

BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of
Consolidated Edison Company of New York
Case 07-S-1315
February 2008

Prepared Testimony of:
Staff Finance Panel

Michael J. Augstell
Senior Utility Financial Analyst
Office of Accounting, Finance
and Economics

Craig E. Henry
Principal Utility Financial
Analyst
Office of Accounting, Finance
and Economics

State of New York
Department of Public Service
Three Empire State Plaza
Albany, New York 12223-1350

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

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

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

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

13 Q. Please describe your educational background and
14 professional experience.

15 A. I received a Bachelor of Arts Degree in
16 Economics from the University of Rochester in
17 1992. Since that time I have worked in
18 commercial loan banking and thereafter as a
19 financial analyst for General Electric Power
20 Systems. In the five years prior to joining the
21 Department I was employed at UHY Advisors NY,
22 Inc. (UHY) in Albany, New York. I worked in the
23 valuation and litigation services department at
24 UHY, conducting business valuations, financial

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

4 Q. Are you a member of any professional societies?

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

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

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

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

21 A. Yes. As a member of the various Staff Finance
22 Panels I provided testimony regarding the fair
23 rate of return in the following cases: Case 07-
24 E-0949, Orange & Rockland Utilities, Inc. -

1 Electric Rates, Case 07-E-0523, Consolidated
2 Edison Company of New York, Inc. - Electric
3 Rates and Case 06-G-1332, Consolidated Edison
4 Company of New York, Inc. - Gas Rates.

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

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

11 Q. Please describe your educational background and
12 professional experience.

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

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

24 A. My primary areas of responsibility include

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

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

10 A. Yes. I have testified in numerous electric, gas
11 and water rate cases before the Commission since
12 1988, most recently in Case 07-E-0949, Orange
13 and Rockland Utilities, Inc. - Electric Rates.

14 **PURPOSE OF TESTIMONY**

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

17 A. The purpose of our testimony is to establish the
18 fair rate of return that will be used by the
19 Accounting Panel to determine the revenue
20 requirement for Consolidated Edison Company of
21 New York, Inc.'s (Con Edison or the Company)
22 steam operations for the rate year ending
23 September 30, 2009. We will also respond to the
24 testimony of Company witnesses Morin and

1 Perkins.

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

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

6 **SUMMARY**

7 Q. Please summarize your testimony.

8 A. We recommend an overall rate of return of 7.35%,
9 as opposed to the Company's request of 8.58%.
10 The primary difference is due to our 9.1% return
11 on equity (ROE) recommendation versus the
12 Company's requested ROE authorization of 11.5%.
13 We also recommend a lower long-term debt cost
14 rate, 5.79% versus 5.91%, and a lower common
15 equity ratio, 47.92% versus 48.37%.

16 With respect to the appropriate capital
17 structure, we advocate a consolidated approach
18 that assures ratepayers will not subsidize its
19 parent's riskier non-regulated investments.
20 Additionally, our ROE recommendation is
21 determined using two different equity costing
22 methodologies, each weighted as the Commission
23 approved in its most recent ROE decisions
24 regarding Orange and Rockland Utilities (C. 06-

1 E-1433) and National Fuel Gas (C. 07-G-0141).
2 We also explain why our recommended rate of
3 return will assure the Company continued access
4 to reasonably priced capital.

5 **FAIR RATE OF RETURN DISCUSSION**

- 6 Q. Earlier you mentioned that the fair rate of
7 return you recommend will be used to establish
8 the Company's revenue requirement. Please
9 explain what you mean by revenue requirement.
- 10 A. In the context of regulated rate-setting, the
11 revenue requirement is the dollar amount
12 required by the Company to provide service
13 during the rate year. It is the amount that
14 will allow it to recover all of its reasonably
15 expected operating costs, including income taxes
16 and depreciation. The revenue requirement also
17 includes a fair return in dollars that will
18 enable the Company to recover the cost of the
19 funds supplied to it by its investors. The
20 funds provided by these investors, of course,
21 are needed in order for the Company to finance
22 its long-term assets, which in the rate-setting
23 context are referred to as its rate base.
- 24 Q. Generally speaking, what is a fair rate of

1 return for a regulated utility?

2 A. A fair rate of return for a regulated utility is
3 one that enables it to provide safe and adequate
4 service to its customers, while at the same time
5 assuring it continuing support in the capital
6 markets for both its debt and equity securities,
7 at terms that are reasonable given the company's
8 risk. Investors in debt securities as well as
9 preferred stock instruments enter into
10 contractual obligations with the utility and
11 receive relatively fixed income streams.

12 Common equity investment, on the other
13 hand, is non-contractual. Common equity
14 investors may share in, but are not guaranteed,
15 a portion of the utility's residual earnings.
16 The fair rate of return, therefore, allows the
17 utility to recover its prudently incurred costs
18 of debt and preferred stock, while providing its
19 common equity investors the opportunity to earn
20 a return that is commensurate with the risk of
21 their investment.

22 Q. How is a fair rate of return calculated?

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

1 through a weighted average of the individual
2 cost components of its expected capitalization
3 during the rate year. Typically, there are four
4 sources of capital. The two primary sources are
5 long-term debt and common equity. Preferred
6 stock is also commonly used, although generally
7 in much smaller proportions than either long-
8 term debt or common equity. Finally, customer
9 deposits, while a very small component, are
10 almost always reflected in the expected
11 capitalization because they are a relatively
12 permanent and stable source of capital employed
13 by utilities.

14 Since New York State utilizes a fully
15 forecast rate year, it is also important that
16 the rate year capitalization reflect the
17 utility's projected capital requirements and be
18 consistent with its stated goals, particularly
19 regarding the use of leverage.

20 Turning to the cost rates of the individual
21 components, the cost of the long-term debt and
22 preferred stock components are relatively easy
23 to compute. This is because the vast majority
24 of the long-term debt and preferred stock

1 instruments projected in the average rate year
2 capitalization have already been issued. Thus,
3 the actual or embedded costs of each can be
4 readily ascertained by examining their
5 contractual terms; i.e., the interest payments
6 for the long-term debt and the preferred
7 dividends for the preferred stock. The costs of
8 any new long-term debt or preferred stock
9 instruments, however, require estimates using
10 relevant market data. The cost rate for
11 customer deposits is simply a matter of applying
12 the cost rate that is currently prescribed by
13 the Commission.

14 As previously mentioned, the common equity
15 component is neither contractual nor prescribed
16 by the Commission. Its calculation is further
17 complicated by the fact that it can not be
18 directly observed. It is important to remember
19 that while both debt and equity holders supply
20 the utility with the funds it needs to build and
21 operate its system, the equity investors only
22 earn a return after the payment of all other
23 expenses. Because these investors run the risk
24 that their achieved returns will not equal their

1 expectations, the return required by equity
2 investors is usually higher than that of the
3 utility's debt holders. We say "usually"
4 because in periods of volatile inflation and
5 high interest rates such as 1980-82, utility
6 bonds had yields that were at least as high as
7 the returns the New York Commission allowed and
8 far above the returns most Commissions allowed.

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

17 **CAPITAL STRUCTURE**

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

20 A. We recommend an after-tax overall rate of return
21 of 7.35%, compared to the Company's request of
22 8.58%. Our proposed pro forma cost of capital
23 can be seen in Exhibit__(FP-1).

24 Q. What was Con Edison's projected rate year

1 capital structure for its steam operations?

2 A. In Exhibit JP-1, Schedule 1, Company witness
3 Perkins forecast a long-term debt ratio of
4 49.20%, a preferred stock ratio of 1.15%, a
5 customer deposits ratio of 1.27% and a common
6 equity ratio of 48.37%.

7 Q. How did the Company develop this capitalization?

8 A. The rate year capitalization was developed based
9 upon an approach that began with Con Edison's
10 latest-known "stand-alone" capital structure,
11 essentially its September 30, 2007
12 capitalization. This "stand-alone"
13 capitalization was then projected for the rate
14 year based upon its forecasted funding
15 requirements for the 12 months ending September
16 30, 2008 (link period), and for the rate year
17 ending September 30, 2009.

18 The forecasted long-term debt component
19 included an additional \$1.16 billion of
20 debentures during the link period and \$1.21
21 billion during the rate year. The long-term
22 debt component was also reduced by \$610 million
23 of maturing obligations during the link-period
24 as well as \$275 million during the rate year.

1 Since the Company is not planning on
2 issuing any new preferred stock, and has no
3 plans to redeem any of its outstanding preferred
4 stock, its rate year balance is the same as the
5 amount reported outstanding on September 30,
6 2007. Con Edison's rate year balance of
7 customer deposits was based upon historical
8 levels, which it forecast to grow by about 0.2%
9 a month.

10 The Company's projection of the common
11 equity component is largely premised upon its
12 assumptions regarding the level of future
13 earnings and the amounts and timing of equity-
14 related transactions with its parent,
15 Consolidated Edison, Inc. (CEI), specifically
16 equity contributions from the parent and
17 dividend payments to it.

18 Q. Please explain why you refer to Con Edison's
19 capitalization as a "stand-alone" capital
20 structure.

21 A. By federal law, a corporation is considered a
22 utility holding company if it owns 10 percent or
23 more of the stock of an electric or gas utility.
24 Today, nearly all of the so-called electric

1 utilities, as well as gas utilities and
2 combination (electric and gas) utilities, are
3 owned by holding companies. Con Edison, a
4 combination electric, gas and steam utility is
5 wholly-owned by its holding company parent
6 Consolidated Edison, Inc. (CEI). CEI also owns
7 100% of the common stock of another New York
8 combination utility, Orange and Rockland, as
9 well as three non-utility subsidiaries.

10 The Securities Act of 1933 requires that
11 investors receive financial and other
12 significant information concerning securities
13 being offered for public sale. The basic
14 objective of this act was to prohibit deceit,
15 misrepresentations, and other fraud in the sale
16 of securities. In general, securities sold in
17 the U.S. must be registered with the Securities
18 and Exchange Commission (SEC). Unless they are
19 privately-held, utility holding companies must
20 register with the SEC in order to issue common
21 stock as well as any long-term debt or preferred
22 stock they wish to issue to the public. Many
23 large utility operating companies such as Con
24 Edison are also registered, but only for the

1 purposes of issuing long-term debt or preferred
2 stock.

3 Because both Con Edison and CEI are
4 registered with the SEC, both companies provide
5 financial information to investors in various
6 reports to the Securities and Exchange
7 Commission (SEC). Orange and Rockland, however,
8 is no longer registered with the SEC; its
9 financial results can only be viewed through the
10 consolidated financial statements of CEI, as it
11 is the typical practice of utility holding
12 companies to report the stand-alone capital
13 structures of their major subsidiaries.

14 CEI reports its consolidated financial
15 position in its annual 10-K and quarterly 10-Q
16 reports to the SEC; it also presents the stand-
17 alone financial statements for its two wholly-
18 owned utility subsidiaries, Con Edison and
19 Orange and Rockland. It is the stand-alone
20 capital structure of Con Edison presented in
21 these financial statements that the Company
22 proposes for the purpose of determining its
23 overall rate of return.

24 Q. Generally speaking, do you believe it is

1 appropriate to use the reported stand-alone
2 capital structures of utilities that are
3 subsidiaries of larger holding companies?

4 A. While there may be particular circumstances in
5 which such an approach is warranted, the use of
6 a stand-alone capitalization should only be
7 employed after a careful analysis of the holding
8 company's financing practices. The primary
9 purpose of this analysis is to ascertain whether
10 the stand-alone capital structures of the
11 utility subsidiaries reflect rational
12 capitalization policies and that their common
13 equity components reflect actual common equity
14 at the parent level. This analysis should also
15 examine the ability of the parent to move common
16 equity from subsidiary to subsidiary as this
17 capability too has the potential to undermine
18 the veracity of a stand-alone capitalization.

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

21 A. First, the stand-alone common equity balance
22 reported by a utility subsidiary of a holding
23 company may not, in fact, be financed by common
24 equity at the holding company level. Some of

1 the utility's common equity balance may actually
2 be proceeds from debt issued at the holding
3 company level and classified on the utility
4 subsidiary's books as common equity at the time
5 the proceeds were invested in the utility
6 subsidiary. This is referred to as double
7 leverage.

8 The use of a stand-alone subsidiary
9 structure is also not appropriate for setting a
10 utility's rates in cases where a holding company
11 parent has financed riskier competitive non-
12 utility operations with less equity (and hence
13 more debt) than would be required for these
14 ventures to achieve the same credit rating as
15 the utility subsidiaries. Unless the utility
16 subsidiary's credit rating is insulated from
17 these risks, using the stand-alone capital
18 structure would effectively require ratepayers
19 of a low-risk transmission and distribution
20 (T&D) company to subsidize its parent's riskier
21 investments.

22 Generally speaking, it is simply not in
23 customers' interests to pay for equity ratios
24 that are higher than the equity ratio of the

1 parent company. Rating agencies, in whole and
2 in part, base their utility ratings on the
3 parent holding company's capital structure.
4 Under these circumstances, there is no reason to
5 pay for additional equity because it will not
6 enable the utility to achieve a higher credit
7 rating and realize lower borrowing costs.

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

11 A. No, we do not believe so.

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

18 A. Yes. Even though CEI's non-utility businesses
19 face much greater business risk than its
20 regulated utility operations, the non-utility
21 investments are currently funded proportionately
22 with only about the same amount of common equity
23 as the utility operations.

24 Q. Given these circumstances, how did you develop

1 an appropriate rate year capitalization?

2 A. Because we believe that the competitive
3 operations should provide as much support for
4 the holding company's credit rating as the
5 regulated operations, we adhered to the
6 Commission's preferred consolidated
7 capitalization approach. Specifically, we began
8 our examination of the appropriate rate year
9 capitalization with the capital that the parent,
10 CEI obtains, and allocated it to the
11 subsidiaries on the basis of their relative
12 business and financial risks.

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

14 A. Business risk is the risk inherent in a
15 company's operation and reflects the risk that
16 it will fail to achieve its expected financial
17 performance. It is affected by items such as a
18 company's sensitivity to the overall economy,
19 the level of competition it faces and its
20 reliance on a large customer or supplier.

21 Both of the major credit rating agencies,
22 Standard & Poor's (S&P) and Moody's Investors
23 Service (Moody's), assess the level of business
24 risk in tandem with the financial risk profiles

1 of debt issuers when they assign their ratings.
2 With respect to its assessment of the relative
3 strength of a company's business position, S&P
4 assigns business risk profiles. In ascending
5 order, these profiles range from "Excellent,"
6 for companies with very little business risk, to
7 "Strong," to "Satisfactory," to "Weak," and
8 finally to "Vulnerable" for those companies with
9 extremely high levels of business risk.

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

13 A. Regulated utilities, and holding companies such
14 as CEI that are primarily utility-focused,
15 virtually always fall into the upper range of
16 business profile scores, i.e., the "Excellent"
17 and "Strong" categories.

18 According to a recent S&P report entitled
19 "U.S. Utilities Ratings Analysis Now Portrayed
20 In The S&P Corporate Ratings Matrix" included as
21 Exhibit___(FP-2), the reason that utilities have
22 significantly less business risk than nearly all
23 other types of businesses is because they have
24 legally defined service territories generally

1 free of meaningful competition, and they provide
2 an essential or near-essential service.
3 Further, underpinning the "Excellent" and
4 "Strong" business risk profiles of the
5 utilities, according to S&P, is the presence of
6 regulators that have an abiding interest in
7 supporting a healthy utility financial profile.

8 With respect to Con Edison in particular,
9 S&P has acknowledged the elevated importance of
10 regulation due to the overall very low risk of
11 its transmission and distribution (T&D)
12 operations. S&P continues to view the Company's
13 business profile as "Excellent" largely because
14 of its historically supportive regulatory
15 environment and the conservative focus of the
16 parent holding company by virtue of its stated
17 strategy of focusing on the low risk T&D
18 operations.

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

21 A. According to CEI's September 30, 2007 10-Q, the
22 parent has three active competitive
23 subsidiaries: Con Edison Solutions, Inc. - a
24 retail energy services company; Consolidated

1 Edison Development, Inc. - an owner and operator
2 of generation and infrastructure investments;
3 and Consolidated Edison Energy, Inc. - a
4 wholesale supply company. While each of these
5 investments falls within the broader utility and
6 power company industry, they operate within its
7 riskiest segment. S&P classifies these high
8 risk ventures as "energy merchant and developer"
9 businesses.

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

12 A. According to a recent study performed by S&P
13 entitled "New Business Profile Scores Assigned
14 for U.S. Utility and Power Companies; Financial
15 Guidelines Revised", included as Exhibit___(FP-
16 3), the business profile of the energy merchants
17 and developers is considered to be "Vulnerable."
18 Pursuant to its published guidelines, S&P would
19 require a *stand-alone* energy merchant and
20 developer, i.e., one that that would need to
21 obtain financing based on its own financial
22 profile, to maintain its total debt to total
23 capital at about 38.5% in order for it to
24 sustain the same "A" rating that S&P currently

1 assigns to both Con Edison and CEI. By
2 contrast, a stand-alone business with an
3 "Excellent" business profile such as Con Edison
4 would only need to maintain its total debt to
5 total capital at about 55.0% in order to sustain
6 an "A" rating.

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

10 A. Given the extremely volatile nature of this type
11 of industry, debt ratings of "A" are virtually
12 unheard of. In fact, most of the competitive
13 generation companies carry speculative-grade
14 ratings, i.e., "BB+" and lower.

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

17 A. CEI, whose senior unsecured debt is rated "A,"
18 has generally issued the debt supporting these
19 risky investments. The parent's strong credit
20 rating is largely attributed to the fact that
21 about 83% of its revenues come from its low-risk
22 utility operations.

23 Q. Please explain how you allocated the debt and
24 equity in CEI's consolidated capital structure

1 according to the relative business and financial
2 risks of the regulated and non-regulated
3 subsidiaries.

4 A. As illustrated on page 1 of Exhibit____(FP-4), we
5 began with the consolidated balance sheet of CEI
6 based on its 10-Q report for the period ending
7 September 30, 2007. Column 1 presents CEI's
8 consolidated balance sheet results for all of
9 the holding company's operations. Column 2
10 shows the balance sheet information provided in
11 the 10-Q report for Con Edison, whose total
12 assets comprise nearly 86% of the enterprise
13 total. Column 3 shows the balance sheet
14 information for Orange and Rockland that is
15 provided to investors on that subsidiary's
16 website.

17 Column 4 is the sum of columns 2 and 3 and
18 thus reflects the combined balance sheet of
19 CEI's two utility subsidiaries. Column 5 is the
20 residual balance sheet of the parent after
21 removing the stand-alone balance sheets of its
22 two utility subsidiaries. It represents the
23 capitalization dedicated to risky non-utility
24 subsidiaries, as well as the goodwill booked by

1 CEI as a result of its acquisition of Orange and
2 Rockland.

3 Q. How does CEI allocate its debt and equity among
4 its utility and non-utility operations?

5 A. As illustrated in Column 4 of Exhibit____(FP-4),
6 Page 1, CEI has financed its utility assets
7 whose business risk, according to S&P is
8 "Excellent" with 49.0% common equity and its
9 unregulated assets whose business risk is
10 considered "Vulnerable" with 51.1%, or just
11 slightly more common equity than the much more
12 stable utility operations.

13 Q. How did you allocate the parent's debt and
14 equity so as to reflect a more rational
15 financing policy for CEI's non-regulated
16 investments?

17 A. As we explained earlier, S&P's guidelines imply
18 that a stand-alone company with a "Vulnerable"
19 business risk profile, would need to offset that
20 risk by employing modest financial risk.
21 Specifically, it would need to maintain its
22 total debt to total capital at about 38.5% in
23 order to sustain the parent's "A" rating.
24 Therefore, as illustrated in Column 6 of

1 Exhibit____(FP-4), Page 1, we adjusted the mix of
2 debt and equity supporting these riskier
3 operations such that the resulting non-utility
4 capitalization illustrated in Column 6,
5 consisted of 38.5% debt and 61.5% common equity.

6 In effect, we reduced the non-utility
7 operations' debt by \$133 million, while
8 simultaneously increasing the amount of common
9 equity supporting these operations by \$133
10 million. Given the much larger scale of the
11 utility operations, this allocation only reduced
12 the effective common equity ratio of the
13 utilities from the reported ratio of 49.0% to
14 48.24%, as illustrated in Column 7 of
15 Exhibit____(FP-4), Page 1.

16 Q. Given that the appropriate utility
17 capitalization that you developed represents a
18 historical balance as of September 30, 2007,
19 please explain how you reflected the impact of
20 such things as construction expenditures,
21 refunding needs and internal cash flows to
22 develop the appropriate capitalization for the
23 rate year?

24 A. As illustrated on page 2 of Exhibit____(FP-4), we

1 developed average rate year balances for both
2 the common equity and long-term debt components
3 based upon the financial forecasts supported in
4 the Company's documents in this proceeding and
5 in Orange and Rockland, Case 07-E-0949.
6 Specifically, we carefully examined the
7 Company's assumptions with regard to its
8 financing activities throughout both the link
9 period and the rate year. We found that these
10 projections reasonably reflect the impact of Con
11 Ed's proposed construction expenditures as well
12 as its anticipated internal cash flows. We also
13 found that the mix of long-term debt and common
14 equity proposed by the Company is consistent
15 with the objective of maintaining its financial
16 integrity.

17 Therefore, our projected balances of long-
18 term debt and common equity attest to this
19 conclusion, as does our preferred stock balance,
20 which is identical to the balance projected by
21 the Company. Our customer deposits balance too
22 reflects the Company's assumptions, however it
23 also includes the customer deposits for both Con
24 Edison and Orange and Rockland, consistent with

1 our consolidated capitalization approach.

2 Turning to our calculations themselves, we
3 determined the appropriate average rate year
4 balance of common equity by averaging the five
5 quarterly ending balances beginning September
6 30, 2008 and ending September 30, 2009. We used
7 the resulting balance of \$9.472 billion shown in
8 Column 9 of Exhibit__(FP-4), Page 1, to
9 determine the capitalization ratios used in
10 Exhibit__(FP-1).

11 For the long-term debt component, we
12 calculated the average rate year balance by
13 averaging the thirteen month ending balances
14 from September 2008 to September 2009. The
15 resulting balance of \$9.830 billion is shown in
16 Column 9 of Exhibit__(FP-4) page 1, and is used
17 in the capitalization ratios shown in
18 Exhibit__(FP-1).

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

22 A. We recommend that the Commission employ a long-
23 term debt ratio of 49.74%, a common equity ratio
24 of 47.92%, a preferred stock ratio of 1.08% and

1 a customer deposit ratio of 1.26% as the rate
2 year capitalization for Con Edison. This can be
3 seen in Column 9 of Exhibit____(FP-4), Page 1.

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

7 A. Yes. As measured by its debt rating, Con Edison
8 has one of the strongest credit profiles among
9 electric and combination electric and gas
10 utilities; thus, comparably speaking, it has a
11 relatively low-risk profile. The Company's debt
12 (specifically its senior unsecured obligations)
13 is rated "A" by S&P, and "A1" by Moody's.

14 S&P's capitalization guidelines call for an
15 "A" rated electric utility with an "Excellent"
16 risk profile to maintain total debt in the range
17 of 52% to 60% of total capital. Thus, our
18 recommended long-term debt ratio of 49.74%
19 compares very favorably. We recognize of course
20 that S&P looks beyond the traditional balance
21 sheet at off-balance sheet financing
22 arrangements and items such as deferred pension
23 and OPEB obligations, which it views as
24 increasing a company's effective leverage. For

1 instance, in its February 12, 2008 analysis, S&P
2 adjusted the Company's actual September 30, 2007
3 long-term debt ratio of 48.3% to 53%. Given
4 that our adjusted utility debt ratio is only
5 about 0.8% higher than the reported ratio (49.1%
6 versus 48.3%) our recommended capital structure
7 is clearly within the range required for the
8 Company to maintain its "A" rating.

9 Q. Your analysis implicitly assumes that the
10 magnitude of CEI's non-regulated investments
11 remain at September 30, 2007 levels, or about
12 7.5% of the consolidated capital structure. Why
13 haven't you reflected the potential sale of
14 nearly all of Consolidated Edison Development's
15 generation projects that the parent, CEI
16 announced in December, 2007?

17 A. We simply believe that there is far too much
18 uncertainty surrounding this transaction to make
19 reasonable assumptions about its impact on the
20 Company's finances. We have no way of knowing
21 for certain when, or even if, this sale will
22 occur, and more to the point, the Company has
23 not provided any testimony or financial
24 documentation pertaining to this sale, and any

1 ramifications that it might have upon its future
2 financing plans. Thus the Commission should
3 adopt our proposed capitalization, which is
4 based upon reasonably expected construction
5 expenditures and reasonably anticipated internal
6 cash flows.

7 Q. How does your recommended equity ratio compare
8 with the equity ratios of the electric utility
9 holding companies in your proxy group?

10 A. As can be seen in Exhibit___(FP-5), our proxy
11 group companies are projected, on average to
12 have a common equity ratio of 48.1%, which is
13 only marginally higher than our recommended
14 common equity ratio of 47.92%.

15 **COST RATES**

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

18 A. As illustrated in Exhibit___(FP-1), there are
19 four separate cost rates we employed together
20 with their respective capitalization ratios to
21 formulate our overall rate of return
22 recommendation. Beginning with the cost rate of
23 the long-term debt component, we reviewed the
24 5.91% cost rate determination of Company witness

1 Perkins and made a few adjustments that resulted
2 in our 5.79% cost rate recommendation.
3 Exhibit___(FP-6) shows how this cost rate was
4 derived. With respect to the cost of preferred
5 stock, we reviewed and accepted the 5.34% cost
6 rate determination of Company witness Perkins.

7 The third cost rate shown in Exhibit___(FP-
8 1) is the cost of customer deposits. The 3.76%
9 customer deposits rate is the rate prescribed by
10 the Commission in October 2007 for use beginning
11 January 1, 2008. The fourth and final rate is
12 the cost of common equity. As we will
13 demonstrate, the Company's 11.5% proposed cost
14 rate for common equity is excessive and should
15 be rejected. We have developed a recommended
16 9.1% cost of equity for the rate year ending
17 September 30, 2009.

18 Q. Regarding the cost of the long-term debt
19 component, would you please explain why you
20 adjusted the 5.91% cost rate submitted by
21 Company witness Perkins, as illustrated in
22 Exhibit JP-1, Schedule 2.

23 A. As we explained earlier, Con Edison's rate year
24 cost of debt determination reflects its embedded

1 cost as of September 30, 2007 as well as the
2 projected cost rates of seven new issuances
3 during the link period and rate year, and the
4 effect of its maturing obligations. We found
5 the estimated cost rates of the seven new
6 issuances to be excessive. Consequently, our
7 cost of debt determination reflects a more
8 reasonable forecast of these costs.

9 Q. Please elaborate.

10 A. As described in his testimony, Company witness
11 Perkins forecast the cost rates of these seven
12 new debenture issues based on estimates of
13 future Treasury rates over the next two years
14 found in the publication Blue Chip Financial
15 Forecast, plus spreads to treasuries based on
16 then-current spreads. The principle reason that
17 Mr. Perkins' forecast cost rates are excessive
18 is that he relied upon forecasted long-term
19 Treasury rates, which are substantially higher
20 than the current yields of long-term Treasury
21 securities.

22 It is almost universally recognized that
23 short-term movements in long-term interest rates
24 are simply not "forecastable." Moreover, not

1 only are these forecasts poor predictors of the
2 magnitude of the expected change in interest
3 rates; they are not even reliable with respect
4 to the direction of the change. Instead the
5 best forecast of long-term interest rates is no-
6 change, i.e., the current rates of these debt
7 instruments.

8 Therefore, based upon current treasury
9 rates and the current spread requirements for A-
10 rated utility issuers published in the February
11 11, 2008 edition of Moody's Credit Perspectives,
12 we computed coupon rates of 5.39% for the
13 projected 10-year debt issuances (based upon the
14 February 7, 2008 yield on 10-year treasury notes
15 of 3.74% plus a spread requirement of 1.65%) and
16 coupon rates of 6.21% for the new 30-year debt
17 obligations (based upon the February 7, 2008
18 yield on 30-year treasury notes of 4.51% plus a
19 spread requirement of 1.70%). The effect of
20 these adjustments is a reduction in the
21 projected cost of long-term debt from 5.91% to
22 5.79%.

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

1 decision?

2 A. Yes. The average long-term debt cost rate
3 should be updated to reflect: the latest known
4 cost rates associated with the Company's
5 variable rate tax-exempt debt issued through
6 NYSERDA; the actual cost rates of any new debt
7 that is subsequently issued; and to reflect the
8 most recent actual treasury rates and spread
9 requirements for those debentures not yet
10 issued.

11 **SUMMARY OF ROE RECOMMENDATION**

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

14 A. We followed the same methodology that Staff
15 advocated, and the Commission adopted in recent
16 Orders in Case 06-E-1433 Orange & Rockland
17 Utilities electric rates and Case 07-G-0141
18 National Fuel Gas Distribution Corp. gas rates.
19 Broadly speaking, we estimated the cost of
20 equity for a proxy group of electric utility
21 companies, using a DCF analysis, which we
22 weighted two-thirds, and a CAPM analysis, which
23 we weighted one-third. We then adjusted this
24 result to reflect: 1) the difference in

1 financial and business risks currently facing
2 Con Edison versus those of the proxy group on
3 average; 2) common equity issuance expenses
4 expected during the rate year; and 3) the
5 business risk that is specific to the Company's
6 steam operations, particularly the extent to
7 which its load factor is determined solely by
8 the heating and cooling requirements of its
9 customers.

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

15 A. The DCF has long been the principle equity
16 costing methodology in New York. In fact, over
17 the past fourteen years the Commission has
18 consistently preferred cost of equity
19 determinations with 2/3 DCF and 1/3 CAPM
20 weightings. While utility witnesses continue to
21 disparage its use because it produces lower
22 estimates than other methodologies, there are
23 numerous good reasons why it should continue to
24 be the preferred methodology.

1 The fact of the matter is that estimating
2 the cost of equity requires using methodologies
3 that are not perfect. We believe that of all
4 the approaches available, the DCF and the CAPM
5 are by far the least flawed and, that between
6 those two, the DCF is clearly superior. It is
7 noteworthy that not too long ago when Company
8 witness Morin raised concerns about the
9 weighting accorded the DCF methodology in Case
10 06-E-1433, Orange and Rockland Utilities, Inc.,
11 the Commission itself remarked on the relative
12 strengths of the DCF. On page 14 of its Order
13 issued October 18, 2007 in Case 06-E-1433, the
14 Commission stated that: "...the method offers the
15 significant benefit of reliance on readily
16 available, objective data to measure an
17 indicator of real importance to investors."

18 We will demonstrate the reasonableness of
19 our two-stage DCF method, and show that while we
20 have reservations with the CAPM methodology in
21 general, our application of this approach
22 produces a reasonable check on our DCF
23 methodology, and as such should be accorded a
24 1/3 weighting.

1 **USE OF PROXY GROUP**

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

4 A. First, the use of a proxy group to determine Con
5 Edison's cost of equity is necessary because its
6 stock is not publicly traded, and thus a direct
7 DCF analysis of the Company is impossible.
8 Equally important is that DCF analyses for an
9 individual company rely on analysts' estimates
10 of growth which are, by their nature, inaccurate
11 and sometimes biased, while beta determinations
12 used in the CAPM methodology are based on
13 historical observations that, due to corporate
14 restructurings, etc. may not be representative
15 of the level of earnings volatility expected in
16 the future. However, we believe that by
17 employing a sufficiently large proxy group of
18 similarly situated companies in our analyses, we
19 can largely diminish the undesirable effects of
20 biased (both upward and downward) or inaccurate
21 growth estimates or beta measures for any one
22 company. We further diminish the effect of
23 these inaccuracies and biases by utilizing the
24 median results in our analyses.

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

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

13 A careful balance must be struck between
14 these two potentially conflicting goals. While
15 the objective is to select a group of companies
16 whose risks closely match those of the company
17 being examined, it is of no less importance to
18 select a group that is also large enough so that
19 we may have sufficient confidence in its
20 results.

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

23 A. We selected a group of 31 companies from a
24 "universe" of 60 companies whose common stock is

1 publicly-traded; all, like Con Edison's parent,
2 deemed to be "electric utilities" by Value Line.
3 Because of its robust size, we are confident
4 that our proxy group will produce reliable
5 estimates of the Company's cost of equity. Just
6 as importantly we also believe that we have
7 carefully selected companies whose risks are
8 substantially similar to those faced by Con
9 Edison. The list of companies we used,
10 including their credit ratings, S&P business
11 profile, percentage of utility revenues, and
12 their equity ratios, is shown in Exhibit___(FP-
13 5).

14 Q. Please explain how you developed your proxy
15 group.

16 A. We began with the 60 publicly-traded companies
17 that Value Line categorizes as electric
18 utilities because that is the primary business
19 of Con Edison. In order to generally match this
20 group's risks with those of Con Edison, we
21 considered two variables, or screening criteria;
22 the credit quality (debt rating) of the parent
23 holding company and its percentage of revenue
24 received from regulated operations.

1 Con Edison's senior unsecured debt is rated
2 "A" by S&P and "A1" by Moody's, and, as a
3 utility operating unit of a holding company,
4 100% of its revenues are from regulated
5 activities. By contrast, only five out of the
6 60 electric utility holding companies followed
7 by Value Line had debt rated as high or higher,
8 and nearly all derived some revenue from riskier
9 unregulated investments.

10 Mindful of our goals of achieving a group
11 of companies that is both sufficiently large and
12 with generally similar business and financial
13 risks to Con Edison, we selected only those
14 dividend paying companies whose senior unsecured
15 debt was at least investment-grade, and whose
16 operating revenues from regulated operations
17 were at least 70% of its total revenue. In
18 three instances, we included companies where the
19 parent holding company was rated at least "BBB+"
20 by S&P and not rated by Moody's. In all three
21 cases, we utilized the Moody's debt rating of
22 its principal utility subsidiary, which likewise
23 needed to be at least investment-grade.
24 Finally, we excluded companies that were

1 involved in merger-related or corporate
2 restructuring activities. Excluding these
3 companies is reasonable because of the potential
4 for such activity to distort their stock prices
5 and hence their individual cost of equity
6 estimates.

7 Q. Would you please explain the rationale
8 underlying your screening criteria?

9 A. In the past Staff relied on proxy groups
10 consisting of only "A" rated utility companies
11 that derived a "substantial" portion of their
12 operating revenues from regulated operations.
13 In the early 1990s there were anywhere between
14 25 and 33 such companies. Today that number has
15 dwindled to between three and five depending
16 upon the specific interpretation of what is
17 implied by "substantial" with respect to
18 regulated revenues.

19 Not only has the credit quality of the
20 electric utility industry fallen, but the
21 preeminent event over the past 25 years has been
22 the steady decline in credit quality of U.S.
23 corporations in general. This broader trend,
24 together with an orientation in the electric

1 utility industry towards consolidation through
2 mergers and an increase in unregulated
3 activities, means that our lowering of the
4 credit quality threshold is the most logical and
5 reasonable response in order to maintain an
6 adequate number of candidate companies.

7 In this case, just as in other recent Con
8 Edison and Orange and Rockland electric and gas
9 rate cases, and consistent with recommendations
10 by Staff in other recent cases involving
11 combination electric and gas utilities, we have
12 determined that the most reasonable proxy group
13 for determining Con Edison's cost of equity is
14 one in which all of the parent holding companies
15 have investment-grade senior unsecured debt
16 ratings, and all receive a minimum of 70% of
17 their total revenue from their regulated
18 operations.

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

22 A. As illustrated in Exhibit___(FP-7), the average
23 debt rating of the proxy group is between "BBB+"
24 and "BBB" for S&P and between "Baa1" and "Baa2"

1 for Moody's. In addition, Exhibit____(FP-5)
2 shows that the group receives, on average, about
3 11.8% of its revenues from non-regulated
4 businesses.

5 **DISCOUNTED CASH FLOW METHODOLOGY**

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

9 A. The DCF approach can be applied to any
10 investment instrument that has an intrinsic
11 value. The DCF approach, as it relates to
12 common stock, recognizes that companies create
13 value for their stockholders by using their
14 earnings in a number of ways, by far the most
15 important of which, is through the payment of
16 cash dividends.

17 Alternatively, earnings that are retained
18 by companies can be used to create value by
19 investing in capital projects designed to
20 increase future profits. The retained earnings
21 can also create value by retiring debt - which
22 reduces interest expense and means more cash
23 flow is available to stockholders, and by buying
24 back some of the company's common stock - which

1 increases future earnings on a *per share* basis.

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

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

1 return requirements.

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

11 Given that rational investors expect growth
12 in dividends largely as a result of productivity
13 gains and inflation, we believe that estimating
14 dividend growth in the relatively stable utility
15 industry, while difficult, is certainly not
16 insurmountable. Furthermore, we believe that
17 when practiced with the application of well-
18 reasoned growth rate estimates, such as the ones
19 we utilized in our approach, the intuitiveness
20 of the DCF methodology is abundantly clear, and
21 it is a primary reason that the methodology is
22 the best tool for estimating the cost of equity
23 for a regulated utility.

24 Q. Please describe your discounted cash flow

1 methodology and its result.

2 A. The calculation of the DCF for the proxy group
3 is shown on pages 1-2 of Exhibit____(FP-8). For
4 each company in the proxy group, we calculated a
5 six-month average stock price by averaging the
6 high and low price for each month. We used the
7 six-month period ending January 2008. The model
8 also contains *Value Line* data for earnings per
9 share, dividends per share, book value per share
10 and the forecasted amount of outstanding common
11 stock for each company.

12 This data is used to estimate the future
13 dividend payments that investors expect for each
14 of the companies. The price that investors are
15 currently willing to pay for that future stream
16 of dividends - here the average stock price
17 taken over the six-month period ending January
18 2008, is essentially the present value of those
19 expected dividends. By calculating the discount
20 rate required to turn the string of expected
21 dividend payments into the current stock price,
22 we determined the rates of return that investors
23 expect for each company.

24 Q. How are dividends projected to change over time?

1 A. Consistent with the approach Staff has used for
2 many years, we employed a two-stage DCF method.
3 In the near-term, we used *Value Line's*
4 forecasted dividends. For the second stage,
5 2012 and beyond, we calculated a "sustainable
6 growth" rate for each company in the proxy group
7 based upon its projected retention of earnings
8 and growth in common stock balances.

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

11 A. 4.63%.

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

15 A. Yes. We compared it with growth estimates of
16 the overall economy. Specifically, we found
17 that it was quite close to the most recent long-
18 range forecast of the growth rate in Nominal
19 GDP. According to the October 10, 2007 edition
20 of Blue Chip Economic Indicators, the consensus
21 long-range estimates of Nominal GDP growth are
22 5.0% for 2009-2013 and 4.9% for 2014-2018.

23 This comparison is apt, because the Nominal
24 GDP rate reflects assumptions about future

1 inflation as well as the real growth in the
2 economy resulting largely from productivity
3 gains. It is not unreasonable for investors to
4 expect future dividends to keep pace with
5 inflation as well as to reflect productivity
6 gains similar to those expected for the economy
7 as a whole. Finally, given the generally lower
8 betas and return requirements associated with
9 companies primarily engaged in low-risk rate-
10 regulated activities, it is not surprising or
11 unexpected that the sustainable growth rate of
12 the proxy group is slightly lower-than-average.

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

15 A. As shown on page 2 of Exhibit____(FP-8), the
16 median return on equity of the proxy group is
17 8.80%. This figure is the appropriate measure
18 of the DCF-derived cost of equity of the proxy
19 group.

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

22 A. While most of the individual company results
23 appear reasonable, we would not recommend a cost
24 of equity based upon any of the individual

1 results themselves because of the potential for
2 biased or inaccurate Value Line growth estimates
3 to improperly influence the result. While Value
4 Line's estimates are based upon its own in-house
5 projections as well as those of other industry
6 analysts, the simple fact remains that all
7 analysts' earnings forecasts are notoriously
8 inaccurate.

9 We do not recommend substituting our own
10 judgment and tossing out any of the individual
11 results that appear unreasonable to us, however,
12 because we advocate the use of the median return
13 of our individual results, as opposed to the
14 average. Use of the median is a widely employed
15 statistical tool that largely diminishes any
16 undue impact that outliers may have on the
17 average result. In other words, by using the
18 median return for the proxy group, individual
19 results that we might otherwise reject, are
20 effectively marginalized.

21 Q. Dr. Morin advocates using five-year earnings
22 growth rate estimates ranging from 6.4% to 7.3%,
23 based upon forecasts provided by *Value Line* and
24 *Zacks Investment*, as the measure of the growth

1 expected by investors in the DCF model. Is this
2 appropriate?

3 A. No. First of all, proper application of the DCF
4 specifically requires the discounting of future
5 dividends. While Dr. Morin argues that
6 investors view earnings growth and dividend
7 growth as essentially one in the same, it is
8 worth noting that he provided no evidence that
9 they are equal. In fact, it is well-known that
10 discounting earnings results in an overstatement
11 of a stock's value, or in this case where the
12 required return is being determined, an
13 overstatement in the expected growth rate of
14 dividends.

15 Second, because analysts' earnings forecast
16 are explicitly short-term in nature and
17 notoriously inaccurate, it is unreasonable to
18 assume that investors would have much confidence
19 at all in the ability of these companies to
20 maintain such growth rates well out into the
21 future. This is especially true since these
22 investors would be well-aware of the consensus
23 forecast calling for long-range Nominal GDP
24 growth of 4.9% to 5.0%. In sum, Dr. Morin's

1 growth estimates are inappropriate as well as
2 unsustainable, and should be rejected.

3 **CAPITAL ASSET PRICING MODEL METHODOLOGY**

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

6 A. The basic logic behind the CAPM is that there is
7 no premium, in terms of an expected return, for
8 bearing risks that can be eliminated through
9 diversification. According to the CAPM,
10 rational investors will hold a portfolio
11 (generally sixty or more) of stocks such that
12 the overall risk of that portfolio, in terms of
13 variability of returns, is identical to that of
14 the market as a whole. Thus, the only risk that
15 matters in the CAPM equation is said to be
16 "systematic" risk, or that which can not be
17 diversified away.

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

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

11 In the case of stocks with betas less than
12 1.0, as has been a hallmark of the utility
13 industry, the CAPM informs us that investors
14 will only be compensated for their actual risk,
15 as measured by beta. In other words, their
16 return requirements will reflect the degree to
17 which they are less volatile than the market as
18 a whole.

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

21 A. Traditionally, CAPM calculations of the cost of
22 equity (K_e) require estimates or inputs of the
23 following variables: the risk free rate (R_f),
24 the market return (R_m), and the beta (b) of the

1 proxy group for which the cost of equity is
2 being sought. Alternatively, a market risk
3 premium (MRP) can be deployed in place of an
4 estimate of the market return; however the MRP
5 determination requires an implicit assumption as
6 to the expected market return because it is
7 calculated by subtracting the risk free rate
8 from the expected market return. Formulaically,
9 the MRP is expressed: $MRP = R_m - R_f$.

10 With respect to the appropriate risk free
11 rate, Staff typically uses long-term Treasury
12 bond yields, specifically the average of 10-year
13 and 30-year bond yields over the most recent
14 six-month period. For the expected market
15 return, Staff generally uses Merrill Lynch's
16 most recent estimate of the expected return for
17 the S&P 500. Finally, with respect to the
18 appropriate beta to be used, Staff has typically
19 employed the average beta of the proxy group,
20 based upon the most recent Value Line
21 determinations. Formulaically, the traditional
22 CAPM is expressed as: $Ke = R_f + (b * (R_m - R_f))$.
23 Q. How did you begin your CAPM analysis?
24 A. Consistent with the approach Staff has employed

1 for many years, we used two different CAPM
2 methods (the traditional and "zero beta") to
3 estimate the cost of equity. The CAPM result is
4 the average of the two estimates.

5 Q. Why do you employ two CAPM methods?

6 A. Research has shown that the CAPM can possibly
7 underestimate the required return when betas are
8 below 1.0. By using a "zero beta" methodology
9 in addition to the traditional approach, such a
10 tendency can be addressed by averaging in a
11 result which is only partially determined by the
12 beta used.

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

15 A. We averaged the 10-year and 30-year Treasury
16 bond yields for the most recent six-month
17 period. The result, for the six-month period
18 ending January 2008, is 4.47%.

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

21 A. We used the .85 median beta of our proxy group,
22 which we calculated using the most recent Value
23 Line betas for each of the companies.

24 Q. Why did you use the median beta, given that the

1 typical Staff practice has been to use the
2 average beta of the proxy group?

3 A. We used the median beta for the same reason that
4 we used the median return of our individual
5 results in our DCF analysis. Specifically, we
6 observed the presence of two outliers among the
7 individual company betas. As illustrated in
8 Column C on page 1 of Exhibit___(FP-8) all but
9 two of the betas were clustered between .70 and
10 .95. The other two beta estimates, for Cleco
11 Corp. (1.15) and Allegheny Energy, Inc. (1.40)
12 are well beyond this range, and thus we consider
13 them to be outliers.

14 Consistent with our DCF methodology, and in
15 order to diminish any undue influence that these
16 two individual beta estimates would have, we
17 employed the median beta of our proxy in our
18 CAPM analysis. As we explained earlier in our
19 testimony, the use of the median is a widely
20 employed statistical tool that should be used in
21 circumstances where one or two extreme
22 observations bias the overall conclusion.

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

1 A. As we previously explained, the MRP is simply
2 the difference between what the expected return
3 on the market is and the risk-free rate. To
4 calculate the current market risk premium, we
5 utilized the expected market return reported in
6 Merrill Lynch's February 2008 *Quantitative*
7 *Profiles*. As illustrated on page 46 of
8 (Exhibit___(FP-9), that publication currently
9 estimates the required return for the market to
10 be 11.00%. Therefore, given our risk-free rate
11 of 4.47%, we calculated the current expected MRP
12 to be (11.0% - 4.47%) or 6.53%.

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

16 A. It is somewhat higher than the actual returns
17 received in the past. According to S&P itself,
18 the annualized total return for the S&P 500
19 since January 1926 was 10.43%. Further, the
20 dividend component consists of 40.59% of the
21 return, while the remainder reflects both
22 capital appreciation and dividends reinvested.

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

- 1 A. 10.02%, calculated as follows:
2 $4.47\% + [0.85 * (11.00\% - 4.47\%)] = 10.02\%$
- 3 Q. Please describe how you calculated a rate of
4 return using the "zero beta" CAPM method.
- 5 A. We used the same inputs as in the traditional
6 CAPM methodology. However, instead of
7 multiplying beta by the risk premium as shown in
8 the calculation of the traditional CAPM
9 methodology, we determined the risk premium for
10 the proxy group by multiplying .75 times beta
11 times the risk premium and adding .25 times the
12 risk premium. This can be shown as: Required
13 return = $R_f + (.75*B*Rp) + (.25*Rp)$
- 14 Q. What is the result of your zero-beta CAPM
15 methodology?
- 16 A. 10.27%, calculated as:
17 $4.47\% + [.75*.85*(11.00\%-4.47\%)] + [.25*(11.00\%-$
18 $4.47\%)] = 10.27\%$
- 19 Q. What CAPM result did you use in your calculation
20 of the required ROE for the proxy group?
- 21 A. We averaged the results of the two CAPM methods
22 to arrive at a result of 10.15%.
- 23 Q. Would you please briefly summarize your main
24 concerns with applying the CAPM methodology to

1 determine a utility's cost of equity?

2 A. While we have numerous theoretical and practical
3 concerns pertaining to the proper application of
4 this methodology, the two areas that cause us
5 the greatest amount of apprehension relate to
6 the estimates of two of its principle inputs,
7 specifically the beta and the market risk
8 premium (MRP). To begin with, we are not
9 completely on board with the theory underlying
10 the CAPM that says that the beta is a complete
11 and sufficient measure of the risk that requires
12 compensation in the market.

13 In addition, beta is supposed to represent
14 the future volatility of a given stock to the
15 market index. However, because that future
16 volatility is unknown, betas are measured on a
17 historical basis, often as long as five years.
18 When the systematic risks of a firm or industry
19 change, the historical beta is not a good
20 indicator of future volatility. Another
21 shortcoming of beta is the disparity of betas
22 between the various firms that report this
23 measure. For instance, Staff has typically
24 relied on Value Line reported betas. Value Line

1 performs five-year correlations and then
2 "smooths" the "raw betas" to reflect the theory
3 that betas have a natural tendency to gravitate
4 to 1.0. Other firms employ shorter periods, and
5 do not adjust the "raw" betas as Value Line
6 does. Our concern is that, depending upon the
7 source, the betas can be very different, and
8 thus can produce very different cost of equity
9 estimates.

10 Our greatest concern with the methodology,
11 however, concerns the derivation of the MRP.
12 Like beta, the MRP should be the expected
13 average premium of the market over the risk-free
14 rate. However, just like beta, the expected
15 premium is unknown. Because it is unknown, many
16 adherents to this methodology, like Dr. Morin,
17 advocate a historical MRP. As we will discuss
18 later in our testimony, we believe that a
19 historical average is inappropriate. The
20 alternative, a forward-looking MRP, however, is
21 subject to a substantial amount of judgment, and
22 thus should be viewed with a considerable amount
23 of caution. In sum, we recognize that the
24 methodology offers some valuable insight

1 regarding the cost of equity capital, but given
2 these concerns we believe that the approach
3 should be accorded no more than a one-third
4 weighting.

5 **RETURN ON EQUITY CONCLUSION**

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

8 A. We weighted the DCF result (8.80%) as two-thirds
9 of the total and the CAPM average (10.15%) as
10 one-third of the total, which resulted in a
11 9.25% cost of equity. These calculations can be
12 seen on page 3 of Exhibit____(FP-8).

13 Q. You explained earlier in your testimony that
14 three adjustments should be made to this cost
15 rate. Please describe these adjustments,
16 beginning with your adjustment to reflect the
17 fact that there is a quantifiable difference
18 between the business and financial risks faced
19 by Con Edison and the proxy group.

20 A. The rationale for this adjustment is based upon
21 the fundamental concept that the return
22 requirements of common equity investors are
23 commensurate with the riskiness of their
24 investment. While our proxy group selection

1 process sought out companies whose risks were
2 "substantially similar" to those faced by Con
3 Edison, the fact is that real and quantifiable
4 differences do exist and they should be
5 reflected in the cost of equity determination.

6 The major credit rating agencies such as
7 Moody's and S&P regularly assess both the
8 business and financial risks of the utilities
9 they rate and assign their credit ratings
10 accordingly. As we discussed earlier, Con
11 Edison is rated "A1" by Moody's and "A" by S&P,
12 while as illustrated in Exhibit___(FP-7), the
13 average Moody's rating for the proxy group is
14 somewhere between the "Baa1" and "Baa2" (about
15 3.4 notches lower), and the average S&P rating
16 is somewhere between "BBB+" and "BBB" (about 2.2
17 notches lower).

18 To calculate a comprehensive credit quality
19 adjustment that recognizes Con Edison's lower
20 business and financial risk vis-à-vis the
21 holding company proxy group, we began with an
22 analysis of the current yield requirements for
23 debt investors. First, we calculated six-month
24 average spreads for "A" rated debt versus "Baa"

1 rated debt, using Moody's monthly data for
2 seasoned utility bonds with remaining maturities
3 of at least 20 years. Based upon this data, and
4 given their respective debt ratings, we
5 calculated implied yields for both Con Edison
6 and the proxy group. The result was 6.09% for
7 the Company and 6.34% for the proxy group,
8 indicating that the current return required by
9 the Company's debt holders is about 24 basis
10 points less than the current return requirements
11 of the proxy group's debt holders.

12 In order to translate that debt discount
13 into the return requirements of the Company's
14 common equity investors, we first calculated the
15 ratio of the proxy group's cost of equity
16 (9.25%) to its cost of debt (6.34%) and found it
17 to be 145.95% higher. Then, we multiplied Con
18 Edison's 6.09% cost of debt by that 145.95%
19 ratio, to determine Con Edison's credit-quality
20 adjusted cost of equity, which we found to be 36
21 basis points lower than the proxy group's cost
22 of equity. Our calculations are illustrated in
23 Exhibit___(FP-10).

24 Q. Did Dr. Morin consider any risk adjustment to

1 his cost of equity determination?

2 A. While Dr. Morin utilized proxy groups with
3 overall credit risks that are somewhat higher
4 than ours, he concluded that no adjustment was
5 necessary for two reasons; the fact that the
6 steam business includes a generation component,
7 and because he felt that Con Edison has higher
8 financial risk.

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

10 A. Generally speaking we do not. With respect to
11 the intent of Dr. Morin's first finding, we do
12 agree that it is important to assess the risks
13 that are specific to the steam business, as the
14 true cost of capital depends on the use to which
15 it is put. We will address our conclusions
16 regarding the business risk inherent in the
17 Company's steam operations later in our
18 testimony.

19 Dr. Morin's second conclusion - that Con
20 Edison has higher financial risk than his proxy
21 group companies, is simply erroneous. As
22 illustrated in Exhibit___(FP-5), the Company's
23 somewhat riskier parent has an "Intermediate"
24 financial risk profile according to S&P, while

1 the overall financial risk profile for our proxy
2 group is somewhat higher, between "Intermediate"
3 and "Aggressive." Thus, Dr. Morin's conclusion
4 is contradicted by the facts.

5 Q. Please explain your second adjustment, the one
6 you made to reflect the costs associated with
7 the Company's proposed infusion of \$495 million
8 in new common equity during the rate year.

9 A. Our review of the Company's financial forecast
10 indicates that CEI will be raising approximately
11 \$495 million of new common equity that will be
12 utilized by Con Edison to finance construction
13 expenditures during the rate year. It has been
14 Commission policy to allow recovery of such
15 expenses when they are reasonably expected to be
16 incurred.

17 Based upon an average of the actual
18 issuance expenses incurred by the parent in its
19 last three public offerings, of about 1.5% of
20 the gross proceeds, we estimate these costs to
21 be about \$7.425 million ($\$495 \text{ million} * 1.5\%$).
22 Given the Company's projections that it will
23 have about \$9.1 billion of common equity on its
24 balance sheet on average during the rate year,

1 an upward adjustment to the cost of equity of 8
2 basis points is necessary (\$7.425 million/\$9.1
3 billion). In sum, this adjustment will allow
4 Con Edison to recover its reasonably expected
5 equity issuance costs during the rate year, and
6 will continue to provide for future issuance
7 expenses as well, until its rates are reset.

8 Q. Please explain the rationale for your final
9 adjustment; specifically, why do you recommend
10 an additional adjustment to reflect the business
11 risk inherent in the Company's steam operations?

12 A. Generally speaking, we would view our credit
13 quality adjustment as definitive with respect to
14 addressing the combined business and financial
15 risk differences between Con Edison and the
16 proxy group. In this case, however, we are
17 interested in determining the risk and return
18 attributes that are specific to the steam
19 system. Because the steam system only generates
20 about 7% of the Company's total revenue, we do
21 not believe that Con Edison's overall business
22 profile is necessarily indicative of the steam
23 system's business risk.

24 Q. How did you examine the relative riskiness of

1 the steam business, and what did you conclude?

2 A. We looked at the variability of the earned
3 returns for each of the Company's three business
4 segments, and found that the steam returns were
5 significantly more volatile, and thus riskier
6 than either the electric or gas businesses. We
7 believe that the reason for this volatility is
8 due to the unique load characteristics of the
9 steam system. The load requirements for steam
10 system are driven almost exclusively by the
11 heating and cooling needs of its customers, and
12 thus lack the diversity of the other systems.

13 Q. The Company proposed a Steam Revenue Adjustment
14 Mechanism (SRAM) that could potentially diminish
15 much of this risk. Does Staff agree with the
16 company's proposal to implement such an SRAM in
17 this case?

18 A. It is our understanding that the Staff Rate
19 Panel is addressing the SRAM, and that it has
20 concluded such a mechanism would not be
21 appropriate in this case.

22 Q. Given that it appears that much of the historic
23 volatility in the Company's steam operations
24 will likely continue, what adjustment do you

1 propose?

2 A. We believe that an adjustment in the range of 10
3 to 20 basis points is warranted. Thus, we have
4 adjusted our recommended ROE upward by 15 basis
5 points.

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

9 A. As illustrated on page 3 in Exhibit____(FP-8), we
10 adjusted the proxy group's 9.25% ROE
11 accordingly: 1) we reduced it by 36 basis points
12 to reflect the Company's superior credit
13 quality; 2) we increased it by 8 basis points to
14 reflect reasonably anticipated common equity
15 issuance expenses; and 3) we increased it by 15
16 basis points to reflect the heightened business
17 risk associated with the Company's steam
18 business that is not readily discernible within
19 the context of our straight-forward credit
20 quality adjustment. As a result of these
21 adjustments, we recommend that Con Edison be
22 allowed the opportunity to earn a 9.1% return on
23 its average common equity during the rate year.
24 Our recommendation is rounded to the nearest

1 tenth of a percent.

2 Q. Do you recommend updating the cost of equity?

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

6 **DISCUSSION OF COMPANY ROE AND FINANCING PRESENTATIONS**

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

11 A. To arrive at his recommendation, Dr. Morin
12 performed a total of four DCF analyses using two
13 different proxy groups for Con Edison. He also
14 performed four risk premium analyses; two using
15 the CAPM methodology and two using historical
16 and allowed risk premium data from electric
17 utility industry aggregate data. He then
18 averaged the results of all three methodologies
19 (DCF, CAPM and risk premium), according each an
20 equal weight, to arrive at an 11.2% cost of
21 equity determination. Finally, he recommended a
22 30 basis point stayout premium in the event that
23 a three-year rate plan was adopted. The
24 Company's revenue requirement reflects the 11.5%

1 cost of equity associated with a three-year rate
2 plan.

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

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

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

19 A. Yes. Not only are Dr. Morin's proxy groups
20 substantially smaller than Staff's proxy group
21 and thus less reliable, but both of Dr. Morin's
22 proxy groups contain companies that may not be
23 suitable surrogates for Con Edison's utility
24 operations. Specifically, only 8 of the 16

1 companies in his electric distributors group and
2 14 out of the 19 companies in the Moody's group
3 receive 70% or more of their operating revenues
4 from utility operations. As a result his
5 electric distributors group receives nearly
6 three times the percentage of non-regulated
7 revenues as Staff's proxy group (30.9% versus
8 11.8%) and his Moody's group receives more than
9 twice as much (25.6% versus 11.8%).

10 Additionally, the electric distributors
11 group includes Energy East which is currently
12 involved in merger-related activity, and TXU
13 Corp. whose debt is in the single-B ratings
14 category, and who only receives about 12% of its
15 revenues from regulated operations. Both of the
16 groups also include Constellation Energy, whose
17 share of revenue from utility sources is only
18 15.6% and FirstEnergy Corp. whose regulated
19 revenue only comes in at 38.6%. In sum, Dr.
20 Morin's proxy groups are not sufficiently
21 comparable to Con Edison, are inferior to
22 Staff's proxy group, and should be rejected.

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

1 A. Dr. Morin performed four separate DCF analyses;
2 he performed two using a proxy group consisting
3 of 14 and 16 parent companies of investment-
4 grade operating electric distribution utility
5 companies (electric distributors), and repeated
6 the same two analyses using alternatively 17 and
7 19 companies comprising the Moody's Electric
8 Utility Index (Moody's group).

9 For both of these flawed proxy groups he
10 calculated two average ROE estimates, all of
11 which relied upon current dividend yield
12 information. In one analysis he used Value Line
13 earnings per share growth estimates and in the
14 other Zack's five-year earnings growth
15 estimates. Among the problems with these
16 estimates is that the Commission has long
17 accepted the premise that sustainable long run
18 utility dividend growth is a product of a
19 company's future expected returns on equity and
20 its dividend payout policy. Dr. Morin's
21 testimony, however, fails to address how these
22 relatively short-term earnings growth estimates
23 relate to the dividend payout policies of his
24 companies and, even more troubling, to

1 demonstrate whether or not they are even
2 sustainable over time.

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

5 A. In order to quantify the risk premium for Con
6 Edison, Dr. Morin performed a total of four risk
7 premium analyses. For the first two risk
8 premium studies he submitted, his "CAPM
9 Estimates," he applied the CAPM and an empirical
10 approximation of the CAPM using current market
11 data. The other two risk premium analyses were
12 performed on historical and allowed risk premium
13 data from electric utility industry aggregate
14 data.

15 Q. Please explain how Dr. Morin performed the two
16 CAPM analyses to determine the incremental
17 return required by Con Edison's investors versus
18 the risk free rate.

19 A. Dr. Morin began with a traditional CAPM
20 methodology. For his inputs he used: a risk-
21 free rate of 4.8% based upon the current level
22 of 30-year Treasury bonds yields; a beta of .91
23 based upon the Value Line betas of the electric
24 utility companies used in his DCF analyses; and

1 a market risk premium of 7.6% based upon the
2 results of both forward-looking and historical
3 studies of market risk premiums.

4 He then used these inputs and determined
5 that the CAPM estimate of the cost of common
6 equity for Con Edison is $11.7\% ((4.8\% + (0.91 * 7.6\%))$, which he adjusted to 12.0% for a
7 flotation cost allowance. In his Empirical CAPM
8 approach, he adjusted this result even further
9 upward, to 12.2%, including a flotation cost
10 allowance, because he believes that for betas
11 less than 1.0 the CAPM underestimates the cost
12 of equity.

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

16 A. Dr. Morin's market risk premium was the result
17 of averaging two estimates of the MRP; a
18 historical MRP (ex post) using Ibbotson
19 Associates data (7.1%), and a forward-looking
20 MRP (ex ante) using Value Line stock data
21 (8.1%).

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

24 A. Dr. Morin's historical MRP was based on the

1 results of an Ibbotson Associates study that
2 compiled historical returns from 1926 to 2005,
3 and found that over this period, common stocks
4 outperformed long-term U.S. Treasury bonds by
5 6.5%. Dr. Morin felt, however, that the
6 appropriate measure was actually 7.1%, because
7 the study should have compared the stock returns
8 only to the income component of the long-term
9 treasury bonds rather than their total return.

10 Dr. Morin argues that if one is to rely on
11 historical relationships to predict the future
12 that the 1926 to 2005 is the best period because
13 it is the longest possible period for which
14 reliable data are available. He also recommends
15 that entire study period be used in order to
16 minimize subjective judgment and to encompass
17 many diverse regimes of inflation, interest rate
18 cycles and economic cycles. Finally, he states
19 that his historical MRP determination is
20 reasonable because he has seen no evidence that
21 it (the MRP) has changed over time.

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

24 A. We have several. First, we completely disagree

1 with his conclusions that the MRP hasn't changed
2 over time and that because of this it is
3 reasonable to use a historic average culled from
4 a very long period time. Many in the financial
5 community believe that the MRP has been
6 decreasing over time and is currently much lower
7 than the 7.1% rate used by Dr. Morin. For
8 instance, Jeremy Siegel, in an article entitled
9 "*The Shrinking Equity Premium*", in The Journal
10 of Portfolio Management, Fall 1999, which is
11 shown as Exhibit___(FP-11), expressed this
12 viewpoint very convincingly.

13 We also note another study, by E. Scott
14 Mayfield, entitled "*Estimating the market risk*
15 *premium*", in the Journal of Financial Economics,
16 March 2002, which is shown as Exhibit___(FP-12),
17 that also concluded that the Ibbotson Study
18 seriously overstates the MRP for the period
19 since the Great Depression. According to that
20 article, a structural shift occurred in the
21 market after 1940 primarily relating to market
22 volatility, and that as a result the historical
23 MRP post-1940 is about 5.6%.

24 In short, we believe that there is ample

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

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

13 A. For his prospective approach in deriving the
14 MRP, Dr. Morin applied a DCF analysis to the
15 approximately 1,550 dividend-paying stocks in
16 the Value Line Composite index. He calculated
17 that group's current dividend yield to be 1.328%
18 and its average projected dividend growth rate
19 to be 11.27%. After adding the yield and growth
20 components and adjusting for the timing of
21 dividend payments, he concluded that the
22 expected return for the market is 12.89%.
23 Subtracting his 4.8% risk-free rate from that
24 return, he concluded a prospective MRP of 8.1%.

1 First, we are quite surprised that Dr.
2 Morin is willing to use expected dividend growth
3 rates to estimate future cash flows in his CAPM
4 analysis, but is not willing to use them in his
5 DCF methodology. While using Value Line's near-
6 term dividend growth forecasts can be a
7 reasonable approach, Dr. Morin makes no attempt
8 to ascertain whether such short-term growth
9 rates can be sustained into the future. Given
10 the abundance of financial information available
11 to investors about historical achieved returns
12 as well as future estimates regarding the growth
13 in the overall economy, it is obvious to us that
14 rational investors would not expect long-run
15 dividend growth near as high as the 11.27%
16 short-term growth rate utilized by Dr. Morin.

17 Likewise, disciplined financial analysts
18 routinely incorporate broad economic factors
19 into their market return analyses. For
20 instance, Merrill Lynch's 11.0% estimated market
21 return for the S&P 500, which we employed in our
22 CAPM analysis, performs just such a reality
23 check on its short-term growth estimates. As
24 illustrated on page 46 of Exhibit____(FP-9),

1 Merrill Lynch clearly did not arrive at its
2 estimated market return simply by adding the
3 2.1% current yield of the S&P 500 index and that
4 group's five year estimated earnings growth rate
5 of 11.6%. In fact, similar to Staff's DCF
6 approach, Merrill Lynch uses a multi-stage
7 dividend discount model to calculate the
8 expected return for the S&P 500. This is the
9 sort of rigorous analysis that is lacking in Dr.
10 Morin's estimated MRP.

11 Q. Are you aware of any other studies that provide
12 additional insight about the forward-looking
13 MRP?

14 A. Yes. Duke University's Fuqua School of Business
15 in conjunction with *CFO* magazine compiles the
16 CFO Outlook Survey by interviewing Chief
17 Financial Officers (CFOs) of companies and
18 subscribers to *CFO* magazine around the world
19 every March, June, September and December.
20 Among the many questions in this comprehensive
21 survey are several that ask CFOs what their
22 expectations are for the S&P 500 return over the
23 next ten years.

24 The December 2007 survey summarized

1 responses from 1,275 U.S. and international
2 CFOs. As illustrated on page 49 of
3 Exhibit___(FP-13), the mean return expected by
4 these CFOs for the S&P 500 for the next ten
5 years is 8.34%. Given that the annual yield on
6 the 10-year Treasury note was 4.1% at the time
7 of this survey; their expected MRP is therefore
8 4.24% (8.34% - 4.1%).

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

12 A. Yes, in Case 95-G-1034, Central Hudson Gas &
13 Electric Corporation, the Commission recognized
14 the use of the Merrill Lynch estimate. On page
15 14 of Opinion 96-28, dated October 3, 1996, the
16 Commission stated, "...the Judge's market return
17 calculation based on Merrill Lynch data is a
18 reasonable method of deriving a risk premium;
19 and it avoids the problems of stale data in the
20 Ibbotson estimate, or the circularity of the
21 implied risk premium approach in relying on
22 other commissions' return allowances."

23 Q. Please comment on the suitability of Dr. Morin's
24 historical risk premium analysis of the electric

1 utility industry for determining the Company's
2 cost of equity?

3 A. There are several reasons why this approach
4 should be rejected. First, Dr. Morin makes no
5 attempt to determine the extent to which Con
6 Edison is more or less risky than the average
7 electric utility contained in the Moody's
8 electric utility common stock index for the
9 period 1932 to 2002. He also provides no
10 evidence about whether the risks of the bonds
11 used to calculate the yield for Moody's
12 composite index have remained at the same level
13 relative to the risks of the electric utility
14 stocks comprising the Moody's electric utility
15 common stock index, for the 1932 to 2002 study
16 period. Finally, Dr. Morin has not provided
17 evidence indicating that the risks of utility
18 bonds have remained at the same level relative
19 to Treasury securities over this time period.

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

23 A. Dr. Morin's use of Regulatory Research
24 Associates *Regulatory Focus* to determine an

1 average allowed return is seriously flawed,
2 primarily because he makes no attempt to assure
3 the comparability of those returns with the
4 particular risks facing Con Edison and the
5 impact on the return requirement that those
6 risks imply. As we address criticisms made by
7 Company witness Perkins later in our testimony,
8 we will explain some of the important elements
9 inherent in our ratemaking that significantly
10 reduce the risk faced by shareholders. In both
11 cases, the Company witnesses fail to account for
12 these important risk-reducing attributes. Thus
13 their conclusions with regard to the returns
14 authorized by other jurisdictions should be
15 rejected.

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

21 A. As we have demonstrated, our cost of equity
22 recommendation represents a reasonable
23 estimation of the return required by the
24 Company's equity investors. As such we do not

1 believe it can appropriately be characterized as
2 either "too low" or "too high." Moreover, given
3 the Company's strong financial profile, its
4 conservative management and supportive
5 regulatory environment, any suggestion that our
6 cost of equity recommendation would result in
7 prohibitive financing costs is unwarranted.

8 Q. Referring to the financial challenges faced by
9 Con Edison, Company witness Perkins noted that
10 the Company has a capital expenditure program,
11 determined by the need to update and expand its
12 electric delivery infrastructure that is
13 significantly higher than levels in the recent
14 past. He also suggests that "sub-standard
15 return" authorizations could impair its ability
16 to raise the necessary capital to fund its
17 operating requirements at reasonable terms. Do
18 you share his concerns?

19 A. We agree that the Company has a substantial
20 capital expenditures program that will be adding
21 significantly to its rate base in the coming
22 years. We also agree that it is important for
23 the Company to have access to the financial
24 markets at reasonable terms. To this end, we

1 have recommended a capital structure and cost
2 rates that are consistent with this objective,
3 while other Staff witnesses have concluded that
4 nearly all of the infrastructure-related capital
5 expenditures proposed by the Company are
6 reasonable, and will thus be fully recovered in
7 our overall revenue requirement.

8 We do not believe however, that the Company
9 is in jeopardy of being able to fund its
10 operating requirements at reasonable terms. In
11 addition to our own analysis, we base this
12 conclusion on objective assessments that we
13 sought from the financial community. Given that
14 the nexus of Con Edison's anxiety about its
15 ability to attract capital at reasonable terms
16 stems from the "Negative" outlook that its S&P
17 debt rating carries, we reviewed recent S&P
18 reports in order to gain a better perspective of
19 the Company's financial standing.

20 As mentioned earlier in our testimony, the
21 Company currently has one of the highest credit
22 ratings of all "electric utilities." In fact,
23 as illustrated in Exhibit___(FP-14), of all the
24 U.S. "electric utilities" rated by S&P, only six

1 currently have a higher rating than Con Edison,
2 while 159 are rated lower. Moreover, according
3 to S&P's most recent analysis of the Company,
4 which is illustrated in Exhibit__(FP-15), the
5 rating agency anticipates that it will have
6 adequate liquidity and cash flows to fund its
7 dividends and capital spending.

8 Turning to the other major rating agency,
9 Moody's, we found that in its most recent
10 analysis of the Company, which is illustrated in
11 Exhibit__(FP-16), the rating agency opined that
12 the Company would have ample access to the
13 capital markets and that it is also expected to
14 "continue to maintain the same high level of
15 market access and strong relationships with the
16 banks going forward." Finally, to gain the
17 perspective of equity analysts we reviewed Value
18 Line's most recent analysis, which is
19 illustrated in Exhibit__(FP-17). In that
20 analysis Value Line reported that the Company's
21 "finances are among the strongest in the
22 industry." The Value Line report further noted
23 that while "capital spending for the next few
24 years will require substantial external

1 financing, a solid balance sheet should enable
2 (the Company) to borrow at reasonable rates."

3 Q. The basis for Mr. Perkins' characterization of
4 the Commission's return authorizations as
5 "substandard" is a comparison he made of New
6 York allowed returns versus the allowed returns
7 of other jurisdictions from 1992 through 2006.
8 Do you believe that Mr. Perkins data provides
9 any meaningful basis for comparing authorized
10 returns?

11 A. No. A meaningful comparison of returns would
12 require adjustments to reflect the credit risks
13 of the individual utilities as well as the
14 underlying risk of each of the referenced rate
15 plans. As we explained earlier, a fundamental
16 concept in financial theory is that investors
17 return requirements are directly linked to the
18 riskiness of their investment. Mr. Perkins does
19 not indicate the credit ratings of any of these
20 utilities, nor does he propose any adjustment to
21 reflect such a difference.

22 Mr. Perkins also does not indicate whether
23 or not any of the return allowances were the
24 result of "settlement agreements" or "joint

1 proposals;" in other words, circumstances in
2 which higher authorized returns may be justified
3 as a result of concessions or tradeoffs made by
4 the utilities. Nor does he indicate which of
5 the returns are for multi-year rate plans, and
6 thus incorporate "stay-out premiums."

7 With respect to the risks underlying the
8 rate plans themselves, there are many important
9 elements, all of which have a direct impact upon
10 a utility's ability to achieve its authorized
11 return on equity, and Mr. Perkins does not
12 reflect any of them. For instance, in New York
13 we generally allow a very high level of expense
14 reconciliation for items such as property taxes,
15 environmental remediation costs, and pension and
16 OPEB expenses. We also utilize purchased power
17 adjustment clauses that not only allow full
18 recovery of this very large and volatile cost
19 element, but just as importantly, on a timely
20 basis as well. Many other jurisdictions do not
21 incorporate these mechanisms into their rate
22 plans, which are clearly beneficial to our
23 utilities' cash flow and which greatly reduce
24 their volatility and uncertainty.

1 Finally, Mr. Perkins does not indicate
2 which of the returns are based upon historic
3 test period and rate base determinations. In
4 periods of escalating operating and maintenance
5 costs such as we are currently witnessing,
6 combined with the need for significant capital
7 additions, it is inarguable that our regulatory
8 approach, which estimates the revenue
9 requirement needs of our utilities based upon
10 fully-forecast test periods and rate bases, is
11 far superior in terms of providing utilities
12 with reasonable opportunities to earn their
13 authorized returns. Once again, Mr. Perkins
14 fails to account for such differences. In fact,
15 his failure to account for any of the factors we
16 have noted critically undermines the relevance
17 of his conclusion.

18 Q. Does this conclude your testimony?

19 A. Yes it does.

20