.1%	11.1%	10.5%
National Instruments	10.0%	12.2%	12.2%	16.2%	12.8%	12.7%	15.0%
Omnicom Group	17.7%	20.0%	22.3%	23.8%	28.4%	22.4%	25.5%
PetSmart Inc.	17.6%	18.1%	18.5%	19.7%	16.8%	18.1%	16.0%
Pharmac. Product	15.6%	17.7%	16.4%	14.2%	15.9%	16.0%	16.5%
Progressive (Ohio)	31.0%	22.8%	24.1%	24.0%	NMF	25.5%	23.5%
QLogic Corp.	17.1%	14.2%	12.1%	14.4%	17.4%	15.0%	14.5%
RLI Corp.	10.3%	14.0%	14.5%	21.5%	15.3%	15.1%	11.0%
Safeway Inc.	13.0%	12.8%	13.7%	13.3%	14.2%	13.4%	14.0%
Sensient Techn.	11.5%	9.1%	9.4%	9.6%	11.1%	10.1%	11.5%
Silgan Holdings	40.1%	34.6%	29.8%	25.3%	26.9%	31.3%	19.0%
Stericycle Inc.	15.8%	17.8%	17.4%	18.0%	22.8%	18.4%	16.0%
Synopsys Inc.	12.8%	4.7%	6.7%	10.8%	13.1%	9.6%	13.0%
Total System Svcs.	17.4%	19.2%	20.5%	30.7%	25.6%	22.7%	16.0%
Valspar Corp.	14.3%	13.9%	14.1%	12.5%	10.4%	13.0%	11.0%
WD-40 Co.	22.8%	21.6%	18.2%	18.7%	17.3%	19.7%	17.5%
Werner Enterprises	11.3%	11.4%	11.3%	9.5%	9.1%	10.5%	16.5%
West Pharmac. Svcs.	13.6%	13.6%	15.7%	17.0%	16.8%	15.3%	14.0%
Yum! Brands	45.2%	52.6%	57.3%	79.8%	13.6%	49.7%	NMF
Average						17.6%	15.5%
Average (excluding values <20%)						12.3%	12.9%

PENNSYLVANIA-AMERICAN WATER COMPANY

Northeast Wastewater Division

Docket No. R-2010-2166214

Appendices A through I
to Accompany the
Direct Testimony

of

Paul R. Moul
Managing Consultant
P. Moul & Associates

Concerning
Rate of Return

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

**EDUCATIONAL BACKGROUND, BUSINESS EXPERIENCE
AND QUALIFICATIONS**

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

I was awarded a degree of Bachelor of Science in Business Administration by Drexel University in 1971. While at Drexel, I participated in the Cooperative Education Program which included employment, for one year, with American Water Works Service Company, Inc., as an internal auditor, where I was involved in the audits of several operating water companies of the American Water Works System and participated in the preparation of annual reports to regulatory agencies and assisted in other general accounting matters.

Upon graduation from Drexel University, I was employed by American Water Works Service Company, Inc., in the Eastern Regional Treasury Department where my duties included preparation of rate case exhibits for submission to regulatory agencies, as well as responsibility for various treasury functions of the thirteen New England operating subsidiaries.

In 1973, I joined the Municipal Financial Services Department of Betz Environmental Engineers, a consulting engineering firm, where I specialized in financial studies for municipal water and wastewater systems.

In 1974, I joined Associated Utility Services, Inc., now known as AUS Consultants. I held various positions with the Utility Services Group of AUS Consultants, concluding my employment there as a Senior Vice President.

In 1994, I formed P. Moul & Associates, an independent financial and regulatory consulting firm. In my capacity as Managing Consultant and for the past twenty-nine years, I have continuously studied the rate of return requirements for cost of service-regulated firms. In this regard, I have supervised the preparation of rate of return studies, which were employed, in connection with my testimony and in the past for other individuals. I have presented direct testimony on the subject of fair rate of return, evaluated rate of return testimony of other witnesses, and presented rebuttal testimony.

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

1 My studies and prepared direct testimony have been presented before thirty-six (36)
2 federal, state and municipal regulatory commissions, consisting of: the Federal Energy
3 Regulatory Commission; state public utility commissions in Alabama, Alaska, California,
4 Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Indiana, Iowa, Kentucky,
5 Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire,
6 New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South
7 Carolina, Tennessee, Texas, Virginia, West Virginia, Wisconsin, and the Philadelphia Gas
8 Commission. My testimony has been offered in over 200 rate cases involving electric power,
9 natural gas distribution and transmission, resource recovery, solid waste collection and
10 disposal, telephone, wastewater, and water service utility companies. While my testimony has
11 involved principally fair rate of return and financial matters, I have also testified on capital
12 allocations, capital recovery, cash working capital, income taxes, factoring of accounts
13 receivable, and take-or-pay expense recovery. My testimony has been offered on behalf of
14 municipal and investor-owned public utilities and for the staff of a regulatory commission. I
15 have also testified at an Executive Session of the State of New Jersey Commission of
16 Investigation concerning the BPU regulation of solid waste collection and disposal.

17 I was a co-author of a verified statement submitted to the Interstate Commerce
18 Commission concerning the 1983 Railroad Cost of Capital (Ex Parte No. 452). I was also co-
19 author of comments submitted to the Federal Energy Regulatory Commission regarding the
20 Generic Determination of Rate of Return on Common Equity for Public Utilities in 1985, 1986
21 and 1987 (Docket Nos. RM85-19-000, RM86-12-000, RM87-35-000 and RM88-25-000).
22 Further, I have been the consultant to the New York Chapter of the National Association of
23 Water Companies, which represented the water utility group in the Proceeding on Motion of
24 the Commission to Consider Financial Regulatory Policies for New York Utilities (Case 91-M-

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

1 0509). I have also submitted comments to the Federal Energy Regulatory Commission in its
2 Notice of Proposed Rulemaking (Docket No. RM99-2-000) concerning Regional Transmission
3 Organizations and on behalf of the Edison Electric Institute in its intervention in the case of
4 Southern California Edison Company (Docket No. ER97-2355-000). Also, I was a member of
5 the panel of participants at the Technical Conference in Docket No. PL07-2 on the
6 Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity.

7 In late 1978, I arranged for the private placement of bonds on behalf of an investor-
8 owned public utility. I have assisted in the preparation of a report to the Delaware Public
9 Service Commission relative to the operations of the Lincoln and Ellendale Electric Company.
10 I was also engaged by the Delaware P.S.C. to review and report on the proposed financing
11 and disposition of certain assets of Sussex Shores Water Company (P.S.C. Docket Nos. 24-
12 79 and 47-79). I was a co-author of a Report on Proposed Mandatory Solid Waste Collection
13 Ordinance prepared for the Board of County Commissioners of Collier County, Florida.

14 I have been a consultant to the Bucks County Water and Sewer Authority concerning
15 rates and charges for wholesale contract service with the City of Philadelphia. My municipal
16 consulting experience also included an assignment for Baltimore County, Maryland, regarding
17 the City/County Water Agreement for Metropolitan District customers (Circuit Court for
18 Baltimore County in Case 34/153/87-CSP-2636).

19 I am a member of the Society of Utility and Regulatory Financial Analysis (formerly the
20 National Society of Rate of Return Analysts) and have attended several Financial Forums
21 sponsored by the Society. I attended the first National Regulatory Conference at the Marshall-
22 Wythe School of Law, College of William and Mary. I also attended an Executive Seminar
23 sponsored by the Colgate Darden Graduate Business School of the University of Virginia
24 concerning Regulated Utility Cost of Equity and the Capital Asset Pricing Model. In October

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

1 1984, I attended a Standard & Poor's Seminar on the Approach to Municipal Utility Ratings,
 2 and in May 1985, I attended an S&P Seminar on Telecommunications Ratings.

3 My lecture and speaking engagements include:

<u>Date</u>	<u>Occasion</u>	<u>Sponsor</u>
4 April 2006	30 Thirty-eighth Financial Forum	Society of Utility & Regulatory Financial Analysts
5 April 2001	31 Thirty-third Financial Forum	Society of Utility & Regulatory Financial Analysts
6 December 2000	32 Pennsylvania Public Utility Law Conference: Non-traditional Players in the Water Industry	Pennsylvania Bar Institute
7 July 2000	33 EEI Member Workshop Developing Incentives Rates: Application and Problems	Edison Electric Institute
8 February 2000	34 The Sixth Annual FERC Briefing	Exnet and Bruder, Gentile & Marcoux, LLP
9 March 1994	35 Seventh Annual Proceeding	Electric Utility Business Environment Conf.
10 May 1993	36 Financial School	New England Gas Assoc.
11 April 1993	37 Twenty-Fifth Financial Forum	National Society of Rate of Return Analysts
12 June 1992	38 Rate and Charges Subcommittee Annual Conference	American Water Works Association
13 May 1992	39 Rates School	New England Gas Assoc.
14 October 1989	40 Seventeenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility Commissioners Florida Public Service Commission and University of Utah
15 October 1988	41 Sixteenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility Commissioners, Florida Public Service Commission and University of Utah
16 May 1988	42 Twentieth Financial Forum	National Society of Rate of Return Analysts
17 October 1987	43 Fifteenth Annual Eastern Utility Rate Seminar	Water Committee of the National Association of Regulatory Utility

APPENDIX A TO DIRECT TESTIMONY OF PAUL R. MOUL

1			Commissioners, Florida
2			Public Service Commis-
3			sion and University of
4			Utah
5	September 1987	Rate Committee	American Gas Association
6		Meeting	
7	May 1987	Pennsylvania	National Association of
8		Chapter	Water Companies
9		annual meeting	
10	October 1986	Eighteenth	National Society of Rate
11		Financial	of Return
12		Forum	
13	October 1984	Fifth National	American Bar Association
14		on Utility	
15		Ratemaking	
16		Fundamentals	
17	March 1984	Management Seminar	New York State Telephone
18			Association
19	February 1983	The Cost of Capital	Temple University, School
20		Seminar	of Business Admin.
21	May 1982	A Seminar on	New Mexico State
22		Regulation	University, Center for
23		and The Cost of	Business Research
24		Capital	and Services
25	October 1979	Economics of	Brown University
26		Regulation	

APPENDIX B TO DIRECT TESTIMONY OF PAUL R. MOUL

RATESETTING PRINCIPLES

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23

Traditional cost of service regulation, as implemented by a regulatory agency engaged in ratesetting, such as the Commission, serves as a substitute for competition. In setting rates, a regulatory agency must carefully consider the public's interest in reasonably priced, as well as safe and reliable, service. The level of rates must also provide the public utility and its investors with an opportunity to earn a rate of return for the public utility and its investors that is commensurate with the risk to which the invested capital is exposed so that the public utility has access to the capital required to meet its service responsibilities to its customers. Without an opportunity to earn a fair rate of return, a public utility will be unable to attract sufficient capital required to meet its responsibilities over time.

It is important to remember that regulated firms must compete for capital in a global market with non-regulated firms, as well as municipal, state and federal governments. Traditionally, a public utility has been responsible for providing a particular type of service to its customers within a specific market area. Although this relationship with customers has been changing, a regulated utility remains quite different from a non-regulated firm, which is free to enter and exit competitive markets in accordance with available business opportunities.

As established by the landmark Bluefield and Hope cases,¹ several tests have been articulated through which the regulator can determine the fairness or reasonableness of the rate of return. These tests include a determination of whether the rate of return is (i) similar to that of other financially sound businesses having similar or comparable risks, (ii) sufficient to ensure confidence in the financial integrity of the public utility, and (iii) adequate to maintain and support the credit of the utility, thereby enabling it to attract, on a reasonable cost basis, the funds necessary to satisfy its capital requirements so that it can meet the obligation to

¹Bluefield Water Works & Improvement Co. v. P.S.C. of West Virginia, 262 U.S. 679 (1923) and F.P.C. v. Hope Natural Gas Co., 320 U.S. 591 (1944).

APPENDIX B TO DIRECT TESTIMONY OF PAUL R. MOUL

1 provide adequate and reliable service to the public.

2 A fair rate of return must not only provide the utility with the ability to attract new capital
3 it must also be fair to existing investors. An appropriate rate of return which may have been
4 reasonable at one point in time may become too high or too low at a subsequent point in time,
5 based upon changing business risks, economic conditions and alternative investment
6 opportunities. When applying the standards of a fair rate of return, it must be recognized that
7 the end result must provide for the payment of interest on the company's debt, the payment of
8 dividends on the company's stock, the recovery of costs associated with securing capital, the
9 maintenance of reasonable credit quality for the company, and support of the company's
10 financial condition, which today would include those measures of financial performance in the
11 areas of interest coverage and adequate cash flow derived from a reasonable level of
12 earnings.

APPENDIX C TO DIRECT TESTIMONY OF PAUL R. MOUL

EVALUATION OF RISK

1

2 The rate of return required by investors is directly linked to the perceived level of risk.
3 The greater the risk of an investment, the higher is the required rate of return necessary to
4 compensate for that risk all else being equal. Because investors will seek the highest rate of
5 return available, considering the risk involved, the rate of return must at least equal the
6 investor-required, market-determined cost of capital if public utilities are to attract the
7 necessary investment capital on reasonable terms.

8

9 In the measurement of the cost of capital, it is necessary to assess the risk of a firm.
10 The level of risk for a firm is often defined as the uncertainty of achieving expected
11 performance, and is sometimes viewed as a probability distribution of possible outcomes.
12 Hence, if the uncertainty of achieving an expected outcome is high, the risk is also high. As a
13 consequence, high risk firms must offer investors higher returns than low risk firms, which pay
14 less to attract capital from investors. This is because the level of uncertainty, or risk of not
15 realizing expected returns, establishes the compensation required by investors in the capital
16 markets. Of course, the risk of a firm must also be considered in the context of its ability to
17 actually experience adequate earnings, which conform with a fair rate of return. Thus, if there
18 is a high probability that a firm will not perform well due to fundamentally poor market
19 conditions, investors will demand a higher return.

19

20 The investment risk of a firm is comprised of its business risk and financial risk.
21 Business risk is all risk other than financial risk, and is sometimes defined as the staying
22 power of the market demand for a firm's product or service and the resulting inherent
23 uncertainty of realizing expected pre-tax returns on the firm's assets. Business risk
24 encompasses all operating factors, e.g., productivity, competition, management ability, etc.
25 that bear upon the expected pre-tax operating income attributed to the fundamental nature of a
26 firm's business. Financial risk results from a firm's use of borrowed funds (or similar sources

APPENDIX C TO DIRECT TESTIMONY OF PAUL R. MOUL

1 of capital with fixed payments) in its capital structure, i.e., financial leverage. Thus, if a firm did
2 not employ financial leverage by borrowing any capital, its investment risk would be
3 represented by its business risk.

4 It is important to note that in evaluating the risk of regulated companies, financial
5 leverage cannot be considered in the same context as it is for non-regulated companies.
6 Financial leverage has a different meaning for regulated firms than for non-regulated
7 companies. For regulated public utilities, the cost of service formula gives the benefits of
8 financial leverage to consumers in the form of lower revenue requirements. For non-regulated
9 companies, all benefits of financial leverage are retained by the common stockholder.
10 Although retaining none of the benefits, regulated firms bear the risk of financial leverage.
11 Therefore, a regulated firm's rate of return on common equity must recognize the greater
12 financial risk shown by the higher leverage typically employed by public utilities.

13 Although no single index or group of indices can precisely quantify the relative
14 investment risk of a firm, financial analysts use a variety of indicators to assess that risk. For
15 example, the creditworthiness of a firm is revealed by its bond ratings. If the stock is traded,
16 the price-earnings multiple, dividend yield, and beta coefficients (a statistical measure of a
17 stock's relative volatility to the rest of the market) provide some gauge of overall risk. Other
18 indicators, which are reflective of business risk, include the variability of the rate of return on
19 equity, which is indicative of the uncertainty of actually achieving the expected earnings;
20 operating ratios (the percentage of revenues consumed by operating expenses, depreciation,
21 and taxes other than income tax), which are indicative of profitability; the quality of earnings,
22 which considers the degree to which earnings are the product of accounting principles or cost
23 deferrals; and the level of internally generated funds. Similarly, the proportion of senior capital
24 in a company's capitalization is the measure of financial risk, which is often analyzed in the
25 context of the equity ratio (i.e., the complement of the debt ratio).

APPENDIX D TO DIRECT TESTIMONY OF PAUL R. MOUL

1 COST OF EQUITY--GENERAL APPROACH

2 Through a fundamental financial analysis, the relative risk of a firm must be established
3 prior to the determination of its cost of equity. Any rate of return recommendation, which lacks
4 such a basis, will inevitably fail to provide a utility with a fair rate of return except by
5 coincidence. With a fundamental risk analysis as a foundation, standard financial models can
6 be employed by using informed judgment. The methods, which have been employed to
7 measure the cost of equity, include: the Discounted Cash Flow ("DCF") model, the Risk
8 Premium ("RP") approach, the Capital Asset Pricing Model ("CAPM") and the Comparable
9 Earnings ("CE") approach.

10 The traditional DCF model, while useful in providing some insight into the cost of
11 equity, is not an approach that should be used exclusively. The divergence of stock prices
12 from company-specific fundamentals can provide a misleading cost of equity calculation. As
13 reported in The Wall Street Journal on June 6, 1991, a statistical study published by Goldman
14 Sachs indicated that only 35% of stock price growth in the 1980's could be attributed to
15 earnings and interest rates. Further, 38% of the rise in stock prices during the 1980's was
16 attributed to unknown factors. The Goldman Sachs study highlights the serious limitations of a
17 model, such as DCF, which is founded upon identification of specific variables to explain stock
18 price growth. That is to say, when stock price growth exceeds growth in a company's earnings
19 per share, models such as DCF will misspecify investor expected returns, which are
20 comprised of capital gains, as well as dividend receipts. As such, a combination of methods
21 should be used to measure the cost of equity.

22 The Risk Premium analysis is founded upon the prospective cost of long-term debt,
23 i.e., the yield that the public utility must offer to raise long-term debt capital directly from
24 investors. To that yield must be added a risk premium in recognition of the greater risk of
25 common equity over debt. This additional risk is, of course, attributable to the fact that the

APPENDIX D TO DIRECT TESTIMONY OF PAUL R. MOUL

1 payment of interest and principal to creditors has priority over the payment of dividends and
2 return of capital to equity investors. Hence, equity investors require a higher rate of return
3 than the yield on long-term corporate bonds.

4 The CAPM is a model not unlike the traditional Risk Premium. The CAPM employs the
5 yield on a risk-free interest-bearing obligation plus a premium as compensation for risk. Aside
6 from the reliance on the risk-free rate of return, the CAPM gives specific quantification to
7 systematic (or market) risk as measured by beta.

8 The Comparable Earnings approach measures the returns expected/experienced by
9 other non-regulated firms and has been used extensively in rate of return analysis for over a
10 half century. However, its popularity diminished in the 1970s and 1980s with the
11 popularization of market-based models. Recently, there has been renewed interest in this
12 approach. Indeed, the financial community has expressed the view that the regulatory
13 process must consider the returns, which are being achieved in the non-regulated sector so
14 that public utilities can compete effectively in the capital markets. Indeed, with additional
15 competition being introduced throughout the traditionally regulated public utility industry,
16 returns expected to be realized by non-regulated firms have become increasingly relevant in the
17 ratesetting process. The Comparable Earnings approach considers directly those
18 requirements and it fits the established standards for a fair rate of return set forth in the
19 landmark decisions on the issue of rate of return. These decisions require that a fair return for
20 a utility must be equal to that earned by firms of comparable risk.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 If $D_1 = D_2 = D_3 = \dots D_n$ as is the case for preferred stock, and n approaches infinity, as is the
2 case for non-callable preferred stock without a sinking fund, then this equation reduces to:

$$3 \quad P_0 = \frac{D_1}{Kp}$$

4 This equation can be used to solve for the annual rate of return on a preferred stock when the
5 current price and subsequent annual dividends are known. For example, with $D_1 = \$1.00$, and
6 $P_0 = \$10$, then $Kp = \$1.00 \div \10 , or 10%.

7 The dividend discount equation, first shown, is the generic DCF valuation model for all
8 equities, both preferred and common. While preferred stock generally pays a constant
9 dividend, permitting the simplification subsequently noted, common stock dividends are not
10 constant. Therefore, absent some other simplifying condition, it is necessary to rely upon the
11 generic form of the DCF. If, however, it is assumed that $D_1, D_2, D_3, \dots D_n$ are systematically
12 related to one another by a constant growth rate (g), so that $D_0(1+g) = D_1, D_1(1+g) = D_2, D_2$
13 $(1+g) = D_3$ and so on approaching infinity, and if Ks (the required rate of return on a common

$$P_0 = \frac{D_1}{Ks - g} \text{ or } P_0 = \frac{D_0(1+g)}{Ks - g}$$

14 stock) is greater than g , then the DCF equation can be reduced to:
15 which is the periodic form of the "Gordon" model.¹ Proof of the DCF equation is found in all
16 modern basic finance textbooks. This DCF equation can be easily solved as:

$$Ks = \frac{D_0(1+g)}{P_0} + g$$

¹Although the popular application of the DCF model is often attributed to the work of Myron J. Gordon in the mid-1950's, J. B. Williams explicated the DCF model in its present form nearly two decades earlier.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 which is the periodic form of the Gordon Model commonly applied in estimating equity rates of
2 return in rate cases. When used for this purpose, K_s is the annual rate of return on common
3 equity demanded by investors to induce them to hold a firm's common stock. Therefore, the
4 variables D_0 , P_0 and g must be estimated in the context of the market for equities, so that the
5 rate of return, which a public utility is permitted the opportunity to earn, has meaning and
6 reflects the investor-required cost rate.

7 Application of the Gordon model with market derived variables is straightforward. For
8 example, using the most recent prior annualized dividend (D_0) of \$0.80, the current price (P_0)
9 of \$10.00, and the investor expected dividend growth rate (g) of 5%, the solution of the DCF
10 formula provides a 13.4% rate of return. The dividend yield component in this instance is
11 8.4%, and the capital gain component is 5%, which together represent the total 13.4% annual
12 rate of return required by investors. The capital gain component of the total return may be
13 calculated with two adjacent future year prices. For example, in the eleventh year of the
14 holding period, the price per share would be \$17.10 as compared with the price per share of
15 \$16.29 in the tenth year which demonstrates the 5% annual capital gain yield.

16 Some DCF devotees believe that it is more appropriate to estimate the required return
17 on equity with a model which permits the use of multiple growth rates. This may be a plausible
18 approach to DCF, where investors expect different dividend growth rates in the near term and
19 long run. If two growth rates, one near term and one long-run, are to be used in the context of
20 a price (P_0) of \$10.00, a dividend (D_0) of \$0.80, a near-term growth rate of 5.5%, and a long-
21 run expected growth rate of 5.0% beginning at year 6, the required rate of return is 13.57%
22 solved with a computer by iteration.

Dividend Yield

24 The historical annual dividend yield for the Water Group is shown on Schedule 3. The
25 2004-2008 five-year average dividend yield was 2.9% for the Water Group. The monthly

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 dividend yields for the past twelve months are shown graphically on Schedule 5. These
2 dividend yields reflect an adjustment to the month-end closing prices to remove the pro rata
3 accumulation of the quarterly dividend amount since the last ex-dividend date.

4 The ex-dividend date usually occurs two business days before the record date of the
5 dividend (i.e., the date by which a shareholder must own the shares to be entitled to the
6 dividend payment--usually about two to three weeks prior to the actual payment). During a
7 quarter (here defined as 91 days), the price of a stock moves up ratably by the dividend
8 amount as the ex-dividend date approaches. The stock's price then falls by the amount of the
9 dividend on the ex-dividend date. Therefore, it is necessary to calculate the fraction of the
10 quarterly dividend since the time of the last ex-dividend date and to remove that amount from
11 the price. This adjustment reflects normal recurring pricing of stocks in the market, and
12 establishes a price which will reflect the true yield on a stock.

13 A six-month average dividend yield has been used to recognize the prospective
14 orientation of the ratesetting process as explained in the direct testimony. For the purpose of
15 a DCF calculation, the average dividend yields must be adjusted to reflect the prospective
16 nature of the dividend payments, i.e., the higher expected dividends for the future rather than
17 the recent dividend payment annualized. An adjustment to the dividend yield component,
18 when computed with annualized dividends, is required based upon investor expectation of
19 quarterly dividend increases.

20 The procedure to adjust the average dividend yield for the expectation of a dividend
21 increase during the initial investment period will be at a rate of one-half the growth component,
22 developed below. The DCF equation, showing the quarterly dividend payments as D_0 , may be
23 stated in this fashion:

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

$$K = \frac{D_0(1+g)^0 + D_0(1+g)^0 + D_0(1+g)^1 + D_0(1+g)^1}{P_0} + g$$

1 The adjustment factor, based upon one-half the expected growth rate developed in my direct
2 testimony, will be 3.500% (7.00% x .5) for the Water Group, which assumes that two dividend
3 payments will be at the expected higher rate during the initial investment period. Using the
4 six-month average dividend yield as a base, the prospective (forward) dividend yield would be
5 3.67% (3.55% x 1.03500) for the Water Group.

6 Another DCF model that reflects the discrete growth in the quarterly dividend (D_0) is as
7 follows:

$$K = \frac{D_0(1+g)^{.25} + D_0(1+g)^{.50} + D_0(1+g)^{.75} + D_0(1+g)^{1.00}}{P_0} + g$$

8 This procedure confirms the reasonableness of the forward dividend yield previously
9 calculated. The quarterly discrete adjustment provides a dividend yield of 3.70% (3.55% x
10 1.04338) for the Water Group. The use of an adjustment is required for the periodic form of
11 the DCF in order to properly recognize that dividends grow on a discrete basis.

12 In either of the preceding DCF dividend yield adjustments, there is no recognition for
13 the compound returns attributed to the quarterly dividend payments. Investors have the
14 opportunity to reinvest quarterly dividend receipts. Recognizing the compounding of the
15 periodic quarterly dividend payments (D_0), results in a third DCF formulation:

$$k = \left[\left(1 + \frac{D_0}{P_0} \right)^4 - 1 \right] + g$$

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 This DCF equation provides no further recognition of growth in the quarterly dividend.
2 Combining discrete quarterly dividend growth with quarterly compounding would provide the
3 following DCF formulation, stating the quarterly dividend payments (D_0):

$$k = \left[\left(1 + \frac{D_0 (1 + g)^{25}}{P_0} \right)^4 - 1 \right] + g$$

4 A compounding of the quarterly dividend yield provides another procedure to recognize the
5 necessity for an adjusted dividend yield. The unadjusted average quarterly dividend yield was
6 0.8875% ($3.55\% \div 4$) for the Water Group. The compound dividend yield would be 3.66%
7 ($1.009026^4 - 1$) for the Water Group, recognizing quarterly dividend payments in a forward-
8 looking manner. These dividend yields conform with investors' expectations in the context of
9 reinvestment of their cash dividend.

10 For the Water Group, a 3.68% forward-looking dividend yield is the average ($3.67\% +$
11 $3.70\% + 3.66\% = 11.03\% \div 3$) of the adjusted dividend yield using the form $D_0/P_0 (1+.5g)$, the
12 dividend yield recognizing discrete quarterly growth, and the quarterly compound dividend
13 yield with discrete quarterly growth.

14 Growth Rate

15 If viewed in its infinite form, the DCF model is represented by the discounted value of
16 an endless stream of growing dividends. It would, however, require 100 years of future
17 dividend payments so that the discounted value of those payments would equate to the
18 present price so that the discount rate and the rate of return shown by the simplified Gordon
19 form of the DCF model would be about the same. A century of dividend receipts represents
20 an unrealistic investment horizon from almost any perspective. Because stocks are not held
21 by investors forever, the growth in the share value (i.e., capital appreciation, or capital gains

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 yield) is most relevant to investors' total return expectations. Hence, investor expected returns
2 in the equity market are provided by capital appreciation of the investment as well as receipt of
3 dividends. As such, the sale price of a stock can be viewed as a liquidating dividend which can
4 be discounted along with the annual dividend receipts during the investment holding period to
5 arrive at the investor expected return.

6 In its constant growth form, the DCF assumes that with a constant return on book
7 common equity and constant dividend payout ratio, a firm's earnings per share, dividends per
8 share and book value per share will grow at the same constant rate, absent any external
9 financing by a firm. Because these constant growth assumptions do not actually prevail in the
10 capital markets, the capital appreciation potential of an equity investment is best measured by
11 the expected growth in earnings per share. Since the traditional form of the DCF assumes no
12 change in the price-earnings multiple, the value of a firm's equity will grow at the same rate as
13 earnings per share. Hence, the capital gains yield is best measured by earnings per share
14 growth using company-specific variables.

15 Investors consider both historical and projected data in the context of the expected
16 growth rate for a firm. An investor can compute historical growth rates using compound
17 growth rates or growth rate trend lines. Otherwise, an investor can rely upon published growth
18 rates as provided in widely-circulated, influential publications. However, a traditional constant
19 growth DCF analysis that is limited to such inputs suffers from the assumption of no change in
20 the price-earnings multiple, i.e., that the value of a firm's equity will grow at the same rate as
21 earnings. Some of the factors which actually contribute to investors' expectations of earnings
22 growth and which should be considered in assessing those expectations, are: (i) the earnings
23 rate on existing equity, (ii) the portion of earnings not paid out in dividends, (iii) sales of
24 additional common equity, (iv) reacquisition of common stock previously issued, (v) changes in
25 financial leverage, (vi) acquisitions of new business opportunities, (vii) profitable liquidation of

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 assets, and (viii) repositioning of existing assets. The realities of the equity market regarding
2 total return expectations, however, also reflect factors other than these inputs. Therefore, the
3 DCF model contains overly restrictive limitations when the growth component is stated in
4 terms of earnings per share (the basis for the capital gains yield) or dividends per share (the
5 basis for the infinite dividend discount model). In these situations, there is inadequate
6 recognition of the capital gains yields arising from stock price growth which could exceed
7 earnings or dividends growth.

8 To assess the growth component of the DCF, analysts' projections of future growth
9 influence investor expectations as explained above. One influential publication is The Value
10 Line Investment Survey which contains estimated future projections of growth. The Value Line
11 Investment Survey provides growth estimates which are stated within a common economic
12 environment for the purpose of measuring relative growth potential. The basis for these
13 projections is the Value Line 3 to 5 year hypothetical economy. The Value Line hypothetical
14 economic environment is represented by components and subcomponents of the National
15 Income Accounts which reflect in the aggregate assumptions concerning the unemployment
16 rate, manpower productivity, price inflation, corporate income tax rate, high-grade corporate
17 bond interest rates, and Fed policies. Individual estimates begin with the correlation of sales,
18 earnings and dividends of a company to appropriate components or subcomponents of the
19 future National Income Accounts. These calculations provide a consistent basis for the
20 published forecasts. Value Line's evaluation of a specific company's future prospects are
21 considered in the context of specific operating characteristics that influence the published
22 projections. Of particular importance for regulated firms, Value Line considers the regulatory
23 quality, rates of return recently authorized, the historic ability of the firm to actually experience
24 the authorized rates of return, the firm's budgeted capital spending, the firm's financing
25 forecast, and the dividend payout ratio. The wide circulation of this source and frequent

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 reference to Value Line in financial circles indicate that this publication has an influence on
2 investor judgment with regard to expectations for the future.

3 There are other sources of earnings growth forecasts. One of these sources is the
4 Institutional Brokers Estimate System ("IBES"). The IBES service provides data on consensus
5 earnings per share forecasts and five-year earnings growth rate estimates. The publisher of
6 IBES has been purchased by Thomson/First Call. The IBES forecasts have been integrated
7 into the First Call consensus growth forecasts. The earnings estimates are obtained from
8 financial analysts at brokerage research departments and from institutions whose securities
9 analysts are projecting earnings for companies in the First Call universe of companies. Other
10 services that tabulate earnings forecasts and publish them are Zacks Investment Research.
11 As with the IBES/First Call forecasts, Zacks provide consensus forecasts collected from
12 analysts for most publically traded companies.

13 In each of these publications, forecasts of earnings per share for the current and
14 subsequent year receive prominent coverage. That is to say, IBES/First Call, Zacks, and
15 Value Line show estimates of current-year earnings and projections for the next year. While
16 the DCF model typically focuses upon long-run estimates of growth, stock prices are clearly
17 influenced by current and near-term earnings prospects. Therefore, the near-term earnings
18 per share growth rates should also be factored into a growth rate determination.

19 Although forecasts of future performance are investor influencing², equity investors
20 may also rely upon the observations of past performance. Investors' expectations of future
21 growth rates may be determined, in part, by an analysis of historical growth rates. It is
22 apparent that any serious investor would advise himself/herself of historical performance prior

²As shown in a National Bureau of Economic Research monograph by John G. Cragg and
Burton G. Malkiel, Expectations and the Structure of Share Prices, University of Chicago Press 1982.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 to taking an investment position in a firm. Earnings per share and dividends per share
2 represent the principal financial variables which influence investor growth expectations.

3 Other financial variables are sometimes considered in rate case proceedings. For
4 example, a company's internal growth rate, derived from the return rate on book common
5 equity and the related retention ratio, is sometimes considered. This growth rate measure is
6 represented by the Value Line forecast "BxR" shown on Schedule 7. Internal growth rates are
7 often used as a proxy for book value growth. Unfortunately, this measure of growth is often
8 not reflective of investor-expected growth. This is especially important when there is an
9 indication of a prospective change in dividend payout ratio, earned return on book common
10 equity, change in market-to-book ratios or other fundamental changes in the character of the
11 business. Nevertheless, I have also shown the historical and projected growth rates in book
12 value per share and internal growth rates.

13 Leverage Adjustment

14 As noted previously, the divergence of stock prices from book values creates a conflict
15 within the DCF model when the results of a market-derived cost of equity are applied to the
16 common equity account measured at book value in the ratesetting context. This is the
17 situation today where the market price of stock exceeds its book value for most companies.
18 This divergence of price and book value also creates a financial risk difference, whereby the
19 capitalization of a utility measured at its market value contains relatively less debt and more
20 equity than the capitalization measured at its book value. It is a well-accepted fact of financial
21 theory that a relatively higher proportion of equity in the capitalization has less financial risk
22 than another capital structure more heavily weighted with debt. This is the situation for the
23 Water Group where the market value of its capitalization contains more equity than is shown
24 by the book capitalization. The following comparison demonstrates this situation where the
25 market capitalization is developed by taking the "Fair Value of Financial Instruments"

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 (Disclosures about Fair Value of Financial Instruments -- Statement of Financial Accounting
 2 Standards ("FAS") No. 107) as shown in the annual report for these companies and the
 3 market value of the common equity using the price of stock. The comparison of capital
 4 structure ratios is:

5	Gas	Capitalization at Market Value	Capitalization at Book Value
6	<u>Group</u>	<u>(Fair Value)</u>	<u>(Carrying Amounts)</u>
7			
8	Long-term Debt	34.92%	49.19%
9	Preferred Stock	0.17	0.23
10	Common Equity	<u>64.91</u>	<u>50.58</u>
11			
12	Total	<u>100.00%</u>	<u>100.00%</u>
13			

14 With regard to the capital structure ratios represented by the carrying amounts shown above,
 15 there are some variances from the ratios shown on Schedule 3. These variances arise from
 16 the use of balance sheet values in computing the capital structure ratios shown on Schedule 3
 17 and the use of the Carrying Amounts of the Financial Instruments according to FAS 107 (the
 18 Carrying Amounts were used in the table shown above to be comparable to the Fair Value
 19 amounts used in the comparison calculations). Also, my calculations in this Appendix E are
 20 based on fiscal year-end 2009 data, whereas Schedule 3 ends with fiscal year 2008 data.

21 With the capital ratios calculated above, is necessary to first calculate the cost of equity
 22 for a firm without any leverage. The cost of equity for an unleveraged firm using the capital
 23 structure ratios calculated with market values is:

$$24 \quad k_u = k_e - (((k_u - i) (1-t) D / E) - (k_u - d) P / E)$$

$$25 \quad 9.39\% = 10.68\% - (((9.39\% - 5.74\%) .65) 34.92\%/64.91\%) - (9.39\% - 6.04\%) 0.17\%/64.91\%$$

26 where k_u = cost of equity for an all-equity firm, k_e = market determined cost equity, i = cost of
 27 debt³, d = dividend rate on preferred stock⁴, D = debt ratio, P = preferred stock ratio, and E =

³ The cost of debt is the six-month average yield on Moody's A rated public utility bonds.

⁴ The cost of preferred is the six-month average yield on Moody's "a" rated preferred stock.

APPENDIX E TO DIRECT TESTIMONY OF PAUL R. MOUL

1 common equity ratio. The formula shown above indicates that the cost of equity for a firm with
2 100% equity is 9.39% using the market value of the Water Group's capitalization. Having
3 determined that the cost of equity is 9.39% for a firm with 100% equity, the rate of return on
4 common equity associated with the book value capital structure is:

$$5 \quad k_e = k_u + (((k_u - i) (1-t) D / E) + (k_u - d) P / E)$$

$$6 \quad 11.71\% = 9.39\% + (((9.39\% - 5.74\%) \cdot 65) \cdot 49.19\% / 50.58\%) + (9.39\% - 6.04\%) \cdot 0.23\% / 50.58\%.$$

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1

INTEREST RATES

2

3

4

5

6

7

8

9

10

11

Interest rates can be viewed in their traditional nominal terms (i.e., the stated rate of interest) and in real terms (i.e., the stated rate of interest less the expected rate of inflation). Absent consideration of inflation, the real rate of interest is determined generally by supply factors which are influenced by investors willingness to forego current consumption (i.e., to save) and demand factors that are influenced by the opportunities to derive income from productive investments. Added to the real rate of interest is compensation required by investors for the inflationary impact of the declining purchasing power of their income received in the future. While interest rates are clearly influenced by the changing annual rate of inflation, it is important to note that the expected rate of inflation that is reflected in current interest rates may be quite different from the prevailing rate of inflation.

12

13

14

15

16

17

18

Rates of interest also vary by the type of interest bearing instrument. Investors require compensation for the risk associated with the term of the investment and the risk of default. The risk associated with the term of the investment is usually shown by the yield curve, i.e., the difference in rates across maturities. The typical structure is represented by a positive yield curve, which provides progressively higher interest rates as the maturities are lengthened. Flat (i.e., relatively level rates across maturities) or inverted (i.e., higher short-term rates than long-term rates) yield curves occur less frequently.

19

20

21

22

23

24

The risk of default is typically associated with the creditworthiness of the borrower. Differences in interest rates can be traced to the credit quality ratings assigned by the bond rating agencies, such as Moody's Investors Service, Inc. and Standard & Poor's Corporation. Obligations of the United States Treasury are usually considered to be free of default risk, and hence reflect only the real rate of interest, compensation for expected inflation, and maturity risk. The Treasury has been issuing inflation-indexed notes, which automatically provide

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 compensation to investors for future inflation, thereby providing a lower current yield on these
2 issues.

3 Interest Rate Environment

4 Federal Reserve Board ("Fed") policy actions, which impact directly short-term interest rates
5 also substantially, affect investor sentiment in long-term fixed-income securities markets. In
6 this regard, the Fed has often pursued policies designed to build investor confidence in the
7 fixed-income securities market. Formative Fed policy has had a long history, as exemplified by
8 the historic 1951 Treasury-Federal Reserve Accord, and more recently, deregulation within the
9 financial system, which increased the level and volatility of interest rates. The Fed has
10 indicated that it will follow a monetary policy designed to promote noninflationary economic
11 growth.

12 As background to the recent levels of interest rates, history shows that the Open
13 Market Committee of the Federal Reserve board ("FOMC") began a series of moves toward
14 lower short-term interest rates in mid-1990 -- at the outset of the previous recession.
15 Monetary policy was influenced at that time by (i) steps taken to reduce the federal budget
16 deficit, (ii) slowing economic growth, (iii) rising unemployment, and (iv) measures intended to
17 avoid a credit crunch. Thereafter, the Federal government initiated several bold proposals to
18 deal with future borrowings by the Treasury. With lower expected federal budget deficits and
19 reduced Treasury borrowings, together with limitations on the supply of new 30-year Treasury
20 bonds, long-term interest rates declined to a twenty-year low, reaching a trough of 5.78% in
21 October 1993.

22 On February 4, 1994, the FOMC began a series of increases in the Fed Funds rate
23 (i.e., the interest rate on excess overnight bank reserves). The initial increase represented the
24 first rise in short-term interest rates in five years. The series of seven increases doubled the
25 Fed Funds rate to 6%. The increases in short-term interest rates also caused long-term rates

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 to move up, continuing a trend, which began in the fourth quarter of 1993. The cyclical peak in
2 long-term interest rates was reached on November 7 and 14, 1994 when 30-year Treasury
3 bonds attained an 8.16% yield. Thereafter, long-term Treasury bond yields generally declined.

4 Beginning in mid-February 1996, long-term interest rates moved upward from their
5 previous lows. After initially reaching a level of 6.75% on March 15, 1996, long-term interest
6 rates continued to climb and reached a peak of 7.19% on July 5 and 8, 1996. For the period
7 leading up to the 1996 Presidential election, long-term Treasury bonds generally traded within
8 this range. After the election, interest rates moderated, returning to a level somewhat below
9 the previous trading range. Thereafter, in December 1996, interest rates returned to a range
10 of 6.5% to 7.0%, which existed for much of 1996.

11 On March 25, 1997, the FOMC decided to tighten monetary conditions through a one-
12 quarter percentage point increase in the Fed Funds rate. This tightening increased the Fed
13 Funds rate to 5.5%. In making this move, the FOMC stated that it was concerned by
14 persistent strength of demand in the economy, which it feared would increase the risk of
15 inflationary imbalances that could eventually interfere with the long economic expansion.

16 In the fourth quarter of 1997, the yields on Treasury bonds began to decline rapidly in
17 response to an increase in demand for Treasury securities caused by a flight to safety
18 triggered by the currency and stock market crisis in Asia. Liquidity provided by the Treasury
19 market makes these bonds an attractive investment in times of crisis. This is because
20 Treasury securities encompass a very large market, which provides ease of trading, and carry
21 a premium for safety. During the fourth quarter of 1997, Treasury bond yields pierced the
22 psychologically important 6% level for the first time since 1993.

23 Through the first half of 1998, the yields on long-term Treasury bonds fluctuated within
24 a range of about 5.6% to 6.1% reflecting their attractiveness and safety. In the third quarter of
25 1998, there was further deterioration of investor confidence in global financial markets. This

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 loss of confidence followed the moratorium (i.e., default) by Russia on its sovereign debt and
2 fears associated with problems in Latin America. While not significant to the global economy
3 in the aggregate, the August 17 default by Russia had a significant negative impact on investor
4 confidence, following earlier discontent surrounding the crisis in Asia. These events
5 subsequently led to a general pull back of risk-taking as displayed by banks growing
6 reluctance to lend, worries of an expanding credit crunch, lower stock prices, and higher yields
7 on bonds of riskier companies. These events contributed to the failure of the hedge fund,
8 Long-Term Capital Management.

9 In response to these events, the FOMC cut the Fed Funds rate just prior to the mid-
10 term Congressional elections. The FOMC's action was based upon concerns over how
11 increasing weakness in foreign economies would affect the U.S. economy. As recently as July
12 1998, the FOMC had been more concerned about fighting inflation than the state of the
13 economy. The initial rate cut was the first of three reductions by the FOMC. Thereafter, the
14 yield on long-term Treasury bonds reached a 30-year low of 4.70% on October 5, 1998. Long-
15 term Treasury yields below 5% had not been seen since 1967. Unlike the first rate cut that
16 was widely anticipated, the second rate reduction by the FOMC was a surprise to the markets.
17 A third reduction in short-term interest rates occurred in November 1998 when the FOMC
18 reduced the Fed Funds rate to 4.75%.

19 All of these events prompted an increase in the prices for Treasury bonds, which lead
20 to the low yields described above. Another factor that contributed to the decline in yields on
21 long-term Treasury bonds was a reduction in the supply of new Treasury issues coming to
22 market due to the Federal budget surplus -- the first in nearly 30 years. The dollar amount of
23 Treasury bonds being issued declined by 30% in two years thus resulting in higher prices and
24 lower yields. In addition, rumors of some struggling hedge funds unwinding their positions
25 further added to the gains in Treasury bond prices.

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 The financial crisis that spread from Asia to Russia and to Latin America pushed
2 nervous investors from stocks into Treasury bonds, thus increasing demand for bonds, just
3 when supply was shrinking. There was also a move from corporate bonds to Treasury bonds
4 to take advantage of appreciation in the Treasury market. This resulted in a certain amount of
5 exuberance for Treasury bond investments that formerly was reserved for the stock market.
6 Moreover, yields in the fourth quarter of 1998 became extremely volatile as shown by Treasury
7 yields that fell from 5.10% on September 29 to 4.70% on October 5, and thereafter returned to
8 5.10% on October 13. A decline and rebound of 40 basis points in Treasury yields in a two-
9 week time frame is remarkable.

10 Beginning in mid-1999, the FOMC raised interest rates on six occasions reversing its
11 actions in the fall of 1998. On June 30, 1999, August 24, 1999, November 16, 1999, February
12 2, 2000, March 21, 2000, and May 16, 2000, the FOMC raised the Fed Funds rate to 6.50%.
13 This brought the Fed Funds rate to its highest level since 1991, and was 175 basis points
14 higher than the level that occurred at the height of the Asian currency and stock market crisis.
15 At the time, these actions were taken in response to more normally functioning financial
16 markets, tight labor markets, and a reversal of the monetary ease that was required earlier in
17 response to the global financial market turmoil.

18 As the year 2000 drew to a close, economic activity slowed and consumer confidence
19 began to weaken. In two steps at the beginning and at the end of January 2001, the FOMC
20 reduced the Fed Funds rate by one percentage point. These actions brought the Fed Funds
21 rate to 5.50%. The FOMC described its actions as "a rapid and forceful response of monetary
22 policy" to eroding consumer and business confidence exemplified by weaker retail sales and
23 business spending on capital equipment and cut backs in manufacturing production.
24 Subsequently, on March 20, 2001, April 18, 2001, May 15, 2001, June 27, 2001, and August
25 21, 2001, the FOMC lowered the Fed Funds in steps consisting of three 50 basis points

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 decrements followed by two 25 basis points decrements. These actions took the Fed Funds
2 rate to 3.50%. The FOMC observed on August 21, 2001:

3 Household demand has been sustained, but business
4 profits and capital spending continue to weaken and
5 growth abroad is slowing, weighing on the U.S. economy.
6 The associated easing of pressures on labor and product
7 markets is expected to keep inflation contained.
8

9 Although long-term prospects for productivity growth and
10 the economy remain favorable, the Committee continues to
11 believe that against the background of its long-run goals of
12 price stability and sustainable economic growth and of the
13 information currently available, the risks are weighted
14 mainly toward conditions that may generate economic
15 weakness in the foreseeable future.
16

17 After the terrorist attack on September 11, 2001, the FOMC made two additional 50 basis
18 points reductions in the Fed Funds rate. The first reduction occurred on September 17, 2001
19 and followed the four-day closure of the financial markets following the terrorist attacks. The
20 second reduction occurred at the October 2 meeting of the FOMC where it observed:

21 The terrorist attacks have significantly heightened
22 uncertainty in an economy that was already weak.
23 Business and household spending as a consequence are
24 being further damped. Nonetheless, the long-term
25 prospects for productivity growth and the economy remain
26 favorable and should become evident once the unusual
27 forces restraining demand abate.
28

29 Afterward, the FOMC reduced the Fed Funds rate by 50 basis points on November 6, 2001
30 and by 25 basis points on December 11, 2001. In total, short-term interest rates were reduced
31 by the FOMC eleven (11) times during the year 2001. These actions cut the Fed Funds rate
32 by 4.75% and resulted in 1.75% for the Fed Funds rate.

33 In an attempt to deal with weakening fundamentals in the economy recovering from the
34 recession that began in March 2001, the FOMC provided a psychologically important one-half
35 percentage point reduction in the federal funds rate. The rate cut was twice as large as the

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 market expected, and brought the fed funds rate to 1.25% on November 6, 2002. The FOMC
2 stated that:

3 The Committee continues to believe that an
4 accommodative stance of monetary policy, coupled with
5 still-robust underlying growth in productivity, is providing
6 important ongoing support to economic activity. However,
7 incoming economic data have tended to confirm that
8 greater uncertainty, in part attributable to heightened
9 geopolitical risks, is currently inhibiting spending,
10 production, and employment. Inflation and inflation
11 expectations remain well contained.

12
13 In these circumstances, the Committee believes that
14 today's additional monetary easing should prove helpful as
15 the economy works its way through this current soft spot.
16 With this action, the Committee believes that, against the
17 background of its long-run goals of price stability and
18 sustainable economic growth and of the information
19 currently available, the risks are balanced with respect to
20 the prospects for both goals in the foreseeable future.

21
22 As 2003 unfolded, there was a continuing expectation of lower yields on Treasury securities.

23 In fact, the yield on ten-year Treasury notes reached a 45-year low near the end of the second
24 quarter of 2003. For long-term Treasury bonds, those yields culminated with a 4.24% yield on
25 June 13, 2003. Soon thereafter, the FOMC reduced the Fed Funds rate by 25 basis points on
26 June 25, 2003. In announcing its action, the FOMC stated:

27 The Committee continues to believe that an
28 accommodative stance of monetary policy, coupled with
29 still robust underlying growth in productivity, is providing
30 important ongoing support to economic activity. Recent
31 signs point to a firming in spending, markedly improved
32 financial conditions, and labor and product markets that
33 are stabilizing. The economy, nonetheless, has yet to
34 exhibit sustainable growth. With inflationary expectations
35 subdued, the Committee judged that a slightly more
36 expansive monetary policy would add further support for
37 an economy which it expects to improve over time.

38
39 Thereafter, intermediate and long-term Treasury yields moved marketedly higher. Higher
40 yields on long-term Treasury bonds, which exceeded 5.00% can be traced to: (i) the market's

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 disappointment that the Fed Funds rate was not reduced below 1.00%, (ii) an indication that
2 the Fed will not use unconventional methods for implementing monetary policy, (iii) growing
3 confidence in a strengthening economy, and (iv) concerns regarding the Federal budget
4 deficit. All these factors significantly changed the sentiment in the bond market.

5 For the remainder of 2003, the FOMC continued with its balanced monetary policy,
6 thereby retaining the 1% Fed Funds rate. However, in 2004, the FOMC initiated a policy of
7 moving toward a more neutral Fed Funds rate (i.e., removing the bias of abnormal low rates).
8 On June 30, 2004, August 10, 2004, September 21, 2004, November 10, 2004, December 14,
9 2004, February 2, 2005, March 22, 2005, May 3, 2005, June 30, 2005, August 9, 2005,
10 September 20, 2005, November 1, 2005, December 13, 2005, January 31, 2006, March 28,
11 2006, May 10, 2006, and June 29, 2006, the FOMC increased the Fed Funds rate in
12 seventeen 25 basis point increments. These policy actions are widely interpreted as part of
13 the process of moving toward a more neutral range for the Fed Funds rate.

14 Just after the FOMC meeting on August 7, 2007, where the FOMC decided to retain a
15 5.25% Fed Funds rate, turmoil in the credit markets prompted central banks throughout the
16 world to inject over \$325 billion of reserves into the banking system over a three-day period in
17 reaction to a credit crunch. Problems had been developing earlier in 2007, beginning in the
18 market for asset-backed securities linked to subprime mortgages. Valuation uncertainties for
19 these securities caused liquidity concerns for hedge funds, investment banks, and financial
20 institutions. The market for commercial paper, the most liquid part of the credit markets for
21 non-Treasury securities, was also affected. In response to the market turmoil, the FOMC
22 issued the following statement, the first of its type since after the September 11, 2001
23 terrorists' attack.

24 The Federal Reserve is providing liquidity to facilitate the
25 orderly functioning of financial markets.
26

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 The Federal Reserve will provide reserves as necessary
2 through open market operations to promote trading in the
3 federal funds market at rates close to the Federal Open
4 Market Committee's target rate of 5-1/4 percent. In current
5 circumstances, depository institutions may experience
6 unusual funding needs because of dislocations in money
7 and credit markets. As always, the discount window is
8 available as a source of funding.
9

10 Then, one week after its initial announcement, the FOMC made a surprise reduction of 50
11 basis points in the discount rate to narrow the spread between this rate and the target Fed
12 Funds rate. At the same time, the FOMC made the following statement:

13 Financial market conditions have deteriorated, and tighter
14 credit conditions and increased uncertainty have the
15 potential to restrain economic growth going forward. In
16 these circumstances, although recent data suggest that
17 the economy has continued to expand at a moderate pace,
18 the Federal Open Market Committee judges that the
19 downside risks to growth have increased appreciably. The
20 Committee is monitoring the situation and is prepared to
21 act as needed to mitigate the adverse effects on the
22 economy arising from the disruptions in financial markets.
23

24 Thereafter, at its regularly scheduled meeting on September 18, 2007, the FOMC reduced the
25 target Fed Funds rate to 4.75% and the discount rate was reduced to 5.25% in an effort to
26 forestall the adverse effects of the financial market turmoil on the economy generally. Further
27 reductions of 25 basis points occurred at the next two FOMC meetings on October 31, 2007
28 and on December 11, 2007. The December 11, 2007 FOMC statement indicated that:

29 Incoming information suggests that economic growth is
30 slowing, reflecting the intensification of the housing
31 correction and some softening in business and consumer
32 spending. Moreover, strains in financial markets have
33 increased in recent weeks. Today's action, combined with
34 the policy actions taken earlier, should help promote
35 moderate growth over time.
36

37 Readings on core inflation have improved modestly this
38 year, but elevated energy and commodity prices, among
39 other factors, may put upward pressure on inflation. In this
40 context, the Committee judges that some inflation risks

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 remain, and it will continue to monitor inflation
2 developments carefully.

3
4 Recent developments, including the deterioration in
5 financial market conditions, have increased the uncertainty
6 surrounding the outlook for economic growth and inflation.
7 The Committee will continue to assess the effects of
8 financial and other developments on economic prospects
9 and will act as needed to foster price stability and
10 sustainable economic growth.

11
12 With these actions, the Fed Funds rate and the discount rate closed the calendar year 2007 at
13 4.25% and 4.75%, respectively.

14 During 2008, many critical events occurred that influenced the capital markets, and
15 hence interest rates. They include: (i) the collapse of The Bear Stearns Company and its
16 acquisition by JPMorgan Chase & Co. with the aid of the Federal Reserve Bank of New York
17 announced on March 16, 2008; (ii) the failure of IndyMac on July 11, 2008, which was at the
18 time the third-largest banking failure in U.S. history, after a "run on the bank" by depositors; (iii)
19 the placement of the government-sponsored enterprises ("GSE") Federal National Mortgage
20 Association (Fannie Mae) and Freddie Mac into conservatorship on September 7, 2008 by the
21 Federal Housing Finance Agency; (iv) the largest bankruptcy filing in history by Lehman
22 Brothers Holding, Inc. on September 15, 2008; (v) the acquisition of the banking operations of
23 Washington Mutual, then the largest U.S. savings bank, by JPMorgan Chase on September
24 24, 2008, (Washington Mutual's holding company subsequently filed for bankruptcy
25 protection); (vi) the rescue of Merrill Lynch & Co., Inc. by Bank of America on September 15,
26 2008, with assistance of the Federal government; (vii) the effective nationalization on
27 September 23, 2008, of American International Group, then the world's largest insurance
28 company, through the acquisition of 79.9% of its equity by the U.S. Treasury and (viii) other
29 significant events affecting financial markets globally. The FOMC acted decisively in response
30 to the events described above. Acting prior to its first regularly scheduled meeting in 2008, on

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 January 22, 2008, the FOMC reduced the fed funds target by 75 basis points to 3.50% and the
2 discount rate was reduced by a corresponding amount to 4.00%. Actions by the FOMC
3 between meetings are unusual occurrences in recent years, thereby signifying the urgency
4 that the FOMC saw in taking immediate action on monetary policy in response to the financial
5 crisis. Then on January 30, 2008, the fed funds target rate and discount rate were further
6 reduced by 50 basis points, bringing those rates to 3.00% and 3.50%, respectively. Credit
7 market turmoil continued, and after the collapse of The Bear Stearn Companies noted above,
8 the FOMC stated:

9 The Federal Reserve on Sunday announced two initiatives
10 designed to bolster market liquidity and promote orderly
11 market functioning. Liquid, well-functioning markets are
12 essential for the promotion of economic growth.

13
14 First, the Federal Reserve Board voted unanimously to
15 authorize the Federal Reserve Bank of New York to create
16 a lending facility to improve the ability of primary dealers to
17 provide financing to participants in securitization markets.
18 This facility will be available for business on Monday,
19 March 17. It will be in place for at least six months and may
20 be extended as conditions warrant. Credit extended to
21 primary dealers under this facility may be collateralized by
22 a broad range of investment-grade debt securities. The
23 interest rate charged on such credit will be the same as the
24 primary credit rate, or discount rate, at the Federal
25 Reserve Bank of New York.

26
27 Second, the Federal Reserve Board unanimously
28 approved a request by the Federal Reserve Bank of New
29 York to decrease the primary credit rate from 3-1/2 percent
30 to 3-1/4 percent, effective immediately. This step lowers
31 the spread of the primary credit rate over the Federal Open
32 Market Committee's target federal funds rate to 1/4
33 percentage point. The Board also approved an increase in
34 the maximum maturity of primary credit loans to 90 days
35 from 30 days.

36
37 The Board also approved the financing arrangement
38 announced by JPMorgan Chase & Co. and The Bear
39 Stearns Companies Inc.

40

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 Then on March 18, 2008, the FOMC reduced the fed funds rate to 2.25% and the discount rate
2 to 2.50%. Afterward on April 30, 2008, the FOMC further reduces the fed funds rate to 2.00%
3 and the discount rate to 2.25%. At subsequent meetings the FOMC held the fed funds rate
4 steady. Then on October 8, 2008, the FOMC took another unusual unscheduled action by
5 reducing the Fed Funds rate to 1.50% and the discount rate to 1.75%. Then, on October 29,
6 the FOMC lowered the Fed Funds rate to 1.00% and the discount rate to 1.25%. As 2008
7 ended, the FOMC lowered the Fed Funds rate to a target range of 0.00% to 0.25%, its lowest
8 rate ever. As a further response to the financial crisis, Congress passed and the President
9 signed on October 3, 2008, the Emergency Economic Stabilization Act of 2008, which, among
10 other provisions, provides the mechanism to deploy up to \$700 billion through the Troubled
11 Asset Relief Program ("TARP") to address urgent needs created by the credit crisis the
12 country has experienced. Then, the Federal Reserve Board instituted its Commercial Paper
13 Funding Facility ("CPFF"), which was authorized on October 7, 2008, and it participated in
14 coordinated efforts by major central banks to support financial stability and to maintain flows of
15 credit in the banking system. These programs included a \$75 billion Term Auction Facility
16 ("TAF"), a future TAF auction totaling \$150 billion, and an increase to \$620 billion of swap
17 authorizations with central banks in Canada, England, Japan, Denmark, the European Union,
18 Norway, Australia, Sweden, and Switzerland. Further, on February 17, 2009, the President
19 signed the American Recovery and Reinvestment Act that committed \$789 billion by the
20 Federal government in an effort to create jobs, jumpstart growth and to transform the economy
21 in reaction to the recession that began in December 2007.

22 The FOMC maintained its target range of 0.00% to 0.25% throughout the remainder of
23 2009. At its March 16, 2010 meeting, the FOMC stated:

24 Information received since the Federal Open Market
25 Committee met in January suggests that economic activity
26 has continued to strengthen and that the labor market is

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 stabilizing. Household spending is expanding at a
2 moderate rate but remains constrained by high
3 unemployment, modest income growth, lower housing
4 wealth, and tight credit. Business spending on equipment
5 and software has risen significantly. However, investment
6 in nonresidential structures is declining, housing starts
7 have been flat at a depressed level, and employers remain
8 reluctant to add to payrolls. While bank lending continues
9 to contract, financial market conditions remain supportive
10 of economic growth. Although the pace of economic
11 recovery is likely to be moderate for a time, the Committee
12 anticipates a gradual return to higher levels of resource
13 utilization in a context of price stability.

14
15 With substantial resource slack continuing to restrain cost
16 pressures and longer-term inflation expectations stable,
17 inflation is likely to be subdued for some time.
18

19 Public Utility Bond Yields

20 The Risk Premium analysis of the cost of equity is represented by the combination of a
21 firm's borrowing rate for long-term debt capital plus a premium that is required to reflect the
22 additional risk associated with the equity of a firm as explained in Appendix G. Due to the
23 senior nature of the long-term debt of a firm, its cost is lower than the cost of equity due to the
24 prior claim, which lenders have on the earnings, and assets of a corporation.

25 As a generalization, all interest rates track to varying degrees of the benchmark yields
26 established by the market for Treasury securities. Public utility bond yields usually reflect the
27 underlying Treasury yield associated with a given maturity plus a spread to reflect the specific
28 credit quality of the issuing public utility. Market sentiment can also have an influence on the
29 spreads as described below. The spread in the yields on public utility bonds and Treasury
30 bonds varies with market conditions, as does the relative level of interest rates at varying
31 maturities shown by the yield curve.

32 Pages 1 and 2 of Schedule 8 provide the recent history of long-term public utility bond
33 yields for the rating categories of Aa, A and Baa (no yields are shown for Aaa rated public

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 utility bonds because this index has been discontinued). The top four rating categories of Aaa,
2 Aa, A, and Baa are known as "investment grades" and are generally regarded as eligible for
3 bank investments under commercial banking regulations. These investment grades are
4 distinguished from "junk" bonds, which have ratings of Ba and below.

5 A relatively long history of the spread between the yields on long-term A-rated public
6 utility bonds and 20-year Treasury bonds is shown on page 3 of Schedule 8. There, it is
7 shown that those spreads were about one percent during the years 1994 through 1997. With
8 the aversion to risk and flight to quality described earlier, a significant widening of the spread
9 in the yields between corporate (e.g., public utility) and Treasury bonds developed in 1998,
10 after an initial widening of the spread that began in the fourth quarter of 1997. The significant
11 widening of spreads in 1998 was unexpected by some technically savvy investors, as shown
12 by the debacle at the Long-Term Capital Management hedge fund. When Russia defaulted its
13 debt on August 17, some investors had to cover short positions when Treasury prices spiked
14 upward. Short covering by investors that guessed wrong on the relationship between
15 corporate and Treasury bonds also contributed to the run-up in Treasury bond prices by
16 increasing the demand for them. This helped to contribute to a widening of the spreads
17 between corporate and Treasury bonds.

18 As shown on page 3 of Schedule 8, the spread in yields between A-rated public utility
19 bonds and 20-year Treasury bonds was about one percentage point prior to 1998, 1.32% in
20 1998, 1.42% in 1999, 2.01% in 2000, 2.13% in 2001, 1.94% in 2002, 1.62% in 2003, 1.12% in
21 2004, 1.01% in 2005, 1.08% in 2006, 1.16% in 2007, 2.17% in 2008, and 1.93% in 2009. As
22 shown by the monthly data presented on pages 4 and 5 of Schedule 8, the interest rate spread
23 between the yields on 20-year Treasury bonds and A-rated public utility bonds was 1.60
24 percentage points for the twelve-months ended March 2010. For the six- and three-month
25 periods ending March 2010, the yield spread was 1.37% and 1.34%, respectively.

APPENDIX F TO DIRECT TESTIMONY OF PAUL R. MOUL

1 political, and economic situations. Moreover, Treasury bill yields have been shown to be
2 empirically inadequate for the CAPM. Some advocates of the theory would argue that the risk-
3 free rate of return in the CAPM should be derived from quality long-term corporate bonds. To
4 take a balanced approach to the risk-free rate of return, the yield on long-term Treasury bonds
5 has been used for this purpose.

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

RISK PREMIUM ANALYSIS

1
2 The cost of equity requires recognition of the risk premium required by common
3 equities over long-term corporate bond yields. In the case of senior capital, a company
4 contracts for the use of long-term debt capital at a stated coupon rate for a specific period of
5 time and in the case of preferred stock capital at a stated dividend rate, usually with provision
6 for redemption through sinking fund requirements. In the case of senior capital, the cost rate
7 is known with a high degree of certainty because the payment for use of this capital is a
8 contractual obligation, and the future schedule of payments is known. In essence, the
9 investor-expected cost of senior capital is equal to the realized return over the entire term of
10 the issue, absent default.

11 The cost of equity, on the other hand, is not fixed, but rather varies with investor
12 perception of the risk associated with the common stock. Because no precise measurement
13 exists as to the cost of equity, informed judgment must be exercised through a study of various
14 market factors, which motivate investors to purchase common stock. In the case of common
15 equity, the realized return rate may vary significantly from the expected cost rate due to the
16 uncertainty associated with earnings on common equity. This uncertainty highlights the added
17 risk of a common equity investment.

18 As one would expect from traditional risk and return relationships, the cost of equity is
19 affected by expected interest rates. As noted in Appendix F, yields on long-term corporate
20 bonds traditionally consist of a real rate of return without regard to inflation, an increment to
21 reflect investor perception of expected future inflation, the investment horizon shown by the
22 term of the issue until maturity, and the credit risk associated with each rating category.

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

1 The Risk Premium approach recognizes the required compensation for the more risky
2 common equity over the less risky secured debt position of a lender. The cost of equity stated
3 in terms of the familiar risk premium approach is:

$$k=i+RP$$

4
5 where, the cost of equity (" k ") is equal to the interest rate on long-term corporate debt (" i "),
6 plus an equity risk premium (" RP ") which represents the additional compensation for the riskier
7 common equity.

Equity Risk Premium

8
9 The equity risk premium is determined as the difference in the rate of return on debt
10 capital and the rate of return on common equity. Because the common equity holder has only
11 a residual claim on earnings and assets, there is no assurance that achieved returns on
12 common equities will equal expected returns. This is quite different from returns on bonds,
13 where the investor realizes the expected return during the entire holding period, absent
14 default. It is for this reason that common equities are always more risky than senior debt
15 securities. There are investment strategies available to bond portfolio managers that
16 immunize bond returns against fluctuations in interest rates because bonds are redeemed
17 through sinking funds or at maturity, whereas no such redemption is mandated for public utility
18 common equities.

19 It is well recognized that the expected return on more risky investments will exceed the
20 required yield on less risky investments. Neither the possibility of default on a bond nor the
21 maturity risk detracts from the risk analysis, because the common equity risk rate differential
22 (i.e., the investor-required risk premium) is always greater than the return components on a
23 bond. It should also be noted that the investment horizon is typically long-run for both
24 corporate debt and equity, and that the risk of default (i.e., corporate bankruptcy) is a concern

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

1 to both debt and equity investors. Thus, the required yield on a bond provides a benchmark or
2 starting point with which to track and measure the cost rate of common equity capital. There is
3 no need to segment the bond yield according to its components, because it is the total return
4 demanded by investors that is important for determining the risk rate differential for common
5 equity. This is because the complete bond yield provides the basis to determine the
6 differential, and as such, consistency requires that the computed differential must be applied to
7 the complete bond yield when applying the risk premium approach. To apply the risk rate
8 differential to a partial bond yield would result in a misspecification of the cost of equity
9 because the computed differential was initially determined by reference to the entire bond
10 return.

11 The risk rate differential between the cost of equity and the yield on long-term
12 corporate bonds can be determined by reference to a comparison of holding period returns
13 (here defined as one year) computed over long time spans. This analysis assumes that over
14 long periods of time investors' expectations are on average consistent with rates of return
15 actually achieved. Accordingly, historical holding period returns must not be analyzed over an
16 unduly short period because near-term realized results may not have fulfilled investors'
17 expectations. Moreover, specific past period results may not be representative of investment
18 fundamentals expected for the future. This is especially apparent when the holding period
19 returns include negative returns, which are not representative of either investor requirements
20 of the past or investor expectations for the future. The short-run phenomenon of unexpected
21 returns (either positive or negative) demonstrates that an unduly short historical period would
22 not adequately support a risk premium analysis. It is important to distinguish between
23 investors' motivation to invest, which encompass positive return expectations, and the
24 knowledge that losses can occur. No rational investor would forego payment for the use of

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

1 capital, or expect loss of principal, as a basis for investing. Investors will hold cash rather than
2 invest with the expectation of a loss.

3 Within these constraints, page 1 of Schedule 9 provides the historical holding period
4 returns for the S&P Public Utility Index which has been independently computed and the
5 historical holding period returns for the S&P Composite Index which have been reported in
6 Stocks, Bonds, Bills and Inflation published by Ibbotson & Associates. The tabulation begins
7 with 1928 because January 1928 is the earliest monthly dividend yield for the S&P Public
8 Utility Index. I have considered all reliable data for this study to avoid the introduction of a
9 particular bias to the results. The measurement of the common equity return rate differential is
10 based upon actual capital market performance using realized results. As a consequence, the
11 underlying data for this risk premium approach can be analyzed with a high degree of
12 precision. Informed professional judgment is required only to interpret the results of this study,
13 but not to quantify the component variables.

14 The risk rate differentials for all equities, as measured by the S&P Composite, are
15 established by reference to long-term corporate bonds. For public utilities, the risk rate
16 differentials are computed with the S&P Public Utilities as compared with public utility bonds.

17 The measurement procedure used to identify the risk rate differentials consisted of
18 arithmetic means, geometric means, and medians for each series. Measures of the central
19 tendency of the results from the historical periods provide the best indication of representative
20 rates of return. In regulated ratesetting, the correct measure of the equity risk premium is the
21 arithmetic mean because a utility must expect to earn its cost of capital in each year in order to
22 provide investors with their long-term expectations. In other contexts, such as pension
23 determinations, compound rates of return, as shown by the geometric means, may be
24 appropriate. The median returns are also appropriate in ratesetting because they are a

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

1 measure of the central tendency of a single period rate of return. Median values have also
2 been considered in this analysis because they provide a return, which divides the entire series
3 of annual returns in half, and are representative of a return that symbolizes, in a meaningful
4 way, the central tendency of all annual returns contained within the analysis period. Medians
5 are regularly included in many investor-influencing publications.

6 As previously noted, the arithmetic mean provides the appropriate point estimate of the
7 risk premium. As further explained in Appendix H, the long-term cost of capital in rate cases
8 requires the use of arithmetic means. To supplement my analysis, I have also used the rates
9 of return taken from the geometric mean and median for each series to provide the bounds of
10 the range to measure the risk rate differentials. While the use of the geometric mean would be
11 inappropriate for CAPM purposes due to the specification of that model, it can provide a limit
12 of the bounds for the Risk Premium approach that does not contain the single-period limitation.
13 This further analysis shows that when selecting the midpoint from a range established with the
14 geometric means and medians, the arithmetic mean is indeed a reasonable measure for the
15 long-term cost of capital. For the years 1928 through 2007, the risk premiums for each class
16 of equity are:

	<u>S&P Composite</u>	<u>S&P Public Utilities</u>	
17			
18			
19			
20	Arithmetic Mean	<u>5.82%</u>	<u>5.52%</u>
21			
22	Geometric Mean	4.23%	3.47%
23	Median	<u>9.27%</u>	<u>7.50%</u>
24			
25	Midpoint of Range	<u>6.75%</u>	<u>5.49%</u>
26			
27	Average of Arithmetic Mean and Midpoint of Range	<u>6.29%</u>	<u>5.51%</u>

28 The empirical evidence suggests that the common equity risk premium is higher for the S&P
29 Composite Index compared to the S&P Public Utilities.

APPENDIX G TO DIRECT TESTIMONY OF PAUL R. MOUL

1 If, however, specific historical periods were also analyzed in order to match more
2 closely historical fundamentals with current expectations, the results provided on page 2 of
3 Schedule 9 should also be considered. One of these sub-periods included the 56-year period,
4 1952-2007. These years follow the historic 1951 Treasury-Federal Reserve Accord, which
5 affected monetary policy and the market for government securities.

6 A further investigation was undertaken to determine whether realignment has taken
7 place subsequent to the historic 1973 Arab Oil embargo and during the deregulation of the
8 financial markets. In each case, the public utility risk premiums were computed by using the
9 arithmetic mean, and the geometric means and medians to establish the range shown by
10 those values. The time periods covering the more recent periods 1974 through 2007 and
11 1979 through 2007 contain events subsequent to the initial oil shock and the advent of
12 monetarism as Fed policy, respectively. For the 56-year, 34-year and 29-year periods, the
13 public utility risk premiums were 6.58%, 6.08%, and 6.37% respectively, as shown by the
14 average of the specific point-estimates and the midpoint of the ranges provided on page 2 of
15 Schedule 9.

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

CAPITAL ASSET PRICING MODEL

1
2 Modern portfolio theory provides a theoretical explanation of expected returns on
3 portfolios of securities. The Capital Asset Pricing Model ("CAPM") attempts to describe the
4 way prices of individual securities are determined in efficient markets where information is
5 freely available and is reflected instantaneously in security prices. The CAPM states that the
6 expected rate of return on a security is determined by a risk-free rate of return plus a risk
7 premium, which is proportional to the non-diversifiable (or systematic) risk of a security.

8 The CAPM theory has several unique assumptions that are not common to most other
9 methods used to measure the cost of equity. As with other market-based approaches, the
10 CAPM is an expectational concept. There has been significant academic research conducted
11 that found that the empirical market line, based upon historical data, has a less steep slope
12 and higher intercept than the theoretical market line of the CAPM. For equities with a beta
13 less than 1.0, such as utility common stocks, the CAPM theoretical market line will
14 underestimate the realistic expectation of investors in comparison with the empirical market
15 line, which shows that the CAPM may potentially misspecify investors' required return.

16 The CAPM considers changing market fundamentals in a portfolio context. The
17 balance of the investment risk, or that characterized as unsystematic, must be diversified.
18 Some argue that diversifiable (unsystematic) risk is unimportant to investors. But this
19 contention is not completely justified because the business and financial risk of an individual
20 company, including regulatory risk, are widely discussed within the investment community and
21 therefore influence investors in regulated firms. In addition, I note that the CAPM assumes
22 that through portfolio diversification, investors will minimize the effect of the unsystematic
23 (diversifiable) component of investment risk. Because it is not known whether the average
24 investor holds a well-diversified portfolio, the CAPM must also be used with other models of
25 the cost of equity.

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

1 To apply the traditional CAPM theory, three inputs are required: the beta coefficient
2 (" β "), a risk-free rate of return (" R_f "), and a market premium (" $R_m - R_f$ "). The cost of equity
3 stated in terms of the CAPM is:

$$k = R_f + \beta (R_m - R_f)$$

4
5 As previously indicated, it is important to recognize that the academic research has
6 shown that the security market line was flatter than that predicted by the CAPM theory and it
7 had a higher intercept than the risk-free rate. These tests indicated that for portfolios with
8 betas less than 1.0, the traditional CAPM would understate the return for such stocks.
9 Likewise, for portfolios with betas above 1.0, these companies had lower returns than
10 indicated by the traditional CAPM theory. Once again, CAPM assumes that through portfolio
11 diversification investors will minimize the effect of the unsystematic (diversifiable) component
12 of investment risk. Therefore, the CAPM must also be used with other models of the cost of
13 equity, especially when it is not known whether the average public utility investor holds a well-
14 diversified portfolio.

Beta

15
16 The beta coefficient is a statistical measure, which attempts to identify the non-
17 diversifiable (systematic) risk of an individual security and measures the sensitivity of rates of
18 return on a particular security with general market movements. Under the CAPM theory, a
19 security that has a beta of 1.0 should theoretically provide a rate of return equal to the return
20 rate provided by the market. When employing stock price changes in the derivation of beta, a
21 stock with a beta of 1.0 should exhibit a movement in price, which would track the movements
22 in the overall market prices of stocks. Hence, if a particular investment has a beta of 1.0, a
23 one percent increase in the return on the market will result, on average, in a one percent
24 increase in the return on the particular investment. An investment, which has a beta less than
25 1.0, is considered to be less risky than the market.

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

1 The beta coefficient (" β "), the one input in the CAPM application, which specifically
2 applies to an individual firm, is derived from a statistical application, which regresses the
3 returns on an individual security (dependent variable) with the returns on the market as a
4 whole (independent variable). The beta coefficients for utility companies typically describe a
5 small proportion of the total investment risk because the coefficients of determination (R^2) are
6 low.

7 Page 1 of Schedule 10 provides the betas published by Value Line. By way of
8 explanation, the Value Line beta coefficient is derived from a "straight regression" based upon
9 the percentage change in the weekly price of common stock and the percentage change
10 weekly of the New York Stock Exchange Composite average using a five-year period. The
11 raw historical beta is adjusted by Value Line for the measurement effect resulting in
12 overestimates in high beta stocks and underestimates in low beta stocks. Value Line then
13 rounds its betas to the nearest .05 increment. Value Line does not consider dividends in the
14 computation of its betas.

Market Premium

15
16 The final element necessary to apply the CAPM is the market premium. The market
17 premium by definition is the rate of return on the total market less the risk-free rate of return
18 (" $R_m - R_f$ "). In this regard, the market premium in the CAPM has been calculated from the total
19 return on the market of equities using forecast and historical data. The future market return is
20 established with forecasts by Value Line using estimated dividend yields and capital
21 appreciation potential.

22 With regard to the forecast data, I have relied upon the Value Line forecasts of capital
23 appreciation and the dividend yield on the 1,700 stocks in the Value Line Survey. According to
24 the April 2, 2010 edition of The Value Line Investment Survey Summary and Index, (see page
25 5 of Schedule 10) the total return on the universe of Value Line equities is:

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

	<u>Dividend Yield</u>	+	<u>Appreciation Potential</u>	=	<u>Total Return</u>
As of April 2, 2010	1.9%	+	10.67%	⁽¹⁾	= 12.57%

1

2 The tabulation shown above provides the dividend yield and capital gains yield of the
3 companies followed by Value Line. Another measure of the total market return is provided by
4 the DCF return on the S&P 500 Composite index. That return is shown below.

<u>DCF Result for the S&P 500 Composite</u>							
D/P	(1+.5g)	+	g	=	k
1.94%	(1.0499)	+	9.98%	=	12.02%
where:	Price (P)	at	31-Mar-2010	=	1169.43		
	Dividend (D)	for	4th Qtr. '09	=	5.66		
	Dividend (D)		annualized	=	22.64		
	Growth (g)		First Call EpS	=	9.98%		

5 Using these indicators, the total market return is 12.30% (12.57% + 12.02% = 24.59% ÷ 2)
6 using both the Value Line and S&P derived returns. With the 12.30% forecast market return
7 and the 4.75% risk-free rate of return, a 7.55% (12.30% - 4.75%) market premium would be
8 indicated using forecast market data.

9 I have also provided market premiums that have been widely circulated among the
10 investment and academic community, which today is published by Morningstar, Inc. These
11 data are contained in the 2009 Ibbotson® Stocks, Bonds, Bills and Inflation ("SBBI") Classic
12 Yearbook. From the data provided on page 6 of Schedule 10, I calculate a market premium
13 using the historical common stock arithmetic mean returns of 11.7% less government bond
14 arithmetic mean returns of 6.1%. For the period 1926-2008, the market premium was 5.6%
15 (11.7% - 6.1%). I should note that the arithmetic mean must be used in the CAPM because it

⁽¹⁾The estimated median appreciation potential is forecast to be 50% for 3 to 5 years hence. The annual capital gains yield at the midpoint of the forecast period is 10.67% (i.e., $1.50^{25} - 1$).

APPENDIX H TO DIRECT TESTIMONY OF PAUL R. MOUL

1 is a single period model. It is further confirmed by Ibbotson who has indicated:

2 *Arithmetic Versus Geometric Differences*

3 For use as the expected equity risk premium in the CAPM,
4 the *arithmetic* or *simple difference* of the *arithmetic* means
5 of stock market returns and riskless rates is the relevant
6 number. This is because the CAPM is an additive model
7 where the cost of capital is the sum of its parts. Therefore,
8 the CAPM expected equity risk premium must be derived
9 by arithmetic, *not geometric*, subtraction.

10
11 *Arithmetic Versus Geometric Means*

12 The expected equity risk premium should always be
13 calculated using the arithmetic mean. The arithmetic mean
14 is the rate of return which, when compounded over multiple
15 periods, gives the mean of the probability distribution of
16 ending wealth values. This makes the arithmetic mean
17 return appropriate for computing the cost of capital. The
18 discount rate that equates expected (mean) future values
19 with the present value of an investment is that investment's
20 cost of capital. The logic of using the discount rate as the
21 cost of capital is reinforced by noting that investors will
22 discount their (mean) ending wealth values from an
23 investment back to the present using the arithmetic mean,
24 for the reason given above. They will therefore require
25 such an expected (mean) return prospectively (that is, in
26 the present looking toward the future) to commit their
27 capital to the investment. (Stocks, Bonds, Bills and Inflation
28 - 1996 Yearbook, pages 153-154)

29
30 Also shown on page 6 of Schedule 10 is the long-horizon expected market premiums
31 of 6.5% also published in the SBBI Classic Yearbook. An average of the historical and
32 expected SBBI market premium is 6.05% ($5.6\% + 6.5\% = 12.1\% \div 2$).

33 For the CAPM, a market premium of 6.80% ($6.05\% + 7.55\% = 13.60\% \div 2$) would be
34 reasonable which is the average of the 6.05% SBBI data and the 7.55% Value Line and S&P
35 500 data.

APPENDIX I TO DIRECT TESTIMONY OF PAUL R. MOUL

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30
31
32
33
34
35
36
37

COMPARABLE EARNINGS APPROACH

Value Line's analysis of the companies that it follows includes a wide range of financial and market variables, including nine items that provide ratings for each company. From these nine items, one category has been removed dealing with industry performance because, under approach employed, the particular business type is not significant. In addition, two categories have been ignored that deal with estimates of current earnings and dividends because they are not useful for comparative purposes. The remaining six categories provide relevant measures to establish comparability. The definitions for each of the six criteria (from the Value Line Investment Survey - Subscriber Guide) follow:

Timeliness Rank

The rank for a stock's probable relative market performance in the year ahead. Stocks ranked 1 (Highest) or 2 (Above Average) are likely to outpace the year-ahead market. Those ranked 4 (Below Average) or 5 (Lowest) are not expected to outperform most stocks over the next 12 months. Stocks ranked 3 (Average) will probably advance or decline with the market in the year ahead. Investors should try to limit purchases to stocks ranked 1 (Highest) or 2 (Above Average) for Timeliness.

Safety Rank

A measure of potential risk associated with individual common stocks rather than large diversified portfolios (for which Beta is good risk measure). Safety is based on the stability of price, which includes sensitivity to the market (see Beta) as well as the stock's inherent volatility, adjusted for trend and other factors including company size, the penetration of its markets, product market volatility, the degree of financial leverage, the earnings quality, and the overall condition of the balance sheet. Safety Ranks range from 1 (Highest) to 5 (Lowest). Conservative investors should try to limit purchases to equities ranked 1 (Highest) or 2 (Above Average) for Safety.

APPENDIX I TO DIRECT TESTIMONY OF PAUL R. MOUL

Financial Strength

1
2
3 The financial strength of each of the more than 1,600
4 companies in the VS II data base is rated relative to all the
5 others. The ratings range from A++ to C in nine steps.
6 (For screening purposes, think of an A rating as "greater
7 than" a B). Companies that have the best relative financial
8 strength are given an A++ rating, indicating ability to
9 weather hard times better than the vast majority of other
10 companies. Those who don't quite merit the top rating are
11 given an A+ grade, and so on. A rating as low as C++ is
12 considered satisfactory. A rating of C+ is well below
13 average, and C is reserved for companies with very
14 serious financial problems. The ratings are based upon a
15 computer analysis of a number of key variables that
16 determine (a) financial leverage, (b) business risk, and (c)
17 company size, plus the judgment of Value Line's analysts
18 and senior editors regarding factors that cannot be
19 quantified across-the-board for companies. The primary
20 variables that are indexed and studied include equity
21 coverage of debt, equity coverage of intangibles, "quick
22 ratio", accounting methods, variability of return, fixed
23 charge coverage, stock price stability, and company size.

Price Stability Index

24
25
26
27 An index based upon a ranking of the weekly percent
28 changes in the price of the stock over the last five years.
29 The lower the standard deviation of the changes, the more
30 stable the stock. Stocks ranking in the top 5% (lowest
31 standard deviations) carry a Price Stability Index of 100;
32 the next 5%, 95; and so on down to 5. One standard
33 deviation is the range around the average weekly percent
34 change in the price that encompasses about two thirds of
35 all the weekly percent change figures over the last five
36 years. When the range is wide, the standard deviation is
37 high and the stock's Price Stability Index is low.

Beta

38
39
40
41 A measure of the sensitivity of the stock's price to overall
42 fluctuations in the New York Stock Exchange Composite
43 Average. A Beta of 1.50 indicates that a stock tends to
44 rise (or fall) 50% more than the New York Stock Exchange
45 Composite Average. Use Beta to measure the stock
46 market risk inherent in any diversified portfolio of, say, 15
47 or more companies. Otherwise, use the Safety Rank,
48 which measures total risk inherent in an equity, including
49 that portion attributable to market fluctuations. Beta is

APPENDIX I TO DIRECT TESTIMONY OF PAUL R. MOUL

1 derived from a least squares regression analysis between
2 weekly percent changes in the price of a stock and weekly
3 percent changes in the NYSE Average over a period of
4 five years. In the case of shorter price histories, a smaller
5 time period is used, but two years is the minimum. The
6 Betas are periodically adjusted for their long-term tendency
7 to regress toward 1.00.
8

9 Technical Rank

10
11 A prediction of relative price movement, primarily over the
12 next three to six months. It is a function of price action
13 relative to all stocks followed by Value Line. Stocks ranked
14 1 (Highest) or 2 (Above Average) are likely to outpace the
15 market. Those ranked 4 (Below Average) or 5 (Lowest)
16 are not expected to outperform most stocks over the next
17 six months. Stocks ranked 3 (Average) will probably
18 advance or decline with the market. Investors should use
19 the Technical and Timeliness Ranks as complements to
20 one another.