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Witness: Douglas P. Horton and Ann Bulkey
Request from: Public Utilities Regulatory Authority

Question:
(ROE-PROXY GROUP) Application, Ex. CLP-ROE-1 (Bulkley Pre-Filed Test.).

a. How does the Company's financial risk compare to that of the companies in the Proxy Group?

b. How does the Company's business risk compare to that of the companies in the Proxy Group?

Response:

a. Please refer to pp. 40-70 of Ms. Bulkley's direct testimony for a detailed discussion of the risk characteristics of CL&P relative to the proxy group. As Ms. Bulkley explains, although the proxy group companies are comparable to CL&P -- no two companies have exactly the same business and financial risk profiles. Accordingly, her analysis considers the Company's regulatory, business and financial risks relative to the proxy group in determining where the Company's ROE should fall within the reasonable range of analytical results.

The Company's business and regulatory risks also have direct financial consequences. Regulatory lag, for example, requires the Company to finance costs before recovering them from customers. To the extent that financing requires additional debt, the Company incurs additional interest payment requirements and repayment obligations. Regulatory lag therefore directly increases financial risk. Ms. Bulkley's testimony evaluates these risks together as part of the overall comparison between the Company and the proxy group.

The referenced section of Ms. Bulkley's testimony also identifies key business and regulatory risks facing the Company and the proxy group and compares the Company's risk profile to the proxy group companies for each of these factors. As shown in Exhibit CLP-ROE-9, the Company relies on a historical test year, while more than half of the proxy group companies rely on forecasted test years. Particularly in a high-inflation environment, jurisdictions that rely on a historical test year and adhere to a strict application of a 'known and measurable' standard for post-test year changes, as PURA has adopted in recent rate case outcomes, are likely to result in rate-year rates that do not reflect the costs that will either be expected to occur (or actually occur), during the rate period, whereas the proxy group companies using forecasted test years are more likely to reflect those expected costs. On this basis, the Company has greater financial risk than the proxy group.

Similarly, although the Company has a revenue decoupling mechanism, approximately 68 percent of the proxy group has either decoupling, formula rates or straight fixed variable rate

design. Therefore, on this basis, the Company has comparable financial risk as the proxy group.

Lastly, the Company and the proxy-group companies all have some form of capital cost recovery mechanism, making the relative risk of the Company and the proxy group comparable in this regard.

Taking these factors together, Ms. Bulkley assesses that the Company has greater overall financial risk than the proxy group, predominantly due to PURA's strict use of a historical test year, with only narrow adjustments for post-test year changes.

In estimating the cost of equity, Ms. Bulkley relied upon market data for the proxy group companies. To the extent that proxy group companies have a mechanism that serves to reduce financial risk that is comparable to a mechanism implemented by the Company, the market data that is used to estimate the cost of equity includes the effect of these mechanisms. Since the cost of equity analysis depends on benchmarking of the proxy group, the fact that the Company has a revenue decoupling and capital cost recovery mechanism does not reduce the Company's relative risk because the proxy group companies also have these mechanisms and that reduced risk is already included in the market data for the proxy companies that are being used to estimate the Company's cost of equity.

b. The Company's business risk likewise is comparable to that of the companies in the Proxy Group. Business risk is broader than revenue variability or the existence of particular regulatory mechanisms. It also includes the risks inherent in the basic operation and execution of a large electric distribution business.

The Company must make and successfully execute a substantial volume of operating and investment decisions across a dynamic and interconnected business. Providing safe and reliable electric service requires the Company to coordinate its workforce and contractors, physical assets, capital projects, materials, technology and other resources, often across activities that depend on one another. The Company must do so while adapting to circumstances that cannot always be predicted or controlled. Weather, equipment failures, supply and scheduling disruptions, technology issues, and unexpected changes in workforce availability can affect the work required, its timing and its cost. The significance of these risks is not any one event in isolation, but the cumulative challenge of executing a large number of interdependent decisions and activities while conditions continually change. These risks remain even when the Company plans and manages its operations effectively.

Regulatory mechanisms can mitigate particular consequences of these risks, but they do not eliminate the underlying business risk. A capital tracker may reduce regulatory lag associated with qualifying investment, and revenue decoupling may mitigate volumetric revenue risk, but

neither eliminates the operational requirements, uncertainty, or execution risk inherent in running the distribution business.