BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Consolidated Edison Company of New York

Cases 13-E-0030, 13-G-0031 & 13-S-0032

May 2013

Prepared Testimony of:

Craig E. Henry
Supervisor, Utility Accounting
and Finance
Office of Accounting, Audits and
Finance

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

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

financial implications of those activities. As I have recently been promoted to my current position of Supervisor, my responsibilities have expanded to include, among other things, analyzing requests for deferral accounting or approval and recovery of costs and original cost determinations, determining revenue requirements in formal cases and assuring compliance with generally accepted accounting and auditing standards.

Q. Have you testified in any prior regulatory proceedings?

A. Yes. I have testified before the Commission in numerous proceedings, primarily regarding issues related to the cost of capital.

PURPOSE OF TESTIMONY

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

A. The purpose of my testimony is to recommend the fair and reasonable rate of return on the common equity capital (ROE) to be used by the Accounting Panel in conjunction with the overall fair rate of return recommendation proposed by the Capital Structure Panel, to determine the

revenue requirement for Consolidated Edison Company of New York, Inc.'s (Con Edison or the Company) electric, gas and steam operations for the rate year ending December 31, 2014. Accordingly, I will demonstrate the reasonableness of my 8.7% recommended ROE and address all the relevant components of Company ROE witness Hevert's testimony, and in particular why his 10.35% recommended ROE is excessive. I will also respond to certain aspects of the testimonies of Company witnesses Sanders and Lapson, particularly as they relate to the current financial market environment, the Company's credit quality and its ability to access the financial markets at reasonable cost.

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

A. I am sponsoring eighteen exhibits, identified as Exhibit___CEH-1 through Exhibit___CEH-18.

FAIR RATE OF RETURN DISCUSSION

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

revenue requirement.

A. In the context of regulated rate-setting, the revenue requirement is the dollar amount required by the Company to provide service during the rate year. It is the amount that will allow the Company the opportunity to earn a fair return after providing for recovery of all of its reasonably expected operating costs, taxes and depreciation.

Thus, the revenue requirement explicitly includes a fair return that will allow the Company the opportunity to recover the cost of funds supplied to it by investors. The funds provided by these investors are needed in order for the Company to finance its long-term utility assets, which in the rate-setting context are referred to as its "rate base".

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

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

at terms that are reasonable given that particular utility's specific business and financial risks. As further explained by the Capital Structure Panel, investors in debt securities as well as preferred stock instruments enter into contractual obligations with the utility and, with the exception of variable rate debt securities, receive relatively predictable income streams.

Common equity investment, on the other hand, is non-contractual. Common equity investors may share in, but are not guaranteed a portion of the utility's residual earnings. The fair rate of return, such as the one recommended by the Capital Structure Panel, therefore, allows the utility to recover its prudently incurred costs of debt, and preferred stock if any, 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 in a ratemaking proceeding?

A. The fair rate of return for a utility company is calculated through a weighted average of the

individual cost components of the utility's expected capitalization during the rate year. Typically, there are four sources of capital. The two primary sources are long-term debt and common equity. Preferred stock is also commonly employed by utilities and their holding companies although generally in much smaller proportions than either long-term debt or common equity. Lastly, customer deposits, while a very small component, are almost always reflected in the expected capitalization because they are a relatively permanent and stable source of capital employed by utilities.

It is also important that the rate year capitalization reflects the utility's projected rate year capital requirements since the Commission employs a fully forecasted rate year. Finally, as elaborated by the Capital Structure Panel, due to the significantly higher cost of common equity, it is critical that the projected mix of debt and common equity optimize the use of debt leverage such that the overall cost of capital is minimized without jeopardizing the utility's financial flexibility and continued

access to capital at reasonable terms.

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

A. Even though both lenders and equity investors supply the utility with the funds it needs to build, maintain and operate its system, the equity investors only earn a return after the payment of all other expenses. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by equity investors is virtually always higher than that of the utility's debt holders. Exceptions may exist during periods of disturbances in the market such as during the recessionary period of 1980 to 1982, in which 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 returns the Commission allowed and far above the returns allowed by most state regulatory commissions.

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

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

SUMMARY OF ROE RECOMMENDATION

Q. Please explain the methodology you used to determine your 8.7% ROE.

A. I 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 my typical practice in order to determine whether an adjustment to the proxy group's cost of equity is warranted, I examined the differences in business risk and financial risk between Con Edison and my proxy group. I also ascertained 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 fifteen years the Commission has consistently issued cost of equity determinations with the same 2/3 DCF and 1/3 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 practicioned 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, the DCF and the CAPM are by far the least flawed and, that

between the two, the DCF is clearly 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 October 18, 2007 order in Case 06-E-1433, Orange and Rockland - Electric Rates, 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."

I will demonstrate the strengths and reasonableness of using Staff's two-stage DCF methodology. I will also show that my forward-looking application of the CAPM continues to produce a reasonable check on my DCF methodology, and as such should continue to be accorded a one third weighting.

USE OF PROXY GROUP

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

A. The use of a proxy group to determine Con Edison's cost of equity is necessary because its 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, inaccurate and sometimes 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 my analyses, however, I can largely diminish the undesirable effects of biased (both upward and downward) or inaccurate growth estimates or beta measures for any one company. Importantly, I 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 sufficiently large and has similar risks to the company in question.

A careful balance must be struck between these two potentially conflicting goals. While the objective is to select a group of companies whose risks closely match those of the company being examined, it is also important that a group be selected which is also large enough so that we have sufficient confidence in its 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 vagaries or irregularities of the data from any one particular company.

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

A. I selected a group of 35 holding companies from a "universe" of 49 holding companies whose common stock is publicly-traded; all, like Con Edison's parent, Consolidated Edison, Inc. (CEI

or the parent) are deemed by *Value Line* to be "electric utilities". Because of its robust size, I am confident that my proxy group will produce reliable estimates of the Company's cost of equity. I have carefully selected companies that face risks substantially similar to those faced by Con Edison. Illustrated on page 1 of Exhibit___CEH-1 is the list of companies I used, including each company's Standard & Poor's Rating Services (S&P) and Moody's Investors Service (Moody's) credit rating, year ending 2012 percentage of utility revenues, and last three years common equity ratios. On pages 2 and 3, I show the same statistics for the entire Value Line Universe of companies and for Company witness Hevert's proxy group, respectively.

Q. Please explain how you developed your proxy group.

A. Beginning with the 49 publicly-traded holding companies that *Value Line* categorizes as electric utilities, I automatically eliminated ITC Holding 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 48 remaining companies with those of Con Edison, I considered two variables, or screening criteria: the credit quality (debt 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 "A3" by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only ten out of the 49 *Value Line* electric utility holding companies had senior unsecured debt ratings in the "A" categories by either S&P or Moody's, and nearly all derived some revenue from riskier unregulated investments.

Mindful of my goal of achieving a proxy group of companies that is both sufficiently large and with generally similar business and financial risks to Con Edison, I selected only those dividend paying companies with investment-grade senior unsecured debt (BBB- and above by

S&P and Baa3 and above by Moody's), and at least 70% of total revenues from regulated operations. I also included MGE Energy Inc., which is unrated by Moody's, however its principal operating subsidiary is rated A1 and the parent holding company carries a "AA-" rating by S&P.

Although no otherwise-qualifying companies are in the midst of merger-related or corporate restructuring activities during the period I use for determining stock prices, I typically exclude such companies from my proxy group. Excluding these companies, as Company witness Hevert agrees, is reasonable because of the potential for such activity to distort their stock prices and hence their individual cost of equity estimates.

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, by the mid-2000s Staff was faced with somewhat of a dilemma regarding the selection criteria for its proxy group. Primarily due to a broad deterioration in electric utility credit quality, the number of potential candidates for our proxy group had dwindled to as few as three companies, depending upon the specific interpretation given to "substantial" with respect to regulated revenues.

The larger picture is that 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 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, has meant that lowering the credit quality threshold is the most logical and reasonable response to maintain an adequate number of candidate companies.

In this case, just as in all recent Con Edison electric, gas and steam rate cases since Case 07-E-0523, and consistent with recommendations by Staff in other recent cases involving combination electric and gas utilities, I have determined that the most reasonable proxy group for determining Con Edison's cost of equity is one in which all of the parent holding companies serve retail customers, have investment-grade senior unsecured debt ratings, and receive a minimum of 70% of total revenue from regulated operations.

Q. 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 in order 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 revenue?

A. As illustrated on page 1 of Exhibit___CEH-1, the average S&P rating of the proxy group is modestly weaker than "BBB+," and for Moody's, it is modestly stronger than "Baa2" and, on average, the group receives about 90.0% of its revenues from regulated operations.

DISCOUNTED CASH FLOW METHODOLOGY

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

A. The DCF approach can be applied to any investment instrument that has an intrinsic

value. The DCF approach, as it relates to common stock, recognizes that companies create value for their stockholders by using their earnings in a number of ways. 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 and means more cash flow is available to stockholders, and by buying back some of the company's common stock – which increases future earnings on a *per share* basis.

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

companies earn the same return on retained earnings as the market demands on their common stock.

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

The main reason that the DCF methodology continues to be the preferred approach for determining a utility's cost of equity is that investors' immediate return requirements, as observed in current stock prices and dividends, are readily quantifiable. The other principle methodology, the CAPM, only relies tangentially

(through the use of utility beta values) upon direct observations of actual utility investor behavior. The primary challenge in applying the DCF is determining the rate of growth in future dividends that investors expect.

Given the relatively 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). I say "generally track" due to the fact that, as I will explain later in my testimony, the U.S. economy continues to move away from a manufacturing economy to a service economy, and as a result, retail electric sales growth should not be expected to grow quite as fast as the economy as a whole.

Moreover, just as nominal GDP growth also incorporates gains achieved through the application of new technologies (otherwise known as productivity) and the effects of changes in

price levels, these investors' growth expectations too will reflect assumptions regarding productivity gains and the rate of inflation. Consequently, when practiced with the application of well-reasoned growth rate estimates, such as the ones used in my 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. Typical of the Commission's stated preference for the DCF methodology is its statement on page 133 of its April 24, 2009 Order in Case 08-E-0539 Con Edison – Electric Rates, where it states that among the reasons its accords 2/3 weight to the DCF methodology is that: "As DPS Staff points out, 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 discounted cash flow methodology and its result.

A. I 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. My "dividend discount" model forecasts those future cash flows, which are dividends, 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 simplistic traditional DCF model, with its assumption of constant growth.

The calculation of the DCF for my proxy group is shown on pages 1 and 2 of Exhibit___CEH-2. For each company in the proxy group, I calculated a three-month average stock price by averaging the high and low price for each month. I used the three-month period

ending April 2013. The model also contains *Value Line* data for earnings per share, dividends per share, book value per share and the forecasted amount of outstanding common stock for each company.

This data is used to estimate the future dividend payments that investors expect for each of the companies. The price that investors are currently willing to pay for that future stream of dividends, here the average stock price taken over the three-month period ending April 2013, is essentially the present value of those expected dividends. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, I 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, I employed a two-stage DCF method. In the near-term, I used *Value Line's* forecasted dividends. For the second stage, essentially 2017 and beyond, I calculated a "sustainable growth" rate 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. My 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 are the average and median sustainable growth rates of your proxy group?

A. The average sustainable growth rate is 4.28% and the median, at 4.24%, is slightly lower.

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

A. Yes. As I generally do, I compared the sustainable growth rate of my proxy group with the most recent consensus long-range growth estimate of nominal GDP. As illustrated in

Exhibit___CEH-3, according to the March 10, 2013 edition of *Blue Chip Economic Indicators*, the consensus long-range estimate of nominal GDP growth is 4.6% for the most distant period forecast, 2020-2024. Thus, as I expected it would be, my sustainable growth rate is modestly lower than the projected growth rate in the overall economy.

It should be noted that the 4.6% nominal GDP growth rate estimate itself is comprised of two components: Real GDP growth of 2.5% and an inflation rate of 2.1%. The long-run projections generally show annual Real GDP steadily tapering from a high rate of 3.1% in 2015 to the aforementioned 2.5% growth rate, while inflation is forecast to hold steady at 2.1% from 2015 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, and 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 slower-than-average growth prospects, it is not unreasonable to expect future dividend growth to be slower than that of overall economy.

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

A. As shown on page two of Exhibit___CEH-2, the median return on equity of the proxy group is 8.19%. 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 many of the individual company results appear reasonable, I would not recommend a cost of equity based on any of the individual results themselves because of the potential for biased or inaccurate *Value Line* growth estimates to improperly influence the result. While *Value Line*'s estimates are based on its own in-house

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

Further, my approach obviates the need to inject personal judgment and to toss out any of the individual results that appear unreasonable because my proxy group is of sufficiently large enough size and I 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 sixty or more) such that the overall risk of that portfolio, in terms of the variability of its returns, is identical to that of the market as a whole. Thus, the only risk that matters in the CAPM equation is said to be "systematic" risk, or that which 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 company are said to affect its "unsystematic" risk.

According to the CAPM, the appropriate way to measure an individual stock's risk is through a correlation of its return relative to the

market as a whole, known as beta. A stock with a beta of 1.0 has a return that mirrors the return of the "market" (usually the S&P 500) as a whole. Betas of less than one, which are typical for utility stocks given the moderating influence of regulation, indicate that the stocks are less volatile than the market as a whole.

In the case of stocks with betas less than 1.0, as has been a hallmark of the utility industry, the CAPM informs us that investors will only be compensated for their actual risk, as measured by beta. In other words, their return requirements will reflect the degree to which they 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 (Rf), the level of systematic risk for an investment (B for beta), and the expected market risk premium (MRP). Typically the MRP itself is calculated

or measured by subtracting the risk-free rate from the expected market return (Rm). The form that the traditional CAPM takes is as follows:

Required Return = Rf + (B * MRP)

Q. How did you begin your CAPM analysis?

A. Consistent with the approach Staff has employed and the Commission has used for more than fifteen years, I used two different CAPM methods, the Traditional approach which I have already discussed and a Zero Beta calculation. My 9.64% CAPM-derived ROE estimate is the average of the results of these two analyses.

Q. Why do you employ two CAPM methods?

A. Because a considerable body of research has shown that the Traditional CAPM may underestimate required returns when betas are below 1.0, 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 veracity of my overall CAPM ROE determination.

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

your analyses?

A. I 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 April 2013, is 2.49%.

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

A. As I will elaborate later on, utility investors have both intermediate and long-term investment horizons. I note as well that on page 75 of its June 17, 2011 order in Case 10-E-0362, the Commission stated its preference for the same approach, stating that it is reasonable to employ the average of 10- and 30-year Treasuries due to "…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 Con Edison's 2009 Electric Rate Order to be consistent with the three-month timeframe employed in its DCF cost of equity determination. Since I am employing the most recent three months of market data in my DCF

calculation, I believe that consistency dictates that here, as well, it is best to employ three months of long-term Treasury yield data in my CAPM analyses.

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

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

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

A. As a practical matter there currently is no difference, as the average beta of the group is also .70. Nonetheless, over time the use of the median beta is desirable for the same reason that I use the median return of the individual results in my DCF analysis – to diminish undue influence of any outlying individual results. Also 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 I explained earlier in my 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 its June 17, 2011 order in Case 10-E-0362, Orange and Rockland – Electric Rates that the median beta was appropriate.

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

A. As I 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, I employed an *ex-ante* analysis, relying upon required market return estimates published monthly by Merrill Lynch in its *Quantitative Profiles* report. Specifically, I used the February 2013, March 2013 and April 2013 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 12.18%. I have illustrated the

appropriate pages from each of those reports in Exhibit___CEH-4. Finally, given my risk-free rate of 2.49%, I calculated the expected MRP to be 9.69% by subtracting the risk-free rate from the 12.18% 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, I use expected market return estimates provided over the most recent three months in order to be consistent with the time-frames of the other data inputs employed in my CAPM and DCF equations. By matching the timeframe upon which my risk-free rate is calculated, I can achieve a more representative estimate of the required market risk premium.

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. 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)?*

Yes, as far back as in its October 3, 1996 order in Case 95-G-1034, Central Hudson Gas & Electric Corporation – Gas Rates, the Commission stated on page 14 that, "…the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problem of stale data in the Ibbotson estimate…"

Q. 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, are highly problematic.

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 typically relied on *Value Line*

reported betas, as they are calculated over a period (five years) long enough to produce reliable estimates, and also because *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 be quite different, and thus can produce very different cost of equity estimates.

My greatest concern with the CAPM methodology, however, remains the derivation of the MRP. Like beta, the MRP should be the expected average premium of the market over the risk-free rate. 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, I do not employ a historically-derived MRP specifically because of its inability to reflect either present economic conditions or the effects of ongoing structural shifts in the economy. While I advocate using an expected MRP in my CAPM methodology, I 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 your stated inputs, what is your Traditional CAPM result?

A. 9.27%, calculated as follows:

2.49% + [0.70 * (12.18% - 2.49%)] = 9.27%

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 times beta times the MRP and adding .25 times the MRP. This can be expressed as: Required return = Rf + (.75 * B * MRP) + (.25 * MRP)

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

A. 10.00%, calculated as:
2.49% + [.75*.70*(12.18%-2.49%)] + [.25*(12.18%-2.49%)] = 10.00%

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. I averaged the results of the two CAPM methods to arrive at a determination of 9.64%. This is the same approach that has been used in rate cases by the Commission for years.

RETURN ON EQUITY CONCLUSION

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

A. By weighting my 8.19% DCF result two-thirds, and my 9.64% CAPM result one-third, and rounding that result to the nearest tenth of a percent, I determined my proxy group's cost of equity to be

8.7%. My calculations are shown on page 3 of Exhibit___CEH-2.

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. As pointed out by Company witnesses Sanders and Lapson, the Company's long-term, senior unsecured debt ratings are "A-" and "A3," respectively, and both have stable outlooks. The comparable average credit ratings for my proxy group, and for Company witness Hevert's proxy group for that matter, are materially weaker. Both proxy groups have average S&P ratings of slightly less than "BBB+" or just

over one notch weaker, and average Moody's ratings of slightly higher than "Baa2" or just under two notches.

Q. Do you recommend an adjustment to your 8.7% ROE given Con Edison's superior credit quality vis-à-vis your proxy group?

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, I am unable find objective evidence indicating that material differences exist in the return requirements of investors within the relatively narrow band of utilities of investment grade. Specifically, after reviewing the DCF returns for each of my proxy group companies, I am unable to discern any meaningful correlation between the indicated return requirements of the individual companies and their respective levels of credit quality. However, as I will elaborate later in my testimony, given the evidence that the Company's collective business and financial risks are less than that of either mine or Company witness Hevert's proxy groups, it is likewise clear that

there is no credible evidence to support an upward adjustment based upon any of the reasons raised by Company witnesses Sanders, Hevert and Lapson

Q. Based upon your examination of the Company's filing is there any need to adjust your 8.7% ROE to reflect reasonably anticipated common equity issuance expenses during the rate year?

A. No. The Company is not proposing to issue any common equity during the rate year. Therefore, no adjustment is necessary.

Q. Would you please explain why your 8.7% recommendation is significantly lower than the Company's currently authorized ROEs?

A. To begin with, Con Edison's currently authorized ROEs are quite stale, as all of the Company's divisions are now operating under multi-year rate plans that expire this year. Con Edison's electric operations are currently authorized an ROE of 10.15% and the gas and steam operations are authorized ROEs of 9.6%. The electric ROE was proposed by a Joint Proposal dated November 23, 2009 that was adopted by the Commission in March 2010, while the gas and steam ROE was

proposed by a Joint Proposal dated May 18, 2010 and adopted by the Commission in September 2010. In both cases, the ROEs reflect the considerably different underlying economic conditions that existed when the respective Joint Proposals were entered into. Additionally, as is the case in nearly all New York multi-year rate plans, each of the ROEs also reflects a premium of 30 to 50 basis points in recognition of the added financial and business risk associated with the resulting stayout provision.

Q. Compared to today, what were economic conditions like well over three years ago when the Electric Joint Proposal was entered into in November 2009?

A. As illustrated in Exhibit___CEH-5, economic conditions were such that investors were requiring yields of 5.64% for long-term "A" rated utility debt, 4.24% for 20-year Treasury securities and 5.65% for CEI's common stock. Currently, investors' yield requirements for each of those instruments are at least 160 basis points lower, indicating the lower return requirements of investors today. As of April

2013, investors currently require a yield of 4.00% for long-term "A" rated utility debt, a yield of 2.55% for 20-year Treasury securities and 3.96% for CEI's common stock. Similarly, the 3.95% yield requirement on the Company's March 2013 30-year long-term debt issuance is much lower than the 5.50% yield required by investors for its 30-year issuance in December 2009.

Q. How does your 8.7% ROE recommendation compare to the current yield requirements of investors of long-term Baa-rated utility debt and 20-year Treasury obligations?

A. Once again as can be gleaned by viewing the data illustrated in Exhibit___CEH-5, my 8.7% ROE recommendation is 421 basis points higher than investors 4.49% current yield requirements for long-term Baa-rated utility debt and 615 basis points higher than 2.55% current yield requirement on 20-year Treasuries. I compare my recommendation with long-term Baa rated utility debt, because the majority of utilities are in this ratings category.

Q. How does the 421 basis point spread above

current long-term Baa-rated utility debt obligations implied by your 8.7% ROE recommendation compare with historical spreads between authorized ROEs and the yields on long-term Baa-rated utility debt?

A. As illustrated in Exhibit___CEH-6, over the past 20 years, the average spread between nationally authorized electric ROEs and long-term Baa rated utility debt has only been 374 basis points. Over the past ten years the average spread has been 422 basis points, virtually identical to my 421 basis point spread.

Q. How does the 615 basis point spread above current 20-year Treasury obligations implied by your 8.7% ROE compare with historical spreads between nationally authorized ROEs and the yields on 20-year Treasuries?

A. As illustrated in Exhibit___CEH-6, over the past 20 years, from 1993 through 2012, the average spread between nationally authorized electric ROEs and 20-year Treasury securities has only been 556 basis points. Over the past ten years, from 2003 through 2012, the spread has been 615 basis points, the same as mine.

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 10.35% 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 well aware that recent authorized ROEs are much closer to my 8.7% ROE.

Q. Does Con Edison 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 *Credit Suisse Energy Summit* on February 5, 2013, a copy of which is presented in Exhibit___CEH-7. On pages 26 through 28 of his presentation, Mr. Hoglund not only describes the mechanics of the Commission's

preferred methodology, he also indicates that actual authorized ROEs, most of which were for multi-year rate plans, have ranged between 9.2% and 9.6% since June 2011.

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

A. Certainly, there are numerous examples of equity research reports acknowledging this information. I will cite from three such reports, full copies of which are illustrated in Exhibit___CEH-8. First is a research report by *Goldman Sachs,* dated October 23, 2011, that notes on page 3 how "NY state regulators generally utilize a formulaic approach to setting authorized ROEs" and also that "recent authorized return levels granted reached levels below 9.5%". More recent is a research report by *Morgan Stanley* dated January 30, 2013, which takes note of recent settlements in lowering its earned ROE estimate to 9.1%. Finally, I point to a report by *Wolfe Research* dated May 3, 2013, which points out that a key issue in the Company's current rate request is that allowed ROEs have been around

9.3% to 9.5%, in contrast to Con Edison's requested 10.35% ROE.

FINANCIAL INTEGRITY

Q. Company witnesses Sanders and Lapson have pointed out the importance of the outcome of the contemporaneous rate proceedings to the credit-worthiness and investment standing of Con Edison, in particular as to how it relates to the Company's ability to access the markets for new capital at reasonable terms. These witnesses have also portrayed the Company's financial metrics as being weaker than those of its peers. Could you please comment on these assertions, and explain what impact Staff's recommendations should have on the Company's ability to continue to attract capital at reasonable terms.

A. To begin with, because Con Edison like most other regulated utilities has an ongoing need to raise capital to support a growing rate base, I agree that it is important to assure a credit profile that will enable it to continue to do so at terms that are reasonable.

Q. How has the utility industry's access to capital

been impacted by current economic conditions?

A. According to recent S&P and Moody's industry reports, utilities continue to enjoy favorable access to the markets. Specifically, as illustrated in Exhibit___CEH-9, in its April 19, 2013 *Industry Report Card,* S&P states: "While the recovery may lead to a modest increase in demand, macroeconomic factors generally affect the financial performance of utilities modestly, certainly relative to many other industries. The essential services that the utility sector provides, limited competitive pressures, and the rate-regulated nature of the business enable them to generate reasonably stable and predictable cash flows through timely recovery of the bulk of their costs from customers, despite economic conditions and the challenge of substantial capital investment. In addition, the U.S. utility sector continues to enjoy favorable access to debt and equity capital markets."

Q. What do the two credit agencies say with respect to Con Edison in particular?

A. As illustrated in Exhibit___CEH-10, in its

December 14, 2012 *Credit Opinion* of Con Edison, Moody's notes: "CECONY's A3 senior unsecured rating reflects its size and scale, as well as its ability to generate stable and predictable cash flows through low-risk regulated transmission and distribution operations in its attractive franchise area." The Moody's report also indicates that because of these characteristics and the Company's strong balance sheet, Con Edison has "better than average flexibility to manage through periods of stress." Meanwhile, in its October 22, 2012 *Ratings Summary*, illustrated in Exhibit___CEH-11, S&P observes that "the Company has good relationships with its banks, in our assessment, and has solid standing in the credit markets."

Q. How do you find that the Company's metrics compare to its peers?

A. In order to test the premise of Company witnesses Lapson and Sanders that Con Edison generally has weaker metrics than its peers, I examined the Company's financial performance over the past ten years and compared it to the performance of its peers. The results of that

study, which are summarized in Exhibit___CEH-12, indicate that Company's overall financial performance has generally exceeded that of its peers, which really is not surprising after all, given that Con Edison's "A-,A3" credit ratings are stronger than my proxy group's "BBB+, Baa2" average credit ratings.

Q. Please explain how you conducted this study.

A. Using financial information reported by Capital IQ, an affiliate of S&P, I calculated the following eight measures of financial performance for Con Edison and for all of my proxy group companies over the past ten years: 1) Year-end Common Equity ratio; 2) Return on Average Common Equity; 3) Earnings Before Interest and Taxes (EBIT) Interest Coverage; 4) Earnings Before Interest and Taxes including Depreciation and Amortization (EBITDA) Interest Coverage; 5) Average Debt to EBITDA; 6) Funds From Operations (FFO) to Construction Expense; 7) Depreciation and Amortization to Construction Expense; and 8) Dividend Payout Ratio.

Q. Why do you compare the Company's financial performance with the electric utility holding

companies comprising your proxy group?

A. Because both myself and Company witness Hevert utilize proxy groups of electric utility holding companies to establish the Company's cost of equity, it is the financial performance of these electric utility holding companies that is the relevant peer comparison. Throughout their testimonies, Company witnesses Hevert and Lapson repeatedly compare Con Edison with other electric utility operating companies. Such a comparison is inappropriate because, as is Con Edison, these electric utility operating companies are only part of larger holding company structures, most of which also own other riskier businesses.

As illustrated on page 2 of Exhibit___CEH-13, in its November 26, 2008 report titled "Key Credit Factors: Business and Financial Risks In The Investor-Owned Utilities Industry," S&P notes that "this fact does not alter how we analyze the regulated utility, but it may affect the ultimate rating outcome because of any higher risk credit drag that the unregulated activities may have on the utility." The flaw

in comparing Con Edison's financial performance to electric utility operating company data, for the purpose of substantiating the reasonableness of ROE estimates based upon holding company proxy groups, is that the higher risks of the holding companies' non-regulated businesses are not reflected in the operating company results. These risks are only captured in the consolidated financial results of the holding companies.

Q. Please summarize your results and explain your reasons for concluding that the Company's financial performance has generally exceeded its peers.

A. As illustrated in Exhibit___CEH-12, Con Edison has consistently employed less leverage than its peers, as indicated by its 49.4% average common equity ratio over the past ten years versus 45.2% for its peers. In recent years the Company has achieved slightly lower ROEs than its peers; 9.58% over the past three years versus 9.78% for its peers. When all ten years studied are considered, however, Con Edison has achieved modestly higher returns than its peers;

9.90% versus 9.79% for its peers. Based largely upon these differences in capitalizations and earnings, the Company has been able to achieve significantly better EBIT interest coverage than its peers; 3.57 times versus only 2.97 times for its peers. Similarly its EBITDA Interest Coverage and Average Debt to EBITDA metrics have been consistently stronger than its peers.

What the next two metrics, both of which incorporate construction expense, show is that the Company's depreciation recoveries relative to its construction expense were somewhat of a relative weakness until very recently. Because of this dynamic, Con Edison's FFO relative to its Construction Expense was slightly lower than its peers over the full ten year period, but is now materially better. Overall, I believe the data from this study clearly indicate that, despite any of the perceived concerns raised by the various Company witnesses, Con Edison has generally been able to achieve financial results that are superior to its peers.

Q. Company witnesses Sanders and Lapson both generally imply that Con Edison's ability to

attract capital at reasonable terms could be jeopardized unless it's requested 10.35% ROE and capital structure with a 50.24% common equity ratio are authorized. Do you agree?

A. Absolutely not. As I explained earlier, the Company is already materially stronger than its peers and is thus able to attract capital on more favorable terms than its peers. Moreover, as illustrated in the third column in Exhibit___CEH-12, granting the Company's request, including its requested recovery amounts for depreciation and amortization would produce financial metrics that far exceed those of its actual performance over the past ten years, and which already exceed its peers. Specifically, if the Commission were to adopt all of the Companies recommendations, its 4.27 times rate year EBIT interest coverage would vastly exceed its 3.57 times ten-year average. Similarly, it's 6.07 times EBITDA would far exceed its 4.95 times ten-year average.

Q. How do the EBIT interest coverage and EBITDA interest coverage ratios implied by your 8.7% ROE, the Capital Structure Panel's 48.0% common

equity ratio and Staff's recommend depreciation and amortization figures compare to the Company's ten-year averages?

A. Our recommendations would result in an EBIT interest coverage ratio of 3.55 times, only marginally lower than the Company's average 3.57 times over the past ten years and our 5.11 times EBITDA interest coverage would materially exceed the 4.95 times ratio achieved by the Company, on average, over the past ten years. I note also that the figures shown in the column labeled "Staff 2014" also reflect Staff adjustments to the Company's rate base and proposed capital expenditures as well as Staff's estimate of the cash flow impact of net deferred income taxes during the rate year.

Q. Do you recommend updating the cost of equity later in this proceeding?

A. Yes. I recommend updating the cost of equity estimate later in this case, consistent with Case 26821, Policy Statement on Test Periods in Major Rate Proceedings (issued November 23, 1977).

DISCUSSION OF COMPANY PRESENTATIONS

Q. You have stated that Company witness Hevert's 10.35% recommended ROE is excessive and should be rejected. Would you please summarize the approach followed by Mr. Hevert?

A. To arrive at his recommendation, Mr. Hevert performed two multi-stage DCF analyses, one a two-stage model and the other a three-stage version of the model. He also performed twelve separate CAPM analyses, essentially by employing both the Traditional and "Zero-Beta" forms of this approach under three separate sets of beta determinations and under two separate market-derived MRPs. He then weighted his 10.35% average DCF result two-thirds and his 10.26% average CAPM result one-third to comply with the Commission's stated preference, and added 0.03% for hypothetical flotation costs, and concluded a 10.35% cost of equity.

Q. What are your principle points of contention with Mr. Hevert's analyses?

A. Overall my concerns can be summarized as follows: 1) the composition of his proxy group; 2) the use of excessive growth rates in his DCF analyses; 3) the use of flawed approaches to

establish the various inputs employed in his CAPM analyses, principally his excessive market return estimates; and, 4) the inclusion of flotation costs.

A. Please explain the concerns you have regarding the composition of Mr. Hevert's proxy group.

A. As a practical matter I do not have major concerns with the composition of his proxy group as his selection criteria are not all that different from mine. Nonetheless, he does manage to exclude five companies, all included in my proxy group, that are perfectly suitable surrogates for Con Edison, and should thus be included in any proxy group analysis of the Company. He also includes two companies, Dominion Resources and OGE Energy Corp. that, based upon their slim percentage of utility revenues (only 56.2% and 41.7% in 2012, respectively), do not appear to be suitable surrogates.

I also note that he injects unnecessary subjectivity into his selection process, as two of the five suitable surrogates that he excludes from his proxy group, specifically CEI and

Edison International, meet all of his selection parameters. He asserts that the reason he removes CEI from his proxy group, is because it is his usual practice to avoid the alleged circular logic that would arise by including the subject company from his proxy group. Even if I disregard the fact that he presents no evidence indicating that using the results of CEI introduces any circularity, the fact remains that CEI is not the subject company here. In fact, by excluding CEI from his proxy group, his results fail to capture the data of a company that by virtue of its relatively rare T&D nature and geographic location is, in fact, the most comparable electric utility holding company to Con Edison.

With respect to Edison International, his stated reason for removing it from his proxy group is because the company had a significant amount of unregulated losses in 2009 and 2011. Just like CEI, however, its results should be reflected in his proxy group. After all, the whole reason for employing screening criteria in the first place is to remove any unnecessary

subjectivity. At the very least, if Mr. Hevert felt that the inclusion of either of these two companies could conceivably skew his results, he could, as I do, employ the median result.

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

A. Mr. Hevert performed a two-stage DCF model somewhat similar in form to mine and a three-stage version as well. While I can understand and appreciate the rationale he used to support the use of a three-stage model, in practical terms it does not appear that the alleged benefits of the second model make much difference. The 10.32% result of the three-stage model was not significantly different from the 10.39% result of his two-stage model. These minor differences lead me to the conclusion that there is no added value gained by using this additional approach. In sum, I do not have serious concerns with the forms of the DCF model he employs, but I do find serious flaws in the manner in which he has employed them. It is because of the numerous faulty assumptions

underpinning his DCF analyses that I strongly recommend they be rejected.

Similar to my own approach, both forms of Mr. Hevert's DCF analyses define the cost of equity as the discount rate that sets the current stock price of his proxy group companies equal to the discounted value of their projected dividends. Likewise, similar to my rationale for employing a two-stage dividend discount model, Mr. Hevert too acknowledges that growth rates in the near-term and long-run might reasonably be expected to diverge. Specifically he notes that expected dividend payout ratios for utilities may decrease during periods such as now when utilities are undergoing a cycle of relatively high capital expenditures. This can readily be seen by looking at the average *Value Line* projected payout ratios of his proxy group, which are forecast to decline from about 65.7% in 2013 to about 62.1% in 2017.

In both of his models, Mr. Hevert projects dividends through 2016, or the near-term, as the product of the average of earnings growth rate estimates provided by *Zacks, ValueLine* and

Thomson First Call and *Value Line* projected payout ratios. Both the two-stage and three-stage models then assume that, beginning in 2017, the earnings of the proxy group companies will all grow at a rate equal to what Mr. Hevert calculates the projected nominal GDP to be. Further, both models assume that their dividend payout ratios will revert to 66.67%, the ratio Mr. Hevert professes to be their long-term norm.

In the case of the two-stage model, the transition from the *Value Line* projected 2016 payout ratio of each of the individual companies in Mr. Hevert's proxy group to his assumed 66.67% long-term norm ratio occurs at once in 2017. In his three-stage model he smoothes this transition over a five year period. As a result, in the case of his two-stage model, the impact on the projected dividends also occurs in 2017, such that any abrupt change resulting from the use of Mr. Hevert's assumed long-term ratio is also reflected in that particular dividend. Finally, the model assumes that all subsequent dividends grow at Mr. Hevert's nominal GDP rate. For the three-stage model the change in the

payout ratios from their *Value Line* projected 2016 levels to his 66.67% long-term norm payout ratio is transitioned through the years 2017 to 2022, and his projected dividends during those years reflect this convergence accordingly. He then assumes that beginning in 2022 all dividends will grow at his nominal GDP rate.

Q. Please explain the concerns you have with the manner in which Mr. Hevert projects his near-term dividends.

A. I have two principle concerns with the manner in which Mr. Hevert projects his near-term dividends. First, even though he specifically recognizes that the analysts' near-term earnings growth estimates he uses only apply to the near-term and that thereafter they are effectively superseded by his long-run nominal GDP growth rate, Mr. Hevert excludes Ameren from his DCF analyses because of its negative near-term earnings growth estimates. Given that there are several instances in which one publication or another supplies near-term earnings growth estimates that far exceed even his excessive nominal GDP growth rate, and that Mr. Hevert did

not see fit to exclude any of these estimates from his analyses, I find his approach to be somewhat biased.

My second concern with the manner in which Mr. Hevert projects his near-term dividends lies with his stated reason for using multiple sources for earnings growth estimates. Rather than relying on *Value Line* dividend growth projections in conjunction with their counterpart forecasted payout ratios as I have done, Mr. Hevert asserts instead that his approach is superior because it mitigates any potential bias that might be introduced by relying solely on *Value Line* as the single source for earnings growth rates. However, because he fails to provide any evidence that the *Value Line* estimates, upon which Staff and the Commission have reasonably relied for many years, and a facet of New York regulation that is generally understood by the investment community, I believe his approach is unnecessary and should be rejected.

His reliance on several sources is also problematic because it does not allow for a

direct "apples to apples" comparison, as neither *Zacks* nor *Thomson First Call* offer any advice regarding the impact of their earnings growth forecasts on the respective payout policies of his proxy group companies. Consequently, because Mr. Hevert's near-term dividend projections are a direct product of the average earnings growth estimates of three different publications, but the projected payout policies of only one of these publications, namely *Value Line*, they are inherently mismatched and should not be relied upon by the Commission.

Q. How does Mr. Hevert derive his long-run dividend projections?

A. As I explained earlier, Mr. Hevert projects the long-run dividends of his proxy group companies premised upon his assumptions that earnings in the long-run can be expected to grow at a rate equal to projected nominal GDP, and that utility dividend payout ratios will revert to what he refers to as their long-term norm.

Q. What concerns do you have with Mr. Hevert's assumption that the long-term norm payout ratio of the electric utility industry is 66.67%?

A. I find that Mr. Hevert has not adequately substantiated his 66.67% payout ratio. While I agree that the 66.67% may very well represent the actual average of the annual median payout ratios of his proxy group companies under the prevailing economic conditions over the past 20 years, his analysis is lacking because he presents no evidence connecting how the economic conditions anticipated in the future would lead investors to assume the average industry payout ratio over the past 20 years. Given that the past 20 years has been a particularly transformative period for the electric utility industry, it is questionable whether investors would find that historic payout ratio to be a suitable surrogate for the future.

Q. Please explain how Mr. Hevert derives his projected nominal GDP and your concerns with his approach.

A. In order to calculate his estimate of nominal GDP, which can best be thought of as the long-term growth rate of the economy as a whole, including expected inflation, Mr. Hevert incorporated two separate elements. First, he

utilized the 3.24% historical growth in real GDP for the period 1929 through 2011, which was calculated as the compound growth rate in the chain-weighted GDP for that period. He then concluded his 5.79% forecasted nominal GDP rate by taking this historical figure together with his expected inflation rate of 2.47%, which Mr. Hevert explained was calculated based upon the compound annual Consumer Price Index (CPI) growth rate and the compound annual GDP Price Index, averaged with the yield spread between the 30-year Treasury Inflation-Protected Securities (TIPS) and nominal 30-year Treasury bonds.

As I will explain, both of these components are flawed. His 2.47% expected inflation rate is inappropriate because of his reliance on expected price changes in the CPI. Unlike the GDP deflator, the CPI does not measure inflation over the entire economy. Additionally, his use of the 3.24% historical real GDP growth rate from 1929 through 2011 is inappropriate because historical averages, while instructive, are simply poor indicators of future economic

activity. As I explained earlier, there is a much better source regarding future economic growth, one that builds upon historical trends, and most importantly takes into account current economic conditions, and that is the *Long-Range Consensus U.S. Economic Projections* provided by *Blue Chip Economic Indicators.* Not only does this report venture out into the future twice as far as nearly any other reputable source of economic data, it also reflects the consensus of the views of some 50 of the financial community's most prominent economists.

According to the March 10, 2013 publication, and as illustrated in Exhibit___CEH-3, the consensus long-run nominal GDP growth rate is 4.6%, which includes both real GDP and expected inflation components. Thus the consensus view of leading economists is considerably less robust about the future growth rate in the economy than Mr. Hevert, and in my view clearly indicates that the nominal GDP growth rate employed by Mr. Hevert in his analyses is excessive.

Q. Do you agree with Mr. Hevert's assumption that

the long-term nominal GDP rate is a reasonable proxy for the long-term dividend growth rate in multi-stage DCF analyses?

A. No, I do not. In these proceedings, just as I generally do, I compared the long-run sustainable growth rate of my proxy group to *Blue Chip's* long-run nominal GDP estimate. I think of this comparison as a sanity check regarding the sustainability of my long run growth estimate. According to Mr. Hevert, however, his assumption is based upon the "common theoretical assumption that, over the long-run, all the companies in the economy will tend to grow at the same constant rate." I disagree with Mr. Hevert because there is ample evidence suggesting a reasonable investor would expect a slower long-term growth rate for the electric utility industry.

Q. Please elaborate.

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___CEH-14, the electric utility industry really 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 one, electricity sales have grown more slowly than the overall economy. My own research, contained in Exhibit___CEH-15, clearly demonstrates the impact of this transformation; while the average real GDP growth rate over the past 30 years has been 2.86%, the growth in total retail electric sales has only averaged 1.94%.

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

A. Exhibit___CEH-16 supports my 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 page 123 of its April 2013 *Annual Energy Outlook 2013* (page 133 of 244), the U.S. Energy Information Administration (EIA) calls for annual growth rates in purchased electricity between 2011 and 2040 of 0.7% for the residential sector, 0.8% for the commercial sector and 0.6% for the industrial sector. I note as well, that on page 92 of its report (102 of 244), the EIA notes

that its base case "projects 2.5% average annual GDP growth from 2011 to 2040, consistent with trends in labor force and productivity growth."

Q. Are there any other reasons you expect that a truly mature and rate-regulated industry such as the electric utility industry can be expected to grow at a slower rate than the overall economy?

A. Yes. As illustrated in Exhibit___CEH-12, the average payout ratio for my proxy group has been around 63.0% for the past ten years. However, as illustrated on page 133 of the Staff Finance Panel's Exhibit in Case 11-E-0408, Orange and Rockland – Electric Rates, Mr. Hevert calculated in response to DPS-110 in that case that the median payout ratio for the S&P 500, which is commonly referred to in rate of return testimony as "the market," since 1994 has been 38.4% and was only 27.8% in 2010.

These divergent payout policies have significant implications in terms of investor expectations of sustainable long-term growth. Simply put, companies such as electric utilities with lower retention ratios, because they pay out substantial portions of their earnings in

the form of dividends, cannot be expected to have the same "headroom" to grow their dividends in the future as do companies that retain a majority of their earnings presumably to fund future growth opportunities.

While Mr. Hevert has pointed to some academic studies that found future earnings growth to be associated with high, rather than low payout ratios, it is extremely difficult to imagine how such logic could apply to the franchise-constrained, rate-regulated electric utility industry, where investors would be hard pressed to envision opportunities for extended periods of extraordinary growth.

Indeed, when one considers that the electric utility industry's base rates are, by and large, set on an original cost or book value basis, it is readily apparent that Mr. Hevert's 5.79% long-run growth rate estimate is not sustainable given his assumed long-run industry payout ratio of 66.67%. In order for the industry to maintain a long-run growth rate of 5.79%, while at the same time retaining only 33.33% of its annual earnings, the industry

would have to achieve an improbable annual return on the average book value of its common equity of 17.37%. Given the industry's high historical payout ratios, together with the fact that the average authorized ROE for the past 20 years has only been about 10.9%, it is extremely difficult to imagine how a rational investor would conceive of a long-run growth rate anywhere near as high as Mr. Hevert's 5.79% growth rate.

Q. Would you please summarize Mr. Hevert's CAPM approaches?

A. Mr. Hevert provided a total of twelve ROE estimates using the same CAPM methodologies that I use. He calculated six using the Traditional CAPM methodology and another six using the Zero-Beta CAPM methodology. The reason that he calculates twelve different ROE estimates, however, is because he elects to use three different beta determinations in combination with two different MRP estimates, and thus he calculates six estimates each within the respective frameworks of his Traditional and Zero-Beta methodologies.

Q. Please explain how Mr. Hevert derived each of the three major components used in his CAPM methodology.

A. As I explained earlier, both the Traditional and Zero Beta CAPM methods require three major inputs: the risk free rate, beta and the MRP, which itself requires an estimate of the expected market return. Both Mr. Hevert's Traditional and Zero-Beta CAPM methodologies use a risk-free rate of 2.86% based on the three-month average yield on 30-year Treasury bonds. To arrive at his 10.14% and 10.15% MRP estimates, he subtracts the 2.86% three-month average yield of the 30-year Treasury bond from two individual estimates of the market return, one of 13.02% and the other at 13.01%, and both derived from constant growth DCF analyses of the S&P 500 Index.

As previously mentioned, Mr. Hevert opted to utilize three different beta determinations within each of his CAPM methodologies. For his first beta calculation, he used the .71 average of the *Value Line* betas of his proxy group. For his second he used his proxy group's .69 average

Bloomberg beta. Finally, for his third beta calculation he took the covariance of the proxy group's mean weekly returns and the S&P 500's weekly returns over the past 12 months and adjusted it using Bloomberg's methodology of multiplying the raw beta coefficient by .67 and then adding .33, to arrive at a beta estimate of .67.

Given these respective inputs, Mr. Hevert then develops six traditional CAPM estimates of the cost of common equity for Con Edison, ranging from 9.70% to 10.10% and six Zero-Beta estimates of the cost of equity ranging from 10.53% to 10.83%. By averaging all twelve of these results, Mr. Hevert's CAPM methodology produced a cost of equity estimate of 10.26%.

Q. Please state your principle concerns with Company witness Hevert's CAPM analyses?

A. As I mentioned earlier, I have concerns with the approaches he uses to determine each of the CAPM model's major inputs, the approach he uses to derive his beta estimates, his sole use of the 30-year Treasury bond to estimate the risk-free rate, and my biggest concern, the approach he

uses to estimate the market risk premium.

Q. Please explain your concerns regarding the derivation of Mr. Hevert's beta estimates.

A. To begin with, the Commission has always utilized *Value Line* betas, and one of the principal reasons for doing so is because *Value Line* calculates its betas over a five-year period, thereby mitigating the inherent volatility of using beta estimates calculated over shorter time periods. While Mr. Hevert's first beta determination uses *Value Line* beta estimates, his second determination uses *Bloomberg* beta estimates that are only calculated over a two-year period, and his own beta estimates calculated over only a 12-month period. Both of these approaches currently produce beta estimates that are generally consistent with the *Value Line* estimates, but because they rely on short time periods, they cannot be counted on to consistently produce reliable results over the long run. As the Commission noted on page 77 of its order in Case 10-E-0362, Orange and Rockland – Electric Rates, "any alteration in this method should be done in

a manner that avoids increasing the volatility of the CAPM." Mr. Hevert has once again introduced an unwarranted alteration to a component of the CAPM, in this case the beta component, and once again his methodology should be rejected.

Q. Why do you reject Mr. Hevert's use of the 30-year Treasury as the appropriate risk-free rate?

A. Mr. Hevert argues that the yield on the 30-year Treasury is appropriate because in his view utility companies represent long-duration investments. However, it has long been Commission policy to rely on the average of the 10- and 30-year Treasuries to arrive at the risk-free rate, as we have done in our calculation. The rationale for this approach is well-established; specifically it reflects the reality that there are utility investors with intermediate-term as well as long-term investment horizons. Mr. Hevert, however, argues that the Commission's preferred approach is flawed because it does not address the Company's asset life, the equity duration of the utility industry, or what *Morningstar* suggests

is "the horizon of whatever is being valued."

While Mr. Hevert is correct that utility plant assets have very long lives, and I would agree that sound financing practices generally dictate these long-lived assets be financed with similarly long-lived securities, his conclusion that this means that all utility equity investors must necessarily have an investment horizon of 30 years is unsubstantiated and erroneous. One needs to look no further than the long-term debt obligations supporting the Company's own rate base to understand that investors' have different time horizons.

Con Edison has generally found it best to issue long-term debt securities with maturities of both ten and 30 years, in nearly equal parts. The fact that there are so many willing investors for utility debt at both of those maturity points is a strong indicator that the Commission's practice is sound, and that Mr. Hevert's recommendation should be rejected.

Q. Please describe the approach Mr. Hevert used to develop his MRP.

A. As I explained earlier, in order to estimate the

expected MRP, it is necessary to first estimate the required market return. The MRP is then calculated by subtracting the assumed risk free rate from the required market return. Just as I did, in order to estimate the required market return, Mr. Hevert relied on an *ex-ante* analysis of the S&P 500, actually two individual analyses. To derive his two expected market returns for the S&P 500, he performed constant growth DCF calculation for all the companies in the index based on market capitalization-weighted growth rates and dividend yields.

The only difference in the two approaches appears to be that in one he relies on Bloomberg's consensus three-to-five year earnings growth estimates, and for the other consensus estimates provided by Capital IQ. Both approaches appear to employ average near-term growth rates of about 10.58%, expected yields of about 2.43% and result in estimated market returns of 13.01%. By subtracting his risk-free rate of 2.86% from these estimated market returns, he calculated respective MRPs of 10.14% and 10.15% respectively, with the

resulting difference presumably due to rounding.

Q. Please explain your concerns with Mr. Hevert's approach to determine the required market return.

A. The overwhelming problem with his approach is that it relies entirely upon a constant growth DCF analysis of the S&P 500. Quite simply, the basic assumption of this model, that the *Bloomberg* and *Capital IQ* reported earnings growth rate estimates formulated for the next three-to-five years will last until perpetuity, is unreasonable. That is precisely why, instead, I rely upon the *ex-ante* estimate of the required return of the S&P 500 provided by *Merrill Lynch*. As I explained earlier, *Merrill Lynch's* multi-stage DCF-derived required return does not make this unrealistic assumption.

The folly of using a constant growth DCF calculation to estimate the required market return is perhaps best illustrated by considering the fact that some 19 to 28 companies in the index have *Bloomberg* or *Capital IQ* near-terms earnings growth estimates in excess of 20%. It is plainly unreasonable that

investors' would assume that those companies would be able to maintain those extraordinary growth rates forever.

Q. Did Mr. Hevert make any adjustment to his DCF and CAPM results to reflect what he contends are costs for issuing common equity that are not reflected in either his DCF or CAPM results?

A. Yes. His 10.35% cost of equity conclusion includes .03%, or 3 basis points, for what he refers to as flotation costs.

Q. On what basis does Mr. Hevert support the need for such an adjustment in this case?

A. He contends that a flotation cost adjustment should be made, not 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.

Q. Given that no common equity issuance is planned for the rate year, do you believe that Mr. Hevert's flotation cost adjustment should be rejected.

A. Yes. Such an adjustment has been repeatedly rejected by the Commission in the past. For instance, in its October 18, 2007 Order in Case 06-E-1433, Orange and Rockland – Electric Rates, the Commission stated that: "The Company's attempt to reach back to past issuances is supported only by a hypothetical statement that such costs may not have been collected, rather than any proof to that effect." Likewise, Mr. Hevert's proposal in this case, to compensate Con Edison's investors for costs incurred for all past issuances, should be rejected.

Q. Did Mr. Hevert recommend that the Commission take into account additional factors in setting the Company's ROE?

A. Yes. Explaining that the mean results of his

proxy group analyses do not necessarily provide an appropriate estimate of the Company's ROE, he noted three additional factors should be considered: 1) the Company's extensive capital expenditure plans; 2) the Company's ability to earn its authorized ROE and generate sufficient cash flow while facing possible disallowances of costs and performance-related penalties; and, 3) the regulatory environment of the Company relative to its proxy group peers.

Q. Did he make any explicit adjustment to his proxy group's results to reflect these risk factors?

A. No, and even though he did not, I will respond to the assertions made by Company witnesses Sanders and Lapson cited by Mr. Hevert with respect to the first two factors in order to explain how they are properly factored into my analysis and recommendations. Then I will explain how the Company's relative regulatory risk should be viewed, and how it is properly reflected in my ROE methodology as well.

Q. What observations did Mr. Sanders and Ms. Lapson make regarding the financial challenges faced by the Company as a result of the capital intensive

nature of its business?

A. Company witness Sanders noted that one of the consequences of being in such a capital intensive industry is that both Con Edison and and its parent CEI must constantly raise capital, and thus must continually remain attractive to investors in order to obtain that capital on favorable terms. He also pointed out the extraordinarily long lives of utility assets, which in his view manifests itself into longer investment horizons for both potential utility debt and equity investors as compared to investors in companies in other industries.

As a result of this general characteristic of the electric utility industry, Mr. Sanders contends that one of Con Edison's primary challenges arises from the fact that its depreciation rates are low relative to its ongoing capital expenditure programs. One of the principle effects of this dynamic, he contends, is that not only have the Company's cash flow metrics been weak for quite some time, but they will remain so. Company witness Lapson concurs, stating that Con Edison's cash flow

tends to be weaker than that of peer utilities.

Q. Do you believe it is reasonable to compare the Company's cash flows with the cash flows of other industries?

A. Absolutely not. Such a comparison fails to take into account the very positive attributes afforded electric utilities as a result of their regulated nature. For instance, on pages 10 and 11 of its August 30, 2012 report entitled *CreditStats: 2011 Adjusted Key U.S. And European Industrial And Utility Financial Ratios*, included in Exhibit___CEH-17, S&P makes it very clear that the pronounced difference in ratio medians between industrial and utility issuers is largely attributable to the utilities much lower business risk as well as their voracious need for fixed-capital improvements and long-established practice of using dividends to return value to their shareholders.

As a result of their very stable cash flows, a comparison of the utilities metrics with their industrial counterparts clearly shows that all across the ratings spectrum utilities are able to achieve ratings similar to the

industrials with far weaker cash flow metrics. For instance, as shown on page 2 of Exhibit___CEH-17, the median EBITDA interest coverage for A rated industrials for the 2009-2011 period was 15.3 times, while A rated utilities over that period only needed to achieve EBITDA interest coverage of 5.1 times.

Q. Please comment on the assertions made by Mr. Sanders and Ms. Lapson that the Company's depreciation rates are low relative to its ongoing capital expenditure programs when compared with the recovery rates of its peers.

A. As I discussed earlier, I conducted my own independent analysis of Con Edison's financial performance, including its capital recovery rates. As illustrated in Exhibit___CEH-12, the Company's depreciation recoveries were relatively weaker than its peers in the earlier part of the last decade. However, recent differences in depreciation recovery rates are far less pronounced, and in 2012 the 50.0% rate achieved by the Company even exceeded the 48.2% median recovery rate of its peers.

Additionally, with respect to the Company's

ability to generate sufficient amounts of cash flow to meet its interest requirements, the fact is that Con Edison has, by and large, outperformed its peers. As illustrated in the three far-right columns of Exhibit___CEH-12, over the past three-,five- and ten-year periods, Con Edison's average EBITDA Interest Coverage has been 5.30 times, 5.04 times, and 4.95 times, respectively. Measured over each of these same time periods, the proxy group medians were only 4.86 times, 4.75 times and 4.74 times respectively. Based upon this performance I do not believe it is accurate to portray the Company as having weaker cash flows than its peers.

Q. Company witness Lapson also performed a study comparing Con Edison's cash flow ratios with the cash flow ratios of a group of utility operating companies. Would you please comment on the reasonableness of her approach and the conclusions she drew?

A. To the extent that the Company is relying on the results of her study as a basis for advocating an upward adjustment to Company witness Hevert's

10.35% cost of equity or even suggesting that his estimate is conservative, her study is unreliable. For purposes of determining whether or not the Company's proxy group-based cost of equity, and more specifically ascertaining its relative riskiness versus its peers, it is necessary to contrast Con Edison's financial performance with the financial performance of the proxy group companies upon which that cost of equity determination is derived. Ms. Lapson's study does not do so. As I pointed out earlier, the flaw in comparing Con Edison's financial performance to electric utility operating company data is that the higher risks of the holding companies' non-regulated businesses are not reflected in the operating company results. The results of her study cannot be relied upon to assess the reasonableness of Mr. Hevert's proxy group-derived cost of equity estimate, or mine for that matter.

Q. What observations did Mr. Sanders make about the financial challenges faced by the Company in relation to its ability to earn its authorized

ROE?

A. In this case, as Company witnesses have done in previous Con Edison and Orange and Rockland rate cases, he asserts that the rates of allowed return granted in New York are well below those in other states. He adds that, because of the existence of penalty-only mechanisms, an absence of any meaningful positive incentives, austerity adjustments, and one-way true-ups of costs, the ability of New York utilities to actually earn these low authorized ROEs is severely hindered.

Q. Would you please comment on his assessment, and explain how this element of risk is reflected in your ROE recommendation?

A. I agree with Mr. Sanders that the earned ROEs of utilities are more relevant to investors than authorized ROEs. I also agree with him that New York's authorized ROEs in the past decade have generally been lower than the national average, particularly during periods, such as now, of historically low interest rates. However, on average over the past ten years, the earned ROEs of Con Edison and New York utilities in general have been higher than earned ROEs of utilities

nationally.

According to data from *Capital IQ* and *Regulatory Research Associates* (RRA), illustrated in Exhibit___CEH-18, the average electric authorized ROE nationally over the past ten years has been 10.46%, notably higher than the 9.65% average electric authorized in New York. However, the average median national earned ROE over the past decade has only been 9.82% or 64 basis points lower than the national average authorized ROE. For New York utilities, the 10.05% average median earned ROE over the past ten years exceeds the 9.65% average authorized ROE by 40 basis points. Con Edison's 9.90% average earned ROE, while marginally lower than the 10.05% New York average, is also higher than the 9.82% national earned ROE.

Q. What sort of conclusion did Mr. Hevert reach with respect to the regulatory environment of the Company relative to its peers?

A. Mr. Hevert cites jurisdictional rankings developed by S&P and by RRA. According to New York's ranking in those two studies, he concludes that the financial community appears

to attribute somewhat higher regulatory risk to Con Edison than to his peer companies.

Q. Would you please comment on his assessment?

A. I would agree with Mr. Hevert insofar as acknowledging that regulatory risk is a very significant factor in determining a utility's overall business risk. As S&P notes in its November 26, 2008 report titled *Utilities: Key Credit Factors: Business and Financial Risks in the Investor Owned Utilities Industry*, which is illustrated in Exhibit___CEH-13, "Regulation is the most critical aspect that underlies regulated integrated utilities' creditworthiness." While regulatory risk is unquestionably very important, it is just one of many business factors analyzed and weighed in conjunction with financial risk.

Q. What other elements of business risk do S&P and Moody's look at?

A. Among other things, they factor in attributes such as the markets in which companies operate the efficiency of their operations, the degree of competition faced, and the effectiveness of their managements.

Q. You stated previously that the combined effect of all the business and financial risks faced by utilities are incorporated into their credit ratings. Does that mean that the perceived amount of regulatory risk faced by a given utility is factored into its business risk profile and then weighed together with its financial risk profile to arrive at an overall risk assessment?

A. Yes. As explained by S&P in its November 26, 2008 report titled *Utilities: Key Credit Factors: Business And Financial Risks in the Investor Owned Utilities Industry*, which is illustrated in Exhibit___CEH-13, "Understanding business risk provides a context in which to judge financial risk, which covers analysis of cash flow generation, capitalization, and liquidity." Because the ratings agencies assessments of Con Edison's overall risk profile has resulted in credit ratings that are stronger than either Mr. Hevert's or my proxy group, his assertion that the financial community appears to attribute somewhat higher regulatory risk to the Company than to his proxy group, while

perhaps true, ignores other material components of overall risk. When these additional components of business and financial risk where the Company clearly compares favorably are considered, it is evident that any negative perceptions of the regulatory environment in New York relative to its peers that may exist, is more than offset by these other relevant measures of risk.

Q. Company witness Lapson also opines about the New York regulatory environment. According to her, that environment is perceived as contentious and punitive. Further, Ms. Lapson notes that the Commission has "in some cases argued that their below-average ROE determinations must be viewed in the context of the superior risk-reducing elements that are typically incorporated in the Commission-approved rate plans." According to Ms. Lapson, however, she has not seen evidence that New York's rate mechanisms are better than average, and in her opinion, there are ways in which they are less favorable to investors than those of other states. Would you please comment on her conclusions about the regulatory

environment in New York?

A. Simply put, the facts clearly appear to support the Commission's observations regarding the superiority of New York's risk-reducing mechanisms. As illustrated in Exhibit___CEH-18, over the past ten years, the average annual authorized ROE in New York was 9.65% and the average median earned ROE was 40 basis points higher at 10.05%. Nationally, the 10.46% average annual authorized ROE during that timeframe was notably higher than New York's, but the 9.82% average median earned ROE was 64 basis points lower than the average annual authorized ROE and below New York's average median earned ROE by 23 basis points. These results are a clear indication that New York's rate making mechanisms have enabled New York utilities to achieve ROEs that are not only closer to their authorized ROEs than their peers elsewhere, but also have produced opportunities that have allowed New York utilities to generally even exceed the authorized ROEs.

Similar results can be seen over the past three years as well. New York's 9.62% average

median earned ROE slightly eclipsed the 9.56% average authorized ROE, while nationally the 9.33% average median earned ROE was well below the 10.27% average authorized ROE.

Q. What conclusion did Mr. Hevert make with respect to the reasonableness of Con Edison's proposed common equity ratio, which was 49.89% prior to the Company's March 25, 2013 Update?

A. In order to assess the reasonableness of the Company's proposed capital structure, Mr. Hevert reviewed the capitalization ratios of the individual utility operating companies owned and operated by the respective companies in his proxy group for the past eight quarters. Specifically, utilizing data provided by *SNL Financial*, he found the mean common equity ratio of his proxy group to be 52.66%, and based upon that calculation determined the 49.89% common equity ratio sought by the Company to be reasonable.

Q. Do you believe that his study provides a reasonable basis to conclude that Con Edison's requested common equity of 50.24% on Update is reasonable?

A. I do not. While the Staff Capital Structure Panel will explain the numerous flaws in Mr. Hevert's analysis and why it should not be relied upon to support the Company's requested common equity ratio, I will note that once again the Company's conclusion inappropriately relies upon electric utility operating data to support its requested common equity ratio. Both Mr. Hevert and I are establishing Con Edison's cost of equity based upon proxy groups of electric utility holding companies, so the reasonableness of the Company's proposed use of leverage in its capital structure must too be weighed against the use of leverage by the proxy group companies. It is the financial risk posed by the holding companies capitalizations together with their business risk that is reflected in the return requirements of equity investors.

Q. Please comment on Mr. Hevert's assertion that the incremental leverage associated with the Company's book-based capital structure warrants consideration of a higher ROE because it generally reflects a higher degree of financial leverage than its market value capital

structure.

A. It appears that Mr. Hevert is suggesting that such an adjustment is warranted because he and I both assess the ROE requirements of investors using market-based methodologies, while the ratemaking process applies that market-derived ROE to a book value capital structure. His premise is misguided, however, because reasonable investors are well aware of the fact that the Commission, like almost every other public utility Commission around the country, sets rates based upon an original-cost rate base. Because rational investors understand how the rates of the underlying utility operating subsidiaries are set, their insight is already reflected in the market prices of the electric utility holding companies that Mr. Hevert and I both use in our proxy group DCF analyses, and thus there is no basis to adjust these ROE requirements as Mr. Hevert suggests.

In fact, it should be noted that Mr. Hevert's argument is actually an old one that has consistently been rejected by the Commission. For instance, on page 123 of its

March 25, 2008 Order in Case 07-E-0523, Con Edison – Electric Rates, the Commission noted: "We find no merit in Con Edison's claim that the DCF method and the Generic Finance Case approach are flawed and should not be used without an upward adjustment applied to the indicated equity return allowance. The Company is correct that market-to-book ratios for many electric utility companies are currently, and have been for a time, substantially above unity. However, the existence of higher market prices does not necessitate an adjustment, in any way, to the calculation of the equity return estimate applied to the regulated company's book value for ratemaking purposes. The Company's argument suggests that it wants its rates set on the market price of its stock and not its rat base. This not only goes against the foundation of historical cost rate base regulation, but it creates the potential of upward or downward spirals depending on whether stock prices are above or below book value."

Q. Does this conclude your testimony at this time?

A. Yes it does.