BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Consolidated Edison Company of New York

Case 09-E-0428

August 2009

Prepared Testimony of:
Staff Finance Panel

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

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

Q. Ms. Prylo, what is your position at the Department?

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

Q. Please describe your educational background and professional experience.

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

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

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

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

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

A. Yes. I testified in Case 08-E-0539, Consolidated Edison Company of New York, Inc. – Electric Rates.

Q. Mr. Henry, what is your position at the Department?
A. I am employed by the Department as a Principal Utility Financial Analyst in the Office of Accounting and Finance.
Q. Please describe your educational background and professional experience.
A. I received a Bachelor of Science Degree in Business Administration from the University of Florida in 1981. In 1985 I received a Master's Degree in Business Administration with a concentration in Finance from the School of Management at the State University of New York at Binghamton. Before joining the Department in August 1988, I was employed by Norstar Bank, N.A. as a Manager Trainee.
Q. What are your responsibilities in the Office of Accounting and Finance?
A. My primary areas of responsibility include analyzing and making recommendations to the Commission concerning rate of return levels and financing requests. I also examine and make recommendations with regard to other utility finance-related activities, such as merger

requests.

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

A. Yes. I have testified in numerous electric, gas, steam and water rate cases before the Commission since 1988, most recently in Case 08-G-1392, St. Lawrence Gas Company – Gas Rates and Case 08-E-0539, Consolidated Edison Company of New York, Inc. – Electric Rates.

PURPOSE OF TESTIMONY

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

A. The purpose of our testimony is to recommend a fair rate of return to be used by the Accounting Panel to determine the revenue requirement for Consolidated Edison Company of New York, Inc.'s (Con Edison or the Company) electric operations for the rate year ending March 31, 2011. We will also respond to the testimony of Company witnesses Morin, Lindenberg and Hoglund.

Q. Will the Panel refer to, or otherwise rely upon, any information produced during the discovery phase of this proceeding in its testimony?

A. Yes. We will refer to, and have relied upon, several responses to Staff Information Requests. These responses are attached as Exhibit___(FP-18), and follow the seventeen additional exhibits we are sponsoring that are identified as Exhibit___(FP-1) through Exhibit___(FP-17).

SUMMARY

Q. Please summarize your testimony, highlighting the major differences between your rate of return recommendation and the overall rate of return requested by the Company.

A. The major difference between our recommended overall rate of return of 7.78% and the Company's updated request of 8.19% is due to our 10.1% return on equity (ROE) recommendation versus the Company's requested ROE authorization of 10.9%. We also recommend a capital structure with a 48.0% common equity ratio which is modestly lower than the 48.2% common equity ratio sought by Con Edison.

Our testimony will explain the reasonableness of our capital structure approach, which the Commission has consistently found to be the proper approach for public

utility ratemaking purposes, as it assures ratepayers will not subsidize the riskier non-regulated investments of Con Edison's parent. We will also demonstrate the reasonableness of our ROE recommendation and explain how we developed the recommendation using two different equity costing methodologies, each weighted consistent with how the Commission has repeatedly weighted them in litigated cases over the past 15 years, including in its April 24, 2009 Rate Order in the Company's last electric rates proceeding in Case 08-E-0539 ("2009 Rate Order"). Finally, we will also explain why our recommended rate of return will assure the Company continued access to reasonably priced capital, and address certain aspects of Con Edison's financial presentation.

FAIR RATE OF RETURN DISCUSSION

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

A. In the context of regulated rate-setting, the revenue requirement is the dollar amount

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

Q. Generally speaking, what is a fair rate of return for a regulated utility?

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

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

Q. How is a fair rate of return calculated?

A. The fair rate of return for a utility company is calculated through a weighted average of the individual cost components of its expected capitalization during the rate year. Typically, there are four sources of capital. The two primary sources are long-term debt and common equity. Preferred stock is also commonly used, although generally in much smaller proportions than either long-term debt or common equity. Finally, customer deposits, while a very small component, are almost always reflected in the expected capitalization because they are a relatively permanent and stable source of

capital employed by utilities.

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

Q. Are the cost rates of the individual components difficult to calculate?

A. The cost rates associated with the Company's long-term debt, preferred stock and customer deposits are relatively simple to ascertain. Both the long-term debt and preferred stock cost rates can be readily calculated by examining their contractual terms; i.e., the interest payments for the long-term debt and the preferred dividends for the preferred stock. The costs of any new long-term debt or preferred stock instruments, however, require estimates using relevant market data. The cost rate for customer deposits is simply a matter of applying the cost rate that is currently prescribed by the Commission.

The cost of common equity, however, is neither contractual nor prescribed by the Commission. Its calculation is further complicated by the fact that it can not be directly observed, and instead requires estimation and the opinion of analysts.

Q. Is the cost of common equity typically more expensive than the cost of debt for a utility?

A. Yes. Even though both lenders and equity investors supply the utility with the funds it needs to build and operate its system, the equity investors only earn a return after the payment of all other expenses. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by equity investors is usually higher than that of the utility’s debt holders. An exception may exist during periods of disturbances in the market. An example of this would be the 1980-1982 recessionary period in which the economy was beset with very high inflation and volatile interest rates. During this time, utility bond yields were at least as high as the returns the Commission allowed and

far above the returns allowed by most state regulatory commissions.

Q. How can a utility's cost of common equity be measured?

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

CAPITAL STRUCTURE

Q. What overall rate of return do you recommend for the rate year?

A. We recommend an after-tax overall rate of return of 7.78%, compared to the Company's request of 8.19%. Our proposed pro forma cost of capital can be seen in Exhibit__(FP-1).

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

A. In Exhibit AP-12, Schedule 1, the Company's Accounting Panel forecast a long-term debt ratio of 49.42%, a preferred stock ratio of 1.07%, a

customer deposits ratio of 1.31% and a common equity ratio of 48.20% in its July 10, 2009 Preliminary Update.

Q. How did the Company develop this capitalization?

A. The rate year capitalization was developed using Con Edison’s latest-known “stand-alone" capital structure, in this case its March 31, 2009 capitalization. This "stand-alone" capitalization was then projected through the rate year based upon the Company’s forecasted funding requirements during both the linkage period ending March 31, 2010, and the rate year ending March 31, 2011.

The forecasted long-term debt component reflects total new debt issuances of $1.530 billion as well as the retirement of $825 million of maturing debt obligations between July 1, 2009 and March 31, 2011.

Since the Company is not planning on issuing any new preferred stock, and has no plans to redeem any of its outstanding preferred stock, its rate year balance is the same as the amount reported outstanding on March 31, 2009. Con Edison’s rate year balance of customer

deposits was based upon historical levels, which it forecast to grow by approximately 0.2% a month.

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

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

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

stock of another New York combination utility, Orange and Rockland Utilities, Inc. (Orange and Rockland), as well as three non-utility subsidiaries.

The Securities Act of 1933 (Act) requires that investors receive financial and other significant information concerning securities being offered for public sale. The Act was promulgated to prohibit deceit, misrepresentations, and other fraud in the sale of securities. In general, all securities sold to the public in the United States must be registered with the Securities and Exchange Commission (SEC). Unless they are privately-held, utility holding companies must register with the SEC in order to issue common stock as well as any long-term debt or preferred stock to the public. Many large utility operating companies such as Con Edison are also registered, but only for the purposes of issuing long-term debt or preferred stock.

Because both Con Edison and CEI are registered with the SEC, both companies provide financial information to investors in various

reports to the SEC. Orange and Rockland, however, is no longer registered with the SEC, which means it can only issue long-term debt or preferred stock through privately-placed deals. Non-registration also means that its financial results can only be viewed through the consolidated financial statements of CEI, as it is the typical practice of utility holding companies to report the stand-alone capital structures of their major subsidiaries.

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

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

A. While there may be particular circumstances in which such an approach is warranted, generally speaking, the use of a stand-alone capitalization should only be employed after a careful analysis of the holding company's financing practices has been conducted. To this end, it has been the established practice of Staff and the Commission to employ a "consolidated approach," which begins with the consolidated capital structure of the utility's parent company, in this case CEI, and to adjust it, if need be, to reflect the relative business and financial risks of the various subsidiary companies. In short, the primary purpose of this analysis is to ascertain whether the stand-alone capital structures of the utility subsidiaries reflect rational capitalization policies and that their common equity components reflect actual common equity at the parent level.

Q. Please elaborate why a stand-alone capital structure may not be reasonable.

A. First, the stand-alone common equity balance reported by a utility subsidiary of a holding

company may not, in fact, be financed by common equity at the holding company level. Some of the utility's common equity balance may actually be proceeds from debt issued at the holding company level and classified on the utility subsidiary's books as common equity at the time the proceeds were invested in the utility subsidiary. This is referred to as double leverage.

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

Generally speaking, it is simply not in

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

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

A. No, we do not believe so.

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

A. Yes. Despite the considerably higher business risks inherent in such competitive endeavors, the non-utility operations have generally been funded with higher levels of debt than their utility counterparts, and most recently, as of

March 31, 2009, were funded only 41.6% with common equity. At the same time, the lower business risk utility operations were more conservatively financed with a 47.2% common equity ratio.

Q. Please explain the concept of business risk in general, and how it is typically assessed.

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

Both of the major credit rating agencies, Standard & Poor's (S&P) and Moody's Investors Service (Moody's), routinely assess the level of business risk in tandem with the financial risk profiles of debt issuers whenever credit ratings are reviewed and/or assigned. Furthermore, as illustrated in Exhibit___(FP-7), S&P employs a very specific and transparent business risk/financial risk matrix that effectively concludes the appropriate credit ratings of debt

issuers based upon their combined business and financial risk profiles. To contrast the relative strength of debt issuers, S&P's matrix employs six categories each for business risk and financial risk.

With respect to its assessment of business risk, S&P examines the relative strength of a company's business position and assigns it one of six distinct business risk profiles, or categories if you will. In descending order, the six categories range from "Excellent," for companies with relatively very little business risk, to "Vulnerable" for companies with extremely high levels of business risk. Similarly, its assessment of financial risk utilizes six distinct financial risk profiles that descend from "Minimal," for companies with little to no debt on their balance sheets, to "Highly Leveraged" for companies financed very aggressively.

Q. What is S&P's assessment regarding the risk profiles of utilities in general?

A. Nearly all regulated utilities and holding companies that are utility-focused fall in the

top two business risk categories, “Excellent” and “Strong.” According to a recent S&P report entitled “U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Rating Matrix” included as Exhibit___(FP-8), the reason that utilities are in the top two tiers is because of what S&P describes as the defining characteristics of most utilities, namely “a legally defined service territory generally free of significant competition, the provision of an essential or near-essential service, and the presence of regulators that have an abiding interest in supporting a healthy utility financial profile.”

Because of their low business risk nature, utility companies are generally able to employ higher levels of financial risk than their non-utility counterparts. In fact, the financial risk profiles of utilities typically range from “Intermediate” to “Significant” to “Aggressive,” or tiers three, four and five on the financial risk side of the matrix.

Q. What is S&P’s assessment regarding the risk profile of Con Edison in particular?

A. With respect to Con Edison in particular, S&P has acknowledged the elevated importance of regulation due to the overall very low risk of its transmission and distribution (T&D) operations. S&P continues to view the Company's business profile as "Excellent," its highest business profile rating, because of Con Edison's historically supportive regulatory environment and the conservative strategy of its parent's focus on low risk transmission and distribution (T&D) operations. S&P considers the Company's financial risk profile to be "Significant," which is the fourth highest tier on the financial side of the matrix.

Q. Why do you contend that the level of business risk faced by CEI's non-regulated subsidiaries is substantially greater than that faced by the parent's utility operations?

A. While S&P offers no direct assessment regarding the riskiness of CEI's non-regulated investments, it is well-established that such investments are, by their nature, riskier. Emblematic of this viewpoint, is a recent statement by S&P in a report provided in

Exhibit___(FP-9), entitled “Key Credit Factors: Business and Financial Risks in the Investor-Owned Utilities Industry.” Specifically, S&P states that while the presence of unregulated activities do not alter the way it analyzes a regulated utility, “it may affect the ultimate rating outcome because of any higher risk credit drag that the unregulated activities may have on the utility.”

Furthermore, with respect to the various utility holding company business models, this same report states, “we view a company that owns regulated generation, transmission, and distribution operations as positioned between companies with relatively low-risk transmission and distribution operations and companies with higher-risk diversified activities on the business profile spectrum.”

Based upon the foregoing, we believe that, at best, the collective business risk profile of the parent’s non-regulated activities could be viewed as “Satisfactory,” which would place it in the third highest tier on the business risk side of the matrix.

Q. With such a business risk profile, how do CEI's non-regulated investments affect Con Edison's credit ratings?

A. We believe the non-regulated investments are a drag on Con Edison's credit ratings. As illustrated in Exhibit___(FP-7), even if the non-regulated activities were financed with the same degree of leverage as Con Edison (i.e., with a common equity ratio of around 47% to 48%), and hence imbedded with the same "Significant" financial risk profile as the Company, the most likely credit rating that these collective businesses could obtain on their own would be BB+. Moreover, given the more aggressive use of leverage CEI actually employs for these operations (i.e., the 41.6% common equity layer currently supporting these riskier investments), it is quite conceivable that the non-utility operations might not receive a rating higher than BB-.

Q. Are the BB ratings you infer typical of the actual ratings of independent unregulated power companies?

A. More or less. Most competitive merchant

companies carry ratings in either the double B or single B ratings categories.

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

A. CEI, whose senior unsecured debt is currently rated A- by S&P and Baa1 by Moody's, has generally issued the debt supporting these risky investments. The parent's relatively strong credit rating reflects the fact that roughly 97% of its total assets and 84% of its revenues come from its low risk utility operations.

Q. In the past, the Company has argued that, due to their relatively small scale, there is no "material" impact on Con Edison's credit ratings and that Staff's "consolidated approach" is unwarranted. Do you agree with this view?

A. No. While we do agree that the current scale of the parent's non-utility investments is quite modest, as just less than 3% of the consolidated capitalization is devoted to these riskier ventures, we completely disagree that such a situation obviates the need to employ our "consolidated approach" to reflect any resulting adjustment that may be warranted.

Q. Has the Commission addressed the Company's arguments with respect to materiality?

A. Yes. In the 2009 Rate Order, the Commission specifically opined that the Company's suggestion that, "when competitive operations are small, cost assignment is not necessary," is illogical, and concurred with Staff's view that "ratepayers should not be providing credit support for competitive operations regardless of their size."

Q. Please explain what you mean when you refer to rational financing policies.

A. Simply stated, we are referring to the basic notion that investments or activities embodied with greater business risk must be offset with the deployment of less financial risk in order to achieve the same credit rating as investments or activities with lower business risk. Therefore, in the context of our "consolidated approach," we determine whether or not the parent has "rationally" employed more conservative financing policies for its higher business risk activities. Specifically, we ascertain whether or not the higher business

risk non-utility operations are being capitalized with sufficient common equity such that they could achieve the same credit rating on a stand-alone basis as the utility operations.

Q. Please explain the findings of your consolidated approach.

A. As illustrated on page 1 of Exhibit___(FP-2), we began our analysis with the consolidated balance sheet of CEI based on its 10-Q report for the period ending March 31, 2009. Column 1 presents CEI's consolidated balance sheet results for all of the holding company’s operations. Column 2 shows the balance sheet information provided in the 10-Q report for Con Edison, whose total assets comprise nearly 91% of the enterprise total. Column 3 shows the balance sheet information for Orange and Rockland that is provided to investors on that subsidiary’s website.

Column 4 is the sum of columns 2 and 3 and thus reflects the combined balance sheet of CEI's two utility subsidiaries. Column 5 is the residual balance sheet of the parent after

removing the stand-alone balance sheets of its two utility subsidiaries. It represents the capitalization dedicated to the riskier non-utility subsidiaries, as well as the goodwill booked by CEI as a result of its acquisition of Orange and Rockland.

Q. Please reiterate how CEI has elected to allocate its debt and equity among its utility and non-utility operations?

A. As illustrated in Columns 4 and 5 of Exhibit___(FP-2), Page 1, the lower business risk utility operations were financed with 47.2% common equity while the higher business risk non-utility operations were more thinly capitalized with 41.6% common equity. We believe that a rational financing policy for the non-utility operations would require greater levels of common equity than the utility operations; not less.

Q. Please explain how you determined the appropriate allocation of the debt and equity in CEI's consolidated capital structure according to the relative business and financial risks of the regulated and non-regulated subsidiaries.

A. In order to determine the manner in which A rated competitive businesses are typically capitalized, we examined an August 28, 2008 report by S&P titled “Credit Stats: 2007 Adjusted Key U.S. Industrial And Utility Financial Ratios,” which is included as Exhibit___(FP-10). We found that for the 2005 to 2007 period, the average A rated non-utility company had a common equity ratio of 63.2%, while the average A rated utility, by virtue of its superior business risk profile, only required a common equity layer of 47.0%.

Given these facts and mindful that the Company is currently rated at the low ends of both S&P and Moody’s A categories (specifically A- by S&P and A3 by Moody’s) and that the purpose of our consolidated approach is to ensure that utility ratepayers are insulated from the credit risk posed by the parent’s actual financing policies for the non-regulated subsidiaries, we conclude that a mix of 60% common equity and 40% long term debt would constitute a rational capitalization for the parent’s non-utility subsidiaries.

As illustrated in Columns 7, 8 and 9, this requires reallocating $103 million of the parent's equity currently supporting the utility businesses to the non-utility businesses, and $103 million of the consolidated debt currently supporting the non-utility businesses to the utilities. In addition to achieving a more appropriately conservative balance sheet for the riskier non-utility businesses, the impact of our reallocation reduces the ratio of common equity supporting the utility operations from 47.2% to 46.7%.

Q. Please explain how you utilized the March 31, 2009 consolidated balance sheet data to forecast the average rate year capitalization shown in Column 11.

A. As illustrated on page 2 of Exhibit___(FP-2), we projected our average rate year balances of common equity and long-term debt by beginning with our March 31, 2009 adjusted stand-alone amounts for each. Because Con Edison comprises 95.5% of the total utility capitalization, our upward adjustment to the Company's stand-alone reported long-term debt and offsetting downward

adjustment to its stand-alone reported common equity was $98 million ($103 million * 95.5%).

Next, we reviewed the documentation supporting the Company's forecasted average rate year capital structure in its July 10 Preliminary Update. Specifically, we examined each of the Company's assumptions with regard to its financing activities throughout the entire link period and rate year. We found that these projections reasonably reflect the impact of Con Edison's proposed construction expenditures as well as its anticipated internal cash flows. We also found the mix of new long-term debt and common equity proposed by the Company to be reasonable. The mix of debt and equity proposed by Con Edison, is geared to maintain an (unadjusted) equity ratio that would "remain at or be slightly above" 48% during the rate year. Such a deployment of leverage is consistent with its recent history and is sufficient to support its current (A-) S&P, and (A3) Moody's, senior unsecured debt ratings.

In summary, as can be seen at the bottom of Column 11 on page 1 of Exhibit___(FP-2), our $98

million adjustment to the Company's stand-alone balance sheet data and our acceptance of the Company's proposed financing mix for the link period and rate year results in an average rate year capitalization consisting of 47.6% common equity, which we have rounded up to 48.0% in our overall rate of return recommendation.

Q. Why do you believe that an average rate year capitalization with a 48.0% common equity ratio is reasonable?

A. We believe that our analysis, when taken together with the Company's recent performance and its assertions with respect to financial targets, confirms the reasonableness of a ratemaking capital structure with about 48.0% common equity. For some time now the Company's financial policy has been to target a consolidated common equity ratio somewhere between 48% and 50%, and the Commission has generally set rates using a capitalization with a 48% common equity ratio, as it did in the 2009 Rate Order. In short, we believe that CEI has sufficient flexibility as well as adequate incentive from the credit rating agencies to

achieve its stated goal of a consolidated common equity ratio somewhat above 48%. Not only will such a policy be sufficient for the Company to maintain its financial integrity, it will also ensure that the non-utility operations are supported with sufficient common equity at the parent holding company level.

Q. Why doesn't Staff advocate a materially lower common equity ratio?

A. For largely the same reason that we argued for a 48% common equity ratio in Case 08-E-0539. We believe that such an equity ratio is in the long-term best interests of customers as it will be sufficient to maintain the Company's current S&P (A-) and Moody's (A3) senior unsecured debt ratings. Moreover, we do not wish to set a course that would result in a low investment-grade rating, because such ratings entail an undesirable diminishment in financing options and flexibility. Such ratings could also put the Company in a position where an unexpected event could cause it to lose its investment-grade rating, which might put in jeopardy its ability to provide safe and adequate service.

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

A. Yes. As measured by its debt ratings, Con Edison has one of the strongest credit profiles among electric and combination electric and gas utilities; thus, comparably speaking, it is among the least risky. The Company's most recent S&P credit analysis is shown in Exhibit___(FP-11), and its most recent Moody's credit opinion is included as Exhibit___(FP-12). S&P's capitalization guidelines call for A rated electric utilities with "Excellent" business risk profiles to maintain total debt in the range of 52% to 60% of total capital.

Moody's on the other hand utilizes a much broader (40% to 60%) range for its A rated electric utilities whose relative business risk it considers, like Con Edison, to be "Medium." Thus, our recommended long-term debt ratio of 49.62% appears to be well within the parameters of the two major credit rating agencies, and should be adequate for the Company to maintain the respective current A- and A3 ratings of its

senior unsecured debt obligations.

We recognize, of course, that the ratings processes of both of these agencies also take into account companies' cash flows from operations. For the most part, these cash flows are Con Edison's earnings and depreciation expense. From a cash flow perspective, Con Edison's leverage can be construed as somewhat high for its ratings, as both S&P and Moody's measure the Company's cash flows relative to its total debt. Since 2005, both S&P and Moody's have considered the Company's cash flow relative to its total debt to be somewhat weak for their "A" categories. Given the Company's forecasted levels of depreciation expense and construction expenditures, it is readily apparent that Con Edison's cash flows will continue to remain low relative to its outstanding debt for quite some time, and its cash flow metrics would remain relatively weak even if the Commission authorized a 50% common equity ratio.

The salient point here is that the relatively weak cash flows and their negative influence on the Company's debt ratings, while

genuine, should not be the central concern of the Company's permanent financing policies. Instead, we believe that focus should be on minimizing its overall cost of capital through the appropriate use of leverage. While authorizing a higher equity ratio and an ROE that is higher than the return required by its investors might help the Company to improve its current credit ratings, neither of these actions appear to us to be consistent with the goal of optimizing its cost of capital. In any event, we believe that our capital structure recommendation should be adequate for the Company to maintain the current credit ratings accorded to its senior unsecured debt obligations.

COST RATES

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

A. As illustrated in Exhibit___(FP-1), there are four separate cost rates we employed, together with their respective capitalization ratios, to formulate our overall rate of return recommendation. Beginning with the cost rate of

the long-term debt component, we reviewed the 5.69% cost rate determination of the Company's Accounting Panel and made a few adjustments that resulted in our 5.67% cost rate recommendation. Exhibit___(FP-3) shows how this cost rate was derived.

With respect to the cost of preferred stock as shown in Exhibit___(FP-1), we reviewed and accepted the 5.34% cost rate determination of the Company's Accounting Panel.

The third cost rate shown in Exhibit___(FP-1) is the cost of customer deposits. The current Rules and Regulations of the Commission require an annual calculation of the customer deposits rate. That rate is updated by the Commission on January 1 of each year. The 4.85% customer deposits rate is the rate prescribed by the Commission in October 2008 for use beginning January 1, 2009. It should be updated at the time of the Commission's final deliberations to reflect the new rate that will become effective January 1, 2010.

The fourth and final rate is the cost of common equity. As we will demonstrate, the

Company's 10.9% proposed cost rate for common equity is excessive and should be rejected. We have developed a recommended 10.1% cost of equity for the rate year ending March 31, 2011.

Q. Regarding the cost of the long-term debt component, please explain why you adjusted the 5.69% cost rate submitted by the Company's Accounting Panel in the Company's July 10, 2009 Preliminary Update, as illustrated in Exhibit AP-12, Schedule 2.

A. As we explained earlier, Con Edison's forecasted rate year cost of debt largely reflects it's actual or "embedded" cost of debt as of April 1, 2009. It also reflects projections regarding the amounts, timing, maturities and cost rates for five new issues contemplated during the link period and rate year, projections of the cost rates for its outstanding variable rate tax-exempt debt, and the effect of its maturing obligations. Our adjusted cost rate of 5.67% is only modestly lower than Con Edison's cost rate because we generally find the Company's assumptions and methodology to be reasonable; our only material disagreement lies in the

Company's use of forecasted interest rates in its cost estimates for the five new issues and its variable rate tax-exempt debt.

Con Edison forecast the cost rates of its future debt issuances based upon current guidance from knowledgeable underwriters with respect to required spreads to treasuries and on estimates of future interest rates over the next two years which can be found in the *Blue Chip Financial Forecast*. The Company's forecast assumes a spread estimate of 1.81% for both 10-year and 30-year new debt issues based upon estimates provided by Citibank at the time the Company's update was prepared. Based upon a comparison of the Citibank spread estimate with the current yield requirements of seasoned utility debt obligations with credit ratings comparable to Con Edison, we found the Citibank required spread estimates to be reasonable.

As we discussed earlier, our 5.67% adjusted cost of debt rate is slightly lower than the Company's average rate year cost of debt because of Con Edison's reliance on forecasted long-term Treasury rates, which for 2010 are somewhat

higher than the current yields of 10-year and 30-year Treasury securities.

Short-term movements in long-term interest rates are extraordinarily difficult to forecast. Such forecasts are not only poor predictors of the magnitude of the expected change in interest rates; they are not even reliable with respect to the direction of the change. Instead, the best estimate of future long-term interest rates is no-change, i.e., the current rates of these debt instruments, as discussed in a study entitled, *On Forecasting Long-Term Interest Rates: Is the Success of the No-Change Prediction Surprising?,* by Dr. James E. Pesando in the Journal of Finance, September 1980.

Therefore, based on the most recent Treasury rates (as of the week ending August 7, 2009) and Citibanks's current spread estimates, provided by the Company, we projected cost rates of 5.58% for the Company's projected 10-year issuances based on the most recent yield on 10-year Treasury bonds of 3.77% plus a spread requirement of 1.81% and a cost rate of 6.33% for its new 30-year debt obligations, based on

the most recent yield on 30-year Treasury bonds of 4.52% plus a spread requirement of 1.81%. These adjustments, i.e. using current Treasury yields in lieu of forecasted Treasury rates, resulted in the reduction of the projected cost of long-term debt from 5.69% to 5.67%. Our average cost of long-term debt determination is illustrated in our Exhibit___(FP-3).

Q. What is your recommendation with regard to the Company's use of forecasted cost rates for its variable-rate tax-exempt debt?

A. As illustrated in Exhibit___(FP-3), the Company will have $1.085 billion of relatively low cost tax-exempt securities outstanding during the rate year, all but $225 million of which are variable rate. Of the $860 million of floating rate securities, $225 million are variable rate demand notes whose rates are reset weekly, and $635 million are variable rate securities whose rates are reset every 35 days through an auction process.

Rather than using the latest known actual rates on the $860 million of variable rate tax-exempt debt securities in its 5.69% cost of debt

calculation, Con Edison employs forecasts of the cost rates of these securities based upon interest rate projections. Currently, the cost rates of all of these securities are at very low levels (between 0.22% and 0.63%) as they are generally priced in accordance with short-term interest rates such as the three month London Interbank Offering Rate (Libor), that are near historically low levels. The Company's forecasted rates (of between 1.2% and 2.1%), however, assume a substantial increase in short-term interest rates, such as an increase in the three month Libor rate from its current rate of 0.75% to 3.00% in 2011.

Generally, we would recommend that the Commission set rates using the latest known actual rates for these securities. However, because we recommend that the cost rates of the variable rate securities continue to be trued-up, we have not adjusted the Company's forecasted cost rates for these securities.

Q. Please explain the rationale for the true-up of these securities.

A. Because of disturbances in certain segments of

the credit markets, and the impact of these disturbances on the ability to accurately estimate Con Edison's tax-exempt interest costs, the Commission first authorized the true-up of the Company's auction rate securities in its 2008 Rate Order. Then, in light of the heightened volatility following in the wake of last fall's financial markets crisis, and its impact on the ability to accurately estimate those interest costs, the Commission authorized the continuation of the true-up. Given the persistent unpredictable nature of these costs, we recommend that the Commission allow such reconciliation in this case as well.

SUMMARY OF ROE RECOMMENDATION

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

A. We generally followed the same methodology that we advocated and that the Commission adopted in Case 08-E-0539. Broadly speaking, we estimated the cost of equity for a proxy group of electric utility companies, using a DCF analysis, weighted two-thirds, and the average of two CAPM analyses, weighted one-third. We then adjusted

this result to reflect the difference in financial and business risks currently facing Con Edison versus those of the proxy group on average and to reflect common equity issuance expenses reasonably expected during the rate year. The result is our 10.1% ROE estimate.

Q. Would you please elaborate your recommendation that the DCF methodology be accorded a two-thirds weighting and your CAPM result one-third.

A. The DCF has long been the principle equity costing methodology in New York. In fact, over the past fifteen years the Commission has consistently preferred cost of equity determinations with 2/3 DCF and 1/3 CAPM weightings. While utility witnesses in recent years have criticized the methodology, particularly when it was producing lower results than other methodologies they were advocating; we believe that there are numerous good reasons why it should continue to be the preferred methodology. This is especially true in light of the exceptional volatility in the credit markets following the collapse of Lehman Brothers in September 2008, and its impact on

estimates using the CAPM methodology.

Estimating the cost of equity requires using methodologies that are not perfect. We believe that of all the approaches available, the DCF and the CAPM are by far the least flawed and, that between the two, the DCF is clearly superior. It is noteworthy that not too long ago when Company witness Morin raised concerns about the weighting accorded the DCF methodology in Case 06-E-1433, Orange and Rockland - Electric Rates, the Commission noted the relative strengths of the DCF. Specifically, on page 14 of its October 18, 2007 Order in Case 06-E-1433, the Commission stated that: "…the method offers the significant benefit of reliance on readily available, objective data to measure an indicator of real importance to investors."

We will demonstrate the reasonableness of our two-stage DCF method, and show that while our long-held reservations with the CAPM methodology remain, our particular forward-looking application of this approach continues to produce a reasonable check on our DCF

methodology, and as such should continue to be accorded a 1/3 weighting.

USE OF PROXY GROUP

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

A. First, the use of a proxy group to determine Con Edison's cost of equity is necessary because its stock is not publicly traded, and thus direct DCF and CAPM analyses of the Company are impossible. Equally important is that DCF analyses for individual companies rely on analysts' estimates of growth which are, by their nature, inaccurate and sometimes biased. Similarly, beta determinations used in the CAPM methodology are based on historical observations that, due to corporate restructurings may not be representative of the level of earnings volatility expected in the future. However, we believe that by employing a sufficiently large proxy group of similarly situated companies in our analyses, we can largely diminish the undesirable effects of biased (both upward and downward) or inaccurate growth estimates or beta measures for any one company. We further

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

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

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

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

Q. What companies did you select for your proxy

group?

A. We selected a group of 33 companies from a "universe" of 54 companies whose common stock is publicly-traded; all, like Con Edison's parent, are deemed to be "electric utilities" serving retail customers by *Value Line*. Because of its robust size, we are confident that our proxy group will produce reliable estimates of the Company's cost of equity. We have carefully selected companies that face risks substantially similar to those faced by Con Edison. The list of companies we used, including each company's credit rating, S&P business and financial profile, percentage of utility revenues, and common equity ratios, is shown on page 1 of our Exhibit___(FP-4).

Q. Please explain how you developed your proxy group.

A. We began with the 54 publicly-traded companies that *Value Line* categorizes as electric utilities that serve retail customers, because that is the primary business of Con Edison. In order to generally match this group's risks with those of Con Edison, we considered two

variables, or screening criteria: the credit quality (debt rating) of the parent holding company and its percentage of revenue received from regulated operations.

Con Edison's senior unsecured debt is rated A- by S&P and A3 by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only four out of the 54 Value Line electric utility holding companies had senior unsecured debt ratings in the A categories by both S&P and Moody's, and nearly all derived some revenue from riskier unregulated investments.

Mindful of our goal of achieving a proxy group of companies that is both sufficiently large and with generally similar business and financial risks to Con Edison, we selected only those dividend paying companies with investment-grade senior unsecured debt, and at least 70% of total revenues from regulated operations. In three instances, we included companies where the parent holding company was rated at least BBB+ by S&P and not rated by Moody's. In all three

cases, we utilized the Moody's debt rating of its principal utility subsidiary, which likewise needed to be at least investment-grade. Finally, we excluded companies that were in the midst of merger-related or corporate restructuring activities. Excluding these companies is reasonable because of the potential for such activity to distort their stock prices and hence their individual cost of equity estimates.

Q. Please explain the rationale underlying your screening criteria.

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

Not only has the credit quality of the electric utility industry fallen, but the

preeminent event over the past 25 years has been the steady decline in credit quality of U.S. corporations in general. This broader trend, together with an orientation in the electric utility industry towards consolidation through mergers and an increase in unregulated activities, means that lowering the credit quality threshold is the most logical and reasonable response to maintain an adequate number of candidate companies.

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

Q. Did the Commission employ Staff's proxy group in its cost of equity determination in the 2009

Rate Order?

A. Yes. In fact, in all of the recent fully litigated rate cases involving Con Edison and Orange and Rockland, the Commission has found the composition of Staff's proxy group to be superior to the proxy groups advocated by Company witness Morin, and, accordingly has employed Staff's proxy group in order to derive its ROE determinations.

Q. What conclusions has the Commission made with respect to the proxy groups advocated by Dr. Morin?

A. The Commission has repeatedly found Dr. Morin's proxy groups to be inferior to Staff's. Notably, in Case 06-E-1433, Orange and Rockland Utilities, Inc. – Electric Rates, the Commission stated on page 11 of its Order issued October 18, 2007, "The record here supports a finding that these groups are too risky because Orange and Rockland includes companies that do not receive 70% or more of their operating revenues from utility operations, companies that are not investment grade, and companies involved in various restructuring activities." A number of

these infirmities remain in Dr. Morin's proxy groups in this case as well.

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

A. As illustrated on page 2 of Exhibit___(FP-4), the average debt rating of the proxy group is between BBB+ and BBB for S&P and between Baa1 and Baa2 for Moody's. In addition, page 1 of Exhibit___(FP-4) shows that the group receives, on average, about 86.6% of its revenues from regulated operations.

DISCOUNTED CASH FLOW METHODOLOGY

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

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

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

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

The DCF theory assures us that stocks only have value because of the cash flows that current investors receive or the appreciation

caused by cash flows that future investors hope to receive. Also, fundamental to the DCF methodology is the notion that cash in the future is not worth as much as cash today. Due to reasons such as the time-preference of individuals to prefer consumption today rather than waiting, and because of effects of expected inflation and productivity on expected future cash flows, the DCF discounts the future expected cash flows according to investors return requirements.

The main reason that the DCF methodology continues to be the preferred approach for determining a utility's cost of equity is that investors' immediate return requirements, as observed in current stock prices and dividends, are readily quantifiable. The other principle methodology, the CAPM, only relies tangentially (through the use of utility beta values) upon direct observations of actual utility investor behavior. The primary challenge in applying the DCF is determining the rate of growth in future dividends that investors expect.

Given the relatively stable nature of the

utility industry we believe that such estimates can be derived with a reasonable degree of certitude. We believe that rational utility investors expect the growth in future dividends to generally follow the changes in output, or growth in the overall economy, as measured by growth in Nominal Gross Domestic product (GDP). Specifically, we believe that over the long-run, rational utility investors would expect dividend growth commensurate with such growth as the increased investments required by utilities to serve their expanding customer bases, at least in the aggregate, are by-and-large driven by population growth.

Moreover, just as Nominal GDP growth also incorporates gains achieved through the application of new technologies (a.k.a. productivity) and the effects of changes in price levels, these investors' growth expectations too will reflect assumptions regarding productivity gains and the rate of inflation. Consequently, we believe that when practiced with the application of well-reasoned growth rate estimates, such as the ones utilized

in our approach, the intuitiveness of the DCF methodology is abundantly clear, and it is a primary reason that the Commission has regularly found this methodology to be the best tool for estimating the cost of equity for a regulated utility.

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

A. The calculation of the DCF for the proxy group is shown on pages 1-2 of Exhibit___(FP-5). For each company in the proxy group, we calculated a three-month average stock price by averaging the high and low price for each month. We used the three-month period ending June 2009. The model also contains *Value Line* data for earnings per share, dividends per share, book value per share and the forecasted amount of outstanding common stock for each company.

This data is used to estimate the future dividend payments that investors expect for each of the companies. The price that investors are currently willing to pay for that future stream of dividends, here the average stock price taken over the three-month period ending June 2009, is

essentially the present value of those expected dividends. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, we determined the rates of return that investors expect for each company.

Q. In the past Staff has used six-month average stock prices; why are you using three-month average prices?

A. In its 2009 Rate Order, the Commission made one modification to Staff's DCF methodology; in response to the dramatic changes in the financial markets that followed in the wake of the collapse of Lehman Brothers in September 2008, it elected to employ three-month average prices. We agree with the use of three-month average stock prices. We also concur with the Commission's rationale that the use of three months data is preferable because it relies on more recent data and is still long enough to neutralize the effects of short-term market disturbances. Moreover, we note that the three month timeframe perfectly matches the publication timeframe of the *Value Line*

estimates used in our DCF and CAPM calculations, thereby ensuring the compatibility of investors return requirements with analysts' estimates.

Q. Would your recommendation to use three-month average prices change in the event the Commission adopts a three-year rate plan?

A. No.

Q. How are dividends projected to change over time?

A. Consistent with the approach Staff has used for many years, we employed a two-stage DCF method. In the near-term, we used *Value Line's* forecasted dividends. For the second stage, 2014 and beyond, we calculated a "sustainable growth" rate for each company in the proxy group based upon its projected retention of earnings and growth in common stock balances.

Q. What is the average sustainable growth rate for the proxy group?

A. 4.75%.

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

A. Yes. We compared it with growth estimates of the overall economy. Specifically, we found

that it was quite close to the most recent long-range forecast of the growth rate in Nominal Gross Domestic Product (GDP). According to the March 10, 2009 edition of *Blue Chip Economic Indicators*, the consensus long-range estimate of Nominal GDP growth is 4.9% for the most distant period forecast, 2016-2020.

It should be noted that the 4.9% Nominal GDP growth rate estimate itself is comprised of two components; Real GDP growth of 2.6% and an inflation rate of 2.3%. The long run projections generally show annual Real GDP steadily falling from a rebound rate of 3.4% in 2011 to the aforementioned 2.6% growth rate, while inflation is forecast to creep up from 1.7% in 2011 to 2.3% in the long-run.

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

the economy as a whole. For a mature sector such as the utility industry, it is unlikely that investors would expect long run growth to exceed that of the overall economy; as Company witness Hoglund acknowledges, there is little opportunity for the technological innovation necessary to achieve such lofty levels.

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

A. As shown on page 2 of Exhibit___(FP-5), the median return on equity of the proxy group is 10.35%. This figure is the appropriate measure of the DCF-derived cost of equity of the proxy group.

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

A. While many of the individual company results appear reasonable, we would not recommend a cost of equity based upon any of the individual results themselves because of the potential for biased or inaccurate *Value Line* growth estimates to improperly influence the result. While *Value Line*'s estimates are based upon its own in-house projections as well as those of other industry

analysts, the simple fact remains that earnings forecasts, even in the relatively stable electric utility industry, can be very difficult to predict, because of the impact of important unpredictable events. For instance, many earnings forecasts over the past decade have turned out to be wide of the mark because of difficulties in forecasting the course of deregulation and the extent of competition.

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

Q. Dr. Morin advocates using average earnings growth rate estimates ranging from 7.2% to 7.6%, based upon the five-year forecasts published in

Value Line and the one to five year estimates provided by *Zacks Investment*, as the measure of the growth expected by investors in the DCF model. Is this appropriate?

A. No. First of all, proper application of the DCF specifically requires the discounting of future dividends. While Dr. Morin argues that investors view earnings growth and dividend growth as essentially one in the same, it is worth noting that he provided no evidence that they are equal. Moreover, as discussed on pages 101 and 102 of his book entitled *Stocks For The Long Run*, Jeremy Siegel explains why discounting earnings results in an overstatement of a stock's value, or in this case where the required return is being determined, an overstatement in the expected growth rate of dividends.

Second, because analysts' earnings forecasts are explicitly short-term in nature and sometimes prone to grave inaccuracies, it is unreasonable to presume that investors would blithely assume the ability of these companies to maintain such growth rates well out into the

future. This is especially true since these investors would be well-aware of the consensus forecast calling for growth in the long-range Nominal GDP in the vicinity of 4.9%. In sum, Dr. Morin's excessive growth estimates are inappropriate as well as unsustainable, and they are the principle reason that his DCF methodology should be rejected.

CAPITAL ASSET PRICING MODEL METHODOLOGY

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

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

"Unsystematic" risk, on the other hand, is

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

According to the CAPM, the appropriate way to measure an individual stock's risk is through a correlation of its return relative to the market as a whole, known as beta. A stock with a beta of 1.0 has a return that mirrors the return of the market (usually the S&P 500) as a whole. Betas of less than one, which are typical for utility stocks given the moderating influence of regulation, indicate that the stocks are less volatile than the market as a whole.

In the case of stocks with betas less than 1.0, as has been a hallmark of the utility industry, the CAPM informs us that investors will only be compensated for the actual amount of risk undertaken, as measured by beta. In other words, the return requirements of utility investors will be tempered according to the

extent to which their investments are less volatile than the market as a whole.

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

A. The traditional CAPM method calculates a required return based on three inputs: the rate of return on a risk-free rate investment (Rf), the level of systematic risk for an investment (B for beta), and the expected market or equity risk premium (MRP). Typically the MRP itself is calculated or measured by subtracting the risk free rate from the expected market return (Rm). The form that the traditional CAPM takes is as follows:

Required Return = Rf + (B * MRP)

Q. How did you begin your CAPM analysis?

A. Consistent with the approach Staff has employed and the Commission has adopted over the past fifteen years, we used two different CAPM methods (the traditional approach we have already discussed and a “zero beta” calculation) to estimate the cost of equity. The CAPM result is the average of these two estimates.

Q. Why do you employ two CAPM methods?

A. Because a considerable body of research has shown that the CAPM may underestimate required returns when betas are below 1.0, we believe that it is appropriate to use a "zero beta" methodology as well. By averaging in the result of the zero beta approach, which is only partially determined by the beta used, we believe that this tendency can be addressed and corrected for, and ultimately enhancing the veracity of our CAPM ROE determination.

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

A. We averaged the 10-year and 30-year Treasury bond yields for the most recent three-month period. The result, for the three-month period ending June 2009, is 3.74%. As the Commission recognized in its 2009 Rate Order it is reasonable to employ the average of 10- and 30-year Treasuries in order to "recognize that different investors have different time horizons for holding stock."

Q. In the past Staff has employed six-month average Treasury bond yields in its calculation; why are you using three-month average bond yields?

A. The Commission employed three-month average bond yields in its 2009 Rate Order in order to be consistent with the three-month timeframe employed in its DCF cost of equity determination. Since we are employing the most recent three months of market data in our DCF calculation, we believe that consistency dictates that we employ three months of bond yield data in our CAPM analyses.

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

A. We used the .70 median beta of our proxy group, which we calculated using the most recent *Value Line* betas for each of the companies.

Q. Why did you use the median beta rather than the average beta of the proxy group?

A. As a practical matter the difference currently is *de minimis*, as the average beta of the group is .71. Nonetheless, over time we believe that use of the median beta is desirable for precisely the same reason that we used the median return of our individual results in our DCF analysis – to diminish undue influence of any outlying individual results. As we

explained earlier in our testimony, the use of the median is a widely employed statistical tool that should be used in circumstances where one or more extreme observations bias the overall conclusion. Furthermore, the Commission concurred that the median beta was appropriate in its 2009 Rate Order.

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

A. As we already explained, the MRP is best expressed as the difference between the expected market return (on common stock) and the rate of return on a risk-free investment. In order to determine the expected market return, we utilized Merrill Lynch's July 2009 *Quantitative Profiles.* As illustrated on page 46 of (Exhibit___(FP-13), that publication currently estimates the required return for the market to be 12.40% (using the average of Merrill Lynch's "Implied Return" and "Required Return" methods). Given our risk-free rate of 3.74%, we calculated the current market risk premium (MRP) to be 8.66% by subtracting the risk-free rate from the 12.40% expected market return.

Q. How does your current expected MRP estimate of 8.66% compare with historical norms?

A. The most widely cited historical MRP estimate is 6.5% based upon the results of an annual Morningstar (formerly Ibbotson Associates) study that compares the historical returns of common stock with long-term Treasury bonds; in the most recent study from 1926 to 2008. Clearly, our 8.66% expected MRP significantly exceeds the average realized MRP for the 1926 to 2008 period. It is also considerably higher than our 7.36% estimate a year ago in the last electric rate case, although it has moderated considerably from the 10.0% MRP the approach yielded, and the Commission employed, in its 2009 Rate Order.

This heightened degree of variability in the expected MRP is a direct result of the exceptional volatility in the credit markets that has followed in the wake of Lehman Brothers collapse last September. Both the credit crisis that unfolded and the widespread economic downturn that followed have had a dramatic impact on the expected MRP. Also important is

the impact of the nascent turnaround in the financial markets as the economy is beginning to show encouraging signs that the end of the recession is very near.

Q. Has the Commission ever discussed its preference for using the forward-looking Merrill Lynch estimate to calculate the expected MRP as opposed to using Morningstar's (formerly Ibbotson's) published historical data?

A. Yes, as far back as 1996, in Case 95-G-1034, Central Hudson Gas & Electric Corporation Opinion 96-28, the Commission stated on page 14 that, "…the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problem of stale data in the Ibbotson estimate…"

Q. Did the Commission express any concerns regarding the derivation of Staff's forward-looking MRP in its 2009 Rate Order?

A. Yes. Observing the relatively great variability in forward-looking estimates of the MRP that have resulted since the collapse of Lehman Brothers in September 2008, the Commission

stated, "…while we prefer a forward-looking market risk premium, the volatility of using just one, as DPS Staff does, raises concerns which should be addressed in future rate cases."

Q. Do you believe that the volatility that has been introduced into the financial markets, and by extension into your determination of the expected MRP, warrants any modification to Staff's approach?

A. No, we do not. To begin with, it is just as clear that the impacts of that volatility, and the added risk that it implies, have been introduced into DCF-derived cost of equity estimates as well, as reflected in the movement of utility share prices. In fact, we will demonstrate that the varying estimates produced by our MRP approach over the past year are quite reasonable as they largely mirror the actual changes in the return requirements of investors as evidenced in both the yield requirements of debt holders and the yield requirements of equity investors. We will also demonstrate the folly of averaging in a historically-derived MRP, and will expound upon the shortcomings of

the CAPM approach in general, in particular the inescapable subjectivity surrounding the calculation of a forward-looking MRP. Finally, we will explain why we continue to recommend that the CAPM be accorded only half as much weight as the DCF in the overall ROE calculation.

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

A. To begin with, unlike the DCF methodology, the CAPM methodology only relies tangentially (through the use of utility beta values) upon direct observations of actual utility investor behavior. Furthermore, we believe that the calculation of two of its principle inputs; the beta and the market risk premium (MRP), are highly problematic. To begin with, we have difficulty with the theory underlying the CAPM that says that the beta is a complete and sufficient measure of the risk that requires compensation in the market.

In addition, beta is supposed to represent the future volatility of a given stock relative

to the market index. But, because that future volatility is unknown, betas are measured on a historical basis, often over periods as long as five years in order to produce reliable estimates. The problem with using historically-derived betas is that when the systematic risks of a firm or an industry change, historical betas will likely not be good indicators of future volatility.

Another shortcoming of utilizing beta is the disparity of betas between the various firms that report this measure. For instance, Staff has typically relied on *Value Line* reported betas. *Value Line* performs five-year correlations and "smooths" the "raw betas" to reflect the theory that betas have a natural tendency to gravitate to 1.0. Other firms employ somewhat shorter periods, and do not adjust the "raw" betas as *Value Line* does. Our concern is that, depending upon the source, the betas can be very different, and thus can produce very different cost of equity estimates.

Our greatest concern with the CAPM methodology, however, remains the derivation of

the MRP. Like beta, the MRP should be the expected average premium of the market over the risk-free rate. Like beta, the MRP should be the expected premium of the market return over the risk-free rate. However, just like beta, the expected MRP is unknown. Because it is unknown, many adherents to this methodology, such as Dr. Morin, advocate use of a historical MRP, such as the 6.5% historical MRP for the 1926 to 2008 period that we discussed earlier. The view of these practitioners is that the MRP is essentially a mean-reverting time series, which may be volatile over the short run, but over the long run exhibits a stable long run average.

Staff has taken note of the many academic studies which have been published on the topic of the MRP and has argued for many years that the use of a historical MRP is unsuitable for the purposes of deriving a CAPM cost of equity. Specifically, we note an article entitled "*The Shrinking Equity Premium",* by Jeremy Siegel in the Journal of Portfolio Management, Fall 1999, Exhibit___(FP-14). The article concluded that

the MRP is not static and that it had been generally decreasing over time. We also note another study by E. Scott Mayfield, entitled *"Estimating the market risk premium"*, in the Journal of Financial Economics, March 2002, Exhibit___(FP-15), which argues that the historical MRP attributed to the Morningstar study seriously overstates the historical MRP because of structural shifts that have occurred in the market after 1940.

The alternative to a historically-derived MRP, of course, is a forward-looking one such as the one we used. While we advocate using an expected MRP in our CAPM methodology, we readily acknowledge that such an approach is, by necessity, subject to a substantial amount of judgment, and is among the principal reasons that we have consistently argued that the CAPM only be accorded half the weight of our DCF-derived cost of equity estimate.

Q. Please explain why you find the recent variability in Staff's forward-looking MRP to be reasonable.

A. While we appreciate the Commission's hesitance

to rely solely on our forward-looking MRP as a result of the volatility that has entered the financial markets since last September, we view the varying estimates produced by our MRP approach over the past year as reasonable because they generally mirror the actual changes in the return requirements of investors in both the debt (in terms of yield requirements) and equity markets (in terms of stock prices). As illustrated on page 2 of Exhibit___(FP-6), it is quite apparent, at least over the past year, that the movement in the forward-looking MRPs derived using Merrill Lynch's monthly estimates of the market return (and for ease of comparison using monthly 20-year Treasury yields as a surrogate for the risk free rate) generally tracks the changes in the spread requirements of debt holders as well as the return requirements of equity investors in terms of the movement in share prices.

Q. How have historical MRPs been impacted by the heightened volatility?

A. In spite of a plethora of evidence suggesting an overall increase in investor return

requirements, the 6.5% historical risk premium for the 1926 to 2008 study period is actually 0.6% lower than the same study's 7.1% estimate one year ago, for the period 1926 to 2007. We believe this result should lay to rest any notion of its suitability for deployment in the CAPM cost of equity determination.

Q. Why do you believe that no change is necessary in your application of the CAPM methodology or its weighting in your overall ROE determination?

A. First of all, as we have demonstrated, our particular application of the CAPM methodology, has actually held up quite well to the challenges posed by the heightened volatility; that is, objectively speaking our MRP appears to broadly reflect the actual changes in investors' return requirements in the capital markets. Nonetheless, recent volatility aside, we believe that the CAPM largely suffers from the same deficiencies that we have noted for some time; specifically, the unavoidable subjectivity surrounding the calculation of the MRP and the unavoidable staleness of its five-year historical beta values. Consequently, we still

believe that the CAPM methodology offers some valuable insight regarding the cost of equity capital, especially when practiced using our well-reasoned approach, but given our ongoing concerns with the CAPM methodology in general, we continue to recommend that it be accorded no more than a one-third weighting.

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

A. 9.80%, calculated as follows:

3.74% + [0.70 * (12.40% - 3.74%)] = 9.80%

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

A. We used the same inputs as in the traditional CAPM methodology. However, instead of multiplying beta by the risk premium as shown in the calculation of the traditional CAPM methodology, we determined the risk premium for the proxy group by multiplying .75 times beta times the risk premium and adding .25 times the risk premium. This can be expressed as:

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

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

A. 10.45%, calculated as:
3.74% + [.75*.70*(12.40%-3.74%)] + [.25*(12.40%-3.74%)] = 10.45%

Q. Please explain how you used the results of these two CAPM methods in your calculation of the required ROE for the proxy group.

A. We averaged the results of the two CAPM methods to arrive at a determination of 10.13%. This is the same approach we recommended and the Commission adopted in its 2009 Rate Order.

RETURN ON EQUITY CONCLUSION

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

A. We weighted the DCF result (10.35%) as two-thirds of the total and the CAPM average (10.13%) as one-third of the total, which resulted in a 10.28% cost of equity. These calculations are shown on page 3 of our Exhibit___(FP-5).

Q. You explained earlier in your testimony that two adjustments should be made to this cost rate. Please describe these adjustments.

A. The first adjustment reflects the fact that there is a quantifiable difference between the

business and financial risks faced by Con Edison and the proxy group. We based this adjustment upon the fundamental concept that the return requirements of common equity investors are commensurate with the riskiness of their investment. While our proxy group selection process sought out companies whose risks were "substantially similar" to those faced by Con Edison, the fact is that real and quantifiable differences do exist and they should be reflected in the cost of equity determination accordingly.

Both Moody's and S&P regularly assess both the business and financial risks of the utilities they rate and assign their credit ratings accordingly. As we discussed earlier, Con Edison is rated A3 by Moody's and A- by S&P, while as illustrated on page 2 of Exhibit___(FP-4), the average Moody's rating for the proxy group is about 1.6 notches lower - somewhere between Baa1 and Baa2, and its average S&P rating is about 1.3 notches lower, falling between the BBB+ and BBB rating categories.

To calculate a comprehensive credit quality

adjustment that recognizes Con Edison's lower business and financial risk vis-à-vis the proxy group of holding companies, we began with an analysis of the bond yield requirements for utility debt investors. As illustrated on page 1 of Exhibit___(FP-6), we calculated five-year average yield requirements for utility debt, by ratings categories in descending order from AA/Aa2 to BBB-/Baa3, using monthly data from Mergent's Bond Record for seasoned utility bonds with current balances outstanding over $100 million and maturities of at least 20 years.

Q. Why did you analyze the yield requirements over a five year time period?

A. In Case 08-E-0539, we only compared the yield requirements over the most-recent six-months of data available at that time. When we filed our testimony, however, we noted that investors were beginning to differentiate between the risks of higher versus lower rated debt obligations, stating that, "the spreads between A/A2 and BBB/Baa2 debt widened to 55 basis points in June 2008, or nearly double the average spread of the past 20 years."

By the time hearings were held in Mid-October 2008, the financial markets were in the midst of a vast and turbulent upheaval that, among other things, resulted in record high yield spreads (the incremental yield requirements over comparable treasury security yields) and an even greater differentiation between the spreads charged to companies with different credit ratings (credit spreads). As a result, Staff noted that the Commission may have to exercise additional judgment in determining the appropriate level of a credit quality adjustment for Con Edison. The Commission may want to consider examining longer term historical spreads to assess the differential between Con Edison and the proxy group.

In its 2009 Rate Order, the Commission heeded our advice, and concluded that in order to temper the impact of the turmoil in the financial markets, while still reflecting some degree of investors' more recent credit consciousness, the appropriate credit quality adjustment should be based on the most recent five-year average spreads between the Company's

bond ratings and those of the proxy group. We believe that the balance struck by the Commission's approach remains reasonable today. Thus, we have employed five-year average debt yields in our analysis.

Q. What was the result of your analysis?

A. Based on the utility bond yield requirements over the five years ending June 2009 for the varying debt rating categories, we calculated implied yields for both Con Edison and the proxy group. The result was 6.26% for the Company and 6.49% for the proxy group, indicating that the return required by the Company's debt holders is about 23 basis points less than the return requirements for the proxy group's lower rated debt securities.

In order to translate that debt discount into the return requirements of the Company's common equity investors, we first calculated the ratio of the proxy group's current cost of equity (10.28%) to its current cost of debt (7.46%; the average cost rate for the three months ending June 2009) and found the current cost of equity to be 137.85% of the current cost

of debt. Then, we multiplied Con Edison's 23 basis point cost of debt discount by that 137.85% ratio, to determine the appropriate credit quality adjustment for Con Edison's equity holders, which we found to be 31 basis points. Our calculations are illustrated on page 1 of Exhibit___(FP-6).

Q. Is it reasonable to assume that companies with higher credit ratings will have lower equity cost requirements?

A. Yes. As Dr. Morin explains on page 13 of his prefiled testimony, the prices of debt capital and equity capital are both influenced by the relationship between the risk and return expected for the respective securities. And on page 33 he also acknowledges that a utility's cost of equity will generally track its cost of debt because a utility's cost of capital (its debt and its equity) is determined by its business and financial risks.

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

A. No. Unlike what he has done in previous cases, including Case 08-E-0539, in this case Dr. Morin

made no attempt to characterize the risk profile of his proxy groups vis-à-vis that of the Company. In Case 08-E-0539, just as in this case, Dr. Morin utilized proxy groups with overall credit risks quite similar to ours, yet in that case he concluded that no adjustment was necessary because in his view, "Con Edison's lower business risk on account of its status as a pure wires utility unencumbered with the riskier power production function offsets its higher financial risk on account of its aggressive capital program, weak financial metrics for its current credit ratings, and high regulatory risk."

In this case, however, Dr. Morin confines his overall assessment of risk to his observation that "the Company's regulatory risk profile has risen relative to historic levels," and furthermore, he characterizes his 10.9% return on equity recommendation as "conservative" due to the "current turmoil and uncertainty in capital markets, and in view of the CAPM's understatement of capital costs under current crisis conditions…"

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

A. No. As we mentioned earlier, the ratings processes of S&P and Moody's are comprehensive; they each factor in assessments of the overall business and financial risks facing a given company. Thus, to suggest that Con Edison with its A3 Moody's and A- S&P ratings is just as risky as proxy groups whose average Moody's and S&P ratings are roughly 1.5 notches lower, is simply not credible.

We have already pointed out that Con Edison has a significantly stronger credit profile than the average electric utility company. According to its August 4, 2009 report entitled *U.S. Regulated Electric Utilities, Strongest to Weakest*, Exhibit___(FP-16), of the 187 holding and operating companies rated by S&P, only 19 have higher ratings than Con Edison, while 137 are rated lower. Meanwhile, according to its July 2009 report entitled *U.S. Regulated Electric Utilities: Six-Month Industry Update,* Exhibit___(FP-17), of the 184 electric utility holding and operating companies rated by

Moody's, only 20 are rated higher than Con Edison, and 142 are rated lower.

In terms of contrasting the Company's overall risk with that of the comparable utilities employed in his analyses, Dr. Morin's point about heightened regulatory risk is also without merit, as any perceived increase in regulatory risk resulting from the Commission's actions is already reflected in the Company's debt ratings, and thus properly reflected in our credit quality adjustment.

Q. Please explain your second adjustment, which reflects the costs associated with the Company's proposed infusion of common equity during the rate year.

A. It has long been Commission policy to allow recovery of forecast common equity issuance expenses when they are reasonably expected to be incurred during the rate year. The Company has forecast a common equity contribution of $200 million from its parent CEI, which the parent intends to raise through a public issuance of common equity during the second quarter of 2010. We have reviewed the Company's forecasted common

equity issues (including another $100 million during the third quarter of 2009, the recovery of issuance costs of which the Commission provided for in the 2009 Rate Order), which Con Edison has tailored in order to maintain a common equity ratio at or slightly above 48%. As we discussed earlier, we find the targeting of a 48% equity ratio for CEI's regulated operations to be reasonable, and thus concur with the Company's projection of a $200 million equity infusion during the rate year. It is reasonable to allow Con Edison recovery of issuance expenses incurred by its parent on the Company's behalf. In the last case, we estimated total issuance expenses of about 1.5% of the gross proceeds based upon an average of the actual issuance expenses incurred by CEI in its most recent three public offerings. However, transaction costs for new common shares have risen due to the turbulence in the credit markets, and we estimate that CEI will incur total issuance expenses of 3.8% in order to raise the additional common equity during the rate year.

Q. How did you derive this estimate?
A. According to the Company's response to Staff IR-339, there have been seven electric holding company common stock issuances since the beginning of the year; the average cost to issue those shares was about 3.8%. At this time, we believe that figure is a reasonable estimate. However, as we noted earlier, the parent is also expected to issue new shares during the third quarter of 2009. In the event that the parent goes forward with this transaction, we recommend updating our flotation cost adjustment using the actual underwriting costs from this sale as opposed to our 3.8% estimate.
Q. Please continue explaining the derivation of your flotation cost adjustment.
A. Given the Company's projection of a $200 million equity infusion during the rate year, and our estimate that the parent will incur issuance expenses of 3.8% of that gross amount, we project total issuance expenses of $7.6 million ($200 million * 3.8%). Given our projection that Con Edison's average rate year balance of common equity will be about $9.52 billion, we

made an upward adjustment to the cost of equity of 8 basis points ($7.6 million/$9.52 billion). Not only will this adjustment allow Con Edison to recover its reasonably expected equity issuance costs during the rate year, it will continue to provide for these costs into the future until its rates are reset.

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

A. As illustrated on page 3 in Exhibit___(FP-5), we reduced the proxy group's 10.28% ROE by 31 basis points to reflect the Company's superior credit quality and we increased it by 8 basis points to reflect reasonably anticipated common equity issuance expenses. Finally, we rounded our recommendation to the nearest tenth of a percent.

Q. Do you recommend updating the cost of equity?

A. Yes. We recommend updating our cost of equity estimate later in this case, consistent with the Commission's policy statement.

DISCUSSION OF COMPANY ROE AND FINANCING PRESENTATIONS

Q. You have stated that Dr. Morin's 10.9% recommended ROE is excessive and should be

rejected. Would you please summarize the approach followed by Dr. Morin?

A. To arrive at his recommendation, Dr. Morin performed a total of four DCF analyses using two different proxy groups for Con Edison. He also performed three risk premium analyses; two using the CAPM methodology and one using historical and risk premium data from electric utility industry aggregate data. He then averaged the results of all three methodologies (DCF, CAPM and risk premium), according each an equal weight, to arrive at a 10.9% cost of equity determination.

Q. Did Dr. Morin suggest that his 10.9% cost of equity estimate is actually below what he considers to be a “just and reasonable return on the common equity capital of (Con Edison’s) electric delivery operations in the state of New York?”

A. Yes. In view of the “current turmoil and uncertainty in capital markets,” and in his view of the “CAPM’s understatement of capital costs under current crisis conditions” he opined that the Company’s cost of equity lies “in a range of

11.0% to 11.5."

Q. Do you agree with Dr. Morin's conclusion that the CAPM understates capital costs under current market conditions?

A. No. Dr. Morin's conclusion is based on two faulty premises; first, that it is reasonable to utilize historically-derived MRPs to calculate the cost of equity, and second, that the historically-derived utility betas "vastly understate risk" because they do not yet reflect the impact of the current financial crisis on volatility. While we concur with his observation that prospective MRP estimates, such as ours, are higher than historically-derived MRPs, it is not the case that the CAPM currently understates the cost of equity. That is to say, the CAPM only understates capital costs under current market conditions to the extent that it relies upon historically-derived MRPs, which we have long rejected in our methodology.

Dr. Morin's second premise, that utility betas currently "vastly understate risk" as they do not yet incorporate the impact of the recent financial turmoil, is completely unfounded. To

begin with, we have already pointed out that, using historically-derived betas is problematic, but generally only when the systematic risks of a firm or industry change. While it is certainly true that the overall risk in the market is higher than it was a year ago, this risk is already (and properly) reflected in our 8.66% expected MRP, which is considerably higher than our 7.36% estimate of a year ago. Dr. Morin, however, has provided no evidence that the systematic risk of utilities has changed. On the contrary, we believe that the continued presence of regulation assures that utilities will be relatively well insulated during the turmoil, and suggests to us that utility betas are unlikely to change all that much, up or down.

Q. How did Dr. Morin address the apparent failing of the historically-derived MRP in his CAPM methodology?

A. Despite his acknowledgement that the historically-derived MRP, “likely does not capture the re-pricing of risk that is occurring in the financial marketplace,” Dr. Morin, in

contrast to his testimony in past cases where he also employed prospective MRP estimates, only relied upon the flawed Morningstar historical MRP. Although the Commission has rejected Dr. Morin's past derivations of forward-looking MRPs, rather than address the Commission's concerns about his method, he did not employ a forward-looking MRP, even though he suggests that historical estimates of the MRP may be flawed. Instead, the Company provides additional ROE testimony by Dr. Lindenberg, which we will address later, that reflects a forward view of risk that is implied by current market data.

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

A. To begin with, Dr. Morin only assigns the DCF a one-third weighting. Consequently, his approach places principal weighting on methodologies that the Commission has either consistently found to be inferior (the CAPM), or rejected (electric utility risk premium studies).

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

A. In previous cases, we have criticized the composition of Dr. Morin's proxy groups on numerous counts; primarily because they were too small and because they included companies that were not suitable surrogates. While we note that Dr. Morin's approach in this case partially addresses some of our previous concerns, his proxy groups are still inferior to ours. Purportedly, he has limited his proxy group to companies with investment-grade ratings, with which we agree, and he includes only companies whose regulated electric revenues are at least 50% of total revenues. However, our criteria, which the Commission has repeatedly adopted, require them to have at least 70% of their revenues from regulated operations (be they electric or gas).

Dr. Morin's proxy groups are only about two thirds the size of our 33 company proxy group. Thus, statistically-speaking and all else the same, the results of his analyses are somewhat less reliable than ours. Of greater concern however, is the composition of Dr. Morin's proxy groups. His proxy groups exclude many companies

that are suitable surrogates (as fully nine investment-grade electric utilities with at least 70% of their revenues from regulated operations that are found in our proxy group are not included in either of his groups), while he includes companies that we do not believe to be suitable surrogates for Con Edison's utility operations.

With respect to the unsuitable companies, two of the 20 companies in his "combination electric and gas" utilities group (Exelon Corp. and Pepco Holdings, Inc.) and three of the 22 companies in the "S&P Electric Utility Index" group (Exelon Corp., PPL Corp. and Pepco Holdings, Inc.) receive less than 70% of operating revenues from utility operations. Additionally, in contradiction to the stated design of his screening selection process, both of Dr. Morin's groups include companies whose senior unsecured Moody's ratings are below investment-grade. Specifically, Ba1-rated CMS Energy Corp is in both of his proxy groups, and Ba1-rated Allegheny Energy Inc. is in the S&P Electric utility Index group. In short, Dr.

Morin's proxy groups are still inferior to our proxy group, and should be rejected.

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

A. Dr. Morin performed four separate DCF analyses; he performed two using a proxy group consisting of 20 companies culled from those companies designated as "combination electric and gas utilities" by *AUS Utility Reports*, and two analyses using 22 companies culled from the S&P Electric Utility Index. The four DCF analyses resulted in cost of equity estimates ranging from 12.0% to 12.4%.

For each of the proxy groups he calculated two average ROE estimates, all of which relied upon current spot prices and dividend yield information. In one analysis he used *Value Line* earnings per share growth estimates, and in the other *Zack's* earnings growth estimates. While there are numerous deficiencies in these analyses, none is more disconcerting than the use of excessive growth rate estimates. Use of these estimates, which range from 7.2% to 7.6%, is contrary to the Commission's long-accepted

premise that sustainable long-run utility dividend growth is a product of a company's future expected returns on equity and its dividend payout policy.

Dr. Morin's testimony, however, fails to address how the relatively short-term earnings growth estimates he uses relate to the dividend payout policies of his proxy companies. Even more troubling, he fails to demonstrate whether or not they are even sustainable over time. Moreover, we have already explained the unlikelihood that rational investors would expect such high short-run growth rates to be sustained well into the future, as they far exceed longer run growth estimates for the economy as a whole.

Dr. Morin's use of spot prices is also inappropriate, because of the undue volatility that such a single point-in-time estimate injects into the calculation. Another flaw in Dr. Morin's DCF methodology is his inclusion of a 30 basis point upward adjustment (which he also adds to his CAPM estimates), that he refers to as a flotation cost allowance. We have

already demonstrated the reasonableness of an 8 basis point adjustment to reflect the issuance expenses associated with the Company's projected rate year issuance of common equity. Dr. Morin's estimate, which purposely attempts to account for past as well as future issuance costs, has repeatedly been rejected by the Commission. Specifically, in Case 06-E-1433, Orange and Rockland – Electric Rates, the Commission stated that: "The Company's attempt to reach back to past issuances is supported only by a hypothetical statement that such costs may not have been collected, rather than any proof to that effect."

Q. Are Dr. Morin's DCF methodology results also overstated to the extent that they reflect the quarterly compounding of dividends?

A. Yes. Even though the Commission found the annual dividend DCF model we employ to be appropriate in the last electric rate case, as it has repeatedly found in all litigated cases for at least the past 15 years, Dr. Morin continues to present overstated DCF estimates as a result of the inappropriate reflection of the

quarterly compounding of dividends.

Q. Why is a model that reflects quarterly compounding of common stock dividends inappropriate?

A. For the reason cited by the Commission in its 2009 Rate Order, specifically that, “any extra return to be achieved on account of quarterly dividend reinvestment will be achieved by those who actually reinvest all their dividends in the Company’s stock.” Furthermore; “any additional allowance would be duplicative for those who actually reinvest dividends and unnecessarily generous to those who do not.”

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

A. In order to quantify the risk premium he asserts is appropriate for Con Edison, Dr. Morin performed a total of three risk premium analyses. For the first two risk premium studies he submitted, his “CAPM Estimates,” he applied the CAPM and an empirical approximation of the CAPM using current market data. The other risk premium analysis was performed on historical risk premium data from electric

utility industry aggregate data.

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

A. Dr. Morin began with a traditional CAPM methodology. For his inputs he used: a risk-free rate of 3.7% based upon the current level of 30-year Treasury bonds yields prevailing in April 2008; a beta of .75 based upon the *Value Line* betas of the electric utility companies used in his DCF analyses; and, a market risk premium of 6.5% based upon the result of a Morningstar study comparing the historical returns of common stocks with long-term Treasury bonds from 1926 to 2008.

He then used these inputs and developed a CAPM estimate of the cost of common equity for Con Edison of 8.6% ((3.7%) + (0.75 * 6.5%)), which he adjusted to 8.9% after including an excessive 30 basis point flotation cost allowance. In his Empirical CAPM approach, he adjusted this result even further upward, to 9.3%, including a flotation cost allowance,

because he believes that for betas less than 1.0 the CAPM underestimates the cost of equity.

Q. Please reiterate how Dr. Morin determined the historical MRP he used in his CAPM calculations?

A. Dr. Morin's historical MRP was based on the results of Morningstar's most recent historical MRP study, which compiled historical returns from 1926 to 2008, and found that over this period, common stocks outperformed long-term U.S. Treasury bonds by 5.6%. Dr. Morin felt, however, that the appropriate measure was actually 6.5%, because the study should have compared the stock returns only to the income component of the long-term treasury bonds rather than the total return.

In the recent New York cases in which he has testified, Dr. Morin has repeatedly argued that if one is to rely on historical relationships to predict the future that one should use data from the longest possible period for which reliable data are available, which he has consistently argued is embodied in the data used in the Morningstar study. He has also repeatedly argued that the entire Morningstar

study period be used in order to minimize subjective judgment and to encompass many diverse regimes of inflation, interest rate cycles and economic cycles. Until the present case, Dr. Morin has repeatedly stated that the historical Morningstar study-derived MRP calculation is reasonable because he has seen no evidence that it (the MRP) has changed over time. Based upon his testimony in this case, Dr. Morin doesn't seem so certain anymore.

Q. What are the principle concerns you have with Dr. Morin's CAPM analyses?

A. The biggest flaw in Dr. Morin's CAPM analyses is the use of a historical MRP. As we have already explained, there is ample evidence to indicate that historical MRPs in general are not suitable for estimating future expected returns. Quite simply, as we have repeatedly argued in recent years, that because of past, as well as ongoing structural shifts in the economy, the use of a historically-derived MRP is inappropriate for use in the CAPM cost of equity determination. In short, we have little confidence that historical MRPs like Dr. Morin's bear any

resemblance to the current investing climate, and as a result we believe his CAPM analyses should be rejected.

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

A. There are several reasons why this approach should be rejected. First, Dr. Morin makes no attempt to determine the extent to which Con Edison is more or less risky than the average electric utility contained in the S&P Utility Index for the period 1930 to 2007. He also provides no evidence about whether the risks of the bonds used to calculate the yield for the S&P Utility Index have remained at the same level relative to the risks of the electric utility stocks comprising that index for the 1930 to 2007 study period. These are the same flaws that have contributed to the Commission's rejection of his risk premium studies in the past.

In our discussion of Dr. Morin's CAPM methodology we have already exposed a flaw in

using a historically based approach. We note that here too, Dr. Morin's risk premium study of the electric utility industry produces counterintuitive results when it is updated to include data from the 2008 period. That is to say that, in spite of overwhelming evidence that return requirements have generally increased over the past year as a result of the added risk introduced in conjunction with the volatility that has beset the financial markets since last September, Dr. Morin, in response to Staff IR DPS-278, which is shown in our Exhibit___(FP-18), acknowledges that the 5.0% risk premium in his 2007 study actually *decreased* to 4.5% when he updated it to reflect data from 2008.

Q. Finally, would you please comment on Dr. Morin's determination that in the event a three year rate plan is approved for the Company, a stayout premium of 71 basis points should be added to the Company's 10.9% cost of equity?

A. To begin with Dr. Morin correctly acknowledges that in the past the Commission has used the differential between 3-year and 1-year Treasury securities to provide guidance as to the

appropriate level of a stayout premium, and specifically that it has been based upon one-half of the five-year average differential. Unfortunately, he then incorrectly asserts that the five-year average differential through the end of October 2008 is 50 basis points. In fact, the five-year average differential through October 2008 was much lower, only 27 basis points; and for the five-year period ending June 2009 it is only 23 basis points. Thus, if a stayout premium were to be authorized in the event of a three-year rate plan in this case, historical precedent suggests no more than 12 basis points (one-half of the five-year average differential through June 2009) would be appropriate.

Dr. Morin, however, does not recommend using the Commission's past approach. Instead, he calculates a 71 basis point stayout premium based upon the yield differential between 3-year and 1-year Treasury securities over the past six-months at the time his testimony was prepared. As a result of his high stayout premium, the Company is requesting an ROE of

11.6% for a three-year rate plan.

As acknowledged by Dr. Morin, the purpose of a stayout premium is to compensate the Company's shareholders from the risk that the cost of equity would go up during the course of the rate plan. However, for purposes of determining the cost of equity, Dr. Morin's use of six-months of recent yield data is totally inappropriate, because, as he acknowledges on page 20 of his direct prefiled testimony, "the expected common stock return is based on very long-term cash flows."

From a comparison with the five-year average yield differentials, it is clear to us that the recent six-month average yield differentials are not representative of such yield differentials over the long-run. In fact, it is specifically because of the aberrational impact the recent turmoil in the credit markets has had upon spreads in general, that we used five-year average spreads to calculate our credit quality adjustment, as opposed to the six-month average that we initially proposed in the last electric rate case.

Given that credit spreads are now tightening in general (i.e., trending towards lower, more traditional levels) we do not envision the Company's risk of "missing out" on considerably higher ROEs as a result of entering into a three-year rate plan as warranting anything near the 71 basis point premium argued for by Dr. Morin. Instead, we believe that an appropriate stayout premium would be much closer to the 12 basis points calculated using the Commission's traditional approach.

Q. With respect to the financial challenges faced by Con Edison, Company witness Hoglund has pointed out that one of Con Edison's primary challenges arises from the fact that its depreciation rates are small relative to its ongoing capital expenditure program. One of the principle effects of this dynamic, he adds, is that the Company's cash flow metrics will remain relatively weak for quite some time. Would you please comment on this assessment?

A. We have already noted the ratings agencies' negative view with respect to this particular element of financial risk. In fact, probably

more than anything else, this dynamic has increased the Company's overall financial risk, and thus cast a downward pressure on its credit ratings. We took this dynamic into consideration in recommending a rate year capital structure of 48.0%, which compares favorably to the actual March 31, 2009 ratio of 47.0% illustrated at the bottom of column 2 on page 1 of Exhibit___(FP-2).

Finally, we also believe that the ratings agencies have taken note of the cost pressures posed by the Company's large capital program as well as the current weakened state of the economy. Specifically, we trust that Con Edison's current S&P and Moody's stable ratings outlooks reflect the realistic constraints posed by these factors.

Q. In discussing the effects that last September's financial market upheaval has had upon the utility industry's ability to raise capital, Mr. Hoglund paints somewhat of a troubling picture in terms of access to the capital markets, as well as borrowing rates. Please comment on his observations, specifically with respect to

current market conditions?

A. With respect to the ability of utilities to access the capital markets during the recent financial turmoil, as provided in Exhibit___(FP-17), in its July 2009 Six-Month Update of the Electric utility Industry, Moody's states that "most utilities had little trouble accessing capital across the entire capital structure." And with respect to Con Edison in particular, in its June 30, 2009 Credit Opinion, provided in Exhibit___(FP-12), Moody's indicated that both the Company and its parent "have superior access to capital and better than average flexibility to manage through periods of stress."

With respect to the effect of the recent financial crisis upon borrowing costs, we only agree with Mr. Hoglund in part. Mr. Hoglund states that U.S. corporate issuers have had to pay record premiums, as compared to U.S. Treasury rates, in order to attract investors. As page 2 of Exhibit___(FP-6) shows, in December 2008, the yield requirements on utility debt were extremely high by historical standards; with the average yields on A and Baa rated

obligations priced at 336 basis points and 495 basis points, respectively, over comparable Treasury securities.

However, we disagree with Mr. Hoglund's assessment that "capital – both debt and common shares – will be more expensive going forward." As page 2 of Exhibit___(FP-6) also shows, the absolute cost of utility debt has actually fallen considerably from its November 2008 highs of 7.60% for A rated debt and 8.98% for Baa rated debt to current levels, as of July 2009, of 5.97% for A rated debt and 6.87% for Baa rated obligations. At the same time the spreads to comparable Treasury securities have also fallen appreciably from their December 2008 highs of 336 basis points for A rated utility debt and 495 basis points for Baa rated utility debt to 159 basis points and 249 basis points, respectively.

Q. Would you please explain the basis for Company witness Lindenberg's testimony?

A. The Company's usual rate of return witness, Dr. Morin, opted not to present forward-looking MRP estimates in his CAPM presentation. According

to Dr. Lindenberg, the purpose of his testimony is to describe how the recent increase in volatility in the financial markets has increased Con Edison's cost of equity.

To calculate the increase in the Company's cost of equity, Dr. Lindenberg presents an alternative ROE model, which he refers to as the Option Market Implied Cost of Equity Model (OMICE). According to Dr. Lindenberg, such a model is needed because "the models traditionally employed in rate cases where cost of capital is linked to underlying measures of equity risk, in practice, have employed risk measures that are usually based on historical data."

Q. According to Dr. Lindenberg, which cost of equity model is particularly challenged by the recent increase in volatility?

A. According to Dr. Lindenberg, "this is especially true of the CAPM where betas are based on regression analysis of historical return data and equity risk premia most often are estimated from historical spreads between equity and bond returns…"

Q. Do you agree with Dr. Lindenberg that the recent volatility has generally increased risk overall, and that this risk ought to be reflected in cost of equity calculations?

A. Yes. Moreover, as we have already explained, we believe that both our DCF and CAPM methodologies appropriately reflect the changes in risk that have occurred within the generally well-insulated utility industry over the past year. Specifically, our 10.35% proxy group DCF ROE estimate is fully 50 basis points higher than our estimate one year ago and our 8.66% MRP determination that we employ in our CAPM equations is 130 basis points higher than our determination at this time last year.

Q. Do you agree with Dr. Lindenberg's basic premise that a new approach is warranted in this case because of shortcomings associated with the "typical" CAPM model; specifically its reliance on historical beta and MRP determinations, which he suggests render it inadequate in terms of capturing the added risk resulting from the increased volatility?

A. Absolutely not. To begin with, we do not employ

a historically-derived MRP for precisely the reasons cited by Dr. Lindenberg, specifically its inability to reflect ongoing structural shifts in the economy. Instead we employ a forward-looking MRP which we have shown to be reasonable as it has generally tracked the changes in the spread requirements of debt holders and the dividend yield return requirements of equity investors during the current period of heightened market volatility. With respect to the CAPM's use of historical betas, we have likewise pointed out our reservations when the systematic risks of a firm or industry change. Just like Dr. Morin, however, Dr. Lindenberg has not presented any evidence indicating that the systematic risk of the utility industry has changed as a result of the increase in volatility since last September. He has provided no evidence suggesting that the approach we recommend here, and that the Commission adopted in its 2009 Rate Order, is lacking as a result of the recent market turbulence.

Q. Aside from the fact that he has not demonstrated

a need to overturn the Commission's sound ROE approach, are there other reasons that Dr. Lindenberg's OMICE methodology is not appropriate for determining Con Edison's cost of equity?

A. Yes, there are several. While we recognize that the OMICE model has some intuitive appeal, as it relies in part on traded financial instruments (stock options) to provide estimates of future price volatility. We believe that the approach also has many outstanding questions that require further study. For instance, there is a question as to whether OMICE includes diversifiable risk in its calculation, thus overstating the cost of equity. We are also particularly troubled by certain of the OMICE model's underlying assumptions that enable it to use relatively short-run publicly-traded options, the lives of which are typically not more than two to three years, to make conclusions about the cost of equity, which is a very long term concept.

In addition to our conceptual concerns with the OMICE model, we also see flaws in Dr.

Lindenberg's methodology, as the proxy group he uses as the basis of his ROE recommendations suffers from the same deficiencies as those presented by Dr. Morin. Like Dr. Morin, Dr. Lindenberg derives a 22 company group that excludes many companies that are suitable surrogates for Con Edison (i.e., investment-grade electric utilities with at least 70% of their revenues from regulated operations), while including a number of companies that are not. With respect to those companies that are ill-suited, three (Allegheny Energy Inc., CMS Energy Corp. and CenterPoint Energy) have senior unsecured Moody's ratings that are below investment-grade, while six others (Constellation Energy Group, Inc., Dominion Resources, Inc., Exelon Corp., Integrys Energy Group Inc., Pepco Holdings, Inc. and PPL Corp.) receive less than 70% of operating revenues from utility operations. Consequently, even if we were to overlook many of the questions surrounding the OMICE methodology, the applicability of Dr. Lindenberg's particular results to Con Edison is questionable.

Perhaps the most troubling aspect of all is the fact that Dr. Lindenberg has not presented evidence on how this new methodology actually works over time, under different interest rate environments and economic cycles. Absent the ability to evaluate how the OMICE model actually works in practice, and how its results compare over time with those of the traditional DCF and CAPM methodologies, it is impossible for us to provide an adequately informed evaluation of its relative merits. Consequently, we believe that the OMICE model, which has never been adopted by a regulatory body for the purposes of establishing a fair rate of return, should not be adopted in this case.

Q. Does this conclude your testimony at this time?

A. Yes it does.