NLH-177 PUB (Re: Page 7, lines 27-28)

Dr. Waverman states that, "cross-utility comparisons are not the foundation for North America's utility rates." Please confirm that, for investor-owned public utilities that are not publicly-traded, the cost of equity capital is typically estimated by reference to the cost of equity of proxies which are publicly-traded. If it cannot be confirmed, please explain why not.

A. Cross-utility comparisons (e.g., proxy groups) can be used to identify the opportunity cost of common stock capital for investor-owned public utilities. The cost of common stock equity capital is a forward-looking concept. There are few ways of looking into the future, particularly from the perspective of what investors expect to occur. Financial models, such as the discounted cash flow (DCF) or capital asset pricing model (CAPM), are designed to take the limited types of information we can observe to draw conclusions about unobservable investor expectations of the future.

Proxy group are used in conjunction with forward-looking financial models, such as DCF or CAPM because the use of proxy groups of companies produce a more reliable and unprejudiced estimate of the current cost of capital required by capital markets and the computation of proxy group cost of capital estimates is consistent with the principle that reference should be made to return on investments with corresponding risks. Further, the regulatory process in a particular jurisdiction affects investor expectations regarding the particular company whose fair rate of return is being set, leading to a problem of circularity; the use of proxy groups will attenuate the circularity problem.