

CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.  
DIRECT TESTIMONY OF  
SCOTT SANDERS - GAS

1 Q. Please state your name and business address.

2 A. My name is Scott Sanders. I am employed by  
3 Consolidated Edison Company of New York, Inc. ("Con  
4 Edison", "CECONY", or the "Company") as Vice President  
5 and Treasurer. My business address is 4 Irving Place,  
6 New York, New York.

7 Q. Briefly describe your educational background.

8 A. I hold a B.S. in Nuclear and Chemical Engineering from  
9 the University of California, Berkeley, and an MBA  
10 from the University of Chicago.

11 Q. Please summarize your professional background.

12 A. I joined Con Edison in January 2010. I previously co-  
13 founded New Infrastructure Advisors in 2009, a  
14 boutique financial advisory firm. Prior to New  
15 Infrastructure Advisors, I was employed at Bank of  
16 America where I was a Managing Director in the Power  
17 and Utilities group covering U.S. utilities. I  
18 previously covered U.S. utilities during my tenure at  
19 Citigroup and New Harbor Incorporated. My work with  
20 utilities also included work as a consultant to U.S.  
21 utilities at Deloitte Consulting. I began my career

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1 with the California Public Utilities Commission,  
2 working as a staff engineer on electric, gas, water  
3 and telecommunications rate matters and then as an  
4 advisor to Commissioner Patricia Eckert on electric  
5 and gas matters. During my twelve years in the  
6 financial services industry, as a senior investment  
7 banking professional, I regularly valued, or directed  
8 the valuation of utilities and utility assets  
9 employing discounted cash flow valuations that applied  
10 capital asset pricing model-derived market costs of  
11 equity.

12 Q. Have you previously sponsored testimony before the New  
13 York State Public Service Commission ("Commission")?

14 A. No.

15 Q. What is the purpose of your testimony?

16 A. My testimony discusses (1) the current financial  
17 market environment, (2) CECONY's historic and  
18 projected capital structure and cost of capital, (3)  
19 CECONY's financial challenges and the need to maintain  
20 access to financial markets at reasonable cost, and

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1 (4) the rate treatment of Directors' and Officers'  
2 ("D&O") insurance costs.  
3

4 **CURRENT FINANCIAL MARKET ENVIRONMENT**

5 Q. Please describe the current state of the financial  
6 markets.

7 A. The markets have improved from their lows of late 2008  
8 and early 2009. However, the pervasive indifference  
9 to risk that characterized investor behavior leading  
10 up to the crisis has not returned, nor is it likely to  
11 in the near future.

12 The financial markets are still challenged by crises,  
13 both domestic and international, and the flight to  
14 quality, which has driven U.S. Treasury debt rates to  
15 historically low levels and kept them there, is  
16 symptomatic of the skittishness of investors. Events  
17 in Europe and elsewhere have caused investors in money  
18 market funds, including CECONY, which invest in a  
19 broad spectrum of instruments, to question the safety  
20 of even the short-term instruments of highly-rated  
21 international banks and to consider switching to ones

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1 that invest only in U.S. government securities or to  
2 invest in Federal Deposit Insurance Corporation-  
3 insured bank accounts. Never has the interdependence  
4 of global financial markets and their susceptibility  
5 to rumors and panic been so well demonstrated.  
6 In response to the recent financial crisis, financial  
7 markets regulators are in the process of imposing  
8 stricter capital guidelines for financial  
9 institutions, requiring significantly more capital,  
10 particularly for the largest banks. We do not yet  
11 know what impact these requirements may have on  
12 capital availability and cost for companies that must  
13 access the bank and bond markets, and as noted by  
14 Company witness Lapson, it is likely that the  
15 importance of having strong credit ratings in order to  
16 access capital on reasonable terms as needed will  
17 continue.

18 Q. Can you discuss how the recent financial crisis has  
19 impacted the Company's ability to access the bank  
20 credit market?

21 A. Prior to the crisis, utilities such as CECONY were

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1 able to arrange a five-year revolving credit facility  
2 with minimal upfront fees (i.e., amortized at a basis  
3 point or so a year) and annual facility fees in single  
4 digit basis points (a basis point equals one-hundredth  
5 of one percent of the stated amount, in this case the  
6 borrowing capacity for which the lenders have  
7 committed).

8 As discussed below, revolvers today have facility  
9 fees, borrowing costs and upfront fees priced at  
10 multiples of what they were and the cost for having a  
11 lower credit rating has also increased. In addition,  
12 CECONY arranged bilateral credit agreements to provide  
13 liquidity for its variable-rate tax-exempt debt  
14 portfolio. Since the financial crisis the  
15 availability of such agreements has diminished and  
16 costs have increased.

17 Q. Why are bank revolving-credit facilities important to  
18 the Company's financing plan?

19 A. There are four purposes for bank credit facilities in  
20 funding a utility company like CECONY. First, the  
21 facilities directly or indirectly provide the

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1 liquidity that allows the Company to raise long-term  
2 financing when desirable, not when it has to. The  
3 facilities thereby save customers money because they  
4 eliminate the need to pre-fund spending and allow the  
5 Company to fund at times of its choosing. Second, the  
6 facilities allow the Company to issue letters of  
7 credit as collateral for its operations including  
8 managing the portfolio of energy commodity purchases  
9 made on behalf of customers in the wholesale and  
10 financial markets. Third, the facilities are the  
11 source of liquidity that assures purchasers of our  
12 commercial paper that they will be repaid. This "back  
13 up" function permits the Company to access a lower-  
14 cost source of funds for the day-to-day operation of  
15 the business. Finally, the facilities assure the  
16 rating agencies that the Company can meet its  
17 obligations even if it loses access to the capital  
18 markets for a period of time (and thus factors into  
19 the credit ratings for the Company).

20

21

1

2

**CAPITALIZATION AND COST OF CAPITAL**

3 Q. What capital structure do you recommend should be used  
4 in this proceeding?

5 A. I recommend the use of the stand-alone capitalization  
6 of CECONY in this proceeding.

7 Q. Please describe the stand-alone capitalization.

8 A. The stand-alone capitalization refers to the actual  
9 capital structure of CECONY, that is to say, the  
10 actual investment of capital required to provide  
11 services to CECONY's customers.

12 Q. Does the initial actual capital structure plus  
13 projected financings represent the expected actual  
14 investment of capital in the Company during the rate  
15 year (i.e., January 1, 2014 - December 31, 2014)  
16 ("Rate Year")?

17 A. Yes, it does.

18 Q. Has the Company prepared a rate of return required  
19 exhibit?

20 A. Yes. The document entitled "CONSOLIDATED EDISON  
21 COMPANY OF NEW YORK, INC. -- RATE OF RETURN REQUIRED

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1 FOR THE RATE YEAR -FORECAST FOR DECEMBER 31, 2014," is  
2 set forth as Exhibit \_\_\_ (AP-12, Schedule 2).

3 Q. Please describe any projected changes in CECONY's  
4 long-term debt and how such changes have been  
5 incorporated into the rate of return required for the  
6 thirteen-month average ending December 31, 2014.

7 A. We expect to issue the following debentures:

8 • Change in the forecasted balance of long-term  
9 debt during the linking period between July 1,  
10 2012 through December 31, 2013 as follows: new  
11 debt to be issued during the period of \$900  
12 million of Debentures, Series A 2013, 4.15% to be  
13 issued June 2013, due June 2043 and \$420 million  
14 of Debentures, Series B 2013, 4.15% to be issued  
15 December 2013, due December 2043.

16 • Changes in the forecasted balance of long-term  
17 debt during the Rate Year are as follows: new  
18 debt to be issued during the period of \$530  
19 million of Debentures, Series A, 4.70% to be  
20 issued April 2014, due April 2044; and \$600

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1 million of Debentures, Series B, 4.70% to be  
2 issued June 2014, due June 2044.

3 Q. Please describe how you developed the cost of long-  
4 term debt.

5 A. Exhibit \_\_ (AP-12, Schedules 5 and 6), present the  
6 detailed calculation of the cost of the long-term debt  
7 at June 30, 2012 and for the thirteen-month average  
8 ending December 31, 2014, respectively. These  
9 schedules detail each issue of long-term debt  
10 outstanding and calculate an effective annual cost for  
11 each issue, taking into consideration the original net  
12 proceeds to the Company and annual interest costs.  
13 The sum of the effective annual cost for all issues is  
14 divided by the gross amount of debt outstanding to  
15 derive the weighted average cost of long-term debt.

16 Q. Did you provide the interest rate forecasts used as a  
17 basis for the cost of debt in this Exhibit?

18 A. Yes.

19 Q. What method have you used to develop interest rate  
20 forecasts?

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1 A. We have used forecasts of Treasury rates from the  
2 publication Blue Chip Financial Forecasts, plus a  
3 spread to Treasuries based on indicative quotes from  
4 financial institutions. The Blue Chip Financial  
5 Forecasts consist of the consensus forecast of more  
6 than fifty economists. This approach provides more  
7 accurate results than simply using the most current  
8 Treasury rates.

9 At the update stage of this proceeding, I will revise  
10 Exhibit \_\_ (AP-12, Schedule 6) to reflect the most  
11 recent data available as well as any new or refinanced  
12 debt that the Company may have issued by that time.

13 Q. Do you have a recommendation for the treatment of  
14 forecasted interest rates?

15 A. Yes. I recommend the continuation of the true-up of  
16 interest costs for debt, that was authorized by the  
17 Commission in the Company's last electric base rate  
18 case (Case 09-E-0428).

19 Q. What would be included in the true-up?

20 A. The true-up would include the difference between the  
21 rates actually prevailing during the Rate Year and the

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1 interest costs set for the debt in this case. The  
2 true-up would also be applied to credit support costs  
3 such as letters of credit or insurance. In addition,  
4 existing long-term debt has associated unamortized  
5 issuance costs (representing underwriting fees and  
6 other costs from the time of issuance) which should  
7 also be included in the true-up. Furthermore, if  
8 CECONY decides that refinancing any debt will likely  
9 reduce total costs or because of government, legal or  
10 regulatory requirements to do so, the actual cost of  
11 the replacement debt issues (including issuance costs  
12 and any credit support) and the new interest rate  
13 would be trued-up as well.

14 Q. Please describe the method used to project the  
15 Company's equity balance through December 31, 2014.

16 A. The average consolidated equity of CECONY at December  
17 31, 2014, excluding all non-utility subsidiaries and  
18 Other Comprehensive Income was projected from June 30,  
19 2012 using the following steps:

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- 1           1. The forecast earnings for June 30, 2012 to  
2           December 31, 2014 were added to the June 30, 2012  
3           equity balance; and  
4           2. The forecast dividends to Consolidated Edison,  
5           Inc. ("CEI") for June 30, 2012 to December 31,  
6           2014 (i.e., \$354.5 million for 2012, \$714.8  
7           million for 2013, and \$720.7 million for 2014)  
8           were subtracted from the equity balance at June  
9           30, 2012.

10   Q.   What stand-alone capital structure for CECONY results  
11       from the calculations that you described?

12   A.   Exhibit \_\_ (AP-12, Schedule 2), shows the forecasted  
13       capital structure for the thirteen months ending  
14       December 31, 2014 of 48.68% long-term debt, 1.43% of  
15       customer deposits, and 49.89% common stock equity.

16   Q.   Does Exhibit \_\_ (AP-12) also show the forecasted  
17       capital structure, based on a thirteen-point average,  
18       for the twelve months ending December 31, 2015 and  
19       December 31, 2016?

20   A.   Yes. Schedules 3 and 4 of this exhibit show the  
21       capital structure for those periods. These schedules

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1 show that over those two years the debt ratios would  
2 increase to 48.97% and 48.84% of the Company's capital  
3 structure, respectively, as new debt is issued. These  
4 schedules also show that the customer deposit ratio  
5 would decrease modestly and the equity ratio would be  
6 reduced to 49.62% and 49.76% for the twelve-month  
7 periods ending December 2015 and 2016, respectively.

8 Q. Are you requesting that the capital structure, upon  
9 which the revenue requirements are calculated in the  
10 contemporaneous rate filings, use an equity ratio of  
11 49.89%?

12 A. Yes, for purposes of calculating the revenue  
13 requirements in the contemporaneous rate filings, the  
14 Company is proposing to use a 49.89% common stock  
15 equity component. Company witness Hevert provides  
16 further justification for the 49.89% equity ratio in  
17 his direct testimony Appendix B, titled "Market Based  
18 Capital Structure and the Financial Leverage  
19 Adjustment".

20 Q. Please explain why the proposed common stock equity  
21 ratio is reasonable.

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1 A. As discussed in the direct testimony of Company  
2 witness Hevert in the contemporaneous rate filings,  
3 the proposed capital structure and proposed equity  
4 ratio are reasonable based on his proxy group  
5 comparative analysis. The analysis demonstrates that  
6 the Company's proposed equity ratio is below the mean  
7 equity ratio of the proxy group companies of 52.66%.

8 Q. What are you proposing for the Company's return on  
9 equity?

10 A. We propose a 10.35% return on equity based on Company  
11 witness Hevert's testimony.

12 Q. How does the Company's overall "pretax" cost of  
13 capital requested in this case with a 49.89% equity  
14 ratio and 10.35% return on equity compare to the  
15 "pretax" cost of capital reflected in the current  
16 electric rate plan?

17 A. The pretax cost of capital requested by the Company in  
18 this case is very close. The pretax cost would be  
19 11.09% versus the 11.00% contained in the joint  
20 proposal that was adopted as part of the current  
21 electric rate plan.

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1 Q. How is it possible that the "pretax" cost of financing  
2 could remain so close to the cost in the current  
3 electric rate plan?

4 A. There are three primary reasons; first, the Company  
5 redeemed all of its previously outstanding preferred  
6 stock during the first part of 2012 and refinanced the  
7 preferred stock with lower cost 30-year debt; second,  
8 due to lower interest rates, the cost of our tax-  
9 exempt variable rate debt has decreased; and third,  
10 the Company has avoided the need to issue new debt  
11 contemplated as part of the current rate plan  
12 resulting in a lower embedded cost of debt.

13 Q. So your proposal to use a 49.89% equity ratio in  
14 conjunction with these other changes would have  
15 minimal impact on revenues?

16 A. Yes.

17 Q. How have the components of the Company's capital  
18 structure changed?

19 A. On May 1, 2012, the Company redeemed all of its  
20 outstanding shares of preferred stock. The preferred

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1 stock had accounted for approximately 2% of the  
2 Company's capital structure prior to its redemption.

3 Q. Using this forecasted capital structure and cost of  
4 long-term debt and the return on equity, what overall  
5 rate of return results?

6 A. The overall rate of return is 7.69% as shown on Exhibit  
7 \_\_\_ (AP-12, Schedule 2).

8

9

**CAPITAL NEEDS AND INVESTOR CONCERNS**

10 Q. What is the nature of your testimony on the capital  
11 needs and investor concerns facing CECONY?

12 A. My testimony concerns the financial challenges and the  
13 need to maintain access to financial markets at  
14 reasonable cost. In addition to my testimony, Company  
15 witness Lapson provides testimony regarding the  
16 importance of the outcome of the contemporaneous rate  
17 proceedings to the credit-worthiness and investment  
18 standing of CECONY.

19 Q. Please describe the financial challenges facing the  
20 Company during the Rate Year and beyond.

21 A. The Company faces the following four inter-related

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1 financial challenges: (A) the capital intensive nature  
2 of its business, (B) its unusually weak cash flows,  
3 (C) the restrictions that regulation places on its  
4 ability to respond to unfavorable developments in its  
5 environment, and (D) its dependence on the market to  
6 fund its capital needs.

7 Q. Please discuss (A) the capital intensive nature of the  
8 Company's business.

9 A. The Company's business requires significant capital  
10 investment every year, its assets are long-lived and  
11 the underlying technology, facilities and customer  
12 base are mature.

13 Capital intensity is high for electric utilities.

14 According to an IHS CERA presentation titled "Post  
15 Fukushima: If not nuclear, what energy mix?" (June  
16 2011), the electric utility industry is second only to  
17 railroads in capital intensity. As shown on Exhibit  
18 \_\_ (SS-1), the Company's capital intensity can be  
19 demonstrated by the fact that its ratio of net fixed  
20 assets per dollar of revenues is \$1.94 versus \$0.70  
21 for the average S&P 500 company and \$0.20 for the

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1 median company. Capital intensity creates extra risk  
2 for investors because capital intensive businesses  
3 have to recover much larger fixed costs (interest and  
4 depreciation) before achieving a return.  
5 CECONY's assets also have extraordinarily long lives.  
6 Long-lived assets in the context of rate regulation  
7 create two financial challenges for the Company that  
8 are also risks for potential investors in the  
9 Company's debt and shares. First, their investment  
10 horizons for capital recovery must be much longer. For  
11 debt investors, utility debt has much longer average  
12 maturities than other companies. Equity investors  
13 must wait for long-term repayment on their investment.  
14 Second, there is a regulatory risk in long-lived  
15 assets because U.S. rate regulation limits returns to  
16 a fraction of historic tangible book cost rather than  
17 replacement or current market value. The Company's  
18 depreciation recoveries, which reflect historic  
19 tangible net book values, are small relative to its  
20 current capital costs, returning only 43% of its  
21 capital expenditures in the form of depreciation in

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1 2011.

2 Due to the long depreciation lives established in  
3 rates, this dynamic is likely to continue for many  
4 years. As shown on Exhibit \_\_ (SS-2, Schedule 1), by  
5 way of comparison, the average S&P 500 company  
6 recovered 167% of its capital expenditures through  
7 depreciation and amortization. This would have placed  
8 CECONY in the bottom 8% of companies in the S&P 500  
9 that had meaningful recovery rates. CEI (which had a  
10 41% capital expenditure recovery rate) had the  
11 seventh-lowest recovery rate among the 33 utilities in  
12 the S&P 500 as shown on Exhibit \_\_ (SS-2, Schedule 2).  
13 The average recovery rate for the utility companies in  
14 S&P 500 utilities was 51%.

15 The Company's large installed base of mature equipment  
16 requires an unrelenting investment in replacement  
17 assets. In other industries, a much larger portion of  
18 investment can be dedicated to new business  
19 (generating offsetting revenues) or new technology  
20 (lowering costs).

21 Mature assets raise operating costs and increase

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1 operating risks, particularly in an environment which  
2 requires the highest level of reliability and imposes  
3 regulatory penalties for failing to achieve it with no  
4 corresponding opportunities to earn rewards for  
5 superior performance.

6 The technology of the business is also mature,  
7 affording little opportunity to significantly reduce  
8 invested capital in the business through technological  
9 innovation. The need for continuous investment to  
10 maintain and improve the system with slight  
11 opportunities for demand growth and limited  
12 depreciation cash flow means that the Company must  
13 seek rate increases and raise new capital frequently  
14 to maintain its operations. Replacement capital needs  
15 alone substantially exceed the cash generated through  
16 depreciation recoveries for the Company.

17 Q. Will the proposal to accelerate recovery of the  
18 deficiency in the depreciation reserve, set forth in  
19 the testimonies of Company witnesses Hutcheson and  
20 Muccilo, help to alleviate this situation?

21 Q Yes. While this proposal, if implemented, will not

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1 remedy completely the Company's unusually weak cash  
2 flows, it certainly is a step in the right direction.

3 Q. Please describe (B) how the Company's unusually weak  
4 cash flows present a financial challenge.

5 A. The Company will continue to be challenged by its  
6 unusually weak cash flows and lack of positive free  
7 cash flow. In her direct testimony, Company witness  
8 Lapson presents an analysis of the sources and  
9 implications of CECONY's weak cash flow metrics. As  
10 Company witness Lapson correctly concludes, weak cash  
11 flows, all else equal, will mean that CECONY will be  
12 more dependent on external funding.

13 Q. Please describe (C) how restrictions on the Company's  
14 business imposed by the Commission present a financial  
15 challenge.

16 A. The Company is subject to several regulatory  
17 restrictions that limit its ability to react to  
18 unfavorable circumstances. It must provide service as  
19 requested, even if doing so entails significant  
20 investment upon unfavorable terms. It cannot refuse  
21 to provide service to new or unprofitable customers.

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1 It also is limited in its ability to reach beyond its  
2 franchise area to serve attractive new customers. The  
3 Company's assets are immovable; unlike those of most  
4 companies they cannot be used in a different location  
5 or business, their usefulness and profitability are  
6 tied to providing utility service in New York.  
7 Unlike other companies, CECONY has no meaningful  
8 ability to retain the advantages of its efforts to  
9 improve its efficiency and thus lower its costs of  
10 doing business for the benefit of its equity  
11 investors, as the Commission's rate orders remove a  
12 fixed percentage upfront through an imputed  
13 productivity adjustment. Moreover, any additional  
14 efficiencies achieved by management are fully  
15 allocated to customers each time rates are reset as  
16 they invariably will given the capital recovery and  
17 cash flow parameters of historic cost-of-service rate  
18 making.

19 Q. Please describe (D) how the fact that the Company must  
20 continually raise capital increases risk for existing  
21 and prospective investors.

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- 1 A. As mentioned earlier in my testimony, the Company must  
2 approach the markets for additional new debt capital  
3 on a frequent and recurring basis. CECONY is  
4 forecasted to raise \$1,320 million in 2013 and \$1,130  
5 million in 2014. CECONY will need the backing of  
6 prospective cash flows and regulatory support to  
7 continue to market this debt.  
8 Each time CECONY markets its securities, investors  
9 will assess the risks they would bear upon investing  
10 in the Company due to the challenges identified above.  
11 Their assessment of these risks is, and will be,  
12 priced in the market each time that the Company seeks  
13 new capital in the years ahead. To the extent that  
14 analysis of risk leads the market to reduce stock  
15 prices or raise interest rates, the existing investors  
16 are disadvantaged and other potential investors are  
17 made more wary. Through this cycle of investors  
18 assessing and pricing risks that the Company faces,  
19 customers are negatively impacted through increases in  
20 the cost of financing the Company.  
21 Q. What is the implication of the above mentioned large

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1 capital needs?

2 A. To raise this capital at a reasonable cost, CECONY and  
3 CEI must remain attractive investments to both debt  
4 and equity investors. To remain attractive to these  
5 investors, CECONY must receive fair and reasonable  
6 treatment from its regulators.

7 Q. How much debt does the Company have outstanding and  
8 what type?

9 A. As of June 30, 2012 CECONY had \$10,144 million of  
10 long-term debt (including long-term debt due within  
11 one year), of which \$9,058 million were unsecured  
12 taxable debentures and \$1,086 million was tax-exempt  
13 debt. CECONY had letters of credit outstanding in an  
14 amount of \$465 million. Of this amount, \$228 million  
15 consisted of letters of credit backing CECONY tax-  
16 exempt debt. Letters of credit represent an additional  
17 capital need which must be met, requiring CECONY to  
18 meet the test of credit quality and to compete for  
19 scarce funds in an increasingly regulated bank market.

20 Q. Who owns the Company's debt?

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1 A. Investment managers, insurance companies, pension  
2 plans, hedge funds, banks, trust companies and  
3 individuals.

4 Q. How do bond investors evaluate CECONY?

5 A. For most investors, the credit ratings assigned by the  
6 SEC-recognized credit rating agencies are the  
7 threshold basis for evaluating individual corporate  
8 credits such as CECONY.

9 Q. What are the current ratings on CECONY debt?

10 A. As noted by Company witness Lapson, the long-term,  
11 senior unsecured debt ratings are A3, A-, and A- by  
12 Moody's, Standard and Poor's ("S&P"), and Fitch,  
13 respectively. The short-term debt is rated P-2, A-2,  
14 and F2, respectively. All ratings are stable.

15 Q. Are bond ratings the correct indicator of the risks to  
16 shareholders?

17 A. No. Shareholders, unlike bondholders, only have a  
18 residual claim to the resources and income of the  
19 Company, and thus face risks even in well-rated  
20 companies. If returns are inadequate, the bondholder  
21 may suffer a loss from a credit downgrade. The

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1 stockholder will suffer the loss directly. Efforts by  
2 the Commission to limit the upside potential of the  
3 shareholder through the elimination of incentives and  
4 other opportunities, combined with true-ups and  
5 implementation of enhanced penalties exacerbate the  
6 effect of lowered targeted returns.

7 Q. Why do companies such as CECONY need a particularly  
8 strong financial condition?

9 A. Capital intensive companies with a duty to serve have  
10 to borrow in spite of the state of the market and need  
11 continuous access to capital. When they are forced to  
12 pay high rates, these rates will stay with the  
13 companies and their customers for as long as 30 years.  
14 On the short end of the maturity spectrum, access to  
15 commercial paper and bank borrowing markets is key to  
16 allowing CECONY to pay for energy that must be  
17 delivered no matter the price. Only prime borrowers  
18 can maintain that status in all markets, a status that  
19 has become more tenuous for CECONY due to its current  
20 A-2/P-2 (Standard and Poor's/ Moody's) rating for  
21 commercial paper. At the height of the financial

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1 crisis of 2008-2009, A-2/P-2 borrowers, if they had  
2 access, paid rates significantly higher than those  
3 paid by A-1/P-1 borrowers.

4 The seizing up of the commercial paper market was  
5 relieved only by the Federal government's  
6 extraordinary decision to provide an effective  
7 backstop for the highest rated (A-1/P-1) commercial  
8 paper issuers, a solution that may not always be  
9 available, and may not extend to lower quality issuers  
10 such as CECONY.

11 If CECONY lost access to the commercial paper market,  
12 borrowing costs would increase as the Company relied  
13 more upon long-term debt, which is more expensive. In  
14 addition, the Company would more often issue debt on  
15 less attractive terms because it lacked the  
16 flexibility to postpone issuance. The recent past has  
17 demonstrated how important maintaining a strong credit  
18 rating and investor confidence can be.

19 Q. Are there new factors which may serve to reinforce the  
20 need for and potentially limited supply of liquidity?

21 A. Yes. In the U.S., the Dodd-Frank legislation may

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1 increase collateral needs for companies which hedge  
2 commodity exposure, such as utilities. Globally, the  
3 Basel III regulations require more capital for banks  
4 and may lower capital available for lending and  
5 increase costs.  
6 Revolving credit facilities are an alternate source of  
7 short-term borrowing. While such facilities have begun  
8 to be offered for five-year periods again, they are  
9 now a significantly more expensive source of funds,  
10 particularly for companies with lower credit ratings.  
11 For example, the Company entered into a new revolving  
12 credit facility in October 2011 with borrowing costs  
13 at more than four times the pricing in the Company's  
14 previous, 2006 revolving credit agreement. Similarly,  
15 the penalty for having a lower credit rating (i.e.,  
16 the pricing premium between a borrower rated A- and  
17 BBB-) increased more than four times as compared to  
18 our previous revolving credit facility.  
19 Q. Have you reflected these increased fees in your costs?  
20 A. Yes, I have forecasted that financing-related fees  
21 would increase by approximately \$3.4 million from the

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1 historical level. The increase is primarily related  
2 to these increased revolving credit facility costs and  
3 letter of credit fees associated with tax-exempt,  
4 variable rate demand notes. This amount was provided  
5 to Company witness Kane who reflected this amount in  
6 Corporate and Fiscal expenses.

7 Q. Please explain why maintaining its current debt  
8 ratings is important for CECONY.

9 A. First, the Company has a significant continuing  
10 construction program which must be met in large part  
11 by debt financing. More important, the risk remains  
12 that access to credit markets will be restricted for  
13 lower quality credits.

14 In addition, a part of CECONY's financing program is  
15 made up of short-term borrowing through its  
16 commercial paper program. Such borrowing is highly  
17 sensitive to credit quality and credit market  
18 conditions.

19 Q. Who owns the Company?

20 A. CECONY has one shareholder, CEI. As of June 30, 2012,  
21 CEI, in turn, is owned by 57,749 registered

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1       shareholders. Registered shareholders are the  
2       individuals or businesses whose names are listed on  
3       the shareholder register of CEI.

4   Q.   What are the characteristics of the registered  
5       shareholders?

6   A.   As of June 30, 2012, institutional investors owned  
7       approximately 43% of CEI's shares, while individuals  
8       owned 57%. Institutional investors often own shares  
9       for the benefit of others. These investors purchase  
10      CEI shares for the benefit of their investors who, in  
11      turn, may be pension funds and individual investors.  
12      Since pension funds exist for the benefit of the  
13      individual participants in their plans, it makes sense  
14      to think of the ultimate beneficiaries of share  
15      ownership in CEI and derivatively in CECONY of being  
16      millions of individuals who may own shares directly,  
17      invest in U.S. stock mutual funds, or receive or  
18      expect benefits from pension plans or life insurance  
19      policies.

20   Q.   What do these people who own the Company provide to  
21      it?

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- 1 A. They provide the capital that the Company needs above  
2 and beyond what debt investors are willing to provide.  
3 Their capital allows the Company to use the goods,  
4 wages, services and borrowings that bring safe,  
5 reliable energy utility service to the Company's  
6 customers. Without these share investors, the  
7 Company's customers would have to pay currently for  
8 all of the costs of the services they receive.  
9 Instead, customers can delay payment by promising to  
10 pay these investors a greater amount in the future.  
11 Therefore, instead of paying for a new substation as  
12 it is constructed, for example, customers can plan to  
13 pay for that asset over the subsequent decades during  
14 the time they benefit from its operation.
- 15 Q. What do these share investors expect in return for the  
16 benefit customers receive from their capital  
17 investment?
- 18 A. They expect compensation either in the form of a  
19 periodic dividend payment or as an increase in the  
20 value of the business, or both.

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1 Q. How do share investors in regulated utilities set  
2 their expectations for compensation?

3 A. The return expectations of share investors in rate-  
4 regulated energy utilities are grounded in the bargain  
5 termed "the regulatory compact." The regulatory  
6 compact's essence is that share investors forgo the  
7 monopoly earnings they would otherwise enjoy in return  
8 for the institutionalization of their monopoly in an  
9 exclusive franchise, and a fair and equitable return  
10 on the capital they have invested.

11 Q. What standards exist to help share investors and  
12 regulators determine whether a rate-regulated utility  
13 offers a fair and equitable return?

14 A. The general standards for a fair and equitable  
15 return for investors in utility shares are well-  
16 established in the U.S. The underlying  
17 requirement for fair treatment for share  
18 investors has been recognized for years. As  
19 discussed in the testimony of Company witness  
20 Hevert, it dates back to the Bluefield and Hope  
21 cases. The Supreme Court in those cases

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1 established that in determining the fairness or  
2 reasonableness of a utility's allowed ROE, one  
3 needed to look at the consistency of a utility's  
4 allowed ROE with the returns on equity  
5 investments in other businesses having similar or  
6 comparable risks.

7 The key point is that in neither of these cases is  
8 there a specific limitation to looking only to the  
9 financial health of utilities when looking at  
10 enterprises with "similar or comparable risks." And,  
11 as has been pointed out many times in prior New York  
12 rate proceedings, comparisons to other utilities  
13 introduces an incurable circularity to the assessment  
14 of an appropriate level of returns.

15 Q. How would a potential share investor evaluate the  
16 return limitations on New York utilities as to their  
17 magnitude, timing and probability?

18 A. There are four significant factors in an equity  
19 investor's assessment of New York utility regulation:  
20 (1) headline rate of return on equity, (2) the  
21 likelihood of earning that return, (3) the symmetry of

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1 potential earned equity returns, and (4) the  
2 restrictions the regulator places on the scope of the  
3 business. To make this assessment, a potential share  
4 investor will start with the basic parameters of the  
5 rate orders from the state.

6 Q. How do the Commission's rate orders influence  
7 investors' evaluation of the first identified return  
8 consideration?

9 A. The first factor, the level of returns on equity, is  
10 important for an equity investor because it provides  
11 the most visible indication in the rate order of the  
12 regulator's willingness to balance the needs of  
13 investors and customers.

14 Q. How have the Commission's authorized returns compared  
15 to those in other jurisdictions?

16 A. As we have stated in previous rate cases, the rates of  
17 allowed return granted in New York are well below  
18 those in other states. I have provided a comparison  
19 of allowed returns in New York versus other states  
20 (based on data from Regulatory Research Associates  
21 ("RRA")) to demonstrate the consistency of this

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1 practice (Exhibit\_\_(SS-3)).

2 In past cases, Staff has argued that each of the rate  
3 cases in the RRA database is unique, and therefore no  
4 meaningful conclusion can be drawn. While I would  
5 agree that each is unique, it is equally obvious that  
6 the differences in the authorizations cannot always be  
7 such that New York companies should consistently and  
8 deservedly be permitted a chance to earn the lowest  
9 returns in the country.

10 Q. Can investors readily measure the degree to which a  
11 regulatory regime fairly rewards share investors?

12 A. In New York, yes. The Commission has a clear and  
13 long-standing policy of setting returns relative to  
14 the historic tangible book value of the investors'  
15 shares. Information about returns on share book  
16 values for publicly-traded U.S. companies is readily  
17 available to investors from public sources as a basis  
18 for comparison.

19 Q. How does CECONY compare to this universe of  
20 alternative investments?

21 A. It does not fare well in the comparison. When looking

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1 at 2011, CECONY had a return on book equity that would  
2 have placed it in the bottom 30% of S&P companies with  
3 meaningful data. The return for the average S&P  
4 company was 16.1%.

5 Q. Have you prepared an exhibit to show this?

6 A. Yes, please refer to my Exhibit \_\_ (SS-4).

7 Q. Are companies typically valued by investors at their  
8 book value?

9 A. No, they are valued by investors based on their  
10 prospects. Exhibit \_\_ (SS-5) shows the five-year  
11 average market to book ratios for those S&P  
12 companies with positive book equity. CEI's  
13 market to book is in the bottom 20% of this  
14 universe for this important measure of investor  
15 perception of prospects, even after a massive  
16 financial crisis which most severely affected the  
17 financial sector and other industries.  
18 Valuation methods such as the DCF can be  
19 reasonable (if imperfect) methods for determining  
20 expected returns for investors when they apply  
21 market-derived data to the firm's market value of

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1 equity. The method and the application are then  
2 internally consistent and reward the equity-  
3 holder for what his or her stock investment is  
4 currently worth. In contrast, the current  
5 practice of applying market-derived returns to a  
6 much lower book value not only strips out the  
7 accumulation of improvements to the business and  
8 its assets, but it is not consistent with  
9 standard, corporate finance practice. The  
10 application of the CAPM methodology suffers from  
11 similar flaws. Market-derived returns must be  
12 applied to market equity values. There is no  
13 theoretical basis to do otherwise.

14 Q. Are you proposing an alternative method to  
15 correct for this inconsistency?

16 A. Not at this time. As we have done in previous  
17 rate cases, we are pointing out a flaw in the  
18 methodology applied by Commission staff and  
19 adopted in previous Commission orders - -  
20 application of a market-derived return to book  
21 value-based equity. To support our view, Company

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1 witness Hevert presents a methodology that, while  
2 much more conservative than applying a market-  
3 derived return to a market value of equity,  
4 represents movement in the right direction. In  
5 his direct testimony Appendix B, titled "Market  
6 Based Capital Structure and the Financial  
7 Leverage Adjustment", Company witness Hevert  
8 proposes an adjustment to the allowed ROE to  
9 account for the differences between financial  
10 leverage embedded in market-derived returns and  
11 returns based on book value. Since financial  
12 leverage measured at book value generally exceeds  
13 financial leverage measured at market value, an  
14 upward adjustment to the ROE to capture the  
15 higher financial risk implied by higher financial  
16 leverage is appropriate.  
17 In this proceeding, to remedy the flaw inherent  
18 in the application of a market-derived return to  
19 book value-based equity, the Commission should  
20 establish the Company's approved ROE at the level  
21 recommended by Company witness Hevert.

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1 Q. Does Company witness Hevert present the  
2 theoretical basis for his proposed ROE  
3 adjustment?

4 A. Yes. Please see Company witness Hevert's direct  
5 testimony Appendix B.

6 Q. How would an investor assess the second factor: the  
7 likelihood of a utility actually earning the headline  
8 equity return?

9 A. The investor would analyze the adjustments made to  
10 actual costs that are allowed to be recovered, imputed  
11 productivity that may or may not be achieved, and any  
12 arbitrary revenue adjustments. To the extent that  
13 such adjustments to real costs are made, the headline  
14 rate of return is unlikely to be achieved.

15 Q. How would an investor assess the third factor: the  
16 symmetry of potential returns?

17 A. There is ample opportunity through penalty-only  
18 performance mechanisms, an absence of any meaningful  
19 positive incentives and one-way true-ups of costs--  
20 burdens which have increasingly been imposed in New  
21 York rate decisions--to realize significantly worse

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1 returns than the headline authorized return. All of  
2 these aspects of New York rate orders create asymmetry  
3 in expected returns, which a rational potential share  
4 investor would judge as reducing his or her expected  
5 return. As pointed out in detail by Company witness  
6 Lapson, little evidence exists that these burdens are  
7 common in other jurisdictions in the country, where  
8 the peers that are the basis for the Commission's DCF  
9 and CAPM results operate.

10 Q. Have the shortcomings in the treatment of Con Edison  
11 been reflected in equity analyst's views of the  
12 Company?

13 A. Yes. As of December 31, 2011, Con Edison ranked as  
14 490th of the 500 companies in the S&P 500 in terms  
15 of analyst buy/sell rankings Exhibit \_\_ (SS-6).

16

1  
2

**CONCLUSION**

3 Q. Please summarize your testimony on the financial  
4 challenges for the Company.

5 A. Company witness Hevert has presented the Company's  
6 calculation of a required equity return for CECONY.  
7 My testimony concerns the financial challenges and  
8 the need to maintain access to financial markets at  
9 reasonable cost. Company witness Lapson has also  
10 presented testimony on the challenges CECONY faces  
11 from the perspective of the rating agencies and  
12 fixed-income investors. Both equity and debt  
13 investors perceive that the New York regulatory  
14 environment is a difficult one in which to operate.  
15 Such a perception, if it continues, will make  
16 financing needed expenditures more expensive in  
17 normal times and less certain in times of financial  
18 crises.  
19 To avoid such an outcome, and to re-establish debt  
20 and equity investors' trust in the fairness of New  
21 York regulation, a fair and equitable rate of

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1 return, competitive with those available elsewhere  
2 in the market, and a reasonable chance to actually  
3 earn that return, are needed. And to achieve such,  
4 the Commission should grant the rate of return  
5 recommended by Company witness Hevert and the  
6 capital structure as recommended in this testimony.

7 **DIRECTORS' AND OFFICERS' INSURANCE**

8 Q. What is D&O insurance?

9 A. Consistent with New York State law, D&O insurance  
10 covers the Company and its directors and officers for  
11 claims and litigation brought against them for good  
12 faith decisions they make in their respective  
13 corporate capacities.

14 Q. Why does Con Edison need D&O insurance?

15 A. The Company purchases D&O insurance as part of its  
16 effort to recruit and retain qualified officers and  
17 directors to serve in those roles. Officers and  
18 directors understand the litigation exposure that  
19 attends to the responsibilities of boards and  
20 managements of companies, particularly large, public  
21 utility companies such as CECONY.

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1 Q. Is D&O insurance an ordinary business expense for U.S.  
2 public companies?

3 A. Yes. D&O insurance is virtually universal among U.S.  
4 public companies. The administrative law judges in  
5 their Recommended Decision in a recent CECONY electric  
6 base rate case (Case 08-E-0539) (p. 172) found that  
7 more than 99% of all types of companies buy this  
8 insurance, a finding which the Commission did not  
9 disturb in its final rate order in that proceeding.

10 Q. Please describe the coverage under the Company's D&O  
11 insurance.

12 A. The Company purchases \$300 million of total D&O  
13 insurance, which is comprised of \$250 million of  
14 standard ABC coverage, discussed below, supplemented  
15 by \$50 million of stand-alone Side A coverage. This  
16 level of coverage has been in place since 2005. The  
17 standard policy coverage contains three coverage  
18 components. Coverage A of the standard policy  
19 protects and defends individual officers and directors  
20 for claims against them in the event of the Company  
21 failing to deliver on its commitment to provide

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1 indemnification. In such cases a \$0 deductible  
2 applies. Coverage B of the standard policy reimburses  
3 Con Edison for all amounts incurred to indemnify our  
4 directors and officers as required or permitted by  
5 applicable common or statutory law, or under our  
6 charter or by-laws, in which case a \$5 million  
7 deductible applies. Coverage C of the standard policy  
8 covers Con Edison for securities claims against it. A  
9 \$5 million deductible also applies to Coverage C.

10 Q. What claims are excluded from D&O coverage?

11 A. D&O policies typically exclude claims arising out of  
12 deliberate, fraudulent, criminal or malicious acts,  
13 claims in which the director or officer has gained a  
14 personal profit to which the director or officer was  
15 not legally entitled, and claims involving any profit  
16 from illegal insider trading. The policies typically  
17 do not cover dishonest, inappropriate, or willful  
18 criminal acts committed by directors and officers.  
19 These policies do cover the typical daily good faith  
20 business decisions, made by officers and directors  
21 related to management and operation of the business.

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1 Q. Do these exclusions apply to Con Edison's D&O  
2 insurance?

3 A. Yes, they do.

4 Q. Have you prepared or caused to be prepared an exhibit  
5 entitled "Consolidated Edison Company of New York,  
6 Inc. - Cost for Levels of D&O Insurance" which shows  
7 the cost of the Company's insurance?

8 A. Yes. I have prepared Exhibit\_\_ (SS-7).

9 Q. Please describe this exhibit.

10 A. The exhibit shows the specific cost for each level of  
11 coverage. For example, the exhibit shows that the  
12 cost of the first \$135 million of coverage above the  
13 applicable deductible is the sum of the first five  
14 layers of coverage or \$2,814,742.

15 Q. How do companies determine the appropriate amount of  
16 D&O insurance coverage?

17 A. The appropriate amount of D&O insurance coverage for  
18 any particular company is a function of many factors  
19 including the riskiness of its operations, the  
20 location of its operations, the volatility of its cash  
21 flows and share price, whether it is a public or

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1 private company, if it is public then the size of its  
2 market capitalization, its industry sector, and the  
3 D&O loss trends in that industry. An individual  
4 company's evaluation of these factors to determine a  
5 prudent level of coverage cannot be reduced to an  
6 algebraic comparison of that company's coverage to the  
7 average amount of coverage maintained by companies in  
8 a particular industry or a of particular market  
9 capitalization.

10 Q. What steps has Con Edison taken to determine the  
11 appropriate amount of D&O insurance coverage for it?

12 A. In making decisions as to amounts of coverage, the  
13 Company has sought the advice of professionals in this  
14 field. In 2005, our D&O insurance program was  
15 reviewed by outside counsel with expertise in  
16 insurance (Dickstein-Shapiro) and, based on that  
17 recommendation, Con Edison increased its overall  
18 coverage from \$250 million to \$300 million, which is  
19 where coverage remains today. In addition, we  
20 reconfirm annually with our insurance broker, Willis,  
21 that our D&O insurance costs and policies are in line

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1 with similar companies.

2 Q. What else does Con Edison do to test the  
3 reasonableness of the financial limits of its D&O  
4 coverage?

5 A. Con Edison compares its level of coverage with other  
6 large utilities on a periodic basis. The Company  
7 gathers confidential coverage data from utilities with  
8 current market capitalizations greater than \$10  
9 billion by contacting the utilities directly.

10 Q. To what extent does the Company's own survey support  
11 its level of coverage?

12 A. The Company's most recent survey of large utilities  
13 was conducted in 2012 and has the benefit of capturing  
14 two of the several factors identified as more  
15 important in assessing the appropriate amount of  
16 coverage for a company. These two factors are  
17 industry and size. Although these factors are  
18 important to the determination of the appropriate  
19 amount of coverage, they are not dispositive.

20 Therefore, we set our coverage limits in consultation  
21 with the professional expertise of insurance brokers

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1 and outside counsel specializing in the field. We use  
2 our survey to test, not establish, the amount of  
3 coverage.

4 Q. What were the results of the Company's most recent  
5 survey?

6 A. In our 2012 survey, Exhibit\_\_ (SS-8), we found that six  
7 of the fifteen utility companies purchased total D&O  
8 limits of \$300 million or more. The average coverage  
9 amount in our latest survey for the fifteen utilities  
10 with current market capitalization of over \$10 billion  
11 is \$271 million. The median limit in our 2012 survey  
12 of the fifteen utilities with a market capitalization  
13 above \$10 billion is \$250 million. The standard  
14 deviation of the data in the survey is approximately  
15 \$80 million, defining a range of coverage for the  
16 survey results of from approximately \$190 million to  
17 \$350 million.

18 Q. Please summarize the result of the steps taken to  
19 assess the Company's amount of D&O insurance coverage.

20 A. Our experts recommended and reconfirmed the amount of  
21 D&O insurance for the Company. Our survey shows us

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1 that our coverage limits are very close to the average  
2 amount for large utilities. Our survey also shows  
3 that of the utilities in our size range, six of  
4 fifteen have \$300 million or more in coverage. We  
5 think it reasonable that the largest distribution  
6 utility in the U.S., serving the largest, most urban  
7 and one of the most litigious cities in the U.S.,  
8 should have insurance coverage no lower than the  
9 midpoint of other large utilities.

10 Q. What steps does the Company take to control the cost  
11 of this insurance?

12 A. Prior to each annual renewal the Company's Insurance  
13 Department and Senior Management review with our  
14 broker: (a) the current D&O market conditions; (b) a  
15 list of insurance carriers who are currently on the  
16 program and those not on the program who may offer a  
17 competitive choice; (c) the financial stability and  
18 claims-paying reputation of each of these insurance  
19 carriers; (d) our goals for the renewal; (e) other  
20 possible program structures; (f) coverage specifics  
21 and (g) the marketing process itself. Our goal is

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1 appropriate coverage terms and conditions at a fair  
2 and equitable market premium from stable and secure  
3 insurers. We work closely with carriers to secure the  
4 most competitive pricing for each level of insurance.

5 Q. Should the Company be allowed to recover in rates the  
6 cost of \$300 million in D&O insurance coverage?

7 A. Yes. As the Commission determined in the Central  
8 Hudson Gas & Electric Corporation rate cases (Cases  
9 08-E-0887 and 08-G-0888), D&O insurance is a necessary  
10 and reasonable business expense, the cost of which  
11 should be recovered in rates. Rate recovery is  
12 allowed so long as the coverage and premium amounts  
13 are reasonable. As discussed above, the Company has  
14 demonstrated the reasonableness of both its D&O  
15 insurance coverage and premium amounts.

16 Q. Does that complete your testimony?

17 A. Yes, it does.