BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Orange & Rockland Utilities, Inc.

Case 07-E-0949

December 2007

Prepared Testimony of:
Staff Finance Panel

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Q. Please state your names, employer, and business address.

A. Michael J. Augstell and Craig E. Henry. We are employed by the New York State Department of Public Service (Department). Our business address is Three Empire State Plaza, Albany, New York 12223.

Q. Mr. Augstell, what is your position at the Department?

A. I am employed as a Senior Utility Financial Analyst in the Office of Accounting, Finance and Economics.

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Arts Degree in Economics from the University of Rochester in 1992. Since that time I have worked in commercial loan banking and thereafter as a financial analyst for General Electric Power Systems. In the five years prior to joining the Department I was employed at UHY Advisors NY, Inc. (UHY) in Albany, New York. I worked in the valuation and litigation services department at UHY, conducting business valuations, financial

analysis and forensic accounting, and, class action claims administration. I joined the Department of Public Service in December 2006.

Q. Are you a member of any professional societies?

A. Yes. I am a candidate member in the American Society of Appraisers (ASA). I am working towards becoming accredited in business valuation.

Q. Please briefly describe your current responsibilities with the Department.

A. I work on assignments that involve analyzing the financial condition, financing mechanisms, risk, cost of debt, cost of equity, diversification and relative business positions of utilities and their holding company parent(s). Assignments involve rate cases, financing proposals and special projects.

Q. Have you previously testified in a regulatory proceeding before the New York State Public Service Commission?

A. Yes. In Case 06-G-1332, Consolidated Edison Company of New York, Inc. - Gas Rates and Case 07-E-0523, Consolidated Edison Company of New York, Inc. – Electric Rates, I provided

testimony to the Commission as part of the Staff Finance Panel on the appropriate capital structure and cost of debt for Consolidated Edison Company of New York, Inc.

Q. Mr. Henry, what is your position at the Department?

A. I am employed by the New York State Department of Public Service as a Principal Utility Financial Analyst in the Office of Accounting, Finance and Economics.

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Science Degree in Business Administration from the University of Florida in 1981. In 1985 I received a Master's Degree in Business Administration with a concentration in Finance from the School of Management at the State University of New York at Binghamton. Before joining the Department of Public Service in August 1988, I was employed by Norstar Bank, N.A. as a Manager Trainee.

Q. What are your responsibilities in the Office of Accounting, Finance and Economics?

A. My primary areas of responsibility include

analyzing and making recommendations to the Public Service Commission concerning rate of return levels and financing requests. I also examine and make recommendations with regard to other utility finance-related activities, such as merger requests.

Q. Have you previously testified in regulatory proceedings regarding the appropriate capital structure and cost of capital?

A. Yes. I have testified in numerous electric, gas and water rate cases before the Commission since 1988, most recently in Case 06-E-1433, Orange and Rockland Utilities, Inc. (Electric Rates).

PURPOSE OF TESTIMONY

Q. Panel, what is the purpose of your testimony in this proceeding?

A. The purpose of our testimony is to establish the fair rate of return that is used in the determination of the revenue requirement for Orange and Rockland Utilities, Inc. (Orange and Rockland or the Company) for the rate year ending June 30, 2009. We will also respond to the testimony of Company witnesses Morin and Perkins.

Q. Please describe the exhibits that you are sponsoring in this proceeding.

A. We are sponsoring fourteen exhibits, identified as Exhibit___(FP-1) through Exhibit___(FP-14).

SUMMARY

Q. Please summarize your testimony.

A. We recommend an overall rate of return of 7.45%, as opposed to the Company's request of 8.79%. The difference is primarily due to our use of a 47.93% common equity ratio and an 8.9% return on equity (ROE), as opposed to the Company's 48.59% common equity ratio and 11.5% ROE. Among other things, our proposed capital structure assures that ratepayers will not subsidize its parent's riskier non-regulated investments, while our ROE recommendation was determined using two different equity costing methodologies, each weighted as the Commission approved in the last Orange and Rockland electric case as well as other prior litigated cases. We also explain why our recommended rate of return provides the Company with a financial profile that will allow it continued access to reasonably priced capital.

FAIR RATE OF RETURN DISCUSSION

Q. What is a fair rate of return for a regulated utility?

A. A fair rate of return for a regulated utility is one that enables it to provide safe and adequate service to its customers, while assuring it continuing support in the capital markets for both its debt and equity securities, at terms that are reasonable given the company's risk. Investors in debt securities enter into contractual obligations with the utility and receive relatively fixed income streams. Common equity investment, on the other hand, is non-contractual. Common equity investors may share in, but are not guaranteed, a portion of the utility's residual earnings. The fair rate of return, therefore, allows the utility to recover its prudently incurred cost of debt, while providing its common equity investors with the opportunity to earn a return commensurate with the risk of their investment.

Q. How is a fair rate of return calculated?

A. Generally, in New York State, the fair rate of return for a utility company is calculated

through a weighted average of the individual cost components of its expected capitalization during the rate year. Determining the proper capital structure for setting rates thus involves forecasting and reconciling a company's sources of capital together with its capital requirements.

Turning to the cost rates of the individual components, the cost of the long-term debt component is relatively easy to compute. This is because in return for lending money to the company, debt holders receive returns in the form of contractual payments of interest and principal. Additionally, forecasting the cost rates for other components such as customer deposits and gas supplier refunds is simply a matter of applying cost rates that are prescribed by the Commission.

As previously mentioned, the common equity component is neither contractual nor prescribed by the Commission. Its calculation is further complicated by the fact that it can not be directly observed. It is important to remember that while both debt and equity holders supply

the utility with the funds it needs to build and operate its system, the equity investors only earn a return after the payment of all other expenses. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by equity investors is usually higher than that of the utility's debt holders. We say "usually" because in periods of volatile inflation and high interest rates such as 1980-82, utility bonds had yields that were at least as high as the returns the New York Commission allowed and far above the returns most Commissions allowed.

The expected return requirements of a utility's common equity investors can only be gleaned through a cost of equity analysis. Generally, methodologies such as the Discounted Cash Flow (DCF) and the Capital Asset Pricing Model (CAPM) are employed to estimate the return required by equity investors.

CAPITAL STRUCTURE

Q. What is the overall rate of return you recommend be allowed for the rate year?

A. We recommend an after-tax overall rate of return

of 7.45%, compared to the Company's originally filed 8.79%. Our proposed pro forma cost of capital can be seen in Exhibit__(FP-2).

Q. What was Orange and Rockland's projected rate year capital structure for its electric operations?

A. In Exhibit E-8, Schedule 1, Company witness Perkins forecast a long-term debt ratio of 50.00%, a common equity ratio of 48.59% and a customer deposits ratio of 1.41%.

Q. How did Orange and Rockland develop this capitalization?

A. The rate year capitalization was developed based upon an approach that began with Orange and Rockland's as-reported "stand-alone" capital structure as of March 31, 2007. This "stand-alone" capitalization was then projected for the rate year based upon actual and contemplated debenture issuances through the end of the rate year, as well as assumptions regarding the level of the Company's future earnings and the amounts and timing of equity-related transactions with its parent, Consolidated Edison, Inc. (CEI), specifically equity contributions from the

parent and dividend payments to it.

Q. Did the Company demonstrate the reasonableness of these projections by linking them to an overall forecast of its cash flows, particularly its construction expenditures, refunding requirements and other internally generated sources funds?

A. No.

Q. Please describe what you mean by the term "stand-alone" capital structure.

A. A utility holding company reports its overall capital structure as part of its consolidated balance sheet in various reports to the Securities and Exchange Commission (SEC) as well as in its Annual and Quarterly Reports to Shareholders. The consolidated balance sheet reflects the financial position of all of the holding company's operations. A holding company with utility subsidiaries also presents individual financial statements for major subsidiaries. The stand-alone capital structure is the capitalization reported for each individual subsidiary.

Orange and Rockland is a wholly-owned

subsidiary of CEI. CEI also owns both Orange and Rockland and Consolidated Edison Company of New York, Inc.(Con Edison), and has investments in several competitive ventures. CEI reports its consolidated financial position in its annual 10-K and quarterly 10-Q reports to the SEC; it also presents stand-alone financial statements for both Orange and Rockland and Con Edison.

Q. Do you agree with the use of the reported stand-alone capital structures for utilities that are subsidiaries of larger holding companies?

A. While there may be instances in which such an approach may be warranted, a careful analysis of the holding company's financing practices is necessary to determine its appropriateness. Stand-alone capital structures for utility subsidiaries of holding companies may not reflect either rational capitalization policies or actual common equity employed, and therefore may not be suitable for establishing a utility's rate of return.

Q. Explain why the use of a stand-alone capital structure may not be reasonable.

A. The stand-alone common equity balance reported by a utility subsidiary of a holding company may not, in fact, be financed by common equity at the holding company level. Rather, some of the utility common equity balance may instead be proceeds from debt issued at the holding company level and classified on the utility subsidiary's books as common equity at the time the proceeds were invested in the utility subsidiary. This is referred to as double leverage.

In addition, the use of a stand-alone subsidiary structure is not appropriate for setting a utility’s rates in cases where a holding company parent has financed riskier competitive non-utility operations with less equity (and hence more debt) than would be required for these ventures to achieve the same credit rating as the utility subsidiaries. Unless the utility subsidiary’s credit rating is insulated from these risks, using the stand-alone capital structure would effectively require ratepayers of a low-risk transmission and distribution (T&D) company to subsidize its parent’s riskier investments.

Finally, it is not in customers' interests to pay for equity ratios that are higher than the equity ratio of the parent company. Rating agencies, in whole and in part, base their utility ratings on the parent company's capital structure. Under these circumstances, there is no reason to pay for additional equity because it will not enable the utility to achieve a higher credit rating and realize lower borrowing costs.

Q. Does it appear that CEI has double leveraged either Con Edison or Orange and Rockland's common equity?

A. No, we do not believe so.

Q. Does it appear that CEI has used the strength of its utility operations to fund its unregulated non-utility investments with less equity than would be required for the unregulated entities to achieve the same credit ratings as its utility operations?

A. Yes. While CEI's non-utility businesses face much greater business risk than its regulated utility operations, the non-utility investments are funded with proportionately the same amount

of common equity as the utility operations. This is not only unreasonable given the wide disparity in the risks of these activities, but is also inconsistent with Standard & Poor's (S&P) guidelines for financing these various types of energy companies and illuminates the inconsistency of the parent's financial policies. While both Orange and Rockland and Con Edison profess the importance of a strong financial profile when putting forth positions to the Commission, their parent pursues riskier financial profiles where it must compete for profits and sales.

Q. Define what you mean by the term business risk.

A. Business risk is the risk inherent in a company's operation and reflects the risk that it will fail to achieve its expected financial performance. It is affected by items such as a company's sensitivity to the overall economy, the level of competition it faces and its reliance on a large customer or supplier. Size is also factored into the equation because it implies less diversification and less financial flexibility. Finally, even within a given

industry, the level of business risk can vary greatly depending on the particular market segment or sub-sector in which the company operates.

Q. Do non-utility operations typically have more or less business risk than utility operations?

A. Non-utility activities nearly always have greater business risk than utility operations. This is because non-utility investments are unregulated, face competition from other entities, and are not subject to “cost-plus” recovery of their expenses. In addition, the products or services of an unregulated company may have alternatives that customers may switch to should their prices change dramatically. In response to Staff IR DPS-87, Dr. Morin agreed that non-utility investments have “generally higher” business risk than utility investments.

Q. What are the current financial profiles of CEI's utility and non-utility subsidiaries?

A. Exhibit___(FP-3), Page 1, presents a condensed balance sheet for CEI, Con Edison and Orange and Rockland based on CEI's 10-Q report for the period ending June 30, 2007 and its Orange and

Rockland-specific financials. Column 1 presents CEI's consolidated balance sheet results for all of its operations. Column 2 shows balance sheet information for Con Edison. Column 3 shows balance sheet information for Orange and Rockland. Column 4 is the sum of columns 2 and 3 and thus reflects the combined balance sheet of CEI's two utility subsidiaries. Column 5 represents the financial profile of CEI's non-utility operations. It is effectively the residual balance sheet of the parent after removing the stand-alone balance sheets of its two utility subsidiaries.

Q. What does this information indicate?

A. This information indicates that as of June 30, 2007, CEI's unregulated assets are financed with approximately 50.4% equity and its utility operations are funded with approximately 50.1% equity.

Q. What types of assets does the non-utility capital structure support?

A. According to CEI's June 30, 2007 10-Q, it has three active competitive subsidiaries: Con Edison Solutions, Inc – a retail energy services

company; Consolidated Edison Development, Inc. – an owner and operator of generation and infrastructure investments; and Consolidated Edison Energy, Inc. – a wholesale supply company. While each of these investments falls within the broader utility and power company industry, they operate within its riskiest segment. S&P classifies these high risk ventures as the "energy merchant and developer" business. The non-utility capitalization also supports any remaining non-earning goodwill booked by CEI as a result of its acquisition of Orange and Rockland.

Q. Is it reasonable for CEI to finance its assets that are devoted to the relatively low-risk provision of transmission and distribution (T&D) service with approximately the same ratio of common equity as its high-risk competitive ventures, and to then utilize the inflated common equity ratios of its utilities' stand-alone capitalizations for setting rates?

A. No, it is not. For a given credit rating, it is axiomatic that assets exposed to greater business risk must employ less financial risk

(i.e. a higher equity ratio). In this case, CEI's non-utility operations face considerably greater business risk than its T&D assets. Thus, CEI should be offsetting the additional business risk faced by its non-utility investments, by financing them with considerably more equity than its T&D assets, if it expects the Commission to accept the stand-alone ratios of its utility subsidiaries for setting rates.

Q. Are there any independent analyses from the financial community that can be used as a basis to quantify a rational financing policy for CEI’s non-utility operations?

A. Yes. There is a fairly recent study performed by S&P entitled "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised", included as Exhibit___(FP-4). This report specifically illustrates target financial ratios for a variety of utility and competitive energy-related companies based upon their given debt rating and “business profile.”

S&P utilizes a ranking system from “1” to “10” to distinguish the relative amount of

business risk facing a particular company, with those company's facing the least amount of business risk assigned a business profile score of "1" and those subject to the most business risk assigned a business profile score of "10."

According to the report, an average T&D company, such as Orange and Rockland and Con Edison, faces relatively little business risk, and as such has a business profiles ranking between "2" and "3." Meanwhile, energy merchants and developers, such as CEI's non-regulated businesses, are found to be subject to much greater business risk and consequently have, on average, business profile rankings of between "8" and "9."

Q. How did you use this information to reflect a more rational financing policy for CEI's non-regulated investments?

A. According to S&P's guidelines, a company with a business profile of "8" would need to maintain its total debt to total capital at about 38.5% in order to sustain S&P's "A" rating of CEI. Therefore, as illustrated in Column 6 of Exhibit___(FP-3), Page 1, we adjusted the mix of

debt and equity supporting these riskier operations such that the resulting capitalization consisted of 38.5% debt and 61.5% common equity. In effect, we reduced the non-utility operations' debt by $140 million, while simultaneously increasing the amount of common equity supporting these operations by $140 million.

Q. How did you use the adjusted non-utility capitalization to derive the appropriate utility capitalization?

A. We subtracted the adjusted non-utility capitalization amounts from CEI's consolidated capital structure (Column 1) to arrive at a residual capital structure that reflects an appropriate debt/equity mix for CEI's regulated operations, including Orange and Rockland. This result can be seen in Column 7 of Exhibit___(FP-3), Page 1.

Q. Given that the appropriate utility capitalization that you developed is as of June 30, 2007, please explain how you reflected the impact of such things as construction expenditures, refunding needs and internal cash

flows to develop the appropriate capitalization for the rate year?

A. As illustrated on page 2 of Exhibit___(FP-3), we developed average rate year balances for both common equity and long-term debt based upon the financial forecast of Company witness Perkins, both in this case and in the concurrent Con Edison steam rates proceeding, Case 07-S-1315. Specifically, we reflected all of Company's assumptions with regard to its financing activities through the end of the rate year.

With respect to the common equity balance we forecast an additional $1.5 billion for Con Edison and about $101 million for Orange and Rockland. Beginning with Staff's June 30, 2007 adjusted utility common equity balance, we calculated quarterly ending balances from September 2007 to June 30, 2009. We determined the average rate year balance of common equity by averaging the five quarterly ending balances beginning June 30, 2008 and ending June 30, 2009. We used the resulting balance of $9.157, billion shown in Column 9 of Exhibit___(FP-3), Page 1, to determine the capitalization ratios

used in Exhibit___(FP-2).

For the long-term debt component, we reflected all of the Company's projected retirements and issuances; for Con Edison the net change in long-term debt through June 30, 2009 is about $1.9 billion, and for Orange and Rockland the net increase is $110 million. Beginning with Staff's June 30, 2007 adjusted utility long-term debt balance, we calculated month ending balances from July 2007 to June 2009. We then calculated the average rate year balance by averaging the thirteen month ending balances from June 2008 to June 2009. The resulting balance of $9.501 billion is shown in Column 9 of Exhibit___(FP-3) page 1, and is used in the capitalization ratios shown in Exhibit___(FP-2).

Q. Your analysis implicitly assumes that the magnitude of CEI's non-regulated investments remain at June 30, 2007 levels, or about 7.5% of the consolidated capital structure. What would you recommend if it appears that the investment level will materially change?

A. Assuming that particular details of such an

event became available during the course of this proceeding, further discovery would be necessary and supplemental testimony may be needed to insure the reasonableness of the capitalization upon which rates are ultimately set.

Q. Given your adjustments, what rate year capitalization do you recommend the Commission apply to Orange and Rockland?

A. We recommend that the Commission employ a long-term debt ratio of 49.73%, a common equity ratio of 47.93%, a preferred stock ratio of 1.12% and a customer deposit ratio of 1.22% as the rate year capitalization for Orange and Rockland. This can be seen in Column 9 of Exhibit___(FP-3), Page 1.

Q. Are there any differences between the approach Staff used in Case 06-E-1433 and the approach you used in this case, to derive the appropriate utility capitalization?

A. There is one noteworthy difference. In Case 06-E-1433 Staff adjusted the mix of debt and equity supporting the riskier non-utility operations such that the resulting capitalization consisted of 50.0% debt and 50.0% common equity. We have,

quite simply, given greater consideration to the actual risks posed by these investments, and have reflected these views accordingly.

Q. Can you substantiate that your recommended capitalization ratios are consistent with Orange and Rockland's overall risk profile?

A. Yes. As measured by its debt rating, Orange and Rockland has one of the strongest financial profiles among electric utilities; thus it has relatively low financial risk. The Company's debt (specifically its senior unsecured obligations) is rated "A" by S&P, and "A2" by Moody's Investors Service or Moody's. In relative terms, the Company also has very low business risk, as evidenced by its S&P business profile score of "2."

S&P's capitalization guidelines call for "A" rated electric utilities with a business profile of "2" to maintain total debt in the range of 52% to 58% of total capital. Our recommended long-term debt ratio of 49.73% thus compares very favorably. We recognize of course that S&P looks beyond the traditional balance sheet at items such as deferred pension and OPEB

obligations, which it views as increasing a company's effective leverage. However, given the large increase in pension and OPEB allowances in Case 06-E-1433, and the recommendations of Staff witness Burke, with respect to the recovery of the Company's deferrals for these items, we believe that our capital structure recommendations are consistent with its current risk profile and should not, in themselves, result in a rating change.

Q. Are your recommended capitalization ratios in line with those of other utilities?

A. Yes. As can be seen in Exhibit___(FP-5), our proxy group companies are projected, on average to have a common equity ratio of 48.9%, which is only slightly higher than our recommended common equity ratio of 47.93%. With an average "business profile" of "5", the proxy group companies have greater business risk than Orange and Rockland. It is therefore not unreasonable to expect these companies to employ higher levels of common equity to mitigate the added business risk.

COST RATES

Q. Please explain how the cost rates shown in Exhibit___(FP-2) were derived.

A. As illustrated in Exhibit___(FP-2), there are four separate cost rates we employed together with their respective capitalization ratios to formulate our overall rate of return recommendation. Beginning with the cost rate of the long-term debt component, we reviewed the 6.30% cost rate determination of Company witness Perkins and made a few adjustments that resulted in our 6.19% cost rate recommendation. Exhibit___(FP-6) shows how this cost rate was derived. With respect to the 5.34% cost of preferred stock we used the cost rate determined by Con Edison in Case 07-E-0523.

The third cost rate shown in Exhibit___(FP-2) is the cost of customer deposits. The 3.76% customer deposits rate is the rate prescribed by the Commission in October 2007 for use beginning January 1, 2008. The fourth and final rate is the cost of common equity. As we will demonstrate, the Company's 11.5% proposed cost rate for common equity is excessive and should be rejected. We have developed a recommended

8.9% cost of equity for the rate year ending June 30, 2009.

Q. Regarding the cost of the long-term debt component, would you please explain why you adjusted the 6.30% cost rate submitted by Company witness Perkins, as illustrated in Exhibit E-8 Schedule 3.

A. As we explained earlier, Orange and Rockland submitted its actual long-term debt outstanding as of March 31, 2007, along with the 6.26% actual cost rate of its embedded debt. However, its rate year cost of debt determination includes estimates of the amounts, timing and cost rates associated with two new issuances of debentures, planned to occur prior to the end of the rate year. We have found the estimated cost rates of these new issuances to be excessive. Consequently, our cost of debt determination reflects a more reasonable forecast of these costs.

Q. Please elaborate.

A. As illustrated in Exhibit E-8 Schedule 3, Company witness Perkins forecasted a 10-year, $60 million issuance of debentures in late 2007,

and a 30-year, $50 million issuance in late 2008. His forecasted cost rates are based on estimates of future Treasury rates from the publication Blue Chip Financial Forecast, plus spreads to treasuries in recent months. Mr. Perkins correctly noted that the spreads required of all types of issuers, including Orange and Rockland, has increased considerably since the last time the Company issued securities in October 2006.

Based upon this methodology, Mr. Perkins forecasted that the 10-year $60 million series would be issued at a coupon rate of 6.13%, with an all-in cost, including issuance expenses, of 6.29%. Similarly, the 30-year $50 million issuance was forecast at rates of 6.63%, and 6.74%, respectively.

While we share Mr. Perkins concerns regarding the use of the Company's most recent debt issue as a guide for determining appropriate spreads for the new issues, we find his use of forecasted treasury rates (between 5.15% and 5.25% for 10-year notes and between 5.3% and 5.35% for 30-year notes) produces

unreasonable estimates compared with today's actual treasury rates of 4.02% for 10-year notes and 4.48% for 30-year notes.

Instead, based upon current treasury rates and the current spread requirements for A-rated utility issuers, we computed a coupon rate of 5.55% for the 10-year debt (based upon the December 6, 2007 yield on 10-year treasury notes of 4.02% plus a spread requirement of 1.53%) and a coupon rate of 6.12% for the 30-year debt (based upon the December 6, 2007 yield on 30-year treasury notes of 4.48% plus a spread requirement of 1.64%). Including Mr. Perkins estimated issuance expenses resulted in all-in cost rates of 5.71% for the 10-year debt and 6.23% for the 30-year debt.

Q. Why did you use the most recent Treasury rates as a proxy for future interest rates?

A. The Commission has long recognized that interest rates can not be reliably forecast, and that the best estimate of future interest rates are the most recent ones.

Q. Do you recommend that your cost of debt be updated at the time of the Commission's decision

in order to reflect the most recent market conditions (actual treasury rates and spreads required for utility debt with Orange and Rockland's debt rating) for the proposed debt issues?

A. Yes.

SUMMARY OF ROE RECOMMENDATION

Q. What methodology did you use to determine your recommended return on equity (ROE)?

A. We followed the same methodology that Staff advocated, and the Commission adopted in its Order in the recent Orange & Rockland electric rate proceeding, Case 06-E-1433. Broadly speaking, we estimated the cost of equity for a proxy group of electric utility companies, using a DCF analysis, which we weighted two-thirds, and a CAPM analysis, which we weighted one-third. We then adjusted this result to reflect: 1) the difference in financial and business risks currently facing Orange and Rockland versus those of the proxy group on average; 2) common equity issuance expenses expected during the rate year; and 3) the potential risk-reducing attributes associated with Staff's

proposed Revenue Decoupling Mechanism.

Q. Would you please elaborate on the appropriateness of your proposed weightings; specifically your recommendation that the DCF methodology be accorded a two-thirds weighting and your CAPM result one-third.

A. The DCF has long been the principle equity costing methodology in New York. In fact, over the past 13 years the Commission has consistently preferred cost of equity determinations with 2/3 DCF and 1/3 CAPM weightings. While utility witnesses continue to disparage its use because it produces lower estimates than other methodologies, there are numerous good reasons why it should continue to be the preferred methodology, and if anything, we would advocate a higher weighting for the DCF approach.

The fact of the matter is that estimating the cost of equity requires using methodologies that are not perfect. We believe that of all the approaches available, the DCF and the CAPM are by far the least flawed and, that between those two, the DCF is clearly superior. It is

noteworthy that when Orange and Rockland raised identical concerns about the weighting accorded the DCF methodology in the last electric rate case, the Commission itself remarked on the relative strengths of the DCF. On page 14 of its Order issued October 18, 2007 in Case 06-E-1433, the Commission stated that: "…the method offers the significant benefit of reliance on readily available, objective data to measure an indicator of real importance to investors."

We will demonstrate the reasonableness of our two-stage DCF method, and show that while we have concerns with the CAPM methodology in general, our application of this approach produces a reasonable check on our DCF methodology, and as such should be accorded no more than a 1/3 weighting.

One of the reasons that the Commission has never relied principally on the results of the CAPM methodology is that it relies heavily on estimates of market return and premiums that can be flawed and have a tendency to change rapidly. While these uncertainties remain today, there is a trend which has developed in recent years

which we believe portends that greater caution be used when relying on CAPM results for setting regulated returns for our low-risk T&D companies. The trend we are referring to is the increase in beta estimates of the electric utility industry over the past 13 years, from around .6 to .9. It strikes us as illogical that the cost of equity estimates using this approach for New York's electric utilities, whose business risks have generally declined as a result of their divestiture of riskier generation assets, now approach return estimates for the market as a whole.

USE OF PROXY GROUP

Q. Why do you use a proxy group in your analyses to estimate the Company's cost of equity?

A. First, the use of a proxy group to determine Orange and Rockland's cost of equity is necessary because its stock is not publicly traded, and thus a direct DCF analysis of the Company is impossible. Equally important is that DCF and CAPM analyses for an individual company rely on analysts' estimates of growth and beta and those estimates are sometimes

biased or inaccurate. However, by employing a sufficiently large group of similarly situated companies in our analysis, we can largely diminish the undesirable effects of biased (both upward and downward) or inaccurate estimates for any one company.

Q. What are the most important considerations for selecting a proxy group?

A. First, it is important to determine the specific industry classification of the company being examined in order to identify its true peers. Then, once the appropriate group of peer companies is established, careful consideration must be given to determining appropriate screening criteria in order to achieve a group of companies that is large enough without becoming unwieldy, and has similar risks to the company in question.

A careful balance must be struck between these two potentially conflicting goals. While the objective is to select a group of companies whose risks closely match those of the company being examined, it is of no less importance to select a group that is also large enough in

order that we may have sufficient confidence in its results.

Q. What companies did you select for your proxy group?

A. We selected a group of 30 companies; all, like Orange and Rockland, classified as electric utilities. Because of its robust size, we are confident that our proxy group will produce reliable estimates of the Company's cost of equity. Just as importantly we also believe that we have carefully selected companies whose risks are substantially similar to those faced by Orange and Rockland. The list of companies we used, including their credit ratings, S&P business profile, percentage of utility revenues, and their equity ratios, is shown in Exhibit___(FP-5).

Q. How did you develop your proxy group?

A. We began with the 60 companies that Value Line categorizes as electric utilities as the appropriate group of peer companies from which our proxy group could be drawn. In order to match this group's risks with those of Orange and Rockland, we considered two variables, or

screening criteria; credit quality (debt rating) and percentage of regulated revenue.

Orange and Rockland's debt is rated "A" by S&P and "A2" by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only five out of the 60 electric utility holding companies followed by Value Line had debt rated A/A or higher, and nearly all derived some revenue from unregulated investments.

Mindful of our goals of achieving a group of companies that is both sufficiently large and with similar risks to Orange and Rockland, we included in the proxy group only those dividend paying companies whose debt was at least investment-grade, and whose operating revenues from regulated operations were at least 70% of its total revenue. In instances where the parent holding company was not rated, the utility subsidiary had to be investment grade. Finally, we excluded companies that were involved in merger-related or corporate restructuring activities. Excluding these

companies is reasonable because of the potential for such activity to distort their stock prices and hence their individual cost of equity estimates.

Q. In addition to the achievement of your goals, would you please elaborate on the reasonableness of your screening criteria?

A. In the past Staff has relied on proxy groups consisting of only “A” rated utility companies that derived a significant portion of their operating revenues from regulated operations. In the early 90s there were anywhere between 25 and 33 such companies. Today that number has dwindled to between three and five depending upon the specific interpretation of what is implied by “substantial” with respect to regulated revenues.

The preeminent event has been the steady decline in credit quality of U.S. corporations in general over the past 25 years. This broader trend, together with an orientation in the electric utility industry towards consolidation through mergers and an increase in unregulated activities, means that a lowering of the credit

quality threshold is the most logical and reasonable response in order to maintain an adequate number of candidate companies.

In this case, just as in the last Orange and Rockland electric rate case, and consistent with recommendations by Staff in other recent cases, we have determined that the most reasonable proxy group for determining Orange and Rockland's cost of equity is one whose debt ratings are at least investment-grade and whose operating revenues are at least 70% of its total revenue.

Q. Would you please summarize the characteristics of your proxy group with respect to credit rating and percentage of regulated revenue?

A. As illustrated in Exhibit___(FP-5), the average debt rating of the proxy group is between "BBB+" and "BBB" for S&P and between "Baa1" and "Baa2" for Moody's. In addition, the group's average business profile is a 5.0; it receives, on average, about 10.7% of its revenues from non-regulated businesses, and has a common equity ratio of 48.9%.

DISCOUNTED CASH FLOW METHODOLOGY

Q. Please describe your discounted cash flow methodology and its result.

A. The calculation of the DCF for the proxy group is shown on pages 1-2 of Exhibit___(FP-8). For each company in the proxy group, there is a six-month average stock price, calculated by averaging the high and low price for each month. We have used the six-month period ending October 2007. The model also contains *Value Line* data for the beta, earnings per share, dividends per share, book value per share and the forecasted amount of outstanding common stock for each company.

This data is used to estimate the dividends that can be expected for each company in the future. The price investors are paying for the stock, the average stock price over a six-month period, is seen as the present value of that dividend stream. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, one can determine the rate of return investors are expecting for each company. The median result, which we calculate to be an 8.58%

return, is used as the DCF methodology result.

Q. How are dividends projected to change over time?

A. Consistent with the approach Staff has used for many years, we employed a two-stage DCF method. In the near-term, the estimates of *Value Line* are used. For the second stage, 2012 and beyond, a "sustainable growth" rate is calculated for each company in the proxy group based on its projected retention of earnings and growth in common stock balances.

Q. What was the median sustainable growth rate for the proxy group?

A. 4.7%.

Q. How does this growth rate estimate compare with growth estimates of the overall economy?

A. It is very close to the current long-range consensus growth rate in Nominal GDP. According to the October 10, 2007 edition of Blue Chip Economic Indicators, the consensus long-range estimates are 5.0% for 2009-2013 and 4.9% for 2014-2018.

Q. What is your proxy group's cost of equity using the DCF methodology?

A. As shown on page 2 of Exhibit___(FP-8), the

median return on equity of the proxy group is 8.58%. This figure is the appropriate measure of the DCF-derived cost of equity of the proxy group.

Q. Do the individual company results within the proxy group appear reasonable?

A. While most of the individual company results appear reasonable, we would not recommend a cost of equity based upon any of the individual results themselves because of the potential for biased or inaccurate beta and growth estimates to influence the result. Furthermore, we do not recommend tossing out individual results that appear unreasonable because we use the median return of our individual results, as opposed to the average. Use of the median is a widely employed statistical tool intended to diminish any undue impact that outliers may have on the average result.

Q. Dr. Morin advocates using future earnings growth estimates ranging from 6.3% to 7.9%, based on information from *Value Line* and *Zacks Investment*, as the measure of the growth in the DCF model. Is this appropriate?

A. No. The DCF is a calculation which determines investors' return expectations based on current stock prices and future cash flows. Those cash flows are the dividends a company is expected to pay out in the future. Dr. Morin has provided no evidence that projected earnings growth is equal to future dividend growth.

CAPITAL ASSET PRICING MODEL METHODOLOGY

Q. Please describe the methodology used to determine your CAPM results.

A. The principle behind the CAPM theory is that the level of systematic risk for an asset determines the level of return that investors will require to invest in that asset. Consistent with the approach Staff has employed for many years, we used two different CAPM methods (the traditional and "zero beta") to estimate the cost of equity. The CAPM result is the average of the two estimates.

Q. Why are two CAPM methods used?

A. Research has shown that the CAPM can possibly underestimate the required return when betas are below 1.0. By using a "zero beta" methodology as well, such a tendency can be addressed by

averaging in a result which is only partially determined by the beta used.

Q. Please describe how a CAPM result is calculated using the “traditional” CAPM method.

A. The traditional CAPM method calculates a required return based on three inputs: The rate of return on a risk-free investment (Rf), the level of systematic risk for an investment (B, known as the “beta”), and the expected risk premium of the market. (Rp). The calculation can be represented as:

Required Return = Rf + (B * Rp)

Q. How did you determine the risk-free investment rate and what was your result?

A. We have averaged the 10-year and 30-year Treasury bond yields for a recent six-month period. The result for the six-month period ending November 2007 is 4.77%.

Q. Is this how Dr. Morin calculated the risk-free rate?

A. No, it is not. Dr. Morin used only the 30-year Treasury bond yield purportedly prevailing in June 2007. We say “purportedly” because his risk-free rate is 10 basis points higher than

the June 2007 average for 30 year treasury bonds in the Federal Reserve Statistical Release. It is also higher than any treasury yields since, and results in a higher CAPM result.

Q. How did you determine the beta for the CAPM?

A. We used the average beta of the proxy group, as reported by *Value Line*. The average beta of our proxy group is 0.91.

Q. How did you determine what risk premium to use and what was your result?

A. The risk premium is the difference between what the expected return on common stock is and the rate on a risk-free investment. In order to determine the expected market return, we have utilized Merrill Lynch's November, 2007 *Quantitative Profiles.* As illustrated on page 46 of (Exhibit___(FP-9), that publication currently estimates the required return for the market to be 10.65% (using an average of Merrill Lynch's "Implied Return" and "Required Return" methods). Given our risk-free rate of 4.77%, a market risk premium (MRP) of 5.88% is calculated.

Q. Using your stated inputs, what was your

"traditional" CAPM result?

A. 10.12%, calculated as follows:

4.77% + [0.91 * (10.65% - 4.77%)] = 10.12%

Q. Please describe how you calculated a rate of return using the "zero beta" CAPM method.

A. The same inputs described for the traditional CAPM methodology were used. Instead of multiplying beta by the risk premium as shown in the calculation of the traditional CAPM methodology, we determined the risk premium for the proxy group by multiplying .75 times beta times the risk premium and adding .25 times the risk premium. This can be shown as: Required return = Rf + (.75*B*Rp) + (.25*Rp)

Q. What is the result of your zero-beta CAPM methodology?

A. 10.25%, calculated as:

4.77% + [.75*.91*(10.65%-4.77%)] + [.25*(10.65%-4.77%)] = 10.25%

Q. What CAPM result did you use in your calculation of the required ROE for the proxy group?

A. We averaged the results of the two CAPM methods to arrive at a result of 10.19%.

RETURN ON EQUITY CONCLUSION

Q. Please explain how you determined your overall cost of equity for the proxy group.

A. We weighted the DCF result (8.58%) as two-thirds of the total and the CAPM average (10.19%) as one-third of the total, which resulted in a 9.12% cost of equity. These calculations can be seen on page 3 of Exhibit___(FP-8).

Q. You explained earlier in your testimony that proposed three adjustments to this cost rate. Please describe these adjustments, beginning with your adjustment to reflect the fact that there is a quantifiable difference between the risks faced by Orange and Rockland and the proxy group.

A. The rationale for this adjustment is based upon the fundamental concept that the return requirements of common equity investors are commensurate with the riskiness of their investment. While our proxy group selection process sought out companies whose risks were "substantially similar" to those faced by Orange and Rockland, the fact is that differences do exist and should be reflected in the cost of equity determination accordingly.

The major credit rating agencies such as Moody's and S&P regularly assess both the business and financial risks of the utilities they rate and assign their credit ratings accordingly. As we discussed earlier, Orange and Rockland is rated "A2" by Moody's and "A" by S&P, while as illustrated in Exhibit___(FP-7), the average Moody's rating for the proxy group is somewhere between the "Baa1" and "Baa2" (2.4 notches lower), and the average S&P rating is somewhere between "BBB+" and "BBB" (2.2 notches lower).

To calculate the discount required by Orange and Rockland's debt holders as compared to the cost requirements of the proxy group's debt holders, we calculated six-month average spreads for "A" rated debt versus "Baa" rated debt, using Moody's monthly data for seasoned utility bonds with remaining maturities of at least 20 years. Based upon this data, and given their respective debt ratings, we calculated implied yields for both Orange and Rockland and the proxy group. The result was 6.18% for the Company and 6.37% for the proxy group, implying

that return required by the Company's debt holders is about 19 basis points less than the return investors would require for proxy group debt.

In order to translate that debt discount into the return requirements of the Company's equity investors, we took the ratio of Orange and Rockland's implied debt cost to the proxy group's implied cost of debt (6.18%/6.37% = 96.87%) and applied it to the proxy group's 9.12% cost of equity and determined that the appropriate discount is 29 basis points. Our calculations are illustrated in Exhibit___(FP-10).

Q. Did Dr. Morin consider any risk adjustment to his cost of equity determination?

A. While Dr. Morin utilized proxy groups with overall credit risks that are somewhat higher than ours, he concluded that no adjustment was necessary. While he conceded that Orange and Rockland has lower business risk than the companies from which his cost of equity estimates are drawn, he concluded that no adjustment is necessary because of what he

alleges is Orange & Rockland's small-size.

Q. Do you agree with Dr. Morin's conclusion with respect to Orange and Rockland's size?

A. Absolutely not. First of all, as we already discussed, the relative size of a company is already factored into its business risk assessment, and thus reflected in its credit rating and our proposed adjustment. Second, given that Orange and Rockland is a wholly-owned subsidiary of CEI, with its $16.1 billion capitalization and conservative business approach, any suggestion that investors would question the Company's financial flexibility by virtue of its size is simply ridiculous on its face.

Q. Please explain your second adjustment, the one you made to reflect the costs associated with the Company's proposed infusion of $40 million of common equity during the rate year.

A. Our review of both Con Edison's and the Company's financial forecasts indicate that CEI will be issuing common equity during the rate year and that $40 million of those proceeds will be supplied to Orange and Rockland to finance

its electric and gas and utility operations. It has been Commission policy to allow recovery of such expenses when they are reasonably expected to be incurred. Based upon an average of the actual issuance expenses incurred by the parent in its last three public offerings, of about 1.5% of the gross proceeds, we estimate Orange and Rockland's share of these costs to be about $600,000 ($40 million * 1.5%). Given the Company's projections that it will have about $480 million of common equity on its balance sheet on average during the rate year, an upward adjustment to the cost of equity of 13 basis points is necessary ($600,000/$480 million). Doing so allows Orange and Rockland to recover expected equity issuance costs in the rate year. Until rates are reset they would provide such recovery for future issuance expenses as well.

Q. Please explain your final adjustment; the one you made to reflect the potential risk-reducing attributes associated with Staff's proposed Revenue Decoupling Mechanism (RDM).

A. Staff is proposing an RDM which would reconcile Orange and Rockland's actual rate year sales to

the amount forecasted by the Company's Forecasting Panel. This would eliminate the risk of weather-related sales variation from the sales forecast, as well as non-weather related usage per customer variations, and customer growth variations. By eliminating this uncertainty, the Company's prospective cash flows and earnings will be more predictable. Consequently, equity investors will gain greater clarity with regard to the future dividend potential of the Company, and the Company's equity becomes a less risky investment.

Q. How have you attempted to quantify the degree to which the Company's risk will be reduced with the implementation of Staff's proposed RDM?

A. We have noted that with respect to the Local Gas Distribution industry, Moody's has opined that "LDCs that have, or soon expect to have, revenue decoupling stand a better chance than others in being able to maintain their credit ratings or stabilize their credit outlook in face of adversity." (See Exhibit___(FP-11)).

Currently, only one of the companies in the proxy group, PG&E Corp., has an operating unit

with an RDM, so there is not a lot of credit information available regarding electric T&D companies. Nonetheless, we see no reason that the rating agencies wouldn't view revenue decoupling favorably for electric T&D companies such as Orange and Rockland. Absent details regarding the exact nature of RDM itself, we believe it is reasonable to assume that the reduction in business risk associated with the increased predictability of the Company's cash flows, is equivalent to a one-notch credit rating upgrade, which our analysis shows is equal to about a ten basis point change in the expected return for its shareholders.

Q. Does your adjustment imply that the implementation of an RDM would necessarily result in an upgrade?

A. Not necessarily. It is possible that CEI could use this reduction in business risk to increase the leverage employed in its utility operations. In such circumstances, the benefit of the reduction in business risk would be conveyed to ratepayers via a lower overall cost of capital, as a result of the lower common equity ratio.

Q. In its position paper to the Commission, dated October 19, 2007, in Case 06-E-1433, the Company alleged that an RDM would increase its regulatory risk, and as a result its cost of equity would be higher. Would you please comment on this argument?

A. The crux of Orange and Rockland's argument is that because of the periodic updating and modifications inherent with an RDM that it would be at risk for the delay or denial of unrecovered, deferred costs. Belying this argument are the facts; the use of true-ups reduces risk and the Company has never been denied the recovery of any of its prudently incurred costs.

Q. Would you please summarize the effect of each of your adjustments to the proxy group's cost of equity?

A. As illustrated on page 3 in Exhibit___(FP-8), we adjusted the proxy group's 9.12% ROE accordingly: 1) we reduced it by 29 basis points to reflect the Company's superior credit quality; 2) we increased it by 13 basis points to reflect reasonably anticipated common equity

issuance expenses; and 3) we reduced it by 10 basis points to reflect the forward-looking reduction in risk associated with the implementation of Staff's proposed RDM. As a result of these adjustments, we recommend that Orange and Rockland be allowed the opportunity to earn an 8.9% return on its average common equity during the rate year. Our recommendation is rounded to the nearest tenth of a percent.

Q. Do you recommend updating the cost of equity?

A. Yes. Prior to a decision by the Commission in this case, we recommend that our methodology be updated.

DISCUSSION OF COMPANY ROE AND FINANCING PRESENTATIONS

Q. You have stated that Dr. Morin's recommended ROE is excessive and should be rejected. Would you please summarize the approach followed by Dr. Morin?

A. To arrive at his recommendation, Dr. Morin performed a total of four DCF analyses using two different proxy groups for Orange and Rockland. He also performed four risk premium analyses; two using CAPM estimates and two using historical and allowed risk premium data from

electric utility industry aggregate data. He then averaged the results of all three methodologies, according each an equal weight, to arrive at an 11.3% cost of equity determination.

Based upon his professional judgment and assessment of the risk circumstances of Orange and Rockland he then concluded an ROE recommendation of 11.2%. The Company's revenue requirement, however, reflects an 11.5% cost of equity to reflect its assessment of the added risk associated with its proposed three-year rate plan.

Q. Please explain your reasons for rejecting Dr. Morin's analyses?

A. To begin with, Dr. Morin only assigns the DCF a one-third weighting while assigning his higher cost of equity risk-premium approaches a two-thirds weighting. He makes the same arguments that the Commission already considered and rejected in the last Orange and Rockland electric proceeding. Therefore, his approach, which places additional weight on methodologies that have consistently been found to be

inferior, should be rejected.

Q. You explain that Dr. Morin, like Staff, relied on proxy groups to determine the cost of equity. Do you have any concerns with Dr. Morin's proxy group selection process?

A. Not only are Dr. Morin's proxy groups considerably smaller than Staff's proxy group and thus less reliable, but both of Dr. Morin's proxy groups contain companies that may not be suitable surrogates for Orange and Rockland's utility operations. Specifically, only 7 of the 12 companies in the electric distributors group and 11 out of the 15 companies in the Moody's group receive 70% or more of their operating revenues from utility operations. Additionally, he electric distributors group includes Energy East which is involved in merger-related activity. And, his Moody's group includes one company (TECO Energy) that is not investment grade. For these reasons his proxy groups are inferior to Staff's and should be rejected.

Q. Please explain Company witness Morin's DCF approach, and your primary concerns with it.

A. Dr. Morin performed four separate DCF analyses;

he performed two using a proxy group consisting of 12 parent companies of investment-grade operating electric distribution utility companies (electric distributors), and repeated the same two analyses using the 15 companies comprising the Moody's Electric Utility Index (Moody's group).

For both of these flawed proxy groups he calculated two average ROE estimates, all of which relied upon current dividend yield information. In one analysis he used Value Line earnings per share growth estimates and in the other Zack's long-term earnings growth estimates. Among the problems with these estimates is that the Commission has long accepted the premise that sustainable long run utility dividend growth is a product of a company's future expected returns on equity and its dividend payout policy. Dr. Morin's testimony, however, fails to address how these relatively short-term earnings growth estimates relate to the dividend payout policies of his companies and, even more troubling, to demonstrate whether or not they are even

sustainable over time.

Q. Would you please summarize Dr. Morin's risk premium analyses?

A. In order to quantify the risk premium for Orange and Rockland, Dr. Morin performed a total of four risk premium analyses. For the first two risk premium studies he submitted, his "CAPM Estimates," he applied the CAPM and an empirical approximation of the CAPM using current market data. The other two risk premium analyses were performed on historical and allowed risk premium data from electric utility industry aggregate data.

Q. Please explain how Dr. Morin performed the two CAPM analyses to determine the incremental return required by investors of Orange and Rockland versus the risk free rate.

A. Dr. Morin began with a traditional CAPM methodology. For his inputs he used: a risk-free rate of 5.3% based upon the current level of 30-year Treasury bonds yields; a beta of .91 based upon the Value Line betas of the electric utility companies used in his DCF analyses; and a market risk premium of 7.4% based upon the

results of both forward-looking and historical studies of long-term risk premiums. He then used these inputs and determined that the CAPM estimate of the cost of common equity for Orange and Rockland is 12.0% ((5.3%+(0.91*7.4%), which he adjusted to 12.3% for a flotation cost allowance. In his Empirical CAPM approach, he adjusted this result even further upward, to 12.5%, because he believes that for betas less than 1.0 the CAPM underestimates the cost of equity.

Q. What concerns do you have with Dr. Morin's CAPM approaches?

A. Our principle concern is the manner in which he determined his 7.4% risk premium. This premium was the result of blending two estimates for the market risk premium; a historical market return (ex post) using Ibbotson Associates data (7.1%), and a forward-looking return (ex ante) using Value Line stock data (7.6%).

Dr. Morin's use of a 7.1% historical risk premium (based on Ibbotson Associates financial data that goes back to 1926) does not reflect the current investing climate. It is an average

of return differentials between bonds and the stock market over periods much different than today. Many in the financial community believe that the equity risk premium has been decreasing over time and is currently very low. For instance, Jeremy Siegel, in "*The Shrinking Equity Premium*", The Journal of Portfolio Management, Fall 1999, articulated this view (See Exhibit___(FP-12)). As a result, there is a debate concerning the relevance of the Ibbotson data in today's markets.

Q. Did Dr. Morin consider any other historical or forward looking market return studies that estimate the MRP?

A. Yes. In response to Staff IR DPS-97, Dr. Morin referenced some studies, including a 2000 published work by Dimson, Marsh and Staunton that reported historical risk premium returns for many countries. They reported an average risk premium over long-term bonds for 12 countries for the period 1900-2000 of 5.6%, with the United States at 7.0%.

Q. Are you familiar with this work done by Dimson, Marsh and Staunton?

A. Yes. However, there is more current research from 2006 by Dimson, Marsh and Staunton titled, "*The Worldwide Equity Premium: A Smaller Puzzle*," that includes market returns for the period, 1900-2005. As illustrated on page 19 of Exhibit___(FP-13), this report concludes an average risk premium over long-term bonds of 6.08% for a group of 17 countries, and an average risk premium of 6.49% for the United States. This recent research is more relevant for developing a current market risk premium for the U.S., since it contains market return data through 2005. The impact of the more recent data is significant; the MRP for the U.S. for the 1900-2005 period is fully 50 basis points less than the MRP for the 1900-2000 period.

Q. Were there any other risk premium studies referenced by Dr. Morin?

A. Yes, Dr. Morin used a paper titled, *Ex Ante Cost of Equity Estimates of S&P 500 Firms: The Choice between Global and Domestic CAPM*. Dr. Morin averaged the ex ante market risk premium (MRP) for each year from 1983-1998, which was 7.2% and compared this to his own estimate of 7.4%.

Q. Did you review this study?
A. Yes, and it is interesting that on page 17-18 of the study, there is a table that shows the breakdown of the full period ex ante risk premium estimates by broad industry groups. The ex ante MRP for the utility industry is 4.15%, substantially lower than what Dr. Morin is using.
Q. Are there other historical or forward looking MRPs that you are aware of?
A. There are many studies and surveys that attempt to estimate the market risk premium for the United States. A study from November, 2006 by Glen Donaldson, Mark Kamstra and Lisa Kramer entitled *Estimating the Ex Ante Equity Premium*, concluded that the true MRP for the United States lies within 50 basis points of 3.5%.

Two well known, forward looking approaches for estimating the MRP are Duke University's CFO Outlook Survey and Merrill Lynch's *Quantitative Profiles*. Duke University's Fuqua School of Business in conjunction with *CFO* magazine compile the CFO Outlook Survey by interviewing Chief Financial Officers (CFOs) of companies and

subscribers to CFO magazine around the world every March, June, September and December. Among the many questions in this comprehensive survey are several that ask CFOs what their expectations are for the S&P 500 return over the next ten years. The December, 2007 survey summarized responses from 1,275 U.S. and international CFOs. As illustrated on page 49 of Exhibit___(FP-14), the mean return expected by these CFOs for the S&P 500 for the next ten years is 8.34%. Given that the annual yield on the 10-year Treasury note was 4.1% at the time of this survey, the expected MRP is therefore 4.24% (8.34% - 4.1%).

Merrill Lynch uses a multi-stage dividend discount model to calculate an expected return for the S&P 500 in its monthly *Quantitative Profiles* publication. As illustrated on page 46 of Exhibit___(FP-9), the expected return for the S&P 500, according to the November 2007 issue, is 10.65%. Using Dr. Morin's risk free rate of 4.6% only results in a MRP of 6.05%. Merrill Lynch's *Quantitative Profiles* provides a more accurate and up-to-date assessment of what

today’s investors require because it is based upon the current expected market return, which takes into account only the current business climate.

Q. Has the Commission ever discussed the use of the Merrill Lynch estimate versus Ibbotson’s historical data for calculating risk premiums?

A. Yes, in Case 95-G-1034, Central Hudson Gas & Electric Corporation, the Commission recognized the use of the Merrill Lynch estimate. On page 14 of Opinion 96-28, dated October 3, 1996, the Commission stated, "…the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problems of stale data in the Ibbotson estimate, or the circularity of the implied risk premium approach in relying on other commissions' return allowances."

Q. On page 35 of his testimony Dr. Morin described his use of a forward looking market risk premium. Please comment on his approach?

A. For some reason, Dr. Morin is not willing to use expected dividend growth rates in his DCF methodology to determine future cash flows, but

is willing to use them to estimate expected returns in his CAPM analysis. While using dividend growth forecasts can be a reasonable approach, Dr. Morin is using exceedingly high forecasts of dividend growth (12.43% per year) to set the expected market return.

Once again, as with the Ibbotson Associates data, Dr. Morin has used a MRP that is far beyond what most independent researchers estimate. We believe that informed investors would weigh all of the information available and make investment decisions based on that data, rather than relying on the one or two methods which result in the highest premium.

Q. Please comment on the suitability of Dr. Morin's historical risk premium analysis of the electric utility industry for determining the Company's cost of equity?

A. There are several reasons why this approach should be rejected. First, Dr. Morin makes no attempt to determine the extent to which Orange and Rockland is more or less risky than the average electric utility contained in the Moody's electric utility common stock index for

the period 1932 to 2002. He also provides no evidence about whether the risks of the bonds used to calculate the yield for Moody's composite index have remained at the same level relative to the risks of the electric utility stocks comprising the Moody's electric utility common stock index, for the 1932 to 2002 study period. Finally, Dr. Morin has not provided evidence indicating that the risks of utility bonds have remained at the same level relative to Treasury securities over this time period.

Q. Please comment on the suitability of Dr. Morin's analysis of allowed return risk premiums in the electric utility industry?

A. Dr. Morin's use of Regulatory Research Associates *Regulatory Focus* to determine an average allowed return is seriously flawed, primarily because he makes no attempt to assure the comparability of those returns with the particular risks facing Orange and Rockland and the return that those risks imply. Specifically, Dr. Morin makes no attempt to factor in the particular company risks associated with any of these ROE decisions, nor

does he differentiate for ROEs that are for multi-year rate plans and as such, likely include stayout premiums.

Q. Finally, would you please comment on Dr. Morin's statement that a low ROE increases the possibility that the Company will not have access to the capital markets for its outside financing needs, or if so, at prohibitive costs.

A. As we have demonstrated, our cost of equity recommendation represents a reasonable estimation of the Company's equity investors. As such we do not believe it can appropriately be characterized as either "too low" or "too high." Moreover, given the Company's strong financial profile, its conservative management and supportive regulatory environment, any suggestion of our cost of equity recommendation resulting in prohibitive financing costs is pure fantasy.

Q. Referring to the financial challenges faced by Orange and Rockland, Company witness Perkins noted that the Company has a capital expenditure program, determined by the need to update and expand its electric delivery infrastructure that

is significantly higher than levels in the recent past. He also suggests that "sub-standard return" authorizations could impair its ability to raise the necessary capital to fund its operating requirements at reasonable terms. Do you share his concerns?

A. No. We agree that it is important for the Company to have access to the financial markets at reasonable terms. To this end, we have recommended a capital structure and cost rates that are consistent with this objective, while other Staff witnesses have concluded that all of the proposed infrastructure-related capital expenditures are reasonable, and will thus be fully recovered in our overall revenue requirement. Finally, we note that our ROE recommendation is based upon an approach the Commission has endorsed in the past and that this Commission has never prohibited the Company from accessing capital at reasonable terms.

Q. The basis for Mr. Perkins characterization of the Commission's return authorizations as substandard is a comparison he made of New York allowed returns versus other jurisdictions from

1992 through 2006. Do you believe that Mr. Perkins data provides any meaningful basis for comparing authorized returns?

A. No. A meaningful comparison of returns would require adjustments to reflect the risk underlying each of the referenced rate plans. As we explained earlier, a fundamental concept in financial theory is that investors return requirements are directly linked to the riskiness of their investment. Thus, Mr. Perkins failure to account for such critical elements of these rate plans as the credit ratings of these utilities, whether or not they were for multi-year periods, what levels of expense reconciliation were allowed, how robust the sales forecasts were relative to historic growth, or whether the test periods were historic or fully forecast, completely undermines the reliability of his conclusion, and it should be rejected.

Q. Does this conclude your testimony?

A. Yes it does.