BEFORE THE NEW YORK STATE PUBLIC SERVICE COMMISSION

In the matter of:

APPLICATION OF CONSOLIDATED)
EDISON COMPANY OF NEW YORK CASE NO. 08-X-0000
FOR AN INCREASE IN ELECTRIC RATES)

TESTIMONY

OF

JULIE M. CANNELL

May 2008

INTRODUCTION

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

A. My name is Julie M. Cannell. I am the president of my own advisory firm, J.M. Cannell, Inc. My business address is P.O. Box 199, Purchase, NY 10577.

Q. Please describe your professional and educational background.

A. My firm, J.M. Cannell, Inc., provides advisory services to electric utility companies and other firms and organizations with an interest in the industry. Prior to establishing my firm in February 1997, I was employed by the New York-based investment manager, Lord Abbett & Company, from June 1978 to January 31, 1997. During my tenure with Lord Abbett, I was a securities analyst specializing in the electric utility and telecommunications services industries; portfolio manager of America's Utility Fund, an equity utility mutual fund, for which Lord Abbett was a subadvisor; portfolio manager of numerous institutional equity portfolios; and co-director of Lord Abbett's Equity Research Department. Further information on my background can be found in Appendix A.

Q. Have you submitted testimony previously before any state regulatory agencies?

A. Yes, I have. I have submitted pre-filed testimony on behalf of investor-owned utilities before Public Service or Public Utility Commissions in the states of Arizona, Connecticut, Kansas, Missouri, Nevada, Oklahoma, Pennsylvania, South Carolina, Texas, Virginia, and Washington.

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

A. I will discuss the perspective of investors with respect to the return on equity for Consolidated Edison Company of New York, Inc. ("CECONY" or the "Company") in the context of the current electric base rate case.

Q. As an analyst or portfolio manager, did you follow CECONY or its parent, Consolidated Edison, Inc. ("Con Edison" or "CEI")?

A. Yes, I did. Both Lord Abbett and America's Utility Fund periodically maintained a holding in the common stock of CEI.

Q. Please summarize the key points of your testimony.

A. As my testimony will explain, investors now require a higher return when investing in the electric industry due to the changing nature of the industry through a hybrid deregulated structure and attendant increased risk. The investment industry itself has undergone major changes in recent years, including a dramatic growth in the amount of capital controlled by institutional investors and hedge funds. Performance pressures have shortened significantly the timeframe during which an investment must realize its expected return.

In making their assessments of utility companies, investors consider various factors, key among them the regulatory environment. Regulators influence a utility's capital structure and returns that may be earned on that capital. Those factors in turn determine a company's ability to provide stable earnings and dividends. Investors have reservations regarding CECONY at this time due, in large measure, to their concerns about the regulatory climate in New York. The uncertainty in the state is a key risk factor in their outlook.

In my judgment, the investment community has seen the rate of return granted in the most recent electric rate case as a strong negative for the Company. They would find an 11.0% return on equity for the Company, as recommended by Dr. Morin, to be reasonable. Such a return level would provide CECONY with the necessary cash flow to help fund its considerable capital expenditure program and meet the expectations of equity investors. Importantly, an 11.0% return on equity ("ROE") would benefit customers by strengthening the Company's finances and lowering its future cost of capital.

Q. Please summarize what in your experience allows you to provide testimony about the viewpoint of investors.

A. As a securities analyst, I specialized in the electric utility industry and the individual companies comprising it. And as a portfolio manager, I applied that knowledge, along with investment fundamentals, toward investment decisions on behalf of institutions and individual investors. Moreover, I have reviewed the various reports of institutional investors, which have addressed the Company and its regulatory situation.

Q. Please describe how your testimony is organized.

A. There are three parts to my testimony.

<u>How Investors Evaluate Investments in Utility Companies.</u> This section discusses why investors choose to invest in electric utilities, with particular emphasis on why the regulatory climate in which the utility operates is of such importance to investors. This section of the testimony also discusses why the risk of investing in the electric utility industry has risen substantially in recent years on an industry-wide basis, and why markets today react so swiftly and strongly to unfavorable news about a company. It further details the risk present in distribution-only companies.

<u>Investors' Perceptions Related to the Present Proceeding</u>. This section reviews the investment community's perceptions of CECONY and New York regulation. This review is based on a number of recent publications by investment analysts discussing their perceptions of the CECONY electric service rate case most recently concluded and the Company's regulatory environment.

<u>Return on Equity.</u> This section discusses CECONY's request for an 11.0% return on equity, which is addressed in greater detail in the direct testimony supplied by Dr. Roger Morin. My conclusion is that the Company's proposal is one that investors view as important and constructive. An allowed ROE of 11.0% would lead to a more robust stream of earnings and cash flow, and would be viewed favorably by the investment community at a time when increased financial stability is very important to the Company.

II. HOW INVESTORS EVALUTE INVESTMENTS IN UTILITY COMPANIES

Q. Why is it important to consider the opinions of the investment community?

A. Electric utilities are in the business of providing the infrastructure needed to give their customers safe, reliable, and efficient service. Electric delivery is a capital intensive business. Investors supply the capital necessary to maintain and expand a utility's infrastructure, which in turn enables utilities like CECONY to provide reliable service to customers. The terms on which the Company is able to obtain that capital have a direct and measurable impact on ratepayers and the amounts they pay for delivery service. If individual or institutional investors believe that the return they are offered is too low in light of the risk involved, they will either sell their stock or elect not to purchase the stock, which generally drives the stock price down. Although lower stock prices would appear at first blush to be a concern only to investors, they also affect ratepayers. When a utility has to go to the equity markets to obtain capital, a low stock price requires it to issue more shares of stock to obtain the same amount of money that it would have received for fewer shares if the per share price had been higher. Because of the resulting increase in the number of shares outstanding, more dollars would have to be expended toward dividends, resulting in less retained earnings for reinvestment in the company.

The corollary is that when investors believe that they are investing in a company that enjoys fair, consistent regulation and a reasonable rate of return, those investors charge less for their capital. And when debt and equity investors demand less for their capital, utility rates remain lower and utilities have more ready access to the capital markets. Thus, a utility and its ratepayers have a shared interest in meeting the expectations of investors and credit rating agencies. Regulators share this interest as well, because fair treatment of one utility decreases the costs of capital for all utilities in that regulatory jurisdiction.

Q. Are you suggesting that the New York Public Service Commission ("PSC" or "Commission") should cater to the desires of investors?

A. No. I realize that the Commission has to balance the interests of both investors, who want consistent and constructive regulatory treatment, and ratepayers, who want lower rates. My point is that the Commission's decision on rate of return is not simply a zero-sum game. If the rate of return is within a zone of reasonableness, both the utility and ratepayers win. If the rate of return is set too low, both the utility and ratepayers lose because of the effect on the cost of capital. The next part of my testimony is devoted to explaining why the correlation of investor and shareholder interests exists.

Q. What goals lead investors to invest in electric utilities?

A. Historically, electric utilities have been regarded as investment vehicles that provide stable performance through the ups and downs of market cycles and changing economic conditions. Electric utilities historically have earned a reasonable return even when conditions were not favorable for other companies. Accordingly, electric utility stocks have been particularly valuable holdings when conditions were not favorable to investments in more volatile industry sectors. In other words, investors might see greater returns from investment in other industries when times were good, but they would lose less on electric utility stocks when times were less favorable.

In addition, the reliability of electric utilities' earnings streams historically has permitted most of the companies to continue to pay regular dividends during both good and bad economic cycles. For investors with a need for regular cash income, the prospect of regular dividends has been an important consideration in making a decision to invest in electric utility stocks

Based on these factors, investors traditionally have viewed electric utility stocks as bond substitutes. In other words, electric utility stocks have provided regular cash returns in the form of dividends and the shares themselves were seen to have a stable underlying value. Electric utilities historically have paid out a large proportion of their earnings as dividends, and their large construction programs have kept them dependent on the capital markets. As a result, electric utility stocks as a group have tended to move closely in line with the direction of interest rates, but in an inverse relationship. That is, utility stock prices rose when interest rates fell, and vice versa. These factors made electric utilities a preferred investment during economic slowdowns or recessions and owning them was a way of balancing the risks in a stock portfolio that included stocks in more volatile industries. Recently, however, utility stock prices have not risen with declining interest rates. This is due to fundamental concerns that investors have about the massive capital expansion program the industry is facing and the amount of capital that will be required to fund it, among other issues.

Q. Have the recent changes in the industry increased the risk of investing in electric utilities?

A. Yes. The predictability of the electric utility industry's earnings, across the sector, was undermined in the last ten to fifteen years by the restructuring of the industry that has taken place in many parts of the country, including New York. Presently, the onset of a major new construction cycle is seen as posing a new and significant challenge to the electric utility sector. In addition, regulatory exposure has become a key focus for investors as utilities face a series of rate cases related to infrastructure hardening and expansion, environmental requirements, and other cost increases. These risks are in addition to those posed by technological, economic, environmental and other policy changes that affect the industry. These increased risks mean that investors no longer perceive electric utilities as a group as being the "safe havens" they once were.

Investors' goals, however, have not fundamentally changed. They still look to electric utilities primarily as defensive investments, and still look for stable performance and regular dividends as the reason to invest in electric utilities. But investors also understand that the investment risk in electric stocks has risen significantly, and that there is considerable risk that investors' goals in investing in this sector may be frustrated.

In the end, investors have a very large universe of stocks from which to select; with few exceptions, they have no requirement to own electric utility stocks. Consequently, investors now require a higher return for investing in the electric utility industry to balance the increased risk associated with it.

Q. How do these concerns affect CECONY?

A. Markets tend to make judgments about investment risks that apply to industry sectors as a whole. Company-specific risk factors are additive to sector risk. In other words, investors first determine the risk involved in investing in a particular sector. They then add to that sector risk the specific risks applicable to individual companies.

Q. You mentioned the industry's current construction cycle as a risk. Please elaborate.

A. In its annual regulatory study, *Capital Complications*, Lehman Brothers explores extensively the ramifications of the current construction cycle. The brokerage firm's global conclusion is "...***that expanding capital programs and increasing cash shortfalls threaten company and shareholder returns*** [emphasis added]."[1]

The study goes on to say:

- A robust capital spending program throughout the industry exacerbates cash flow issues, as capex levels look to settle above $50 billion a year, almost double the levels of 2004. FCF [free cash flow] appears negative by as much as $16 billion a year post-dividend, and negative $4 billion pre-dividend, in the next few years.
- The need for external capital to fund dividends and capital programs is beginning to grow. We estimate that approximately $60 billion of external debt and equity funding will be necessary by the end of 2010.
- Complicating this picture further for regulated utilities will be the need to seek more frequent rate increases to fund rate base growth. Historically, more trips to the regulator, coupled with rate increase requests to fund larger capital budgets, have resulted in a compression of allowed returns and significant effects from regulatory recovery lag.
- We believe that the quality of regulation will play a larger role in stock selection, as this capital cycle wears on. We focus on jurisdictions that favor settlement over litigation, performance-based regulation over traditional ratemaking, and those in which infrastructure growth is incentivized with healthy returns.[2]

Q. Does CECONY face additional risks in a competitive market for energy?

A. Yes, it does. When the Company was an integrated utility involved in the broad provision of generation, transmission, and distribution services, CECONY was able to spread the risks involved in any of those businesses across a broader base. It was also able to profit from the production cost of electricity. However, as a

[1] Lehman Brothers, Capital Complications. May 2007.
[2] Ibid.

wires-only company now, focusing on energy delivery, CECONY has all of its assets concentrated in a single line of business and thus is fully exposed to any risks, including those pertaining to size and scope, that may impact its core business. In addition, CECONY makes no profit from the production or procurement of electricity, and can no longer control the cost of power to the customer. As commodity costs increase uncontrollably, customers and regulators will subject the only part of the value chain they can control—the delivery business—to further financial pressures.

Q. What additional risk factors are facing wires-only companies today?

A. High commodity prices have also contributed to a reluctance on the part of politicians and regulators to subject consumers to additional rate increases, as was true in Maryland and Illinois in 2006.

A related factor is rising environmental requirements such as RGGI, RPS, and other forms of carbon regulation, coupled with a significantly heightened public awareness of climate issues, making the prospect of higher expenditures within the near future more likely. Even though CECONY does not own generation, it would bear the expenses associated with environmental compliance through the costs it pays for purchased power, which would factor in higher environmental-related power production expenses. Again, this puts pressure on total costs, and thus makes it more difficult to accept rate increases.

Q. Have further risks related to wires-only companies presented themselves?

A. Yes. A number of factors are converging to suggest there will be more regular rate cases, which raise questions about the timing and certainty of a utility's cash recovery of costs. Such proceedings will be driven the substantial current-dollar costs of maintaining a mature utility infrastructure. Indeed, this is CECONY's second electric rate case in just a little over one year.

Q. You've discussed the mounting risks you see a distribution company facing. Do those risks have the potential to reduce the company's earnings and cash flow streams and increase their volatility?

A. Yes. A single line of business increases exposures to enterprise credit risk, operating issues, prospective new costs, and technology issues, all of which can have negative financial ramifications. Moreover, because these factors are in large part beyond a company's control, the company's investors have little guidance and more uncertainty. Uncertainty leads to investor concern and demands for higher investment returns.

Q. Please turn now to utility regulation. Why is the perception of regulatory climate of such importance to investors?

A. Equity investors today still seek companies that can offer stability in earnings and dividends. Fixed income investors look for stable and adequate cash flows to ensure payment of principal and interest when due, as indicated by stable credit ratings. The ability to pay dividends and sustain credit ratings is directly related to the consistency and sufficiency of a utility's earnings, which depend in large part on how the utility is regulated. If there is uncertainty about whether regulation will allow a utility the opportunity to earn a reasonable return in future years, then that uncertainty will lead investors to avoid holding investment positions in the utility, all other things being equal.

As a result, I believe that investors selecting electric utility stocks today place a very high value on consistent and constructive regulation. And, with a new round of base rate case filings underway in the industry, the quality of regulation is receiving renewed investor attention.

Q. In your experience as an analyst and portfolio manager, could a perceived change in a company's regulatory climate affect your investment opinion?

A. Absolutely. During my tenure as an institutional investor, a company's regulatory environment was a critical factor in my assessment of its investment attractiveness. An adverse regulatory decision could be a key determinant in my recommendation or decision to sell a stock already owned or not to make an investment in one under consideration.

Q. Who are typical investors in utility stocks?

A. There are two kinds of investors: individuals, who generally seek stability and income from their utility holdings, and institutions, which generally seek total return (i.e., price appreciation plus dividend income) from their utility investments.

Q. How has the investment industry itself changed in recent years?

A. In recent years, institutional investors and hedge funds have grown dramatically in the amount of capital they control. This growth has had a significant impact on the speed with which the market reacts to unfavorable developments. It has led the market to be much more reactive and much less forgiving than it may have been in the past. In the context of a regulatory decision, investors will not necessarily wait, as they would have in the past, to see how the ramifications of a decision might play out. Rather, they simply sell their shares if a regulator's decision runs counter to their expectations.

Q. What has led to that change in the market's reaction?

A. The market is now heavily populated by institutional investors, who play a significant role in the marketplace.

Q. Why are institutional investors of such importance generally?

A. Because of the sheer size of their investment positions, institutions can effectively direct the course of individual securities, and sometimes can move the market as a whole. Institutional investors include financial institutions such as: mutual funds, investment companies, insurance companies, commercial and investment banks, and various types of public retirement funds. They approach the investment selection process from the standpoint of a portfolio. An investment portfolio is a collection of stocks selected to achieve the highest possible return within a commensurate level of risk. Therefore, institutional investors keep electric utilities in their portfolios only when such stocks contribute to achieving the desired risk/return relationship.

It should be remembered that, generally, the customers of institutional investors are individuals and it is they who ultimately gain or suffer loss from changes in the value of the institution's investments. Anyone who has a stake in a retirement plan, owns a mutual fund, or has a trust fund, for example, is directly or indirectly a client of an institutional investor. But the individuals who make the decisions concerning these investments are paid money managers, and how they see their responsibilities to the clients they serve, and the way that their performance is judged, have a great deal to do with how they react to developments in the market.

Q. Why are institutional investors important to CECONY and its parent CEI?

A. Institutional investors today hold roughly 52% of CEI's total common shares. Such investors warrant significant attention because they can dramatically change the market for CEI shares. Because institutional investors own large blocks of shares relative to the volumes typically traded, their activity in moving in or out of the company's shares is often noticeable as a significant change in the price and volume of shares being traded for the company. This change may be picked up by other institutional investors, by the investment community in general, and eventually by individual investors. These other entities will then look to see what is driving this trend in the stock and whether the trend is likely to continue or disappear. If they see support for the trend, they may follow the lead of the firms that initially began to move the market, and by following the leaders, the late movers may further strengthen the trend.

Q. What does this mean for investments in regulated utilities specifically?

A. This shortened time frame means that if there is bad news, institutional investors are more likely to react quickly. In the instance of a rate proceeding, these investors are unlikely to wait to see what the outcome of the next rate decision will be. That would represent an opportunity cost to them. Rather, institutional investors would be more prone to sell their shares on the news of an adverse regulatory outcome. This would not be good for ratepayers either, for the reasons discussed earlier.

Q. Do all institutional investors function within the time frames you describe?

A. No. There is a type of institutional investor called a hedge fund that frequently buys and sells the same stock during the course of a day.

Q. What impact do hedge funds have on the market in general and stocks in particular?

A. Their impact can be dramatic. Hedge funds are well known for trading in information; their actions are frequently event-driven. Sometimes that information is factual and other times it falls into the category of rumor. Because investors at hedge funds have wide information networks and are in frequent communication with companies and a broad range of other investors, they have the ability and the power to create volatility, which in turn impacts the movement of stock prices. The number of hedge funds participating in the market and the funds' assets have grown exponentially in over the past two decades—recent estimates put the numbers at over 10,000 firms with assets of $1.868 trillion globally at year-end 2007, compared to 610 firms with $39 billion in assets in 1990. Thus, they have become a very strong force both in the market and in stocks in which they are interested. When they like an industry group or a stock, hedge funds can provide substantial support to stock prices. But, conversely, when they become disenchanted, their tendency is to sell quickly and without remorse. Although their focus is not on contributing to orderly markets, hedge funds are a formidable presence in the market place and must be reckoned with.

Q. Can you give an example of how hedge funds might traffic in Con Edison's stock?

A. Yes. Investors have been aware for several months that the Company intends to file a new rate case. Hedge funds assuredly made assumptions about the details of the case, including its resolution, prior to the filing. If, when the Commission's decision is ultimately announced, the details fall short of those expectations, the hedge funds could put significant pressure on the stock either through outright sales, or short-selling (i.e., selling stock that is borrowed in anticipation that the price of the stock will drop before the borrowed stock must be replaced). Hedge funds seek to get ahead of the broader market and react to news before the market can. The presence of such funds also can serve to attract like-minded hedge funds to join forces into a herd mentality that can prove a highly disruptive force.

Q. What role do credit agencies play in investors' expectations?

A. In the wake of financial disasters, bankruptcies, and the ensuing severe erosion in investor confidence in the past few years, credit issues have become critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, a spillover effect soon was experienced by healthy utilities. Part of this was due to the fact that the rating agencies came under harsh criticism that they had failed to detect problems early enough in companies such as Enron Corp. As a result, they began to heighten their scrutiny of all entities under their watch and became far more proactive in making rating changes. As well, "headline risk" began to come into play, as investors worried that –when credit problems in an industry are in the headlines—any company in the sector could be vulnerable to a downgrade. Thus, equity investors now closely watch the actions of the credit agencies, because any change in ratings can signal underlying problems and have a significant impact on a company's stock price.

Q. What happens when a credit downgrade occurs?

A. In the simplest terms, it becomes more expensive for a company to raise money in the capital markets because a downgrade raises a company's risk profile and consequently, increases the cost of debt. And because of the increased linkage these days between negative events and stock prices, the stock price frequently reacts—sometimes quite strongly—to a downgrade. It should be noted that both negative and positive changes in credit ratings can and do occur as a result of regulatory actions.

III. INVESTORS' PERCEPTIONS OF THE CURRENT PROCEEDING

Q. How have you gauged investors' perceptions of the issues in this proceeding?

A. To supplement my own knowledge of the industry, I have reviewed various reports related to CECONY and CEI written by investment analysts. A clear picture of investors' perceptions emerges from these reports, which is in keeping with my own views.

Q. How would you characterize investors' views of CECONY's risk profile?

A. Investors' assessment of the Company's risk level is somewhat complex. The fact that CECONY has a simple energy delivery business model is viewed positively. Parent CEI's perceived secure dividend and relatively high dividend yield are attractive to certain investors. More than offsetting those factors, however, is the fact that the Company, as will be discussed below, has significant capital market risk. CECONY has embarked on a massive construction program that will increase its current market capitalization by more than half over the next few years. That construction is being undertaken during a time of rising costs and mounting inflationary pressures, which makes increases in budgets more likely than decreases. In addition, these budgets assume successful realization of significant demand reductions. Without successful demand programs, capital expenses will be even larger Moreover, the large building program will also require significant amounts of financing from the capital markets during a period when those markets are in turmoil. Most important, however, is the fact that investors have serious concerns about the regulatory environment in which the Company operates. Key Banc Capital Markets provides a succinct description of CECONY's risks: "We believe the primary risk to ED remains regulatory uncertainty in an environment in which high levels of growth and reliability spending are exacerbated by inflationary pressures induced by a weak dollar and global demand for materials."[3]

Q. Please expand on security analysts' views of CECONY's regulatory situation.

A. Investors generally do not view New York regulation favorably. The Company's electric rate decision issued by the Commission in March 2008 caused widespread concern in the investment community. The titles of several reports issued at the time express investors' unease with the Commission's action: "NYPSC Order

[3] KeyBanc Capital Markets, "Consolidated Edison, Inc.: ED: Onerous New York Regulation Continues." March 20, 2008

Worse Than Expected,"[4] "Rate Case Disappoints,"[5] "ED: Onerous New York Regulation Continues;"[6] "At Least Your Bill Won't Rise As Much…"[7] The commentary within the reports is also illustrative of the analysts' concern. As KeyBanc Capital Markets noted,

> In our view, the rate case presented a new commission a cathartic opportunity to clear the decks of former policy views with which it has philosophical differences. This represents to us in essence retroactive ratemaking, where ED acted according to the signals the former commission willingly gave, only to have the new commission change the rules mid-game.[8]

Credit Suisse opined:

> The New York Public Service Commission (PSC) issued a fairly punitive oral decision on ConEd's CENY electric rate case, breaking a 20 year pattern of multi-year settlements. . . . In order for the New York lights to stay on, we believe ED (and investors) will need more support from the Commission than evidenced today. … The New York regulatory scene could remain tricky to navigate over the next year.[9]

Q. Has New York regulation been evaluated in a broader sense than the recent decision?

A. Yes. Both Regulatory Research Associates (RRA) and Lehman Brothers have ranked the New York Public Service Commission from an investor perspective. In its most recent quarterly evaluation of state regulatory commissions, RRA accorded New York regulation an "Average-3" rating.[10] There are three tiers to RRA's ranking scheme: Above Average, Average, and Below Average, with a numeric designation of 1, 2, or 3 (with 1 being the strongest) within the principal

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[4] Lehman Brothers, "Consolidated Edison: NYPSC Order Worse Than Expected." March 20, 2008.
[5] Merrill Lynch, "Consolidated Edison: Rate Case Disappoints." March 20, 2008.
[6] Key Banc Capital Markets, op. cit.
[7] Credit Suisse," Con Edison: At Least Your Bill Won't Rise as Much." March 20, 2008.
[8] KeyBanc Capital Markets, op.cit.
[9] Credit Suisse, op. cit.
[10] Regulatory Research Associates, "State Regulatory Evaluations," April 1, 2008.

rating category employed to indicate relative strength therein. The regulatory firm notes that its evaluations "are assigned from an investor perspective and indicate the relative regulatory risk associated with the ownership of securities issued by the jurisdiction's electric, gas, and telephone utilities. Each evaluation is based upon our studies of the numerous factors affecting the regulatory process in the state, and is changed as major events occur that cause us to modify our view of the regulatory risk accruing to the ownership of utility securities in that individual jurisdiction."[11]

It bears mention that on October 25, 2007, RRA lowered its rating of the New York regulatory environment to "Average/3" from "Average/2" as a result of the Commission's decision in CEI subsidiary Orange and Rockland Utilities' ("ORU") rate case. The "Average/3" ranking reflects the weakest segment or low end of the Average tier:

> This New York Public Service Commission (PSC) decision for Orange and Rockland Utilities (ORU), a subsidiary of Consolidated Edison, Inc., is negative from an investor viewpoint. This case was initiated as an earnings investigation by the PSC, in response to ORU's relatively strong earnings over the previous three-year rate plan, and the fact that the plan expired without a new rate plan in place. While the PSC determined that the company's rates should remain unchanged, the Commission adopted a 9.1% return on equity (ROE), which, to our knowledge is the lowest ROE authorized an energy utility nationwide in at least the last 30 years. We noted that prior to this decision for ORU, the lowest equity return was 9.45%, which was authorized by the Arkansas Public Service Commission in a 2005 gas rate decision for CenterPoint Energy Arkansas Gas. The low return authorization in that case reflected a penalty related to the Arkansas Public Service Commission's determination that the company's record keeping was deficient. We should point out that in cases without rate settlements, the New York PSC, historically, has authorized ROEs that were well below prevailing nationwide averages; however, this return authorization was far below our expectations and has lowered the bar for

[11] Ibid.

> the industry. Therefore, we are lowering our rating of New York regulation to Average/3 to Average/2.[12]

Q. You mentioned that Lehman Brothers also has a regulatory ranking.

A. Yes. For the past several years, Lehman Brothers has published an annual regulatory study that includes an evaluation of state utility commissions from an investor perspective. Tier 1 is deemed "Most Shareholder Oriented" and Tier 5, "Most Consumer Oriented." Lehman bases its rankings on 6 criteria: 1) elected versus appointed commissions; 2) performance-based ratemaking mechanism or not; 3) allowed ROEs; 4) settlements versus litigation 5) rate levels; and 6) a subjective investor friendless rating. In its May 2007 assessment, the investment firm ranked New York in "Tier 4" on this scale.[13] This ranking indicates that the perception of the New York regulatory environment in 2007 was that it did not fairly balance the interests of investors and consumers, and that consumer interests received more emphasis than did the interests of investors.

Two additional points regarding the Lehman ranking bear mention. First, according to the score derived from Lehman's analytical criteria referenced above, the 2007 tally for New York regulation in 2007 was 9.83, which placed it 42nd among the 48 state commissions evaluated from an investor perspective. Second, Lehman's 2008 regulatory report, which would incorporate recent rate decisions in the state, has not yet been published.

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[12]Regulatory Research Associates, "Final Report: New York, Orange and Rockland Utilities: Electric Delivery Rates to Remain Unchanged Following Earnings Investigation." October 25, 2007.
[13]Lehman Brothers, Capital Complications, op. cit.

Q. Please return to CECONY's recent rate order. What were some of the specific concerns the analysts voiced regarding the PSC's decision?

A. Two aspects of the decision troubled the analysts: the low level of the allowed ROE and the shortfall in the permitted revenue allowance. CECONY was granted a 9.1% ROE and $425 million rate increase, compared to its request for an 11.5% ROE and $1.2 billion rate increase.

Q. Please elaborate on investors' opinions about the authorized ROE.

A. Analysts were disappointed about two aspects of the allowed ROE. First, the absolute level of ROE was very low. As noted previously, Regulatory Research Associates characterized the 9.1% allowed CECONY's sister company ORU last October as "the lowest ROE authorized an energy utility nationwide in at least the last 30 years," and the Commission continued a pattern of authorizing subpar ROEs in the National Fuel Gas and CECONY electric cases. In its analysis of the March decision, RRA used the same language as it did with ORU, cited above, to characterize CECONY's ROE.[14] Second, the 9.1% ROE was substantially below the Company's requested 11.5%, and only fractionally above the PSC ALJ's and Staff's respective recommendations of 9.0% and 8.9%. As BMO Capital Markets opined: "The allowed ROE of 9% [sic] was significantly lower than the company's original request of 11.5% and does appear punitive."[15]

Q. Have other investor studies commented on ROE awards in general?

A. Yes. Lehman Brothers' previously cited regulatory analysis presented projections for annual allowed ROEs for the industry for 2007 through 2010. Lehman

[14] Regulatory Research Associates, "New York, Consolidated Edison of New York: $425 million electric distribution rate increase authorized." April 8, 2008.
[15] BMO Capital Markets, "Lowering EPS Estimates Reflecting the Rate Decision." March 28, 2008.

estimated an 11.03% average ROE award annually over that period. The firm notes, however, that "Primarily because of regulatory lag and increased financing expenses that cause balance sheet strain and execution risks, utilities suffer subpar returns during periods of heavy capital investment."[16] While the of a future test year eliminates the problem of regulatory lag, other Commission practices such as delayed cash recovery on certain expenditures are relevant to CECONY in terms of Lehman's thesis.

Q. What are the implications of Lehman's industry ROE analysis for CECONY?

A. There are several. First, Lehman is projecting an 11.3% average allowed ROE for the industry over each of the next five years. Dr. Morin's recommendation of an 11% ROE is consistent with Lehman's 11.3% average return figure. Second, Lehman's caution that subpar returns are likely during periods of heavy capital expenditures is especially relevant to the Company, given the handicap with which it is embarking on its capital spending program because of the recently allowed 9.1% ROE. That subpar return will result in CECONY's being required to raise more funds in the capital markets to fund construction than would have been the case with a higher ROE.

Q. You mentioned that the revenue allowance was also a disappointment to investors.

A. Yes. As Goldman Sachs, which has a "Sell" investment rating on CEI stock noted,

[16] Lehman Brothers, <u>Capital Complications</u>, <u>op. cit</u>.

> The CECONY Electric case proved disappointing, not only on an allowed RoE basis but also on rate base growth implications.[17]

Merrill Lynch also expressed displeasure with the revenue increase:

> Yesterday, the NY PSC issued a final order in the Con Ed of NY (CECONY) electric rate case, approving a rate increase of $425M based upon an ROE of 9.1%. This was almost 30% below the Administrative Law Judges' original recommendation for a rate increase of $601.4M (9.0% ROE) and 65% below ConEd's request for $1.2B (11.5% ROE). We had expected the PSC to accept the ALJ's proposal, so the approved increase was a further disappointment.[18]

A similar viewpoint was offered by KeyBanc Capital Markets:

> While a higher ROE offers higher potential EPS vs. the staff position, the lower authorized revenue increase impacts cash flow in the midst of the large capital program, which we believe pushes Consolidated Edison (ED-NYSE) more toward dilutive raising of funds in the capital markets as opposed to internally.[19]

Q. Please expand on the import of the ROE and revenue allowances to CECONY.

A. The Company has embarked on a very significant construction program—the largest in its history. Between 2008 and 2010, capital expenditures are estimated to total $7.53 billion. Because of the low level of cash flow projected to be generated as a result of the ROE and revenue provisions in the rate order, the utility will be forced to raise capital from investors in greater measure than it would have otherwise. Merrill Lynch addressed that point directly:

> The PSC Staff supported the lower increase by adjusting property tax refunds, the depreciation reserve deficiency, amortization of recovery of the last three years' overspend, and tax benefits. These adjustments lower ED's incoming cash flow and may add to Con Ed's considerable financing needs.[20]

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[17] Goldman Sachs, "Consolidated Edison: Lowering estimates for CECONY rate case, maintaining Sell." April 9, 2008.
[18] Merrill Lynch, op. cit.
[19] Key Banc Capital Markets, op. cit.
[20] Merrill Lynch, op. cit.

Q. How much additional external financing will be required due to the shortfall in the Company's request?

A. Over the next year, the capital markets will be tapped to supply approximately 85% of construction expenditures, according to Company estimates. For the three years following the PSC's decision in this case, nearly three-quarters must be externally financed. In the rate order, the gap between the requested and granted amounts of revenue was $800 million, or $483 million after-tax. Thus the total additional external financing requirements directly caused by the rate order is approximately a half billion dollars.

Q. Are there additional inferences to be drawn from investors' views of the Company?

A. Yes. One of the key factors analysts use to evaluate the quality of a regulatory climate is the consistency of a commission's decisions. Investors value certainty and predictability; a lack of consistency in a commission's actions or decisions serves to increase the investment risk associated with a utility. With an unpredictable track record of regulatory decisions and actions, investors are unable to anticipate reliably the future actions of a commission. That in turn depresses valuations—i.e., lowers the price of a stock and increases a company's cost of borrowing. In a study I prepared in 2005 for the Edison Electric Institute on investors' perceptions of state regulation, respondents were asked to cite the regulatory factors they felt characterized a constructive environment, as well as a non-constructive environment. On the positive side of the ledger, one of the top set of factors was a regulatory climate that is "fair, stable, predictable, and consistent." The top factor cited by the respondents as characterizing a non-constructive environment was a climate that is "arbitrary, inconsistent, and unwilling to acknowledge the economic realities that utilities face." One investor summed up that type of non-constructive regulation as "regulatory purgatory."[21] Moving from a pattern of multi-year rate plans to a one-year plan; shifting from awarding incentives and ordering penalties to a sole focus on penalties; and embarking on an ex-post examination of capital expenditures are examples of an inconsistent approach taken by the Commission in regard to CECONY.

Q. Have other investors offered opinion on regulatory quality in general?

A. Yes. In addition to the previously-referenced regulatory study undertaken by Lehman Brothers' equity utility analysts, the firm's fixed income research area also publishes an annual study of regulation. That analysis includes a list of characteristics the firm believes comprise a state commission that is supportive of credit quality.[22] Although the list is extensive, the top factor pertains to decisions that are supportive of credit quality and the authorized return on equity and equity ratios. The firm notes:

> State commissions are cognizant of how their decisions affect a company's credit quality. They consistently aim to adopt legislative policy that results in the stability of cash flow, earnings, and coverage ratios. The rates or return (ROEs) and equity ratios that are authorized in the state commissions' orders are fair and reasonable, and above the industry average. We believe that it is no accident that the state commissions that authorize higher than average ROEs and are aware of how their decision will affect the credit quality of the utility, also have the highest rated utilities in the country (e.g., Wisconsin).[23]

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[21] J.M. Cannell, Inc., "State Utility Regulation: An Assessment of Investor Perceptions," August 2005.

[22] Lehman Brothers, Electric Utilities: The Regulatory Roundup; an Overview of State Commissions. August 2007.

[23] Ibid.

While Lehman Brothers does not rank the various regulatory commissions, it does provide data on each to permit investors to draw their own conclusions.

Q. What inference do you draw from the various analysts' comments about the quality of regulation in general and New York regulation in particular as they pertain to this regulatory proceeding?

A. In my opinion, investors—both equity and debt—would clearly view a Commission decision that is consistent with the Company's request to be reflective of constructive regulation in New York. Investors have expressed considerable concern about the regulatory environment in which CECONY operates; a supportive decision in this proceeding would help to assuage those worries.

IV. RETURN ON EQUITY FOR CONSOLIDATED EDISON COMPANY OF NEW YORK

Q. How do you believe that CECONY's requested return on equity of 11.0% comports with investors' perceptions?

A. I believe that the investment community would find an 11.0% ROE supportive for the company. It is consistent with investors' expectations for ROE allowances in 2007 for supportive jurisdictions.

Q. Why do return on equity rewards vary among state commissions and companies?

A. As Dr. Morin's testimony sets forth, generic factors such as interest rates and industry issues contribute to a determination of return on equity, but in the final analysis, the appropriate ROE level is specific to the company in question. For example, as noted previously, CECONY 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. Please comment on Dr. Morin's ROE recommendation.

A. Dr. Morin notes that the just and reasonable cost of equity capital for the Company is 11.0%. Investment risk in the electric utility industry is higher than it has been, and investors are requiring greater levels of compensation to assume that added risk. In addition, investors believe there is currently a higher risk present in New York due to regulatory uncertainty, including trends in ROEs allowed by the Commission and their non-systematic treatment of costs. As an input in valuation models, earnings levels logically translate into the attractiveness of a stock, other factors being equal. A reasonable ROE award should help bolster the Company's financial health, earnings power, and, accordingly investment valuations.

Q. Please say more about investor valuations of CECONY and its parent, CEI.

A. Among the universe of fifteen investors publishing investment opinions on CEI, only one—Argus Research—recommends a "Buy" on the stock. One firm, Goldman Sachs, carries a "Sell" opinion. The remaining investment firms carry a "Hold" or "Neutral" rating. I believe that this central tendency toward neutrality reflects the fact that the negative impact of the March 2008 rate order has been priced into the stock, and there is little to commend its purchase at the current time because of the lingering uncertainty surrounding CEI's and CECONY's fundamentals.

Q. What metrics reflect investors' relative valuation of CEI?

A. While there are numerous metrics used to assess a stock's relative attractiveness, two stand out: the price/earnings ratio, which is a more short-term assessment, and the market capitalization/book value ratio which is a longer-term evaluation.

Q. Please comment on those metrics relative to CEI and how they relate to the allowed ROE.

A. CEI's current price/earnings ratio of 11.83, significantly below the utility industry average of 15.96, suggests that investors consider the company's earnings power over the next year to be far less robust than that of other potential investments in the industry. While this ratio is important, its orientation is by definition short-term in nature and thus impacted by factors that might be ephemeral. The price/book value ratio comparison—currently 1.23 for CEI, compared to a 1.78 average for the industry—is a more fundamental and longer-term assessment of how investors view the company. Because book value is a gauge of the intrinsic worth of a company, it is clear that investors have reservations about CEI's investment attractiveness on a longer-term basis as well. I believe that the low ROE allowance accorded CECONY, CEI's major operating subsidiary, in the March 2008 rate case, coupled with the significant risks that lie ahead for the Company, have signaled to investors that the utility's earnings power is severely limited, which has translated into low valuations on CEI's stock.

Q. Could a return on equity award that is consistent with investor expectations also be expected to provide benefits to CECONY's customers?

A. Absolutely. A higher ROE permits the realization of a stronger earnings stream. In turn, that can improve a company's stock's valuation prospects, which results in a higher stock price. Thus, when a company needs to tap the equity markets for capital required to meet customer needs, it can get more for its money. Said another way, each share sold brings more equity into the Company with the same commitment by the Company to generate earnings and pay dividends to support the value of that share. In regard to debt financing, a higher ROE awarded to CECONY would be viewed as a sign of constructive regulation and would be positive for the Company's credit rating. Importantly, customers' rates will eventually reflect this lower cost of capital.

Q. Does this conclude your testimony?

A. Yes.

Appendix A

JULIE M. CANNELL
P.O. Box 199
Purchase, New York 10577

<u>BUSINESS EXPERIENCE:</u>

1997- <u>J.M. CANNELL, INC.</u>

<u>President</u> of firm providing advisory services specializing in the electric utility industry.

1977 - 1997 <u>LORD ABBETT & COMPANY,</u> New York, New York

1995 - 1997	Equity Portfolio Manager. Responsibility for management and client servicing of ten institutional equity portfolios with total assets in excess of $700M. Actively and successfully involved in new institutional business marketing effort.
1994-1996	Associate Director of Equity Research. Provided oversight of departmental activities, including supervision of analysts' research efforts and support staff functions.
1992-1995	Portfolio Manager, America's Utility Fund. Full portfolio management responsibility for the fund since its May 1992 inception.
1978-1995	Securities Analyst. Sole responsibility for analysis of and stock recommendations for the electric utility and telecommunications industries. Other areas of coverage previously included housing (2 years) and pollution control (1 year).
Summer 1977	Research Assistant in Utilities.

1973-1976 UNIVERSITY OF COLORADO. Colorado Springs, Colorado.

Public Services Librarian
Instructor in Bibliography to undergraduate and M.B.A. students

1971-1973 CAMERON COLLEGE, Lawton, Oklahoma.

Reference Librarian

EDUCATION:

1978	COLUMBIA UNIVERSITY, MBA - Finance
1971	EMORY UNIVERSITY, M.Ln. - Librarianship
1970	MARY BALDWIN COLLEGE, B.A. - English

PROFESSIONAL Chartered Financial Analyst (C.F.A.)

DESIGNATIONS

MEMBERSHIPS: CFA Institute
New York Society of Security Analysts
Wall Street Utility Group