

Before the  
New York State Public Service Commission

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**In the Matter of**  
**Consolidated Edison Company of New York, Inc.**

**Case: 08-E-0539**

**September 8, 2008**

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Prepared Testimony of:

Harvey Arnett  
189 Gordon Road  
Carmel, New York 10512

On Behalf of:

The City of New York  
The Metropolitan Transportation  
Authority  
The Port Authority of New York and  
New Jersey

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1 **Q. Please state your name and address.**

2 A. My name is Harvey Arnett, and my address is 189 Gordon Road,  
3 Carmel, New York 10512.

4

5 **Q. What is your current position?**

6 A. I am an independent consultant doing business as Arnett Energy. For  
7 this rate proceeding I have been retained on behalf of the City of  
8 New York, the Metropolitan Transportation Authority (“MTA”) and  
9 The Port Authority of New York and New Jersey (“Port Authority”)  
10 to analyze certain aspects of Con Edison’s rate filing.

11

12 **Q. Could you briefly describe your education and experience?**

13 A. I graduated from The Cooper Union School of Engineering and  
14 Science in June 1970 with a Bachelor of Engineering degree  
15 majoring in Chemical Engineering. I then began employment at the  
16 Department of Public Service (“DPS”) where I was given positions  
17 of increasing responsibilities.

18 In April 2005 I retired from DPS as the Deputy Director of  
19 Electric and Gas Rates. By that time I had been a member of the  
20 DPS rate team responsible for oversight of Con Edison’s Electric and

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1 Steam Departments almost 30 years, and had been the lead rate  
2 engineer for that team for 25 years. While at the DPS, I testified  
3 before the New York State Public Service Commission in 35  
4 proceedings covering a broad range of topics.

5 Since leaving the DPS, I have testified before the New York  
6 State Public Service Commission twice, in the most recent Con  
7 Edison Electric Rate Proceeding, and in the most recent Con Edison  
8 Steam Rate Proceeding and I have testified once before the  
9 Connecticut Department of Public Utility Control.

10 I am registered as a Professional Engineer in New York State.

11

12 **Q. What is the scope of your testimony in this proceeding?**

13 A. I have been asked to address items that impact the utility's need for  
14 rate relief and will address the following areas:

- 15 ● Negative Net Salvage in Depreciation Rates
- 16 ● Productivity
- 17 ● Capital Projects and O&M Programs

18

19 **Context of the Case**

20 **Q. Do you have any general comments on the proposed rate**

1           **increase?**

2       **A.**     Before discussing the specifics, I would note that Con Edison has  
3           again proposed a large increase in the rates it charges for utility  
4           service. In the last gas rate proceeding, Case 06-G-1332, the utility  
5           filed for a 34 percent increase in delivery charges. In the last electric  
6           rate proceeding, Case 07-E-0523, the utility sought an increase of  
7           almost 38 percent in delivery rates. In the ongoing steam rate  
8           proceeding, Case 07-S-1315, the utility proposed a rate increase  
9           equivalent to about 35 percent net of fuel costs. In this case, Con  
10          Edison is seeking an increase of 15.4 percent in electric delivery  
11          rates.

12

13       **Q.**     **Have you prepared a comparison of Con Edison's Electric Rates**  
14           **with other large US electric utilities?**

15       **A.**     Yes, I have relied on a table available from the Department of  
16           Energy's Energy Information Administration (EIA) at the following  
17           website:

18           <http://www.eia.doe.gov/cneaf/electricity/esr/table6.xls>

19

20       **Q.**     **What information is presented on this table?**

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1 A. This table, which is labeled by EIA as Table 6, shows, for each FERC  
2 jurisdictional electric utility, the full service average rates for  
3 residential customers taking bundled electric service from their  
4 utility. The table I used was based on 2006 data, which is the latest  
5 summary data available.

6 Based on the information on EIA Table 6, I have prepared  
7 Exhibit \_\_\_\_ (HA-1), which shows the bundled residential electric rate  
8 for the 25 largest electric utilities, in terms of number of residential  
9 customers, as sorted by the average bundled residential rate.

10

11 **Q. What does Exhibit \_\_\_\_ (HA-1) tell us about Con Edison's**  
12 **bundled residential rates?**

13 A. It shows that Con Edison's rates are much higher than other large  
14 utilities.

15

16 **Q. The table you relied on was based on 2006, do you think the**  
17 **disparity between Con Edison's rates and those charged by these**  
18 **other large utilities has remained the same.**

19 A. I expect that the disparity has increased. Con Edison's bundled  
20 residential rate for 2006 as shown on Exhibit \_\_\_\_ (HA-1) is 20.90

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1 cents per kWh. Rates for 2008 are likely to be higher. Much of this  
2 increase is driven by this area's heavy dependence on oil and gas as  
3 the marginal fuel. The balance is attributable to Con Ed's most recent  
4 delivery rate increase.

5

6 **Q. Do high existing rates mean that Con Edison's rates are not just  
7 and reasonable?**

8 A. Not necessarily, there are many valid reasons why Con Edison's rates  
9 are above those of other utilities. However, the intent of Exhibit \_\_\_\_  
10 (HA-1) is to show that Con Edison's current electric rates, before this  
11 proposed rate increase, already place a much heavier burden on its  
12 customers than the electric rates in other cities, and make it harder for  
13 NYC to compete with other areas of the country.

14

15

**Depreciation**

16 **Q. What is your recommendation regarding Depreciation?**

17 A. I recommend, as I did in the last Con Edison electric rate proceeding  
18 and the last steam rate proceeding, that negative net salvage no  
19 longer be reflected in electric depreciation rates, and that a type of a  
20 "Pay As You Go" (PAYGO) mechanism be used in its place.

1

2 **Q. What is negative net salvage?**

3 A. When a depreciable asset is retired, there is a cost of removal and a  
4 potential salvage value. A negative net salvage indicates that the net  
5 of these two will be an out of pocket cost to the utility. Thus,  
6 negative net salvage is based on projections of salvage values and  
7 removal costs decades in the future.

8

9 **Q. Can you briefly summarize the PAYGO method and how it  
10 differs from what Con Edison currently does?**

11 A. Depreciation rates under the current approach recover in equal annual  
12 charges over the expected service life of that asset both the original  
13 cost of the asset and the net salvage cost of removing that asset from  
14 service. For example, an asset with a 10 year expected service life,  
15 an original cost of \$100 and a net salvage of negative 50 percent  
16 (\$50), would have an annual depreciation expense of \$15 per year,  
17 \$10 towards recovering the original cost of the asset, and \$5 towards  
18 recovering the future negative net salvage.

19 Under a PAYGO approach, the depreciation expense would  
20 recover the original cost of the asset in the same way, \$10 per year,

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1 but the \$50 negative net salvage would be recovered only after it was  
2 incurred.

3 The stated rationale for the current approach is that ratepayers  
4 who are served by that specific asset should contribute to the full cost  
5 incurred to place that asset in service, and to maintain and eventually  
6 retire it. This argument is referred to as one of intergenerational  
7 equity in that the single generation of ratepayers served by an asset  
8 pays all the costs to support that asset.

9

10 **Q. Do you agree with recovering negative net salvage in depreciation**  
11 **rates on this basis?**

12 A. No. There are several reasons why this approach is not justifiable.

13 First, in the case of this utility, the “intergenerational inequity”  
14 defense is not applicable because negative net salvage is almost  
15 always incurred to allow the installation of a new asset to serve the  
16 greater needs of the future ratepayers.

17 Second, including negative net salvage in depreciation rates  
18 for long-lived assets requires the Commission to make highly  
19 speculative estimates of removal costs far into the future.

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1 Third, the current treatment requires ratepayers to fund an  
2 interest free loan to the Federal and State Treasuries.

3 Fourth, the “intergenerational inequity” argument is not  
4 applicable to “mass accounts,” which include most if not all of Con  
5 Edison’s Electric Department accounts. Mass accounts are those  
6 where there are many thousands and sometimes millions of assets  
7 having varying vintages. For mass accounts ratepayers in any given  
8 year will pay about the same revenue requirement regardless of  
9 whether one uses the current methodology or a PAYGO approach.

10 Fifth, continuation of the current approach will leave for a  
11 future Commission a rate “time bomb” in that the recent, large,  
12 negative net salvages that have been incurred have not yet been  
13 reflected in depreciation rates or in the calculation of the adequacy of  
14 the depreciation reserve.

15 Each of these points is more fully explained below.

16

17 **Q. Are there differences between the arguments you present to**  
18 **support your methodology in this case compared to those that**  
19 **you set forth in the two recent electric and steam Con Edison**  
20 **rate proceedings?**

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1 A. Yes, the third and fifth reasons set forth above are two significant  
2 additional arguments that support my position. I will discuss both in  
3 more detail below. However, to summarize the first new rationale,  
4 for income tax purposes, negative net salvage is not deductible until  
5 the cost is incurred. So, when ratepayers are required to pay for  
6 negative net salvage in advance, as they do under the current  
7 mechanism, they also must support the utility's payment to cover  
8 income taxes that become due. Once the negative net salvage is  
9 incurred, the tax deduction can be taken. However, in the interim,  
10 the ratepayers have supported an interest-free loan to the Federal and  
11 State Treasuries.

12 Recognition of this tax impact, which I had not done in  
13 previous testimony, has a major positive impact on the long term  
14 cost-effectiveness of my proposal. In the prior electric and steam rate  
15 cases, I had acknowledged that over the long term, ratepayers  
16 ultimately were likely to have to pay Con Edison more money under  
17 my previous PAYGO approach. With the tax impact recognized, that  
18 is no longer true. Instead, the long-term ratepayer impacts of the  
19 current method versus the PAYGO method are a toss up, with the net  
20 present values close to each other under various assumptions on

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1 service lives, percent salvage, plant growth rate, discount rate and  
2 utility pre-tax rate of return.

3 The second new rationale for changing the handling of  
4 negative net salvage is that, in view of the continuing increase in  
5 negative net salvage, which has yet to be reflected in depreciation  
6 rates, continuation of the current methodology creates a “rate time  
7 bomb.”

8  
9 **Q. Are there differences between the mechanics of your proposal in  
10 this case compared to those that you set forth in the two most  
11 recent Con Edison rate proceedings?**

12 A. Yes. I had previously recommended an amortization over ten years  
13 of net negative salvage costs as they are incurred with a starting  
14 accrual set to delay the need for future rate increases. In the last  
15 Electric proceeding my recommended starting accrual was \$50  
16 million. In the current case I am recommending a starting accrual of  
17 \$70 million, and would charge any actual amounts over that amount  
18 to the \$365 million surplus in the actual depreciation reserve that  
19 would exist compared to the theoretical reserve required under my  
20 proposal.

1

2

3

4 **Q. What factors compel you to recommend this change in how Con**  
5 **Edison’s Electric Department should recover negative net salvage**  
6 **value?**

7 A. I am making this recommendation for the Electric Department, as I  
8 did in the two previous Con Edison rate cases, because of the  
9 confluence of the following circumstances:

- 10 1) The magnitude of the requested increase  
11 2) The level of net negative salvage in depreciation rates  
12 3) The existing depreciation reserve deficiency  
13 4) Recent growth in plant balances  
14 5) The nature of the Con Edison Electric Department, where  
15 retired facilities generally are removed only to make room for  
16 a replacement.  
17

18 **Q. For purposes of your testimony, did you accept the actual**  
19 **negative net salvage value that Con Edison is booking at face**  
20 **value?**

21 A. Yes. I have done no analysis that would confirm or undermine those  
22 numbers.

23

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1   **Q.    Have you prepared an exhibit that shows the impact on**  
2       **depreciation rates of eliminating negative net salvage?**

3    A.    Yes, I have prepared Exhibit \_\_\_\_ (HA-2).  This exhibit is modeled  
4       after Con Edison witness Hutcheson’s Exhibit \_\_\_\_ (CH-1), but  
5       eliminates the columns showing the utility-proposed basis, which, in  
6       this case, are the same as the columns showing the book basis  
7       because the utility is not proposing any depreciation rate changes.  
8       My Exhibit \_\_\_\_ (HA -2) addresses only Electric Plant Accounts, as  
9       does my proposal.  Common Plant Accounts do not have high levels  
10      of negative net salvage.

11                 I have added columns showing the impacts of removing  
12      negative net salvage from depreciation of electric plant.

13  
14   **Q.    What does your proposal do to the annual depreciation rates?**

15    A.    As shown on Exhibit \_\_\_\_ (HA-2), using the utility-proposed basis,  
16       but eliminating the impact of negative net salvage, reduces  
17       depreciation rates by 28.5 percent.  Applying this reduction to the  
18       Company’s Accounting Panel Exhibit \_\_\_\_ (AP-11),  Schedule 5,  
19       produces a downward depreciation rate adjustment of \$140 million  
20       for the Rate Year.

1

2 **Q. What does the Exhibit \_\_\_ (HA-2) show regarding the deficiency**  
3 **in the depreciation reserve?**

4 A. There would be a surplus of \$365 million in the actual versus  
5 theoretical depreciation reserve, compared to the \$670 million  
6 deficiency under the existing rates. This surplus exists because,  
7 under the PAYGO approach, the theoretical depreciation reserve  
8 would not reflect any need for negative net salvage, while the actual  
9 reserve reflects the past accumulation of funds to cover negative net  
10 salvage.

11

12 **Q. How would you transition from the current methodology to a**  
13 **PAYGO approach?**

14 A. I am recommending a more straightforward method to transition to a  
15 PAYGO approach than the amortization I had previously proposed. I  
16 have prepared Exhibit \_\_\_ (HA-3), which shows the five and ten year  
17 average level of actual net salvage for Con Edison's Electric Plant as  
18 drawn from Exhibit \_\_\_ (CH-3). These amounts are \$127 million  
19 and \$101 million, respectively.

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1           In view of the surplus in the actual depreciation reserve, my  
2           proposal is to charge ratepayers \$70 million per year for negative net  
3           salvage, and charge any excess negative net salvage to the existing  
4           depreciation reserve. This is fair because the \$365 million surplus in  
5           the depreciation reserve is only there because ratepayers have been  
6           paying excess depreciation due to negative net salvage for many  
7           years. Once the depreciation reserve surplus is exhausted (in 5 to 10  
8           years), a full current recovery of negative net salvage could be  
9           implemented.

10

11   **Q.    What are the net rate impacts of your proposed treatment of**  
12   **negative net salvage?**

13   A.    The net rate impact would be a \$70 million reduction in the  
14   Company's requested revenue requirement, comprised of \$140  
15   million in reduced depreciation expense and a \$70 million allowance  
16   to cover a portion of negative net salvage. There would be rate base  
17   and tax implications as well, but I would rely on DPS Staff to provide  
18   that information.

19

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1    **Q.    Turning to the first of your five reasons, could you explain why**  
2           **considering negative net salvage as part of the cost of future**  
3           **assets, rather than a cost of providing service to current**  
4           **ratepayers, actually promotes intergenerational equity?**

5    A.    The current method rests on the assumption that negative net salvage  
6           must be paid by customers served by that asset over the asset's life  
7           based on the assumption that future customers will not benefit from  
8           the asset. This assumption is fundamentally flawed here. Although  
9           Con Edison's electric facilities may become inadequate for the needs  
10          of future ratepayers, technologically obsolete or simply fail, they will  
11          almost always be replaced by new facilities at the current sites. The  
12          current Con Edison practice is akin to requiring homeowners to cover  
13          through their mortgage payments the eventual demolition of their new  
14          house when it becomes inadequate for the needs of the then-current  
15          owners.

16                 Pre-funding negative net salvage in a densely populated area  
17                 only makes sense if the asset has to be removed and the space it  
18                 occupied cannot be used. I am not aware of such circumstances  
19                 affecting any significant portion of Con Edison electric assets and, if  
20                 they exist, they should be demonstrated on a case-by-case basis,

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1           instead of assuming that all of the assets are so affected. In other  
2           words, future ratepayers will not be saddled with negative net salvage  
3           costs. The current method does not promote intergenerational equity  
4           because new assets will replace those that are retired.

5                     An example of the problem can be found in Account 9514,  
6           which according to Exhibit\_\_\_ (CH-1), has a theoretical reserve of  
7           about \$25 million and a negative actual reserve of almost \$77 million,  
8           creating a reserve deficiency of over \$100 million for this single  
9           account. The bulk of these costs related to the demolition that had to  
10          take place at the East River Station to accommodate ERRP, a new  
11          clean cogeneration plant designed to serve Con Edison electric and  
12          steam customers for future decades. Thus, the beneficiaries of the  
13          ERRP demolition are future ratepayers, and collecting negative net  
14          salvage costs only from historic ratepayers pursuant to the  
15          Company's current methodology was inequitable and provided a  
16          windfall to future ratepayers.

17

18       **Q.    Could you explain your second rationale for eliminating negative**  
19       **net salvage from depreciation rates?**

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1 A. Depreciation of the original cost of a facility involves the recovery of  
2 a known cost. Net salvage must be estimated far into the future. With  
3 long-lived assets, these estimates become little more than  
4 “guesstimates” that are likely to bear little relationship to the eventual  
5 costs.

6 For example, one of the larger accounts, Underground  
7 Conduits, has an average service life of 80 years and a net salvage of  
8 negative 40 percent. Therefore, conduits going into service during  
9 this rate plan are expected to be in service, on average, until about  
10 2090. Charging today’s ratepayers based on a forecast of the removal  
11 costs of conduits that far out in the future is impossible to defend.

12

13 **Q. Could you explain your third objection, that the current**  
14 **approach to depreciation requires ratepayers to fund an interest**  
15 **free loan to the Federal and State Treasuries?**

16 A. In NYC IR 13 and IR 43, which I have included in their entirety in  
17 my interrogatory exhibit, I asked Con Edison the tax effect of  
18 charging ratepayers for negative net salvage before that cost is  
19 incurred. As Con Edison acknowledged in its revised response to  
20 NYC IR 43 (b):

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1  
2 Yes, the Company agrees that, compared to  
3 the PAYGO method, the Company's current  
4 method of recovering net salvage results in  
5 a higher income tax liability prior to  
6 retirement of the asset. This is because  
7 the revenue is taxable in the year of  
8 receipt whereas negative net salvage  
9 recovery is not deductible until the costs  
10 are incurred. The Company's proper method  
11 of negative net salvage recovery seeks to  
12 recover a ratable share of the future  
13 retirement costs over the expected life of  
14 the asset while it is in service.  
15

16 **Q. Do you agree that the Company's current method of recovering**  
17 **negative net salvage is "proper?"**

18 A. No. According to the utility responses, the current combined Federal  
19 and State income tax rate is 40.61 percent. This means that for every  
20 dollar of negative net salvage charged to ratepayers under the current  
21 methodology, Con Edison must pay income taxes of 40.61 cents.  
22 Con Edison then accrues these tax payments and adds them to rate  
23 base. Ratepayers provide a return on rate base, and the Treasuries  
24 get the free use of the money. When the negative net salvage is  
25 incurred and the tax deduction is taken, the utility retains that cash  
26 and rate base gets reduced. In effect, the Federal and State Treasuries  
27 are being lent money by Con Edison and ratepayers pay the interest to

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1 the utility at the utility pre-tax rate of return. That loan can be  
2 outstanding for 80 years, or more, if the plant survives beyond the  
3 account average service life or if removal is delayed beyond the  
4 retirement, which is often the case for some utility facilities.

5

6 **Q. In the two past Con Edison cases where you made this type of**  
7 **proposal, your testimony acknowledged that while the PAYGO**  
8 **approach would reduce rates in the short run, a PAYGO**  
9 **approach would generally result in ratepayers paying higher**  
10 **revenue requirements over the long term. Is that still your**  
11 **opinion?**

12

13 **A.** No, recognizing the income tax effects has a dramatic impact on the  
14 economics of the current approach and the PAYGO approach. I have  
15 analyzed a series of scenarios that recognize the income tax effects,  
16 and it is clear that, under a broad range of plausible assumptions, the  
17 current approach to recovering negative net salvage and a PAYGO  
18 approach would produce long term revenue requirements with  
19 roughly the same net present value.

20

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1 **Q. Please continue.**

2 A. I have prepared Exhibit \_\_\_\_ (HA-4), which summarizes some of  
3 these results. The first scenario just looks at a one time investment  
4 of \$100 in plant. The remaining scenarios in Exhibit \_\_\_\_ (HA-4) are  
5 based on annual investment of \$100 that escalates each year at the  
6 indicated growth rate, in the scenarios shown, by either seven or eight  
7 percent per year. For the purposes of the analysis, the plant is  
8 assumed to be retired at its assumed average service life. For these  
9 plant growth scenarios I have shown the Net Present Value of the  
10 Revenue Requirement under a “Steady State”, that is, when plant is  
11 being added and retired each year of the period studied.

12 For this exhibit, the PAYGO calculations assume that negative  
13 net salvage is recovered from ratepayers as it is incurred, which is  
14 what would happen over the long term under my approach.

15

16 **Q. What does Exhibit \_\_\_\_ (HA-4) demonstrate?**

17 A. As can be seen in Exhibit \_\_\_\_ (HA-4), the variation between the  
18 current approach and a PAYGO approach is very small in these  
19 scenarios, especially in the steady state scenarios, where the largest  
20 variation was 0.6 percent. Accordingly, the Exhibit demonstrates

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1 that, when the uncontroverted effects of the tax impacts associated  
2 with the current, pre-funding method of recognizing negative net  
3 salvage are included, there no longer is any reasonable basis for  
4 assuming that the PAYGO approach will cost ratepayers more over  
5 the long term than the current approach.

6

7 **Q. Please explain your fourth objection, that intergenerational**  
8 **equity is not an issue for mass accounts.**

9 A. Intergenerational equity can be an issue where the asset is unique and  
10 has a finite life that will not be replaced in like kind. A good example  
11 is a nuclear power plant. For the reasons stated earlier, I do not agree  
12 that the intergenerational equity argument applies to Con Edison  
13 because most assets are replaced in kind. In addition, the argument  
14 fails because most, if not all of Con Edison's Electric Department  
15 accounts are mass accounts, comprised of many thousands, and  
16 sometimes millions, of retirement units.

17

18 **Q. Why should mass accounts be viewed differently?**

19 A. For mass accounts, where retirement units have varying vintages,  
20 ratepayers in any given year will pay about the same revenue

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1 requirement regardless of whether one uses the current methodology  
2 or a PAYGO approach, because the plant in service in any year  
3 contains assets of varying vintages, some old, some new, and most in-  
4 between. For example, for the steady state scenarios presented in  
5 Exhibit\_\_\_ (HA-4), the minimal variations shown in the net present  
6 value of the requirement are also equal to the variations in the  
7 nominal revenue requirement for each individual year analyzed.  
8 This occurs because these scenarios all assume a constant rate of  
9 retirements and additions, which does not precisely happen in real  
10 life. While real life may differ, for mass accounts, such differences  
11 should not be large over time.

12           These thousands or millions of retirement units, each with its  
13 own vintage and actual service life, are put in service and taken out of  
14 service each year, just as ratepayers come and go. It is hard to see  
15 how a ratepayer taking service for a single year is substantially  
16 advantaged or disadvantaged if a PAYGO methodology is used in  
17 place of the current approach. Thus, intergenerational equity is not a  
18 real issue for mass accounts.

19

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1    **Q.    Please explain your fifth objection, that the current negative net**  
2           **salvage method leaves for a future Commission a rate “time**  
3           **bomb.”**

4    A.    Large negative net salvages associated with recent and planned  
5           capital expenditures have not yet been reflected in depreciation rates  
6           or in the calculation of the adequacy of the depreciation reserve.  
7           This delay in reflecting certain large negative net salvage values has  
8           been approved by the Commission, presumably as a means to reduce  
9           approved revenue requirements.  However, if the current approach is  
10          not modified, and large negative net salvage values continue to be  
11          incurred, at some time in the near future there will be a need to both  
12          substantially increase the depreciation rates and to recover from  
13          ratepayers a very substantial depreciation reserve deficiency,  
14          probably several times larger than the \$670 million currently shown  
15          on Exhibit \_\_\_\_ (CH-1).

16  
17   **Q.    Can you provide an example of this rate time bomb?**

18   A.    Yes.  I have prepared Exhibit \_\_\_\_ (HA-5) which shows the results of  
19          such a calculation.  This exhibit is similar to Exhibit \_\_\_\_ (HA-2) in  
20          that it compares the book basis to a proposed basis that changes the

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1 treatment of negative net salvage. In Exhibit \_\_\_\_ (HA-2) I  
2 eliminated negative net salvage recoveries from depreciation rates  
3 and from the theoretical depreciation reserve. In Exhibit \_\_\_\_ (HA-5),  
4 I reflected negative net salvages in depreciation rates and in the  
5 theoretical depreciation reserve. For each account I used the most  
6 recent five year actual average negative net salvage, as shown in  
7 Company Exhibit \_\_\_\_ (CH-3).

8 As can be seen on Exhibit \_\_\_\_ (HA-5), recognizing these  
9 recent negative net salvages would increase depreciation rates by  
10 almost 75 percent or over \$300 million annually. In addition, the  
11 depreciation reserve deficiency would be over \$3.7 billion.

12 Deficiencies in the depreciation reserve, when large enough,  
13 are generally recovered from ratepayers through a ten or fifteen year  
14 amortization. In this case, assuming a ten year amortization of the  
15 full deficiency, the annual charge would be \$370 million, for a total  
16 annual rate impact of over \$670 million (\$300 million for increased  
17 depreciation and \$370 million for amortization of the depreciation  
18 reserve). Con Edison would also have to pay income taxes on this  
19 full amount, supported by ratepayers, since the amortization and the

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1 higher depreciation expense would be considered taxable income as it  
2 was collected.

3 I am not advocating the use of the most recent five year  
4 average negative net salvage to set depreciation rates. Rather, I am  
5 merely using these readily available numbers as an illustration of  
6 what could happen if negative net salvages continue at recent levels  
7 and the current methodology is not drastically revised.

8

9 **Q. Are you opposed to keeping rates low by not immediately**  
10 **recognizing large negative net salvages in depreciation rates.**

11 A. No, I am not objecting to the recent practice of using negative net  
12 salvages that are below recent actual levels in setting depreciation  
13 rates and measuring the adequacy of the depreciation reserve,  
14 effectively putting this issue off for a future Commission to deal with.  
15 Doing so lowers electric rates without causing any long-term  
16 ratepayer harm. What I do object to is continuation of the current  
17 method of recognizing negative net salvage, which effectively forces  
18 these hard decisions on the Commission.

19 Moreover, freezing depreciation rates is not a long term  
20 solution. Actual negative net salvages get charged to the depreciation

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1 reserve, and if they continue at the current high levels, it would lead  
2 to a rapid growth in the depreciation reserve deficiency.

3 Exhibit \_\_\_\_ (CH-1) provides a prime example of what  
4 happens to the reserve deficiency if the depreciation rates ignore  
5 actual salvage experience. This exhibit shows a reserve deficiency  
6 for Electric Plant to be amortized of \$162.5 million. This amount  
7 represents the reserve deficiency above a 10 percent tolerance band  
8 for the year ending December 31, 2006. Exhibit \_\_\_\_ (CH-1), based  
9 on only one more year of experience, shows an additional deficiency  
10 above the 10 percent tolerance band of \$120 million.

11 If the current negative net salvage method is continued, at  
12 some point not far down the road, whether depreciation rates stay  
13 frozen or not, the utility can be expected to ask the Commission for  
14 an amortization of a deficiency that is measured in the billions.

15

16 **Q. How does the PAYGO method eliminate the rate time bomb?**

17 A. The PAYGO approach removes this looming threat because there is  
18 no need to fund the negative net salvage of plant now in service  
19 through depreciation rates and there is no need for a theoretical  
20 depreciation reserve to have sufficient funds in it to cover negative

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1 net salvages on future retirements decades before these costs are  
2 incurred.

3 As can be seen on Exhibit \_\_\_\_ (HA-2), the PAYGO approach  
4 results in a surplus in the actual depreciation reserve and a reduction  
5 in annual depreciation expense. Once the \$365 million surplus in the  
6 depreciation reserve is used up, the PAYGO approach, with its  
7 starting allowance of \$70 million, will eventually have to increase to  
8 a full current recovery of negative net salvage costs. That increase  
9 might put upward pressure on future revenue requirements, but it  
10 would be nothing like the \$670 million or more increase discussed  
11 above.

12

13 **Q. Do other jurisdictions exclude negative net salvage from**  
14 **depreciation rates?**

15 A. Yes. New Jersey and Pennsylvania, states where Con Edison has  
16 affiliate operations, do not allow negative net salvage in depreciation.  
17 In addition, for Con Edison's Gas Department, gas mains have a  
18 hybrid treatment, with a cap on the negative net salvage in the  
19 depreciation rates and amounts above the cap being expensed.

20

ARNETT

1    **Q.    Is your recommended methodology recognized by the National**  
2           **Association of Regulatory Utility Commissioners?**

3    A.    Yes, in general terms. In its publication entitled Public Utility  
4           Depreciation Practices, NARUC states on page 157:

5                   Some commissions have abandoned the above procedure and  
6                   moved to current-period accounting for gross salvage and/or cost  
7                   of removal. In some jurisdictions gross salvage and cost of  
8                   removal are accounted for as income and expenses, respectively,  
9                   when they are realized. Other jurisdictions consider only gross  
10                  salvage in depreciation rates, with the cost of removal being  
11                  expensed in the year incurred.

12  
13                  The fact that a PAYGO approach is used elsewhere and is  
14                  recognized by NARUC, by itself, does not mean the Commission  
15                  should adopt my recommendation. It only indicates that a PAYGO  
16                  approach is an acceptable practice that does not violate any  
17                  regulatory or accounting standards. The sound rationales for  
18                  switching to a PAYGO method are the five reasons I have provided  
19                  above.

20  
21    **Q.    Will your proposal have a negative impact on Con Edison's**  
22           **financing costs?**

23    A.    The utility, in its reply to City IR-43 (revised), suggests it would,  
24           stating:

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1           In addition to representing the proper  
2           accounting and matching of benefits and  
3           costs, the after-tax cash flow provided by  
4           the accrual of removal costs are used to  
5           fund our construction expenditures and  
6           reduce rate base to the advantage of the  
7           customer. Without this accounting, our  
8           financing cost would be much higher. In  
9           addition to lowering the financing costs,  
10          this improves our cash flow and helps  
11          maintain our bond rating.

12

13

14   **Q.    Do you agree with the utility position?**

15

16   **A.**    No. My adjustment would impact short term annual cash flows by a  
17          trivial amount. The net short term impact should be around \$50  
18          million, once it is recognized that over 40% percent of the proposed  
19          \$70 million adjustment is offset by avoided income taxes. This drop  
20          in cash flow is dwarfed by the one billion plus dollar increase in  
21          annual capital spending that has taken place over the last five years.  
22          Given this, I cannot accept that my proposal would make the utility  
23          financing costs “much higher” than would otherwise be the case.

24

25                As for longer term financing impacts, the status quo presents  
26                more of a risk -- the financial community would have to be concerned  
27                that the Commission will not allow the type of future increases in  
28                rates that the status quo will inevitably produce.

28

ARNETT

1 **Productivity**

2 **Q. What productivity is reflected in the utility's rate filing?**

3 A. The utility has built into its forecasts for the three year rate plan the  
4 Commission's traditional general productivity adjustment of one  
5 percent of Company labor charged to O&M for each of the three  
6 years. This equates to a reduction in the requested revenue  
7 requirements of \$10.6 million for RY 1.

8 It should be noted that while the one percent is measured  
9 against Company labor, it is expected to encompass all sources of  
10 productivity.

11

12 **Q. Could you explain the purpose of this general productivity  
13 adjustment?**

14 A. Yes. The Commission has relied on a forecast rate year since at least  
15 the mid-1970's. The utility must link its cost projections for this  
16 forecast rate year to an historic actual year, the test year. The utility  
17 must show escalation by cost area as well as any positive or negative  
18 program changes to link the test year to the forecasted rate year.  
19 Identifiable and quantifiable productivity gains are supposed to be  
20 recognized as program changes.

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1           As this forecast rate year policy was being implemented, an  
2           issue arose over non-identifiable, non-quantifiable productivity that  
3           could be achieved from the test year through the rate year. The test  
4           year theoretically reflects any non-identifiable, non-quantifiable level  
5           of productivity achieved up until that time, but the link period and the  
6           rate year do not. To close this gap, the Commission chose to use an  
7           annual productivity rate of one percent of Company labor charged to  
8           O&M soon after it adopted forecast rate years.

9           In this case, and in many others, the period between the Test  
10          Year and the Rate Year is 27 months. Here the Test Year is the  
11          calendar year ending December 31, 2007 and the Rate Year is the 12  
12          months ending March 31, 2010.

13

14   **Q. Do any of Con Edison program changes include expense**  
15   **reductions due to identifiable and quantifiable productivity**  
16   **gains?**

17   A. Not to my knowledge.

18

19   **Q. Do you believe that the general productivity adjustment reflected**  
20   **in the rate plan is adequate?**

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1 A. No. The one percent productivity adjustment does not reflect the  
2 technology, operational and labor savings that should be embodied in  
3 the unprecedented levels of new Capital Projects and O&M Programs  
4 that the utility has undertaken over the past few years and is  
5 proposing to continue and expand for the new rate plan. Con  
6 Edison's actual and projected Transmission and Distribution capital  
7 spending (in millions) are as follows:

8	2000	\$ 478
9	2001	\$ 536
10	2002	\$ 581
11	2003	\$ 654
12	2004	\$ 755
13	2005	\$1,008
14	2006	\$1,288
15	2007	\$1,457
16	2008	\$1,658
17	2009	\$1,767

18

19 **Q. Have you reviewed these Capital Projects and O&M Programs**  
20 **for their potential to increase productivity?**

21 A. Yes, I have reviewed the Company's Infrastructure Investment Panel  
22 (IIP) exhibits, and based on this review I have identified those  
23 projects where the IIP exhibits state in plain language that the project  
24 is partly or fully justified by productivity and efficiency gains it will

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1 produce. My detailed review covered only programs and projects  
2 presented by Con Edison's IIP witnesses, but I believe that other  
3 Company witnesses have proposed projects and programs that also  
4 will enable the utility to achieve higher levels of productivity.

5

6 **Q. Have you prepared an exhibit showing the results of your review**  
7 **of the potential for productivity gains for Capital Projects and**  
8 **O&M Programs sponsored by the IIP?**

9 A. Yes, I have prepared Exhibit \_\_\_\_ (HA-6). This exhibit presents the  
10 IIP Capital Projects for the calendar year 2009 and O&M Programs  
11 for the Rate Year in the same major groupings as the utility presented  
12 them. My exhibit has a summary schedule, and then a schedule that  
13 corresponds to each of the seven IIP Exhibits \_\_\_\_ (IIP 2-7 and 9)  
14 listing each project or program.

15

16 **Q. Please continue.**

17 A. Exhibit \_\_\_\_ (HA-6) first indicates whether the project or program  
18 presents a productivity opportunity for the utility. That determination  
19 was based solely on the plain language of the IIP "White Paper"  
20 exhibits, Exhibits \_\_\_\_ (IIP 10-25). Those IIP exhibits describe the

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1 cost, the schedule, the work being done and the justification for each  
2 project or program. If a project or program was identified by the IIP  
3 as only avoiding costs that are not yet being incurred, I did not  
4 identify it as a productivity opportunity.

5 The last column of Exhibit \_\_\_\_ (HA-6) provides one of four  
6 generic comments I used to summarize the type of productivity  
7 opportunities for each project or program, as identified by the IIP. I  
8 have further described each of these generic comments below. I also  
9 provide an example for each generic comment. In an attempt to be  
10 random, I used as examples the project or program where that generic  
11 comment first appears. For these four examples, I replicated the full  
12 justification section from the corresponding IIP exhibit that led to my  
13 conclusion that the project or program should improve productivity.

14 **Reduced failures and maintenance – The project or**  
15 **program would reduce the amount of failures in the**  
16 **system, reducing emergency repair costs, and would**  
17 **reduce maintenance from current levels.**

18  
19 Example – Elmsford Substation Refurbishment  
20 Exhibit \_\_\_\_ (IIP-3) Page 3

21  
22 Justification from the IIP exhibit:

23  
24 The Elmsford substation located in Westchester County is  
25 over 49 years old and nearing the end of its useful life. The  
26 existing substation consists of transformers sections of

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1 switchgear and 3-20 MVAR capacitor banks. The switchgear  
2 utilizes obsolete circuit breakers. The equipment enclosures  
3 have deteriorated resulting in leaks and equipment outages  
4 due to water damage. The equipment supporting structures are  
5 corroding and switchgear components have also been  
6 susceptible to water damage. As the structural components  
7 age manual operation of the old heavy circuit breakers has  
8 become increasingly difficult and requires more time and  
9 resources. This project will vastly improve the feeder  
10 processing durations of the Elmsford electric distribution  
11 system.

12

13 **Reduced maintenance – The project or program would**  
14 **reduce current costs of maintaining equipment.**

15

16 Example – High Voltage Test Sets  
17 Exhibit \_\_\_\_ (IIP-13) Page 45

18

19 Justification from the IIP exhibit:

20

21 DC High Pot Test Sets

22 A minimum of two feeder processing DC test sets per  
23 distribution station are required to process feeders These test  
24 sets will be used to perform on-site testing and diagnostics of  
25 medium voltage feeder cables primarily for 13, 27, and 33 kV  
26 feeders and for locating network ground faults outside of the  
27 station. Various test sets are over 20 years old and require  
28 constant repair. The replacement program will systematically  
29 replace existing test sets based on age corrective maintenance  
30 and availability of parts. The worst performing test sets will  
31 be slated for replacement first.

32

33 A/C VLF Test Sets Mobile Fixed Location

34 These test sets will be used to perform on-site testing and  
35 diagnostics of medium voltage feeder cables primarily for 4,  
36 13, 27, and 33 kV feeders. This program is to support  
37 conducting A/C hipot testing on EPR and Poly cable. The test  
38 sets are required to meet our feeder processing objectives and  
39 recommendations to conduct more VLF A/C hi-pot tests.

40

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1 A/C Test Sets 345 kV  
2 The W49th St test set is no longer supported by the  
3 manufacturer and is approximately 30 years old Dunwoodie  
4 Substation no longer has an A/C test set. It is no longer  
5 functioning and has reached the end of its useful life and  
6 cannot be repaired. These sets are used to perform  
7 conditioning and proof tests of equipment after overhauls and  
8 repairs and are no longer reliable. Replacement of these units  
9 will eliminate the need to rent units when required which is  
10 not preferred due to cost and vendor availability constraints.  
11 The transmission test sets are required to maintain the  
12 reliability of station equipment and to ensure equipment is  
13 tested prior to restoring to service.  
14

15 **Improved operational response – the project or program**  
16 **would provide the operators with opportunities to better**  
17 **utilize its resources to respond to system events.**  
18

19 Example – Rapid Restore-Expansion of TOMS  
20 Exhibit \_\_\_ (IIP-13) Page 48  
21

22 Justification from the IIP exhibit:  
23

24 Implementation of Rapid Restore improves productivity and  
25 feeder processing time. Previously, a number of phone calls  
26 between the Substation Operator and the District Operator DO  
27 were necessary in order to issue and verify moves clarify  
28 feeder numbers and locations and to understand the Operating  
29 Order objectives. Rapid Restore, however, eliminates the need  
30 for many of the phone calls by providing an electronic means  
31 of downloading Operating Orders and Work Permits to the  
32 Substation Operators Substation Operators can view all the  
33 details of the orders or permits on line and elect to accept  
34 them if they are accurate or reject them if there is any  
35 inaccuracy or miscommunication. Rapid Restore TOMS  
36 minimizes the number of phone calls, thereby improving  
37 productivity, feeder processing time, and reducing error  
38

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1                   **More efficient operation – The project or program would**  
2                   **provide for more efficient utilization of resources outside**  
3                   **of system events.**

4  
5                                   Example – USS Automation  
6                                   Exhibit \_\_\_\_ (IIP-15) Page 28

7  
8                   Justification from the IIP exhibit:

9  
10                   The work is required in order to remotely operate circuit  
11                   breakers at the 4kV Unit Substations from the regional control  
12                   centers. This can be done as soon as system conditions allow  
13                   it to and without the need for station operator allowing  
14                   Customers to be restored more quickly. In order for all 240  
15                   unit substations to be controlled and monitored from the  
16                   regional control center this work must be completed.

17  
18                   Exhibit \_\_\_\_ (HA-6) also addresses all IIP O&M Programs in  
19                   the same way except these O&M costs were sorted by spending in  
20                   Rate Year 1, which is how the costs were reported by the utility.

21   **Q.    What does Exhibit \_\_\_\_ (HA-6) demonstrate?**

22    A.    Exhibit \_\_\_\_ (HA-6), Schedules 1-5, demonstrates that, according to  
23           the IIP, capital projects of over \$500 million (out of a total projected  
24           spending of almost \$1.8 billion for 2009) will provide the utility with  
25           the opportunity to achieve productivity savings. Further, Exhibit \_\_\_\_  
26           (HA-6), Schedules 6-8, identifies IIP-sponsored O&M programs that  
27           also provide an opportunity to achieve productivity savings of over

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1           \$100 million out of projected spending of \$145 million for the Rate  
2           Year.

3

4   **Q.   Isn't it correct that not all of the 2009 capital investments will be**  
5   **for plant that will be in service by the end of the Rate Year?**

6   A.   Yes. Such projects will not be able to contribute to productivity  
7       during the Rate Year. However, there were similar projects in the  
8       past that should be going into service between the beginning of the  
9       Test Year and the end of the Rate Year, and those projects will  
10      provide the utility with an opportunity to achieve productivity savings  
11      during the Link Period.

12                 I note that in the prior electric proceeding I sponsored a  
13      similar analysis of the Capital Projects and O&M Programs. Many of  
14      the projects identified there now are impacting the Link Period and  
15      the Rate Year. My analysis of productivity savings in the last electric  
16      case showed IIP-sponsored capital projects of over \$200 million and  
17      IIP-sponsored O&M programs of about \$57 million per year. The  
18      greater estimated savings in this proceeding reflects that fact that, by  
19      relying on the IIP's testimony and exhibits, I have broadened the

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1 criteria I used to determine if a project or program presents an  
2 opportunity to improve productivity.

3

4 **Q. Can you explain how you have broadened the criteria?**

5 A. In the prior case, my analysis focused on projects or programs that  
6 enabled the utility to make better use of its manpower resources. In  
7 this case, I am relying more on the plain productivity assertions  
8 presented by the Company IIP witnesses and their White Papers.  
9 Moreover, I have increased the productivity review to encompass  
10 projects or programs that reduce costs other than just manpower  
11 costs. For example, in the last proceeding a project or program that  
12 replaced obsolete, hard to repair equipment, might not have been  
13 listed as a productivity opportunity, but in this case I have listed it,  
14 consistent with the IIP Testimony.

15

16 **Q. Why is the productivity adjustment important?**

17 A. The utility is spending hundreds of millions of dollars annually on its  
18 system to improve its operations and reduce costs. Because  
19 ratepayers are being asked to pay the costs, it is imperative that  
20 productivity savings are accurately reflected in establishing the

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1 revenue requirement so that they equitably share in the expected  
2 benefits.

3

4 **Q. What is your recommendation on productivity?**

5 A. According to the Company's own testimony, past and planned  
6 investments by Con Edison will provide unprecedented opportunities  
7 for Con Edison to reduce costs. The standard productivity reflected  
8 in the Company's filing does not fairly reflect the large step up in  
9 spending in recent years. Accordingly, I am recommending that the  
10 productivity adjustment be increased from one to three percent of  
11 Company labor per year, an additional adjustment of \$21.2 million  
12 for the Rate Year, based on Exhibit \_\_\_\_ (AP-5, Schedule 1, Page 3).

13 It should be pointed out that my adjustment is rather  
14 conservative. With my adjustment, productivity gains of less than  
15 \$32 million (the as-filed one percent plus my adjustment) would be  
16 recognized over a full 27 month period. In comparison, the cost of  
17 the projects and programs with productivity potential as shown on  
18 Exhibit \_\_\_\_ (HA-6) are all for a single twelve month period.  
19 Because projects and programs of a similar nature and cost level  
20 appear to exist in the other 15 months, the utility is actually spending

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1 more like \$1.125 billion on capital projects and \$225 million in  
2 O&M programs that have the potential to increase productivity over  
3 the 27 month period. I recognize that not all of the spending is  
4 solely for productivity. Nevertheless, looking at the total amount of  
5 productivity that I would impute into rates (i.e., including my  
6 adjustment), the payback period (spending divided by productivity  
7 savings) is a very unimpressive 42 years.

8 Finally, it is worth noting again that I have looked only at IIP  
9 sponsored projects and programs. It is likely that many non-IIP  
10 sponsored projects and programs also would have the potential to  
11 improve productivity. Thus, my adjustment is undoubtedly very  
12 conservative.

13

14 **Q. Isn't it correct that the utility has hired many new employees in**  
15 **the recent years and it is unreasonable to expect that these new**  
16 **employees would be more productive than those who are being**  
17 **replaced?**

18 **A.** I cannot accept that argument for several reasons. First, reductions in  
19 labor costs are only one area where productivity can be achieved.

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1                   Second, it is correct that the utility has hired and expects to  
2                   continue to hire more employees. For example, a New York Times  
3                   article dated July 3, 2008 stated that “Con Edison has hired more  
4                   than 1,200 people in each of the past three years, and its total work  
5                   force has grown by 11 percent since 2003, to around 14,000.”  
6                   ([http://www.nytimes.com/2008/07/03/nyregion/03coned.html?scp=1](http://www.nytimes.com/2008/07/03/nyregion/03coned.html?scp=1&sq=mikсад&st=csecite)  
7                   1&sq=mikсад&st=csecite). That same article also quotes utility  
8                   officials as saying the company “received 68,000 applications for  
9                   1,300 spots last year.”

10                   The utility has extensive training programs and is able to  
11                   choose its new hires from many candidates. I have no reason to  
12                   believe that a well trained new hire would not be as productive as the  
13                   employee preparing for retirement who is being replaced.

14

15   **Q. Did you propose a similar adjustment in the last proceeding?**

16   A. Yes. The Commission adopted the recommendation of the ALJs in  
17   that case. The RD had concluded that (RD at 62):

18                   We find that a sufficient amount of productivity has been  
19                   assumed and quantified for the upcoming rate year and it is not  
20                   necessary to factor any greater amounts of productivity in the  
21                   calculations used in this case as has been suggested by the NYC  
22                   Government Customers. The best estimate of the Company’s  
23                   operating and capital expenditures have been developed in this

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1 case are they are being used for the upcoming twelve-month  
2 period.  
3  
4 Nonetheless, we agree with the NYC Government Customers  
5 that the scale and scope of the Company’s efforts should provide  
6 new and greater opportunities to produce operating efficiencies  
7 and such improvements should become apparent as the programs  
8 are implemented. In our opinion, the objective that the NYC  
9 Government Customers seek can best be achieved by examining  
10 Con Edison’s operations in succeeding years when it files again  
11 to increase rates. At that time, the results that the NYC  
12 Government Customers are looking for should have materialized  
13 and they should be demonstrated in the costs that Con Edison  
14 submits when it seeks to increase its rates by as much as \$335  
15 million in 2009-10 and by \$390 million in 2010-11.  
16

17 **Q. Please comment on the relevance of the RD here.**

18 A. As I stated earlier, there is no productivity built into the Link Period  
19 or the Rate Year other than the general productivity adjustment of  
20 one percent. The Test Year is adjusted for normalization,  
21 escalations, specific program changes that increase costs, and the one  
22 percent general productivity level. Whatever productivity gains that  
23 have been achieved have “materialized” but only during the Test  
24 Year. Con Edison has not made any quantitative representation of  
25 the productivity it actually achieved in the Test Year, or expects to  
26 achieve in the Link Period, or the Rate Year.

27 Productivity gains for specific programs are meant to be  
28 incremental to the one or three percent general productivity

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1 adjustment, which has always been meant to cover non-identifiable,  
2 non-quantifiable productivity, The inclusion of a limited number of  
3 identified productivity gains due to specific programs would thus not  
4 impact the validity of a one or a three percent productivity gain. In  
5 any event, in its rate request, Con Edison did not identify any specific  
6 program changes with quantifiable productivity gains through the  
7 Rate Year.

8  
9 **Q. Do you have any other comments on Productivity?**

10 A. In the last rate case, the IBEW Union's position that the current  
11 approach to calculate the Productivity Adjustment based on  
12 Company labor charged to O&M gives the utility an unneeded  
13 incentive to rely on outside contractors. As I said earlier, the general  
14 productivity adjustment was never meant to cover productivity gains  
15 solely through reductions in Company labor. Rather, it is meant to  
16 include gains in all cost elements. However, if it so desired, the  
17 Commission could abandon this practice and utilize another factor  
18 for the calculation, such as O&M less Fuel and Purchased Power or  
19 total Company and Contracted labor. Such a change would require a  
20 careful recalibration of the adjustment factor. For example, in this

1 case, the annual one percent of Company labor charged to O&M is  
2 equal to 0.32 percent annually of O&M less Fuel and Purchased  
3 Power, or 0.72 percent for the 27 month Link Period and Rate Year.

4 **Capital Projects and O&M Programs**

5 **Q. Are you proposing any specific adjustment to Capital Projects or**  
6 **O&M Programs?**

7 A. Yes, the Commission should consider setting rates that cover no more  
8 than 92 percent of the Rate Year costs of IIP-sponsored Capital  
9 Projects and O&M Programs. I am making this recommendation to  
10 balance the need for safe and adequate service and the need for just  
11 and reasonable rates. My estimate of the revenue requirement  
12 impact of this adjustment is about \$25 million, comprised of an  
13 estimate of \$14 million related to Capital Projects and \$11 million  
14 related to O&M Programs.

15

16 **Q. Please continue.**

17 A. I had recommended in the prior Con Edison electric and steam rate  
18 proceedings that the Commission consider placing a rate cap on Con  
19 Edison's Capital Projects and O&M Programs, but had not proposed  
20 a level. In this case, I am proposing that the same eight percent

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1 adjustment that the Commission applied in the prior electric rate case  
2 to Capital Projects be applied to Capital Projects and O&M Programs  
3 in this proceeding. The Commission Order at page 91 stated:

4 ...The basis for the adjustment adopted here is not simply one  
5 of slippage but rather a reasonable restriction on overall  
6 spending, in order to mitigate rate increases, without undue  
7 disruption of the Company's construction schedule. The  
8 purpose of the adjustment is to reflect a realistic overall  
9 funding level, not to discourage the Company from  
10 undertaking any particular project. The recommendation of a  
11 capital budget of \$1.65 billion, and a \$62 million adjustment  
12 to the Company's Plant in Service, is adopted.

13  
14 The allowance for capital spending authorized here is made in  
15 the context of serious concerns regarding the pace of growth  
16 of the Company's capital program. The abrupt acceleration of  
17 spending raises questions regarding the Company's planning  
18 and implementation of capital programs, the potential  
19 inefficiencies of highly compressed construction schedules,  
20 and the level of oversight and leadership provided by the  
21 Company's Board.

22  
23 I agree with the Commission's conclusion in the last electric  
24 rate case. The Commission also adopted my recommendation to  
25 perform an audit of Con Edison's budget process, to answer the  
26 questions raised in the above quote. But that audit is not going to be  
27 available for use in this case. As a result, I am left with the same low  
28 level of confidence in Con Edison's budget process that I had during  
29 the last proceeding.

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1

2 **Q. Why don't you have confidence in Con Edison's budget process?**

3 A. It has long been recognized that a utility has an incentive to invest in  
4 plant because it is a way to grow the utility's earnings, assuming the  
5 PSC allows what the utility views as a reasonable return. Traditional  
6 regulation relied on regulatory lag to provide the utility a counter-  
7 incentive to control capital spending to offset this incentive.

8 However, that counter-incentive is nonexistent when a forecast rate  
9 year is used with a full true-up (as in the rate plan from Case 04-E-  
10 0572) or almost as inconsequential when the true-up only works for  
11 under spending (as in the current Rate Year).

12 Moreover, investing as much as possible in utility  
13 infrastructure and in O&M may be one way to protect stockholders  
14 against lawsuits or Commission determinations of imprudence,  
15 regardless of whether those investments are cost effective for the  
16 customers who have to fund them.

17 The recent increase in spending may be the result of Con  
18 Edison responding, and not necessarily unreasonably from its own  
19 viewpoint, to these incentives. In any event, in the last rate case the  
20 Commission raised serious concerns about the Company's budgeting

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1 process and I have no basis for concluding that these concerns have  
2 been rectified.

3

4 **Q. Isn't safe and adequate service vital to Con Edison's customers?**

5 A. Yes, especially in a densely populated area that is highly dependent  
6 on its electric infrastructure. But there are many other critical  
7 services provided by government, such as police, fire, schools, mass  
8 transit, roads and highways, garbage collection, water supply,  
9 national defense and so on. These governmental services are funded  
10 directly through tax dollars or through usage charges (for example,  
11 subway fares and tolls).

12 However, even for critical services there has to be an analysis  
13 of how to provide those services in the most cost-effective way.  
14 There is a point at which the incremental cost of providing a service  
15 is greater than the incremental benefit of receiving it. For example,  
16 just as it would not be rational for there to be a firehouse at every  
17 corner, there should not be a utility worker stationed at every  
18 manhole. In the case of a government entity, the government must  
19 select the funding levels and the actual programs, in effect balancing

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1 safe and reliable service with the just and reasonable rates for each of  
2 these public services.

3 New York State, New York City and various governmental  
4 bodies (including the PSC) are being asked to cut costs as hard  
5 financial times are having a broad impact. These cuts will result in  
6 reduced services to the public, but these government bodies are  
7 making the hard choices that balance the value of these services with  
8 their costs. Con Edison, as a utility relying on the public to fund its  
9 operations, should not be immune from this process.

10

11 **Q. Have you prepared an exhibit showing how your**  
12 **recommendation could be implemented?**

13 A. I have prepared Exhibit \_\_\_\_ (HA-7), which is based on the priorities  
14 provided by the utility in response to DPS IR 50. This exhibit  
15 contains the same IIP sponsored Capital Projects and O&M Programs  
16 as Exhibit \_\_\_\_ (HA-6), except I have sorted them by the priorities  
17 provided in the utility response to DPS IR 50. Like the earlier  
18 exhibit, Exhibit \_\_\_\_ (HA-7) has a summary schedule, and then a  
19 schedule that corresponds to each of the seven IPP exhibits, Exhibits  
20 \_\_\_\_ (IIP 2-7 and 9) listing each project or program. One exception is

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1 that for this exhibit the programs listed on Exhibits \_\_\_\_ (IIP-4) and  
2 \_\_\_\_ (IIP-9) have been combined as they were in the utility's IR  
3 response.

4 The summary schedule shows the revenue requirement impact  
5 of a 15, 10, 8 and 5 percent reduction in the IIP sponsored 2009  
6 Capital Projects and the Rate Year O&M Programs. The revenue  
7 requirement impact of the 2009 Capital Projects assumes only 50  
8 percent of the amount impacts rate base for the Rate Year that starts  
9 three months later, and that the carrying charge, including pre tax rate  
10 of return, depreciation and property and other taxes, are 20 percent.  
11 These are rough estimates, so the Revenue Requirement impact is just  
12 a ballpark value.

13 The individual schedules show where these cut off points fall  
14 for the groupings shown.

15

16 **Q. Do you anticipate that the utility, if your recommendation was**  
17 **accepted, would eliminate the projects and programs that fall**  
18 **below these cut off points?**

19 A. Not at all. For one thing, the priority listing is by grouping, rather  
20 than covering all IIP sponsored Projects and Programs. I expect that

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1           some of these groupings are far higher in overall priority than other  
2           groupings.

3                       Second, I have not examined non-IIP sponsored programs and  
4           projects, and these may also be reduced if they have a lower priority  
5           than the IIP projects.

6                       Further, utility priorities are not frozen in time, so that the list  
7           provided in response to the IR should not be considered cast in  
8           concrete.

9                       More importantly, I do not doubt that some projects and  
10          programs would be eliminated or deferred, but it is more likely that  
11          projects and programs would be scaled back. The utility's priority  
12          system treats each project or program as an all or nothing proposition,  
13          when in fact many of them can be pursued with less than the original  
14          scope.

15

16   **Q.    Is the eight percent reduction a floor?**

17    A.    No. Because of my concerns regarding the budgeting process, I  
18          simply have used the number the Commission used in the last rate  
19          case. However, if DPS Staff of another party is able to demonstrate

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1           that the budgets are overstated by more than eight percent, then the  
2           Commission should consider a greater reduction in the budgets.

3

4   **Q.   The Commission applied the eight percent reduction only to**  
5   **Capital Projects, why are you recommending that the eight**  
6   **percent reduction be applied as well to incremental O&M**  
7   **Programs?**

8   A.   It will be the utility that decides how the money is spent and whether  
9       it is spent on Capital or O&M. My main concern is in mitigating the  
10      rate increase through a reduction in controllable costs.

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1 **Summary of Rate Impacts**

2 **Q. Could you summarize the revenue requirement**  
3 **recommendations?**

4 A. Yes, the NYC Governmental Customers are supporting the following  
5 adjustments for the Rate Year:

6	Depreciation	\$ 70.0 million
7	Productivity	\$ 21.2 million
8	Capital and O&M	\$ 25.0 million
9	<b>Total</b>	<b>\$126.2 million</b>

10 These adjustments do not reflect the full impact of my  
11 recommendations on items such as rate base, income taxes, revenues  
12 taxes, etc. I would rely on DPS Staff to provide a more accurate  
13 assessment of the Rate Year impacts of my proposals.

14  
15 **Q. Do you have an exhibit which contains the interrogatories**  
16 **responses you wish to offer as evidence?**

17 A. Yes, I have prepared Exhibit \_\_\_\_ (HA-8) for this purpose.

18  
19 **Q. Does this conclude your direct testimony?**

20 A. Yes .