Q. HOW CAN THE ABOVE INFORMATION BE USED TO ESTIMATE NJAWC's COE?

A. The recent earnings of the proxy utilities and S&P 500 groups can be viewed as an indication of the level of return realized and expected in the regulated and competitive sectors of the economy. In order to apply these returns to the COE for the proxy utilities, however, it is necessary to compare the risk levels of the water utilities and the competitive companies. I do this in Schedule DCP-10, which compares several risk indicators for the S&P 500 group and the utility group. The information in Schedule DCP-10 indicates that the S&P 500 group is slightly more risky than the utility proxy group.

Q. WHAT COE IS INDICATED BY YOUR CE ANALYSIS?

A. Based on recent earnings and market-to-book ratios, my CE analysis indicates that the COE for the proxy utilities is no more than 9.5 percent to 10.5 percent. Recent returns of 9.5 percent to 11.4 percent have resulted in market-to-book ratios more than 170 percent. Prospective returns of 9.3 percent to 10.8 percent have been accompanied by market-to-book ratios over 180 percent. As a result, it is apparent that authorized returns below this level would continue to result in market-to-book ratios of well above 100 percent. An earned return of 9.5 percent to 10.5 percent should thus result in a market-to-book ratio well above 100 percent. As I indicated earlier, the fact that market-to-book ratios substantially exceed 100 percent indicates that historic and prospective returns of over 10.5 percent reflect earnings levels that are well above the actual cost of equity for those regulated companies. I also note that a company whose stock sells above book value can attract capital in a way that enhances the book value of existing stockholders, thus creating a favorable environment for financial integrity.

XI. <u>RETURN ON EQUITY RECOMMENDATION</u>

Q. PLEASE SUMMARIZE THE RESULTS OF YOUR THREE COE ANALYSES.

A. My three analyses produce the following:

DCF	9.0-10.0%	(9.5% midpoint)
CAPM	6.8%	
CE	9.5-10.5%	(10.0% mid-point)

These results indicate an overall broad range of 6.9 percent to 10.5 percent, which focuses on the respective ranges of my individual model results. Focusing on the respective midpoints, the range is 6.9 percent to 10.0 percent. I recommend a COE range of 9.5 percent to 10.0 percent for NJAWC. Though this recommendation is higher than my CAPM findings, it includes the mid-point of my DCF range (9.5 percent) and the mid-point of my CE range (10.0 percent). For the purposes of this proceeding, I recommend the mid-point of this range, which is 9.75 percent.

Q. IT APPEARS THAT YOUR CAPM RESULTS ARE SOMEWHAT LOWER THAN YOUR DCF RESULTS. DOES THIS INDICATE THAT THE CAPM RESULTS SHOULD NOT BE USED AT THIS TIME?

A. No, this is not the case. Although my recommended range is above the CAPM results, I have not disregarded the CAPM results. It is apparent that the CAPM results are lower than the DCF results, as well as being lower than CAPM results in recent years. The two reasons for this are the current relatively low yields on U.S. Treasury bonds (i.e., risk-free rate) and a lower risk premium that reflects the decline in stock prices of the past few years. However, these currently lower CAPM results are only one-half of the impact of recent economic conditions. The other impact is on the DCF results, which are somewhat higher currently due to the higher yields attributable to the decline in stock prices. It would not be proper to disregard the lower CAPM results while not discounting the higher DCF results.

XII. TOTAL COST OF CAPITAL

Q. WHAT IS THE TOTAL COST OF CAPITAL FOR NJAWC?