BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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In the Matter of

Consolidated Edison Company of New York

Case 08-E-0539

September 2008

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Prepared Testimony of:
Staff Finance Panel

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

A. Our names are Kristine A. Prylo 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. Ms. Prylo, what is your position at the Department?

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

Q. Please describe your educational background and professional experience.

A. I graduated from Siena College in 1999 and received a Bachelor of Science degree in Finance. From August 1999 to May 2006 I worked in various positions at The Ayco Company, L.P., a Goldman Sachs company. My duties included monitoring various aspects of individual equity and fixed income portfolios, reviewing laddered high net worth municipal bond portfolios for additional yield opportunities, preparing income tax returns, advising clients on various tax,

estate planning and asset allocation issues and providing multiple cash flow scenarios for determining appropriate long-term financial plans. In May 2006, I joined Robert Half International, a financial recruiting firm. At Robert Half International, I was responsible for interviewing and placing potential candidates in accounting and finance positions at local companies. I joined the Department in January 2008.

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. Is this your first time testifying in front of the New York State Public Service Commission (Commission)?

A. Yes.

Q. Mr. Henry, what is your position at the Department?
A. I am employed by the Department as a Principal Utility Financial Analyst in the Office of Accounting and Finance.
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 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 and Finance?
A. My primary areas of responsibility include analyzing and making recommendations to the 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, steam and water rate cases before the Commission since 1988, most recently in Case 07-S-1315, Consolidated Edison Company of New York, Inc. - Steam 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 will be used by the Accounting Panel to determine the revenue requirement for Consolidated Edison Company of New York, Inc.'s (Con Edison or the Company) electric operations for the rate year ending March 31, 2010. We will also respond to the testimony of Company witnesses Morin, Hoglund and Cannell.

Q. Please describe the exhibits that you are

sponsoring in this proceeding.

A. We are sponsoring seventeen exhibits, identified as Exhibit___(FP-1) through Exhibit___(FP-17).

**SUMMARY**

Q. Please summarize your testimony.

A. We recommend an overall rate of return of 7.57%, as opposed to the Company's request of 7.86%. The primary difference is due to our 9.5% return on equity (ROE) recommendation versus the Company's requested ROE authorization of 10.0%. We also recommend a lower common equity ratio, 47.96% versus 48.51%.

With respect to the appropriate capital structure, we advocate an approach that seeks to achieve the optimal cost of capital and also assures ratepayers will not subsidize Con Edison's parent's riskier non-regulated investments. Additionally, our ROE recommendation is determined using two different equity costing methodologies, each weighted as the Commission approved in its most recent ROE determinations in Case 06-E-1433, Orange and Rockland Utilities - Electric Rates and Case 07-

E-0523, Con Edison - Electric Rates. We also explain why our recommended rate of return will assure the Company continued access to reasonably priced capital.

**FAIR RATE OF RETURN DISCUSSION**

Q. Earlier you mentioned that the fair rate of return you recommend will be used to establish the Company's revenue requirement. Please explain what you mean by revenue requirement.

A. In the context of regulated rate-setting, the revenue requirement is the dollar amount required by the Company to provide service during the rate year. It is the amount that will allow it to recover all of its reasonably expected operating costs, including income taxes and depreciation. The revenue requirement also includes a fair return in dollars that will enable the Company to recover the cost of the funds supplied to it by its investors. The funds provided by these investors, of course, are needed in order for the Company to finance its long-term assets, which in the rate-setting context are referred to as its rate base.

Q. Generally speaking, 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 at the same time 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 as well as preferred stock instruments 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 costs of debt and preferred stock, while providing its common equity investors the opportunity to earn a return that is 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. Typically, there are four sources of capital. The two primary sources are long-term debt and common equity. Preferred stock is also commonly used, although generally in much smaller proportions than either long-term debt or common equity. Finally, customer deposits, while a very small component, are almost always reflected in the expected capitalization because they are a relatively permanent and stable source of capital employed by utilities.

Since New York State utilizes a fully forecast rate year, it is also important that the rate year capitalization reflect the utility's projected capital requirements and be consistent with the goal of achieving the optimal cost of capital, particularly regarding the use of leverage.

Turning to the cost rates of the individual

components, the cost of the long-term debt and preferred stock components are relatively easy to compute. This is because the vast majority of the long-term debt and preferred stock instruments projected in the average rate year capitalization have already been issued. Thus, the actual or embedded costs of each can be readily ascertained by examining their contractual terms; i.e., the interest payments for the long-term debt and the preferred dividends for the preferred stock. The costs of any new long-term debt or preferred stock instruments, however, require estimates using relevant market data. The cost rate for customer deposits is simply a matter of applying the cost rate that is currently 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 Commission allowed and far above the returns most state regulatory Commissions allowed.

The expected return requirements of a utility's common equity investors can only be gleaned through a cost of equity analysis. Generally, market-based 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 7.57%, compared to the Company's request of 7.86%. Our proposed pro forma cost of capital can be seen in Exhibit__(FP-1).

Q. What is Con Edison's projected rate year capital structure for its electric operations?

A. In Exhibit AP-12, Schedule 1, the Company's Accounting Panel forecast a long-term debt ratio of 49.14%, a preferred stock ratio of 1.09%, a customer deposits ratio of 1.25% and a common equity ratio of 48.51% in its July 25, 2008 Preliminary Update.

Q. How did the Company develop this capitalization?

A. The rate year capitalization was developed based upon an approach that began with Con Edison's latest-known "stand-alone" capital structure, in this case its June 30, 2008 capitalization. This "stand-alone" capitalization was then projected for the rate year based upon its forecasted funding requirements for both the nine month link period ending March 31, 2009, and for the

rate year ending March 31, 2010.

The forecasted long-term debt component reflects total new debt issuances of $1.980 billion as well as the retirement of $575 million of maturing debt obligations between July 1, 2008 and March 31, 2010.

Since the Company is not planning on issuing any new preferred stock, and has no plans to redeem any of its outstanding preferred stock, its rate year balance is the same as the amount reported outstanding on June 30, 2008. Con Edison's rate year balance of customer deposits was based upon historical levels, which it forecast to grow by about 0.2% a month.

The Company's projection of the common equity component is largely premised upon its assumptions regarding the level of 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. Please explain why you refer to Con Edison's

capitalization as a "stand-alone" capital structure.

A. By federal law, a corporation is considered a utility holding company if it owns 10% or more of the stock of an electric or gas utility. Today, nearly all of the so-called electric utilities, as well as gas utilities and combination utilities (electric and gas), are owned by holding companies. Con Edison, a combination electric, gas and steam utility is wholly-owned by its holding company parent CEI. CEI also owns 100% of the common stock of another New York combination utility, Orange and Rockland Utilities, Inc. (Orange and Rockland), as well as three non-utility subsidiaries.

The Securities Act of 1933 (Act) requires that investors receive financial and other significant information concerning securities being offered for public sale. The Act was promulgated to prohibit deceit, misrepresentations, and other fraud in the sale of securities. In general, securities sold in the United States must be registered with the

Securities and Exchange Commission (SEC). Unless they are privately-held, utility holding companies must register with the SEC in order to issue to the public common stock as well as any long-term debt or preferred stock. Many large utility operating companies such as Con Edison are also registered, but only for the purposes of issuing long-term debt or preferred stock.

Because both Con Edison and CEI are registered with the SEC, both companies provide financial information to investors in various reports to the SEC. Orange and Rockland, however, is no longer registered with the SEC; its financial results can only be viewed through the consolidated financial statements of CEI, as it is the typical practice of utility holding companies to report the stand-alone capital structures of their major subsidiaries.

CEI reports its consolidated financial position in its annual 10-K and quarterly 10-Q reports to the SEC; it also presents the stand-alone financial statements for its two wholly-owned utility subsidiaries, Con Edison and

Orange and Rockland. It is the stand-alone capital structure of Con Edison presented in these financial statements that the Company proposes for the purpose of determining its overall rate of return.

Q. Generally speaking, do you believe it is appropriate to use the reported stand-alone capital structures of utilities that are subsidiaries of larger holding companies?

A. While there may be particular circumstances in which such an approach is warranted, the use of a stand-alone capitalization should only be employed after a careful analysis of the holding company's financing practices. The primary purpose of this analysis is to ascertain whether the stand-alone capital structures of the utility subsidiaries reflect rational capitalization policies and that their common equity components reflect actual common equity at the parent level. This analysis should also examine the presence or absence of regulatory insulation for the utility subsidiaries (such as ring-fencing protections) as well as the overall

ability of the parent to move common equity from subsidiary to subsidiary, as this capability too has the potential to undermine the veracity of a stand-alone capitalization.

Q. Please explain some of the reasons why a stand-alone capital structure may not be reasonable.

A. First, 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. Some of the utility's common equity balance may actually 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.

The use of a stand-alone subsidiary structure is also 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.

Generally speaking, it is simply 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 holding 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's 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. Despite the fact that CEI's non-utility businesses face much greater business risk than its regulated utility operations, the non-utility investments over the past 21 months have generally only been funded with anywhere from 34% to just over 50% common equity. At the same time the relatively stable and much less risky utility operations have been financed with roughly 49% common equity.

Q. Why do you say "generally?"

A. As of December 31, 2007, CEI's non-utility businesses were funded with 51.9% common equity. However, due to the recent sale of various competitive generation projects owned by one of the parent's competitive energy subsidiaries, CEI's non-utility businesses were able to record a substantial gain and ended the June 30, 2008 quarter capitalized with about 76% common

equity.

Q. Does the parent intend to continue financing its competitive energy businesses with 76% common equity throughout the rate year?

A. No. The Company's updated capitalization forecast indicates that the parent intends to flow $700 million of the cash proceeds it received from the merchant plant sales to Con Edison, which will also be reflected in the Company's common equity component as additional paid in capital, sometime during the third quarter of 2008. Following this transaction, the competitive energy businesses will only be supported by a capitalization consisting of about 50.8% common equity.

Q. Please explain the concept of business risk in general and why you have concluded that the parent's non-regulated investments have much greater business risk than the Company's utility operations.

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.

Both of the major credit rating agencies, Standard & Poor's (S&P) and Moody's Investors Service (Moody's), assess the level of business risk in tandem with the financial risk profiles of debt issuers when they assign their ratings. With respect to its assessment of the relative strength of a company's business position, S&P assigns business risk profiles. In ascending order, these profiles range from "Excellent," for companies with very little business risk, to "Strong," to "Satisfactory," to "Weak," and finally to "Vulnerable" for those companies with extremely high levels of business risk.

Q. What is S&P's assessment regarding the level of business risk faced by utilities in general and Con Edison in particular?

A. Regulated utilities, and holding companies such as CEI that are primarily utility-focused, virtually always fall into the upper range of

business profile scores, i.e., the "Excellent" and "Strong" categories.

According to a recent S&P report entitled "U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix" included as Exhibit___(FP-8), the reason that utilities have significantly less business risk than nearly all other types of businesses is because they have legally defined service territories generally free of meaningful competition, and they provide an essential or near-essential service. Further, underpinning the "Excellent" and "Strong" business risk profiles of the utilities, according to S&P, is the presence of regulators that have an abiding interest in supporting a healthy utility financial profile.

With respect to Con Edison in particular, S&P has acknowledged the elevated importance of regulation due to the overall very low risk of its transmission and distribution (T&D) operations. S&P continues to view the Company's business profile as "Excellent," its highest business profile rating, largely because of Con

Edison's historically supportive regulatory environment and the conservative strategy of its parent by virtue of its focus on low risk transmission and distribution (T&D) operations.

Q. What is the level of business risk faced by CEI's non-regulated subsidiaries?

A. According to CEI's December 31, 2007 10-K, the parent pursues competitive energy opportunities through three wholly owned 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 "energy merchant and developer" businesses.

Q. What are the financial implications associated with this heightened level of business risk?

A. According to a 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-9), the average or typical business profile of an energy merchant and developer is considered to be "Vulnerable," S&P's lowest business profile rating. Pursuant to its published guidelines, S&P would require a *stand-alone* energy merchant and developer, i.e., one that that would need to obtain financing based on its own financial profile, to maintain its total debt to total capital at no more than 40% in order for it to sustain the same "A-" rating that S&P currently assigns to both Con Edison and CEI. By contrast, "A-" rated stand-alone businesses with "Excellent" business profiles such as Con Edison can sustain their rating even with total debt to total capital as high as 60%.

Q. Is it typical for stand-alone energy and merchant developer companies to achieve "A" rated debt?

A. Given the extremely volatile nature of this type of industry, debt ratings of "A" are virtually

unheard of. In fact, most of the competitive generation companies carry speculative-grade ratings, i.e., "BB+" and lower.

Q. How have CEI's unregulated subsidiaries obtained their debt financing?

A. CEI, whose senior unsecured debt is rated "A-," has generally issued the debt supporting these risky investments. The parent's strong credit rating is largely attributed to the fact that about 90% of its total assets, revenues, and operating income have come from its low-risk utility operations. Prospectively, after the sale of its merchant generating plants, the utility operations will play an even more prominent role.

Q. Besides your concern that the $700 million equity contribution from the parent during the third quarter of 2008 would leave the parent's non-regulated businesses inadequately capitalized, are there any other aspects of the Company's forecasted rate year capitalization that require scrutiny?

A. Yes. We believe that the Company's updated

capitalization results in a common equity ratio that is unnecessarily high. As illustrated on page 2 of Exhibit___(FP-2), the Company originally forecast total net additions of common equity of $1.335 billion for the period beginning July 1, 2008 through the end of the rate year. Its updated filing reflects net additions totaling $1.62 billion, or about $270 million more than its initial forecast. At the same time, the updated filing reduced projected long term debt issuances by $100 million. The net effect of these revisions is a rate year average capitalization consisting of 48.51% common equity as compared to the 48.02% common equity ratio originally filed.

Q. Please explain what you mean when you say that the resulting common equity ratio is unnecessarily high.

A. For some time, the Company's financial policy has been to target a consolidated common equity ratio of 48% to 50%, and to maintain or improve its credit ratings. While we certainly understand and appreciate that, generally

speaking, stronger credit ratings will provide the Company with greater financial flexibility, we believe that equally, if not more important, the goal of permanent long-term financing should be to achieve the optimal cost of capital. To that end, we will demonstrate that our recommended capital structure with its 47.96% common equity ratio will not only continue to provide the Company with adequate financial flexibility, but that it will provide this flexibility in a manner that better minimizes the capital costs borne by its customers.

Q. How does your recommended common equity ratio compare to the common equity ratio approved by the Commission in its Order in Case 07-E-0523 (2008 Rate Order)?

A. Our 47.96% common equity ratio is virtually identical to the 47.98% ratio adopted by the Commission in the 2008 Rate Order.

Q. Wasn't that common equity ratio insufficient to maintain the Company's then-current credit ratings?

A. Subsequent to the 2008 Rate Order, Con Edison's

long term debt rating was downgraded by S&P from "A" to "A-," and while it's "A1" rating was affirmed by Moody's its outlook was revised to negative from stable. However, it is unclear to what extent the authorized common equity ratio in itself weighed into the rating agencies' actions. We note, however, that the Company did not see the to need ramp up its common equity ratio when it subsequently filed for rates in this case employing a capital structure with a 48.02% common equity ratio. At any rate, we believe that the common equity ratio should be set in a manner that seeks to minimize the Company's overall cost of capital, while preserving adequate financial flexibility, rather than focusing on achieving or maintaining a particular credit rating that might not necessarily be consistent with that goal.

Q. Did you perform any analyses to determine whether or not the Company's targeted credit ratings of "A1" by Moody's and "A" by S&P, produced an optimal cost of capital?

A. Yes. Using Moody's data, we began by looking at

the difference in bond yields for "A" rated and "Baa" rated utility debt over the past 20 years. We found the three year, five year and twenty year average spreads all to be about .30% or 30 basis points. Next we looked at S&P's published ratings criteria to determine the difference in leverage employed between "A" rated and "BBB" rated utilities. S&P, whose "BBB" rating is identical to Moody's "Baa" rating, provides much clearer guidance with respect to leverage than Moody's. As can be gleaned from those guidelines, which are illustrated on page 4 of Exhibit___(FP-9), the midpoint of the total debt/total capital for an "A" rated utility with an Excellent Business Profile, here, categories 1 and 2, is 56%, while the midpoint for "BBB" utilities with the same Business Profile is 64%. Therefore, with respect to debt management for a utility with Con Edison's "Excellent" business profile, the difference in leverage between a solid "A" rating and a solid "BBB" rating is approximately 8% of total capital.

Based upon these historical average

differences in borrowing costs and S&P's guidelines regarding the use of leverage, we contrasted our recommended capital structure, with its long term debt ratio of 49.64% and common equity ratio of 47.96%, and cost components, 5.85% cost of long term debt and 9.50% cost of equity, with a hypothetical capital structure consisting of 57.64% long term debt and 39.96% common equity and the attendant cost rates, 6.15% cost of long term debt and 9.99% cost of equity, of a Con Edison whose debt ratings have consistently been three ratings lower, i.e. "Baa2" versus "A2" and "BBB" versus "A." Once again, we have assumed that the credit rating decrement is purely the result of increased financial risk due to the increased leverage, with no difference whatsoever in the underlying business risk.

As illustrated on page 1 of Exhibit___(FP-3), we found that the pre-tax rate of return of this hypothetical three-credit rating lower capital structure resulted in lower capital costs, as its 10.30% pre-tax rate of return is

less than the 10.60% pre-tax rate of return of our recommended capital structure and rate of return.

Q. What conclusions have you drawn from this analysis?

A. Based upon the actual credit conditions that have existed, on average, over the past 20 years with respect to debt issuances, and current market conditions with respect to the cost of equity, it appears that lower investment-grade credit ratings produce lower capital costs. This is largely because of the lower income tax allowances associated with these capital structures.

Q. Given the results of your analysis, why aren't you recommending that Con Edison immediately begin pursuing a long term financing strategy that is consistent with a lower investment-grade credit rating, such as "Baa2" or "BBB?"

A. First, we note that credit spreads are currently at historically very high levels. As of June, the spread between "A" and "Baa" debt widened to .55% or 55 basis points, which is nearly double

the spread that has existed, on average, over the past 20 years. This, together with the fact that the Company has a very large construction budget to finance, and will be issuing roughly $2 billion in new debt before the end of the rate year, suggests to us that a sudden material drop in the Company's authorized common equity ratio might not be in anyone's best interests, especially if these historically high credit spreads persist for a long period of time. We also recognize that in order for material alterations in long term financial planning to be successfully implemented, they need to be done in a thoughtful and deliberate manner so as not to jeopardize the ability of the Company to provide safe and adequate service to its customers at reasonable rates.

Given the scope of the Company's financing needs over the next five years, and with an eye toward optimizing the overall cost of capital in the long run, we recommend that the Commission direct the Company to provide alternative financing strategies along with all the related

costs of each approach in its next rate filing in order for the Commission to make an informed decision regarding the establishment of the optimal capital structure for setting the Company's rates.

Q. Are there any other reasons why you wouldn't necessarily recommend a capitalization consistent with a low investment-grade rating?

A. Yes. In addition to the diminishment in financing options and flexibility that low investment-grade credit ratings entail, the use of such a target could put the Company in a position where an unexpected event could cause it to lose its investment-grade rating, and thus put in jeopardy its ability to provide safe and adequate service.

Q. Is there any precedent for the Company targeting "A" ratings?

A. Yes. Throughout the 1980s and into the early 1990s, it was the conventional wisdom in New York that the maintenance of an "A" rating would provide utilities with an adequate measure of financial strength, and at the same time assure

a reasonable overall cost to customers.

Q. Why do you believe that this presumption, specifically the targeting of an "A" rating, warrants further consideration?

A. Since capital structure issues were last considered here deregulation in New York as well as throughout much of the United States has tended to drive up overall business risk, and has also had a negative effect on credit ratings. For instance, in the early 1990s there were roughly 30 or so "A" rated electric utility companies that derived a "substantial" portion of their operating revenues from regulated operations. Today, only a handful of such companies exist. Another surprising effect of deregulation that we have observed is that more diversified companies, instead of employing less leverage in their capital structures than their less risky T&D counterparts, actually have higher debt ratios; and they also carry lower credit ratings.

In fact, CEI itself has generally capitalized its non-utility operations with far

less equity than the non-utility risk profiles would suggest would be necessary for the parent to maintain its credit ratings. Thus, it appears to us, that when profits are determined by market forces rather than by regulation, the capital structures typically targeted by management are much more leveraged. We believe, therefore, that at the very least, utilities such as Con Edison should demonstrate that the relatively high equity ratios that they propose are necessary for their debt obligations to carry "A" ratings, are in the best interests of their customers.

Q. With respect to your concerns regarding the appropriate financing of CEI's non-utility operations, and the overarching goal of optimizing the Company's cost of capital, please explain how you determined your recommended rate year capitalization.

A. As illustrated on page 1 of Exhibit___(FP-2), we began our analysis with the consolidated balance sheet of CEI based on its 10-Q report for the period ending June 30, 2008. Column 1 presents

CEI's consolidated balance sheet results for all of the holding company's operations. Column 2 shows the balance sheet information provided in the 10-Q report for Con Edison, whose total assets comprise nearly 85% of the enterprise total. Column 3 shows the balance sheet information for Orange and Rockland that is provided to investors on that subsidiary's website.

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 is the residual balance sheet of the parent after removing the stand-alone balance sheets of its two utility subsidiaries. It represents the capitalization dedicated to risky non-utility subsidiaries, as well as the goodwill booked by CEI as a result of its acquisition of Orange and Rockland. As we mentioned earlier, the non-utility operations reflect a robust common equity ratio of 76.1% as a result of the recent sale of certain of its merchant generating plants. Finally, Column 6 represents the pro

forma capitalization of the non-utility operations after the planned redeployment of $700 million of the sale proceeds to Con Edison.

Q. Please explain how you utilized the June 30, 2008 balance sheet data to forecast the appropriate rate year capitalization shown in Column 9.

A. As we previously mentioned, Con Edison is not planning on issuing any new preferred stock, and has no plans to redeem any of its outstanding preferred stock. Therefore, its rate year balance is the same as the amount reported outstanding on June 30, 2008, specifically $212.6 million. With respect to the customer deposits balance, we projected an average rate year balance of $252.8 million based upon the Company's June 30, 2008 actual amount which we forecast to grow by the 0.2% rate the Company uses in its forecast.

As illustrated on page 2 of Exhibit___(FP-2), we developed the average rate year balances of the common equity and long-term debt components by utilizing Con Edison's June 30,

2008 stand-alone reported amounts for each as a starting point. We then reviewed all of the documentation supporting the Company's forecasted average rate year capital structure illustrated in Exhibit___(AP-12) Schedule 1. Specifically, we carefully examined each of the Company's assumptions with regard to its financing activities throughout the entire link period and rate year.

We also compared the financing activities buttressing the average rate year capitalization in Con Edison's preliminary update with the financing activities supporting the capital structure in its initial filing. While we found the mix of additional long-term debt and common equity forecast by the Company in its initial filing to be consistent with its recent history and sufficient to support its current (A-) S&P senior unsecured debt rating as well as a comparable rating by Moody's (A3), we found the financing mix supporting the preliminary update's capitalization to be somewhat over-weighted with new common equity.

As shown in columns 1 and 2 on page 2 of Exhibit___(FP-2), the Company's original filing reflected $1.355 billion in net additions of common equity for the period June 30, 2008 through March 31, 2010. In addition to common equity raised through its various stock plans, the amount also included equity contributions from its parent of $350 million during 2008 and $400 million during the rate year. Con Edison also projected $2.08 billion in debt issuances during this time frame, which resulted in total net additions of $1.505 billion of debt, after taking into account maturing obligations of $575 million. Thus, of the $2.84 billion of additional capital projected for the combined link period and rate year, the Company forecast a mix of 47% common equity and 53% long term debt which resulted in an average rate year capitalization consisting of 48.02% common equity and 49.60% long term debt.

In the Company's preliminary update, which is illustrated in columns 3 and 4 on page 2 of Exhibit___(FP-2), however, the Company increased

its projection of new common equity by about $285 million to $1.62 billion, and decreased new debt issues by $100 million. While the Company's updated forecast eliminated all new equity raised through its various stock plans, it increased the equity contributions from its parent substantially. During 2008, the parent's contribution rose from $350 million to $700 million, and during the rate year the proposed contribution was increased from $400 million to $450 million. Thus, of the $3.025 billion of additional capital now projected for the combined link period and rate year, the Company forecasts a mix of 53.5% common equity and 46.5% long term debt.

As illustrated in columns 5 and 6 on page 2 of Exhibit___(FP-2), we made two significant adjustments to the Company's updated forecast in order to bring the forecasted mix of common equity and long term debt back into synch with the Company's initial financing mix as well as with its existing capital structure ratios. We also made several minor adjustments to the

Company's projected common equity mostly the result of differing assumptions. We believe that our adjustments are warranted because they produce a rate year capitalization that better optimizes the overall cost of capital, while continuing to afford the Company with substantial financial flexibility. Further, we believe that the modest nature of our near-term adjustments assures that they can readily be incorporated into the Company's long run financing plans. Finally, to the extent that Con Edison believes that the additional equity it proposed is warranted to bolster its consolidated equity ratio then it is, of course, free to deploy the additional equity to support its riskier non-utility operations accordingly.

As we indicated before, we felt that the Company's updated capitalization unnecessarily turned the financing mix on its head; moving from 47% additional common equity and 53% long term debt in its original filing to 53.5% common equity and 46.5% long term debt. We believe that the best manner in which to bring the mix

back in line is to reduce the projected rate year contribution from the parent by $200 million, while simultaneously increasing the amount of new debt issuances by the same amount. As compared to the net additions originally forecast by the Company, our projected rate year capitalization is premised upon an increase in common equity additions of $115 million, and an increase in new debt issuances of $100 million.

Q. Please explain the other adjustments you made.

A. The balances of our minor adjustments and the rationale for each are as follows. First, we reduced the beginning balance of common equity by about $26.5 million to $8.191 billion in order to reflect the actual common equity balance reported on the Company's 10-Q report. Second, we increased the common equity component forecast for the 3rd quarter of 2008 by $21 million because the Company's forecast incorrectly included capital stock expense of this amount. Given that the $700 million equity contribution from the parent during this quarter was not raised by issuing equity, the recording

of any capital stock expense is inappropriate. Third, we reduced the capital stock expense reflected in the 3rd quarter of 2009 by $9.75 million (from $13.5 million to $3.75 million), because we reduced the amount of common equity contributed by the parent from $450 million to $250 million and because we project actual issuance expenses to be about 1.5% (as opposed to the 3.0% forecast by Con Edison) of the amount raised, which is consistent with the parent's last three public offerings. Finally, we reduced the rate year average balance by $17.5 million in order to reflect the lower level of retained earnings associated with our 9.5% ROE as opposed to 10.0% earnings reflected in the Company's forecast.

Q. Given all your adjustments, what rate year capitalization do you recommend the Commission apply to Con Edison?

A. We recommend that the Commission employ a long-term debt ratio of 49.64%, a common equity ratio of 47.96%, a preferred stock ratio of 1.10% and a customer deposit ratio of 1.30% as the rate

year capitalization for Con Edison. This can be seen in Exhibit___(FP-1).

Q. Can you substantiate that your recommended capitalization ratios are consistent with Con Edison's overall risk profile?

A. Yes. As measured by its debt ratings, Con Edison has one of the strongest credit profiles among electric and combination electric and gas utilities; thus, comparably speaking, it is among the least risky. Specifically, the Company's senior unsecured obligations are rated "A-" by S&P, and "A1" by Moody's. The Company's most recent S&P credit analysis is Exhibit___(FP-10), and its most recent Moody's credit opinion is Exhibit___(FP-11). S&P's capitalization guidelines call for "A" rated electric utilities with "Excellent" business risk profiles to maintain total debt in the range of 52% to 60% of total capital.

Moody's on the other hand utilizes a much broader (40% to 60%) range for its "A" rated electric utilities whose relative business risk it considers, like Con Edison, to be "Medium."

Thus, our recommended long-term debt ratio of 49.64% appears to be well within the parameters of the two major credit rating agencies, and should thus be adequate for the Company to maintain the ratings of its senior unsecured debt obligations within their respective "A" categories.

We recognize, of course, that the ratings processes of both of these agencies also take into account companies' cash flows from operations. For the most part these cash flows are the Company's earnings and its depreciation expense. From a cash flow perspective, Con Edison's leverage can be construed as somewhat high for its ratings, as both S&P and Moody's measure the Company's cash flows relative to its total debt. Since 2005, both S&P and Moody's have considered the Company's cash flow relative to its total debt to be somewhat weak for their "A" categories. Given the Company's forecasted levels of depreciation expense and construction expenditures, it is readily apparent that Con Edison's cash flows will continue to remain low

relative to its outstanding debt for quite some time, and its cash flow metrics would remain relatively weak even if the Commission authorized a 50% common equity ratio.

The salient point here is that the relatively weak cash flows and their negative influence on the Company's debt ratings, while genuine, should not be the central concern of the Company's permanent financing policies. As we have already stated, we believe that focus should be on minimizing its overall cost of capital. And while authorizing higher equity ratios and ROEs that are higher than the returns required by its investors would clearly help the Company to retain, or perhaps even improve its current credit ratings, neither of these actions appear to us to be consistent with the goal of optimizing its cost of capital. In any event, we believe that our capital structure recommendation should be adequate for the Company to maintain ratings for its senior unsecured debt obligations within their respective "A" categories.

Q. How does your recommended common equity ratio of 47.96% compare with the common equity ratios of the electric utility holding companies in your proxy group?

A. As can be seen on page 1 of Exhibit___(FP-4), according to Value Line, our proxy group holding companies are projected, on average, to have a common equity ratio of 48.95%. Value Line doesn't include short term debt in its capitalization ratios, however. We found that, on average, the electric utility holding companies financed about 7.5% of their total capitalization with short term debt. Thus, the average percentage of common equity supporting the total capitalization of these companies is really about 45.3%.

**COST RATES**

Q. Please explain how the cost rates shown in Exhibit___(FP-1) were derived.

A. As illustrated in Exhibit___(FP-1), 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 5.90% cost rate determination of the Company's Accounting Panel and made a few adjustments that resulted in our 5.85% cost rate recommendation. Exhibit___(FP-5) shows how this cost rate was derived. With respect to the cost of preferred stock, we reviewed and accepted the 5.34% cost rate determination of the Company's Accounting Panel.

The third cost rate shown in Exhibit___(FP-1) is the cost of customer deposits. The 3.75% 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 11.0% proposed cost rate for common equity is excessive and should be rejected. We have developed a recommended 9.5% cost of equity for the rate year ending June 30, 2010.

Q. Given that the Company's 7.86% overall rate of return is premised upon an ROE of 10.0%, why do

you contrast the reasonableness of your 9.5% recommendation with an 11.0% ROE?

A. Our testimony addresses the reasonableness of the 11.0% ROE because Company witness Morin has submitted testimony arguing that rate is Con Edison's just and reasonable cost of equity. Moreover, even though the overall rate of return sought pursuant to Con Edison's mitigation efforts is premised upon a 10.0% ROE, the Company's Accounting Panel clearly states: "Should the Commission exclude costs in the calculation of the revenue requirement that lower the mitigated revenue requirement, the Company does not waive its rights to a reasonable return (i.e., greater than 10.0%...and in the range identified by Dr. Morin."

Q. Regarding the cost of the long-term debt component, would you please explain why you adjusted the 5.90% cost rate submitted by the Company's Accounting Panel, as illustrated in Exhibit AP-12, Schedule 2.

A. As we explained earlier, Con Edison's rate year

cost of debt determination reflects its embedded cost as of June 30, 2008 as well as the projected cost rates of four new issuances during the link period and rate year, and the effect of its maturing obligations. We found the estimated cost rates of three of the four new issuances to be excessive. Consequently, our cost of debt determination reflects a more reasonable forecast of these costs.

Q. Please elaborate.

A. The Company typically forecasts the cost rates of its future debt issuances based upon its current estimates of required spreads to treasuries and on estimates of future Treasury rates over the next two years which can be found in the Blue Chip Financial Forecast. We have generally observed the Company's spread estimates to be a little on the high side as compared with Moody's determination of the current yield requirements of outstanding utility debt obligations, as well as compared to the current yield spreads of its own outstanding obligations.

However, the principal reason that the Company's forecast cost rates for three of its new issues are excessive is because of the Company's reliance on forecasted long-term Treasury rates, which are substantially higher than the current yields of long-term Treasury securities.

It is almost universally recognized that short-term movements in long-term interest rates are simply not "forecastable." Moreover, not only are these forecasts poor predictors of the magnitude of the expected change in interest rates; they are not even reliable with respect to the direction of the change. Instead the best forecast of long-term interest rates is no-change, i.e., the current rates of these debt instruments.

Therefore, based on treasury rates as of August 12, 2008 and the current spread requirements for A-rated utility issuers reported by Moody's Credit Trends as of August 12, 2008, we projected cost rates of 5.87% for the Company's projected 10-year debt issuances

based on the August 12, 2008 yield on 10-year treasury notes of 3.91% plus a spread requirement of 1.96% and a cost rates of 6.51% for its new 30-year debt obligations, based on the August 12, 2008 yield on 30-year treasury notes of 4.55% plus a spread requirement of 1.96%. These adjustments, together with our projection of an additional $200 million of principal to be raised in the Company's proposed June 2009 series, results in the reduction of the projected cost of long-term debt from 5.90% to 5.85%. Our average cost of long-term debt determination is illustrated in Exhibit___(FP-5).

Q. What is your recommendation with regard to the Company's auction rate tax-exempt debt?

A. As illustrated in Exhibit___(FP-5), the Company will have approximately $1.1 billion in tax-exempt securities outstanding during the rate year. Approximately $635 million of those obligations are variable rate securities whose rates are reset periodically through an auction process. Because of turmoil in the credit

markets that was causing those auctions to "fail," the Commission, in the 2008 Rate Order, authorized Con Edison to true-up the interest expense associated with these issues. The auctions were failing, not because of any perceived concerns with Con Edison, rather because of the financial distress facing the bond insurers of these obligations as a result of the sub-prime mortgage crisis.

It is our understanding that the cost rates of these obligations presented by the Company, and reflected in our determination of the overall long term debt cost rate as well, are Con Edison's latest known actual rates. Rather than updating these cost rates for the latest actual rates at the time of the Commission's determination in this proceeding, as has traditionally been the Commission's policy, we understand that the Company would like to continue truing-up the cost rates of these securities. We have no objection to continuing the true-up of these obligations provided that it is done only when the auction rate debt

market continues to be in a very unsettled state.

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

A. Yes. The actual cost rates of any forecasted new debt that is issued prior to the Commission's decision should be reflected, as well as the projected cost rates of rate year issuances, based upon the most recent actual treasury rates and spread requirements. Further, if the auction rate debt market returns to normalcy, the average long-term debt cost rate should be updated to reflect the latest known cost rates associated with the Company's variable rate tax-exempt debt.

**SUMMARY OF ROE RECOMMENDATION**

Q. What methodology did you use to determine your recommended ROE?

A. We followed the same methodology that Staff advocated, and the Commission adopted in recent Orders in Case 06-E-1433, Orange & Rockland - Electric Rates and Case 07-E-0523, Con Edison -

Electric Rates. 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 the difference in financial and business risks currently facing Con Edison versus those of the proxy group on average and to reflect common equity issuance expenses expected during the rate year.

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 fourteen years the Commission has consistently preferred cost of equity determinations with 2/3 DCF and 1/3 CAPM weightings. While recently utility witnesses often 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.

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 not too long ago when Company witness Morin raised concerns about the weighting accorded the DCF methodology in Case 06-E-1433, Orange and Rockland - Electric Rates the Commission itself noted 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 reservations 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 a 1/3 weighting.

**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 Con Edison'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 analyses for an individual company rely on analysts' estimates of growth which are, by their nature, inaccurate and sometimes biased, while beta determinations used in the CAPM methodology are based on historical observations that, due to corporate restructurings may not be representative of the level of earnings volatility expected in the future. However, we believe that by employing a sufficiently large proxy group of similarly situated companies in our analyses, we can largely diminish the undesirable effects of biased (both upward and downward) or inaccurate growth estimates or beta measures for any one

company. We further diminish the effect of these inaccuracies and biases by utilizing the median results in our analyses.

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 so 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 31 companies from a "universe" of 58 companies whose common stock is publicly-traded; all, like Con Edison's parent, are deemed to be "electric utilities" by Value Line serving retail customers. Because of its robust size, we are confident that our proxy group will produce reliable estimates of the Company's cost of equity. We also believe that we have carefully selected companies that have risks which are substantially similar to those faced by Con Edison. The list of companies we used, including each company's credit rating, S&P business profile, percentage of utility revenues, and common equity ratios, is shown on page 1 of Exhibit___(FP-4).

Q. Please explain how you developed your proxy group.

A. We began with the 58 publicly-traded companies that Value Line categorizes as electric utilities and that serve retail customers, because that is the primary business of Con

Edison. In order to generally match this group's risks with those of Con Edison, we considered two variables, or screening criteria: the credit quality (debt rating) of the parent holding company and its percentage of revenue received from regulated operations.

Con Edison's senior unsecured debt is rated "A" by S&P and "A1" 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 (four if the Company's parent CEI is excluded) out of the 58 Value Line electric utility holding companies had debt rated in the "A" categories by both S&P and Moody's, and nearly all derived some revenue from riskier unregulated investments.

Mindful of our goals of achieving a proxy group of companies that is both sufficiently large and with generally similar business and financial risks to Con Edison, we selected only those dividend paying companies with investment-grade senior unsecured debt, and at least 70% of total revenues from regulated operations. In

three instances, we included companies where the parent holding company was rated at least "BBB+" by S&P and not rated by Moody's. In all three cases, we utilized the Moody's debt rating of its principal utility subsidiary, which likewise needed to be at least 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. Would you please explain the rationale underlying your screening criteria?

A. In the past, Staff relied on proxy groups consisting of only "A" rated utility companies that derived a "substantial" portion of their operating revenues from regulated operations. In the early 1990s there were anywhere between 25 and 33 such companies. Today that number has dwindled to between four and five depending upon the specific interpretation of what is implied

by "substantial" with respect to regulated revenues.

Not only has the credit quality of the electric utility industry fallen, but the preeminent event over the past 25 years has been the steady decline in credit quality of U.S. corporations in general. This broader trend, together with an orientation in the electric utility industry towards consolidation through mergers and an increase in unregulated activities, means that lowering the credit quality threshold is the most logical and reasonable response to maintain an adequate number of candidate companies.

In this case, just as in other recent Con Edison and Orange and Rockland electric and gas rate cases, and consistent with recommendations by Staff in other recent cases involving combination electric and gas utilities, we have determined that the most reasonable proxy group for determining Con Edison's cost of equity is one in which all of the parent holding companies serve retail customers, have investment-grade

senior unsecured debt ratings, and all receive a minimum of 70% of total revenue from regulated operations.

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

A. As illustrated on page 2 of Exhibit___(FP-4), 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, page 1 of Exhibit___(FP-4) shows that the group receives, on average, about 88.2% of its revenues from regulated operations.

**DISCOUNTED CASH FLOW METHODOLOGY**

Q. Would you please explain the basic theory underlying the DCF methodology and why you place principle reliance on its results?

A. The DCF approach can be applied to any investment instrument that has an intrinsic value. The DCF approach, as it relates to common stock, recognizes that companies create value for their stockholders by using their earnings in a number of ways, by far the most

important of which, is through the payment of cash dividends.

Alternatively, earnings that are retained by companies can be used to create value by investing in capital projects designed to increase future profits. The retained earnings can also create value by retiring debt - which reduces interest expense and means more cash flow is available to stockholders, and by buying back some of the company's common stock - which increases future earnings on a *per share* basis.

It is important to note that while earnings drive companies' dividend payout policies, the value of the companies' common stock is always equal to the present value of all future dividends. This is because the earnings that are retained will only have value to the stockholders when they are paid as dividends in the future. Underlying this principle is the strong assumption in capital market theory that companies earn the same return on retained earnings as the market demands on their common stock.

The DCF theory assures us that stocks only have value because of the cash flows that current investors receive or the appreciation caused by cash flows that future investors hope to receive. Also, fundamental to the DCF methodology is the notion that cash in the future is not worth as much as cash today. Due to reasons such as the time-preference of individuals to prefer consumption today rather than waiting, and because of inflation and productivity, the DCF discounts the future expected cash flows according to investors return requirements.

The main reason that the DCF methodology continues to be the preferred approach for determining a utility's cost of equity is that investors' immediate return requirements, as observed in current stock prices and dividends, are readily quantifiable. The primary challenge in applying this methodology is determining the rate of growth in future dividends that investors expect.

Given that rational investors expect growth

in dividends largely as a result of productivity gains and inflation, we believe that estimating dividend growth in the relatively stable utility industry, while difficult, is certainly not insurmountable. Furthermore, we believe that when practiced with the application of well-reasoned growth rate estimates, such as the ones we utilized in our approach, the intuitiveness of the DCF methodology is abundantly clear, and it is a primary reason that the methodology is the best tool for estimating the cost of equity for a regulated utility.

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-6). For each company in the proxy group, we calculated a six-month average stock price by averaging the high and low price for each month. We used the six-month period ending June 2008. The model also contains *Value Line* data for 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 future dividend payments that investors expect for each of the companies. The price that investors are currently willing to pay for that future stream of dividends, here the average stock price taken over the six-month period ending June 2008, is essentially the present value of those expected dividends. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, we determined the rates of return that investors expect for each company.

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, we used *Value Line's* forecasted dividends. For the second stage, 2013 and beyond, we calculated a "sustainable growth" rate for each company in the proxy group based upon its projected retention of earnings and growth in common stock balances.

Q. What is the median sustainable growth rate for

the proxy group?

A. 5.30%.

Q. Did you check the reasonableness of this result by comparing it with any macroeconomic indicators?

A. Yes. We compared it with growth estimates of the overall economy. Specifically, we found that it was somewhat stronger than the most recent long-range forecast of the growth rate in Nominal gross domestic product (GDP). According to the March 10, 2008 edition of Blue Chip Economic Indicators, the consensus long-range estimates of Nominal GDP growth are 5.0% for 2010-2014 and 4.8% for 2015-2019.

This comparison is apt, because the Nominal GDP rate reflects assumptions about future inflation as well as the real growth in the economy resulting largely from productivity gains. It is not unreasonable for investors to expect future dividends to generally keep pace with inflation as well as to reflect productivity gains similar to those expected for the economy as a whole.

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

A. As shown on page 2 of Exhibit___(FP-6), the median return on equity of the proxy group is 9.83%. 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 many 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 *Value Line* growth estimates to improperly influence the result. While *Value Line*'s estimates are based upon its own in-house projections as well as those of other industry analysts, the simple fact remains that all analysts' earnings forecasts are notoriously inaccurate.

Further, our approach obviates the need to substitute our own judgment and toss out any of the individual results that appear unreasonable

to us, because we advocate the use of the median return of our individual results, as opposed to the average. Use of the median is a widely employed statistical tool that largely diminishes any undue impact that outliers may have on the average result. In other words, by using the median return for the proxy group, individual results that we might otherwise reject, are effectively marginalized.

Q. Dr. Morin advocates using average five-year earnings growth rate estimates ranging from 6.0% to 7.8%, based upon forecasts provided by *Value Line* and *Zacks Investment*, as the measure of the growth expected by investors in the DCF model. Is this appropriate?

A. No. First of all, proper application of the DCF specifically requires the discounting of future dividends. While Dr. Morin argues that investors view earnings growth and dividend growth as essentially one in the same, it is worth noting that he provided no evidence that they are equal. In fact, it is well-known that discounting earnings results in an overstatement

of a stock's value, or in this case where the required return is being determined, an overstatement in the expected growth rate of dividends.

Second, because analysts' earnings forecast are explicitly short-term in nature and notoriously inaccurate, it is unreasonable to assume that investors would have much confidence at all in the ability of these companies to maintain such growth rates well out into the future. This is especially true since these investors would be well-aware of the consensus forecast calling for long-range Nominal GDP growth of 4.8% to 5.0%. In sum, Dr. Morin's growth estimates are inappropriate as well as unsustainable, and should be rejected.

**CAPITAL ASSET PRICING MODEL METHODOLOGY**

Q. Would you please describe the basic theory underlying the CAPM?

A. The basic logic behind the CAPM is that there is no premium, in terms of an expected return, for bearing risks that can be eliminated through diversification. According to the CAPM,

rational investors will hold a portfolio (generally sixty or more) of stocks such that the overall risk of that portfolio, in terms of variability of returns, is identical to that of the market as a whole. Thus, the only risk that matters in the CAPM equation is said to be "systematic" risk, or that which can not be diversified away.

"Unsystematic" risk, on the other hand, is risk that is specific to a particular stock. While it is assumed that most stocks tend to go along with the general market, at least to some extent, factors that are specific to an individual company are said to affect its "unsystematic" risk.

According to the CAPM, the appropriate way to measure an individual stock's risk is through a correlation of its return with the overall market, known as beta. Typically the calculation begins by assigning a beta of 1.0 to a broad market index, usually the S&P 500. Relatively stable stocks like utilities tend to have betas less than 1.0 while stocks that

amplify the overall market's movements have betas higher than 1.0.

In the case of stocks with betas less than 1.0, as has been a hallmark of the utility industry, the CAPM informs us that investors will only be compensated for their actual risk, as measured by beta. In other words, their return requirements will reflect the degree to which they are less volatile than the market as a whole.

Q. Please describe how the CAPM is traditionally employed to determine the cost of equity?

A. Traditionally, CAPM calculations of the cost of equity (Ke) require estimates or inputs of the following variables: the risk free rate (Rf), the market return (Rm), and the beta (b) of the proxy group for which the cost of equity is being sought. Alternatively, a market risk premium (MRP) can be deployed in place of an estimate of the market return; however the MRP determination requires an implicit assumption as to the expected market return because it is calculated by subtracting the risk free rate

from the expected market return. Formulaically, the MRP is expressed: MRP = Rm - Rf.

With respect to the appropriate risk free rate, Staff typically uses long-term Treasury bond yields, specifically the average of 10-year and 30-year bond yields over the most recent six-month period. For the expected market return, Staff generally uses Merrill Lynch's most recent estimate of the expected return for the S&P 500. Finally, with respect to the appropriate beta to be used, Staff has typically employed the average beta of the proxy group, based upon the most recent Value Line determinations. Formulaically, the traditional CAPM is expressed as: Ke = Rf + (b * (Rm - Rf)).

Q. How did you begin your CAPM analysis?

A. 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 do you employ two CAPM methods?

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 in addition to the traditional approach, such a tendency can be addressed by averaging in a result which is only partially determined by the beta used.

Q. How did you calculate the risk-free rate used in your analyses?

A. We averaged the 10-year and 30-year Treasury bond yields for the most recent six-month period. The result, for the six-month period ending June 2008, is 4.14%.

Q. How did you determine the appropriate beta for your CAPM analyses?

A. We used the .80 median beta of our proxy group, which we calculated using the most recent *Value Line* betas for each of the companies.

Q. Why did you use the median beta, given that Staff has often used the average beta of the proxy group?

A. We used the median beta for the same reason that we used the median return of our individual results in our DCF analysis - to diminish the

undue influence of any outlying individual results. As we explained earlier in our testimony, the use of the median is a widely employed statistical tool that should be used in circumstances where one or more extreme observations bias the overall conclusion.

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

A. As we previously explained, the MRP is simply the difference between what the expected return on the market is and the risk-free rate. To calculate the current market risk premium, we utilized the expected market return reported in Merrill Lynch's July 2008 *Quantitative Profiles*. As illustrated on page 46 of (Exhibit___(FP-14), that publication currently estimates the required return for the market to be 11.50%. Therefore, given our risk-free rate of 4.14%, we calculated the current expected MRP to be (11.50% - 4.14%) or 7.36%.

Q. How does Merrill Lynch's expected return on the S&P 500 compare to the historical return of the index?

A. It is slightly more than 100 basis points higher than the actual returns received in the past. According to S&P itself, the annualized total return for the S&P 500 since January 1926 was 10.43%. Further, the dividend component consists of 40.59% of the return, while the remainder reflects both capital appreciation and dividends reinvested.

Q. Using your stated inputs, what was your "traditional" CAPM result?

A. 10.03%, calculated as follows:

4.14% + [0.80 * (11.50% - 4.14%)] = 10.03%

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

A. We used the same inputs as in the traditional CAPM methodology. However, 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 expressed as:

Required return = Rf + (.75*B*Rp) + (.25*Rp)

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

A. 10.40%, calculated as:

4.14% + [.75*.80*(11.50%-4.14%)] + [.25*(11.50%-4.14%)] = 10.40%

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 10.22%.

Q. Would you please briefly summarize your main concerns with applying the CAPM methodology to determine a utility's cost of equity?

A. While we have numerous theoretical and practical concerns pertaining to the proper application of this methodology, the two areas that cause us the greatest amount of apprehension relate to the estimates of two of its principle inputs, specifically the beta and the market risk premium (MRP). To begin with, we have difficulty with the theory underlying the CAPM that says that the beta is a complete and sufficient measure of the risk that requires compensation in the market.

In addition, beta is supposed to represent the future volatility of a given stock to the market index. However, because that future volatility is unknown, betas are measured on a historical basis, often as long as five years. When the systematic risks of a firm or industry change, the historical beta is not a good indicator of future volatility. Another shortcoming of beta is the disparity of betas between the various firms that report this measure. For instance, Staff has typically relied on *Value Line* reported betas. *Value Line* performs five-year correlations and then "smooths" the "raw betas" to reflect the theory that betas have a natural tendency to gravitate to 1.0. Other firms employ shorter periods, and do not adjust the "raw" betas as *Value Line* does. Our concern is that, depending upon the source, the betas can be very different, and thus can produce very different cost of equity estimates.

Our greatest concern with the methodology, however, concerns the derivation of the MRP.

Like beta, the MRP should be the expected average premium of the market over the risk-free rate. However, just like beta, the expected premium is unknown. Because it is unknown, many adherents to this methodology, like Dr. Morin, advocate a historical MRP. As we will discuss later in our testimony, we believe that a historical average is inappropriate. The alternative, a forward-looking MRP, however, is subject to a substantial amount of judgment, and thus should be viewed with a considerable amount of caution. In sum, we recognize that the methodology offers some valuable insight regarding the cost of equity capital, but given these concerns we believe that the approach should be accorded no more than a one-third weighting.

**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 (9.83%) as two-thirds of the total and the CAPM average (10.22%) as one-third of the total, which resulted in a

9.96% cost of equity. These calculations can be seen on page 3 of Exhibit___(FP-6).

Q. You explained earlier in your testimony that two adjustments should be made to this cost rate. Please describe these adjustments, beginning with your adjustment to reflect the fact that there is a quantifiable difference between the business and financial risks faced by Con Edison 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 Con Edison, the fact is that real and quantifiable differences do exist and they should be reflected in the cost of equity determination.

Both 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,

Con Edison is rated "A1" by Moody's and "A-" by S&P, while as illustrated on page 2 of Exhibit___(FP-4), the average Moody's rating for the proxy group is somewhere between the "Baa1" and "Baa2" (about 3.5 notches lower than Con Edison), and the average S&P rating is somewhere between "BBB+" and "BBB" (about 1.3 notches lower than the Company).

To calculate a comprehensive credit quality adjustment that recognizes Con Edison's lower business and financial risk vis-à-vis the holding company proxy group, we began with an analysis of the current yield requirements for debt investors. First, 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 the respective debt ratings, we calculated implied yields for both Con Edison and the proxy group. The result was 6.27% for the Company and 6.60% for the proxy group, indicating that the current return required by the Company's debt

holders is about 33 basis points less than the current return requirements of the proxy group's debt holders.

In order to translate that debt discount into the return requirements of the Company's common equity investors, we first calculated the ratio of the proxy group's cost of equity (9.96%) to its cost of debt (6.60%) and found it to be 150.94% higher. Then, we multiplied Con Edison's 33 basis point cost of debt discount by that 150.94% ratio, to determine the appropriate credit quality adjustment for Con Edison's equity holders, which we found to be 49 basis points. Our calculations are illustrated in Exhibit___(FP-7).

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

A. No. While Dr. Morin utilized proxy groups with overall credit risks that are quite similar to ours, he concluded that no adjustment was necessary because in his view "Con Edison's lower business risk on account of its status as a pure wires utility unencumbered with the

riskier power production function offsets its higher financial risk on account of its aggressive capital program, weak financial metrics for its current credit ratings, and high regulatory risk." He also characterized his return on equity recommendation as "conservative" due to the "higher risks associated with a company operating under temporary rates."

Q. Do you agree with Dr. Morin's conclusions?

A. Absolutely not. As we mentioned earlier, the ratings processes of S&P and Moody's are comprehensive; they each factor in assessments of the overall business and financial risks facing a given company. Thus, to suggest that Con Edison with its "A1" Moody's and "A-" S&P ratings is just as risky as proxy groups whose average rating is well below "Baa1" and "BBB+" is disingenuous at best.

We have already pointed out the reality is that Con Edison has a significantly stronger credit profile than the average electric utility company. According to its August 5, 2008 report

entitled *U.S. Regulated Electric Utility Companies, Strongest to Weakest*, Exhibit___(FP-12), of the 184 holding and operating companies rated by S&P, only nineteen have higher ratings than the Company, while 131 are rated lower. Meanwhile, according to its July 2008 report entitled *U.S. Investor-Owned Electric Utilities: Six-Month Industry Update,* Exhibit___(FP-13), of the 132 holding and operating companies rated by Moody's, none are rated higher than Con Edison, and 128 are rated lower.

Dr. Morin's second conclusion is also without merit. We have already noted that the rating agencies reacted negatively to the 2008 Rate Order. Therefore, any perceived increase in risk resulting from the Commission's actions is already reflected in the Company's debt ratings, and thus properly reflected in our credit quality adjustment.

Q. Please explain your second adjustment, the one you made to reflect the costs associated with the Company's proposed infusion of $450 million in new common equity during the rate year.

A. First, as we discussed earlier, our issuance expense adjustment reflects our belief that CEI should reasonably contribute only $250 million of the proceeds it intends to raise through a public issuance of common equity during the third quarter of 2009. It is reasonable to allow Con Edison recovery of issuance expenses incurred by its parent on the Company's behalf. To that end, we have forecast that an equity contribution of $250 million can reasonably be expected during the rate year, and that the amount of issuance expenses incurred in order to raise that amount of common equity will be about 1.5% of the gross proceeds.

The 1.5% estimate is based upon an average of the actual issuance expenses incurred by CEI in its last three public offerings. Therefore, our estimate of issuance expenses is $3.75 million ($250 million * 1.5%). Given our projection that Con Edison's average rate year balance of common equity will be about $9.3 billion, we made an upward adjustment to the cost of equity of 4 basis points ($3.75

million/$9.3 billion). Not only will this adjustment allow Con Edison to recover its reasonably expected equity issuance costs during the rate year, it will continue to provide for these costs into the future until its rates are reset.

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

A. As illustrated on page 3 in Exhibit___(FP-6), we reduced the proxy group's 9.96% ROE by 49 basis points to reflect the Company's superior credit quality and we increased it by 4 basis points to reflect reasonably anticipated common equity issuance expenses. Finally, we rounded our recommendation to the nearest tenth of a percent.

Q. In the last electric rate case, Staff proposed an ROE adjustment to account for the risk reduction inherent in its proposed RDM. Why haven't you adjusted your ROE recommendation to reflect the RDM's risk-reducing attributes?

A. Because the RDM was implemented following the last electric case, Con Edison's credit ratings,

used in our credit quality adjustment, now reflect the effects of the RDM on the Company's risk profile, and thus an explicit RDM adjustment is no longer necessary.

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 Con Edison. He also performed four risk premium analyses; two using the CAPM methodology and two using historical and allowed risk premium data from electric utility industry aggregate data. He then averaged the results of all three methodologies (DCF, CAPM and risk premium), according each an equal weight, to arrive at an 11.0% cost of

equity determination.

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. Consequently, his approach places principal weighting on methodologies that the Commission has either consistently found to be inferior (the CAPM), or rejected (electric utility risk premium studies).

Q. Please explain the concerns you have regarding the composition of Dr. Morin's proxy groups.

A. In previous cases, we have criticized the composition of Dr. Morin's proxy groups on numerous counts, primarily because they were too small and because they included companies that were not suitable surrogates. We note that in this case, Dr. Morin's approach addresses some of our previous concerns. He has limited his proxy group to companies with investment-grade ratings, with which we agree, and he includes only companies whose regulated electric revenues are at least 50% of total revenues. However, our criteria requires them to have at least 70%

of their revenues from regulated operations.

We remain concerned with the small size of the proxy groups relied upon by Dr. Morin in his DCF analyses. His groups are only between one third and one half the size of Staff's 31 company proxy group. Consequently, his proxy group results have to be viewed as considerably less reliable. Furthermore, the already-thin ranks of Dr. Morin's proxy groups still contain companies that may not be suitable surrogates for Con Edison's utility operations. Specifically, three of the 12 companies in his electric distributors group and three of the 15 companies in the Moody's group receive less than 70% of operating revenues from utility operations. Additionally, the electric distributors group includes Energy East which is currently involved in merger-related activity with Iberdrola, S.A. In short, Dr. Morin's proxy groups are inferior to Staff's proxy group, 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 10 and 12 parent companies of investment-grade operating electric distribution utility companies (electric distributors), and repeated the same two analyses using alternatively 13 and 15 companies comprising the Moody's Electric Utility Index (Moody's group).

For both of these 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* five-year 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 Con Edison, 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 Con Edison's investors versus the risk free rate.

A. Dr. Morin began with a traditional CAPM methodology. For his inputs he used: a risk-free rate of 4.5% based upon the current level of 30-year Treasury bonds yields prevailing in

April 2008; a beta of .82 based upon the *Value Line* betas of the electric utility companies used in his DCF analyses; and, a market risk premium of 7.6% based upon the results of both forward-looking and historical studies of market risk premiums.

He then used these inputs and determined that the CAPM estimate of the cost of common equity for Con Edison is 10.7% ((4.5%) +(0.82*7.6%)), which he adjusted to 11.0% for a flotation cost allowance. In his Empirical CAPM approach, he adjusted this result even further upward, to 11.4%, including a flotation cost allowance, because he believes that for betas less than 1.0 the CAPM underestimates the cost of equity.

Q. Please explain how Dr. Morin determined his 7.6% market risk premium?

A. Dr. Morin's market risk premium was derived by averaging two estimates of the MRP; a historical MRP (ex post) using Ibbotson Associates data (7.1%), and a forward-looking MRP (ex ante) using *Value Line* stock data (8.1%).

Q. Please explain how Dr. Morin determined the historical MRP?

A. Dr. Morin's historical MRP was based on the results of an Ibbotson Associates study that compiled historical returns from 1926 to 2007, and found that over this period, common stocks outperformed long-term U.S. Treasury bonds by 6.5%. Dr. Morin felt, however, that the appropriate measure was actually 7.1%, because the study should have compared the stock returns only to the income component of the long-term treasury bonds rather than the total return.

Dr. Morin argues that if one is to rely on historical relationships to predict the future that 1926 to 2007 is the best period because it is the longest possible period for which reliable data are available. He also recommends that the entire study period be used in order to minimize subjective judgment and to encompass many diverse regimes of inflation, interest rate cycles and economic cycles. Finally, he states that his historical MRP determination is reasonable because he has seen no evidence that

it (the MRP) has changed over time.

Q. What concerns do you have with Dr. Morin's historical MRP analysis?

A. We have several. First, we completely disagree with his conclusions that the MRP hasn't changed over time and that because of this it is reasonable to use a historic average culled from a very long period time. Many in the financial community believe that the MRP has generally been decreasing over time. For instance, Jeremy Siegel, in an article entitled "*The Shrinking Equity Premium*", in The Journal of Portfolio Management, Fall 1999, Exhibit___(FP-15), expressed this viewpoint.

We also note another study, by E. Scott Mayfield, entitled "*Estimating the market risk premium*", in the Journal of Financial Economics, March 2002, Exhibit___(FP-16), that also concluded that the Ibbotson Study seriously overstates the MRP for the period since the Great Depression. According to that article, a structural shift occurred in the market after 1940 primarily relating to market volatility,

and that as a result the historical MRP post-1940 is about 5.6%.

In short, we believe that there is ample evidence to indicate that historical MRPs in general are not suitable for estimating future expected returns. With respect to Dr. Morin's historical MRP, we believe that past, as well as ongoing structural shifts in the economy, severely undermine its use in the CAPM cost of equity determination. Quite simply, we have little confidence that it bears any resemblance to the current investing climate, and as a result it should be rejected.

Q. What concerns do you have with Dr. Morin's forward-looking MRP?

A. For his prospective approach in deriving the MRP, Dr. Morin applied a DCF analysis to the dividend-paying stocks in the *Value Line* Composite index. He calculated that group's current dividend yield to be 1.68% and its average projected dividend growth rate to be 10.53%. After adding the yield and growth components and adjusting for the timing of

dividend payments, he concluded that the expected return for the market is 12.59%. Subtracting his 4.5% risk-free rate from that return, he concluded a prospective MRP of 8.1%.

First, we are quite surprised that Dr. Morin is willing to use expected dividend growth rates to estimate future cash flows in his CAPM analysis, but is not willing to use them in his DCF methodology. While using *Value Line's* near-term dividend growth forecasts can be a reasonable approach, Dr. Morin makes no attempt to ascertain whether such short-term growth rates can be sustained into the future. Given the abundance of financial information available to investors about historical achieved returns as well as future estimates regarding the growth in the overall economy, it is obvious to us that rational investors would not expect long-run dividend growth near as high as the 10.53% short-term growth rate utilized by Dr. Morin.

Likewise, disciplined financial analysts routinely incorporate broad economic factors into their market return analyses. For

instance, Merrill Lynch's 11.5% estimated market return for the S&P 500, which we employed in our CAPM analysis, performs just such a reality check on its short-term growth estimates. As illustrated on page 46 of Exhibit___(FP-14), Merrill Lynch clearly did not arrive at its estimated market return simply by adding the 2.3% current yield of the S&P 500 index and that group's five year estimated earnings growth rate of 11.5%. In fact, similar to Staff's DCF approach, Merrill Lynch uses a multi-stage dividend discount model to calculate the expected return for the S&P 500. This is the sort of rigorous analysis that is lacking in Dr. Morin's estimated MRP.

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 - Gas Rates, 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. 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 Con Edison 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 2006. 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 2006 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 Con Edison and the impact on the return requirement that those risks imply. As we address criticisms made by Company witness Hoglund later in our testimony, we will explain some of the important elements inherent in our ratemaking that significantly reduce the risk faced by Con Edison's shareholders. In both cases, the Company witnesses fail to account for these important risk-reducing attributes. Thus, their

conclusions with regard to the returns authorized by other jurisdictions should be rejected.

Q. Finally, would you please comment on Dr. Morin's insinuation that the "unreasonably low" 9.1% ROE authorized in the 2008 Rate Order was directly responsible for the recent downgrade in Con Edison's securities, and his conclusion that the downgrade will cost ratepayers $175 million over the next two decades?

A. First of all, we would like to clarify that S&P's stated rationale for the downgrade was simply that its expectations regarding the Company's ability to achieve certain financial measures would be more commensurate with the "A-" rating as opposed to its prior "A" rating. Second, assuming that the 11.0% ROE that Dr. Morin advocated in that proceeding would have forestalled S&P's ratings action, the additional cost to ratepayers to do this, and presumably "save" ratepayers his alleged $175 million in additional interest costs over the next two decades, would have been on the order of about

$200 million for just that rate year alone (assuming that the revenue requirement impact of each additional 10 basis points was about $11 million).

Finally, we note that Dr. Morin's alleged increase in interest costs as a result of Con Edison's downgrade are based upon the assumption of a 25 basis point increase on every new issue. We have already pointed out that, historically, a one notch rating change from "A" to "A-" is only about 10 basis points. Of course, the more glaring flaw in Dr. Morin's observation is that it only presents the alleged increase in borrowing costs. His analysis is incomplete because he fails to present a comparison of the overall financing costs associated with the different credit ratings. As mentioned earlier, we have performed such an analysis and have demonstrated that the overall capital costs of lower rated utilities can actually be lower.

Q. With respect to the financial challenges faced by Con Edison, Company witness Hoglund has pointed out that one of Con Edison's primary

challenges arises from the fact that its depreciation rates are small relative to its ongoing capital expenditure program. One of the principle effects of this dynamic he adds, is that the Company's cash flow metrics will remain relatively weak for quite some time. Would you please comment on this assessment?

A. We have already noted the ratings agencies' negative view with respect to this particular element of financial risk. In fact, probably more than anything else, this dynamic has increased the Company's overall financial risk and thus cast a downward pressure on its credit ratings. This dynamic was also a consideration of ours when we projected a mix of debt and equity funding that essentially maintains the current capital structure. Our 47.96% recommended common equity ratio actually compares favorably to the actual June 30, 2008 ratio of 47.8% illustrated at the bottom of column 2 on page 1 of Exhibit___(FP-4).

We have already mentioned that we do not believe it to be consistent with an optimal

financing strategy for the Company to further reduce its use of leverage in order to improve its cash flows. Moreover, we believe that the rating agencies are cognizant of this constraint as well, and that any significant decrease in leverage is not anticipated.

Q. Regarding the recent downgrading of the Company's debt obligations by S&P, Mr. Hoglund has averred that this action will increase the Company's prospective borrowing costs by 40 to 60 basis points. Mr. Hoglund based this assertion on the actual cost rates required of two of its new debt issuances that occurred almost immediately in the wake of the ratings actions. Please comment on the Company's recent financings and your assessment of the effect on future borrowing costs of Con Edison's S&P downgrading.

A. In describing the cost rates that Con Edison obtained on its April 2008 debt issuances, Mr. Hoglund has asserted that not only had the Company's borrowing costs gone up since some unspecified time before the 2008 Rate Order, but

that Con Edison actually paid more than a company with a comparable rating would ordinarily pay. To this he attributed an expectation on the part of the Company's counterparties in these transactions that further declines in credit quality would follow.

While we recognize that such aberrations can occur, especially when events are so new that investors have had insufficient time to fully digest their impact, it is also plausible that Con Edison either could not, or did not press these counterparties on the discrepancies between these cost rates and the cost rates of comparably rated securities. This concerns us, and Staff will be looking very closely to see how the Company fares in its future issuances of securities.

Finally, with respect to the prospects of future borrowings costing an extra 40 to 60 basis points as a result of the downgrading, we have already presented evidence that clearly shows this estimate to be excessive. Again, for the past 20 years, the spread requirement for

utility debt obligations with a one-notch rating difference is only about 10 basis points.

Q. Turning to allowed returns, Mr. Hoglund has depicted the recent authorized returns in New York as being "as discouraging as any jurisdiction's in the United States. The basis for this characterization is a comparison he made of New York allowed returns versus the allowed returns of other jurisdictions from 1992 through the present using a database from Regulatory Research Associates (RRA). Do you believe that this data provides any meaningful basis for comparing authorized returns?

A. Not without adjustments for comparability. A meaningful comparison of returns would require adjustments to reflect the credit risks of the individual utilities as well as the underlying risk of 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. Mr. Hoglund does not indicate the credit ratings of any of these

utilities, nor does he propose any adjustment to reflect such a difference.

Mr. Hoglund also does not indicate whether or not any of the return allowances were the result of "settlements" or "joint proposals". In other words, circumstances in which higher authorized returns may be justified as a result of concessions or tradeoffs made by the utilities. Nor does he indicate which of the returns are for multi-year rate plans, and thus incorporate "stay-out premiums."

With respect to the risks underlying the rate plans themselves, there are many important elements, all of which have a direct impact upon a utility's ability to achieve its authorized return on equity, and Mr. Hoglund does not reflect any of them. For instance, in New York the Commission generally allows for a high level of expense reconciliation for items such as property taxes, environmental remediation costs, and pension and OPEB expenses. We also utilize purchased power adjustment clauses that not only allow full recovery of this very large and

volatile cost element, but just as importantly, on a timely basis as well. Many other jurisdictions do not incorporate these mechanisms into their rate plans, which are clearly beneficial to our utilities' cash flow and which greatly reduce their volatility and uncertainty.

Finally, Mr. Hoglund does not indicate which of the returns are based upon historic test period and rate base determinations. In periods of escalating operating and maintenance costs such as we are currently witnessing, combined with the need for significant capital additions, it is inarguable that our regulatory approach, which estimates the revenue requirement needs of our utilities based upon fully-forecast test periods and rate bases, is far superior in terms of providing utilities with reasonable opportunities to earn their authorized returns.

Q. Have you performed any analyses that substantiate the superiority of the fully-forecast test period during periods of rising

operating costs and significant infrastructure investment needs?

A. Yes. To demonstrate this point, we compared the pre-tax dollars that would be provided the Company under our recommended ROE using Con Edison's fully forecast rate base with the ROE that would be required under an historical rate base approach in order to provide the Company with essentially the same revenues to pay for its capital costs and their associated income tax obligations.

As illustrated on page 2 of Exhibit___(FP-3), our 9.5% recommended ROE results in a pre-tax rate of return allowance of about 10.60%. Applying this rate to Con Edison's fully forecasted rate base of $14.494 billion, our rate of return recommendation implies an authorization of about $1.536 billion during the rate year. Under a historical test year approach, however, the rate base to which this pre-tax rate of return allowance would be applied would be considerably lower.

For instance, the Company estimates that

its rate base will grow by about $1.7 billion a year over the next three years. Assuming these additions are spread evenly throughout the year, the known or "historical" rate base at the beginning of a given rate period would be about one-half of that amount, or $850 million less. The implications of this can be seen on page 3 of Exhibit___(FP-3). Specifically, due to the substantially lower rate base under a historical test year approach, Con Edison would require an ROE about 80 basis points higher (10.33%), in order to provide it with roughly the same amount of dollars that it would be authorized under our fully forecast rate base approach. Similarly, investors in utilities that operate in jurisdictions that use historical test years would require a higher ROE, all else equal.

Q. Have you seen any evidence suggesting that the ROEs authorized in other states are beginning to reflect the interest rate environment in a manner that is closer to Staff's approach?

A. Yes. RRA's data base indicates that while the average authorized ROE in electric rate cases

was 10.51% (10.52% without one New York authorized ROE) in 2005, they have generally declined, and so far this year the average return authorized is 10.28% (10.40% excluding two New York authorized ROEs).

Q. How does that average compare to the ROE under your recommended approach?

A. While we still have many of the same reservations about the comparability of these returns that we expressed earlier, we believe that comparing the 2008 average authorized ROEs to our "raw" proxy group ROE of 9.96% is somewhat informative. The reasons we say that this comparison is "somewhat" apt are primarily twofold. First, because the authorized ROEs are from roughly the same time period as the economic data underlying Staff's approach, they reflect generally similar interest rate environments. Second, because Staff's proxy group ROE reflects the cost of equity for an electric utility with between BBB+ and BBB credit ratings, it is generally comparable to the industry average authorized ROE, as the

underlying companies also have between BBB+ and BBB credit ratings.

Q. Did you prepare an exhibit to illustrate the composition of the 10.28% average electric ROE authorized in 2008?

A. Yes. We prepared a two page exhibit, entitled Exhibit___(FP-17). Page one illustrates all of the 25 electric cases decided this year, and shows the average ROE to be 10.28%. Page two illustrates the 18 electric rate decisions in which an ROE was specified; it also excludes the two New York cases decided so far this year.

Q. Do you have any further comments or observations regarding the comparability of the recent authorized ROEs and your proxy group ROE determination?

A. Yes. Considering that seven of the ROEs are based upon historic test periods, and that five are based upon settlements in which higher authorized returns may be justified as a result of concessions or tradeoffs made by the utilities, we see pretty clear evidence that these recently authorized ROEs would, on

average, be expected to be higher than our raw 9.96% ROE.

Q. You have stated that you believe New York's approach is far superior in terms of providing utilities with reasonable opportunities to earn their authorized returns. How do the actual earnings of Con Edison's electric operations compare with electric returns authorized nationally?

A. According to RRA's data base, the average authorized electric ROEs for the 2005 to 2007 period were 10.51%, 10.35% and 10.31% respectively. In its compliance filings to Staff in Case 04-E-0572 Con Edison - Electric Rates, the Company reports that its earned rates of return over the past three rate periods ending March 31, 2008 were 10.96%, 10.76% and 11.86% respectively. Each of these returns is comfortably above the 10.3% ROE authorized in that proceeding. Thus, New York's regulation has clearly afforded the Company the ability to achieve returns that exceed not only its own authorized ROE, but also those being authorized

nationally.

Q. What comments do you have with respect to the testimony of Company witness Cannell?

A. Company witness Cannell provided testimony addressing the following topics: how equity investors evaluate investments in utility companies in general; how these same investors perceive Con Edison and the New York regulatory environment; and, how the investment community would view Dr. Morin's recommended ROE. Generally speaking, we found much of Ms. Cannell's testimony to be pure opinion in nature, as there was no evidence to back up many of her claims. Thus, we will confine our comments to two of her central conclusions.

Q. What has Company witness Cannell opined regarding the Company's level of risk and the ROE it should be authorized?

A. Ms. Cannell argues that Con Edison has "a number of risk factors relevant to a wires-only utility that increase its risk, coupled with company-specific issues, such as its major capital expansion program, which should argue for a

higher allowed ROE as compensation for that greater risk level."

Q. Does your ROE approach reflect the risks cited by Ms. Cannell?

A. Absolutely. Our approach establishes a cost of equity for a proxy group of companies whose risks are substantially similar to the Company. As we have already explained, via our credit quality adjustment, we adjusted the proxy group's cost of equity to reflect the actual differences in the financial and business risks facing Con Edison and the proxy group. Both S&P and Moody's are well aware of the risks cited by Ms. Cannell. Consequently, these risks are fully reflected in their respective credit ratings of the Company, and hence incorporated in our credit quality adjustment.

Q. What is your response to Ms. Cannell's assertion that "investors have expressed considerable concern about the regulatory environment in which (the Company) operates…"?

A. We certainly understand that some investors might have been disappointed with certain

aspects of the 2008 Rate Case and the implications that the outcome portends for the Company's future financial performance. For instance we don't believe that investors are heartened by the fact that the Commission felt compelled to investigate $1.6 billion of the Company's prior capital expenditures, as this suggests doubts regarding the effectiveness of the Company's management.

Ms. Cannell argues that, as a result of the last electric case, the financial community has taken a very dim view of the regulatory environment in New York. The one telling piece of information that she provided, however, suggests that the regulatory environment here is relatively neutral. According to Ms. Cannell, RRA accorded New York an "Average" rating in its most recent quarterly evaluation of state regulatory commissions. We generally find RRA to provide views that are not only well-informed, but unbiased as well. Thus, while the regulatory environment in New York may not be viewed quite as favorable to investors as it has

been in the past, it is also clear that the tone of regulation here should not be of great concern either.

Q. Does this conclude your testimony at this time?

A. Yes it does.