BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Consolidated Edison Company of New York, Inc.

Cases 16-E-0060 & 16-G-0061

May 2016

Prepared Testimony of Staff
Finance Panel:

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

A. Our names our Kristine A. Prylo and David P. Warnock. 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 an Associate Utility Financial Analyst in the Office of Accounting, Audits 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 as well as providing clients with 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 am responsible for 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 proceeding before the New York State Public Service Commission (Commission)?

A. Yes. I have been involved in a variety of rate cases throughout my career and have testified

before the Commission in the following Consolidated Edison of New York, Inc. (Con Edison or the Company) rate cases: Case 08-E-0539, Case 09-E-0428, Case 09-S-0794, Case 09-G-0795, Case 13-E-0030, Case 13-G-0031 and Case 13-S-0032. I have also testified in the following Orange and Rockland Utilities, Inc. rate cases: Case 11-E-0408, Case 14-E-0493 and Case 14-G-0494.

Q. Ms. Prylo, have you also been involved with proceedings before the Federal Energy Regulatory Commission (FERC)?

A. Yes. As part of my duties, I regularly provide rate of return analysis for gas pipeline proceedings going before the FERC on behalf of New York State and, at times, a coalition of states with similar interests to New York. I have been involved in a handful of gas pipeline proceedings over the years for companies such as Tennessee Gas Pipeline, Transcontinental Gas Pipeline, National Fuel Gas Supply and, most recently, Iroquois Pipeline and Empire Pipeline.

Q. Mr. Warnock, what is your position at the Department?

A. I am employed as an Excelsior Fellow in the Office of Accounting, Audits and Finance.

Q. Please describe your educational background and professional experience.

A. I graduated from New York University in May 2015, receiving a Masters of Public Administration degree in Finance. While enrolled in school, I interned with the Better Business Bureau of New York in their accreditation division. My duties included analyzing applicants' financial documents in light of Better Business Bureau standards and assessing their financing condition and business practices. I joined the Department in September 2015.

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

A. My responsibilities are currently similar to those of a financial analyst within the Department. I am responsible for 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 these Con Edison rate cases, certain financing proposals and special projects.

Q. Have you previously testified in a regulatory proceeding before the Commission?

A. No. This is my first testimony before the Commission.

Q. What is the purpose of the Finance Panel's testimony in this proceeding?

A. The purpose of our testimony is to recommend a fair rate of return to be used by the Staff Accounting Panel to determine the revenue requirements for Con Edison's electric and gas operations, for the rate year ending December 31, 2017. We will also respond to the testimony of Company witnesses Sanders and Vander Weide.

Q. Please identify the exhibits that you are sponsoring in this proceeding.

A. We are sponsoring 41 exhibits, identified as Exhibit__(FP-1) through Exhibit__(FP-40).

SUMMARY

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

A. We recommend an overall after-tax rate of return of 6.63%, as opposed to the Company's updated

request of 7.31%. Our proposed pro forma rate of return is provided in Exhibit__(FP-2).

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

A. The major difference between our recommended overall rate of return of 6.63% and the Company's updated request of 7.31% is due to our recommended 8.60% return on equity (ROE) recommendation versus the Company's proposed ROE of 9.75%. In addition, we are recommending a 4.92% cost of long-term debt, as opposed to the Company's proposed cost rate of 5.19%. While we are in agreement with the Company's use of a 48.0% common equity ratio at this point in time, we arrive at the same ratio using a different approach than the Company and will discuss the differences which contribute to how these common equity ratios are derived. We will also discuss in detail our recommendation for additional ring-fencing provisions to be implemented at this time.

Additionally, our testimony will explain

why our capital structure and cost of debt recommendations are reasonable and consistent with Commission policy and why the continuation of the Company's existing variable rate debt cost reconciliation is reasonable as well. We will also demonstrate the reasonableness of our ROE recommendation using two different equity costing methodologies, each weighted consistent with how the Commission has repeatedly weighted them in litigated cases over the past twenty years. In doing so, we will demonstrate that the Company's requested ROE is excessive and unnecessary in order for the Company to continue to attract capital at reasonable terms.

FAIR RATE OF RETURN

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

A. In the context of Commission rate proceedings, the revenue requirement is the dollar amount required by a company to provide service during the rate year. It is the amount that will allow

the Company to recover all of its reasonably expected operating costs, including taxes and depreciation. In addition, the revenue requirement includes a fair return that will allow the utility 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 utility assets and working capital requirements, which in the rate-setting context are referred to as its "rate base."

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

A. A fair rate of return for a regulated utility is one that enables it to provide safe and adequate service to its customers, while at the same time assuring it continuing support in the capital markets for both its debt and equity securities, at terms that are reasonable given the company's risk.

The fair rate of return, therefore, allows the utility to recover its prudently incurred cost of debt, 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. The two primary sources are long-term debt and common equity. Customer deposits, while typically a very small component, are almost always reflected in the expected capitalization as well because they are a relatively permanent and stable source of capital employed by utilities. It should be noted that preferred stock is sometimes a source of capital as well, although generally in much smaller proportions than either long-term debt or common equity.

Since the Commission uses 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. How are the cost rates of the individual cost components typically calculated?

A. The cost rates associated with a utility's long-term debt, preferred stock and customer deposits are relatively straightforward to ascertain. Both the embedded cost of the long-term debt and preferred stock components can be readily calculated by examining the contractual terms; i.e., the interest payments for the long-term debt and the preferred dividends for the preferred stock. The projected impact of the cost of any new or incremental long-term debt or preferred stock issuances, however, requires 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 is not contractual or prescribed by the Commission. Its calculation is further complicated by the fact that it cannot 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 long-term debt for a utility?

A. Yes. Even though both lenders and common equity investors supply the utility with the funds it needs to build and operate its system, the common 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 common equity investors is usually higher than that of the utility's long-term debt holders. Exceptions may exist during periods of disturbances in the market, such as during the recessionary period of 1980-1982, at which point the economy was beset with very high inflation and volatile interest rates. During that time, utility bond yields were at least as high as the equity 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 common equity investors.

CAPITAL STRUCTURE

Q. What does a company's capital structure represent?

A. The capital structure is the mixture of types of capital, such as debt and equity, which a company uses to finance its business; in the case of a utility company, its rate base.

Q. What was Con Edison's actual capital structure at September 30, 2015?

A. The Company's actual "stand-alone" capital structure at September 30, 2015 consisted of a long-term debt ratio of 48.46%, a customer deposits ratio of 1.46%, and a common equity ratio of 50.08%. This is illustrated in the Company's electric operations Exhibit___AP-E12, Schedule 1, and gas operations Exhibit ___AP-G12, Schedule 1, in its March 25, 2016 Preliminary Update.

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

A. As illustrated in the Company's electric operations Exhibit___AP-E12, Schedule 2, and its gas operations Exhibit___AP-G12, Schedule 2, its Accounting Panel forecasts a long-term debt ratio of 50.55%, a customer deposits ratio of 1.45% and a common equity ratio of 48.0% in its March 25, 2016 Preliminary Update.

Q. How did the Company develop this capitalization?

A. The rate year capitalization was developed by starting with Con Edison's "stand-alone" capital structure, as of September 30, 2015. This "stand-alone" capitalization was then projected through the rate year based on the Company's forecasted funding requirements during both the linking period (October 1, 2015 through December 31, 2016) and the rate year (January 1, 2017 through December 31, 2017).

The Company's forecasted long-term debt component accounts for its actual November 17, 2015, $650 million 30-year debt issuance as well as prospective new debt issuances of $1.3 billion during the remainder of the linking

period and $1.225 billion during the rate year. It also accounts for the retirement of $1.0 billion of maturing debt obligations during the linking period. No debt obligations will mature during the rate year.

Con Edison's rate year balance of customer deposits was projected based on the $334 million actual average balance during the historic test year ending September 30, 2015. The Company then forecast that average balance to grow at an annualized rate of 0.4%, based upon the actual average annual change in customer deposits during the historic test year, which resulted in an average rate year balance of approximately $364 million.

The Company's projection of the common equity component is largely premised upon its assumptions regarding the level of earnings during the linking period and rate year as well as the amounts and timing of dividend payments to Consolidated Edison, Inc. (CEI), Con Edison's parent company.

Q. Do you believe the Company's proposed capitalization ratios of 50.55% for long-term

debt, 1.45% for customer deposits and 48.0% for common equity are reasonable for the purpose of establishing the Company's overall rate of return and its electric and gas revenue requirements for the rate year?

A. We do. The reasons for our acceptance of those capitalization ratios, all of which address the reasonableness of the 48.0% requested common equity ratio, are threefold. First, we find it reasonable based upon our own analysis of the parent company's financing practices. Second, we find it reasonable because the Company has demonstrated both the willingness and the ability to maintain somewhat thicker common equity ratios on a consolidated basis than its rate authorized levels. Finally, we believe that authorization of a 48.0% common equity ratio will be sufficient to maintain the Company's current credit ratings which we generally find to be economically efficient.

Q. You mentioned that Con Edison uses its "stand-alone" capital structure to project its rate year capitalization. Please explain what you mean by "stand-alone" capital structure.

A. When we say "stand-alone" capital structure, we are referring to the capitalization of Con Edison alone. That is, without accounting for the individual capitalizations of its parent or the other subsidiaries owned by CEI.

Q. Please explain why there are both "stand-alone" and parent company capitalizations.

A. 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 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 non-utility subsidiaries.

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 private-placements.

CEI reports its consolidated financial position in its annual 10-K and quarterly 10-Q reports to the SEC. In those filings, 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 the Commission use to determine 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. Generally speaking, the use of a utility subsidiary's stand-alone capitalization should only be employed after conducting an analysis of the parent holding company's financing practices. In recent years, both Staff and the Commission have concluded that the capitalizations of stand-alone utility operations may be appropriate for rate-setting purposes in situations where sufficient legal and operational credit separation of the utility subsidiary from its parent and sister companies has been achieved.

Q. In what situations would the legal and operational corporate credit structures be deemed sufficient?

A. The stand-alone capital structures of the utility operations have been found to be appropriate in those situations where effective ring-fencing mechanisms have been put into place to insulate the utility subsidiary from the

potential risks posed by the parent's riskier non-regulated activities such that the credit rating agencies have acknowledged these devices to be sufficient to justify a ratings separation from the parent and other subsidiaries. Depending upon the magnitude and composition of the unregulated businesses and the parent's financing practices, effective ring-fencing mechanisms will result in anywhere between one to three notches differential in the ratings of the regulated utility and its diversified parent.

Q. Is Con Edison currently subject to any ring-fencing provisions?

A. Con Edison is currently subject to restrictions as a result of its acquisition of Orange and Rockland in 1998. Although these restrictions are minimal, they could be viewed as ring-fencing provisions nonetheless. Among these restrictions are that the regulated utility will not pay out more than 100% of income available for dividends calculated on a two-year rolling average basis and that the debt of the regulated utility would be raised directly by the

regulated utility and not the holding company. In addition, the regulated utility, without prior permission from the Commission, will not make loans to, guarantee the obligations of, or pledge its assets as security for indebtedness to the holding company or any of the affiliates.

Q. Has the Company had any problems abiding by the restrictions currently stipulated in the 1998 Order?

A. No, we recognize that the Company has not had any issues complying with the restrictions currently stipulated in the 1998 Order. It should be noted that the ring-fencing provisions we are recommending in these proceedings are prospective changes for the purpose of ensuring greater protections to Con Edison, but we do acknowledge the Company's good track record of adhering to the restrictive provisions currently in place and of safely deploying capital to date.

Q. Do you believe that these ring-fencing provisions satisfactorily insulate Con Edison from the added risks posed by the parent and other affiliates?

A. We do not. Currently, Con Edison is rated "A-" by Standard & Poor's Financial Services (S&P) and "A2" by Moody's Investors Service, Inc. (Moody's) while CEI is rated "A-" by S&P and "A3" by Moody's. While Con Edison and its parent maintain the same credit ratings for Moody's, Con Edison is currently rated one notch stronger than CEI by S&P. To our knowledge, the only reason that there is any separation in credit rating at present is due to structural subordination. As we will discuss, as CEI's investments into its regulated transmission and competitive energy businesses grow and continue to pose additional risk, we are concerned that Con Edison's credit ratings may ultimately suffer.

Q. Why do you recommend the institution of greater ring-fencing provisions in these proceedings?

A. As a result of the recent growth in CEI's regulated transmission and competitive energy businesses, we believe that additional ring-fencing provisions should be employed in order to insulate the utility from undue risk that may result from these riskier regulated transmission

or competitive investments.

Q. What has brought about this cause for concern and why are you recommending that greater ring-fencing provisions be implemented now?

A. The reason we are recommending additional ring-fencing provisions stems from our witness of recent sizeable investments made by CEI in these regulated transmission and competitive energy businesses, coupled with recent statements by S&P and Moody's outlining respective parameters as to when the scale of these riskier businesses could conceivably pose a threat to the credit quality of the overall organization, and ultimately to the Company.

Q. What particular recent statements by S&P and Moody's have caused your concern?

A. In its April 21, 2016 report entitled, "Rating Action: Moody's Affirms ConEd's A3 Rating; Outlook Stable," Exhibit__(FP-7), Moody's indicates that a downgrade could occur "…if CEI's investments in higher-risk, non-utility businesses increased to where the size of this segment grew to above 15% of the consolidated operations (e.g. measured by revenue, assets,

and/or cash flow; or where the businesses exposed CEI to greater cash flow volatility." Similarly, S&P, in its November 23, 2015 report entitled, "Consolidated Edison Inc. and Subsidiaries Outlook Revised to Negative from Stable; 'A-' Ratings Affirmed," Exhibit__(FP-8), echoed this sentiment when it stated, "Con Edison also engages in higher-risk unregulated activities through three wholly owned subsidiaries that collectively account for less than 5% of consolidated earnings…if these businesses grow to about 10% they could negatively affect the consolidated business risk profile." These reports, coupled with the relative magnitude of CEI's recent investments in these businesses, have made us wary that the scale of these riskier transmission and competitive businesses may be soon approaching critical mass, and thus potentially pose a threat to the Company's credit ratings in the absence of sufficient ring-fencing provisions.

Q. Please provide examples of recent investments in these regulated transmission and competitive energy businesses.

A. We note several investments in differing solar projects in the last quarter of 2015 alone, as well as ventures in a wind project in 2015, and its more recent significant investments of approximately $1.4 billion in the first quarter of 2016 in the midstream gas pipeline and storage businesses. A listing of CEI's merger and acquisition activity is attached in Exhibit__(FP-9).

Q. Why do you believe these new investments add additional risk?

A. Aside from the fact these ventures are riskier than the typical regulated utility business, even some equity analysts have expressed their confusion as to how these investments fit in with CEI's risk-averse nature; in particular, the most recent gas pipeline and storage investments. According to an April 25, 2016 UBS report, attached as Exhibit__(FP-10), when discussing Con Edison's latest Stagecoach joint venture with Crestwood Equity Partners, UBS analysts state "the question remains how management judged value in the latest acquisition." Likewise, as Regulatory Research

Associates summarized in its report, attached as Exhibit__(FP-11), an analyst from Jeffries LLC in an April 22, 2016 report stated that "…without any growth assumption [the deal] is break-even to slightly dilutive…we struggle to think [Con Edison] management would enter into a transaction that is at best break-even given their risk-averse nature."

Q. How is adequate ring-fencing generally achieved?

A. Adequate ring-fencing is generally achieved by restricting the shifting of assets and liabilities between the parent and the subsidiary. This is generally accomplished via a variety of restrictive covenants. In addition to these restrictive covenants, two other devices that have proven to be effective with the rating agencies are the "golden share" and non-consolidation opinions.

Q. Do other major utilities operating in New York State have ring-fencing provisions in place that the rating agencies have found to be effective?

A. Yes, all of the other electric and gas combination utilities in New York State, with the exception of Con Edison and Orange and

Rockland, have effective ring-fencing provisions in place, as do KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island. Examples of the ring-fencing provisions in place for these utilities, as well as those currently in place for Con Edison, are attached in Exhibit__(FP-12).

Q. Please describe the specific ring-fencing provisions you are recommending the Commission impose in these proceedings.

A. In addition to the provisions already in place as ordered in Case #98-M-0961, *Joint Petition of Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc. for Approval of a Certificate of Merger and Stock* Acquisition, which we will refer to as the 1998 Order, we recommend that greater protections be imposed in order to insulate Con Edison from any heightened risks posed by investments other than the non-core utility delivery businesses, such as the regulated transmission and competitive energy businesses. For example, in order to maintain the common equity capitalization on which rates

are based, we recommend that Con Edison be prohibited from paying dividends to CEI if its average common equity ratio for the 13 months prior to the proposed dividend was more than 200 basis points below the ratio used in setting rates. This would ensure that the utility's financial strength is not undermined between rate cases. Given Con Edison's long track record of maintaining relatively thick common equity ratios, compliance with this requirement should not be problematic.

Q. Are you recommending that any other dividend restrictions be imposed?

A. Yes. Should Con Edison's senior unsecured debt rating be downgraded below "BBB+" by more than one credit rating agency and the downgrade is a result of the performance of, or concerns about, the financial condition of CEI or an affiliate, dividends to CEI shall be limited to a rate of not more than 50% of the average annual income available for dividends, on a two-year rolling average basis. This dividend restriction forces CEI to retain earnings with the utility operations rather than shifting cash toward

financially troubled affiliates in the event the non-core utility investments encounter financial difficulties.

Q. In addition to these greater dividend restrictions, are you recommending any other ring-fencing provisions be imposed?

A. Yes, we recommend the creation of a special class of preferred stock to be held by a trustee approved by the Commission, which shall be referred to as the "golden share." The holder of the "golden share" would be independent of the utility and its affiliates, and would be able to prevent the initiation of a voluntary bankruptcy should it occur in the future. This holder of the "golden share" would exercise the voting right for the protection of the interests of New York ratepayers. With this "golden share" in place, Con Edison would then be permitted to demonstrate in future rate cases that its stand-alone capital structure, which the Company has advocated use of in its rate cases for numerous years, should be used for setting rates provided it is reasonable, demonstrates maintenance of an optimal capital

structure and no double leverage concerns exist.

The existence of the "golden share" would need to be demonstrated by submitting current written evaluations from at least two rating agencies supporting the evaluation of Con Edison as a separate company, without material adjustments based on risks related to the capital structure and ratings of CEI or its affiliates. In addition to this, a non-consolidation letter issued by the Company's general counsel should be filed to further demonstrate the implementation of ring-fencing provisions and, therefore, the legal and credit separation of the utility from its parent and related affiliates. This would be of value in that it would provide further declaration by the Company that legal separation between the entities exist. In addition, S&P has explicitly pointed to the use of non-consolidation letters as a strong ring-fencing measure.

Q. Although you have discussed that satisfactory ring-fencing provisions are currently not in place in order to protect the utility from the added risks posed by the growth in the regulated

transmission and competitive energy businesses, why do you find a 48.0% common equity ratio to still be reasonable?

A. Despite the fact that we are recommending stronger protections be imposed, we are concerned with the risks involved with the growth in the regulated transmission and competitive energy businesses on a prospective basis. As we will continue to discuss, at this time we have not seen evidence that a common equity ratio other than 48.0% is either optimal or necessary for Con Edison to continue attracting capital at favorable terms. A common equity ratio of 48.0% should be sufficient for the Company to maintain its financial integrity at this time.

Q. Please explain the approach you used in the derivation of your recommended 48.0% common equity ratio for purposes of these proceedings.

A. It has typically 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 financing policies and if their common equity components reflect actual common equity at the parent level.

Q. What do you mean by ascertain if the utility stand-alone capital structure reflects rational financing policies?

A. Nearly all utility holding companies have both regulated utility assets as well as unregulated businesses. Given the significant differences in business risk between unregulated operations and regulated utilities, there should be differing amounts of equity employed in each type of business.

Specifically, when we refer to rational financing policies, we are referring to the concept that investments or activities with greater business risk must be offset with less financial risk in order to achieve the same credit rating as those investments or activities

that have lower risk. Our goal is to determine whether or not these higher business risk non-regulated subsidiaries 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 concept of business risk and financial 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 the diversity of its customer and/or supplier bases. Financial risk, on the other hand, is the risk a company faces from the uncertainty of the amount of leverage used to finance its investments.

Both of the major credit rating agencies, S&P and 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.

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

A. 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. 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 with debt.

Nearly all regulated utilities and holding companies that are heavily utility-focused fall in the top two business risk categories, "Excellent" and "Strong." In fact, according to the S&P report entitled, "U.S. Regulated Utilities on Stable Trajectory Amid Moderate Economic Growth," Exhibit__(FP-13), 71% of

utility business risk profiles, including Con Edison, are in the "Excellent" category. This article explains that S&P sees only a modest influence on utilities' creditworthiness from economic fluctuations due to "…the essential nature of the services that they provide, the rate-regulated character of the business, and the generally supportive posture of regulators toward cost recovery for incremental capital investments."

Q. What is S&P's assessment regarding the risk profile for Con Edison specifically?

A. S&P, in its October 8, 2015 "Summary: Consolidated Edison Company of New York, Inc." report, Exhibit__(FP-14), attributes an "A-" rating and "Excellent" business risk to Con Edison, largely due to the Company's "low-risk and regulated transmission and distribution business" as well as the Company's "large and diversified customer base" which "limits the Company's susceptibility to economic cyclicality and provides for relatively stable cash flows."

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

A. As Moody's indicates in its November 6, 2015 report entitled, "2016 Outlook – U.S. Regulated Utilities," Exhibit__(FP-15), its outlook for the U.S. regulated utilities industry is stable, which is largely attributable to the credit-supportive regulatory environment in which they operate. Moody's expects that "the relationship between regulators and utilities in 2016 will remain credit-supportive, enabling utilities to recover costs in a timely manner and maintain stable cash flows."

Q. What is Moody's assessment regarding the risk profile of Con Edison specifically?

A. Moody's, in its July 31, 2015, "Credit Opinion: Consolidated Edison Company of New York, Inc." report, Exhibit__(FP-16), states that Con Edison's "A2" rating takes into consideration that "as a T&D utility company, it has low business risk and has produced consistent credit metrics" and that it "has benefited from stabilizing cost recovery mechanisms that are credit-positive."

Q. Given the variances in business risk between utilities and unregulated companies, what

capitalization differences would be expected between utility subsidiaries and unregulated subsidiaries?

A. As a result of their low business risk nature, utility companies are generally able to employ significantly higher levels of financial risk than their non-utility counterparts for a given credit rating. Because unregulated businesses are riskier than utilities, as they face competition and do not benefit from rates being set to recover all of their prudent costs, such businesses would be expected to have, relative to utilities, larger equity "cushions" to protect against variances in earnings impacting their ability to meet debt obligations. Essentially, unregulated investments should have lower levels of financial leverage.

Q. Is it common industry practice for utility holding companies to capitalize their riskier unregulated businesses with more equity than is deployed on the balance sheets of their utility operating company subsidiaries, as expected?

A. No. Both Staff's own analyses and independent research confirm this is not the case.

Q. Please provide an example of independent research that confirms your contention that utility holding companies generally capitalize their riskier unregulated businesses with common equity ratios that, based upon the riskiness of these investments, are insufficient relative to the equity ratios employed by utility subsidiaries?

A. We recently reviewed two *SNL Energy* research reports that clearly confirm this practice. Illustrated in Exhibit__(FP-17) and Exhibit__(FP-18), respectively, are the reports by *SNL Energy*, which are entitled "Quality Measures – Utility Parent Companies; Financial Quality at September 30, 2015 Down Slightly Versus Calendar 2014" and its companion report "Quality Measures – Utility Subsidiaries; Calendar Years 2011-2014, and 12 Months Ended September 30, 2015." SNL regularly reports on the financial performance of its "RRA Index," which is currently comprised of 44 utility holding companies, 37 of which are electric utility holding companies, and the remaining seven are gas. Twenty four of these companies

are also in our 28 company proxy group. As shown in Table X of Exhibit__(FP-17), the 44 holding companies in the RRA Index had an average common equity ratio of 45.0% as of September 30, 2015 and a three-year average common equity ratio of 44.6% for the 2012-2014 period. By contrast, as shown on the last page of Exhibit__(FP-18), the utility subsidiaries of these holding companies had an average common equity ratio of 49.8% as of September 30, 2015 and a three-year average common equity ratio of 49.0% for the 2012 to 2014 period. Thus, it appears that these holding companies have elected to capitalize their less risky rate-regulated utility companies with layers of common equity that exceed the common equity ratios of the parent by approximately 4.5% to 5.0%.

Q. If the utilities have equity ratios that are, on average, higher than the holding companies' average equity ratios, what does this imply for the unregulated subsidiaries of the holding companies?

A. This implies that the unregulated businesses

have common equity ratios that are even lower than the holding company average. And given that non-regulated businesses generally only account for a minority of the investment of the holding companies, the capitalization ratios of these riskier businesses must be well below the holding company averages, since the utility ratios are higher by a significant amount.

Q. Without the presence of the utility assets, would the holding companies be able to capitalize their riskier unregulated operations in this way and maintain an investment-grade rating?

A. No, most probably not. Given the need for an adequate cushion to guard against unforeseen circumstances, unregulated businesses that are not affiliated with a utility would normally have much higher levels of equity.

Q. How did you determine if CEI uses the strength of its utility operations to fund its regulated transmission and competitive energy businesses with less common equity, and more debt, than would be required for the unregulated entities if not for their affiliation with Con Edison?

A. To determine whether or not this is the case, we examined CEI's past and present financing practices, in light of the higher business risk associated with its transmission and competitive energy businesses.

Q. On what basis do you conclude that the level of business risk faced by CEI's regulated transmission and competitive energy businesses are substantially greater than that faced by the parent's utility operations?

A. First and foremost, because these businesses face competition and do not benefit from all the regulatory attributes and safeguards afforded Con Edison and Orange and Rockland, such a conclusion is fairly self-evident. Nonetheless, we note that in its October 8, 2015 report "Summary: Consolidated Edison, Inc.," Exhibit__(FP-19), S&P states that CEI "…engages in higher risk unregulated activities through three wholly owned subsidiaries that collectively account for less than 5% of consolidated earnings." As we mentioned earlier in our testimony, when we discussed our concern about the growth of the unregulated businesses

and the need for the implementation of ring-fencing provisions, it is likely these higher risk unregulated businesses will grow significantly in the near future, which will place greater pressure on the credit quality of the entire organization. Fitch Ratings, in its November 12, 2015 report entitled, "Fitch Affirms Ratings of Con Ed & Subsidiaries at 'BBB+'; Outlook Stable," Exhibit__(FP-20), states that "a more aggressive management strategy towards the unregulated businesses that leads to incremental parent leverage" is one of the factors that may "individually or collectively lead to a negative rating action." This is indicative of the affect the higher risk unregulated businesses could have on the credit quality of the overall organization. In addition to this, Moody's, in its April 21, 2016 report entitled, "Rating Action: Moody's Affirms Con Ed's A3 Rating; Outlook Stable," Exhibit__(FP-21), references the riskiness of the competitive businesses and specifically delves into the riskiness of CEI's recent investments into the midstream business.

Moody's states "…while the midstream investments in Mountain Valley Pipeline (MVP) and SGS are part of CEI's regulated transmission business, we view them as akin to the competitive investments, since each segment has a higher business risk than its traditional utility asset base over the long-term. The midstream investments do not have authorized cost recovery mechanisms, function in a competitive environment, have greater sensitivity to commodity price volatilities, and have a higher exposure to speculative grade counterparties."

Q. What do you conclude from these analyses of CEI's regulated transmission and competitive energy businesses?

A. That these businesses are considerably riskier than Con Edison. Without ring-fencing provisions in place, should these regulated transmission and competitive energy businesses grow significantly in the near future, it could potentially pose a risk to Con Edison and Orange and Rockland's credit ratings.

Q. What did your analysis find with respect to CEI's financing practices?

A. We found that, in the past, CEI had employed common equity ratios for its unregulated businesses that we consider inadequate. As Exhibit__(FP-4) shows, the unregulated businesses only had common equity ratios ranging from 33% to 43% for the three-year period ending 2008. However, CEI's unregulated entities were supported by an average common equity ratio of approximately 64.4% for the 2011 to 2013 period. Over the past several years, the unregulated businesses have had common equity ratios averaging approximately 56.0%.

Q. Why do you find the recent average equity ratio of 56.0% supporting CEI's regulated transmission and competitive energy businesses to be reasonable?

A. One of the tenets of the consolidated approach is that the non-regulated businesses be financed in a manner that is commensurate with the significantly higher degree of business risk inherent in their operations, and consequently, in such a manner that there are no ratings drags on either Con Edison or Orange and Rockland. CEI has generally succeeded in doing so over the

past three years by comparing the 56.0% average common equity ratio with the equity ratios that are typical of "A" rated industrial issuers. As illustrated on page 2 of Exhibit__(FP-22), entitled "2013 Adjusted Key U.S. and European Industrial and Utility Financial Ratios," the median or "typical" debt ratio for "A" rated industrial issuers was 30.7% for the 2011 to 2013 period. While the corresponding 69.3% common equity ratio is notably higher than the approximate average 56.0% common equity ratio supporting the riskier transmission and unregulated businesses over the past several years, this does not signify cause for concern to us at this time.

Q. Please explain why you are not concerned.

A. In light of the preponderance of non-recourse debt supporting much of Con Edison Development's solar projects, a somewhat lower common equity ratio might be justifiable. Also, a significant amount of capital not supporting the regulated utilities is financing the transmission business. These businesses, although riskier than the Company's typical utility operations,

are less risky than the competitive energy businesses. As a result of the parents' willingness to issue common equity for such ventures, we are not as concerned as we might otherwise be.

Q. Are there any other reasons why you are not concerned at this time?

A. Yes. As of late, the Company has been consistent in maintaining the capitalization of the unregulated businesses in an adequate manner and, although it is approaching common equity levels recognized during the three-year period ending 2008, it has not quite reached those levels as there is still a bit of an equity cushion. Also, due to the fact that we are recommending the adoption of greater ring-fencing provisions, should these ring-fencing provisions be implemented, the utility would be well insulated from any potential impacts related to the regulated transmission and competitive energy businesses.

Q. Do you have any other observations regarding the reasonableness of a 48.0% common equity ratio for the purposes of establishing the Company's

overall rate of return and its electric and gas revenue requirements for the rate year?

A. While we believe it is incumbent upon management of the parent company to allocate its common equity in a rational manner, inherent in our conclusion regarding the appropriateness of a given ratemaking capital structure is our expectation that the mix of capital deployed also be done so in an optimal, or most cost-effective, manner. For at least the past decade, the Commission has consistently found that an authorized common equity ratio for Con Edison of no higher than 48.0% was sufficient for this purpose, and for the Company to continue to attract capital at terms that are reasonable. Simply put, at this time we have not seen evidence that a common equity ratio other than 48.0% is either optimal or necessary for the Company to continue attracting capital at favorable terms. At least in the near-term, a common equity ratio of 48.0% should continue to be cost-effective and satisfactory to maintain its current credit ratings. Aside from this, rating agencies and investors alike are

expecting the Company to continue to manage the common equity ratio as such. Therefore, we recommend that the Commission continue to authorize a common equity ratio of 48.0% in order to optimize the Company's overall cost of capital.

Q. Please explain what you mean by optimal capital structure?

A. An optimal capital structure is, by definition, one which strikes an ideal balance between the debt and equity ratio of a firm in order to minimize its overall cost of capital. A capital structure that contains too much debt increases a company's overall financial risk and could result in non-investment grade credit ratings that could make it difficult to access the capital markets when necessary. Conversely, while a capital structure containing too much equity may lower a company's financial risk, it would also result in higher capital costs given common equity is significantly more expensive than debt. The importance of establishing cost effective financing policies is especially important in the case of regulated utilities

where revenue requirements are designed to provide for expected income taxes on equity returns.

COST RATES

Q. Please explain how you derived the cost rates shown in Exhibit__(FP-2).

A. As illustrated in Exhibit__(FP-2), there are three 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 5.19% cost rate determination of the Company's Accounting Panel and made a few adjustments that resulted in our 4.92% cost rate recommendation. Exhibit__(FP-3) shows how this cost rate was derived.

The second cost rate shown in Exhibit__(FP-2) 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 effective on January 1 of each year. The 0.85% customer deposits rate is the rate

that was prescribed by the Commission in November 2015 for use beginning January 1, 2016.

The third and final rate is the cost of common equity. As we demonstrate, the Company's 9.75% proposed cost rate for common equity is excessive and should be rejected by the Commission. Our recommendation of an 8.60% cost of equity is included in our overall capitalization for the rate year ending December 31, 2017.

Q. Regarding the cost of the long-term debt component, please explain why you adjusted the 5.19% cost rate proposed by the Company's Accounting Panel in the March 25, 2016 Preliminary Update, as illustrated in the Company's electric operations Exhibit___AP-E12, Schedule 2, and its gas operations Exhibit___AP-G12, Schedule 2.

A. As we explained earlier, Con Edison's forecasted rate year cost of debt largely reflects its current actual or "embedded" cost of debt. It also reflects projections regarding the amounts, timing, maturities and cost rates for a total of four new 30-year debt issuances anticipated

during the linking 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 4.92% forecasted rate year cost of debt differs from the Company's determination in regards to the cost rates associated with the four new issuances projected during the linking period and rate year. While we do not take issue with the amounts, timing and maturities of the Company's debt forecast, we acknowledge that the Company may endeavor to issue shorter maturities, such as 10-year, or even 5-year debt, for that matter, which almost always have a lower cost. However, it is solely with the Company's forecasted costs rates that we take issue as we do not believe the forecasted rates will reach the levels anticipated by the Company during the rate year.

Q. Please describe how Con Edison forecasted the costs rates for its four new issuances.

A. Con Edison forecasted the cost rates of its future debt issuances based upon guidance from knowledgeable underwriters with respect to

required spreads to Treasuries expected on these future issuances, and on estimates of future benchmark Treasury interest rates over the next two years which can be found in the *Blue Chip Financial Forecasts*. The current required spread estimates are added to the forecasted benchmark Treasury yields to arrive at the cost rates for the new issuances.

Q. What is the current spread requirement reflected in the Company's forecasted cost rates for its proposed new debt?

A. The Company's forecast assumes a spread estimate of 1.50% for new 30-year long-term debt issuances based upon estimates provided by financial institutions at the time the Company's March 2016 Preliminary Update was prepared. When the Company originally prepared its rate filing, it used a spread estimate of 1.45% for new 30-year long-term debt issuances based upon estimates from similar underwriters. Taking into consideration a comparison of these spread estimates to the actual spread to Treasury of 1.40% the Company obtained in its most recent debt issuance during November 2015, we find a

spread estimate of 1.50% to be a reasonable estimate for use in the forecast of its new 30-year debt issuances during the linking period and rate year.

Q. Please explain how you adjusted the cost rates associated with the four new long-term debt issuances projected during the linking period and the rate year.

A. The Company projected cost rates of 4.48% for its two new long-term debt issuances during 2016, based upon the assumption that the yield on the 30-year Treasury would rise from current levels of approximately 2.6% to about 3.0% during 2016. Likewise, the Company projected cost rates of 5.48% for its long-term debt issuances during the rate year, based upon the assumption that the yield on the 30-year Treasury would rise to about 4.00% during 2017.

Our cost of debt calculation, however, assumes that the 30-year Treasury yield will approximate its recent level throughout the end of the rate year. Specifically, we used the average of the actual 30-year Treasury rate for the week ending April 8, 2016 of 2.60% and added

the underwriters' estimated spread requirement of 1.50% to arrive at an estimate of 4.10% for the four projected long-term debt issuances throughout the linking period and rate year. Our overall cost of debt calculation is illustrated in Exhibit__(FP-3).

Q. Why do you recommend the use of the most recent actual Treasury yield in your calculation of the cost rates for the projected new issuances?

A. The reason we recommend the use of the most recent actual Treasury yield is because relatively short-term movements in long-term interest rates are 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; in other words, the current rates of these debt instruments. Recent actual Treasury yields should be employed, rather than future estimated yields, which are used by the Company.

Q. Do you have any evidence supporting your use of

recent actual Treasury yields?

A. Yes. This is 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, included as Exhibit__(FP-23). In this study, James Pesando concludes that "short-run movements in long-term interest rates, quite simply, are not likely to be forecastable". Instead, as we mentioned earlier, the best estimate of future long-term interest rates is no-change; in other words, the best estimate is current rates of these debt instruments.

Q. What has past experience taught you in regards to setting these debt cost rates?

A. Past experience has demonstrated to us that our use of the most recent actual Treasury yields have been more comparable to actual debt yields than the Company's use of forecasted rates. For example, in Cases 14-E-0493 and 14-G-0494, the Company witness from Orange and Rockland predicted, through the use of *Blue Chip Financial Forecasts*, that the forecasted 30-year

Treasury yield for the year 2015 would be 4.00%, on average. In actuality, the average 30-year Treasury for the year 2015 was 2.84%. This amounted to a difference of 116 basis points. In fact, these same forecasts have predicted average 30-year Treasury yields of 4.70% for the year 2016. Thus far in 2016, the average 30-year Treasury yield has been 2.69%, which amounts to a difference of over 200 basis points. In the same Orange and Rockland rate case, Staff used an average of the actual 30-year Treasury rate of 2.71%. Overall, Staff's use of the actual 30-year Treasury yield of 2.71% compared much more favorably to the 2015 average actual 30-year Treasury yield of 2.84%, as opposed to the Company's use of a forecasted rate of 4.00%. It seems then that Staff's recommended use of the most current actual rate has appeared to be a more comparable indicator of actual rates than the Company's use of forecasted rates.

Q. Company witness Sanders claims in his direct testimony that the Company is "setting the cost of debt rates anywhere from three months to

three years forward and this timeframe is not consistent" with Pesando's research. What is your position on this statement?

A. Despite Company witness Sanders claim that the timeframe indicated in Pesando's research does not directly coincide with how often the Company sets its debt rates, he does not take into consideration that the length of time in which these cost rates are forecasted is actually only a period of approximately thirteen months. This timeframe is inclusive of when the Commission considers the Company's rates in December 2016, at which time Staff recommends the cost of debt be updated, through the end of the rate year.

In addition, Company witness Sanders has not provided solid evidence demonstrating that the use of forecasted Treasury rates are a better predictor of future rates than the use of actual Treasury rates. As we discussed earlier, Staff's methodology has been more comparable to, and a better predictor of, future rates as opposed to the Company's methodology which has, in the recent past, proven to be consistently overstated. Aside from the fact that Company

witness Sanders states that he believes a consensus forecast of Treasury rates provides a more reasonable estimate and that a forward rate is the rate you lock in today to borrow in the future, in our opinion, we have yet to see the Company provide specific examples or a thorough explanation as to why its methodology is better than what Staff has continually recommended, and the Commission has adopted in its rate proceedings for many years.

Q. How should your cost of long-term debt estimate be updated at the time of the Commission's rate order in these proceedings?

A. Each of the projected 30-year issuances should be updated to reflect the latest known actual 30-year Treasury rate at the time of the Commission decision plus 1.50% to reflect the underwriter's required spread estimate. In addition, the actual amount and cost rate of the projected June 2016 issuance should be reflected in the Company's actual cost of debt upon update. Finally, if the Commission prefers a more recent estimate of the underwriters' estimated spread requirement in order to more

reliably project the cost rates of the projected rate year issuances, the Company should be directed to provide that estimate, which should be added to the rate of the latest known weekly average of the 30-year Treasury rate accordingly.

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 approximately $1.085 billion of relatively low-cost tax-exempt securities outstanding during the rate year, all of which are variable rate. Of the $1.085 billion of floating rate securities, $225 million are variable rate demand notes whose rates are reset weekly, and $860 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 these $1.085 billion of variable rate tax-exempt debt securities in its 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 low levels (between 0.49% and 1.34%) as they are generally priced in accordance with short-term interest rates such as the three-month London Interbank Offering Rate (Libor) that remains at low levels. The Company's forecasted rates of between 2.24% and 3.47%, however, assume a substantial increase in short-term interest rates, especially when considering that the three-month Libor rate is currently at 0.63%.

Assuming interest rate hikes of some 200 basis points over the next 20 months or so strikes us as excessive. Therefore, we used the Company's December 31, 2015 actual rates for its variable rate securities in our cost of debt calculation. However, at the time of the Commission's decision, we recommend that the most recent actual rates be used in the calculation of the variable rate debt securities.

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

A. As a result of disturbances in the credit

markets, and their impact on the ability to accurately estimate interest costs, the Commission first authorized the true-up of the Company's variable rate securities in its 2009 Electric Rate Order in Case 08-E-0539. In light of the continued volatility following the financial markets crisis in the fall of 2008, the Commission authorized the continuation of the true-up of these variable rate securities in subsequent cases. Currently, Federal policy has held these rates to low levels. When the Federal policy does inevitably change, we can logically expect these rates to go higher. Without a true-up in place, it may dissuade the Company from pursuing longer-term re-pricing options. Therefore, given the persistent unpredictable nature of these costs, and that the cost rates associated with these tax-exempt securities are almost entirely out of the Company's control, we recommend that the Commission require such a true-up to continue as it relates only to the variable rate debt securities and all credit support costs associated with it.

Q. What does the true-up of the credit support costs related to the variable rate debt securities entail and how much of a dollar value is associated with this true-up?

A. The credit support costs associated with the variable rate debt securities include only the costs associated with the letters of credit and bond insurance. The dollar amount related to the letters of credit is approximately $3.5 million and the dollar amount related to the bond insurance is approximately $1.3 million. We propose allowing these costs associated with the variable rate debt continue to be trued-up in the rate year.

Q. Are you proposing an adjustment related to the letters of credit associated with the variable rate debt in the rate year?

A. Yes, we are proposing a $600,000 adjustment. The annual target costs associated with the letters of credit for the variable rate debt have been relatively constant at approximately $4.1 million. Upon further review, we noticed that actual letters of credit costs during the year 2015 had decreased to approximately $3.5

million. We addressed this with the Company and the Company anticipates that letters of credit costs should remain at this level throughout the rate year. Therefore the new annual target for the true-up relating to the letters of credit for the variable rate debt should be $3.5 million, not $4.1 million as the target has been in the past. This information is confirmed in IR DPS-676, located in Exhibit__(FP-1).

Q. Company witness Sanders does not request a true-up of interest costs associated with the Company's fixed-rate debt portfolio, provided that forecasted Treasury rates are used in the calculation of the cost of debt for its projected issuances. Do you agree with this proposal?

A. We do not agree with the Company's proposal of using forecasted Treasury rates in the calculation of the cost of debt for its projected issuances for the reasons we stated earlier. We do not recommend a true-up of the fixed-rate long-term debt securities, nor do we recommend the true-up of any debt that may be refinanced throughout the rate year. Interest

rates on long-term debt securities have stabilized considerably over the past several years and these rates can be projected with somewhat relative certainty. This is evidenced by reviewing Exhibit__(FP-24). This exhibit demonstrates, through the use of utility debt spreads and the VIX index, an indicator of implied volatility, how long-term debt yields were fluctuating after the fall of Lehman in 2008. Since then, this exhibit shows how volatility has decreased, in turn leading to more stabilized rates. Therefore, we do not see the need to true-up the fixed-rate long-term debt securities at this time.

SUMMARY OF ROE RECOMMENDATION

Q. Please explain the methodology used to determine your 8.60% ROE.

A. We estimated the cost of equity for a proxy group of electric utility holding companies, using a DCF analysis, weighted two-thirds, and the average of two CAPM analyses, weighted one-third. As is Staff's typical practice, in order to determine whether an adjustment to the proxy group's cost of equity is warranted, we examined

the differences in business risk and financial risk between Con Edison and our proxy group. We also examined whether or not an adjustment was necessary to reflect reasonably anticipated common equity issuance expenses during the rate year.

Q. Would you please explain why you specifically recommend that the DCF methodology be given a two-thirds weighting and your CAPM result one-third?

A. The DCF has long been the principal equity costing methodology in New York. In fact, for over 20 years, the Commission has consistently issued cost of equity determinations with the same two-third DCF and one-third CAPM weightings. During this time, Staff ROE testimony has consistently noted the numerous reasons why the DCF has been, and should continue to be, the preferred methodology. Its preferability over the CAPM methodology was particularly evident when a frequently used version of the CAPM began producing counterintuitive results in the wake of the volatility in the credit markets that followed

the collapse of Lehman Brothers in September 2008.

Estimating the cost of equity requires using methodologies that are not perfect. Of all the approaches available, however, the DCF and the CAPM are by far the least flawed and, between the two, the DCF is superior. In fact, the Commission has noted the relative strengths of the DCF methodology in many of its previous rate orders. For example, on page 14 of its Order Setting Permanent Rates, Reconciling Overpayments During Temporary Rate Period and Establishing Disposition of Property Tax Refunds, issued October 18, 2007, in Case 06-E-1433, the Commission stated that, "…the method offers the significant benefit of reliance on readily available, objective data to measure an indicator of real importance to investors."

We will demonstrate the strengths and reasonableness of the two-stage DCF methodology. We will also show that our particular forward-looking application of the CAPM continues to produce a reasonable check on our DCF methodology, and, as such, should continue to be

accorded a one-third weighting.

USE OF PROXY GROUP

Q. Why is a proxy group used to estimate Con Edison's cost of equity?

A. The use of a proxy group to determine Con Edison's cost of equity is necessary because the Company's common stock is not publicly traded, and, thus, direct DCF and CAPM analyses of the Company are not possible. Equally important is that DCF analyses for individual companies rely on equity analysts' estimates of growth which are, by their nature, somewhat biased. Similarly, beta determinations used in the CAPM methodology are based on historical observations that, due to circumstances such as corporate restructurings or industry transformations, may not be representative of the level of earnings volatility expected in the future.

By employing a sufficiently large proxy group of similarly situated companies in our analyses, however, we can largely diminish the undesirable effects of bias, both upward and downward, or inaccurate growth estimates and beta measures for any one company. In addition,

we further diminish the effect of any potential 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.

Second, 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 both sufficiently large and of similar risk 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 also important that this group be large enough to provide sufficient confidence in the results. The greater the number of suitable companies that can be found, the less sensitive the overall cost of equity estimate will be to the fluctuations or

irregularities of the data from any one particular company.

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

A. We selected a group of 28 holding companies from a "universe" of 45 holding companies whose common stock is publicly-traded; all, like Con Edison's parent, CEI, are deemed by *Value Line* to be "electric utilities." Due to 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 similar to those faced by Con Edison. Illustrated on page 1 of Exhibit__(FP-5) is the list of companies that we used, including each company's S&P and Moody's credit ratings and year ending 2015 percentage of utility revenues. On pages 2 and 3, we show the same statistics for the entire *Value Line* universe of companies and for Company witness Vander Weide's proxy group, respectively.

Q. Please explain how you developed your proxy group.

A. Beginning with the 45 publicly-traded holding

companies that *Value Line* categorizes as electric utilities, we automatically eliminated ITC Holdings Corp. because it is a FERC-regulated transmission-only company that is not fundamentally comparable to any New York regulated electric utility, as it does not serve retail customers. Then, in order to generally match the risks of the 44 remaining companies with those of Con Edison, we considered two variables, or screening criteria: the credit quality (long-term debt credit ratings) 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 "A2" by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only seven out of the 45 *Value Line* electric utility holding companies have 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 ratings (which would include ratings of "BBB-" and above by S&P and "Baa3" and above by Moody's) and at least 70% of total revenues from regulated operations. Of the 44 remaining companies in the *Value Line* universe, 35 met these criteria. One company in the *Value Line* electric universe, Unitil Corporation, was unrated by Moody's and did not have *Value Line* forecasts for future dividend or earnings estimates, which are necessary components for the DCF calculation. In addition, six companies were eliminated because of their involvement in transformational transactions such as mergers or acquisitions and one company, Cleco, is being taken private. Of the companies eliminated, two were involved in mergers and also had insufficient regulated revenues; these companies were Exelon Corp and Next Era Energy. It should be noted that we did opt to include MGE Energy Inc. in our proxy

group, despite it being unrated by Moody's and S&P. The reason we included this company is because its principal operating subsidiary, accounting for over 98% of its revenue, is rated "A1" by Moody's and "AA-" by S&P. Therefore, we are confident it would be rated investment-grade should it be rated by both S&P and Moody's. In sum, applying all of our selection criteria resulted in a proxy group of 28 companies.

Q. Please provide the historical context and rationale underlying your screening criteria.

A. Back in the early 1990s when Staff first began deploying proxy groups in its cost of equity analyses, an "A" rating was considered the industry standard. Accordingly, Staff advocated, and the Commission relied upon, proxy groups consisting solely of "A" rated utility companies. Further, in order to better match the proxy group companies with the subject utilities, Staff required that the proxy group companies derive a "substantial" portion of their operating revenues from regulated operations. Relying upon these two sound selection criteria, Staff was routinely able to

produce robust-sized proxy groups consisting of anywhere from 25 to 33 companies. However, a transformation of the industry was well underway and, as a result, around ten years ago Staff was faced with somewhat of a dilemma regarding the selection criteria for its proxy group. Due to a shrinking pool of companies as a result of industry consolidation and broad deterioration in electric utility credit quality at that time, the number of potential candidates for the proxy group had dwindled to as few as three companies, depending upon the specific interpretation given to "substantial" with respect to regulated revenues.

Not only has the credit quality of the electric utility industry generally fallen, the preeminent event over the past three decades has been the steady decline in the credit quality of not just utilities, but U.S. corporations in general. Coupled with an orientation in the electric utility industry in the 1990s and early part of the last decade towards consolidation through mergers and an increase in unregulated activities, this has meant that lowering the

credit quality threshold is the most logical and reasonable response to maintain an adequate number of candidate companies.

Q. Given this history, what is your recommendation for a reasonable proxy group for determining Con Edison's cost of equity?

A. 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, and are not involved in any transformational proceedings, such as a merger or acquisition. This is consistent with all recent Con Edison electric, gas, and steam rate cases and Orange & Rockland electric and gas rate cases, and also consistent with recommendations by Staff in other recent cases involving combination electric and gas utilities.

Q. Has the Commission employed Staff's proxy group in its cost of equity determination in previous rate orders?

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 witnesses and, accordingly, has employed Staff's proxy group to derive its ROE determinations.

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

A. As illustrated on page 1 of Exhibit__(FP-5), the average S&P rating of the proxy group is "BBB+", and for Moody's, it is "Baa1". On average, the group receives about 91% of its revenues from regulated operations.

DISCOUNTED CASH FLOW METHODOLOGY

Q. 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, the most important of which, by far, 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, thereby resulting in a greater cash flow 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 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 preference of individuals to consume 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 recent 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 mature and stable nature of the utility industry, such estimates can be derived with a reasonable degree of certitude. Also, rational utility investors expect the growth in future dividends to generally track the changes in output, or growth in the overall economy, as measured by growth in the nominal Gross Domestic Product (GDP).

Moreover, just as nominal GDP growth incorporates gains achieved through the application of new technologies, otherwise known as productivity, and the effects of changes in price levels, the investors' growth expectations, too, will reflect assumptions regarding productivity and the rate of inflation. Consequently, when practiced with the application of well-reasoned growth rate estimates, such as those used in our approach, the intuitiveness of the DCF methodology is abundantly clear.

This intuitiveness 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. In its Order Setting Electric Rates, issued April 24, 2009, in Case 08-E-0539, the Commission stated that, among the reasons it accords a two-thirds weighting to the DCF methodology, is that, "…the DCF relies on readily available data to make objective estimates of investors' return requirements. While the DCF has one input of primary controversy (growth), two CAPM inputs (beta and the market risk premium) are dependent on estimates which are contested and volatile."

Q. Please describe your DCF methodology and its result.

A. We developed DCF estimates using a two-stage "dividend discount" model. Financial theory dictates that the value of a company's stock is equivalent to its future cash flows. Our dividend discount model forecasts those cash flows out into the future and discounts them back to their present value. This model embodies less restrictive assumptions than the

traditional constant growth DCF methodology. Such a model is preferred, especially when growth rates in the near-term and long-run might reasonably be expected to diverge, thus making it superior to the traditional DCF model with its assumption of constant growth. However, it should be noted that current Federal tax policy may be distorting the near-term growth as companies accelerate their construction projects to take advantage of bonus depreciation which expires in 2019.

The calculation of the DCF for our proxy group is shown on pages 1 and 2 of Exhibit__(FP-6). For each company in the proxy group, a three-month average stock price was calculated by averaging the high and low price for each month for the period ending March 2016. The model also contains *Value Line* data for earnings per share, dividends per share, book value per share and forecasted amounts 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, represented in this instance by the average stock price taken over the three-month period ending March 2016, 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 prices, we determined the rates of return that investors expect for each company.

Q. How are dividends projected to change over time?

A. Consistent with the approach Staff has used for many years, we employed a two-stage DCF method. In the near-term, we used *Value Line's* forecasted dividends. For the second stage, essentially 2021 and beyond, a "sustainable growth" rate was calculated for each company in the proxy group, primarily based upon the product of its expected earned return on average common equity and its projected retention of earnings. Our sustainable growth rate also incorporates growth resulting from the increase in common share balances over time at prices above book value.

Q. Please explain what you mean by "sustainable growth" rate?

A. The "sustainable growth" rate is commonly viewed as the maximum growth rate an enterprise can achieve while maintaining a constant debt to equity ratio, i.e., without having to increase its financial leverage.

Q. What is the median sustainable growth rate of your proxy group?

A. The median sustainable growth rate is 4.23%.

Q. Did you check the reasonableness of your proxy group's presumed sustainable growth with any macroeconomic indicators?

A. Yes. As we typically do, we compared the sustainable growth rate of our proxy group with the most recent consensus long-range growth estimate of nominal GDP. As illustrated in Exhibit__(FP-25), according to the March 10, 2016 edition of *Blue Chip Economic Indicators*, the consensus long-range estimate of nominal GDP growth is 4.2% for the 2018-2022 period as well as 4.2% for the most distant period forecast, 2023-2027. Thus, as expected, our sustainable growth rate is quite close to the projected

growth rate in the overall economy, if not slightly optimistic on utility growth prospects, considering one could reasonably expect a mature industry such as this to grow slower than the overall economy.

It should be noted that the 4.2% nominal GDP growth rate estimate is comprised of two components: real GDP growth of 2.1% and an inflation rate of 2.1%. The long-run projections generally show annual real GDP staying relatively steady from a rate of 2.2% in 2018 to the aforementioned 2.1% growth rate, while inflation is forecasted to hold steady at 2.1% from 2018 and beyond into the long-run.

This comparison is appropriate because the nominal GDP rate reflects assumptions about future inflation, in addition to the real growth expected in the economy as a result of productivity gains. Therefore, it would not be unreasonable for investors in the market as a whole to expect their future dividends to generally keep pace with overall inflation, as well as, to reflect productivity gains similar to those expected for the economy as a whole.

Likewise, for investors in a mature sector of the economy, such as the utility industry with perhaps slower-than-average growth prospects, it is not unreasonable to expect future dividend growth to be roughly equivalent than that of the overall economy.

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

A. As shown on page 2 of Exhibit__(FP-6), the median return on equity of the proxy group is 8.22%. The median result 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 most of the individual company results appear reasonable, we would not recommend a cost of equity based solely on any of the individual results because of the potential for biased or inaccurate *Value Line* growth estimates to improperly influence the result. The simple fact remains that earnings forecasts, even in the relatively stable utility industry, can be very difficult to predict because of the impact

of important unpredictable events. For instance, many earnings forecasts in the early part of the last decade turned out to be wide off the mark because of difficulties in forecasting the course of deregulation and the extent of competition.

Further, our approach eliminates the need to inject personal judgment and to toss out any of the individual results that appear unreasonable because the proxy group is of sufficiently large enough size and we advocate the use of the median return of individual company 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 might otherwise be rejected, are effectively marginalized.

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 of stocks (generally 60 or more) such that the overall risk of that portfolio, in terms of the variability of its returns, closely approximates that of the market as a whole. Thus, the only risk that matters in the CAPM equation is said to be "systematic" risk, or risk that cannot 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 stock 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 1.0, which are typical for utility stocks given the moderating influence of regulation and the accompanying perception of reduced risk, indicate that the stocks are less volatile than the market as a whole. Therefore, the CAPM informs us that investors will only be compensated for their actual risk, as measured by beta. Thus, in the case of estimating the return requirements of utility investors, the CAPM result will reflect the degree to which utility stocks 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 investment (R_f), the level of systematic risk for an investment (B for beta), and the expected market risk premium (MRP). Typically, the MRP is calculated by subtracting the risk-free rate from the expected market return (R_m). 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 used for more than 20 years, we used two different CAPM methods, the Traditional approach, as we just described, and a Zero Beta calculation. The 9.24% CAPM-derived ROE estimate is the average of the results of these two analyses.
Q. Please describe how you calculated a return on equity 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 MRP, as shown in the calculation of the Traditional CAPM methodology, we determined the MRP for the proxy group by multiplying .75 by beta by the MRP and adding .25 times the MRP. This can be expressed as: Required return = R_f + (.75 * B * MRP) + (.25 * MRP)
Q. Why do you employ two CAPM methods?
A. We employ two CAPM methods because a considerable body of research has shown that the Traditional CAPM may underestimate required returns when betas are below 1.0. Therefore, 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, this tendency is addressed and corrected for, and ultimately enhances the accuracy of our overall 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 March 2016, is 2.33%.

Q. Why do you use the yields for two different Treasury securities?

A. We use the yields for two different Treasury securities because utility investors generally have both intermediate and long-term investment horizons, so the use of both the ten-year and 30-year Treasury securities is appropriate. In the past, the Commission has adopted our approach. Specifically, on page 75 of its Order Establishing Rates for Electric Service, issued June 17, 2011, in Case 10-E-0362 (2011 O&R

Electric Plan Order), in adopting this approach, the Commission noted that "…using a combination of treasury yields is consistent with our practice and supported by the varying nature of investor holding periods."

Q. Why are you using three-month averages of the Treasury security yields in your calculation?

A. The Commission employed three-month average yields in Case 09-E-0428 in order to be consistent with the three-month timeframe employed in its DCF cost of equity determination. In an effort to maintain consistency, since we are employing the most recent three months of market data in our DCF calculation, as well as the most recent three months average of 30-year Treasury yields in our estimates for projected new 30-year long-term debt issuances, it is only logical to employ three-month average Treasury yield data in the CAPM analysis as well.

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

A. We used the .75 median beta of the proxy group, which we calculated using the most recent *Value*

Line betas for each of the proxy group companies.

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

A. As a practical matter, there currently is no difference, as the average beta of the proxy group is also .75. Nonetheless, over time the use of the median beta is desirable for the same reason that we use the median return of the individual results in our DCF analysis, to diminish undue influence of any outlying individual results. In addition, it is important for our calculations to remain as transparent and consistent as possible, as those are the general expectations within the investment community.

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 determined, in the 2011 O&R Electric Plan Order, that the median beta was appropriate.

Q. How did you determine the appropriate MRP 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 return required on a risk-free investment. Because the cost of equity is, by its nature, a forward-looking concept, we employed an *ex-ante* analysis, relying upon required market return estimates published monthly by Merrill Lynch in its *Quantitative Profiles* report. Specifically, we used the February 2016, March 2016, and April 2016 editions of *Quantitative Profiles*, and averaged the required and implied market returns of each of the three point-in-time estimates, to arrive at an appropriate required return for the market of 11.17%. We have illustrated the appropriate pages from each of these reports in Exhibit__(FP-26). The full reports are available upon request. Finally, given our risk-free rate of 2.32%, we calculated the expected MRP to be 8.85% by subtracting the risk-free rate from the 11.17% expected market return.

Q. Why are you using an average of the most recent three months of Merrill Lynch's expected market returns in your calculation?

A. Generally speaking, we use expected market return estimates provided over the most recent three months in order to be consistent with the timeframes of the other data inputs employed in our CAPM and DCF calculations, as well as for the projected issuances in our cost of debt calculation. By matching the timeframe upon which our risk-free rate is calculated, we can achieve a more representative estimate of the required MRP.

Q. Does the use of three months of Merrill Lynch's cost of market data bias your results?

A. No, it does not, because using the most recent three months of data, as opposed to using only the estimates provided in the most recent month's data, could produce higher results, lower results or no change at all. Therefore, over time, there is no bias introduced as a result of using the average of the three months of data.

Q. Why didn't you rely on an *ex-post* method to

derive the appropriate MRP?

A. That method is fundamentally flawed because *ex-post* MRP's are based on the faulty premise that past performance is a valid proxy for expectations regarding future results. In addition, another critical flaw of this approach is that it is highly sensitive to the actual time period selected to calculate the premium.

Q. Has the Commission ever stated its preference for relying on forward-looking MRP analyses as opposed to *ex-post* analyses, which typically employ data reported by *Morningstar* (formerly *Ibbotson's*)?

A. Yes. Specifically, in its Opinion and Order Concerning Revenue Requirement and Rate Design, issued October 3, 1996, in Case 95-G-1034, the Commission stated 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. 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, on direct observations of actual utility investor behavior. Furthermore, the calculation of two of its principle inputs, the beta and the MRP, is highly problematic.

Q. Can you please explain how the calculation of the beta and MRP are highly problematic?

A. First, beta is supposed to represent the future volatility of a given stock relative to the market as a whole. However, because future volatility is an unknown, betas must be measured on a historical basis. The problem with using historically-derived betas, though, is that, when the systematic risks of a firm or an industry change, these historically-derived betas may not be reliable indicators of future volatility.

Another, and perhaps more significant, shortcoming of beta calculations is the often wide disparity of betas between the various firms that report this measure. For instance, Staff has relied on *Value Line* reported betas

exclusively for at least the past twenty years, as they are calculated over a five-year period, which is long enough to produce reliable estimates. Moreover, *Value Line* "smoothes" the "raw betas" to reflect the theory that betas have a natural tendency to gravitate to 1.0. Other firms, such as *Bloomberg,* however, employ less reliable, shorter periods, and others do not adjust the "raw" betas as *Value Line* does. Our concern is that, depending upon the source, betas can vary significantly, and thus produce CAPM-based ROE results that differ quite substantially solely because of the source chosen for the beta input.

Our greatest concern with the CAPM methodology, however, remains the derivation of the MRP. The MRP should be the expected premium of the expected market return over the risk-free rate. However, just like beta, the expected MRP is unknown and, because it is unknown, many adherents to this methodology advocate use of an *ex-post* MRP. 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.

The alternative to a historically-derived MRP, of course, is a forward-looking one. As stated earlier, we do not employ a historically-derived MRP specifically because it inherently does not reflect current economic conditions, and as such it utterly lacks the ability to capture and reflect the effects of ongoing structural shifts in the economy. While we advocate using an expected MRP in our CAPM methodology, we also acknowledge that such an approach is, by necessity, subject to a substantial amount of judgment, and is among the principal reasons that Staff has consistently argued that the CAPM only be accorded half the weight of the DCF-derived cost of equity estimate.

Q. Using the stated inputs, what is your Traditional CAPM result?

A. 8.96%, calculated as follows:

2.32% + [.75 * (11.17% - 2.32%)] = 8.96%

Q. What is the result of your Zero Beta CAPM methodology?

A. 9.51%, calculated as:
2.32% + [.75 *.75*(11.17% - 2.32%)] +
[.25*(11.17% - 2.32%)] = 9.51%

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 9.24%. This is the same approach that has been adopted or approved by the Commission in rate cases for many years.

RETURN ON EQUITY CONCLUSION

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

A. By weighting the 8.22% DCF result two-thirds and the 9.24% CAPM result one-third, and rounding that result to the nearest tenth of a percent, we determined the proxy group's cost of equity to be 8.60%. Our calculations are shown on page 3 of Exhibit__(FP-6).

Q. You stated previously that it is your typical practice to examine the differences in financial and business risk between the company and the proxy group in order to determine whether or not

an adjustment is warranted. Please explain how you conducted this examination and your conclusion with respect to the need for an adjustment.

A. S&P and Moody's regularly assess the full breadth of risks facing the utilities they rate; hence the combined effect of all the business and financial risks faced by those utilities are incorporated into the credit ratings they assign. Con Edison's long-term, senior unsecured debt ratings are "A-" and "A2", respectively. S&P currently has Con Edison on negative outlook while Moody's has the Company on stable outlook. The comparable average credit ratings for our proxy group, and for Company witness Vander Weide's proxy group for that matter, are approximately one to two notches weaker, with both proxy groups having average S&P ratings of "BBB+" and average Moody's ratings of "Baa1".

Q. Do you recommend an adjustment to your 8.60% ROE given this modest risk differential?

A. No. While one of the fundamental tenets of financial theory is that the return on a given

investment be commensurate with its level of risk, we are unable to find objective evidence indicating that material differences exist in the return requirements of equity investors within the relatively narrow band of utilities in the investment grade category. Specifically, after reviewing the DCF returns for each of our proxy group companies, we are unable to discern any meaningful correlation between the indicated return requirements of the individual companies and their respective levels of credit quality. However, given the unquestionable evidence that the Company's collective business and financial risks are less than that of both ours and Company witness Vander Weide's proxy groups, it is likewise clear that there is no credible evidence to support an upward adjustment.

Q. How does your 8.60% recommendation compare to the Company's current authorized ROEs?

A. Con Edison's current authorized gas operations ROE is stale as it is operating under a rate plan established several years ago. The Company's current authorized ROE of 9.3% for its gas operations dates back to the 2013 Gas Rate

Plan. The Company's electric operations, however, is currently authorized a 9.0% ROE that dates back to the 2015 Electric Rate Extension in effect for the rate year ending December 31, 2016. The ROE authorized in this extension represents a reduction from the 9.2% authorized ROE that dates back to the 2013 Electric Rate Plan. It is important to note that, as is the case with nearly all New York multi-year rate plans, part of the premium allowed in the return is in recognition of the added financial and business risks associated with the resulting stayout provision. Simply put, the differential that exists between our 8.60% recommendation and the Company's current authorized ROEs is that the current authorizations incorporate stayout premiums and were set in different interest rate environments.

Q. Compared to today, what were economic conditions like when the Company entered into the Joint Proposal, adopted in the 2013 Gas Rate Plan, over two years ago in February 2014, and the Joint Proposal, adopted in the 2015 Electric Rate Plan Extension?

A. As illustrated in Exhibit__(FP-27), when the Company entered into the gas Joint Proposal in February 2014, which was later adopted by the Commission, economic conditions were such that investors were requiring yields of 4.53% for long-term "A" rated utility debt and 3.38% for 20-year Treasury securities. Two years later, when the Company entered into its latest electric Joint Proposal, in June 2015, which was later adopted by the Commission in the 2015 Electric Rate Plan Extension, economic conditions were such that investors were requiring yields of 4.39% for long-term "A" rated utility debt and 2.85% for 20-year Treasury securities. Currently, investors' yield requirements for each of those instruments are 37 and 110 basis points lower, respectively, from June 2013 levels and 23 and 57 basis points lower, respectively, from February 2012 levels, indicating the lower return requirements of investors at this time. To be more specific, as of March 2016, investors currently require a yield of 4.16% for long-term "A" rated utility debt and a yield of 2.28% for 20-year Treasury

securities.

Q. What other evidence do you have to show that the current economic environment is highly favorable to utilities?

A. Not too many months ago, on November 17, 2015, Con Edison issued $650 million of unsecured debt with a 30-year maturity. This issuance was offered at a coupon of 4.5% and immediately began trading in the secondary market at an even lower yield. By mid-April 2016, demand for its debt in the secondary market had driven investors yield requirements down to levels below 4.00%. This signifies robust demand for Con Edison's debt offerings, even at these historically low yields.

Q. How does the 8.60% ROE recommendation compare to the current yield requirements of investors of long-term "Baa" rated utility debt and 20-year Treasury obligations?

A. As can be observed from viewing the data illustrated in Exhibit__(FP-27), our 8.60% ROE recommendation is 381 basis points higher than investors 4.79% current yield requirements for long-term "Baa" rated utility debt and 639 basis

points higher than the 2.21% current yield requirement on 20-year Treasuries. We compare our recommendation with the long-term "Baa" rated utility debt because the majority of utilities are in this ratings category.

Q. How does the 381 basis point spread above current long-term "Baa" rated utility debt obligations implied by the 8.60% ROE recommendation compare with historical spreads between authorized ROEs and the yields on long-term "Baa" rated utility debt?

A. As illustrated in Exhibit__(FP-27), over the past 20 years, the average spread between nationally authorized electric ROEs and long-term "Baa" rated utility debt has been 402 basis points.

Q. How does the 639 basis point spread above current 20-year Treasury obligations implied by your 8.60% ROE compare with historical spreads between nationally authorized ROEs and the yields on 20-year Treasuries?

A. As illustrated in Exhibit__(FP-27), over the past 20 years, the average spread between nationally authorized electric ROEs and 20-year

Treasury securities has been 594 basis points. Over the past 10 years, however, the spread has been 645 basis points, which is quite similar to the current 639 basis point spread that results from our 8.60% ROE recommendation.

Q. Is there any reason a rational investor would expect the Commission to authorize an ROE in this proceeding anywhere close to the Company's 9.75% requested ROE?

A. No. Rational investors are well aware of the Commission's preference for a formulaic approach to the cost of common equity and are also aware that recent authorized ROEs are closer to our 8.60% ROE recommendation. In fact, the Joint Proposal for the recent NYSEG and RG&E proceeding, which is expected to be coming before the Commission next month, cites a multi-year ROE of 9.0%.

Q. Does the Company routinely discuss the Commission's approach to ROE with the investment community?

A. Yes. The Company's Chief Financial Officer, Robert Hoglund, makes several presentations to the investment community each year. A key

segment of his presentations is a discussion of the regulatory framework in New York, including the Commission's preferred approach to ROE. For instance, Mr. Hoglund recently made a presentation at the *EEI Finance Conference* in November, 2015, a copy of which is presented in Exhibit__(FP-28). On pages 31 through 34 of his presentation, Mr. Hoglund not only describes the mechanics of the Commission's preferred methodology, but he indicates that actual authorized ROEs, most of which were for multi-year rate plans, have remained in the low 9.0% range over the past several years.

Q. Do you have any evidence that the investment community incorporates this information into its return expectations?

A. Yes. In a recent report by *UBS* dated February 19, 2016, the full report which is included as Exhibit__(FP-29), *UBS* states, "We emphasize keeping its (Con Ed's) authorized ROE at 9% would appear to be a *good* outcome given the wider pressures using the formulaic approach employed by the NY PSC amidst recent low interest rates and high utility valuation; the

methodology grabs both metrics, suggesting a mid-to-low 8%." Therefore, our recommendation of an 8.60% ROE should not come as any surprise to the Company or investors alike.

Q. Do you have any other supporting evidence indicating minimal concern on the part of the Company and investors with regard to an authorized ROE in the 8.60% range?

A. Yes. CEI's Board of Directors was clearly not deterred when it raised its quarterly dividend on January 21, 2016. This amounted to an annualized increase of eight cents over its previous annualized dividend of $2.60 a share. In fact, CEI has raised its dividend by eight cents a share each of the last two years and in years prior, representing a step up from the four cent and six cent hikes in the two years prior, respectively. That CEI has conveyed such optimism with respect to its future cash flows in the current low ROE and interest rate environment is noteworthy.

FINANCIAL INTEGRITY

Q. Have you examined the financial metrics implied by Staff's recommendations in this proceeding to

ascertain their impact on the Company's financial integrity?

A. Yes, as illustrated in Exhibit__(FP-30), we reviewed a number of metrics for the Company based on our recommendation of an 8.60% ROE and a 48.0% common equity ratio to see what the effects would be on the Company's coverage ratios. Specifically, we looked at the Earnings Before Interest and Taxes (EBIT) and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) coverage ratios because these are two ratios utilized by both S&P and Moody's in developing a Company's overall financial risk profile.

Q. How do the EBIT interest coverage and EBITDA interest coverage ratios implied by your 8.60% ROE and 48.0% common equity ratio, and Staff's recommended depreciation and amortization figures, compare to both the Company's projected metrics with its requested ROE of 9.75% and five-year averages?

A. As illustrated in the third column in Exhibit__(FP-30), granting the Company's requested ROE of 9.75% would produce financial

metrics that exceed, in some instances quite substantially, those of its actual performance over the past ten years, and those of the proxy group as well. If the Commission were to adopt the Company's requested ROE of 9.75%, its 3.92 times rate year EBIT interest coverage ratio would exceed its 3.70 times ten-year average. Similarly, it's 5.84 times rate year EBITDA interest coverage ratio would substantially exceed its 5.23 times ten-year average.

Our recommendations, however, would result in an EBIT interest coverage ratio of 3.63 times, which is comparable to the Company's 3.70 actual performance over the past ten years, yet greatly exceed the 3.31 ten-year average EBIT interest coverage ratio of the proxy group. In addition, our 5.44 times EBITDA interest coverage ratio exceeds the 5.23 times ratio average achieved by the Company over the past ten years, as well as the 5.22 times average EBITDA interest coverage ratio of the proxy group over the last ten years. We note that the figures shown in the column labeled "Staff 2017" reflect the impacts on the Company's credit

metrics based solely on Staff's cost of capital adjustments.

Therefore, adopting our recommendations should result in financial metrics that are comparable to Con Edison's historical numbers and stronger than the historical numbers of the proxy group overall. This will continue to support strong investment-grade ratings such as the Company's current "A-" S&P and "A2" Moody's senior unsecured debt ratings.

COMPANY'S RECOMMENDED RETURN ON EQUITY

Q. You have stated that Con Edison's 9.75% requested ROE is excessive and should be rejected. Is the 9.75% ROE request based upon the recommendation of its ROE witness Mr. Vander Weide?

A. No. Company witness Vander Weide's recommendation is even more excessive; he recommends that the Commission grant Con Edison an ROE of 10.3%. This is 170 basis points higher than the 8.60% ROE that we recommend, and 55 basis points higher than what the Company is requesting.

Q. Does Company witness Vander Weide explain the

discrepancy between the ROE that he is recommending and what the Company is asking for?

A. No, he does not. However, page 12 of the Company Accounting Panel's direct testimony indicates that the Company is filing its rate request with the lower 9.75% ROE in order to facilitate the resolution of issues in these proceedings.

Q. Would you please summarize Company witness Vander Weide's approach in the derivation of his ROE?

A. To arrive at his recommendation, Company witness Vander Weide performs a single-stage quarterly DCF analysis which results in an ROE of 10.0%. He also conducts three separate CAPM analyses, which are comprised of two different historical-based CAPM analyses and an *ex-ante* analysis that employs a constant growth DCF calculation for the S&P 500 in order to estimate the market return. He takes the average result of the two historical-based CAPM analyses and averages it with the DCF-based CAPM result, which results in an overall CAPM ROE of 10.15%. Lastly, he conducts a comparable earnings methodology

analysis using the same group of electric utilities that he uses in his DCF calculation, and arrives at a ROE result of 10.8%. He then weights each of these methods (the DCF, CAPM and comparable earnings) one-third to arrive at his final ROE recommendation of 10.3%.

Q. What are your principal points of contention with Company witness Vander Weide's analyses?

A. Overall, we are concerned with the composition of his proxy group, use of questionable criteria to eliminate individual company results, his use of excessive growth rates as well as the inclusion of flotation costs directly into his DCF calculation. We are also concerned with the use of flawed approaches to establish the various inputs employed in his CAPM analyses, principally his excessive market return estimates, as well as his risk-free rate calculation and beta, and the use of the comparable earnings methodology in the derivation of his ROE.

Q. Please explain how Company witness Vander Weide developed his proxy group.

A. Company witness Vander Weide begins with the

same *Value Line* electric utility universe that Staff uses in its analysis. From this universe of companies, he excludes those that have not paid a quarterly dividend for at least the past two years as well as those companies in which the dividend has decreased. He then excludes companies that do not have an I/B/E/S long-term growth forecast and companies that are the subject of a merger offer that has yet to be completed. Finally, he also excludes companies that do not have a *Value Line* Safety Rank of 1, 2, or 3. As we will explain later in our testimony, it turns out that these are actually not all the criteria he uses to arrive at his 24 company proxy group.

Q. How does the composition of Company witness Vander Weide's 24 company proxy group contrast to that of Staff's?

A. First of all, one quarter of his companies are substantially diversified, and are thus inappropriate for the purpose of establishing Con Edison's ROE. Specifically, Company witness Vander Weide includes six companies in his proxy group that we have excluded because their 2015

proportion of regulated revenues were under the 70% threshold. These companies were: Allete, Dominion Resources, DTE Energy, Exelon Corporation, NextEra Energy, and Vectren Corporation.

In addition to these companies, he also includes Duke Energy and Southern Company in his proxy group, which are both currently party to a merger. It should also be noted that, not only did Exelon Corporation and NextEra Energy not meet the 70% regulated revenue threshold, they are also both party to a merger and, therefore, would not have met Staff's criteria either way.

Conversely, Company witness Vander Weide excludes twelve companies that meet our selection criteria. Those companies are: Black Hills Corporation, Centerpoint Energy, Edison International, El Paso Electric, Entergy Corporation, FirstEnergy Corporation, IDACORP Inc, MGE Energy Inc, OGE Energy Corporation, Portland General Electric, PPL Corporation and Westar Energy. These companies were excluded due to no I/B/E/S growth forecasts, negative I/B/E/S growth forecasts and, for the majority

of these companies, because he deemed their DCF result as too low and thus were rejected as "outliers" for use in his methodology.

Q. Please explain the concerns you have regarding the composition of Company witness Vander Weide's proxy group.

A. We agree with Company witness Vander Weide's criteria that ensures the proxy group be limited to dividend paying, investment-grade rated *Value Line* electric utility holding companies. We also do not take issue with the fact that he eliminated companies for which no I/B/E/S growth rate is published, even though we disagree with the use of I/B/E/S growth rates to calculate a return, which we will discuss later in our testimony. However, one of his screening criterion is to include only those companies with a *Value Line* Safety Rank of 1, 2, or 3, which is presumably used to filter out companies that are exposed to higher risk. Yet, not one single electric utility holding company followed by *Value Line* has a Safety Rank higher than 3. Therefore, it appears this criteria has no material effect in identifying or eliminating

companies with the presence of substantially higher operating risks. It would have been preferable to, as Staff does, screen companies based on their portion of regulated revenues because unregulated businesses have substantially greater business risk than their regulated counterparts, which we addressed earlier in our testimony. For this reason, a screen similar to Staff's, which requires a company to derive 70% of its revenue from regulated operations, would have been preferable.

Q. Regarding the elimination of companies involved in merger activity, how does Company witness Vander Weide's criteria differ from Staff's?

A. Unlike Staff's practice of eliminating all companies that are involved in a merger proceeding, Company witness Vander Weide eliminates only those companies that are the subject of an acquisition. That is to say, his proxy group includes companies perceived as the acquiring company, whereas Staff screens out those companies as well as those companies that are being acquired.

Q. Why is it important that the acquiring companies be screened out of the proxy group?

A. It is important because companies planning to merge are in a state of flux and, therefore, are facing a materially different situation from companies that are conducting business as usual. This transformational activity changes investor expectations and analysts' growth forecasts do not necessarily reflect this reality. In fact, *Value Line* stops reporting on merging companies until the mergers in question are finalized. In addition, when a merger proposal is made public, in many instances both the purchasing company and the company that is being purchased will have a potentially distorted stock price with the target company stock elevated to a higher price than it would otherwise be and, conversely, the purchasing company price somewhat depressed from where it would otherwise be. By eliminating only one side of this price distortion, Company witness Vander Weide appears to be injecting an undesirable bias into his analysis. For these reasons, we believe all companies party to a merger or acquisition

should be removed from proxy group consideration.

Q. How does Company witness Vander Weide support his position?

A. According to Staff IR DPS-356, included in Exhibit__(FP-1), Company witness Vander Weide asserts that the stock price of the acquiring company changes little in light of an announced merger because the expected cost savings resulting from the merger accrue to the acquiring company, thereby offsetting any premium being offered to purchase the company being acquired.

Q. Did Company witness Vander Weide produce any evidence to support this claim?

A. No. He has not produced any evidence to support his claim that the stock price of the acquiring company changes little in light of an announced merger. However, we have located research that contradicts this claim.

Q. What research did you discover?

A. According to Richard Rosen's article "Merger Momentum and Investor Sentiments: The Stock Market Reaction to Merger Announcements,"

published in The Journal of Business V. 79 No. 2 in March 2006, included as Exhibit__(FP-31), the average acquiring firm experiences a short-term increase in its stock price followed by a long-term decrease, all else equal. In addition, the long-term decrease would appear to more than counter the short-term increase.

Q. Are there any other significant differences in the characteristics of your proxy group and that of Company witness Wander Weide?

A. Yes, in terms of the percentage of revenue that comes from riskier non-regulated operations, there is a notable difference between the two groups. For the year ending 2015, the utility holding companies that comprised our proxy group received, on average, 9.15% of their revenue from riskier non-utility activities. In contrast, the 24 utility holding companies that comprise Company witness Vander Weide's proxy group received about 15.0% of their revenues from non-utility operations.

Q. What does the larger presence of riskier non-regulated operations imply with respect to investor return requirements?

A. Because a greater proportion of its revenue is derived from riskier, non-regulated activities, it is reasonable to expect investors would require a somewhat higher rate of return on their equity investment to compensate for the greater risk to which they are exposed. Our proxy group more closely matches the return requirements of Con Edison's investors.

Q. Are there any other differences between your proxy groups that are worth noting?

A. Yes. Company witness Vander Weide includes ITC Holdings in his proxy group. We eliminated that company, and so should have he, because it is regulated exclusively by the FERC, maintains only transmission lines, and has no retail customers. Moreover, it is now the subject of a potential acquisition by Fortis.

Q. Earlier you mentioned you have concerns surrounding companies that he deems as "outliers," and affectively removes from his proxy group even though they have met all of his other selection criteria. Please describe the criteria for and results of what he refers to as "outliers" in his DCF calculation.

A. Company witness Vander Weide determined that an acceptable upper limit for his DCF results would be 17.7%, and that an acceptable lower limit would be the forecasted bond yield given the bond rating of the specific proxy company in question plus 100 basis points.

According to Staff IR DPS-348, included in Exhibit__(FP-1), Company witness Vander Weide arbitrarily derives the upper limit of 17.7% from a 2006 Bangor Hydro FERC case. While this upper limit was deemed appropriate in this particular Bangor Hydro case, it is certainly not used as a set upper limit in every FERC case. Therefore, the use of a decade-old upper limit ROE results in no companies being removed from his proxy group as an outlier for having too high of a DCF result.

If Company witness Vander Weide was truly interested in setting lower limit parameters similar to that of FERC practice in order to establish "outliers", he does not do so correctly. FERC's practice is to base lower limit parameters on the average of six-month actual "Baa" bond yield results, plus 100 basis

points. Company witness Vander Weide, however, bases his lower limit parameters on forecasted bond yields determined by the bond rating of the individual proxy company, plus 100 basis points. According to Staff IR DPS-348, included in Exhibit__(FP-1), as of January 2016, forecasted bond yields exceeded recent actual bond yields by 135 to 196 basis points. Had Company witness Vander Weide used actual bond yields to set his lower limit parameters, all but one company labeled as an "outlier", Public Service Enterprise Group, would be included in his DCF calculation.

After all, the purpose of using reliable selection criteria in order to establish a suitable proxy group is to eliminate or minimize potential outliers and non-comparable companies from the group. Provided this selection criteria is effective, an outlier screen would result in few, if any, companies being removed.

Q. Why else do you think the selection criteria of these "outliers" is problematic?

A. Removing the companies whose DCF results are considered to be "outliers" due to "low" ROE

results is particularly problematic, especially when considering such a large portion of these proxy companies were initially deemed to be seemingly suitable surrogates. For example, nine out of the 33 companies that passed his initial proxy group screening criteria were found to be "outliers" after the fact, because their DCF results were deemed too low. Each of these "outlier" companies had DCF results between 5.0% - 8.0%. Had these "outlier" companies been included in Company witness Vander Weide's DCF analysis, the overall DCF result would have undoubtedly been lower.

Company witness Vander Weide's ROE recommendation uses a pared back proxy group for not only his DCF analysis but also for his other two methods of ROE estimation as well.

Q. What are Staff's objections to using near-term earnings growth forecasts from I/B/E/S as a surrogate for long-run dividend growth?

A. We note several issues with obtaining growth forecasts from I/B/E/S. First, Company witness Vander Weide selected a data source which contains insufficient information for all the

companies that were included in his proxy group. As mentioned earlier, this is one reason why Staff has historically relied on *Value Line*, due to the availability of data for all of the companies in our proxy group.

Company witness Vander Weide states that his reasons for using I/B/E/S growth forecasts include wide circulation in the investment community, development of forecasts by reputable analysts, the communication of these estimates in a timely manner to investors, and the wide use by institutional and other investors. However, it is important to note that these characteristics are not unique to I/B/E/S estimates. For example, *Value Line* estimates include a specific dividend forecast as well as an earnings per share forecast. By contrast, I/B/E/S only forecasts growth in earnings per share. The two variables, however, do not necessarily approximate each other.

Because Company witness Vander Weide's analysis does not begin with a base earnings per share number, and instead applies his I/B/E/S growth forecast only to the current and

forecasted dividend, there is no way of isolating a sustainable growth rate. This would seem to be a weakness, particularly if the I/B/E/S forecasts seem incongruent with forecasted growth in the U.S. economy in general and within the U.S. electric utility industry specifically.

Q. What are your objections to using a single-stage DCF model?

A. As we discussed previously, the theory underlying the single-stage DCF assumes growth at a constant rate into the indefinite future. However, based on historic observation we know that such constant growth rarely, if ever, happens in any industry. The desire to screen out additional companies from his proxy group illustrates the point that some companies can go through periods of slow growth or perhaps even shrinkage. While a constant long-term growth rate needs to be assumed in order to derive a ROE estimate in a DCF Calculation, there are typically short-term fluctuations in the true growth rate. It is therefore unlikely that recently evidenced and presently expected growth

rates will continue indefinitely into the future. To impute these figures for the long-term does not yield reliable results. This is why Staff uses a two-stage DCF process, as it allows us to account for short-term and long-term growth prospects separately.

Q. Is there any possible explanation or example of why short-term and long-term growth rates could diverge?

A. Yes. A recent example of how short-term and long-term growth rates could differ markedly could be the policy of the Federal government since the financial crisis to allow companies to utilize bonus depreciation in order to encourage capital intensive companies such as utilities to accelerate planned construction projects in order to boost overall economic growth. As the law is currently structured, bonus depreciation will begin phasing out in 2018 and be completely eliminated by 2020. Logically, a company that had plans to begin large construction projects in 2020 or beyond may weigh the advantages of moving up the timeframe of when those projects are undertaken in order to take advantage of

bonus depreciation before it phases out. This would have the net effect of accelerating short-term growth at the expense of long-term growth. In theory, a two-stage DCF model would better reflect a company's growth under such a scenario.

Q. What long-term growth rate can be implied from the I/B/E/S growth forecast data that is in Company witness Vander Weide's single-stage DCF calculation?

A. The average I/B/E/S growth rate forecast of future earnings growth for his proxy group, after the removal of his outliers, is 5.80% with a nearly identical median of 5.81%.

Q. How does this compare with the long-term growth rate of Staff's proxy group?

A. As mentioned previously, Staff's proxy group has an implied long-term growth rate median of 4.23% which would seem more realistic for regulated companies in a mature industry.

Q. What evidence do you have that the long-term sustainable growth rate produced by your model is a more realistic reflection of what long-term growth would be in the electric utility

industry?

A. As pointed out on page 21 of a research article by *UBS Investment Research,* dated July 12, 2010, which is shown in its entirety in Exhibit__(FP-32), the electric utility industry was a growth industry back in the 1950s and 1960s. Beginning sometime in the 1980s, however, with the move away from a manufacturing economy to a more service-oriented economy, electricity sales have grown more slowly than the overall economy. Our own research, contained in Exhibit__(FP-33), clearly demonstrates the impact of this transformation. Indeed, while the average real GDP growth rate over the past 30 years has been 2.6%, the growth in total retail electric sales has only averaged 1.7%.

Q. Based upon what evidence do you contend that this trend is expected to continue?

A. Exhibit__(FP-34) supports our assertion that the electric utility industry will continue to grow in the future at a rate slower than the overall economy. In projections contained on pages A-9 through A-13 of its April 2015 *Annual Energy Outlook 2015,* the U.S. Energy Information

Administration (EIA) calls for annual growth rates in purchased electricity between 2013 and 2040 of 0.5% for the residential sector, 0.8% for the commercial sector and 0.7% for the industrial sector. We note, as well, that, on page 1 of its report, the EIA states that its base case "…projects 2.4% average annual GDP growth from 2012 to 2040, consistent with trends in labor force and productivity growth."

Q. What would the average and median of the I/B/E/S growth forecast of future earnings growth for Company witness Vander Weide's proxy group be if he included those companies that he chose to exclude because of their outlier status or forecasted reduction in I/B/E/S growth?

A. The average would be 4.7% and the median would be 4.9%, which would be somewhat close to the growth rates of Staff's proxy group.

Q. Would you please summarize Company witness Vander Weide's CAPM approaches?

A. Company witness Vander Weide conducted three CAPM analyses in order to arrive at his overall CAPM result. He calculated two CAPM analyses using what he refers to as the historical CAPM

methodology and another one using a DCF-based *ex-ante* CAPM analysis.

Q. Please begin explaining how he derived each of the three major components used in his CAPM methodologies.

A. Both his historical and DCF-based CAPM methodologies require three major inputs: the risk-free rate, beta and the market risk premium, which itself requires an estimate of the expected market return. Both of his historical and DCF-based CAPM methodologies use a risk-free rate of 4.3% based on the forecasted yield to maturity on 20-year Treasury bonds from *Value Line* and the EIA. These forecasted 20-year Treasury bond yields were in actuality derived by Company witness Vander Weide from forecasted 10-year Treasury bond yields.

Q. How did Company witness Vander Weide calculate his historic market risk premium?

A. In order to arrive at the 7.00% historic market risk premium he employed in both of his historical CAPM calculations, he subtracts the 5.07% average income return of the 20-year U.S. Treasury going back to 1926 from the arithmetic

mean total return on the S&P 500 from the same time frame of 1926-2015.

Q. How does Company witness Vander Weide derive the betas used in his historical CAPM calculations?

A. He applies two different betas to the CAPM formula, which he then averages to achieve his overall historical CAPM number. The first beta he applies is the average beta of his proxy group of .72 as reported by *Value Line*. The second beta of .90 is derived from the historical ratio of the utility risk premium to the S&P risk premium. Company witness Vander Weide states this second beta is integrated into his calculation because of the historical tendency of the CAPM to underestimate the cost of equity for companies with an average beta of less than 1.0, which is similar to the reasoning behind Staff's use of the Zero Beta CAPM.

Q. Please explain how he derives the beta used in his DCF-based CAPM analysis.

A. For his DCF-based CAPM analysis, he uses the same procedure as his historical CAPM we just described as well as the .72 beta of his proxy group. The only difference is that for the DCF-

based CAPM, the risk premium is the difference between the DCF cost of equity for the S&P 500 and the forecasted yield to maturity on 20-year U.S. Treasury bonds.

Q. What is the overall result of Company witness Vander Weide's CAPM calculations?

A. Given the inputs we just discussed, Company witness Vander Weide developed three CAPM estimates ranging from 9.6% to 10.8%. By averaging the results of his historic CAPM methods together, and averaging in the result of his DCF-based CAPM, his CAPM methodology results in a cost of equity estimate of 10.15%.

Q. What inputs to Company witness Vander Weide's CAPM calculation do you view as problematic?

A. We have concerns with the use of a second estimate for beta, the value for the total market portfolio rate of return, and the use of an excessive risk-free rate of return.

Q. Please describe how Company witness Vander Weide estimates beta.

A. Company witness Vander Weide uses two estimates for beta. For his first method, he averages the values of beta that are reported by *Value Line*

for all of the companies in his proxy group. This is similar to the method we employ, however, we utilize the median result as opposed to the average. Using this method, he arrives at a beta of .72.

For his second method, he compares the historical returns of the S&P utilities stock index to the historical returns of the S&P 500 over the period of 1937 through 2015. Upon comparing the two, he derives a ratio that he uses to calculate the second beta in his calculation. In order to calculate this ratio, he takes the average risk premium of the S&P utilities stock return dating back to 1937 and divides it by the average market risk premium, which he defines as the annual S&P 500 return minus the annual return on the 10-year Treasury for the same period. He claims this is necessary because of the CAPM's tendency to underestimate the cost of equity for companies with betas less than 1.0. Using this method, he arrives at a beta of .90.

Q. What are your concerns with Company witness Vander Weide's second estimate of beta?

A. While we recognize that a shortcoming of the CAPM methodology is the tendency to underestimate the cost of equity for companies with betas less than 1.0, we factor this into our analysis when we attribute a lesser weighting to the CAPM estimate than we do the DCF when averaging our results, and it is why we employ the Zero Beta CAPM calculation to balance the estimate. Our main objection stems from Company witness Vander Weide's attempt to adjust the value for beta.

Beta is a measure of whether an investment is more or less volatile than the market. In employing this second method, he is effectively changing the asset being compared to the market from the companies in his proxy group to the companies in the S&P stock utility. However, there is no reason to believe that the historical S&P stock utility index is a better collection of companies than an appropriately screened proxy group. In addition, the data used to derive beta via this method extends back to 1937, a time when the utility industry faced different challenges and was structured

different than today.

Q. How much of an impact does the use of Company witness Vander Weide's second historical-based beta have on his overall ROE estimate?

A. The use of the .90 beta from his second beta calculation yields a CAPM result of 10.8%, which is 120 basis points higher than the result of his other historical CAPM calculation which uses the beta of .72. Because he averages the results of the two historical CAPM methods together, and then averages that with his DCF-based CAPM result and gives the entire CAPM a one-third weighting in his overall ROE estimate, the net result to his overall ROE estimate is approximately 8 basis points.

Q. Please describe the issue with Company witness Vander Weide's estimated value for the total market portfolio rate of return?

A. For the historical CAPM, Company witness Vander Weide estimates the total market portfolio rate of return as the arithmetic mean total return on the S&P 500 for each year between 1926 and 2015. Our main concern is with the time frame chosen, particularly because Company witness Vander

Weide describes the year 1937 as having such significance being that it was the first year after the Public Utility Holding Company Act of 1935 had been fully realized. One would assume, then, that Company witness Vander Weide would want to use the period from 1937-2015 in his calculation, thereby excluding the years before the Public Utility Holding Act in order to maintain consistency with the timeframe he used in his second beta measurement.

Our most significant objection to the use of his historical total market portfolio rate of return, however, is that it shares many similar flaws to that of his DCF model. Among these flaws, as we discussed earlier, is that many of the component companies of the S&P 500 do not pay dividends, which is necessary in a DCF calculation in order to produce a result. He eliminated companies that have no growth, or negative growth, estimates as well as companies that have only 1 or 2 analyst estimates. In addition, he eliminated the top 25% and bottom 25% of companies with the highest and lowest DCF results. Thus, a very substantial portion of

the "market", roughly two-thirds the actual size of the S&P 500, is eliminated from the measurement of S&P's historical growth between 1926 and 2015, leaving only 133 companies to be representative as the "market". Since a significant number of the companies that were eliminated from consideration had negative growth rates, it is evident why his total market portfolio rate of return is biased upward.

Q. Please describe your concerns with using two different values for risk-free rate of return?

A. Company witness Vander Weide uses two different values for the risk-free rate in his CAPM calculation. The forecasted total return on the 20-year U.S. Treasury, 4.3%, is used once, while the forecasted income return on the 20-year U.S. Treasury Note, 5.07%, is also used in his calculation.

He supports his use of two risk-free rates by stating that only the income return is truly risk-free, as the total return includes a speculative, capital gain/loss component. If this is the case, then the income return should have been used in both instances in the

equation.

Q. Please describe your concerns with Company witness Vander Weide's estimated value for the risk-free rate of return?

A. Our concern has to do with his estimation of the 20-year Treasury. In order to estimate the 20-year Treasury, he begins with the forecasted yield on the 10-year Treasury and adds to it the spread between the coupon rates of the 10-year and 20-year Treasury. Estimating the yield on the 20-year U.S. Treasury in this way assumes that the current spread between the 10-year and 20-year Treasury remains a constant. However, there is no assurance that the spread will remain at the same level for the forecasted period. We maintain that averaging the yields for the 10-year and 30-year U.S. Treasuries is a much less convoluted way to arrive at an appropriate estimate of the risk-free rate of return.

Q. Please explain Company witness Vander Weide's comparable earnings methodology.

A. He uses the same 24 company proxy group of electric utilities that he uses in his DCF

calculation. He estimates the expected rate of return on book equity for each company in his comparable group by calculating the average expected rate of return on book equity reported by *Value Line* for the years 2015, 2016, and 2018-2020. He states that the rate of return based on year-end equity as reported by *Value Line* understates the rate of return on average equity investment during the year, so he adjusts *Value Line*'s estimates to reflect expected rates of return on average equity for the year. The result of his comparable earnings methodology is 10.8%.

Q. What are your concerns with the use of the comparable earnings methodology?

A. In addition to the comparable earnings methodology's lack of determining the actual cost of equity as a result of its use of estimated book earnings which have an insubstantial link to the actual cost of equity and the companies in the comparable group not actually earning the returns included in the analysis, we also note that the companies used in the comparable group are holding companies

and not operating companies. This distinction is highly problematic because of holding companies' tendency to consistently achieve higher book returns than their underlying utilities. As demonstrated in Exhibit__(FP-40), over the past ten years, the holding companies average median ROE was 10.03%, while for the operating companies that figure was only 9.57%. Given that Company witness Vander Weide's proxy group includes six companies with extensive proportions of risky non-regulated revenues, this distinction potentially poses a more substantial discrepancy. Aside from these concerns, we are also unaware of any Public Utility Commission in the U.S. that actually uses the comparable earnings methodology in its calculation of ROE.

Q. Has the Commission previously addressed the use of the comparable earnings methodology?

A. Yes, the Commission has specifically rejected the use of the comparable earnings methodology in the past. In Opinion No. 96-28, the Commission stated on page 13, "…we have consistently found the comparable earnings

approach unreliable because it does not adequately reflect the cost of equity of the companies in the proxy group." In addition to this Opinion, the Administrative Law Judges in the Generic Finance Case (GFC) recommended decision rejected using this approach in setting a return. On page 47 they stated, "…that approach, for a number of reasons, has almost nothing to do with determining the cost of equity, even for competitive firms. Observations of reported book earnings have only a tenuous link to the cost of equity in any given year, and the inclusion of six observations – one forecast, one current, and four historical – does not cure that defect. Investors in the companies in the "comparable" group do not earn the returns included in the analysis; they earn returns based on the process they paid for their investments."

Q. Company witness Sanders asserts that "the practice of using just two methods is out of step with both the academic literature and with the practices in most, if not all other, jurisdictions in the U.S." What is your

position on this statement?

A. It appears Company witness Sanders' assertion is not based on thorough factual evidence. Aside from his use of a research article dating back to 1978 that indicates more than one model should be used, and his reference to a study from 2006 in which it states that three types of methods are "typically" used but not "must" be used, when prompted for additional information about the research he and his team conducted in regards to the number of methods used to calculate return on equity in other jurisdictions, Company witness Sanders was not able to provide thorough research that was conducted in support of his claim. As indicated in IR DPS-360, included in Exhibit__(FP-1), he states "the Company relied on SNL Financial's state commission write-ups" and goes on to say that "other jurisdictions do not employ such a rigorously formulaic approach to calculating a utility's ROE." If Company witness Sanders and his team had done further research, they would have discovered that, not only is use of the DCF very common across many jurisdictions in the

calculation of ROE, but that a few other jurisdictions also utilize formulaic approaches to establish utility ROEs.

Q. Please elaborate.

A. We are aware of at least two other states where a formulaic ROE approach is used. Additionally, our research indicates that our preferred approach, the DCF methodology, is the most widely employed.

Q. Please continue.

A. With respect to the prominence of the DCF methodology, according to a November 2008 Public Utility Fortnightly article, Exhibit__(FP-35), Public Utility Fortnightly states, "…the discounted-cash flow method remains the gold standard for financial modeling of utility cost of capital." The article also mentions the use of risk premium analyses yet does not make mention of comparable earnings analyses. Similar to New York, Connecticut also uses the DCF methodology in its ROE calculation, as well as the CAPM. In addition, in regards to purely formulaic calculations of ROE as used in the state of Illinois, as demonstrated in the

Regulatory Research Associates article, Exhibit__(FP-36), Ameren Illinois recently filed for an 8.64% ROE as a result of the Formulaic Rate Plan statute in Illinois which "…incorporates a formula for the purpose of calculating the allowed ROE – application of a 580 basis point premium to the 12-month average 30-year Treasury bond yield." Illinois is not the only state with this formulaic approach. Likewise, in California, authorized ROEs are reviewed annually and reset if changes in the 12-month average of a Moody's long-term utility bond index yield are greater than plus or minus 100 basis points. Thus, it appears that other jurisdictions besides New York, in their calculations of ROE based on formulaic approaches utilizing Treasury yields, also rely on "rigorously formulaic approach[es]" in calculating ROE.

Use of formulaic approaches, such as we recommend, are known by investors and is most probably factored into their pricing decisions with respect to investing in the CEI. The use of a formulaic approach is a positive because it

makes the ROE result transparent and predictable, thereby causing less uncertainty in the expected results.

Q. The Company also takes issue with the DCF methodology's weakness, as referenced in the GFC, to understate the return on equity when the market value share price is above the book value share price. What is your response to this claim?

A. Although the GFC acknowledges the weakness of the DCF methodology, one can agree that no methodology is absolutely perfect. Each methodology has its strengths and weaknesses, and that is why most analysts do not rely on only one methodology to arrive at a ROE result. This is one of the reasons Staff does not rely solely on one methodology, and weights its DCF methodology two-thirds and CAPM one-third.

Q. Does Company witness Vander Weide make an adjustment to his ROE result for flotation costs?

A. Yes, Company witness Vander Weide makes a flotation cost adjustment to his DCF results. To make this adjustment, he reduces the three-

month average stock price for each company in his proxy group by 5.0%. The net result of this adjustment is an increase in his DCF result from a 9.8% ROE to the 10.0% that he presents in his testimony.

Q. On what basis does Company witness Vander Weide support the need for such an adjustment in this case?

A. He contends that a flotation cost adjustment should be made, not only to reflect current or future financing costs, but to compensate investors for costs incurred for all past issuances.

Q. What has been the Commission's practice with respect to common stock issuance expenses?

A. The Commission has provided for recovery of anticipated issuance expenses when a public common stock issuance is reasonably expected to occur during the rate year.

Q. Is the Company's parent, CEI, planning a common equity issuance during the rate year to which some of the proceeds would be down-streamed to Con Edison?

A. No. The Company's cash flow forecasts indicate

that no common equity issuance is planned for the rate year.

Q. Has the Commission addressed the issue of flotation costs in previous rate cases?

A. Yes. Such an adjustment has repeatedly been rejected by the Commission in the past. For instance, in the Order Setting Permanent Rates, issued October 18, 2007, in Case 06-E-1433, the Commission stated, "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." Even if the Company were projecting an actual equity issuance during the rate year, we would not accept Company witness Vander Weide's flotation cost proposal.

Q. Does Company witness Vander Weide check the reasonableness of his recommended ROE estimate?

A. Yes. Company witness Vander Weide utilizes two methods as a check on the reasonableness of his 10.3% result.

Q. Please describe these methods and your objections to them.

A. His first method of check is to compare the

10.3% result to the expected rate of return on book equity for a collection of low-risk industrial companies. Aside from the issues with the use of return on book equity, we take issue with the fact that he uses a sample of competitive businesses as a comparison to a regulated utility.

The collection of 24 low-risk industrial companies he includes are categorized by the Global Industrial Classification System (GICS) as part of the consumer staple (16), consumer discretionary (4), health care (4), and telecommunications (2) sectors. Companies in these sectors have different business risks than those categorized by GICS in the utilities sector. In addition to the difference in business risks, these companies operate in competitive environments and are not afforded the same safeguards as regulated utilities.

His second method of check is to consider the risk premium associated with investing in utility equity as compared to utility debt between September 1999 and September 2015. This method is itself broken down into two separate

checks; one an *ex-ante* and one an *ex-post* cost of equity analysis.

For the *ex-ante* analysis Company witness Vander Weide performs a historical DCF analysis of the utility companies in his proxy group and subtracts the yield on Moody's "A" rated utility bonds from the expected DCF return to arrive at his risk premium determination. He then uses a regression analysis to estimate investors required risk premium. That risk premium is then added to forecasted utility bond yields for "A" rated companies from *Value Line* and EIA. As neither *Value Line* nor EIA directly forecast the yield for "A" rated utility bonds, Company witness Vander Weide arrives at the "A" rated yield by adding the spreads between what the credit ratings that they do forecast for ("Aaa" for *Value Line* and "AA" for EIA) and then averages them together to arrive at his forecasted "A" rated utility yield of 6.2%.

For the *ex-post* analysis Company witness Vander Weide performs a similar calculation as above except that to derive his risk premium he performs two different historical analyses. For

one analysis he calculates the historical return difference between investing a dollar in the S&P 500 and investing a dollar in an "A" rated utility bond in 1937. For his other analysis he does the same except he measures the historical return difference between investing a dollar in the S&P utilities instead of the S&P 500. By averaging the results of these two calculations he arrives at an overall risk premium number which he again adds to the forecasted "A" rated utility yield in the *ex-ante* analysis to arrive at his final *ex-post* Cost of Equity.

Q. Did you find any academic research that might question Company witness Vander Weide's methodology of checking his results with these two methods?

A. Yes. According to academic research by James Claus and Jacob Thomas, "Equity Premia as low as Three Percent? Evidence from Analyst's Earnings Forecasts for Domestic and International Stock Markets" *The Journal of Finance*, Vol. 56 No. 5, October 2001, pp. 1629-1666, included as Exhibit__(FP-37), the estimates derived by the Equity Risk Premium method tend to be biased

upwards. Any method based on past stock market performance, which both the ex-ante and ex-post versions are, are subject to this bias. This would suggest that the results reported by Mr. Vander Weide may be too high.

REFORMING THE ENERGY VISION (REV) AND NEW YORK'S REGULATORY ENVIRONMENT

Q. Does Company witness Sanders express concern about the potential effects of the Commission's REV proceeding?

A. Yes, Company witness Sanders claims that the basic framework of REV could provide financial challenges to the Company. His concerns surround the increased volatility to earnings and cash flows from the dependence on incentives to achieve a fair and equitable return, the use of proxy peers to calculate an allowed return on equity which operate under a fundamentally different regulatory framework, and the general uncertainty regarding the outcome of the REV proceeding which, in turn, may place pressure on the Company's credit ratings and cost of capital.

Q. Do you have any observations with respect to the

concerns raised by Company witness Sanders?

A. First, and foremost, we must note that our ROE recommendation of 8.60% represents a fair and equitable return. Incentives will not be necessary in order to achieve this return. The incentives and other positive earnings opportunities under REV would be in addition to that fair return.

Second, it should be noted that CEI's stock has been trading at a multiple to book value of 1.6x. Although the Company has expressed potential concerns about the implications of the REV proceeding, it does not seem to have deterred equity investors from purchasing CEI's stock. In addition, in November 2015, Con Edison issued $650 million of unsecured debt with a 30-year maturity. As we mentioned earlier, shortly after this debt was issued, it was yielding less than 4.0%. This signifies robust demand for Con Edison's debt offerings, even at these historically low yields. The Company has planned debt issuances for June 2016, and we expect the Company to issue its required amounts of capital with the same ease

as it has in the past. We have yet to observe any investor reluctance to invest in utilities in New York as a result of the REV proceeding.

Such confidence from both debt and equity investors should dispel any notion that REV, or the inclusion of distributed energy resources for that matter, is perceived negatively. Moreover, we do not anticipate any material changes to the Company's risk profile in the rate year.

Q. What is your opinion about Company witness Sanders concern regarding the use of proxy peers, which operate under a different regulatory framework, being used to calculate an allowed return on equity?

A. To begin with, the entire utility industry faces varying degrees of risk as a result of distributed generation. In fact, in its June 12, 2015 report entitled, "How the Rise of Solar Energy Could Affect U.S. Regulated Utilities' Credit Quality," illustrated in Exhibit__(FP-41), S&P believes that the utility holding companies most at risk are vertically integrated utilities with strong sun and higher-than-

average customer bills. S&P indicates that roughly one quarter of the industry is at greater risk; it identifies 12 out of the 45 *Value Line* electric utility holding companies, and six out of our proxy group, as being most at risk. CEI was not among the holding companies most at risk to distributed generation.

In addition, despite the fact that our proxy group is sufficiently large to give us confident results, there is no proxy group that will identically reflect the exact same risks afforded by Con Edison, unless we were to run a DCF using solely Con Edison's information. For example, if we were to run such a calculation with our DCF model solely on CEI, the resulting ROE would be 6.75%. The point is, at any time, there are different issues and proceedings occurring in each jurisdiction that will inherently create differing risks at differing times for different companies. The fact that each company in any proxy group is facing different risks is not a new occurrence and, as we have continually stated in the past, a sufficiently large proxy group will reduce the

risks of any one company having a significant impact on the overall ROE.

It is also worth noting that Con Edison is less risky than our proxy group. We presently use a proxy group that, on average, receives 9.15% of its revenues from non-utility businesses and also includes many holding companies whose utilities are vertically-integrated. These companies are exposed to greater risks than Con Edison.

Q. What is your overall opinion regarding the risks associated with the REV proceeding?

A. REV is proactively addressing what the utility industry is only now beginning to face in response to developing technological and market changes largely driven by distributed energy resources, and is attempting to provide a regulatory framework to address these issues sooner rather than later. With the goal of proactively positioning New York's utilities more positively in the long run, the Commission's approach should be viewed as an evolutionary process. As stated in the Conclusion of the Track 2 Order "This order

provides directional guidance for long-term reform and a carefully measured set of near-term actions designed to facilitate needed change while maintaining traditional principles of gradualism, equity, and opportunity to earn fair returns on investment."

We believe it is speculative at this time to determine whether REV will increase the risk profile of utilities, but given the Commission's interest in maintaining financial integrity, should the Company's concerns materialize and are not otherwise addressed through risk mitigating ratemaking conventions, the Commission would be apprised to revise its approach. In fact, in regards to maintaining a financially sound utility industry, the Track 2 Order states "this requires a careful balance of immediate regulatory changes to support necessary systemic changes with ensuring that the needs of consumers of all types are met, that the industry remains financially attractive to capital markets, and that new entrants can invest and build businesses with confidence in our markets."

Q. Have the rating agencies commented on the REV proceeding?

A. Yes, in its October 19, 2015 report entitled "New York's REV: Seeking a Greener Utility Grid for the Environment and Investors," Exhibit__(FP-38), Moody's states that "…although REV brings uncertainty to the long-term risk profile of New York utilities, the New York State Public Service Commission (NYPSC) is motivated to keep utilities financially healthy, so that they can raise a substantial amount of capital at reasonable cost to implement this key state policy. The utilities' central role in this policy, combined with REV's intended gradual implementation, counterbalance the uncertainty. In addition, by proactively encouraging utilities to adopt a business model that supports new technologies, a long-term plan like REV could prove to be an orderly and economic response to the technology risk facing the utility industry." Moody's goes on to say that REV will take a decade or so to implement and, therefore, "its impact will be limited in this decade as New York rolls out the initiative

gradually."

Q. In the past the Company has expressed concerns about the symmetry of potential returns, specifically, penalty-only performance mechanisms. Do you believe the Company's concerns regarding the potential for positive incentives are valid?

A. Due to the inclusion of Earnings Adjustment Mechanisms, as discussed in Staff's Electric and Gas Policy Panel testimony, going forward the Company will have the opportunity to increase its return based on meeting specific metrics as outlined in the REV proceeding. In addition, the Track 2 Order provides earnings opportunities associated with sharing of platform service revenues as well as earnings tied to achievement of alternatives that reduce utility capital spending and provide definitive consumer benefit. Plus, Staff's Gas Policy Panel is recommending certain new positive incentives for performance on gas metrics in this case. While the Company often references its exposure to penalty-only performance mechanisms, the fact is these mechanisms are in

place to ensure reasonable performance metrics and sufficient revenues are included in the revenue requirement to achieve these metrics. Both Staff and the Commission have been supportive of the Company's operating plans in the past and, with the introduction of REV, we anticipate additional earnings opportunities will be introduced over time. As REV evolves and DSIPs and the Track 2 Order are implemented, it would be reasonable to revisit the current overall return approach in the future to assess whether it requires any changes.

Q. On page 46 of his direct testimony, Company witness Sanders states that both equity and debt investors perceive the New York regulatory environment as a difficult environment in which to operate. What proof has he provided to support this statement?

A. Company witness Sanders does not have any evidence to support this statement. Regulatory Research Associates, in its objective review of state regulation, has rated New York "Average/2", which is indicative of an average rating in the middle of its rating scale and

certainly not the most difficult regulatory environment in which to operate. The only statement he makes in support of this argument is that, if this "perception" continues, it will "make the financing of needed expenditures more expensive in normal times and less certain in times of financial crises." In order to avoid this outcome, he claims that the Commission needs to grant a "fair and equitable return, competitive with those available elsewhere in the market, and a reasonable chance to actually earn that return."

Q. How has the Company fared in its ability to earn its allowed return?

A. Generally speaking, the Company has been successful at earning its allowed return and has also outperformed the majority of its peers over the past ten years. In addition to the Company's most recent annual compliance filing indicating an earned ROE of 10.16% for its electric operations, we reviewed the Company's earned returns over the past five and ten years and found that the Company has not only met, but exceeded its allowed returns, even in comparison

to the operating companies in our proxy group. Over the last five-years, the Company earned a 9.67% ROE, while the operating companies earned a 9.49%. In addition, over the last ten years, the Company earned a 9.72%, as opposed to the operating companies which earned a 9.57%. This information is included in Exhibit__(FP-39). Although the Company claims that New York returns are among the lowest in the country and well below those in other states, our research seems to indicate the Company consistently fairs just as well, if not better, than its peers in earning its allowed return.

Q. Taking into consideration Company witness Sanders statement in his direct testimony that the Company should be allowed a reasonable chance to actually earn its return, do you believe the Company has been given a reasonable chance to earn its allowed return in the past?

A. Yes. New York State regulation allows for fully forecasted test years, which reduces regulatory lag and, in turn, helps the Company with its ability to earn its allowed return. This is echoed in Regulatory Research Associates' (RRA)

evaluation of New York State regulation, illustrated in Exhibit__(FP-40). The report states, "…rate cases in New York incorporate fully forecasted test periods that improve the utilities' opportunity to earn the authorized ROE." This is acknowledged by Moody's as well. In its July 31, 2015 "Credit Opinion: Consolidated Edison Company of New York, Inc.," included as Exhibit__(FP-16), Moody's states that, "…the New York regulatory framework has a number of credit-positive features. For example, in rate case filings, utilities file for a future test year, which reduces regulatory lag. Rate cases conclude on a timely basis, in 11 months. The NYPSC has granted multi-year plans, which provide revenue certainty over its course. CECONY has full revenue decoupling for both electric and gas services and weather normalization for gas, which protects its margins from variations in sales volumes." This sentiment is also echoed by Fitch Ratings in its November 12, 2015 report entitled, "Fitch Affirms Ratings of ConEd & Subsidiaries at 'BBB+'; Outlook Stable," included as

Exhibit__(FP-20). Fitch states that, "CECONY and ORU enjoy several mechanisms that Fitch considers to be supportive of credit quality including forward-looking test years, multi-year rate plans, trackers for large operating expenses, and a revenue decoupling mechanism that isolates net margins from variations in retail sales. Those mechanisms do support the utilities' long-term financial stability."

Q. Aside from fully forecasted test years and the ability to earn its allowed return, what are some other benefits of New York State regulation?

A. New York State regulation offers a myriad of benefits to its utilities. In addition to fully forecasted test years and the ability to earn its allowed return, we also have rate cases that conclude on a timely basis, risk reducing deferral and true-up mechanisms, a full pass-through of commodity costs to ratepayers and an approach to setting ROEs that is very transparent and predictable. Indeed, the positives of New York regulation, as we previously stated, have been widely recognized.

Q. Does this conclude your testimony at this time?

A. Yes it does.