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STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission
as to the Rates, Charges, Rules and
Regulations of Niagara Mohawk Power
Corporation for electric service

Case 10-E-0050

EVIDENTIARY HEARING

Wednesday, September 1, 2010
10:56 a.m.
Public Service Commission
3 Empire Plaza, 3rd Floor
Albany, New York

BEFORE: WILLIAM BOUTEILLER, ALJ
RUDY STEGEMOELLER, ALJ

APPEARANCES:

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12

13 ALSO PRESENT

14 CHRISTOPHER SMITH, ESQ.
15 SARAH MILLER

16

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1 ALJ BOUTEILLER: Let me call case 10-E-0050.
2 This is the Commission's proceeding concerning
3 National Grid and the Niagara Mohawk Power Company
4 and the electric rate proposal that was filed earlier
5 this year by this company.

6 On July 12th of this year we issued a Notice
7 noticing the fact that we would begin the evidentiary
8 hearings in this case today at this location, and
9 we're within approximately the starting time, for
10 purposes primarily of conducting cross-examination on
11 all the witnesses who have filed either for the
12 company in support of the rate filing made by
13 National Grid, Niagara Mohawk, or in opposition or in
14 response to proposals contained in that testimony.
15 Generally speaking, I can see that we probably have
16 all our parties in attendance.

17 At this time I guess I'd like to take the
18 appearances of the parties. Start with the company
19 and staff and then we'll work our way around the
20 room. For the company?

21 MS. NESSER: Good morning, Your Honor. For
22 Niagara Mohawk Power Corporation, doing business as
23 National Grid, I'm Catherine Nesser, and with me are
24 Kenneth Maloney, George Pond, Peter Flynn, Carrie
25 Sweet, Patric O'Brien.

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1 ALJ BOUTEILLER: Thank you very much. For
2 the staff, please?

3 MS. CICERANI: For the Department of Public
4 Service, Jane Cicerani, and with me are Diane Dean
5 and Dakin Lecakes.

6 ALJ BOUTEILLER: Thank you. To Mr. Duthie.

7 MR. DUTHIE: On behalf of the Town of
8 Amherst, the Town of Tonawanda, the Village of
9 Kenmore, the City of Syracuse and the City of
10 Buffalo, NOPW.

11 ALJ BOUTEILLER: Thank you very much.
12 Mr. Mager.

13 MR. VAN NOSTRAND: Excuse me, Judge
14 Bouteiller. On behalf of the Pace Energy and Climate
15 Center and National Resources Defense Council, James
16 Van Nostrand, and with me will be Anne Marie
17 Hirschberger.

18 ALJ BOUTEILLER: Thank you very much. I was
19 looking for a much younger gentleman to be in the
20 room today.

21 MR. MAGER: That would be me, Your Honor.
22 On behalf of Multiple Intervenors from the law firm
23 of Couch White, by myself, Michael B. Mager. And I'd
24 like to enter an appearance for a colleague of mine,
25 S. Jay Goodman.

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1 ALJ BOUTEILLER: Very good. Mr. Levenson.

2 MR. LEVENSON: Yes, Your Honor. Gary
3 Levenson with the New York Power Authority, and also
4 enter the appearances of Eileen Flynn and Javier
5 Bucobo, who will also be appearing at various times
6 at this hearing.

7 ALJ BOUTEILLER: Thank you very much.
8 Mr. Walters.

9 MR. WALTERS: On behalf of the New York
10 State Consumer Protection Board, John Walters. And
11 I'd also like to notice the appearance of Mr. Saul
12 Rigberg. Thank you.

13 MR. ANDERSON: On behalf of AMP, I'm Ken
14 Anderson of the Howrey law firm in Washington, DC,
15 and I'm ably assisted in all of these endeavors by
16 Sarah Miller.

17 ALJ BOUTEILLER: Thank you very much.

18 Mr. Pond, I think we constructively have
19 your appearance, is that correct?

20 MR. POND: I believe Ms. Nesser included me
21 in the list of company's counsel.

22 ALJ BOUTEILLER: Across the rest of the room
23 are there any other attorneys that need to make an
24 appearance for this case? If not, then we have
25 everyone.

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1 As I understand our proceedings for today,
2 we have a list of potentially five witnesses, and I
3 believe that as of last night we had some
4 arrangements being made with respect to not our first
5 two witnesses but the witnesses who had been up after
6 them. And can I hear from Mr. Pond and Mr. Duthie
7 with respect to where do we stand now with respect
8 to, now, it is Mr. Walter and with respect to the two
9 witnesses proposed by municipalities?

10 MR. POND: Your Honor, before we do that,
11 perhaps we could hear from Ms. Nesser about the scope
12 of the case.

13 ALJ BOUTEILLER: Yes, I think that makes
14 good sense. We also heard yesterday afternoon in
15 communication from the company that your posture with
16 respect to the rate filings you've made in this case
17 has been reformed or altered or modified in some way.
18 As we understood the filing, it was a filing which
19 satisfied all the requirements for a one-year rate
20 case, but it also considered or contemplated the
21 possibility of the Commission in this case setting
22 rates for three years, and along those lines you
23 provided financial information and rather -- and all
24 the sorts of data that the Commission would examine
25 if it were to go beyond a strict requirement of just

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1 setting rates for one year and were to set a rate
2 plan to accommodate a three-year horizon. I believe
3 you communicated with the parties yesterday, and if
4 you can share for the record what is the company's
5 position and attitude with respect to the rates
6 you're seeking in the context of this proceeding.

7 MS. NESSER: Yes, Your Honor. I believe my
8 communication of yesterday afternoon is more or less
9 a follow-up to the discussion we began to have at the
10 procedural conference last week. And as Your Honors
11 know, we filed -- the company filed a three-year
12 case. Staff responded with a one-year cost of
13 service analysis. So we are -- we think by default
14 we are litigating here the one-year case on which the
15 issues are joint.

16 My note to the parties yesterday was there's
17 no reason to consume hearing time talking about
18 changes in base rates or rate design extending beyond
19 the first rate year. It's not our intention for
20 either the company's part or other parties' part that
21 the failure to cross-examine a witness on issues
22 related to rate years two and three would be any sort
23 of concession. It's just we are by necessity
24 litigating a one-year case here.

25 ALJ BOUTEILLER: But you're not reforming

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1 your pre-filed testimony, and for the purposes of
2 creating our record here, everything that was
3 pre-filed will be introduced into the record by the
4 company, is that correct?

5 MS. NESSER: That's correct, with the one
6 exception of an arrangement that Mr. Pond reached
7 with Mr. Duthie.

8 ALJ BOUTEILLER: I believe there's your
9 segue, Mr. Pond.

10 MR. POND: Thank you. Thank you,
11 Ms. Nesser. Thank you, Your Honor.

12 Yes. Mr. Duthie and I have agreed that with
13 respect to the street lighting issue only that the
14 testimony of Messrs. Teumin and Radigan will not be
15 entered into the record. That dealt only with the
16 second- and third-year issues, and the company had
17 rebuttal testimony that dealt with the Teumin and
18 Radigan testimony and nothing else, and so it seemed
19 that there was no reason to burden the record with
20 that, either. Mr. Duthie will go forward with
21 cross-examining John Walter with respect to issues in
22 rate year one only.

23 ALJ BOUTEILLER: Just as a mechanic, when we
24 see the pre-filed testimony of Mr. Walter coming in
25 later today, will you be omitting the portion that

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1 deals with the pricing exceptions or not?

2 MR. POND: We will not be redacting any
3 portion of Mr. Walter's direct testimony. We will
4 simply not be filing any part of his -- the whole of
5 his rebuttal testimony and exhibits will be withheld.
6 The whole of his direct testimony and exhibits will
7 be entered into the record in the same manner as the
8 company's other testimony and exhibits which have not
9 been purged for years two and three.

10 ALJ BOUTEILLER: Okay. You're clear on the
11 record. I thank you for that.

12 Now let me turn to Mr. Duthie. You've heard
13 the representations made by Mr. Pond. Are you in
14 concurrence?

15 MR. DUTHIE: Yes, Your Honor, we are.

16 ALJ BOUTEILLER: Okay, thank you very much.
17 So what we had scheduled, then, your witnesses for
18 today, they are excused and there's no need for them
19 to come into the proceeding. That's my understanding
20 of your arrangement. And we will hear from
21 Mr. Walter later on today, is that correct?

22 MR. POND: That is correct, Your Honor.

23 ALJ BOUTEILLER: Okay, very good. What
24 other preliminaries should we take up before we turn
25 to our first witness in this case? Mr. Mager?

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1 MR. MAGER: Just to get on the record
2 something we talked about off the record, Multiple
3 Intervenors' understanding of this development is
4 that none of the proposed rate design changes for
5 years two and three currently are on the table.
6 They're essentially rendered moot by the company's
7 decision and that the parties are going to try in the
8 coming days to negotiate a stipulation that would add
9 clarity to that. And failing that, I would like to
10 revisit this on the next hearing day, just so the
11 record is as clear as possible, in terms of the
12 ramifications of the company's decision prior to
13 getting into any of the rate design witnesses.

14 ALJ BOUTEILLER: Okay. I will leave it to
15 you to raise it on the next hearing day, Mr. Mager,
16 but at this time let's ask Ms. Nesser to respond to
17 what she's just heard from you.

18 MS. NESSER: I agree with what Mr. Mager
19 said. We'll make an effort to nail this down in
20 stipulations and, if not, we'll have to take it up at
21 that time.

22 ALJ BOUTEILLER: Any other preliminaries
23 before we ask the company to identify their first
24 witness? If not, Ms. Nesser, can you call your first
25 witness? Or Mr. Maloney?

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1 MR. MALONEY: Thank you, Your Honor. For
2 the reporter's benefit, my name is Kenneth Maloney.
3 The company calls Dr. Roger Morin.

4 ALJ BOUTEILLER: Thank you, Mr. Maloney.
5 Mr. Morin, please rise.

6 R O G E R A. M O R I N, P h D,
7 having been first duly sworn by the notary public,
8 was examined and testified as follows:

9 ALJ BOUTEILLER: Please for the record state
10 your name and your business address.

11 THE WITNESS: Roger A. Morin, Georgia State
12 University, Robinson College of Business, University
13 Plaza, Atlanta, Georgia 30303.

14 ALJ BOUTEILLER: Thank you very much. We'll
15 turn to your counsel who will assist us in getting
16 your testimony into the record.

17 MR. MALONEY: Thank you, Your Honor.

18 DIRECT EXAMINATION

19 BY MR. MALONEY:

20 Q Good morning, Dr. Morin.

21 A Good morning.

22 Q Doctor, you have before you a document consisting of
23 101 pages of testimony and two appendices under a cover
24 sheet entitled "Direct Testimony of Roger A. Morin, PhD"?

25 A I do.

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1 Q Was this testimony prepared as part of the company's
2 initial filing in this proceeding?

3 A It was.

4 Q And do you have any corrections or changes to your
5 direct testimony?

6 A No changes.

7 Q And if I were to ask you the questions appearing in
8 your direct testimony today, would your answers be the
9 same?

10 A They would.

11 Q Do you adopt your prepared testimony as your sworn
12 testimony in this proceeding?

13 A Yes, I do.

14 Q Dr. Morin, is it also correct that as part of your
15 direct testimony you sponsored 14 exhibits which have been
16 marked Exhibit ___ (RAM 1 through RAM 14)?

17 A That is correct.

18 Q Were these exhibits prepared under your direction and
19 supervision?

20 A Yes.

21 MR. MALONEY: Your Honor, I guess I'd ask --
22 these are the first exhibits coming into the record.
23 I assume will we pre-mark these as 1 through 14. Is
24 that the way you are prepared to proceed?

25 ALJ BOUTEILLER: Let's go off the record and

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1 let me just clarify.

2 (Discussion off the record.)

3 ALJ BOUTEILLER: Off the record what's been
4 distributed to the parties and provided for the Bench
5 is a series of numbers which have in advance
6 identified the record numbers that we will use for
7 the pre-filed exhibits in the case. There will be
8 some instances where numbers were reserved and not
9 used, and we will have to provide numbers to
10 documents that were not pre-filed. So we will use
11 this sequence.

12 And let me turn back now to company counsel.
13 From looking at this list, I believe the numbers that
14 we've reserved for Dr. Morin are Numbers 1 through
15 14. Are they all associated with just the direct
16 testimony now?

17 MR. MALONEY: Yes, Your Honor, that's
18 correct.

19 ALJ BOUTEILLER: Okay. So we will identify
20 for the record that the pre-filed exhibits associated
21 with the direct testimony of Dr. Morin will come into
22 the record as Exhibits 1 through 14. Do we have a
23 copy?

24 MR. MALONEY: Copies have been handed to the
25 reporter.

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1 ALJ BOUTEILLER: Of the testimony?

2 MR. MALONEY: Of the testimony and the
3 exhibits.

4 ALJ BOUTEILLER: Can I receive the exhibits
5 up here, please? The ones you gave the reporter will
6 suffice.

7 MR. MALONEY: This will be a full set of
8 them right here.

9 ALJ BOUTEILLER: To make things easy for the
10 reporter, we will receive at the Bench the exhibits
11 for the case. We'll stamp them. We'll provide them
12 for central files purposes, okay? The reporter just
13 needs your pre-filed testimonies, just the testimony.
14 We won't be asking the reporter to take custody of
15 the exhibits. We'll take direct custody of the
16 exhibits here at the Bench.

17 We've identified the exhibits associated
18 with Dr. Morin.

19 Please proceed, Counsel.

20 BY MR. MALONEY:

21 Q Yes, as Numbers 1 to 14. I now move on to the
22 rebuttal of testimony of Dr. Morin.

23 Dr. Morin, do you also have before you a document
24 consisting of 49 pages under a cover sheet entitled
25 "Rebuttal Testimony of Roger A. Morin, PhD"?

1 A I do.

2 Q Was this document prepared as part of the company's
3 August rebuttal filing in this proceeding?

4 A It was.

5 Q And do you have any corrections or changes to your
6 rebuttal testimony?

7 A I have one correction.

8 Q Could you identify it, please?

9 A Page 89, line 19 through 21, delete the word
10 "allowance" at the end of line 19, all the way up to the
11 word "group" on line 21. I'll repeat. Delete the package
12 starting with the word "allowance" with line 19, ending
13 with the word "group" on line 21. These are my only
14 corrections.

15 MR. MALONEY: For clarity, this is page 7 of
16 49 or page 89, depending on how you've got it marked.

17 A Those are my corrections.

18 MR. MALONEY: Does everyone have that?

19 BY MR. MALONEY:

20 Q With those changes, if I were to ask you the
21 questions appearing in your rebuttal testimony today,
22 would your answers be the same?

23 A Yes.

24 Q And do you adopt your rebuttal testimony as your
25 sworn testimony in this proceeding?

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1 A I do.

2 MR. MALONEY: Your Honor, at this time I'd
3 ask that the direct and rebuttal testimony of
4 Dr. Morin be copied into the record as if orally
5 given.

6 ALJ BOUTEILLER: Just before we do that,
7 just for clarity on the record, there are no exhibits
8 associated with the rebuttal testimony?

9 MR. MALONEY: That's correct, Your Honor.

10 ALJ BOUTEILLER: I will instruct the
11 reporter to copy into the record as if given orally
12 today both the direct testimony of Dr. Morin and the
13 rebuttal testimony of Dr. Morin.

14 (The referenced testimony is inserted into
15 the record as follows.)

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Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL GRID

Direct Testimony

of

Roger A. Morin, PhD

Dated: January 29, 2010

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Testimony of Dr. Roger A. Morin, PhD

1 **I. Introduction and Purpose**

2 **Q. Please state your name, address, and occupation.**

3 A. My name is Dr. Roger A. Morin. My business address is Georgia State
4 University, Robinson College of Business, University Plaza, Atlanta,
5 Georgia, 30303. I am Emeritus Professor of Finance at the Robinson
6 College of Business, Georgia State University and Professor of Finance
7 for Regulated Industry at the Center for the Study of Regulated Industry at
8 Georgia State University. I am also a principal in Utility Research
9 International, an enterprise engaged in regulatory finance and economics
10 consulting to business and government.

11

12 **Q. Please describe your educational background.**

13 A. I hold a Bachelor of Engineering degree and an MBA in Finance from
14 McGill University, Montreal, Canada. I received my Ph.D. in Finance and
15 Econometrics at the Wharton School of Finance, University of
16 Pennsylvania.

17

18 **Q. Please summarize your academic and business career.**

19 A. I have taught at the Wharton School of Finance, University of
20 Pennsylvania, Amos Tuck School of Business at Dartmouth College,
21 Drexel University, University of Montreal, McGill University, and

Testimony of Dr. Roger A. Morin, PhD

1 Georgia State University. I was a faculty member of Advanced
2 Management Research International, and I am currently a faculty member
3 of The Management Exchange Inc. and Exnet, Inc., where I continue to
4 conduct frequent national executive-level education seminars throughout
5 the United States and Canada. In the last thirty years, I have conducted
6 numerous national seminars on “Utility Finance,” “Utility Cost of
7 Capital,” “Alternative Regulatory Frameworks,” and on “Utility Capital
8 Allocation,” which I have developed on behalf of The Management
9 Exchange Inc. and Exnet in conjunction with Public Utilities Reports, Inc.
10
11 I have authored or co-authored several books, monographs, and articles in
12 academic scientific journals on the subject of finance. They have
13 appeared in a variety of journals, including The Journal of Finance, The
14 Journal of Business Administration, International Management Review,
15 and Public Utilities Fortnightly. I published a widely-used treatise on
16 regulatory finance, Utilities' Cost of Capital, Public Utilities Reports, Inc.,
17 Arlington, Va. 1984. In late 1994, the same publisher released Regulatory
18 Finance, a voluminous treatise on the application of finance to regulated
19 utilities. A revised and expanded edition of this book entitled The New
20 Regulatory Finance was published in August 2006. I have engaged in
21 extensive consulting activities on behalf of numerous corporations, legal

Testimony of Dr. Roger A. Morin, PhD

1 firms, and regulatory bodies in matters of financial management and
 2 corporate litigation. Exhibit __ (RAM-1) describes my professional
 3 credentials in more detail.

4

5 **Q. Have you previously testified on cost of capital before utility**
 6 **regulatory commissions?**

7 A. Yes, I have been a cost of capital witness before some fifty (50) regulatory
 8 bodies in North America, including the New York Public Service
 9 Commission (Commission). I have testified before the following federal,
 10 state, provincial, and other local regulatory commissions:

Alabama	Florida	Missouri	Ontario
Alaska	Georgia	Montana	Oregon
Alberta	Hawaii	Nevada	Pennsylvania
Arizona	Illinois	New Brunswick	Quebec
	Indiana	New Hampshire	South Carolina
British Columbia	Iowa	New Jersey	South Dakota
California	Kentucky	New Mexico	Tennessee
City of New Orleans	Louisiana	New York	Texas
Colorado	Maine	Newfoundland	Utah
CRTC	Manitoba	North Carolina	Vermont
Delaware	Maryland	North Dakota	Virginia
District of Columbia	Michigan	Nova Scotia	Washington
FCC	Minnesota	Ohio	West Virginia
FERC	Mississippi	Oklahoma	

11

12 The details of my participation in regulatory proceedings are provided in
 13 Exhibit __ (RAM-1).

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

Testimony of Dr. Roger A. Morin, PhD

1 A. The purpose of my testimony in this proceeding is to present an
2 independent appraisal of the fair and reasonable rate of return on Niagara
3 Mohawk Power Corporation's ("Niagara Mohawk" or the "Company")
4 electricity delivery operations in the State of New York, with particular
5 emphasis on the fair return on the Company's common equity capital or
6 book equity (ROE) committed to that business. Based upon this appraisal,
7 I have formed my professional judgment as to a return on such capital that
8 would: (1) be fair to the customer, (2) allow the Company to attract capital
9 on reasonable terms, (3) maintain the Company's financial integrity, and
10 (4) be comparable to returns offered on comparable risk investments. I
11 will testify in this proceeding as to that opinion. I have also been asked to
12 comment on the reasonableness of the Company's capital structure.

13

14 This testimony and accompanying exhibits and appendices were prepared
15 by me or under my direct supervision and control. The source documents
16 for my testimony are Company records, public documents, commercial
17 databases, and my personal knowledge and experience.

18

19 **Q. Please briefly identify the exhibit and appendices accompanying your**
20 **testimony.**

Testimony of Dr. Roger A. Morin, PhD

1 A. I have attached to my testimony Exhibit __ (RAM-1) through Exhibit __
2 (RAM-14) and Appendices A and B. These exhibits and Appendices
3 relate directly to points in my testimony, and are described in further detail
4 in connection with the discussion of those points in my testimony.

5

6 **Q. Please summarize your findings concerning Niagara Mohawk's cost of**
7 **common equity.**

8 A. I have examined Niagara Mohawk's risks and concluded that the
9 Company's risk environment, including the impact of adopting the
10 Company's proposal to adopt a revenue decoupling mechanism, is
11 comparable to the industry average. It is my opinion that a just and
12 reasonable rate of return on common equity ("ROE") invested in Niagara
13 Mohawk's electric utility operations is 10.85%. In the event that rates are
14 established for a three-year period in this proceeding, it is my opinion that
15 this ROE should be raised by 25 basis points to 11.1% to compensate
16 investors for the risk of a three year plan.

17

18 **Q. What methods have you employed in arriving at such an opinion?**

19 A. My opinion derives from studies I performed using the Discounted Cash
20 Flow (DCF), Capital Asset Pricing Model (CAPM), and Risk Premium
21 methods. I performed DCF analyses on two surrogates for the Company.

Testimony of Dr. Roger A. Morin, PhD

1 They are a group of investment-grade, dividend-paying, combination
2 electric and gas electric utilities and a group consisting of the electric
3 utilities that make up Standard & Poor's Electric Utility Index. The
4 companies in both groups were required to have the majority of their
5 revenues from regulated electric utility operations. I performed two
6 CAPM analyses: a "traditional" CAPM and a method using an empirical
7 approximation of the CAPM (ECAPM). I also performed a historical risk
8 premium analysis on the electric utility industry.

9
10 My recommended rate of return reflects the application of my professional
11 judgment to the indicated returns from my DCF, Risk Premium, and
12 CAPM analyses, to the Company's current risk environment which I
13 estimate to be comparable on balance to the industry average, and to
14 capital market conditions that continue to reflect uncertainty.

15

16 **Q. Dr. Morin, please describe how your testimony is organized.**

17 A. The remainder of my testimony is divided into three (3) sections:

18 I. Regulatory Framework and Rate of Return

19 II. Cost of Equity Estimates

20 III. Summary and Cost of Equity Recommendation

Testimony of Dr. Roger A. Morin, PhD

1 The first section discusses the rudiments of rate of return regulation and
2 the basic notions underlying rate of return. The second section contains
3 the application of DCF, CAPM, and Risk Premium tests. In the third
4 section, the results from the various approaches used in determining a fair
5 return are summarized.

6

7 **II. Regulatory Framework and Rate of Return**

8 **Q. Please explain how a regulated company's rates should be set under**
9 **traditional cost of service regulation.**

10 A. Under the traditional regulatory process, a regulated company's rates
11 should be set so that the company recovers its costs, including taxes and
12 depreciation, plus a fair and reasonable return on its invested capital. The
13 allowed rate of return must necessarily reflect the cost of the funds
14 obtained, that is, investors' return requirements. In determining a
15 company's required rate of return, the starting point is investors' return
16 requirements in financial markets. A rate of return can then be set at a
17 level sufficient to enable the company to earn a return commensurate with
18 the cost of those funds.

19

20 Funds can be obtained in two general forms, debt capital and equity
21 capital. The cost of debt funds can be easily ascertained from an

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1 examination of the contractual interest payments. The cost of common
 2 equity funds, that is, investors' required rate of return, is more difficult to
 3 estimate. It is the purpose of the next section of my testimony to estimate
 4 Niagara Mohawk's cost of common equity capital.

5

6 **Q. What fundamental principles underlie the determination of a fair and**
 7 **reasonable ROE?**

8 A. The heart of utility regulation is the setting of just and reasonable rates by
 9 way of a fair and reasonable return. There are two landmark United States
 10 Supreme Court cases that define the legal principles underlying the
 11 regulation of a public utility's rate of return and provide the foundations
 12 for the notion of a fair return:

- 13 1) *Bluefield Water Works & Improvement Co. v. Public Service*
 14 *Commission of West Virginia*, 262 U.S. 679 (1923), and
 15 2) *Federal Power Commission v. Hope Natural Gas Company*,
 16 320 U.S. 591 (1944).

17 The *Bluefield* case set the standard against which just and
 18 reasonable rates of return are measured:

19 *A public utility is entitled to such rates as will permit it to earn a*
 20 *return on the value of the property which it employs for the*
 21 *convenience of the public equal to that generally being made at the*
 22 *same time and in the same general part of the country on*
 23 *investments in other business undertakings which are attended by*
 24 *corresponding risks and uncertainties ... The return should be*

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1 *reasonable, sufficient to assure confidence in the financial*
 2 *soundness of the utility, and should be adequate, under efficient*
 3 *and economical management, to maintain and support its credit*
 4 *and enable it to raise money necessary for the proper discharge of*
 5 *its public duties.*

6 *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W.*
 7 *Va, 262 U.S. at 692 (emphasis added).*

8
 9 The *Hope* case expanded on the guidelines to be used to assess the
 10 reasonableness of the allowed return. The Court reemphasized its
 11 statements in the *Bluefield* case and recognized that revenues must cover
 12 “capital costs.” The Court stated:

13
 14 *From the investor or company point of view it is important that*
 15 *there be enough revenue not only for operating expenses but also*
 16 *for the capital costs of the business. These include service on the*
 17 *debt and dividends on the stock ... By that standard the return to*
 18 *the equity owner should be commensurate with returns on*
 19 *investments in other enterprises having corresponding risks. That*
 20 *return, moreover, should be sufficient to assure confidence in the*
 21 *financial integrity of the enterprise, so as to maintain its credit and*
 22 *attract capital.*

23
 24 *Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. at 603 (Emphasis*
 25 *added).*

26
 27
 28 The United States Supreme Court reiterated the criteria set forth in *Hope*
 29 in *Federal Power Commission v. Memphis Light, Gas & Water Division,*
 30 *411 U.S. 458 (1973), in Permian Basin Rate Cases, 390 U.S. 747 (1968),*
 31 *and most recently in Duquesne Light Co. vs. Barasch, 488 U.S. 299*

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1 (1989). In the *Permian Basin Rate Cases*, the Supreme Court stressed that
2 a regulatory agency's rate of return order should

3 *reasonably be expected to maintain financial integrity, attract*
4 *necessary capital, and fairly compensate investors for the risks*
5 *they have assumed.*

6
7 *Permian Basin Rate Cases*, 390 U.S. at 792.

8

9 Therefore, the “end result” of this Commission's decision should be to
10 allow Niagara Mohawk the opportunity to earn a return on equity that is:
11 (1) commensurate with returns on investments in other firms having
12 corresponding risks, (2) sufficient to assure confidence in the Company’s
13 financial integrity, and (3) sufficient to maintain the Company’s
14 creditworthiness and ability to attract capital on reasonable terms.

15

16 **Q. How is the fair rate of return determined?**

17 A. The aggregate return required by investors is called the “cost of capital.”
18 The cost of capital is the opportunity cost, expressed in percentage terms,
19 of the total pool of capital employed by the Company. It is the composite
20 weighted cost of the various classes of capital (*e.g.*, bonds, preferred stock,
21 common stock) used by the utility, with the weights reflecting the
22 proportions of the total capital that each class of capital represents. The
23 fair return in dollars is obtained by multiplying the rate of return set by the

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1 regulator by the utility's "rate base." The rate base is essentially the net
2 book value of the utility's plant and other assets used to provide utility
3 service in a particular jurisdiction.

4
5 While utilities like Niagara Mohawk enjoy varying degrees of monopoly
6 in the sale of public utility services, they must compete with everyone else
7 in the free, open market for the input factors of production, whether labor,
8 materials, machines, or capital. The prices of these inputs are set in the
9 competitive marketplace by supply and demand, and it is these input
10 prices that are incorporated in the cost of service computation. This is just
11 as true for capital as for any other factor of production. Since utilities and
12 other investor-owned businesses must go to the open capital market and
13 sell their securities in competition with every other issuer, there is
14 obviously a market price to pay for the capital they require, for example,
15 the interest on debt capital, or the expected return on equity.

16

17 **Q. How does the concept of a fair return relate to the concept of**
18 **opportunity cost?**

19 A. The concept of a fair return is intimately related to the economic concept
20 of "opportunity cost." When investors supply funds to a utility by buying
21 its stocks or bonds, they are not only postponing consumption or giving up

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1 the alternative of spending their dollars in some other way; they are also
2 exposing their funds to risk and forgoing returns from investing their
3 money in alternative comparable risk investments. The compensation they
4 require is the price of capital. If there are differences in the risk of the
5 investments, competition among firms for a limited supply of capital will
6 bring different prices. These differences in risk are translated by the
7 capital markets into differences in required return, in much the same way
8 that differences in the characteristics of commodities are reflected in
9 different prices.

10

11 The important point is that the required return on capital is set by supply
12 and demand, and is influenced by the relationship between the risk and
13 return expected for those securities and the risks expected from the overall
14 menu of available securities.

15

16 **Q. What economic and financial concepts have guided your assessment**
17 **of the Company's cost of common equity?**

18 A. Two fundamental economic principles underlie the appraisal of the
19 Company's cost of equity, one relating to the supply side of capital
20 markets, the other to the demand side.

21

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1 On the supply side, the first principle asserts that rational investors
2 maximize the performance of their portfolios only if they expect the
3 returns on investments of comparable risk to be the same. If not, rational
4 investors will switch out of those investments yielding lower returns at a
5 given risk level in favor of those investment activities offering higher
6 returns for the same degree of risk. This principle implies that a company
7 will be unable to attract capital funds unless it can offer returns to capital
8 suppliers that are comparable to those achieved on competing investments
9 of similar risk.

10

11 On the demand side, the second principle asserts that a company will
12 continue to invest in real physical assets if the return on these investments
13 equals, or exceeds, the company's cost of capital. This principle suggests
14 that a regulatory board should set rates at a level sufficient to create
15 equality between the return on physical asset investments and the
16 company's cost of capital.

17

18 **Q. How does the Company obtain its capital and how is its overall cost of**
19 **capital determined?**

20 A. The funds employed by the Company are obtained in two general forms,
21 debt capital and equity capital. The cost of debt funds can be ascertained

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1 easily from an examination of the contractual interest payments. The cost
2 of common equity funds, that is, equity investors' required rate of return,
3 is more difficult to estimate because the dividend payments received from
4 common stock are not contractual or guaranteed in nature. They are
5 uneven and risky, unlike interest payments.

6
7 Once a cost of common equity estimate has been developed, it can then
8 easily be combined with the embedded cost of debt based on the utility's
9 capital structure, in order to arrive at the overall cost of capital (overall
10 rate of return).

11

12 **Q. What is the market required rate of return on equity capital?**

13 A. The market required rate of return on common equity, or cost of equity, is
14 the return demanded by the equity investor. Investors establish the price
15 for equity capital through their buying and selling decisions in capital
16 markets. Investors set return requirements according to their perception of
17 the risks inherent in the investment, recognizing the opportunity cost of
18 forgone investments in other companies, and the returns available from
19 other investments of comparable risk.

20

21 **Q. What must be considered in estimating a fair ROE?**

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1 A. The basic premise is that the allowable ROE should be commensurate
2 with returns on investments in other firms having corresponding risks.
3 The allowed return should be sufficient to assure confidence in the
4 financial integrity of the firm, in order to maintain creditworthiness and
5 ability to attract capital on reasonable terms. The attraction of capital
6 standard focuses on investors' return requirements that are generally
7 determined using market value methods, such as the Risk Premium,
8 CAPM, or DCF methods. These market value tests define fair return as
9 the return investors anticipate when they purchase equity shares of
10 comparable risk in the financial marketplace. This is a market rate of
11 return, defined in terms of anticipated dividends and capital gains as
12 determined by expected changes in stock prices, and reflects the
13 opportunity cost of capital. The economic basis for market value tests is
14 that new capital will be attracted to a firm only if the return expected by
15 the suppliers of funds is commensurate with that available from alternative
16 investments of comparable risk.

17

18 **Q. How does Niagara Mohawk's cost of capital relate to that of its parent**
19 **company?**

20 A. Niagara Mohawk is a wholly owned subsidiary of Niagara Mohawk
21 Holdings, Inc., which is a wholly owned subsidiary of National Grid USA,

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1 which in turn is an indirect, wholly owned subsidiary of United Kingdom-
2 based National Grid plc (“National Grid”). I am treating Niagara
3 Mohawk’s electric utility operations as a separate stand-alone entity,
4 distinct from its holding company, National Grid, because it is the cost of
5 capital for Niagara Mohawk’s electric utility business that we are
6 attempting to measure and not the cost of capital for National Grid’s
7 consolidated activities. Financial theory establishes that the true cost of
8 capital depends on the use to which the capital is put, which, in this case,
9 is Niagara Mohawk’s electric utility operations in the State of New York.
10 The specific source of funding an investment and the cost of funds to the
11 investor are irrelevant considerations.

12
13 For example, if an individual investor borrows money at the bank at an
14 after-tax cost of 5% and invests the funds in a speculative oil extraction
15 venture, the required return on the investment is not the 5% cost but rather
16 the return foregone in speculative projects of similar risk, say 20%.

17 Similarly, the required return on Niagara Mohawk is the return foregone in
18 comparable risk electric utility operations, and is unrelated to the parent’s
19 cost of capital. In other words, the cost of capital is governed by the risk
20 to which the capital is exposed and not by the source of funds. The
21 identity of the shareholders has no bearing on the cost of equity.

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1 Just as individual investors require different returns from different assets
2 in managing their personal affairs, corporations should behave in the same
3 manner. A parent company normally invests money in many operating
4 companies of varying sizes and varying risks. These operating
5 subsidiaries pay different rates for the use of investor capital, such as long-
6 term debt capital, because investors recognize the differences in capital
7 structure, risk, and prospects between subsidiaries. Therefore, the cost of
8 investing funds in an operating utility subsidiary such as Niagara Mohawk
9 is the return foregone on investments of similar risk and is unrelated to the
10 identity of the investor. This is particularly true with respect to Niagara
11 Mohawk and other New York State utilities that are owned by corporate
12 holding company parents with multiple businesses in other states and/or
13 countries.

14

15 III. Cost of Equity Estimates

16 Q. How did you estimate the fair ROE for Niagara Mohawk?

17 A. I employed three methods: (1) the DCF, (2) the CAPM, and (3) the Risk
18 Premium. All three are market-based methods and are designed to
19 estimate the return required by investors on the common equity capital
20 committed to Niagara Mohawk.

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1 **Q. Why did you use more than one approach for estimating the cost of**
2 **equity?**

3 A. No one individual method provides the necessary level of precision for
4 determining a fair return, but each method provides useful evidence to
5 facilitate the exercise of an informed judgment. Reliance on any single
6 method or preset formula is inappropriate when dealing with investor
7 expectations because of possible measurement errors and vagaries in
8 individual companies' market data. Examples of such vagaries include
9 insufficient or unrepresentative historical data due to a recent merger,
10 impending merger or acquisition, and a new corporate identity due to
11 restructuring activities. The advantage of using several different
12 approaches is that the results of each one can be used to check the others.

13
14 As a general proposition, it is dangerous to rely on only one generic
15 method to estimate equity costs. The difficulty is compounded when only
16 one variant of that method is employed. It is compounded even further
17 when that one method is applied to a single company. Hence, several
18 methods applied to several comparable risk companies should be
19 employed to estimate the cost of capital.

20

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1 As I have stated, there are three broad generic methods available to
2 measure the cost of equity: DCF, CAPM, and Risk Premium. All three of
3 these methods are accepted and used by the financial community and
4 firmly supported in the financial literature. The weight accorded to any
5 one method may very well vary depending on unusual circumstances in
6 capital market conditions.

7
8 Each method requires the exercise of considerable judgment on the
9 reasonableness of the assumptions underlying the method and on the
10 reasonableness of the proxies used to validate the theory and apply the
11 method. Each method has its own way of examining investor behavior,
12 its own premises, and its own set of simplifications of reality. Investors
13 do not necessarily subscribe to any one method, nor does the stock price
14 reflect the application of any one single method by the price-setting
15 investor. There is no guarantee that a single DCF result is necessarily the
16 ideal predictor of the stock price and of the cost of equity reflected in that
17 price, just as there is no guarantee that a single CAPM or Risk Premium
18 result constitutes the perfect explanation of a stock's price or the cost of
19 equity.

20

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1 **Q. Are there any practical difficulties in applying cost of capital methods**
2 **in the current environment of turmoil in capital markets?**

3 A. Yes, there are. All the traditional cost of equity estimation methods are
4 difficult to implement when you are dealing with the unprecedented
5 conditions of instability and volatility in the capital markets and the fast-
6 changing circumstances of the utility industry. This is not only because
7 stock prices are extremely volatile at this time, but also utility company
8 historical data have become less meaningful for an industry experiencing
9 considerable volatility. Past earnings and dividend trends may simply not
10 be indicative of the future. For example, historical growth rates of
11 earnings and dividends have been depressed by eroding margins due to a
12 variety of factors including the sluggish economy, restructuring, and the
13 transition to a more competitive environment. Moreover, historical
14 growth rates may not be representative of future trends for several utilities
15 involved in mergers and acquisitions, as these companies going forward
16 are not the same companies for which historical data are available.

17

18 **A. DCF Estimates**

19 **Q. Please describe the DCF approach to estimating the cost of equity**
20 **capital.**

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1 A. According to DCF theory, the value of any security to an investor is the
 2 expected discounted value of the future stream of dividends or other
 3 benefits. One widely used method to measure these anticipated benefits in
 4 the case of a non-static company is to examine the current dividend plus
 5 the increases in future dividend payments expected by investors. This
 6 valuation process can be represented by the following formula, which is
 7 the traditional DCF model:

$$8 \quad K_e = D_1/P_o + g$$

9 where:

10 K_e = investors' expected return on equity

11 D_1 = expected dividend at the end of the coming year

12 P_o = current stock price

13 g = expected growth rate of dividends, earnings, book value, stock
 14 price

15

16 The traditional DCF formula states that under certain assumptions, which
 17 are described in the next paragraph, the equity investor's expected return,
 18 K_e , can be viewed as the sum of an expected dividend yield, D_1/P_o , plus
 19 the expected growth rate of future dividends and stock price, g . The
 20 returns anticipated at a given market price are not directly observable and
 21 must be estimated from statistical market information. The idea of the

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1 market value approach is to infer 'K_e' from the observed share price, the
2 observed dividend, and an estimate of investors' expected future growth.

3

4 The assumptions underlying this valuation formulation are well known,
5 and are discussed in detail in Chapter 8 of my new text, The New
6 Regulatory Finance. The standard DCF model requires the following
7 main assumptions: a constant average growth trend for both dividends and
8 earnings, a stable dividend payout policy, a discount rate in excess of the
9 expected growth rate, and a constant price-earnings multiple, which
10 implies that growth in price is synonymous with growth in earnings and
11 dividends. The standard DCF model also assumes that dividends are paid
12 at the end of each year when in fact dividend payments are normally made
13 on a quarterly basis.

14

15 Comparable Groups

16 **Q. How did you estimate Niagara Mohawk's cost of equity with the DCF**
17 **model?**

18 A. I applied the DCF model to two proxies for Niagara Mohawk. As a first
19 proxy, I started with the universe of electric utilities covered by Value
20 Line (SIC Codes 4911-4913). From this original group, I eliminated
21 foreign companies, private partnerships, private companies, and

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1 companies below investment-grade (*i.e.*, companies with a bond rating
2 below Baa3 under Moody’s Investor Service’s ratings). From this
3 narrowed group, I further eliminated companies that do not pay dividends
4 and companies with market capitalization less than \$500 million (to
5 minimize any stock price anomalies due to thin trading). I eliminated
6 companies that derive less than 50% of their revenues from regulated
7 electric utility operations. Finally, from this restricted group, I retained
8 those companies designated as “combination electric and gas” utilities by
9 AUS Utility Reports, meaning that these companies all possess large
10 amounts of energy distribution assets.

11

12 As a second proxy for Niagara Mohawk, I examined a group consisting of
13 the electric utilities that make up S&P’s Electric Utility Index. The two
14 groups are displayed on Exhibit __ (RAM-2) and Exhibit __ (RAM-3),
15 respectively.

16

17 **Q. Are you aware that the Commission has expressed some reservations**
18 **with your comparable groups in the past, and, if so, how do you**
19 **respond?**

20 A. In the past, the Commission has expressed concern that my comparable
21 groups of electric and combination utilities were riskier than New York

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1 electric utilities because their bond ratings were superior to the average
2 bond rating for my comparable groups. But as I show later, there is little
3 relationship between bond ratings and equity risk for entities that hold
4 investment grade bond ratings. Credit ratings examine risk from a
5 bondholder viewpoint rather than from a shareholder viewpoint. The
6 former is concerned mainly with the ability to service debt and
7 creditworthiness while the latter is concerned with variability and
8 uncertainty of return. Moreover, this criticism is essentially moot because
9 the vast majority of the companies in my two groups of utilities are also
10 members of the comparable groups that have been relied upon by the
11 Commission in recent decisions. Also, my beta risk estimate for Niagara
12 Mohawk of 0.74 is virtually identical to the average beta of the group of
13 companies relied upon by the Commission in other cases, implying
14 comparability of risk.

15
16 The Commission has also criticized my two groups of companies because
17 I employed a 50% minimum regulated revenues screening criterion
18 instead of 70%. Again, this criticism is not justified because the average
19 percentage of regulated electric revenues in my two comparable groups of
20 utilities are 71% and 74%, respectively.

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1 In practical terms, there are only minor differences between the groups of
2 companies that the Commission has relied upon in other cases and my
3 own, and I am confident that the comparable groups that I utilize are
4 regarded by investors as utility businesses that are similar to Niagara
5 Mohawk.

6

7 DCF Dividend Yield Component

8 **Q. How did you estimate the two components of the DCF model?**

9 A. In order to apply the DCF model, two components are required: the
10 expected dividend yield (D_1/P_0) and the expected long-term growth (g).
11 The expected dividend D_1 in the annual DCF model can be obtained by
12 multiplying the current indicated annual dividend rate by the growth factor
13 $(1 + g)$.

14

15 From a conceptual viewpoint, the stock price to employ in calculating the
16 dividend yield is the current price of the security at the time of estimating
17 the cost of equity. This is because the current stock prices provide a better
18 indication of expected future prices than any other price in an efficient
19 market. An efficient market implies that prices adjust rapidly to the
20 arrival of new information. Therefore, current prices reflect the
21 fundamental economic value of a security. A considerable body of

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1 empirical evidence indicates that capital markets are efficient with respect
2 to a broad set of information. This implies that observed current prices
3 represent the fundamental value of a security, and that a cost of capital
4 estimate should be based on current prices.

5
6 In implementing the DCF model, I have used the dividend yields reported
7 in the November 2009 edition of Value Line's VLIA software. Basing
8 dividend yields on average results from a large group of companies
9 reduces the concern that the vagaries of individual company stock prices
10 will result in an unrepresentative dividend yield.

11

12 **Q. Dr. Morin, are you aware that in recent decisions, the Commission**
13 **has criticized the dividend yield component of your DCF**
14 **methodology?**

15 A. Yes, I am. In recent cases, the Commission has relied on the average
16 stock price over either three months or six months periods to compute the
17 dividend yield component of the DCF model. I disagree with the use of
18 stock prices reaching back three to six months. The proper stock price to
19 employ is the current price of the security at the time of estimating the cost
20 of equity, rather than some historical average stock price reaching back
21 three or six months. The reason is that the analyst is attempting to

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1 determine a utility's cost of equity in the future, and since current stock
2 prices provide a better indication of expected future prices than any other
3 price according to the basic tenets of the Efficient Market Hypothesis, the
4 most relevant stock price is the most recent one. The Efficient Market
5 Hypothesis, which is widely accepted, states that capital markets, at least
6 as a practical matter, incorporate into security prices relevant publicly
7 available information, such that current security prices reflect the most
8 recent information and thus are the best representation of investor
9 expectations. Use of any other price violates market efficiency principles.

10

11 There is yet another justification for using current stock prices. In
12 measuring the cost of equity as the sum of dividend yield and growth, the
13 period used in measuring the dividend yield component must be consistent
14 with the estimate of growth with which it is paired. Since the current
15 stock price is caused by the growth foreseen by investors at the present
16 time and not at any other time, it is clear that the use of spot prices is
17 preferable. It is inappropriate to match an average stock price reaching
18 back three to six months with a current estimate of expected growth. This
19 not only violates market efficiency principles, but also constitutes a
20 mismatch in the application of the DCF model. An average stock price

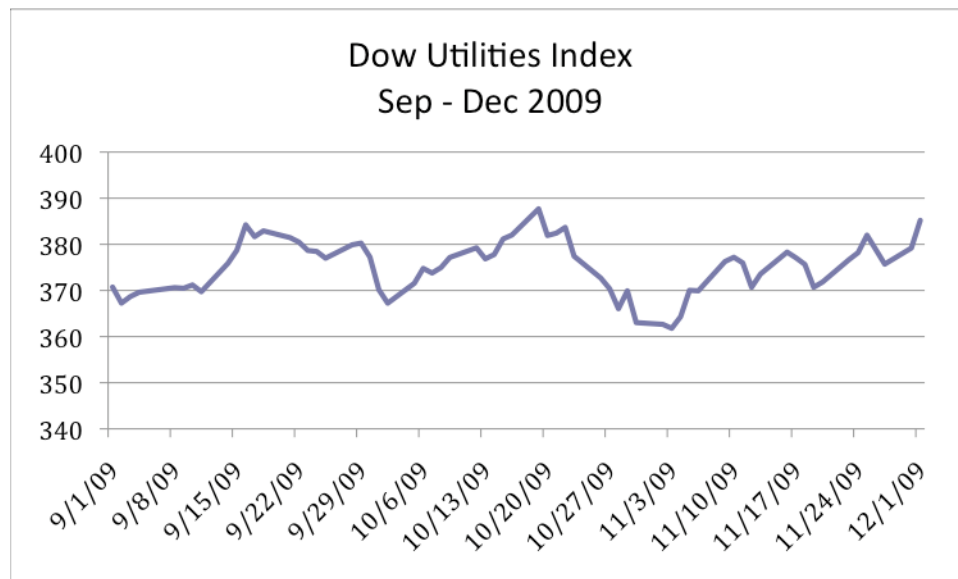
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1 dating back three to six months reflects stale information and may not be
2 representative of current market conditions.

3

4 **Q. As a practical matter at this point in time, does it matter if one relies**
5 **on current stock prices or on average stock prices going back three**
6 **months?**

7 A. As a practical matter, it does not. This is because utility stock prices have
8 been relatively constant over the past three months, as the graph below
9 illustrates over the September-December 2009 period. The Dow Jones
10 Utility Index has remained relatively stable over the period, suggesting
11 that DCF estimates based on current stock prices would not differ
12 markedly from estimates based on the past three months.



13

14

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1 **DCF Growth Component**

2 **Q. How did you estimate the growth component of the DCF model?**

3 A. The principal difficulty in calculating the required return by the DCF
4 approach is in ascertaining the growth rate that investors currently expect.
5 Because no explicit estimate of expected growth is observable, proxies
6 must be employed.

7
8 As proxies for expected growth, I examined the consensus growth
9 estimates developed by professional analysts employed by large
10 investment brokerage institutions. Projected long-term growth rates
11 actually used by institutional investors to determine the desirability of
12 investing in different securities influence investors' growth anticipations.
13 These forecasts are made by large reputable organizations, and the data are
14 readily available to investors and are representative of the consensus view
15 of investors. Because of the dominance of institutional investors in
16 investment management and security selection, and their influence on
17 individual investment decisions, analysts' growth forecasts influence
18 investor growth expectations and provide a sound basis for estimating the
19 cost of equity with the DCF model.

20

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1 Growth rate forecasts of several analysts are available from published
2 investment newsletters and from systematic compilations of analysts'
3 forecasts, such as those tabulated by Zacks Investment Research Inc.
4 (Zacks). I used analysts' long-term growth forecasts contained in Zacks as
5 proxies for investors' growth expectations in applying the DCF model.
6 The latter are also conveniently provided in the Value Line software. I
7 also used Value Line's growth forecasts as additional proxies.

8

9 **Q. Why did you reject the use of historical growth rates in applying the**
10 **DCF model to electric utilities?**

11 A. The average historical growth rates in earnings and dividends for electric
12 utilities are 3.2%, and 2.0% over the past 5 years, respectively. Please see
13 Exhibit __ (RAM-4), columns 2 and 3, for the historical growth in
14 earnings and dividends per share over the last five years for the electric
15 utility companies that make up Value Line's Electric Utility composite
16 group. Several companies have experienced negative earnings growth
17 rates, as evidenced by the numerous historical growth rates reported on the
18 table that are negative. If we eliminate the negative growth rates, the
19 corresponding growth rates are 5.1% and 3.6%.

20

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1 Historical growth rates have little relevance as proxies for future long-term
2 growth at this time. They are downward-biased by the sluggish earnings
3 performance in the last five/ten years, due to the structural transformation
4 of the electric utility industry from a fully integrated regulated monopoly
5 to a more competitive environment. These anemic historical growth rates
6 are certainly not representative of these companies' long-term earning
7 power, and produce unreasonably low DCF estimates, well outside
8 reasonable limits of probability and common sense. To illustrate, adding
9 the historical growth rates of 3.2% and 2.1% to the average dividend yield
10 of approximately 4.8% prevailing currently for those same companies,
11 produces preposterous cost of equity estimates of 8.0% and 6.9% using
12 earnings and dividends growth rates, respectively. Of course, these
13 estimates of equity costs are unreasonable as they are barely above or
14 below the cost of long-term debt for these companies. A similar pattern
15 emerges if ten-year instead of five-year historical growth rates are
16 examined.

17
18 I have therefore rejected historical growth rates as proxies for expected
19 growth in the DCF calculation. In any event, historical growth rates are
20 somewhat redundant because such historical growth patterns are already
21 incorporated in analysts' growth forecasts that should be used in the DCF

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1 model.

2

3 **Q. Did you consider any other method of estimating expected growth to**
 4 **apply the DCF model?**

5 A. Yes, I did. I considered using the so-called “sustainable growth” method,
 6 also referred to as the “retention growth” method. I am aware that this
 7 method has been used by the Commission in its DCF analyses in past
 8 cases. According to this method, future growth is estimated by
 9 multiplying the fraction of earnings expected to be retained by the
 10 company, 'b', by the expected return on book equity, ‘ROE’. That is, $g = b$
 11 \times ROE where:

12 $g =$ expected growth rate in earnings/dividends

13 $b =$ expected retention ratio

14 $ROE =$ expected return on book equity

15

16 As described below, I am not a proponent of this method because it is
 17 inherently circular, for it requires an estimate of the projected ROE, which
 18 is the very quantity we are trying to determine in this case.

19

20 **Q. Please describe your reservations in regards to the sustainable growth**
 21 **method.**

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1 A. First, the sustainable growth method of predicting growth is only accurate
2 under the assumptions that the return on book equity (ROE) is constant
3 over time and that no new common stock is issued by the company, or if
4 so, it is sold at book value. Second, and more importantly, the sustainable
5 growth method contains a logic trap: the method requires an estimate of
6 ROE to be implemented. But if the ROE input required by the model
7 differs from the recommended return on equity, a fundamental
8 contradiction in logic follows. Third, the empirical finance literature
9 demonstrates that the sustainable growth method of determining growth is
10 not as significantly correlated to measures of value, such as stock price and
11 price/earnings ratios, as are other measures of growth. Other proxies for
12 growth, such as analysts' growth forecasts, outperform retention growth
13 estimates. A summary of this literature is available in The New Regulatory
14 Finance, Chapter 9.

15

16 **Q. Did you consider using analysts' forecasts of dividend growth in**
17 **applying the DCF model?**

18 A. No, not at this time. This is because it is widely expected that some
19 utilities will continue to lower their dividend payout ratio over the next
20 several years in response to heightened business risk and the need to fund
21 very large construction programs over the next decade. In other words,

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1 earnings and dividends are not expected to grow at the same rate in the
2 future.

3
4 Whenever the dividend payout ratio is expected to change, the
5 intermediate growth rate in dividends cannot equal the long-term growth
6 rate, because dividend/earnings growth must adjust to the changing payout
7 ratio. The assumptions of constant perpetual growth and constant payout
8 ratio are clearly not met. Thus, the implementation of the standard DCF
9 model is of questionable relevance in this circumstance.

10
11 Dividend growth rates are unlikely to provide a meaningful guide to
12 investors' growth expectations for utilities in general. This is because
13 utilities' dividend policies have become increasingly conservative as
14 business risks in the industry have intensified steadily. Dividend growth
15 has remained largely stagnant in past years as utilities are increasingly
16 conserving financial resources in order to hedge against rising business
17 risks. As a result, investors' attention has shifted from dividends to
18 earnings. Therefore, earnings growth provides a more meaningful guide
19 to investors' long-term growth expectations. Indeed, it is growth in
20 earnings that will support future dividends and share prices.

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1 Moreover, as a practical matter, while earnings growth forecasts are
2 widely available, there are very few dividend growth forecasts.

3

4 **Q. Dr. Morin, are you aware that the Commission has employed**
5 **forecasts of dividend growth in determining the DCF-derived cost of**
6 **equity in past cases?**

7 A. Yes. I am. For the reasons described above, I disagree. In fact, as
8 displayed on the table below, the current and projected dividend payout of
9 the electric utility industry is declining. Utility dividend policies have,
10 and will continue to be, increasingly conservative in response to growing
11 needs of internal financing that are in turn driven by massive capital
12 expenditure budgets over the next decade.

13

Composite Statistics: Electric Utility Industry

	2009	2010	2012-2014
Div'ds to Profit	65%	59%	56%

Source: Value Line 12/209

14

15 **Q. Is there any empirical evidence documenting the importance of**
16 **earnings in evaluating investors' expectations?**

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1 A. Yes, there is an abundance of evidence attesting to the importance of
2 earnings in assessing investors' expectations. First, the sheer volume of
3 earnings forecasts available from the investment community relative to the
4 scarcity of dividend forecasts attests to their importance. To illustrate,
5 Value Line, Zacks Investment, First Call Thompson, Reuters, Yahoo
6 Finance, and Multex provide comprehensive compilations of investors'
7 earnings forecasts. The fact that these investment information providers
8 focus on growth in earnings rather than growth in dividends indicates that
9 the investment community regards earnings growth as a superior indicator
10 of future long-term growth. Second, Value Line's principal investment
11 rating assigned to individual stocks, Timeliness Rank, is based primarily
12 on earnings, which accounts for 65% of the ranking.

13

14 DCF Estimates

15 **Q. What DCF results did you obtain for the combination utilities group?**

16 A. Exhibit __ (RAM-5) provides the DCF results for the proxy group of
17 combination utilities using the average long-term growth forecast obtained
18 from Value Line. No growth projection was available for Pepco, and
19 ALLETE was eliminated from the computation on account of its negative
20 growth rate. As shown on Column 2 of Exhibit __ (RAM-5), the average
21 long-term growth forecast obtained from Value Line is 6.6% for this

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1 group. Adding this growth rate to the average expected dividend yield of
2 5.2% shown in Column 3 produces an estimate of equity costs of 11.9%
3 for the group. Recognition of flotation costs brings the cost of equity
4 estimate to 12.2%, shown in Column 5. Using the median instead of the
5 average, the estimate of equity costs is 11.8% for the group.

6
7 Exhibit __ (RAM-6) presents the DCF results using the Zacks growth
8 forecast for each company. Using the Zacks analysts' consensus forecast
9 of long-term earnings instead of the Value Line forecast, the cost of equity
10 for the group is 10.9% unadjusted for flotation costs. Recognition of
11 flotation costs brings the cost of equity estimate to 11.2%, shown in
12 Column 5 of Exhibit __ (RAM-6). Using the median instead of the
13 average, the cost of equity estimate for the group is 10.9%.

14

15 **Q. What DCF results did you obtain for the S&P utility index group?**

16 A. Exhibit __ (RAM-7) displays the DCF analysis using Value Line growth
17 projections for the electric utilities that make up Standard & Poor's Utility
18 Index. As shown on Column 2 of Exhibit __ (RAM-7), the average long-
19 term growth forecast obtained from Value Line is 5.6% for this group.
20 Coupling this growth rate with the average expected dividend yield of
21 5.2% shown in Column 3 for each company produces an estimate of

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1 equity costs of 10.8% for the group, unadjusted for flotation costs.

2 Adding an allowance for flotation costs to the results of Column 4 brings
3 the cost of equity estimate to 11.1%, as shown in Column 5. The median
4 estimate is 10.9%. If we limit the sample to those companies with a
5 majority of their revenues that are regulated utility operations, the median
6 cost of equity estimate is 10.6%. This analysis is shown on Exhibit __
7 (RAM-8).

8
9 Using the consensus analysts' growth forecast from Zacks instead of the
10 Value Line growth forecast, the median cost of equity estimate for the
11 entire S&P group is 11.7%. This analysis is displayed on Exhibit __
12 (RAM-9). If we limit the sample to those companies with a majority of
13 their revenues that are regulated utility operations, the median cost of
14 equity estimate is 11.6%. This analysis is shown on Exhibit __ (RAM-
15 10).

16

17 **Q. Please summarize your DCF estimates.**

18 A. The table below summarizes the DCF estimates:

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1

DCF STUDY	ROE
Comb. Elec. & Gas Utilities Value Line Growth	11.8%
Comb. Elec. & Gas Utilities Zacks Growth	10.9%
S&P Electric Utilities Value Line Growth	10.6%
S&P Electric Utilities Zacks Growth	11.6%

2

3

B. CAPM and Risk Premium Estimates

4

Q. Dr. Morin, please provide an overview of your risk premium analyses.

5

A. In order to quantify the risk premium for Niagara Mohawk, I performed

6

three risk premium studies. The first two studies deal with aggregate

7

stock market risk premium evidence using two versions of the CAPM

8

method and the third study deals directly with the utility industry.

9

10

CAPM Estimates

11

Q. Please describe your application of the CAPM risk premium

12

approach.

13

A. My first two risk premium estimates are based on the CAPM and on

14

ECAPM, an empirical approximation to the CAPM. The CAPM is a

15

fundamental paradigm of finance. The fundamental idea underlying the

16

CAPM is that risk-averse investors demand higher returns for assuming

17

additional risk, and higher-risk securities are priced to yield higher

18

expected returns than lower-risk securities. The CAPM quantifies the

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1 additional return, or risk premium, required for bearing incremental risk.

2 It provides a formal risk-return relationship anchored on the basic idea that
3 only market risk matters, as measured by beta (β).

4

5 According to the CAPM, securities are priced such that:

6
$$\text{Expected Return} = \text{Risk-Free Rate} + \text{Risk Premium}$$

7

8 Denoting the risk-free rate by R_F and the return on the market as a whole
9 by R_M , the CAPM is stated as follows:

10
$$K = R_F + \beta(R_M - R_F)$$

11

12 This is the seminal CAPM expression, which states that the return required
13 by investors is made up of a risk-free component, R_F , plus a risk premium
14 given by β times the market risk premium ($R_M - R_F$). The latter bracketed
15 expression is known as the market risk premium (MRP). To derive the
16 CAPM risk premium estimate, three quantities are required: the risk-free
17 rate (R_F), beta (β), and the MRP, ($R_M - R_F$). For the risk-free rate, I used
18 4.7%, based on current and projected interest rates on long-term U.S.
19 Treasury bonds. For beta, I used 0.74, and for the MRP I used 6.5%.
20 These inputs to the CAPM are explained below.

21

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1 **Q. How did you derive the risk free rate of 4.7%?**

2 A. To implement the CAPM and Risk Premium methods, an estimate of the
3 risk-free return is required as a benchmark. As a proxy for the risk-free
4 rate, I have relied on the current yields of 30-year Treasury bonds. The
5 yields on interest-bearing and zero-coupon U.S. Treasury 30-year long-
6 term bonds prevailing in December 2009 as reported in Value Line are
7 4.6% and 4.8%, respectively. Moreover, it is widely expected that interest
8 rates will rise in 2010 in response to the recovering economy and record-
9 high federal deficits. Value Line's quarterly economic forecast dated
10 November 27th, 2009, calls for an increase of 40 basis points on long-term
11 Treasury bonds at the end of 2010 and higher still in 2011. Bloomberg
12 calls for a similar increase. Based on all these considerations, I use 4.7%
13 as my estimate of the risk-free rate component of the CAPM.

14

15 The appropriate proxy for the risk-free rate in the CAPM is the return on
16 the longest term Treasury bond possible, which is the 30-year Treasury
17 bond. This is because common stocks are very long-term instruments
18 more akin to very long-term bonds rather than to short-term or
19 intermediate-term Treasury notes. In a risk premium model, the ideal
20 estimate for the risk-free rate has a term to maturity equal to the security
21 being analyzed. Common stock is a very long-term investment because

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1 the cash flows to investors in the form of dividends last indefinitely.
2 Accordingly, the yield on the longest-term possible government bonds,
3 that is, the yield on 30-year Treasury bonds, is the best measure of the
4 risk-free rate for use in the CAPM. The expected common stock return is
5 based on very long-term cash flows, regardless of an individual's holding
6 time period. Moreover, utility asset investments generally have very long-
7 term useful lives and should correspondingly be matched with very long-
8 term maturity financing instruments.

9
10 While long-term Treasury bonds are potentially subject to interest rate
11 risk, this is only true if the bonds are sold prior to maturity. A substantial
12 fraction of bond market participants, usually institutional investors with
13 long-term liabilities (pension funds, insurance companies), in fact hold
14 bonds until they mature, and therefore are not subject to interest rate risk.
15 Moreover, institutional bondholders neutralize the impact of interest rate
16 changes by matching the maturity of a bond portfolio with the investment
17 planning period, or by engaging in hedging transactions in the financial
18 futures markets. The merits and mechanics of such immunization
19 strategies are well documented by both academicians and practitioners.

20

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1 Another reason for utilizing the longest maturity Treasury bond possible is
2 that common equity has an infinite life span, and the inflation expectations
3 embodied in its market-required rate of return will therefore be equal to
4 the inflation rate anticipated to prevail over the very long-term. The same
5 expectation should be embodied in the risk free rate used in applying the
6 CAPM model. It stands to reason that the actual yields on 30-year
7 Treasury bonds will more closely incorporate within their yield the
8 inflation expectations that influence the prices of common stocks than do
9 short-term or intermediate-term U.S. Treasury notes.

10

11 **Q. Dr. Morin, are there other reasons why you reject short-term interest**
12 **rates as a proxies for the risk-free rate in implementing the CAPM?**

13 A. Yes. Short-term rates are volatile, fluctuate widely, and are subject to
14 more random disturbances than are long-term rates. Short-term rates are
15 largely administered rates. For example, as was seen recently in an
16 attempt to combat the weak economy, Treasury bills are used by the
17 Federal Reserve as a policy vehicle to stimulate the economy and to
18 control the money supply, and are used by foreign governments,
19 companies, and individuals as a temporary safe-house for money.

20

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1 As a practical matter, it makes no sense to match the return on common
2 stock to the yield on 90-day Treasury Bills. This is because short-term
3 rates, such as the yield on 90-day Treasury Bills, fluctuate widely, leading
4 to volatile and unreliable equity return estimates.

5
6 As a conceptual matter, short-term Treasury Bill yields reflect the impact
7 of factors different from those influencing the yields on long-term
8 securities such as common stock. For example, the premium for expected
9 inflation embedded into 90-day Treasury Bills is likely to be far different
10 than the inflationary premium embedded into long-term securities yields.
11 On grounds of stability and consistency, the yields on long-term Treasury
12 bonds match more closely with common stock returns.

13

14 **Q. Dr. Morin, are you aware that the commission has in the past relied**
15 **on an average of 10-year and 30-year treasury bond yields over a**
16 **three-month period as a proxy for the risk-free rate in the CAPM?**

17 A. Yes, I am.

18

19 **Q. Do you agree with this procedure?**

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1 A. Not quite, for two reasons. First, yield estimates computed over a three-
2 month period are stale. I discussed this issue earlier. Second, only the
3 yields on 30-year bonds are relevant proxies in the CAPM.
4

5 The Commission's rationale for effectively assigning equal weight to both
6 the 10-year and 30-year bond yield is that some investors may have a 10-
7 year investment horizon. The expected common stock return is based on
8 very long-term cash flows, regardless of an investor's holding time period.
9 This is fundamentally different than an investor's expected return on a
10 debt security which is, in part, depended upon the amount of time that
11 investor chooses to loan money to a borrower. Thus, in contrast to a debt
12 investor, an equity investor will require a return that reflects the risk of the
13 stock, irrespective of holding period, whether it is one month, ten years,
14 thirty years, or fifty years. It is a well known fact that the DCF model is
15 insensitive to holding period because it is based on a uniform discount of
16 expected future cash flows. The latter point is formally demonstrated in
17 Chapter 8 of my latest book, The New Regulatory Finance. The important
18 point is that common stock is a very long-term investment, and
19 accordingly, the yield on the longest-term possible government bonds is
20 the best proxy for the risk-free rate for use in the CAPM. Because utility

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1 asset investments have very long-term useful lives, they should be
2 matched with very long-term financing instruments.

3

4 **Q. Dr. Morin, if one were to rely on an average of 10-year and 30-year**
5 **treasury bond yields over a three-month period as a proxy for the**
6 **risk-free rate in the CAPM, what would that estimate be?**

7 A. The average risk-free rate would be 3.9% using the procedure on which
8 the Commission has relied upon in the past. This estimate compares with
9 the current yield of 4.7% on 30-year Treasury Bonds, and is clearly stale
10 and unrepresentative of current capital market conditions.

11

12 **Q. How did you select the beta for your CAPM analysis?**

13 A. A major thrust of modern financial theory as embodied in the CAPM is
14 that perfectly diversified investors can eliminate the company-specific
15 component of risk, and that only market risk remains. The latter is
16 technically known as “beta”, or “systematic risk”. The beta coefficient
17 measures change in a security's return relative to that of the market. The
18 beta coefficient states the extent and direction of movement in the rate of
19 return on a stock relative to the movement in the rate of return on the
20 market as a whole. The beta coefficient indicates the change in the rate of
21 return on a stock associated with a one percentage point change in the rate

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1 of return on the market, and thus measures the degree to which a particular
2 stock shares the risk of the market as a whole. Modern financial theory
3 has established that beta incorporates several economic characteristics of a
4 corporation that are reflected in investors' return requirements.

5
6 Niagara Mohawk is not publicly traded and, therefore, proxies must be
7 used for Niagara Mohawk. In the earlier discussion of DCF estimates, I
8 developed two samples of comparable companies. As shown on Exhibit
9 __ (RAM-11) and Exhibit __ (RAM-12), the average beta for the
10 combination gas and electric group and the S&P Electric Utility Index
11 group are 0.72 and 0.75, respectively. Removing the companies with less
12 than the majority of their revenues from regulated electric operations, the
13 average beta is 0.74.

14
15 Based on these results, I shall use the average beta of the two groups, 0.74,
16 as an estimate for the beta applicable to the electric utility industry
17 business. It is important to note that betas are estimated on five-year
18 historical periods and, therefore, do not fully capture the increase in
19 capital costs that have occurred since the commencement of the financial
20 crisis in October 2008.

21

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1 **Q. What MRP estimate did you use in your capm analysis?**

2 A. For the MRP, I used 6.5%. This estimate was based on the results of
3 historical studies of long-term risk premiums, and on the general findings
4 of the academic literature on the subject. First, the Morningstar (formerly
5 Ibbotson Associates) study, *Stocks, Bonds, Bills, and Inflation, 2009*
6 *Yearbook*, compiling historical returns from 1926 to 2008, shows that a
7 broad market sample of common stocks outperformed long-term U. S.
8 Treasury bonds by 5.6%. The historical MRP over the income component
9 of long-term Treasury bonds rather than over the total return is 6.5%.
10 Morningstar recommends the use of the latter as a more reliable estimate
11 of the historical MRP, and I concur with this viewpoint. The historical
12 MRP should be computed using the income component of bond returns
13 because the intent, even using historical data, is to identify an expected
14 MRP. This is because the income component of total bond return (*i.e.*, the
15 coupon rate) is a far better estimate of expected return than the total return
16 (*i.e.*, the coupon rate + capital gain), as realized capital gains/losses are
17 largely unanticipated by bond investors. The long-horizon (1926-2008)
18 MRP (based on income returns, as required) is specifically calculated to be
19 6.5% rather than 5.6%.

20

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1 **Q. On what maturity bond does the Morningstar historical risk premium**
2 **data rely?**

3 A. Because 30-year bonds were not always traded or even available
4 throughout the entire 1926-2008 period covered in the Morningstar Study
5 of historical returns, the latter study relied on bond return data based on
6 20-year Treasury bonds. Because the yield curve is virtually flat above
7 maturities of 20 years over most of the period covered in the Morningstar
8 study, the difference in yield is not material.

9

10 **Q. Why did you use long time periods in arriving at your historical MRP**
11 **estimate?**

12 A. Because realized returns can be substantially different from prospective
13 returns anticipated by investors when measured over short time periods, it
14 is important to employ returns realized over long time periods rather than
15 returns realized over more recent time periods when estimating the MRP
16 with historical returns. Therefore, a risk premium study should consider
17 the longest possible period for which data are available. Short-run periods
18 during which investors earned a lower risk premium than they expected
19 are offset by short-run periods during which investors earned a higher risk
20 premium than they expected. Only over long time periods will investor
21 return expectations and realizations converge.

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1 I have therefore ignored realized risk premiums measured over short time
2 periods. Instead, I relied on results over periods of enough length to
3 smooth out short-term aberrations, and to encompass several business and
4 interest rate cycles. The use of the entire study period in estimating the
5 appropriate MRP minimizes subjective judgment and encompasses many
6 diverse regimes of inflation, interest rate cycles, and economic cycles.

7
8 To the extent that the estimated historical equity risk premium follows
9 what is known in statistics as a random walk, one should expect the equity
10 risk premium to remain at its historical mean. Since I found no evidence
11 that the MRP in common stocks has changed over time, that is, no
12 significant serial correlation in the Morningstar study, it is reasonable to
13 assume that these quantities will remain stable in the future.

14

15 **Q. Did you base your MRP estimate on any other source?**

16 A. Yes, I did. I examined a 2003 comprehensive article published in
17 Financial Management, Harris, Marston, Mishra, and O'Brien (HMMO)
18 that provides estimates of the *ex ante* expected returns for S&P 500
19 companies over the period 1983-1998¹. HMMO measure the expected

¹ Harris, R. S., Marston, F. C., Mishra, D. R., and O'Brien, T. J., "Ex Ante Cost of Equity Estimates of S&P 500 Firms: The Choice Between Global and Domestic CAPM," Fin'l Mgt., Fall 2003, pp. 51-66.

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1 rate of return (cost of equity) of each dividend-paying stock in the S&P
2 500 for each month from January 1983 to August 1998 by using the
3 constant growth DCF model. The prevailing risk-free rate for each year
4 was then subtracted from the expected rate of return for the overall market
5 to arrive at the MRP for that year. The average MRP estimate for the
6 overall period is 7.2%, which is reasonably close to the historical estimate
7 of 6.5% and almost identical to the historical estimate of 7.1% if the
8 disastrous performance of the capital markets during 2008 is excluded
9 from the historical average.

10

11 **Q. Dr. Morin, is your MRP estimate of 6.5% consistent with the**
12 **academic literature on the subject?**

13 A. Yes, it is. In their authoritative corporate finance textbook, Professors
14 Brealey, Myers, and Allen² conclude from their review of the fertile
15 literature on the MRP that a range of 5% to 8% is reasonable for the MRP
16 in the United States. My own survey of the MRP literature, which appears
17 in Chapter 5 of my latest textbook, The New Regulatory Finance, is also
18 quite consistent with this range. Moreover, I deem my MRP estimate of

² Richard A. Brealey, Stewart C. Myers, and Paul Allen, Principles of Corporate Finance, 8th Edition, Irwin McGraw-Hill, 2006.

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1 6.5% conservative, given the unsettled conditions in the equity market
2 following the financial crisis that commenced in 2008.

3

4 **Q. Are you familiar with the methodology for determining the MRP**
5 **component of the CAPM used by the commission in recent cases?**

6 A. Yes, I am. In the past, the Commission has relied on Merrill Lynch's
7 estimate of the MRP, which has generally been in the 7% - 9% range.
8 This range is higher than historical estimates as a result of the financial
9 crisis that began in October 2008. If we were to duplicate the
10 Commission's approach of specifying the MRP, that estimate would be
11 8%, that is, the current Merrill Lynch forecast market return of 11.95%
12 minus the Commission risk-free rate proxy of 3.9%. I anticipate a
13 reversion to historical MRP levels as the financial crisis subsides, and
14 view my own estimate as very conservative at this time.

15

16 **Q. What is your risk premium estimate of the Company's cost of equity**
17 **using the CAPM approach?**

18 A. Inserting those input values in the CAPM equation, namely a risk-free rate
19 of 4.7%, a beta of 0.74, and a MRP 6.5%, the CAPM estimate of the cost
20 of common equity is: $4.7\% + 0.74 \times 6.5\% = 9.5\%$. This estimate
21 becomes 9.8% with flotation costs, discussed later in my testimony.

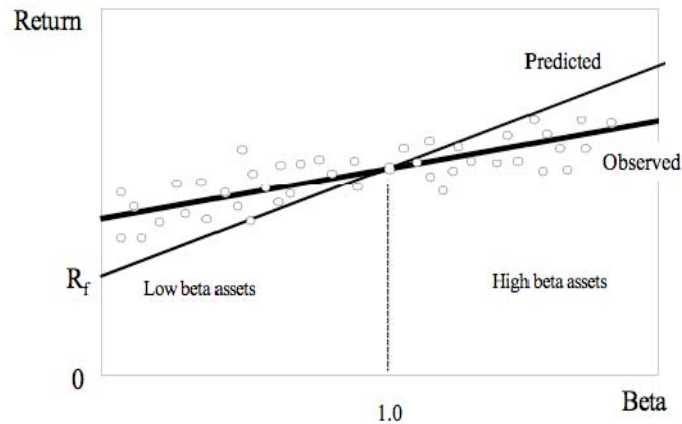
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1 **Q. What is your risk premium estimate using the empirical version of the**
2 **CAPM?**

3 A. With respect to the empirical validity of the plain vanilla CAPM, there
4 have been numerous empirical tests of the CAPM to determine to what
5 extent security returns and betas are related in the manner predicted by the
6 CAPM. This literature is summarized in Chapter 6 of my latest book, The
7 New Regulatory Finance, published by Public Utilities Report Inc. The
8 results of the tests support the idea that beta is related to security returns,
9 that the risk-return tradeoff is positive, and that the relationship is linear.
10 The contradictory finding is that the risk-return tradeoff is not as steeply
11 sloped as the CAPM would predict. That is, empirical research has long
12 shown that low-beta securities earn returns somewhat higher than the
13 CAPM would predict, and high-beta securities earn less than predicted.
14
15 A CAPM-based estimate of cost of capital underestimates the return
16 required from low-beta securities and overstates the return required from
17 high-beta securities, based on the empirical evidence. This is one of the
18 most well-known results in finance, and it is displayed graphically below.

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CAPM: Predicted vs Observed Returns



1

2

A number of variations on the original CAPM theory have been

3

proposed to explain this finding. The ECAPM makes use of these

4

empirical findings. The ECAPM estimates the cost of capital with the

5

equation:

6

$$K = R_F + \alpha + \beta \times (MRP - \alpha)$$

7

where the symbol alpha, α , represents the “constant” of the risk-return

8

line, MRP is the market risk premium ($R_M - R_F$), and the other symbols

9

are defined as usual.

10

11

Inserting the long-term risk-free rate as a proxy for the risk-free rate, an

12

alpha in the range of 1% - 2%, and reasonable values of beta and the

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1 MRP in the above equation produces results that are indistinguishable
2 from the following more tractable ECAPM expression:

$$3 \quad K = R_F + 0.25 (R_M - R_F) + 0.75 \beta (R_M - R_F)$$

4
5 An alpha range of 1% - 2% is somewhat lower than that estimated
6 empirically. The use of a lower value for alpha leads to a lower
7 estimate of the cost of capital for low-beta stocks such as regulated
8 utilities. This is because the use of a long-term risk-free rate rather than
9 a short-term risk-free rate already incorporates some of the desired effect
10 of using the ECAPM. In other words, the long-term risk-free rate
11 version of the CAPM has a higher intercept and a flatter slope than the
12 short-term risk-free version that has been tested. This is also because
13 the use of adjusted betas rather than the use of raw betas also
14 incorporates some of the desired effect of using the ECAPM³. Thus, it
15 is reasonable to apply a conservative alpha adjustment.

16

³ The regression tendency of betas to converge to 1.0 over time is very well known and widely discussed in the financial literature. As a result of this beta drift, several commercial beta producers adjust their forecasted betas toward 1.00 in an effort to improve their forecasts. Value Line, Bloomberg, and Merrill Lynch betas are adjusted for their long-term tendency to regress toward 1.0 by giving approximately 66% weight to the measured raw beta and approximately 33% weight to the prior value of 1.0 for each stock:

$$\beta_{\text{adjusted}} = 0.33 + 0.66 \beta_{\text{raw}}$$

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1 Appendix A contains a full discussion of the ECAPM, including its
 2 theoretical and empirical underpinnings. In short, the following equation
 3 provides a viable approximation to the observed relationship between risk
 4 and return, and provides the following cost of equity capital estimate:

$$5 \quad K = R_F + 0.25 (R_M - R_F) + 0.75 \beta (R_M - R_F)$$

6

7 Inserting 4.7% for the risk-free rate R_F , an MRP of 6.5% for $(R_M - R_F)$ and
 8 a beta of 0.74 in the above equation, the return on common equity is 9.9%.
 9 This estimate becomes 10.2% with flotation costs, discussed later in my
 10 testimony.

11

12 **Q. Please summarize your CAPM estimates.**

13 A. The table below summarizes the common equity estimates obtained from
 14 the CAPM studies.

<u>CAPM Method</u>	<u>% ROE</u>
Traditional CAPM	9.8%
Empirical CAPM	10.2%

15

16 **Q. How do your CAPM estimates compare with those derived from the**
 17 **Commission's approach?**

18 A. Using the Commission's approach to estimating the risk-free rate
 19 component (3.9%) and MRP component (8%) of the CAPM/ECAPM, the

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1 estimates would be 9.9% and 10.4% without flotation costs, coincidentally
2 almost identical to my own estimates of 9.8% and 10.2%.

3

4 **C. Historical Risk Premium Estimate**

5 **Q. What is currently happening in the debt and equity markets?**

6 A. Since the financial crisis began in 2008, the financial markets, both in the
7 U.S. and abroad, have become extremely volatile, unpredictable, and have
8 displayed unusual behavior. In light of a fundamental structural upward
9 shift in risk aversion as capital markets are re-pricing risk, equity capital
10 has become, and will continue to be, more expensive for all market
11 participants, including utilities, relative to government bond yields.

12

13 **Q. Dr. Morin, given the current state of the capital markets at this time,
14 is a historical risk premium analysis using government bond yields
15 appropriate?**

16 A. No, I do not believe it is. Trends in utility cost of capital are not directly
17 captured by a risk premium estimate tied to government bond yields.
18 Because a utility's cost of capital is determined by its business and financial
19 risks, it is reasonable to surmise that its cost of equity will track its cost of
20 debt more closely than it will track the government bond yield. Therefore,
21 in contrast to past testimonies prior to the financial crisis, I have performed a

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1 historical premium analysis using the utility bond yield instead of the
2 government bond yield.

3

4 **Q. Please describe your historical risk premium analysis of the electric**
5 **utility industry using utility bond yields.**

6 A. A historical risk premium for the electric utility industry was estimated
7 with an annual time series analysis applied to the utility industry as a
8 whole over the 1930-2007 period, using *Standard and Poor's Utility Index*
9 as an industry proxy. The analysis is depicted on Exhibit __ (RAM-13).
10 The risk premium was estimated by computing the actual realized return
11 on equity capital for the S&P Utility Index for each year, using the actual
12 stock prices and dividends of the index, and then subtracting the long-term
13 utility bond return for that year. As the average Moody's bond rating in
14 the electric utility industry is Baa, the analysis was performed using the
15 yields on utility bonds rated Baa by Moody's.

16

17 As shown on Exhibit __ (RAM-13), the average risk premium over the
18 period was 4.1% over historical long-term utility bond returns and 4.5%
19 over long-term utility bond yields. Given that the current yield on Baa-
20 rated utility bonds is 6.6%, and using the historical estimate of 4.1%, the
21 implied cost of equity for the average risk utility from this particular

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1 method is $6.6\% + 4.1\% = 10.7\%$ without flotation costs and 11.0% with
2 the flotation cost allowance. The need for a flotation cost allowance is
3 discussed at length later in my testimony.

4

5 **Q. Dr. Morin, are risk premium studies widely used?**

6 A. Yes, they are. Although the Commission has not relied on this approach
7 in the past, risk premium analyses of the type I am describing here are
8 widely used by analysts, investors, economists, and expert witnesses. Most
9 college-level corporate finance and/or investment management texts,
10 including Investments by Bodie, Kane, and Marcus, McGraw-Hill Irwin,
11 2002, which is a recommended textbook for Chartered Financial Analyst
12 certification and examination, contain detailed conceptual and empirical
13 discussion of the risk premium approach. The latter is typically
14 recommended as one of the three leading methods of estimating the cost of
15 capital. Professor Brigham's best-selling corporate finance textbook, for
16 example, Corporate Finance: A Focused Approach, 3rd ed., South-
17 Western, 2008, recommends the use of risk premium studies, among
18 others. Techniques of risk premium analysis are widespread in investment
19 community reports. Professional certified financial analysts are certainly
20 well versed in the use of this method.

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1 **Q. Are you concerned about the realism of the assumptions that underlie**
2 **the historical risk premium method?**

3 A. No, I am not, for they are no more restrictive than the assumptions that
4 underlie the DCF model or the CAPM. While it is true that the method
5 looks backward in time and assumes that the risk premium is constant over
6 time, these assumptions are not necessarily restrictive. By employing
7 returns realized over long time periods rather than returns realized over
8 more recent time periods, investor return expectations and realizations
9 converge. Realized returns can be substantially different from prospective
10 returns anticipated by investors, especially when measured over short time
11 periods. By ensuring that the risk premium study encompasses the longest
12 possible period for which data are available, short-run periods during
13 which investors earned a lower risk premium than they expected are offset
14 by short-run periods during which investors earned a higher risk premium
15 than they expected. Only over long time periods will investor return
16 expectations and realizations converge; otherwise, investors would never
17 invest any money.

18

19 **Q Dr. Morin, the Commission has criticized the historical risk premium**
20 **approach in recent cases. How do you respond?**

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1 A. The Commission has stated in the past that the historical risk premium
2 approach is inappropriate because New York electric utilities may be more
3 or less risky than the companies that make up the S&P Electric Utility Index
4 over the 1926-2006 period. I disagree. Over most of the long period that
5 covers my historical risk premium study, 1926-2007, the electric utility was
6 relatively homogenous in risk and under the umbrella of regulatory
7 protection for all of its functions (power generation, transmission,
8 distribution).

9

10 The Commission also critiqued the risk premium method on the grounds
11 that the method assumes that the risk premium is constant over time, that
12 is, that the risk premium has remained at the same level relative to the
13 risks of the electric utility stocks. This criticism is unwarranted. To the
14 extent that the historical equity risk premium estimated follows what is
15 known in statistics as a random walk, one should expect the equity risk
16 premium to remain at its historical mean. The best estimate of the future
17 risk premium is the historical mean. This approach is no different than
18 using long term historical earning results to calculate the market risk
19 premium used in the CAPM analyses.

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1 As discussed earlier, the Risk Premium approach is conceptually sound and
2 firmly rooted in the conceptual framework of Capital Market Theory. It is
3 widely used by analysts, investors, and expert witnesses.

4

5 **D. Flotation Cost Adjustment**

6 **Q. Please describe the need for a flotation cost allowance.**

7 A. All the market-based estimates reported above include an adjustment for
8 flotation costs. Common equity capital is not free, and flotation costs
9 associated with stock issues are similar to the flotation costs associated
10 with bonds and preferred stocks. Flotation costs are not expensed at the
11 time of issue, and therefore must be recovered via a rate of return
12 adjustment. This is done routinely for bond and preferred stock issues by
13 most regulatory boards, including the Commission. Clearly, the common
14 equity capital accumulated by the Company is not cost-free. The flotation
15 cost allowance to the cost of common equity capital is discussed and
16 applied in most corporate finance textbooks; it is unreasonable to ignore
17 the need for such an adjustment.

18

19 Flotation costs are very similar to the closing costs on a home mortgage.
20 In the case of issues of new equity, flotation costs represent the discounts
21 that must be provided to place the new securities. Flotation costs have a

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1 direct and an indirect component. The direct component is the
2 compensation to the security underwriter for marketing/consulting
3 services, for the risks involved in distributing the issue, and for any
4 operating expenses associated with the issue (printing, legal, prospectus,
5 etc.). The indirect component represents the downward pressure on the
6 stock price as a result of the increased supply of stock from the new issue.
7 The latter component is frequently referred to as “market pressure.”

8
9 Investors must be compensated for flotation costs on an ongoing basis to
10 the extent that such costs have not been expensed in the past, and therefore
11 the adjustment must continue for the entire time that these initial funds are
12 retained in the firm. Appendix B discusses flotation costs in detail, and
13 shows: (1) why it is necessary to apply an allowance of 5% to the dividend
14 yield component of equity cost by dividing that yield by 0.95 (100% - 5%)
15 to obtain the fair return on equity capital; (2) why the flotation adjustment
16 is permanently required to avoid confiscation even if no further stock
17 issues are contemplated; and (3) that flotation costs are only recovered if
18 the rate of return is applied to total equity, including retained earnings, in
19 all future years.

20

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1 **Q. Would you provide an example to illustrate the flotation cost**
2 **allowance concept?**

3 A. Yes. Assume a stock is sold for \$100, and investors require a 10% return,
4 that is, \$10 of earnings. But if flotation costs are 5%, the Company nets
5 \$95 from the issue, and its common equity account is credited by \$95. In
6 order to generate the same \$10 of earnings to the shareholders, from a
7 reduced equity base, it is clear that a return in excess of 10% must be
8 allowed on this reduced equity base, here 10.52%.

9
10 According to the empirical finance literature discussed in Appendix B,
11 total flotation costs amount to 4% for the direct component and 1% for the
12 market pressure component, for a total of 5% of gross proceeds. This in
13 turn amounts to approximately 30 basis points, depending on the
14 magnitude of the dividend yield component. To illustrate, dividing the
15 average expected dividend yield of around 5.0% for utility stocks by 0.95
16 yields 5.3%, which is 30 basis points higher.

17
18 Sometimes, the argument is made that flotation costs are real and should
19 be recognized in calculating the fair return on equity, but only at the time
20 when the expenses are incurred. In other words, the flotation cost
21 allowance should not continue indefinitely, but should be made in the year

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1 in which the sale of securities occurs, with no need for continuing
2 compensation in future years. This argument is valid only if the Company
3 has already been compensated for these costs. If not, the argument is
4 without merit. My own recommendation is that investors be compensated
5 for flotation costs on an on-going basis rather than through expensing, and
6 that the flotation cost adjustment continue for the entire time that these
7 initial funds are retained in the firm.

8
9 There are several sources of equity capital available to a firm including:
10 common equity issues, conversions of convertible preferred stock,
11 dividend reinvestment plan, employees' savings plan, warrants, and stock
12 dividend programs. Each carries its own set of administrative costs and
13 flotation cost components, including discounts, commissions, corporate
14 expenses, offering spread, and market pressure. The flotation cost
15 allowance is a composite factor that reflects the historical mix of sources
16 of equity. The allowance factor is a build-up of historical flotation cost
17 adjustments associated and traceable to each component of equity at its
18 source. It is impractical and prohibitively costly to start from the
19 inception of a company and determine the source of all present equity. A
20 practical solution is to identify general categories and assign one factor to
21 each category. My recommended flotation cost allowance is a weighted

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1 average cost factor designed to capture the average cost of various equity
2 vintages and types of equity capital raised by the Company.

3

4 **Q. Is a flotation cost adjustment required for an operating subsidiary
5 like Niagara Mohawk that does not trade publicly?**

6 A. Yes, it is. It is sometimes alleged that a flotation cost allowance is
7 inappropriate if the utility is a subsidiary whose equity capital is obtained
8 from its ultimate parent, in this case, National Grid. This objection is
9 unfounded since the parent-subsidary relationship does not eliminate the
10 costs of a new issue, but merely transfers them to the parent. It would be
11 unfair and discriminatory to subject parent shareholders to dilution while
12 individual shareholders are absolved from such dilution. Fair treatment
13 must consider that, if the utility-subsidary had gone to the capital markets
14 directly, flotation costs would have been incurred.

15

16 **Q. What flotation cost treatment does the Commission rely upon?**

17 A. The Commission has only provided for recovery of flotation costs when a
18 public common issuance is planned during the rate year. The standard
19 flotation cost allowance used in my direct testimony is designed to recover
20 the flotation costs associated with all past issues that were not expensed,
21 but rather written off against common equity.

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1 By analogy, in the case of a debt issue, flotation costs are amortized over
2 the life of the debt, and the annual amortization charge usually is
3 embedded in the cost of debt for ratemaking purposes. This is done
4 whether the company intends to issue debt in the future or not. The
5 recovery of debt flotation expense continues year after year irrespective of
6 whether the company issues new debt capital until recovery is complete, in
7 the same way that the recovery of past investments in plant and equipment
8 through depreciation allowances continues in the future even if no new
9 construction is contemplated. Unlike the case of bonds, common stock
10 has no finite life so that flotation costs cannot be amortized and must
11 therefore be recovered via an upward adjustment to the allowed return on
12 equity. As in the case of bonds, the recovery continues year after year
13 regardless of whether the utility raises new equity capital until the
14 recovery process is terminated.

15

16 To the extent that Niagara Mohawk's flotation costs associated with past
17 common equity issues have not been recovered, the only recovery
18 mechanism available for the recovery of such costs is an upward
19 adjustment to the return on equity.

20

21

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1 **IV. Summary and Cost of Equity Recommendation**

2 **Q. Can you summarize your results and recommendation?**

3 A. To arrive at my final recommendation, I performed three risk premium
 4 analyses. For the first two risk premium studies, I applied the CAPM and
 5 an empirical approximation of the CAPM using current market data. The
 6 other risk premium analysis was performed on historical data from electric
 7 utility industry aggregate data, using the yield on long-term utility bonds.
 8 I also performed DCF analyses on two surrogates for Niagara Mohawk: a
 9 group of investment-grade dividend-paying combination electric and gas
 10 utilities, and a group of electric utilities that make up the S&P Utility
 11 Index. The results are summarized in the table below.

12	STUDY	ROE
13	CAPM	9.80%
	Empirical CAPM	10.20%
	Hist. Risk Premium Elec Utility Industry	11.00%
	DCF Comb. Elec & Gas Utilities Value Line Growth	11.80%
	DCF Comb. Elec & Gas Utilities Zacks Growth	10.90%
	DCF S&P Elec Utilities Value Line Growth	10.60%
	DCF S&P Elec Utilities Zacks Growth	11.60%

14
 15 The results range from 9.8% to 11.8% with a midpoint of 10.8%. The
 16 overall average result is 10.8% and the truncated mean is 10.9%. From
 17 these results, I conclude that a ROE of 10.85% is reasonable.

18

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1 **Q. Dr. Morin, if you were to rely on weighting of 2/3 for the DCF results**
2 **and 1/3 for the CAPM results, what would be Niagara Mohawk's cost**
3 **of common equity estimate?**

4 A. From the above table, the average CAPM result is 10.0%. The average
5 DCF result is 11.2%. Giving one-third weight to the CAPM result of
6 10.0% and two-thirds weight to the DCF result of 11.2%, the weighted
7 average result is 10.82%, which is almost identical to the average result
8 reported in the above summary table.

9

10 **Q. Did you adjust your proxy group cost of equity results to reflect the**
11 **risk differential between the proxy group and the Company?**

12 A. No, I did not. The Company's investment risk is average in my view.

13

14 Because the cost of equity estimates derived from the various comparable
15 groups reflect the risk of the average investment grade utility and because
16 Niagara Mohawk's investment risks are broadly comparable to those of
17 the industry, the expected equity returns developed above are applicable to
18 Niagara Mohawk.

19

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1 **Q. Did you consider the impact of the Company's proposal to implement**
2 **a revenue decoupling mechanism (RDM) on the Company's cost of**
3 **equity?**

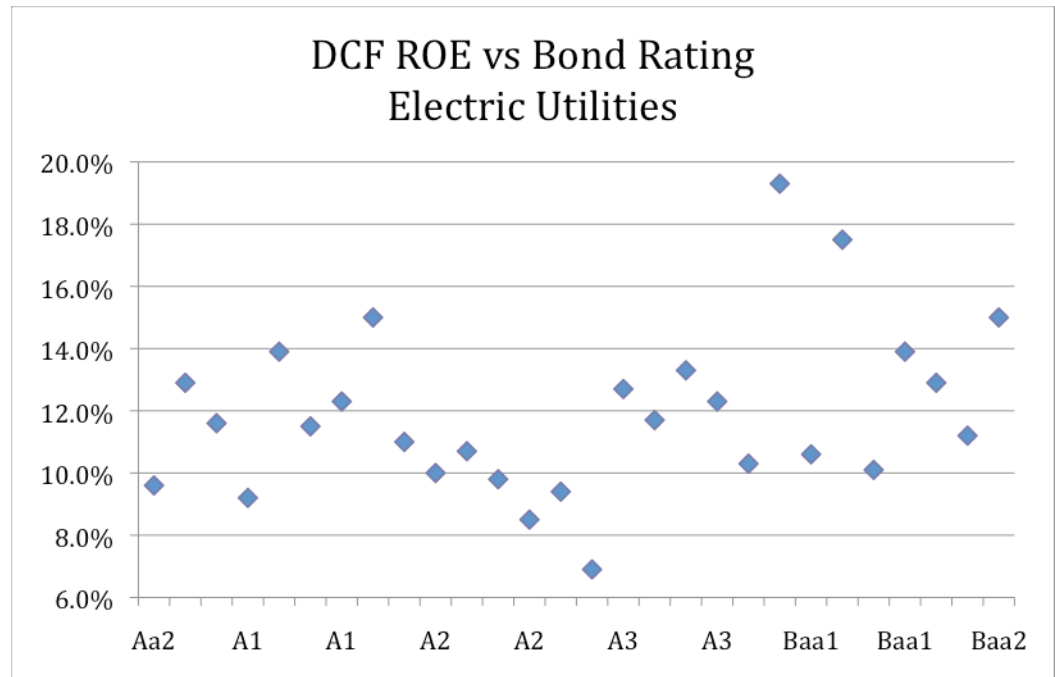
4 A. No, I did not. Any risk-mitigating impact such mechanisms may have on
5 the Company's risk profile is largely reflected in the capital market data of
6 the comparable companies. RDMs or similar margin adjustment
7 mechanisms are becoming increasingly commonplace in the energy utility
8 industry. A number of electric companies in my comparable groups
9 possess some form of revenue decoupling and/or similar margin
10 adjustment rider mechanism. At the same time, revenue decoupling,
11 depending on how it is implemented, might not reduce risk for certain
12 companies in my comparable group that do not have such mechanisms and
13 serve growing markets. Such utilities depend on increases in revenue to
14 offset increases in cost of service and this may be less risky without a
15 RDM. For all these reasons, it is unnecessary to account for the impact a
16 RDM has on the Company's ROE.

17
18 **Q. Did you include a return adjustment to your results to account for any**
19 **credit rating differential between the proxy group and the Company?**

20 A. No, I did not. This is because credit ratings and debt rate differentials are
21 not directly related to required equity returns. As shown on the graph

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1 below, there is no correlation between the DCF results for the companies
 2 in my two sample groups and the bond ratings of these companies.



3
 4
 5
 6
 7
 8
 9
 10

Moreover, the table below displays the DCF results for each bond rating category. There is no positive relationship between return and declining credit quality for these companies, which are all investment grade. I also point out that there is no correlation between equity risk as measured by beta and the credit ratings of the companies in the two sample groups as evidenced by the data in the last column in the table below.

Bond Rating	DCF Estimates	Beta Estimates
Aa3	10.87%	0.65

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A2	11.69%	0.70
A3	10.70%	0.60
Baa1	10.31%	0.71
Baa2	10.67%	0.70
Baa3	10.22%	0.76

1

2 **Q. Why isn't it logical to assume that an entity with a higher credit**
 3 **rating and therefore a lower cost of debt will not have a lower cost of**
 4 **equity as well?**

5 **A.** The primary reason is that credit ratings are intended to reflect an estimate
 6 of the likelihood that a company will fulfill its debt obligations. Such
 7 ratings do not attempt to estimate the likelihood of whether an equity
 8 investor will realize the appropriate return on equity. Moreover, for
 9 companies that are considered investment grade, as an entity takes steps to
 10 increase its credit quality, it may create additional risks for equity
 11 investors. For example, one of the actions that a company can undertake
 12 in order to increase credit quality is to reduce the amount of debt as a
 13 percentage of its total capital. However, as long term debt becomes less
 14 risky, it is quite possible that a further equity investment becomes
 15 somewhat riskier. My point here is not that an entity with better credit
 16 quality will experience an increase in the cost of equity, but that there is
 17 no evidence that improvements in credit quality necessarily reduce the

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1 cost of equity for investment grade utilities. Thus, it is inappropriate to
2 apply a credit quality adjustment to the cost of equity results in this case.

3

4 **Q. Dr. Morin, do you consider your recommendation conservative?**

5 A. Yes, I do. Yields on 20-year Treasury bonds are projected to increase by
6 50 basis points (0.5%) by December 2010. Value Line's Quarterly
7 Economic Review dated August 2009 also projects the yields on 10-year
8 Treasury bonds to increase by 50 basis points in 2010. Because long-term
9 interest rates generally move in unison, an increase (decrease) in the yield
10 on 10/20-year Treasury bonds should be accompanied by a parallel
11 increase (decrease) in the yield on 30-year bonds. A projected increase in
12 interest rates, if materialized, would clearly increase my CAPM and Risk
13 Premium estimates, and therefore ROE. I therefore view my ROE
14 recommendation as conservative.

15

16 **Q. Dr. Morin, what capital structure assumption underlies your
17 recommended ROE for Niagara Mohawk?**

18 A. My recommended ROE for Niagara Mohawk is predicated on the adoption
19 of a rate year capital structure consisting of 50% common equity capital.

20

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1 **Q. Did you examine the reasonableness of the Company’s capital**
2 **structure?**

3 A. Yes, I did. I have compared Niagara Mohawk’s rate year capital structure
4 with: 1) the capital structures adopted by regulators for electric utilities,
5 and 2) the actual capital structures of electric utilities.

6
7 The October 2009 edition of SNL Energy’s (formerly Regulatory
8 Research Associates) “*Regulatory Focus: Major Rate Case Decisions*”
9 reports an average percentage of common equity in the adopted capital
10 structure of 48.4% for electric utilities for 2008 and 48% for 2009, which
11 is quite close to the Company’s proposed common equity ratio in this
12 case. I have also examined the actual capital structures of my comparable
13 group of combination electric and gas utilities as reported by Value Line.
14 As shown on Exhibit __ (RAM-14), the average common equity ratio for
15 the group is 47%, which is very close to the Company’s proposal. I
16 conclude that the Company’s requested common equity ratio is reasonable
17 for ratemaking purposes.

18

19 **Q. Dr. Morin, what is your final conclusion regarding Niagara**
20 **Mohawk’s cost of common equity capital?**

21 A. Based on the results of all my analyses, the application of my professional

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1 judgment, and the risk circumstances of Niagara Mohawk, it is my opinion
2 that a just and reasonable return on the common equity capital of Niagara
3 Mohawk's electric utility operations is 10.85%. My recommended rate of
4 return reflects the application of my professional judgment to the results in
5 light of the indicated returns from my Risk Premium, CAPM, and DCF
6 analyses. My recommended ROE assumes the approval of the Company's
7 rate year capital structure.

8

9 **Q. Would you now discuss the implications for the allowed ROE of a**
10 **stayout for Niagara Mohawk?**

11 A. The Company has informed me that it is proposing a three-year rate plan.
12 This exposes Niagara Mohawk to the risk that the cost of equity may go
13 up during the course of the rate plan, without the Company having an
14 opportunity to reset the allowed return to reflect such an increase. I am
15 informed that in the past, the Commission has used the differential
16 between 3-year and 1-year Treasury securities to provide guidance as to
17 what the "stayout premium" in such circumstances should be. More
18 specifically, I am informed that the Commission has used one-half of the
19 five-year average differentials between (1) a Treasury security reflecting
20 the length of the rate plan and (2) a 1-year Treasury security. The five-
21 year average differential, through the end of October 2009, between 3-year

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1 and 1-year Treasury securities is approximately 50 basis points, excluding
2 those months where the differential was negative, that is, when the yield
3 curve was negative. Half of this differential is about 25 basis points. Thus,
4 a stayout premium in the neighborhood of 25 basis points would be
5 reasonable for Niagara Mohawk, and that brings my recommended ROE
6 to 11.1%.

7

8 **Q. Finally, Dr. Morin, if capital market conditions change significantly**
9 **between the date of filing your prepared testimony and the date your**
10 **oral testimony is presented, would this cause you to revise your**
11 **estimated cost of equity?**

12 A. Yes. Interest rates and security prices do change over time, and risk
13 premiums change also, although much more sluggishly. If substantial
14 changes were to occur between the filing date and the time my oral
15 testimony is presented, I will update my testimony accordingly.

16

17 **Q. Does this complete your direct testimony?**

18 A. Yes, it does.

APPENDIX A

CAPM, EMPIRICAL CAPM

The Capital Asset Pricing Model (CAPM) is a fundamental paradigm of finance. Simply put, the fundamental idea underlying the CAPM is that risk-averse investors demand higher returns for assuming additional risk, and higher-risk securities are priced to yield higher expected returns than lower-risk securities. The CAPM quantifies the additional return, or risk premium, required for bearing incremental risk. It provides a formal risk-return relationship anchored on the basic idea that only market risk matters, as measured by beta. According to the CAPM, securities are priced such that their:

$$\text{EXPECTED RETURN} = \text{RISK-FREE RATE} + \text{RISK PREMIUM}$$

Denoting the risk-free rate by R_F and the return on the market as a whole by R_M , the CAPM is:

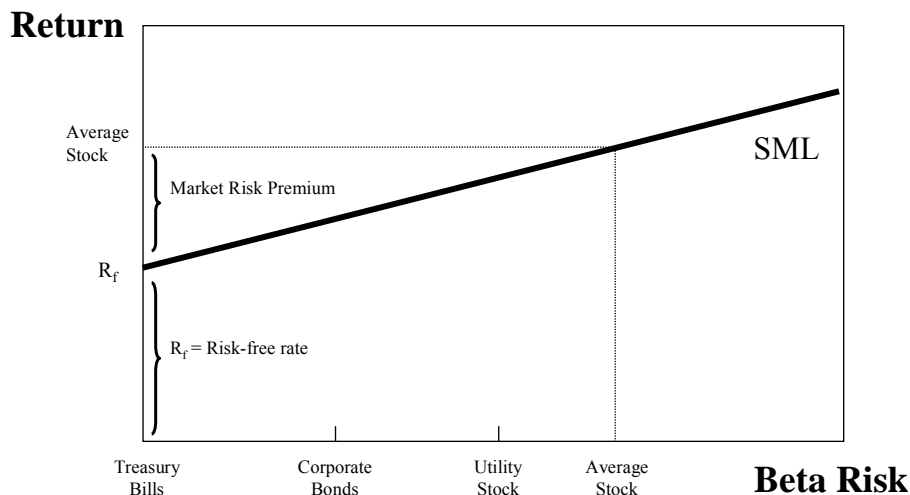
$$K = R_F + \beta(R_M - R_F) \quad (1)$$

Equation 1 is the CAPM expression which asserts that an investor expects to earn a return, K , that could be gained on a risk-free investment, R_F , plus a risk premium for assuming risk, proportional to the security's market risk, also known as beta, β , and the market risk premium, $(R_M - R_F)$, where R_M is the market return. The market risk premium $(R_M - R_F)$ can be abbreviated MRP so that the CAPM becomes:

$$K = R_F + \beta \times \text{MRP} \quad (2)$$

The CAPM risk-return relationship is depicted in the figure below and is typically labeled as the Security Market Line (SML) by the investment community.

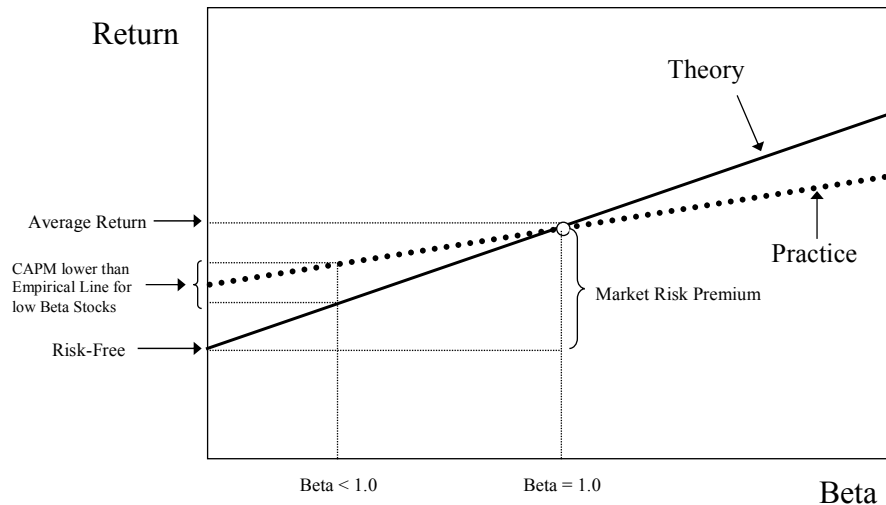
CAPM and Risk - Return in Capital Markets



A myriad empirical tests of the CAPM have shown that the risk-return tradeoff is not as steeply sloped as that predicted by the CAPM, however. That is, low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted. In other words, the CAPM tends to overstate the actual sensitivity of the cost of capital to beta: low-beta stocks tend to have higher returns and high-beta stocks tend to have lower risk returns than predicted by the CAPM. The difference between the CAPM and the type of relationship observed in the empirical studies is depicted in the figure below. This is one of the most widely known empirical findings of the finance literature. This extensive literature is summarized in Chapter 13 of Dr. Morin's book [Regulatory Finance, Public Utilities Report Inc., Arlington, VA, 1994].

Risk vs Return

Theory vs. Practice



A number of refinements and expanded versions of the original CAPM theory have been proposed to explain the empirical findings. These revised CAPMs typically produce a risk-return relationship that is flatter than the standard CAPM prediction. The following equation makes use of these empirical findings by flattening the slope of the risk-return relationship and increasing the intercept:

$$K = R_F + \alpha + \beta (MRP - \alpha) \quad (3)$$

where α is the "alpha" of the risk-return line, a constant determined empirically, and the other symbols are defined as before. Alternatively, Equation 3 can be written as follows:

$$K = R_F + a MRP + (1-a) \beta MRP \quad (4)$$

where a is a fraction to be determined empirically. Comparing Equations 3 and 4, it is easy to see that alpha equals 'a' times MRP, that is, $\alpha = a \times MRP$

Theoretical Underpinnings

The obvious question becomes what would produce a risk return relationship which is flatter than the CAPM prediction, or in other words, how do you explain the presence of “alpha” in the above equation. The exclusion of variables aside from beta would produce this result. Three such variables are noteworthy: dividend yield, skewness, and hedging potential.

The dividend yield effects stem from the differential taxation on corporate dividends and capital gains. The standard CAPM does not consider the regularity of dividends received by investors. Utilities generally maintain high dividend payout ratios relative to the market, and by ignoring dividend yield, the CAPM provides biased cost of capital estimates. To the extent that dividend income is taxed at a higher rate than capital gains, investors will require higher pre-tax returns in order to equalize the after-tax returns provided by high-yielding stocks (e.g. utility stocks) with those of low-yielding stocks. In other words, high-yielding stocks must offer investors higher pre-tax returns. Even if dividends and capital gains are undifferentiated for tax purposes, there is still a tax bias in favor of earnings retention (lower dividend payout), as capital gains taxes are paid only when gains are realized.

Empirical studies by Litzenberger and Ramaswamy (1979) and Litzenberger et al. (1980) find that security returns are positively related to dividend yield as well as to beta. These results are consistent with after-tax extensions of the CAPM developed by Breenan (1973) and Litzenberger and Ramaswamy (1979) and suggest that the relationship between return, beta, and dividend yield should be estimated and employed to calculate the cost of equity capital.

As far as skewness is concerned, investors are more concerned with losing money than with total variability of return. If risk is defined as the probability of loss, it appears more logical to measure risk as the probability of achieving a return which is below the expected return. The traditional CAPM provides downward-biased estimates of cost of capital to the extent that these skewness effects are significant. As shown by Kraus and Litzenberger (1976), expected return depends on both on a stock's systematic risk (beta)

and the systematic skewness. Empirical studies by Kraus and Litzenberger (1976), Friend, Westerfield, and Granito (1978), and Morin (1981) found that, in addition to beta, skewness of returns has a significant negative relationship with security returns. This result is consistent with the skewness version of the CAPM developed by Rubinstein (1973) and Kraus and Litzenberger (1976).

This is particularly relevant for public utilities whose future profitability is constrained by the regulatory process on the upside and relatively unconstrained on the downside in the face of socio-political realities of public utility regulation. The process of regulation, by restricting the upward potential for returns and responding sluggishly on the downward side, may impart some asymmetry to the distribution of returns, and is more likely to result in utilities earning less, rather than more, than their cost of capital. The traditional CAPM provides downward-biased estimates of cost of capital to the extent that these skewness effects are significant.

As far as hedging potential is concerned, investors are exposed to another kind of risk, namely, the risk of unfavorable shifts in the investment opportunity set. Merton (1973) shows that investors will hold portfolios consisting of three funds: the risk-free asset, the market portfolio, and a portfolio whose returns are perfectly negatively correlated with the riskless asset so as to hedge against unforeseen changes in the future risk-free rate. The higher the degree of protection offered by an asset against unforeseen changes in interest rates, the lower the required return, and conversely. Merton argues that low beta assets, like utility stocks, offer little protection against changes in interest rates, and require higher returns than suggested by the standard CAPM.

Another explanation for the CAPM's inability to fully explain the process determining security returns involves the use of an inadequate or incomplete market index. Empirical studies to validate the CAPM invariably rely on some stock market index as a proxy for the true market portfolio. The exclusion of several asset categories from the definition of market index mis-specifies the CAPM and biases the results found using only stock market data. Kolbe and Read (1983) illustrate the biases in beta estimates which result from applying the CAPM to public utilities. Unfortunately, no comprehensive and easily accessible data exist for several classes of assets, such as

mortgages and business investments, so that the exact relation between return and stock betas predicted by the CAPM does not exist. This suggests that the empirical relationship between returns and stock betas is best estimated empirically (ECAPM) rather than by relying on theoretical and elegant CAPM models expanded to include missing assets effects. In any event, stock betas may be highly correlated with the true beta measured with the true market index.

Yet another explanation for the CAPM's inability to fully explain the observed risk-return tradeoff involves the possibility of constraints on investor borrowing that run counter to the assumptions of the CAPM. In response to this inadequacy, several versions of the CAPM have been developed by researchers. One of these versions is the so-called zero-beta, or two-factor, CAPM which provides for a risk-free return in a market where borrowing and lending rates are divergent. If borrowing rates and lending rates differ, or there is no risk-free borrowing or lending, or there is risk-free lending but no risk-free borrowing, then the CAPM has the following form:

$$K = R_Z + \beta(R_m - R_F)$$

The model, christened the zero-beta model, is analogous to the standard CAPM, but with the return on a minimum risk portfolio which is unrelated to market returns, R_Z , replacing the risk-free rate, R_F . The model has been empirically tested by Black, Jensen, and Scholes (1972), who found a flatter than predicted CAPM, consistent with the model and other researchers' findings.

The zero-beta CAPM cannot be literally employed in cost of capital projections, since the zero-beta portfolio is a statistical construct difficult to replicate.

Empirical Evidence

A summary of the empirical evidence on the magnitude of alpha is provided in the table below.

Empirical Evidence on the Alpha Factor		
Author	Range of alpha	Period relied
Black (1993)	-3.6% to 3.6%	1931-1991
Black, Jensen and Scholes (1972)	-9.61% to 12.24%	1931-1965
Fama and McBeth (1972)	4.08% to 9.36%	1935-1968
Fama and French (1992)	10.08% to 13.56%	1941-1990
Litzenberger and Ramaswamy (1979)	5.32% to 8.17%	
Litzenberger, Ramaswamy and Sosin (1980)	1.63% to 5.04%	1926-1978
Pettengill, Sundaram and Mathur (1995)	4.6%	
Morin (1994)	2.0%	1926-1984
Harris, Marston, Mishra, and O'Brien (2003)	2.0%	1983-1998

Given the observed magnitude of alpha, the empirical evidence indicates that the risk-return relationship is flatter than that predicted by the CAPM. Typical of the empirical evidence is the findings cited in Morin (1989) over the period 1926-1984 indicating that the observed expected return on a security is related to its risk by the following equation:

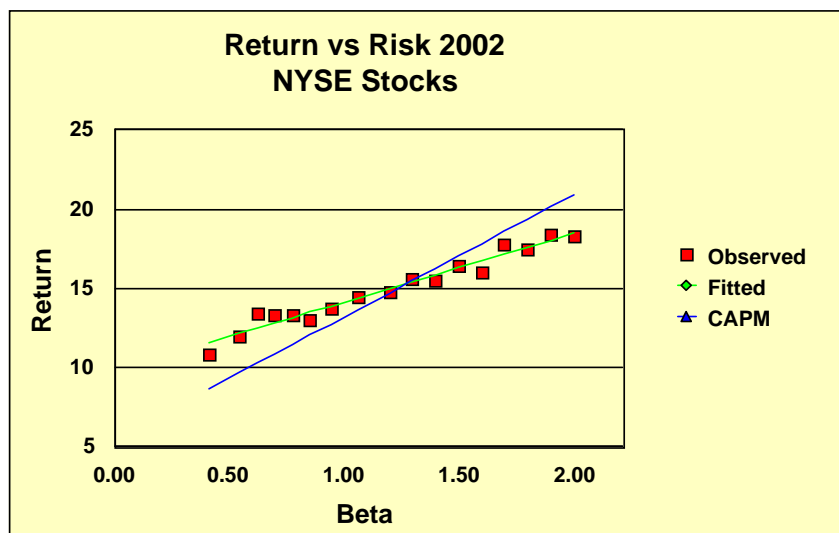
$$K = .0829 + .0520 \beta$$

Given that the risk-free rate over the estimation period was approximately 6 percent, this relationship implies that the intercept of the risk-return relationship is higher than the 6 percent risk-free rate, contrary to the CAPM's prediction. Given that the average return on an average risk stock exceeded the risk-free rate by about 8.0 percent in that period, that is, the market risk premium ($R_M - R_F$) = 8 percent, the intercept of the observed relationship between return and beta exceeds the risk-free rate by about 2 percent, suggesting an alpha factor of 2 percent.

Most of the empirical studies cited in the above table utilize raw betas rather than Value Line adjusted betas because the latter were not available over most of the time

periods covered in these studies. A study of the relationship between return and adjusted beta is reported on Table 6-7 in Ibbotson Associates Valuation Yearbook 2001. If we exclude the portfolio of very small cap stocks from the relationship due to significant size effects, the relationship between the arithmetic mean return and beta for the remaining portfolios is flatter than predicted and the intercept slightly higher than predicted by the CAPM, as shown on the graph below. It is noteworthy that the Ibbotson study relies on adjusted betas as stated on page 95 of the aforementioned study.

CAPM vs ECAPM

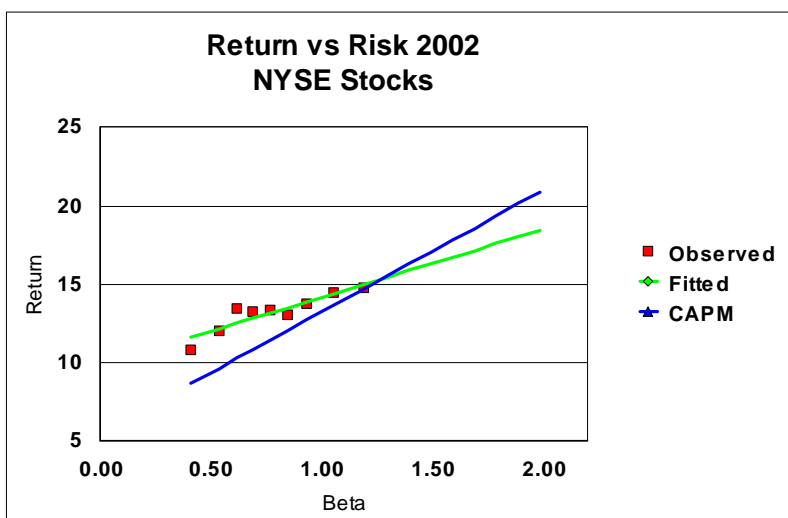


Another study by Morin in May 2002 provides empirical support for the ECAPM. All the stocks covered in the Value Line Investment Survey for Windows for which betas and returns data were available were retained for analysis. There were nearly 2000 such stocks. The expected return was measured as the total shareholder return (“TSR”) reported by Value Line over the past ten years. The Value Line adjusted beta was also retrieved from the same data base. The nearly 2000 companies for which all data were available were ranked in ascending order of beta, from lowest to highest. In order to palliate measurement error, the nearly 2000 securities were grouped into ten portfolios of

approximately 180 securities for each portfolio. The average returns and betas for each portfolio were as follows:

Portfolio #	Beta	Return
portfolio 1	0.41	10.87
portfolio 2	0.54	12.02
portfolio 3	0.62	13.50
portfolio 4	0.69	13.30
portfolio 5	0.77	13.39
portfolio 6	0.85	13.07
portfolio 7	0.94	13.75
portfolio 8	1.06	14.53
portfolio 9	1.19	14.78
portfolio 10	1.48	20.78

It is clear from the graph below that the observed relationship between DCF returns and Value Line adjusted betas is flatter than that predicted by the plain vanilla CAPM. The observed intercept is higher than the prevailing risk-free rate of 5.7 percent while the slope is less than equal to the market risk premium of 7.7 percent predicted by the plain vanilla CAPM for that period.



In an article published in *Financial Management*, Harris, Marston, Mishra, and O'Brien ("HMMO") estimate ex ante expected returns for S&P 500 companies over the

period 1983-1998¹. HMMO measure the expected rate of return (cost of equity) of each dividend-paying stock in the S&P 500 for each month from January 1983 to August 1998 by using the constant growth DCF model. They then investigate the relation between the risk premium (expected return over the 20-year U.S. Treasury Bond yield) estimates for each month to equity betas as of that same month (5-year raw betas).

The table below, drawn from HMMO Table 4, displays the average estimate prospective risk premium (Column 2) by industry and the corresponding beta estimate for that industry, both in raw form (Column 3) and adjusted form (Column 4). The latter were calculated with the traditional Value Line – Merrill Lynch – Bloomberg adjustment methodology by giving 1/3 weight of to a beta estimate of 1.00 and 2/3 weight to the raw beta estimate.

Table A-1 Risk Premium and Beta Estimates by Industry

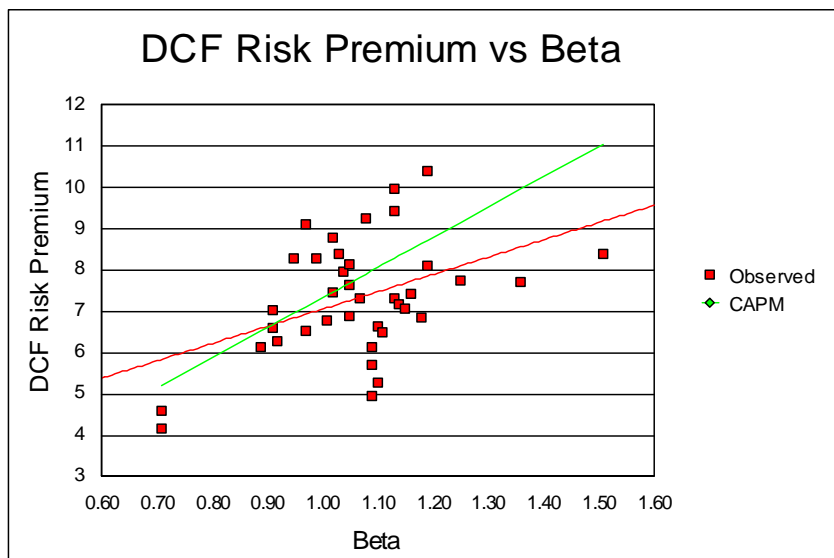
	Industry	DCF Risk Premium	Raw Industry Beta	Adjusted Industry Beta
	(1)	(2)	(3)	(4)
1	Aero	6.63	1.15	1.10
2	Autos	5.29	1.15	1.10
3	Banks	7.16	1.21	1.14
4	Beer	6.60	0.87	0.91
5	BldMat	6.84	1.27	1.18
6	Books	7.64	1.07	1.05
7	Boxes	8.39	1.04	1.03
8	BusSv	8.15	1.07	1.05
9	Chems	6.49	1.16	1.11
10	Chips	8.11	1.28	1.19
11	Clths	7.74	1.37	1.25
12	Cnstr	7.70	1.54	1.36
13	Comps	9.42	1.19	1.13
14	Drugs	8.29	0.99	0.99
15	ElcEq	6.89	1.08	1.05
16	Energy	6.29	0.88	0.92
17	Fin	8.38	1.76	1.51
18	Food	7.02	0.86	0.91
19	Fun	9.98	1.19	1.13
20	Gold	4.59	0.57	0.71
21	Hlth	10.40	1.29	1.19
22	Hslid	6.77	1.02	1.01

¹ Harris, R. S., Marston, F. C., Mishra, D. R., and O'Brien, T. J., "Ex Ante Cost of Equity Estimates of S&P 500 Firms: The Choice Between Global and Domestic CAPM," *Financial Management*, Autumn 2003, pp. 51-66.

Appendix A
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	Industry	DCF Risk Premium	Raw Industry Beta	Adjusted Industry Beta
	(1)	(2)	(3)	(4)
23	Insur	7.46	1.03	1.02
24	LabEq	7.31	1.10	1.07
25	Mach	7.32	1.20	1.13
26	Meals	7.98	1.06	1.04
27	MedEq	8.80	1.03	1.02
28	Pap	6.14	1.13	1.09
29	PerSv	9.12	0.95	0.97
30	Retail	9.27	1.12	1.08
31	Rubber	7.06	1.22	1.15
32	Ships	1.95	0.95	0.97
33	Stee	4.96	1.13	1.09
34	Telc	6.12	0.83	0.89
35	Toys	7.42	1.24	1.16
36	Trans	5.70	1.14	1.09
37	Txtls	6.52	0.95	0.97
38	Util	4.15	0.57	0.71
39	Whlsl	8.29	0.92	0.95
	MEAN	7.19		

The observed statistical relationship between expected return and **adjusted beta** is shown in the graph below along with the CAPM prediction:



If the plain vanilla version of the CAPM is correct, then the intercept of the graph should be zero, recalling that the vertical axis represents returns in excess of the risk-free rate. Instead, the observed intercept is approximately 2 percent, that is approximately equal to 25 percent of the expected market risk premium of 7.2 percent shown at the bottom of Column 2 over the 1983-1998 period, as predicted by the ECAPM. The same is true for the slope of the graph. If the plain vanilla version of the CAPM is correct, then the slope of the relationship should equal the market risk premium of 7.2 percent. Instead, the observed slope of close to 5 percent is approximately equal to 75 percent of the expected market risk premium of 7.2 percent, as predicted by the ECAPM.

In short, the HMMO empirical findings are quite consistent with the predictions of the ECAPM.

Practical Implementation of the ECAPM

The empirical evidence reviewed above suggests that the expected return on a security is related to its risk by the following relationship:

$$K = R_F + \alpha + \beta (MRP - \alpha) \quad (5)$$

or, alternatively by the following equivalent relationship:

$$K = R_F + a MRP + (1-a) \beta MRP \quad (6)$$

The empirical findings support values of α from approximately 2 percent to 7 percent. If one is using the short-term U.S. Treasury Bills yield as a proxy for the risk-free rate, and given that utility stocks have lower than average betas, an alpha in the lower range of the empirical findings, 2 percent - 3 percent is reasonable, albeit conservative.

Using the long-term U.S. Treasury yield as a proxy for the risk-free rate, a lower alpha adjustment is indicated. This is because the use of the long-term U.S.

Treasury yield as a proxy for the risk-free rate partially incorporates the desired effect of using the ECAPM². An alpha in the range of 1 percent - 2 percent is therefore reasonable.

To illustrate, consider a utility with a beta of 0.80. The risk-free rate is 5 percent, the MRP is 7 percent, and the alpha factor is 2 percent. The cost of capital is determined as follows:

$$\begin{aligned} K &= R_F + \alpha + \beta (MRP - \alpha) \\ K &= 5\% + 2\% + 0.80(7\% - 2\%) \\ &= 11\% \end{aligned}$$

A practical alternative is to rely on the second variation of the ECAPM:

$$K = R_F + a MRP + (1-a) \beta MRP$$

With an alpha of 2 percent, a MRP in the 6 percent - 8 percent range, the 'a' coefficient is 0.25, and the ECAPM becomes³:

$$K = R_F + 0.25 MRP + 0.75 \beta MRP$$

Returning to the numerical example, the utility's cost of capital is:

$$\begin{aligned} K &= 5\% + 0.25 \times 7\% + 0.75 \times 0.80 \times 7\% \\ &= 11\% \end{aligned}$$

For reasonable values of beta and the MRP, both renditions of the ECAPM

² The Security Market Line (SML) using the long-term risk-free rate has a higher intercept and a flatter slope than the SML using the short-term risk-free rate

³ Recall that alpha equals 'a' times MRP, that is, alpha = a MRP, and therefore a = alpha/MRP. If alpha is 2 percent, then a = 0.25

produce results that are virtually identical⁴.

⁴ In the Morin (1994) study, the value of “a” was actually derived by systematically varying the constant “a” in equation 6 from 0 to 1 in steps of 0.05 and choosing that value of 'a' that minimized the mean square error between the observed relationship between return and beta:

$$K = 0.0829 + .0520 \beta$$

The value of a that best explained the observed relationship was 0.25.

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APPENDIX B

FLOTATION COST ALLOWANCE

To obtain the final cost of equity financing from the investors' expected rate of return, it is necessary to make allowance for underpricing, which is the sum of market pressure, costs of flotation, and underwriting fees associated with new issues. Allowance for market pressure should be made because large blocks of new stock may cause significant pressure on market prices even in stable markets. Allowance must also be made for company costs of flotation (including such items as printing, legal and accounting expenses) and for underwriting fees.

1. MAGNITUDE OF FLOTATION COSTS

According to empirical studies, underwriting costs and expenses average at least 4% of gross proceeds for utility stock offerings in the U.S. (See Logue & Jarrow: "Negotiations vs. Competitive Bidding in the Sale of Securities by Public Utilities", Financial Management, Fall 1978.) A study of 641 common stock issues by 95 electric utilities identified a flotation cost allowance of 5.0%. (See Borum & Malley: "Total Flotation Cost for Electric Company Equity Issues", Public Utilities Fortnightly, Feb. 20, 1986.)

Empirical studies suggest an allowance of 1% for market pressure in U.S. studies. Logue and Jarrow found that the absolute magnitude of the relative price decline due to market pressure was less than 1.5%. Bowyer and Yawitz examined 278 public utility stock issues and found an average market pressure of 0.72%. (See Bowyer & Yawitz, "The Effect of New Equity Issues on Utility Stock Prices", Public Utilities Fortnightly, May 22, 1980.)

Eckbo & Masulis ("Rights vs. Underwritten Stock Offerings: An Empirical Analysis", University of British Columbia, Working Paper No. 1208, Sept., 1987) found an average flotation cost of 4.175% for utility common stock offerings. Moreover, flotation costs increased progressively for smaller size issues. They also found that the relative price decline due to market pressure in the days surrounding the announcement amounted to slightly more than 1.5%. In a classic and monumental study published in the prestigious *Journal of Financial Economics* by a prominent scholar, a market pressure effect of 3.14% for industrial stock issues and 0.75%

for utility common stock issues was found (see Smith, C.W., "Investment Banking and the Capital Acquisition Process," Journal of Financial Economics 15, 1986). Other studies of market pressure are reported in Logue ("On the Pricing of Unseasoned Equity Offerings," Journal of Financial and Quantitative Analysis, Jan. 1973), Pettway ("The Effects of New Equity Sales Upon Utility Share Prices," Public Utilities Fortnightly, May 10 1984), and Reilly and Hatfield ("Investor Experience with New Stock Issues," Financial Analysts' Journal, Sept.- Oct. 1969). In the Pettway study, the market pressure effect for a sample of 368 public utility equity sales was in the range of 2% to 3%. Adding the direct and indirect effects of utility common stock issues, the indicated total flotation cost allowance is above 5.0%, corroborating the results of earlier studies.

As shown in the table below, a comprehensive empirical study by Lee, Lochhead, Ritter, and Zhao, "The Costs of Raising Capital," Journal of Financial Research, Vol. XIX, NO. 1, Spring 1996, shows average direct flotation costs for equity offerings of 3.5% - 5% for stock issues between \$60 and \$500 million. Allowing for market pressure costs raises the flotation cost allowance to well above 5%.

FLOTATION COSTS: RAISING EXTERNAL CAPITAL

(Percent of Total Capital Raised)

Amount Raised in \$ Millions	Average Flotation Cost: Common Stock	Average Flotation Cost: New Debt
\$ 2 - 9.99	13.28%	4.39%
10 - 19.99	8.72	2.76
20 - 39.99	6.93	2.42
40 - 59.99	5.87	1.32
60 - 79.99	5.18	2.34
80 - 99.99	4.73	2.16
100 - 199.99	4.22	2.31
200 - 499.99	3.47	2.19
500 and Up	3.15	1.64

Note: Flotation costs for IPOs are about 17 percent of the value of common stock issued if the amount raised is less than \$10 million and about 6 percent if more than \$500 million is raised. Flotation costs are somewhat lower for utilities than others.

Source: Lee, Inmoo, Scott Lochhead, Jay Ritter, and Quanshui Zhao, "The Costs of Raising Capital," *The Journal of Financial Research*, Spring 1996.

Therefore, based on empirical studies, total flotation costs including market pressure amount to approximately 5% of gross proceeds. I have therefore assumed a 5% gross total flotation cost allowance in my cost of capital analyses.

2. APPLICATION OF THE FLOTATION COST ADJUSTMENT

The section below shows: 1) why it is necessary to apply an allowance of 5% to the dividend yield component of equity cost by dividing that yield by 0.95 (100% - 5%) to obtain the fair return on equity capital, and 2) why the flotation adjustment is permanently required to avoid confiscation even if no further stock issues are contemplated. Flotation costs are only recovered

if the rate of return is applied to total equity, including retained earnings, in all future years.

Flotation costs are just as real as costs incurred to build utility plant. Fair regulatory treatment absolutely must permit the recovery of these costs. An analogy with bond issues is useful to understand the treatment of flotation costs in the case of common stocks.

In the case of a bond issue, flotation costs are not expensed but are rather amortized over the life of the bond, and the annual amortization charge is embedded in the cost of service. This is analogous to the process of depreciation, which allows the recovery of funds invested in utility plant. The recovery of bond flotation expense continues year after year, irrespective of whether the company issues new debt capital in the future, until recovery is complete. In the case of common stock that has no finite life, flotation costs are not amortized. Therefore, the recovery of flotation cost requires an upward adjustment to the allowed return on equity. Roger A. Morin, Regulatory Finance, Public Utilities Reports Inc., Arlington, Va., 1994, provides numerical illustrations that show that even if a utility does not contemplate any additional common stock issues, a flotation cost adjustment is still permanently required. Examples there also demonstrate that the allowance applies to retained earnings as well as to the original capital.

From the standard DCF model, the investor's required return on equity capital is expressed as:

$$K = D_1/P_o + g$$

If P_o is regarded as the proceeds per share actually received by the company from which dividends and earnings will be generated, that is, P_o equals B_o , the book value per share, then the company's required return is:

$$r = D_1/B_o + g$$

Denoting the percentage flotation costs 'f', proceeds per share B_o are related to market price P_o as follows:

$$P - fP = B_o$$

$$P(1 - f) = B_o$$

Substituting the latter equation into the above expression for return on equity, we obtain:

$$r = D_1/P(1-f) + g$$

that is, the utility's required return adjusted for underpricing. For flotation costs of 5%, dividing the expected dividend yield by 0.95 will produce the adjusted cost of equity capital. For a dividend yield of 6% for example, the magnitude of the adjustment is 32 basis points: $.06/.95 = .0632$.

In deriving DCF estimates of fair return on equity, it is therefore necessary to apply a conservative after-tax allowance of 5% to the dividend yield component of equity cost.

Even if no further stock issues are contemplated, the flotation adjustment is still permanently required to keep shareholders whole. Flotation costs are only recovered if the rate of return is applied to total equity, including retained earnings, in all future years, even if no future financing is contemplated. This is demonstrated by the numerical example contained in pages 7-9 of this Appendix. Moreover, even if the stock price, hence the DCF estimate of equity return, fully reflected the lack of permanent allowance, the company always nets less than the market price. Only the net proceeds from an equity issue are used to add to the rate base on which the investor earns. A permanent allowance for flotation costs must be authorized in order to insure that in each year the investor earns the required return on the total amount of capital actually supplied.

The example shown on pages 7-9 shows the flotation cost adjustment process using illustrative, yet realistic, market data. The assumptions used in the computation are shown on page 7. The stock is selling in the market for \$25, investors expect the firm to pay a dividend of \$2.25 that will grow at a rate of 5% thereafter. The traditional DCF cost of equity is thus $k = D/P + g = 2.25/25 + .05 = 14\%$. The firm sells one share stock, incurring a flotation cost of 5%. The traditional DCF cost of equity adjusted for flotation cost is thus $ROE = D/P(1-f) + g = .09/.95 + .05 = 14.47\%$.

The initial book value (rate base) is the net proceeds from the stock issue, which are \$23.75, that is, the market price less the 5% flotation costs. The example demonstrates that only

if the company is allowed to earn 14.47% on rate base will investors earn their cost of equity of 14%. On page 8, Column 1 shows the initial common stock account, Column 2 the cumulative retained earnings balance, starting at zero, and steadily increasing from the retention of earnings. Total equity in Column 3 is the sum of common stock capital and retained earnings. The stock price in Column 4 is obtained from the seminal DCF formula: $D_1/(k - g)$. Earnings per share in Column 6 are simply the allowed return of 14.47% times the total common equity base. Dividends start at \$2.25 and grow at 5% thereafter, which they must do if investors are to earn a 14% return. The dividend payout ratio remains constant, as per the assumption of the DCF model. All quantities, stock price, book value, earnings, and dividends grow at a 5% rate, as shown at the bottom of the relevant columns. Only if the company is allowed to earn 14.47% on equity do investors earn 14%. For example, if the company is allowed only 14%, the stock price drops from \$26.25 to \$26.13 in the second year, inflicting a loss on shareholders. This is shown on page 9. The growth rate drops from 5% to 4.53%. Thus, investors only earn $9\% + 4.53\% = 13.53\%$ on their investment. It is noteworthy that the adjustment is always required each and every year, whether or not new stock issues are sold in the future, and that the allowed return on equity must be earned on total equity, including retained earnings, for investors to earn the cost of equity.

ASSUMPTIONS:

ISSUE PRICE = \$25.00
FLOTATION COST = 5.00%
DIVIDEND YIELD = 9.00%
GROWTH = 5.00%

EQUITY RETURN = **14.00%**
($D/P + g$)
ALLOWED RETURN ON EQUITY = **14.47%**
($D/P(1-f) + g$)

Yr	COMMON STOCK (1)	RETAINED EARNINGS (2)	TOTAL EQUITY (3)	STOCK PRICE (4)	MARKET	EPS (6)	DPS (7)	PAYOUT (8)
					/ BOOK RATIO (5)			
1	\$23.75	\$0.000	\$23.750	\$25.000	1.0526	\$3.438	\$2.250	65.45%
2	\$23.75	\$1.188	\$24.938	\$26.250	1.0526	\$3.609	\$2.363	65.45%
3	\$23.75	\$2.434	\$26.184	\$27.563	1.0526	\$3.790	\$2.481	65.45%
4	\$23.75	\$3.744	\$27.494	\$28.941	1.0526	\$3.979	\$2.605	65.45%
5	\$23.75	\$5.118	\$28.868	\$30.388	1.0526	\$4.178	\$2.735	65.45%
6	\$23.75	\$6.562	\$30.312	\$31.907	1.0526	\$4.387	\$2.872	65.45%
7	\$23.75	\$8.077	\$31.827	\$33.502	1.0526	\$4.607	\$3.015	65.45%
8	\$23.75	\$9.669	\$33.419	\$35.178	1.0526	\$4.837	\$3.166	65.45%
9	\$23.75	\$11.340	\$35.090	\$36.936	1.0526	\$5.079	\$3.324	65.45%
10	\$23.75	\$13.094	\$36.844	\$38.783	1.0526	\$5.333	\$3.490	65.45%
				5.00%	5.00%	5.00%	5.00%	

Yr	COMMON STOCK (1)	RETAINED EARNINGS (2)	TOTAL EQUITY (3)	STOCK PRICE (4)	MARKET/ BOOK RATIO (5)	EPS (6)	DPS (7)	PAYOUT (8)
1	\$23.75	\$0.000	\$23.750	\$25.000	1.0526	\$3.325	\$2.250	67.67%
2	\$23.75	\$1.075	\$24.825	\$26.132	1.0526	\$3.476	\$2.352	67.67%
3	\$23.75	\$2.199	\$25.949	\$27.314	1.0526	\$3.633	\$2.458	67.67%
4	\$23.75	\$3.373	\$27.123	\$28.551	1.0526	\$3.797	\$2.570	67.67%
5	\$23.75	\$4.601	\$28.351	\$29.843	1.0526	\$3.969	\$2.686	67.67%
6	\$23.75	\$5.884	\$29.634	\$31.194	1.0526	\$4.149	\$2.807	67.67%
7	\$23.75	\$7.225	\$30.975	\$32.606	1.0526	\$4.337	\$2.935	67.67%
8	\$23.75	\$8.627	\$32.377	\$34.082	1.0526	\$4.533	\$3.067	67.67%
9	\$23.75	\$10.093	\$33.843	\$35.624	1.0526	\$4.738	\$3.206	67.67%
10	\$23.75	\$11.625	\$35.375	\$37.237	1.0526	\$4.952	\$3.351	67.67%
			4.53%	4.53%			4.53%	4.53%

Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION

d/b/a NATIONAL GRID

Rebuttal Testimony

of

Roger A. Morin, PhD

Dated: August 6, 2010

1 **Q. PLEASE STATE YOUR NAME, ADDRESS, AND OCCUPATION.**

2 A. My name is Dr. Roger A. Morin. My business address is Georgia State
3 University, Robinson College of Business, University Plaza, Atlanta, Georgia,
4 30303. I am Emeritus Professor of Finance at the College of Business, Georgia
5 State University and Professor of Finance for Regulated Industry at the Center for
6 the Study of Regulated Industry at Georgia State University. I am also a principal
7 in Utility Research International, an enterprise engaged in regulatory finance and
8 economics consulting to business and government.

9 **Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING ON**
10 **BEHALF OF NIAGARA MOHAWK POWER CORPORATION D/B/A**
11 **NATIONAL GRID (“NIAGARA MOHAWK” OR THE “COMPANY”)?**

12 A. Yes, I did.

13 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

14 A. I will respond to certain statements contained in the direct testimony of: 1) Mr.
15 Duah and Mr. Piscitelli (“Finance Panel”) on behalf of the New York State
16 Department of Public Service (“DPS Staff or “Staff”), and 2) Mr. Niazi on behalf
17 of the New York State Consumer Protection Board (“CPB”).

18 **Q. PLEASE DESCRIBE HOW YOUR REBUTTAL TESTIMONY IS**
19 **ORGANIZED.**

20 A. My rebuttal testimony is organized in two sections, corresponding to each of the
21 aforementioned testimonies.

22 **Q. PLEASE SUMMARIZE THE RATE OF RETURN RECOMMENDATIONS**
23 **OF THE TWO WITNESSES YOU ARE REBUTTING IN THIS CASE.**

1 A. The rate of return on common equity capital (“ROE”) recommended by each
2 party I am rebutting in this case is as follows:

3 Staff 9.0%

4 CPB 9.0%

5 Given that CPB witness Mr. Niazi’s testimony is almost an exact duplicate
6 of Staff’s testimony, most of my rebuttal comments are directed to the latter and
7 are applicable to Mr. Niazi’s testimony as well.

8 **I. BRIEF COMMENTS ON MR. NIAZI’S TESTIMONY**

9 **Q. PLEASE SUMMARIZE MR. NIAZI’S RATE OF RETURN ON EQUITY**
10 **RECOMMENDATION.**

11 A. Mr. Niazi recommends that a return allowance of only 9.0% be applied to Niagara
12 Mohawk’s common equity capital for ratemaking purposes.

13 **Q DO YOU HAVE ANY GENERAL COMMENT ON MR. NIAZI’S**
14 **TESTIMONY?**

15 A. In determining the cost of equity, Mr. Niazi’s testimony is virtually identical to
16 Staff’s testimony in all respects, and therefore adds very little to this proceeding.
17 Given the striking similarity between the two testimonies, and in the interest of
18 brevity, portions of the rebuttal comments directed at Staff are equally applicable
19 to comparable portions of Mr. Niazi’s testimony.

20 Also, both Mr. Niazi and Staff have very similar criticisms of my own
21 direct testimony, namely on the issue of the Risk Premium methodology, choice
22 of comparable companies, flotation costs, and choice of DCF growth rates. Given
23 the nearly identical nature of both testimonies, my responses to Staff’s criticisms

1 are equally applicable to similar criticisms set forth in Mr. Niazi's testimony.

2 **II. REBUTTAL OF STAFF'S TESTIMONY**

3 **Q. PLEASE SUMMARIZE STAFF'S RATE OF RETURN**
4 **RECOMMENDATION.**

5 A. Staff recommends that Niagara Mohawk's allowed ROE be set at only 9.0%. In
6 determining Niagara Mohawk's cost of common equity capital, Staff applies a
7 two-stage Discounted Cash Flow ("DCF") analysis to a group of thirty-four
8 electric utilities.¹ For the first-stage growth component of the DCF analysis, Staff
9 relies on Value Line's forecast of dividend payments over the next few years. For
10 the more important second-stage growth component that produces the majority of
11 the value calculated by the DCF analysis, Staff uses the earnings retention
12 method, also known as the "sustainable growth" method, again using Value Line
13 estimates as input data.

14 Staff also applies a Capital Asset Pricing Model ("CAPM") and an
15 Empirical CAPM ("ECAPM") (also referred to as a "zero beta" CAPM) analysis
16 to the same group of companies, using an average of 10-year and 30-year
17 Treasury bond yields as proxies for the risk-free rate, and Value Line beta
18 estimates. Staff's estimate of the market risk premium ("MRP") component of
19 the CAPM is based on a Merrill Lynch estimate. Applying a weight of two-thirds
20 to the DCF results and one-third to the CAPM-ECAPM average result, Staff
21 concludes that Niagara Mohawk's cost of common equity capital is 9.0%, after a
22 return decrement of 22 basis points in order to account for Niagara Mohawk's

¹ Mr. Niazi's proxy group has 35 companies. Mr. Niazi included UIL Holdings Corp. in his proxy group. Staff did not. It is not clear why there is a difference. UIL Holdings Corp. apparently meets the criteria for inclusion in Staff's proxy group.

1 superior credit quality and an 8.5 basis point decrement to account for the risk
2 mitigating aspects of the Company's proposed revenue decoupling mechanism.

3 **Q. DO YOU HAVE ANY GENERAL COMMENTS ON STAFF'S RATE OF**
4 **RETURN TESTIMONY?**

5 A. Yes. Before I engage in specific criticisms of Staff's testimony, I should set forth
6 my general reaction to its testimony. At the outset, I was very surprised by Staff's
7 extremely low recommendation of only 9.0% in this case given that it is less than
8 any ROE recently granted for a utility by the Commission. In recent New York
9 cases, the following ROEs were approved or have been submitted to the
10 Commission for approval via joint proposal:

1

Company	Case No.	Date	ROE	
Central Hudson	09-E-0588	6/18/10	10.00%	
Central Hudson	09-G-0589	6/18/10	10.00%	
ConEd NY	09-E-0428	3/26/10	10.15%	
New York E&G	09-E-0715	7/14/10	10.00%	*
New York E&G	09-G-0716	7/14/10	10.00%	*
Rochester G&E	09-E-0717	7/14/10	10.00%	*
Rochester G&E	09-G-0718	7/14/10	10.00%	*
ConEd NY	09-G-0795	5/18/10	9.60%	*
Central Hudson	08-E-0887	6/22/09	10.00%	
Central Hudson	08-G-0888	6/22/09	10.00%	
Niagara Mohawk	08-G-0609	5/18/09	10.20%	
Corning Natural Gas	08-G-1137	8/20/09	10.70%	
Orange & Rockland	08-G-1398	10/16/09	10.40%	

Note: * denotes JP proposed to the Commission

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These ROEs approved/submitted to the Commission for New York utilities differ markedly from Staff's extremely low recommendation in this case even after one accounts for the fact that many of the referenced returns apply to multi-year periods and thus presumably reflect a stayout premium.

My second reaction is that Staff's recommended 9.0% ROE for Niagara Mohawk would be among the lowest authorized rates of return for a major electric utility in the United States. According to the latest issue of AUS dated July 2010, 58 of 59 electric utilities have an authorized ROE well in excess of 9.0%. This is a clear indication that Staff's ROE recommendation of 9.0% is too low. During the past two and a half years, the allowed ROEs for electric utilities authorized by state commissions across the country have consistently averaged approximately 10.5%² compared to Staff's very low recommended ROE of 9.0%:

² Regulatory Research Associates ("RRA"), Regulatory Focus, July 7, 2010.

1	2008 Average Allowed ROE	10.5%
2	2009 Average Allowed ROE	10.5%
3	2010 Average Allowed ROE	10.4%

4 Similarly, the average authorized ROE for the electric utility industry as
5 reported in AUS Utility Reports published in July 2010 is 10.6%.

6 In my opinion, this evidence demonstrates that there is something about
7 Staff's methodology that is producing results that are totally out of step with
8 returns being allowed by regulatory commissions across the country. In this
9 rebuttal testimony, I will highlight certain flaws that create a clear downward bias
10 in the Staff presentation. In addition, the fact that the Staff methodology is based
11 on the recommended decision in the Generic Financing Case (Case 91-M-0509),
12 and other Commission precedent does not change the fact that Staff's
13 recommendation is outside the range of returns being afforded to comparable
14 enterprises with corresponding risks. In the long run, the Commission cannot
15 expect that Niagara Mohawk can continue to attract the capital it needs to finance
16 ongoing and increasingly large infrastructure improvements if it is afforded an
17 opportunity earn a return that is 100 to 150 basis points less than the returns being
18 provided to comparable businesses.

19 **Q. IS THERE SOME DEGREE OF AGREEMENT BETWEEN YOUR RATE**
20 **OF RETURN TESTIMONY AND STAFF'S?**

21 A. Yes, there is some degree of agreement between Staff and myself. Under current
22 capital market conditions, I agree generally with: (i) the use of several
23 methodologies in estimating a fair return on common equity; (ii) the magnitude of

1 the beta estimates in the CAPM analyses; and (iii) the magnitude of the estimate
2 of the market risk premium (MRP) in the CAPM analyses.

3 **Q. WHAT SIGNIFICANT DISAGREEMENTS DO YOU HAVE WITH**
4 **STAFF'S TESTIMONY?**

5 A. I disagree with the following aspects of Staff's testimony: 1) the crucial second
6 stage growth rate used by Staff in its Two-Stage DCF approach; 2) Staff's use of
7 the median instead of the mean to determine the average ROE of 9.14% for its
8 proxy group of companies 3) the risk-free rate used by Staff in its CAPM
9 analyses, 4) the downward return adjustments made by Staff in order to account
10 for a revenue decoupling mechanism (RDM) and credit quality differences
11 between Niagara Mohawk and the comparable group, which reduce Staff's
12 recommended ROE by 30 basis points, and 5) the absence of an allowance for
13 flotation costs. I also have other less significant disagreements that I will note
14 throughout my testimony.

15 **Q. WHAT ARE YOUR BASIC CONCLUSIONS REGARDING STAFF'S**
16 **COST OF EQUITY TESTIMONY?**

17 A. Staff seriously understates the ROE that would be fair and reasonable for Niagara
18 Mohawk. Inclusion of a proper growth rate and flotation cost allowance in the
19 DCF results, inclusion of a proper risk-free rate in the CAPM analyses, and
20 elimination of the inappropriate credit quality adjustment would bring Staff's
21 recommendation up to 10.5%, close to my own from these corrections alone.

22

23

1 **Q. PLEASE SUMMARIZE YOUR COMMENTS ON STAFF'S TESTIMONY.**

2 A. I have the following specific disagreements with Staff's testimony:

3 **1. Allowed returns.** The ROE recommended by Staff is well outside the range of
4 currently authorized ROEs for electric utilities in the United States and outside the
5 zone of currently authorized ROEs for Staff's own sample of comparable
6 companies.

7 **2. DCF Growth Rates: Earnings Retention Method.** Staff's principal, and in
8 fact only, technique for estimating the second-stage growth component of the
9 DCF model is the earnings retention growth technique. There is a logical
10 inconsistency in the retention growth technique because Staff is forced to assume
11 the answer to implement the method. More importantly, from Staff's own
12 evidence, investors expect substantially higher returns for utilities than what Staff
13 recommends.

14 **3. DCF Growth Rates: Analysts' Forecasts.** Investors are expecting
15 substantially higher growth rates than Staff's growth rates for the sample
16 companies. Using the analysts' consensus growth forecast instead of Staff's would
17 increase the DCF estimate of the cost of common equity by 80 basis points
18 (0.8%), that is, from 9.14% to 9.94% because of that correction alone.

19 **4. DCF Growth Rates: Long-term Economic Growth.** Staff's long-term
20 growth forecast for its comparable group, based on the earnings retention growth
21 method, is below the long-term expected nominal growth of the economy by
22 100 basis points.

23 **5. CAPM Risk-Free Rate.** Staff's risk-free rate proxy relies on the yield on

1 10-year and 30-year Treasury bonds instead of just the yield on 30-year Treasury
2 bonds. Using the appropriate risk-free rate raises Staff's CAPM estimates by 40
3 basis points because of this correction alone.

4 **6. Flotation Costs.** Staff's DCF estimates of equity costs are downward-biased
5 by approximately 20-30 basis points to the extent that not all the flotation costs
6 associated with past equity issues have been expensed or recovered in the past.

7 **7. Credit Quality Return Adjustment.** Staff's downward ROE adjustment for
8 credit quality differences should be rejected by the Commission as it is not
9 supported by even the evidence provided by Staff.

10 **8. Decoupling ROE Adjustment.** Staff's downward ROE adjustment in order to
11 account for the risk-mitigating impact of the revenue decoupling mechanism
12 (RDM) should be rejected by the Commission as it is already accounted for in
13 capital market data and otherwise without support.

14 **9. Criticisms of my testimony.** Staff's criticisms of my ROE recommendation
15 are without foundation for the reasons I discuss later in my testimony.

16 1. ALLOWED RETURNS

17 **Q. DR. MORIN, CAN YOU COMMENT ON RECENT DECISIONS**
18 **REGARDING ALLOWED ROES FOR ELECTRIC UTILITIES?**

19 A. Yes, I can. Allowed ROEs, although not a precise indication of a utility's cost of
20 equity capital, are nevertheless important determinants of investor growth
21 perceptions and investor expected returns. They also serve to provide some
22 perspective on the validity and reasonableness of Staff's recommended ROE.
23 Using Regulatory Research Associates (now SNL) reported data for ROE

1 decisions rendered for 2008, 2009, and 2010, the average allowed ROE for
 2 electric utilities was 10.5%, 10.5%, and 10.4%, respectively. Even if these
 3 averages include 25 to 30 basis point premiums for multi-year settlements and the
 4 give and take process involved in reaching settlements, these ROE decisions
 5 would still be well in excess of Staff's recommended 9.0%.

6 **Q. IS STAFF'S RECOMMENDED ROE FOR NIAGARA MOHAWK**
 7 **CONSISTENT WITH THE AVERAGE AUTHORIZED ROE OF THE**
 8 **ELECTRIC UTILITIES IN STAFF'S COMPARABLE GROUP?**

9 A. No, it is nowhere near that average. The AUS Utility Reports survey for July
 10 2010 reports that the average authorized ROE is 10.6% for both the combination
 11 gas and electric industry and the overall electric utility industry. All but one of
 12 the 59 authorized ROEs reported by AUS Utility Reports exceed Staff's 9.0%
 13 recommendation.

14 Moreover, Staff's recommended ROE is below the authorized ROE of
 15 each electric utility in Staff's comparable group and far below the average
 16 authorized ROE of 10.8% for the same group, as shown on the table below:

17 Table 1 Allowed ROEs for Staff's Proxy Group Companies

	Company Name	Allowed ROE
1	ALLETE	10.74
2	Alliant Energy	10.41
3	Amer. Elec. Power	10.66
4	Ameren Corp.	10.64
5	Avista Corp.	10.33
6	Black Hills	10.71
7	CH Energy Group	10.00
8	Cleco Corp.	10.70
9	Consol. Edison	10.11

10	DPL Inc.	11.00
11	DTE Energy	11.00
12	Duke Energy	10.63
13	Edison Int'l	10.66
14	Empire Dist. Elec.	10.80
15	Entergy Corp.	10.80
16	FPL Group	10.50
17	G't Plains Energy	10.45
18	Hawaiian Elec.	10.82
19	IDACORP Inc.	10.18
20	MGE Energy	10.40
21	Northeast Utilities	9.72
22	NSTAR	12.50
23	PG&E Corp.	11.35
24	Pinnacle West Capital	11.00
25	Portland General	10.80
26	Progress Energy	12.00
27	SCANA Corp.	10.67
28	Sempra Energy	11.46
29	Southern Co.	11.93
30	TECO Energy	11.00
31	Vectren Corp.	10.43
32	Westar Energy	10.20
33	Wisconsin Energy	10.43
34	Xcel Energy Inc.	10.72
	AVERAGE	10.8
	MEDIAN	10.7

1 Source: AUS Utility Reports 7/2010

2 Although decisions of other regulatory bodies regarding authorized ROEs
3 do not bind this Commission, one cannot overlook the glaring difference between
4 Staff's recommended ROE and the ROEs currently authorized for the electric
5 utility industry. One also cannot overlook the fact that those allowed ROEs also
6 impact investor expectations, which in turn impact both access to and the cost of
7 equity capital.

1 **Q. WHAT WAS THE REACTION OF THE FINANCIAL COMMUNITY IN**
2 **2007 WHEN THE COMMISSION ESTABLISHED A RETURN ON**
3 **EQUITY FOR CONSOLIDATED EDISON COMPANY OF NEW YORK,**
4 **INC. THAT WAS COMPARABLE TO WHAT IS BEING**
5 **RECOMMENDED FOR NIAGARA MOHAWK IN THIS CASE?**

6 A. To illustrate the pivotal role of allowed ROE on the evaluation of utility risk in
7 the marketplace, I refer Staff to the low 9.1% ROE authorized in Consolidated
8 Edison Company of New York (CECONY)'s 2008 Rate Order and its role in the
9 recent downgrading of CECONY's securities.

10 Standard & Poor's ("S&P") made the following statement in its research
11 update entitled *Consolidated Edison Inc Downgraded to 'A-' From 'A' on Rate*
12 *Decision:*

13 *"The rating action reflects our expectations that the firm's financial measures will*
14 *be commensurate with 'A-' after the recent New York Public Service Commission's*
15 *\$425 million rate order for subsidiary Consolidated Edison Co. of New York Inc.*
16 *becomes effective at month's end."*

17 Fitch Ratings ("Fitch") also issued research reports on Consolidated
18 Edison on March 20, 2008 ("Fitch Downgrades Con Ed of NY & Con Ed Inc. to
19 'A-' on Rate Decision") and March 28, 2008 ("Fitch Completes Review of Con Ed
20 Inc. Group"). Fitch made the following comments:

21 *The outcome of the yesterday's rate decision by the New York Public Service*
22 *Commission (NYPSC) will not produce cash flow credit measures consistent with*
23 *the prior credit ratings...The authorized return on equity of 9.1% is below the*
24 *average for utilities of comparable risk, and in Fitch's view is inconsistent with*
25 *the heavy investment program and capital raising needs facing the utility...Fitch's*
26 *prior ratings were based on the historical support shown by the NYPSC to*
27 *preserve this urban utility's strong access to capital. However, the rate decision*
28 *and the related discussion by commissioners in the hearing indicate the NYPSC's*
29 *low regard for maintaining ratings at Consolidated Edison Co. of New York*
30 *Ince..above the lowest rungs of investment grade.*

1
2 *Also, the authorized ROE for Consolidated Edison Co. of New York Inc. of 9.1%*
3 *is not only well below the sector average but is also below average for utilities of*
4 *comparable risk and in Fitch's view is not supportive of the projected need to*
5 *raise equity and debt capital.*
6

7 Lastly, Moody's, in its Credit Opinion of March 21, 2008 made the
8 following comments:

9 *Moody's affirmed the ratings of Consolidated Edison Co. of New York Inc. and*
10 *O&R but revised the rating outlook for all three companies to negative from*
11 *stable. This action reflected our growing concern with regard to the ability of the*
12 *three companies to achieve a materially stronger financial profile given the*
13 *persistent weakness in key credit metrics for the companies relative to what we*
14 *typically see for companies in the "A" rating category coupled with the decision*
15 *by the NYPSC with respect to Consolidated Edison Co. of New York Inc.'s latest*
16 *rate case....The change to negative rating outlooks for the companies also takes*
17 *into account our more guarded view than we have had in the past about the extent*
18 *to which the New York regulatory environment will be supportive in future rate*
19 *case decisions for Consolidated Edison Co. of New York Inc. and O&R. In*
20 *particular, we note the 9.1% allowed return on equity (ROE) used by the*
21 *NYPSC in late 2007 for O&R's rate investigation.... And the recent fully*
22 *litigated decision in Consolidated Edison Co. of New York Inc.'s electric rate*
23 *case, which granted only about 35% of the \$1.2 billion rate increase*
24 *requested...also based on a 9.1% allowed ROE (reportedly the lowest ROE*
25 *granted to an electric utility in over 30 years).* (emphasis added)

26 It is abundantly clear from these statements that the level of allowed ROE
27 is indeed a major factor affecting the credit rating of a utility's securities, and that
28 Staff's recommended ROE in this case is likely to be viewed as deficient.

29 **Q. IS THERE OBJECTIVE EVIDENCE THAT THE FINANCIAL**
30 **COMMUNITY IS CONCERNED ABOUT THE COMMISSION'S**
31 **WILLINGNESS TO ESTABLISH RATES AND RATE RECOVERY**
32 **MECHANISMS SUFFICIENT TO PROVIDE INVESTORS WITH THE**
33 **OPPORTUNITY TO EARN REASONABLE RATES?**

1 A. Yes. Exhibit __ (PP/KD-12) attached to Staff’s testimony, indicates that Moody’s
2 places New York regulation in the fourth lowest of six categories, supportive of
3 only “Baa” credit quality. Moreover, I understand that Moody’s has assigned the
4 same metric to its view of Niagara Mohawk’s ability to recover the costs of its
5 electric operations, pending the outcome of this case. Similarly, in S&P in its
6 recent assessment of regulatory environments, New York was classified in the
7 “less credit supportive” category³.

8 2. EARNINGS RETENTION GROWTH METHOD

9 Q. WHAT SPECIFIC DCF METHODOLOGY DID STAFF EMPLOY TO 10 DETERMINE THE COST OF EQUITY?

11 A. Staff applied a two-stage DCF analysis to a sample of 34 electric utilities, using
12 the earnings retention growth method as a proxy for the expected long-term
13 growth component in the second stage. Staff’s analysis produced a median DCF
14 cost of equity estimate of 9.14% reported on the last column of Exhibit __
15 (PP/KD-20).⁴

16 Q. PLEASE COMMENT ON STAFF'S LONG-TERM GROWTH ESTIMATE 17 IN THE DCF MODEL.

18 A. Staff relies exclusively on the earnings retention growth method in the crucial
19 second stage of the DCF analysis, where the growth rate is based on the equation
20 $g = b(\text{ROE})$, where b is the percentage of earnings retained and ROE is the

³ S&P “Assessing U.S. Utility Regulatory Environments.” March 11, 2010.

⁴ The mean of Staff’s proxy group DCF result is 9.45%. Staff offers no meaningful reason why it excludes consideration of the mean. While Staff asserts that the use of the median reduces the impact of outliers on its recommendation, Staff offers no reason why some members of its proxy group should be given more weight than others. As discussed more fully later in this testimony, using the mean rather than the median would result in a 32 basis point increase to Staff’s DCF estimate.

1 expected ROE. The impact of external stock financing on growth is also
2 accounted for by adding an external growth term ($g = sv$).

3 I disagree with the earnings retention growth technique for four reasons:
4 1) the method is logically circular, 2) it is inconsistent with the empirical evidence
5 as demonstrated in academic research, 3) the Value Line forecasts are potentially
6 not representative proxies for the market consensus, and 4) a technical error.

7 **Q. ARE THE GROWTH RATES USED BY STAFF CONSISTENT WITH ITS**
8 **RATE OF RETURN RECOMMENDATION?**

9 A. No, they are not. Staff's retention growth methodology contains a puzzling
10 logical contradiction. The contradiction arises because the method requires an
11 explicit assumption on the ROE expected from the retained earnings that produce
12 future growth. Staff bases its ROE estimate on Value Line's forecast ROE for the
13 2014 period **and beyond**, as reported on the second column of Exhibit _ (PP/KD-
14 20) page 2. But the ROEs used by Staff in calculating the retention growth rate do
15 not match Staff's ROE recommendation. Table 2 below replicates the ROE
16 forecasts used by Staff in deriving the retention growth rates.

17 **Table 2 Staff's Forecast ROE**
18

1	ALLETE	8.63
2	Alliant Energy	11.80
3	Amer. Elec. Power	10.39
4	Ameren Corp.	6.84
5	Avista Corp.	9.03
6	Black Hills	8.05
7	CH Energy Group	8.34
8	Cleco Corp.	10.08
9	Consol. Edison	9.50
10	DPL Inc.	24.65
11	DTE Energy	9.32

12	Duke Energy	8.20
13	Edison Int'l	9.13
14	Empire Dist. Elec.	10.13
15	Entergy Corp.	13.40
16	FPL Group	11.60
17	G't Plains Energy	7.91
18	Hawaiian Elec.	10.88
19	IDACORP Inc.	8.67
20	MGE Energy	11.23
21	Northeast Utilities	9.03
22	NSTAR	14.09
23	PG&E Corp.	12.19
24	Pinnacle West Capital	9.24
25	Portland General	8.73
26	Progress Energy	9.22
27	SCANA Corp.	10.17
28	Sempra Energy	11.02
29	Southern Co.	13.24
30	TECO Energy	13.15
31	Vectren Corp.	10.43
32	Westar Energy	8.87
33	Wisconsin Energy	12.61
34	Xcel Energy Inc.	10.34

AVERAGE **10.59%**

MEDIAN **10.11%**

Source: Staff Exhibit _(PP/KD-20) Page 2

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The average expected ROE of 10.6% as set forth above exceeds Staff's recommended ROE of 9.0% by 160 basis points. Staff's analysis assumes that the earned ROEs of the sample companies exceed what it has determined to be their cost of equity forever. That is, Staff is assuming that these companies will earn a ROE higher than that granted by their regulators and reflected in their rates.

While this scenario may be imaginable for an unregulated company, it is implausible to assume this will occur for a regulated company whose rates are re-set by its regulator at a level designed to permit the company to earn a return equal to its cost of capital. This logical flaw compromises the integrity of Staff's

1 analysis, and should be a sufficient basis for rejecting the results Staff produced
2 by this method, which constitutes the cornerstone of its DCF analysis and the
3 majority of the basis for its ROE recommendation. In essence, by using an ROE
4 that differs from its final recommended cost of equity, Staff requires the
5 Commission to make two inconsistent findings regarding ROE. I am perplexed as
6 to why Staff assumes that its group of comparable electric utilities is expected to
7 earn 10.6% forever, while at the same time it recommends an ROE of 9.0% for
8 Niagara Mohawk. The only way that these utilities can earn an ROE of 10.6% is
9 if rates are set so that they will in fact earn 10.6%. The only logical conclusion to
10 be drawn from the data is that the group's cost of equity is 10.6%, since these are
11 the returns implied in Staff's retention growth analysis.

12 **Q. IS THE RETENTION GROWTH RATE TECHNIQUE CONSISTENT**
13 **WITH THE EMPIRICAL EVIDENCE PRESENTED IN PUBLISHED**
14 **ACADEMIC FINANCIAL RESEARCH?**

15 A. No, it is not. The second difficulty with the retention growth rate approach is that
16 the empirical finance literature demonstrates that the sustainable growth method of
17 determining growth is not as significantly correlated to measures of value, such as
18 stock price and price/earnings ratios, as other historical growth measures or analysts'
19 growth forecasts. Other proxies for growth, such as historical growth rates and
20 analysts' growth forecasts, outperform retention growth estimates⁵.

⁵ See for example Timme, S.G. and Eiseman, P.C. "On the Use of Consensus Forecasts of Growth in the Constant Growth Model: The Case of Electric Utilities." *Financial Management*, Winter 1989, 23-35.

1 **Q. ARE VALUE LINE'S ROE AND RETENTION RATIO ESTIMATES**
 2 **REPRESENTATIVE OF THE MARKET CONSENSUS?**

3 A. No, not necessarily. The third difficulty with Staff's retention growth rates is that
 4 exclusive reliance on a Value Line forecast of ROEs and retention ratios runs the
 5 risk that Value Line forecasts are not representative of investors' consensus
 6 forecast. As discussed below, averages of sell-side equity analysts' growth
 7 forecasts are more reliable estimates of the investors' consensus expectations
 8 likely to be impounded in stock prices.

9 **Q. PLEASE DISCUSS THE FOURTH PROBLEM WITH STAFF'S**
 10 **RETENTION GROWTH ESTIMATES.**

11 A. The fourth difficulty with Staff's retention growth approach is that the forecasts of
 12 the expected return on equity published by Value Line are based on end-of-period
 13 book equity rather than on average book equity. The following formula,
 14 discussed and derived in Chapter 9 of my latest book, The New Regulatory
 15 Finance, adjusts the reported end-of-year values so that they are based on average
 16 common equity, which is the common regulatory practice:

$$17 \quad r_a = r_t \frac{2 B_t}{18 \quad B_t + B_{t-1}} \\ 19 \quad 20$$

21 Where: r_a = return on average equity
 22 r_t = return on year-end equity as reported
 23 B_t = reported year-end book equity of the current year
 24 B_{t-1} = reported year-end book equity of the previous year
 25

26 The result of this error is that Staff's DCF estimates are understated by

1 some 10-20 basis points, depending on the magnitude of the book value growth
2 rate.

3 **3. DCF GROWTH RATES: ANALYSTS' FORECASTS**

4 **Q. WHAT DOES THE PUBLISHED ACADEMIC LITERATURE SAY ON**
5 **THE SUBJECT OF GROWTH RATES IN THE DCF MODEL?**

6 A. Published studies in the academic literature demonstrate that (i) analysts' growth
7 rate forecasts are reasonable indicators of investor expectations and (ii) investors
8 rely on such forecasts. Cragg and Malkiel present detailed empirical evidence
9 that (i) the average analysts' growth rate forecasts are a better predictor of
10 investor expectations than historical growth rates; (ii) the average analysts'
11 growth rate forecast represents the best possible source of DCF growth rate
12 forecasts; and (iii) historical growth rates do not contain any information not
13 already included in analysts' growth rate forecasts.⁶ Other studies confirm the
14 superiority of analysts' growth rate forecasts over historical growth
15 extrapolations.⁷

16 **Q. DO YOU SEE ANY DANGERS IN RELYING ON VALUE LINE AS AN**
17 **EXCLUSIVE SOURCE OF FORECASTS IN APPLYING THE DCF**
18 **MODEL?**

19 A. Yes, I do. Staff relies exclusively on Value Line forecasts for its major inputs
20 into the DCF analysis, including short-term dividend forecasts in the first stage of

⁶ Malkiel Burton & John Cragg, *Expectations and the Structure of Share Prices* (1982).

⁷ James Vander Weide & Willard Carleton, "Investor Growth Expectations: Analysts vs. History," *The Journal of Portfolio Management* (Spring 1988); Stephen Timme & Peter Eisemann, "On the Use of Consensus Forecasts of Growth in the Constant Growth Model: The Case of Electric Utilities," *Financial Management* (Winter 1989).

1 the DCF methodology, expected return, new stock issues, and expected retention
2 ratio. Staff's exclusive reliance on Value Line growth forecasts runs the real risk
3 that such forecasts are not representative of investors' consensus forecast. One
4 would expect that averages of a myriad of analysts' growth forecasts such as those
5 contained in First Call, Thomson, Multex, and/or Zacks, rather than one particular
6 analyst's in-house forecast, are more reliable estimates of the investors' consensus
7 expectations likely to be impounded in stock prices.

8 **Q. SHOULD THE VALUE LINE DIVIDEND GROWTH ESTIMATES BE**
9 **CONSIDERED IN APPLYING THE DCF MODEL TO UTILITIES?**

10 A. No, not at this time. For its first-stage growth rates in its DCF analysis, Staff
11 relies on Value Line dividend growth estimates. I disagree. First, as said earlier,
12 heavy reliance on Value Line growth forecasts runs the risk that such forecasts are
13 not representative of investors' consensus forecast. Second, reliance on "near-
14 term" dividend growth is improper because it is expected that utilities will
15 continue to lower their dividend payout ratios over the next several years in
16 response to increasing capital expenditures. In the current environment where
17 utilities are substantially increasing their capital expenditures and increasing cash
18 reserves, dividends cannot be expected to grow at the same rate that investors
19 expect earnings to grow. Therefore, earnings and dividends are not expected to
20 grow at the same rate in the near future.

21 Incidentally, Staff does not explain why it chose not to rely on the same
22 earnings retention methodology for the first stage of its DCF analysis as it did in
23 the second stage.

1 **Q. ARE INVESTORS EXPECTING GROWTH RATES EQUAL TO STAFF'S**
 2 **RANGE?**

3 A. No. The best evidence shows that investors are expecting growth rates higher
 4 than what Staff has found. For its group of 34 electric utilities, Staff's
 5 methodology [see Exhibit (PP/KD-20) pages 1 and 2] has produced median
 6 growth rates of 3.8% and 4.46% for the first and second growth stages of the DCF
 7 analysis, respectively. Table 2 below sets forth the long-term growth forecast
 8 from Value Line and the consensus long-term growth forecast reported by Zacks
 9 Investment Research from the same time period used by Staff. It is evident from
 10 the table that the expected growth rates lie within the range of 4.8% - 5.7%, with a
 11 midpoint of 5.3%, as evidenced from the average and median results. These
 12 growth estimates are 80 basis points (0.8%) above Staff's long-term second-stage
 13 growth estimate of 4.5%.

14 Table 3 Staff's Comparable Companies
 15 Analysts' Growth Forecasts

Company	Value Line Projected Growth	Zacks Analysts Growth
1 ALLETE	-0.5	3.7
2 Alliant Energy	7.0	
3 Amer. Elec. Power	3.0	3.6
4 Ameren Corp.	0.5	3.5
5 Avista Corp.	6.5	4.8
6 Black Hills	8.5	6.0
7 CH Energy Group	3.5	
8 Cleco Corp.	8.0	9.0
9 Consol. Edison	2.5	3.0
10 DPL Inc.	6.5	5.0
11 DTE Energy	7.0	5.0
12 Duke Energy	5.5	4.4
13 Edison Int'l	3.5	5.0
14 Empire Dist. Elec.	7.5	

15 Entergy Corp.	5.0	4.0
16 FPL Group	4.5	7.1
17 G't Plains Energy	4.5	5.0
18 Hawaiian Elec.	7.0	8.6
19 IDACORP Inc.	4.5	5.0
20 MGE Energy	4.0	5.0
21 Northeast Utilities	7.0	7.9
22 NSTAR	5.5	6.1
23 PG&E Corp.	6.5	7.7
24 Pinnacle West Capital	3.0	7.0
25 Portland General	3.5	5.8
26 Progress Energy	4.5	4.0
27 SCANA Corp.	3.5	5.3
28 Sempra Energy	5.5	7.0
29 Southern Co.	4.5	7.1
30 TECO Energy	6.0	6.2
31 Vectren Corp.	4.5	5.8
32 Westar Energy	4.5	5.0
33 Wisconsin Energy	8.0	8.7
34 Xcel Energy Inc.	6.5	5.7
Average	5.0%	5.7%
Median	4.8%	5.3%

Source: Value Line Investment Analyzer 05/10
Zacks Investment Research 05/10

1
2
3

4 **Q. HOW WOULD STAFF'S DCF RESULT CHANGE USING ANALYSTS'**
5 **GROWTH FORECASTS INSTEAD OF THE COMPROMISED**
6 **EARNINGS RETENTION GROWTH METHOD IN ITS DCF ANALYSIS?**

7 A. The Value Line growth forecast and the analysts' consensus growth forecast
8 range from 4.8% to 5.7% with a midpoint of 5.3% versus Staff's 4.5% in Staff's
9 Exhibit (PP/KD-21). The difference of 0.8% increases Staff's DCF result from
10 9.14% to virtually 10.0% because of this correction alone.

11

4. DCF GROWTH: LONG-TERM ECONOMIC GROWTH

1 **Q. HOW DOES STAFF'S DCF GROWTH RATE COMPARE WITH THAT**
2 **OF THE OVERALL ECONOMY?**

3 A. In order to assess the reasonableness of Staff's DCF long-term growth rate of
4 4.5%, I compared its growth estimates with the historical long-term growth of the
5 economy as a whole and/or the long-range growth forecasts in GDP projected for
6 the very long-term.

7 As discussed below, a long-term forecast of nominal growth in GDP can be
8 formulated by combining a long-term inflation estimate (2.1%) with a long-term real
9 growth rate forecast (3.4%). This produces a long-term expected GDP nominal
10 growth rate of approximately 5.5% ($3.4\% + 2.1\% = 5.5\%$), which is very similar
11 to the analysts' consensus growth forecast for Staff's sample companies discussed
12 earlier. In other words, as was the case earlier, Staff's long-term growth forecast
13 of 4.5% for its comparable group of electric utilities is less than the long-term
14 expected GDP nominal growth by 100 basis points. Moreover, one can argue that
15 the long-term growth rate of the electric utility industry could very well exceed
16 that of GDP on account of the massive capital expenditures that will be required
17 to effect the transition to alternative energy technologies.

18 **Q. HOW WOULD STAFF'S DCF RESULTS CHANGE IF THE**
19 **APPROPRIATE LONG-TERM GDP GROWTH FORECAST WERE**
20 **USED IN THE TWO-STAGE DCF ANALYSIS?**

21 A. Use of the GDP long-term growth forecast of 5.5% in Staff's second-stage DCF
22 analysis instead of Staff's forecast of 4.5% would raise Staff's DCF estimates by
23 100 basis points, from 9.14% to approximately 10.14% because of this change

1 alone.

2 **Q. DO YOU HAVE CONCERNS WITH STAFF'S USE OF THE MEDIAN**
3 **RATHER THAN THE MEAN TO DETERMINE THE AVERAGE ROE OF**
4 **ITS PROXY GROUP?**

5 A. Yes I do. Using the mean instead of the median to determine the DCF result for
6 Staff's proxy group would increase the ROE estimate for the group by 32 basis
7 points, from 9.14% to 9.46%. In general, when there are a large number of
8 observations in a statistical sample, the mean and median will tend to converge
9 and be nearly identical. If they are not that indicates that the distribution of
10 observations in the sample is skewed and the median will treat a significant
11 number of the observations as outliers when in fact they are more representative
12 of what can be expected for the sample as a whole. Therefore, given that there is
13 a 32 basis point differential between the median and mean DCF estimate for
14 Staff's proxy group it would be more appropriate to use the mean rather than the
15 median to determine the DCF result for the group.

16 **5. CAPM: RISK-FREE RATE**

17 **Q. WHAT INPUTS DOES STAFF USE IN ITS CAPM ANALYSIS?**

18 A. Three inputs are required in order to implement the CAPM: the risk-free rate, the
19 beta risk measure, and the MRP. As shown on Exhibit __ (PP/KD-21), for the
20 risk-free rate, Staff uses 4.1%; for beta, Staff uses 0.70, based on Value Line beta
21 estimates for its sample of electric companies; and for the MRP, Staff uses 7.3%.

22 **Q. DO YOU AGREE WITH STAFF'S BETA ESTIMATES?**

23 A. Yes, I do.

1 **Q. DO YOU AGREE WITH STAFF'S MRP ESTIMATE?**

2 A. Yes, I do.

3 **Q. DO YOU AGREE WITH STAFF'S RISK-FREE RATE ESTIMATE?**

4 A. No, I do not. As a proxy for the risk-free rate, Staff uses the average yield on 10-
5 year and 30-year bonds over the March 2010 – May 2010 three-month period,
6 which is 4.1%. I disagree. Only the yields on 30-year bonds are relevant
7 proxies in the CAPM.

8 **Q. WHAT IS THE APPROPRIATE PROXY FOR THE RISK-FREE RATE IN**
9 **A CAPM ANALYSIS?**

10 A. As I explained in my direct testimony, the appropriate proxy for the risk-free rate
11 in the CAPM is the return on the longest term Treasury bond possible. This is
12 because common stocks are very long-term instruments more akin to very long-
13 term bonds rather than to short-term or intermediate-term Treasury notes, for
14 example, 10-year Treasury notes. Since common stock is a very long-term
15 investment because the cash flows to investors in the form of dividends last
16 indefinitely, the yield on the longest-term possible government bonds, (i.e., yield
17 on 30-year Treasury bonds) is the best measure of the risk-free rate for use in the
18 CAPM. Moreover, utility asset investments generally have very long-term useful
19 lives and should correspondingly be matched with very long-term maturity
20 financing instruments.

21 Another reason for using the longest maturity Treasury bond possible is
22 that common equity has an infinite life span, and the inflation expectations
23 embodied in its market-required rate of return will therefore be equal to the

1 inflation rate anticipated to prevail over the very long-term. The same
2 expectation should be embodied in the risk-free rate used in applying the CAPM
3 model. It stands to reason that the yields on 30-year Treasury bonds will more
4 closely incorporate within their yields the inflation expectations that influence the
5 prices of common stocks than do short-term or intermediate-term U.S. Treasury
6 notes.

7 In short, 30-year Treasury bonds have the longest term to maturity and
8 Staff should have relied on the yield on such securities as proxies for the risk-free
9 rate in applying the CAPM.

10 **Q. WHAT IS THE AVERAGE YIELD ON 30-YEAR TREASURY BONDS**
11 **REPORTED BY STAFF IN ITS CAPM ANALYSIS?**

12 A. On Exhibit __ (PP/KD-21), Staff reports the average yield on 30-year Treasury
13 bonds over the March 2010 – May 2010 period as being 4.54%.

14 **Q. HOW WOULD STAFF'S CAPM RESULTS CHANGE IF THE**
15 **APPROPRIATE RISK-FREE RATE PROXY WAS USED IN THE CAPM**
16 **ANALYSIS?**

17 A. Use of the appropriate risk-free rate of 4.54% in Staff's CAPM analysis instead of
18 the 4.1% estimate based in part on 10-year Treasury yields raises Staff's
19 traditional CAPM estimates by 40 basis points (4.5% - 4.1%), from 9.21% to
20 9.61%.

1 **Q. HOW WOULD STAFF'S ZERO-BETA CAPM RESULTS CHANGE IF**
2 **THE APPROPRIATE RISK-FREE RATE PROXY WAS USED IN THAT**
3 **ANALYSIS?**

4 A. Use of the appropriate risk-free rate of 4.54% in Staff's Zero-Beta CAPM
5 analysis raises Staff's Zero-Beta CAPM estimates by 40 basis points (4.5% -
6 4.1%), from 9.76% to 10.16%. Averaging the two CAPM estimates, Staff's final
7 generic CAPM ROE reported on Exhibit __ (PP/KD-16) becomes 9.88% and not
8 the 9.48% reported.

9 **Q. DR. MORIN, ARE YOU AWARE THAT THE COMMISSION HAS USED**
10 **THE AVERAGE OF THE YIELD ON 10 AND 30 YEAR BONDS IN A**
11 **NUMBER OF PREVIOUS DECISIONS?**

12 A. Yes. This is one of the methodological flaws arising from the GFM that does
13 nothing more than bias the Staff recommendations downward. Given the
14 extremely steep yield curve, that bias has an unusually large impact on Staff's
15 return recommendation in this case.

16 **6. FLOTATION COSTS**

17 **Q. IN YOUR DIRECT TESTIMONY, YOU STATED THAT THE RETURN**
18 **ON EQUITY SHOULD BE ADJUSTED TO INCLUDE AN ALLOWANCE**
19 **FOR FLOTATION COSTS. PLEASE COMMENT ON FLOTATION**
20 **COSTS.**

21 A. Flotation costs are very similar to the closing costs on a home mortgage. In the
22 case of issues of new equity, flotation costs represent the discounts that must be
23 provided to place the new securities. Flotation costs have a direct and an indirect

1 component. The direct component represents monetary compensation to the
2 security underwriter for marketing/consulting services, for the risks involved in
3 distributing the issue, and for any operating expenses associated with the issue
4 (e.g., printing, legal, prospectus). The indirect component represents the
5 downward pressure on the stock price as a result of the increased supply of stock
6 from the new issue. The latter component is frequently referred to as "market
7 pressure."

8 Flotation costs for common stock are analogous to the flotation costs
9 associated with past debt issues which, as a matter of routine regulatory policy,
10 continue to be amortized over the life of the debt, even though no new debt issues
11 are contemplated. In the case of common stock, which has no finite life, flotation
12 costs are not amortized. Therefore, the recovery of flotation cost requires an
13 upward adjustment to the allowed return on equity.

14 As demonstrated in my original testimony, the expected dividend yield
15 component of the DCF model must be adjusted for flotation cost by dividing it by
16 $(1 - f)$, where f is the flotation cost factor.

17 **Q. WHAT FLOTATION COST TREATMENT DOES STAFF RECOMMEND**
18 **IN THIS CASE?**

19 A. Staff recommends no allowance at all for flotation costs on the grounds that
20 Niagara Mohawk or its parent is not contemplating any common stock issue in the
21 near future. This point of view is only correct if the flotation costs associated
22 with all past common equity issues have been recovered. The standard flotation
23 cost allowance used in my direct testimony is designed to recover the flotation

1 costs associated with all past issues that were not expensed, but rather written off
2 against common equity.

3 By analogy, in the case of a debt issue, issuance costs are amortized over
4 the life of the debt, and the annual amortization charge is usually embedded in the
5 cost of debt for ratemaking purposes. The recovery of debt flotation expense
6 continues year after year irrespective of whether the company issues new debt
7 capital until recovery is complete, in the same way that the recovery of past
8 investments in plant and equipment through depreciation allowances continues in
9 the future even if no new construction is contemplated. In the case of common
10 stock, which has no finite life, flotation costs are not amortized to a specific
11 issuance as is the case for a bond. However, the recovery of flotation costs
12 requires a similar upward adjustment to the return on equity that is allowed for
13 ratemaking purposes. Unlike the case of bonds, common stock has no finite life
14 so that flotation costs cannot be amortized and must therefore be recovered via an
15 upward adjustment to the allowed return on equity. As in the case of bonds, the
16 recovery continues year after year regardless of whether the utility raises new
17 equity capital until the recovery process is terminated.

18 To the extent that Niagara Mohawk's flotation costs associated with past
19 common equity issues have not been recovered, the only recovery mechanism
20 available for the recovery of such costs is an upward adjustment to the return on
21 equity as was used in my direct testimony.

22 Furthermore, Staff's testimony contains an inconsistency in this regard.
23 Staff employs a version of the DCF model that explicitly accounts for continuous

1 external common stock issues over time and even quantifies the effect of such
2 issues on company growth on Exhibit (PP/KD-20). Yet, Staff completely ignores
3 the flotation costs associated with such common stock issues.

4 In short, Staff's DCF estimates of equity costs are downward-biased by
5 approximately 20-30 basis points to the extent that the flotation costs associated
6 with past equity issues have not been expensed or recovered in the past.

7 **7. CREDIT QUALITY ADJUSTMENT**

8 **Q. DID STAFF PROPOSE A RETURN ADJUSTMENT TO ITS ROE**
9 **RESULTS TO ACCOUNT FOR CREDIT QUALITY DIFFERENCES?**

10 A. Yes, it did. Staff proposes (page 38) that Niagara Mohawk's ROE be reduced by
11 22 basis points (0.22%) to account for credit quality differences between Niagara
12 Mohawk/National Grid and the proxy group. The details of the calculation are
13 provided in Exhibit __ (PP/KD-23). Staff argues that Niagara Mohawk/National
14 Grid is less risky than the comparable group because its debt ratings are slightly
15 higher than those of the comparable companies.

16 **Q. WHAT IS THE BASIS FOR STAFF'S DOWNWARD ROE**
17 **ADJUSTMENT?**

18 A. The adjustment is based on the yield differentials between A-rated and BBB-rated
19 utility bonds over the past five years. I note that in past recent testimonies, the
20 adjustment was based on a six-month period rather than a five-year period.

21 **Q. DO YOU AGREE WITH STAFF'S 22 BASIS POINTS DOWNWARD**
22 **RETURN ADJUSTMENT?**

23 A. No, I do not. Staff's adjustment is based on debt yield differentials and not on

1 common stock return differentials. Based on available information, it does not
2 appear that credit ratings and debt rate differentials are directly related to required
3 equity returns for investment grade companies in the utility industry. Staff does
4 not offer any evidence of any relationship, let alone a causal relationship, between
5 credit quality and required or observed equity returns in the utility industry.

6 **Q. ON PAGE 76 OF ITS TESTIMONY, STAFF REFERS TO CERTAIN**
7 **EVIDENCE THAT IT ASSERTS DEMONSTRATES “THAT A**
8 **CORRELATION EXISTS BETWEEN STOCK RETURNS AND CREDIT**
9 **RATINGS OF UTILITIES.” DO YOU AGREE WITH THIS**
10 **STATEMENT?**

11 A. No. Before I answer that question, let me be clear as to what the dispute is in this
12 case. I am not contending that there would not be any difference in the cost of
13 equity between a group of investment grade and non-investment grade companies.
14 Companies with speculative credit ratings will likely have a higher cost of equity
15 than investment grade companies.

16 What I am contending is that it has not been demonstrated that differences
17 among investment grade debt ratings equal to the difference in Niagara
18 Mohawk’s/National Grid’s credit rating and the average rating of the proxy group
19 give rise to the differences in the cost of equity that Staff assumes. Indeed, the
20 data cited by Staff appears to prove my point. On Exhibit __ (PP/KD-27),
21 Standard & Poor’s constructed a variety of equity portfolios and followed their
22 performance over a twenty-year period. While the investment grade portfolio
23 clearly outperformed the speculative grade portfolio, the “A+ to BBB-” portfolio

1 were correct, one would observe a positive relationship between return and
 2 declining credit quality. No such relationship exists. There is no relationship at
 3 all between equity returns and bond rating. In fact, the Baa2 and Baa3 portfolios
 4 have lower equity costs than the A-rated portfolios.

Bond Rating	DCF Estimates
A1	9.09%
A2	9.49%
A3	9.51%
Baa1	10.56%
Baa2	9.01%
Baa3	8.93%

5

6 Thus, the notion that the DCF results should be adjusted not only lacks a
 7 theoretical foundation but it is refuted by Staff's own data.

8 **Q. ARE THERE OTHER REASONS WHY STAFF'S CREDIT QUALITY**
 9 **ADJUSTMENT IS INAPPROPRIATE?**

10 A. Yes. The Company's cost of capital is being evaluated at a crucial point in time
 11 when Niagara Mohawk has an ambitious capital expenditures program and will
 12 require external financing. Niagara Mohawk's large capital expenditure program
 13 over the next several years increases its dependence on capital markets which
 14 have become more volatile and unpredictable. This is certainly no time to apply a
 15 return decrement and reduce the Company's return relative to its industry peers
 16 for a reason that has not been substantiated by any meaningful evidence. In this
 17 proceeding, Staff has proposed a capital structure that it believes will allow the
 18 Company to maintain a low "A" bond rating. At the same time however, Staff
 19 applies an unsupported return decrement that renders it less likely that the

1 Company will actually maintain that rating. This makes no sense.

2 In short, Staff's downward ROE adjustment of 22 basis points for credit
3 quality should be rejected by the Commission.

4 **8. REVENUE DECOUPLING ADJUSTMENT**

5 **Q. DR. MORIN, DO YOU AGREE WITH STAFF'S DOWNWARD RISK**
6 **ADJUSTMENT ON ACCOUNT OF THE RDM?**

7 A. Staff argues that a downward ROE adjustment of 8.5 basis points is required to
8 account for what it considers to be the risk-reducing effect of the RDM relative to
9 the comparable companies. I no longer support such an adjustment. Most, if not
10 all, energy utilities in the industry are under some form of adjustment clause/cost
11 recovery/rider mechanism(s). The existence of revenue reconciling mechanisms
12 such as RDMs is becoming the mainstream position for regulated utilities across
13 the U.S., with regulators in approximately 30 states utilizing some form of
14 revenue decoupling and/or lost revenue adjustment mechanisms.⁸ Therefore, the
15 approval of adjustment clauses, riders, and cost recovery mechanisms by
16 regulatory commissions is widespread in the utility business and is increasingly
17 embedded in financial data, such as bond ratings, business risk scores, and stock
18 prices. Thus, if the market-derived cost of common equity for other firms already
19 incorporates the results of these or similar mechanisms, then no further
20 adjustment is appropriate or reasonable in determining the cost of common equity
21 for Niagara Mohawk.

⁸ See Edison Foundation study entitled "State Electric Efficiency Regulatory Frameworks", July 2010.

1 Moreover, an RDM can actually increase regulatory risks, either because of
2 the risk that the Commission may deny timely recovery of deferred balances if
3 they become too large or by depriving a utility of the ability to use growth in
4 revenues to offset increases in costs in between rate cases. Therefore, it is
5 speculative as to whether, and if so how, an RDM will affect the Company's risk
6 profile.

7 **9. RESPONSE TO STAFF'S CRITICISMS**

8 **Q. DO YOU HAVE A GENERAL COMMENT ON STAFF'S CRITICISMS OF**
9 **YOUR TESTIMONY?**

10 A. Yes, I do. Before I address my specific criticisms of Staff's testimony, there is a
11 general theme that runs throughout Staff's criticisms of my testimony, namely,
12 that some of my procedures and methodologies depart from Commission
13 precedents which are in turn based on the Generic Financing Methodology
14 (GFM).

15 In my vast experience in regulatory proceedings, there is nothing unusual
16 about regulators/witnesses changing course and adopting previously rejected
17 positions. Capital markets are fluid, evolve rapidly, and continuously reflect
18 changing investor expectations and risk attitudes. The Commission itself has
19 departed from the GFM in view of altered capital market circumstances. For
20 example, in a recent ConEd electric base rate case, the Commission modified the
21 GFM due to turmoil in the financial markets and determined that DCF and CAPM
22 estimates should rely on more recent data rather than the most recent six months

1 of data required by the GFM.⁹

2 I have argued in past cases in New York that the Commission's continued
3 application of a methodology for determining the cost of equity that is based on
4 the GFM, with its resulting inadequate rates of return, threatens credit ratings.
5 As I discussed earlier, following CECONY's 2008 Rate Order, both S&P and
6 Fitch downgraded CECONY's credit rating while Moody's placed the Company
7 on negative outlook on the grounds that the ROE awarded by the Commission
8 was inadequate.

9 As I have documented in past cases before the Commission and in this
10 proceeding, there are several methodological aspects to the GFM that produce
11 abnormally low ROE results. For example, the use of both 10-year and 30-year
12 Treasury bond yields in the CAPM/ECAPM analyses, an inappropriate credit
13 quality adjustment, and the use of Value Line dividend growth estimates in the
14 DCF first-stage analysis all continue to produce an unreasonably low cost of
15 equity recommendation.

16 **Q. HAVE YOUR CONCERNS ABOUT THE GFM BEEN ACCEPTED BY**
17 **ANY ADMINISTRATIVE LAW JUDGES ("ALJS") WHO PRESIDE OVER**
18 **RATE CASES IN NEW YORK?**

19 A. Yes. In a recent CECONY electric rate case, the recommended decision ("RD")
20 issued by the ALJs considered my testimony and recommended that the
21 Commission use quarterly rather than annual dividends and modify the growth
22 calculation used in the DCF methodology. The RD in that case also concluded,

⁹ Case 08-E-0539, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Electric Service, Order Setting Electric Rates (issued April 24, 2009) ("2009 Electric Rate Order")(p. 125).

1 on the record of that case, that the DCF and CAPM results should be given equal
2 weight. While the Commission ultimately rejected these recommendations, it is
3 nonetheless important to recognize that in each case the determination of the
4 return on equity requires an evaluation of both the methodology employed and the
5 result reached. If the end result reached is not objectively reasonable, then the
6 methodology must be closely scrutinized to see why this is the case. In this case,
7 it is readily apparent that the end result of Staff's recommendation is
8 unreasonable. As a result, it is important to closely examine the flaws in the
9 methodology in order to determine why this is the case.

10 **Q. DOES STAFF FULLY RELY ON THE GFM?**

11 A. No, it does not. It appears to me that Staff picks and chooses certain facets of the
12 GFM methodology while it ignores others. For example, the choice of
13 comparable companies and the choice of the historical time period over which to
14 measure bond yields and stock prices has changed over time. In addition, Staff
15 has used a particular version of the recommendations of the GFM that uses only
16 the DCF and CAPM and ignores the comparable earnings approach. What is left
17 of the GFM is a mechanistic approach that has led to allowed returns that have
18 consistently been among the lowest in the country. The net result is that the GFM
19 for the past several years has produced allowed ROEs that are the lowest in the
20 nation, with the relative position of New York utilities deteriorating over time, as
21 evidenced by recent credit rating downgrades and lower than industry average
22 market to book ratios.

1 From my understanding as a regulatory economist, not as a legal
2 interpretation, the landmark Supreme Court decisions in the *Bluefield*¹⁰ and
3 *Hope*¹¹ cases require that a utility be allowed an opportunity to earn a return that
4 is equivalent to that earned by companies of comparable risk. The cases
5 recognized that a utility must compete with other companies for capital. Unless
6 the utility offers a return that is similar to that available from other opportunities
7 of similar risk, capital will not be forthcoming to the utility. In my view, the GFM
8 as advocated by Staff and Mr. Niazi produces returns well outside the mainstream
9 and, therefore, violates the fairness standards laid out in the Bluefield and Hope
10 cases.

11 **Comparable Group**

12 **Q, DOES STAFF ADHERE TO THE GFM WHEN IT COMES TO THE**
13 **CONSTRUCTION OF COMPARABLE GROUPS?**

14 A. No, it does not. Staff relies on a large sample of investment-grade utilities with
15 at least 70% of its electric revenues regulated. The end-result is a sample of
16 BBB-rated utilities, in contravention to the GFM which specifically required A-
17 rated utilities. Instead of simply relying on utilities that have one or more “A”
18 level credit rating, Staff uses a broader proxy group of companies that it believes
19 are not comparable in terms of overall risk and then makes an unsupported
20 downward credit quality adjustment (as shown earlier) to its ROE estimates to
21 account for the alleged difference between the average credit rating of its
22 comparable group and that of Niagara Mohawk/National Grid.

¹⁰ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm’n*, 262 U.S. 679 (1923).

¹¹ *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

1 **Q. WHAT DCF RESULTS WOULD STAFF HAVE OBTAINED HAD IT**
 2 **ADHERED TO SIMPLY SELECTING COMPANIES THAT HAD AT**
 3 **LEAST ONE “A” OR HIGHER BOND RATING?**

4 A. Had Staff simply relied on those proxy group companies with at least one single
 5 A rating or higher in its sample group,¹² the median DCF estimate would be
 6 increased from 9.1% to 9.5%, an increase of 40 basis points, and the average DCF
 7 estimate would be 10.4%, as shown on the table below. This is yet another
 8 example of Staff modifying a methodology in a manner guaranteed to produce
 9 low ROE results.

Staff DCF	Company	Moody's Rating	S&P Rating
8.55	Con Edison	BAA-1	A-
17.18	DPL	BAA-1	A-
8.44	Duke	BAA-2	A-
10.5	FPL	BAA-1	A-
9.09	MGA	A1	AA-
9.49	NStar	A2	A+
10.6	Southern	A3	A
9.04	Vectron	BAA-1	A-
10.48	Wisc. Energy	A-3	BBB+

10
 11
 12
 13

Median DCF: 9.5%
 Average DCF: 10.4%

14 **Q. HOW DO YOU RESPOND TO STAFF'S CRITICISM OF YOUR**
 15 **COMPARABLE GROUP OF ELECTRIC UTILITIES?**

16 A. Staff criticizes (pp. 62-63) my two groups of companies on the grounds that I
 17 employed a 50% minimum regulated revenues screening criterion instead of 70%.

¹² It should be noted that CH Energy Group, Inc. has been excluded from this group because it has no credit rating of its own.

1 This criticism is unjustified given that the average percentage of regulated electric
2 revenues in my two comparable groups of utilities are 71% and 76%, respectively,
3 above the 70% threshold and within the Commission's 70% utility revenue
4 criterion.

5 Staff then argues that relaxation of the 50% criterion leads to a comparable
6 group of electric utilities that is riskier than Niagara Mohawk on the grounds that
7 such companies possess riskier unregulated businesses. I disagree. Staff's beta
8 estimate for Niagara Mohawk of 0.70 is virtually identical to the average beta of
9 my two groups and, therefore, comparable in risk to the two groups.

10 **Q. DO YOU HAVE ANY MORE COMMENTS ON STAFF'S CRITICISMS**
11 **OF YOUR COMPARABLE GROUPS?**

12 A. Yes, I do. On page 64 Staff argues that Unisource Energy and Centerpoint
13 Energy should not be in my comparable on the grounds that they are not
14 investment grade. I disagree. Unisource has a S&P bond rating of BBB+ and
15 Centerpoint has a S&P rating of BBB+ and a Moody's bond rating of Baa1 as
16 published in AUS Utility Reports July 2010 page 11.

17 On page 64, Staff also argues that I should have included 12 more
18 companies in my comparable groups on the grounds that they are classified as
19 electric utilities by Value Line. A more careful reading of my testimony by Staff
20 would have indicated that of the 12 companies cited by Staff, 5 were indeed
21 included (See Exhibits __ (RAM-2) and __ (RAM-3) in the sample groups. More
22 importantly, none of the 12 companies cited by Staff are combination gas and
23 electric utilities; they are predominantly vertically integrated electric utilities, and

1 as such they are not nearly as comparable in risk to Niagara Mohawk's energy
2 delivery operations.

3 **Q. DOES STAFF APPEAR TO HAVE MADE ARBITRARY ADJUSTMENTS**
4 **TO ITS PROXY GROUP?**

5 A. Yes. It appears that Staff arbitrarily excluded UIL Holdings Corporation, which
6 was included in Mr. Niazi's group. Staff also includes CH Energy Inc. even
7 though it appears to possess no investment grade credit rating of its own.

8 **Historical Risk Premium**

9 **Q. DO YOU AGREE WITH STAFF'S FIRST CRITICISM OF YOUR**
10 **HISTORICAL RISK PREMIUM STUDY?**

11 A. No, I do not. Staff argues on page 69 that I have not demonstrated whether Niagara
12 Mohawk is more or less risky than the companies that make up S&P Electric Utility
13 Index over the time period. I disagree. Over most of the long period that covers my
14 historical risk premium study, the electric utility was relatively homogenous in risk
15 and under the umbrella protection of regulation for all of its functions (power
16 generation, transmission, distribution).

17 **Q. DO YOU AGREE WITH STAFF'S SECOND CRITICISM OF YOUR**
18 **HISTORICAL RISK PREMIUM STUDY?**

19 A. No, I do not. On page 70, Staff critiques the risk premium method on the grounds
20 that the method assumes that the risk premium is constant over time, that is, that
21 the risks of Treasury securities have remained at the same level relative to the
22 risks of the electric utility stocks.

23 This criticism is unwarranted. To the extent that the historical equity risk

1 premium estimated follows what is known in statistics as a random walk, one
2 should expect the equity risk premium to remain at its historical mean. The best
3 estimate of the future risk premium is the historical mean. As I explained in my
4 direct testimony, since I found no evidence that the market price of risk or the
5 amount of risk in common stocks has changed over time, at least prior to the
6 2008-9 financial crisis, that is, there is no significant serial correlation in the
7 successive market risk premiums from year to year, it is reasonable to assume that
8 these quantities will remain stable in the future under normal circumstances.

9 Moreover, my historical risk premium analysis provides a very
10 conservative downward-biased estimate of the current risk posture of the industry
11 and Niagara Mohawk given that the risk of the electric utility industry has
12 intensified steadily in the past decade and given the negative effect of the 2008-9
13 financial crisis on investor risk aversion.

14 **Q. IS THE RISK PREMIUM METHODOLOGY CONSISTENT WITH**
15 **FINANCIAL THEORY?**

16 A. It certainly is. The Risk Premium approach is conceptually sound and firmly rooted
17 in the conceptual framework of Capital Market Theory. It is widely used by
18 analysts, investors, and expert witnesses. Most college-level corporate finance
19 and/or investment management texts contain detailed conceptual and empirical
20 discussions of the risk premium approach.¹³ The latter is typically recommended
21 as one of the three leading methods of estimating the cost of capital.¹⁴ Techniques

¹³ See Bodie, Z., Kane, A., and Marcus, A. J., *Investments*, McGraw-Henry Irwin, 6th ed., 2005, a recommended textbook for Chartered Financial Analyst certification and examination.

¹⁴ See Brigham and Erhardt (2005), *Corporate Finance: A Focused Approach*, 2nd ed., Thomson 2006.

1 of risk premium analysis are widespread in investment community reports.
2 Professional certified financial analysts are certainly well versed in the use of this
3 method.

4 Data requirements to implement the method are not prohibitive. The
5 methodology is responsive to changes in capital market conditions and provides a
6 timely signaling device for current interest rate trends in contrast to the DCF
7 method, which may be sluggish in detecting changes in return requirements,
8 especially when based on historical data. One advantage of risk premium over DCF
9 is that the former takes a broader time-series perspective rather than a snapshot
10 point-in-time viewpoint, and is therefore less vulnerable to the vagaries of any one
11 particular capital market environment.

12 I remain extremely puzzled by Staff's refusal to endorse the Risk Premium
13 method when it refers to the curriculum of the Certified Financial Analysts (CFA)
14 Institute on page 75. In the cited passage, CFA strongly endorses the Risk Premium
15 approach.

16 *"...risk premium approach is based on the fundamental tenet in financial*
17 *theory that the cost of capital of a riskier cash flow is higher than that of less risk*
18 *cash flow."*

19 Staff goes on to indicate that the CFA Institute indicates that the return on equity is
20 the sum of the cost of debt and a risk premium. How can Staff then reject the Risk
21 Premium approach in one part of its testimony and endorse it on another part? I find
22 Staff's views on the Risk Premium approach quite inconsistent and self-serving.

23 **DCF Growth Rates**

1 **Q. PLEASE COMMENT ON STAFF'S CRITICISM OF YOUR DCF**
2 **ANALYSIS.**

3 A. On pages 60-63, Staff criticizes my DCF earnings growth rates on the grounds
4 that I have not addressed how these earnings growth estimates relate to the
5 dividend payout policies of my companies and whether they are sustainable over
6 time. I totally disagree with this point of view. First, one of the key assumptions
7 that underlies the DCF model is that earnings, dividends, book value, and market
8 price all grow at a constant rate forever. In other words, the dividend payout ratio
9 remains constant over time. That is the assumption I made, and that is the
10 assumption that Staff also made in the second stage of its DCF analysis. Second,
11 in my direct testimony and earlier in my rebuttal, I discussed the merits of using
12 consensus analysts' earnings growth forecasts in the DCF model and the
13 supportive empirical literature.

14 I have relied on earnings growth rates because dividend growth can only be
15 sustained if there is growth in earnings. Since the ability to pay dividends stems
16 from a company's ability to generate earnings, growth in earnings per share can be
17 expected to strongly influence the market's dividend growth expectations.

18 Also, from a practical perspective, casual inspection of the Zacks
19 Investment Research, First Call Thompson, and Multex Web sites, among others,
20 reveals that earnings per share forecasts dominate the information provided.
21 There are few, if any, dividend growth forecasts. Only Value Line provides
22 comprehensive long-term dividend growth forecasts on which Staff relies in the
23 first stage of the DCF analysis. The wide availability of earnings forecasts is not

1 surprising. There is an abundance of evidence attesting to the importance of
2 earnings in assessing investors' expectations. The sheer volume of earnings
3 forecasts available from the investment community relative to the scarcity of
4 dividend forecasts attests to their importance. The fact that these investment
5 information providers focus on growth in earnings rather than growth in dividends
6 indicates that the investment community regards earnings growth as a superior
7 indicator of future long-term growth.

8 Staff also argues that analysts' earnings growth forecast are short-term in
9 nature and it is unreasonable to assume that investors extrapolate the short-term
10 forecast into their long-term growth estimate. That is a strange criticism coming
11 from Staff given that it relies on one individual analyst's forecast (Value Line) of
12 expected ROE for 2014 and beyond in the second stage of the DCF analysis.

13 **Q. WHY DID YOU NOT RELY ON THE SUSTAINABLE GROWTH**
14 **APPROACH ENDORSED BY THE COMMISSION IN IMPLEMENTING**
15 **YOUR DCF ANALYSIS?**

16 A. For reasons discussed at length earlier, I did not rely on the sustainable growth
17 approach because of its inherent circularity and inconsistency with the empirical
18 evidence.

19 **Q. ON PAGE 71 STAFF ARGUES THAT I HAVE PLACED EQUAL**
20 **WEIGHT ON THE DCF AND CAPM RESULTS. IS THIS CORRECT?**

21 A. No, it is not. As shown on the summary table of results on page 66 of my direct
22 testimony, four of the seven estimates are DCF-based and three are risk premium
23 based.

1 **Allowed Returns**

2 **Q. IS STAFF'S RATE OF RETURN RECOMMENDATION COMPATIBLE**
3 **WITH CURRENTLY ALLOWED RETURNS IN THE UTILITY**
4 **INDUSTRY?**

5 A. As discussed earlier, Staff's ROE recommendation is well outside the mainstream
6 of the allowed rates of return that were current during the period in which Staff
7 performed its analysis, lies outside the zone of recently authorized ROEs for
8 electric utilities and for its sample of companies, and would constitute among the
9 lowest ROE allowance in the country for a major utility. The Commission is not
10 bound by decisions of other regulators regarding allowed ROE, but one cannot
11 overlook the obvious difference between Staff's recommendation and the returns
12 currently allowed for the same firms that Staff deems comparable in risk.

13 Unreasonable rate treatment for a New York utility, if implemented, may
14 have serious public policy implications and repercussions for the State of New
15 York, which are not mentioned in Staff's testimony. For example, the quality of
16 regulation and the reasonableness of rate of return awards clearly have
17 implications for regulatory climate, economic development and job creation in a
18 given territory. The consistency of regulation in a given state has similar
19 implications. It is my belief that Staff's recommended return has negative
20 implications on these grounds and is not consistent with the economic well-being
21 of the State.

22 To provide some economic perspective on the unreasonableness of Staff's
23 recommended ROE of only 9.0% relative to the average 10.5% allowed returns

1 across the industry over the past two and one half years, Niagara Mohawk's beta
2 would have to fall from 0.70, the average beta risk measure for Staff's group of
3 companies, to 0.50 in order to account for a return difference of 1.5% (10.5% -
4 9.0% = 1.5%)¹⁵. There is no electric utility with such a low beta in Staff's
5 sample of companies and I am unaware of any electric utility with such a low
6 beta. In short, Staff's recommended ROE makes little economic sense when
7 compared with the implied beta for Niagara Mohawk which would be by far the
8 lowest in Staff's sample of companies and the lowest in the industry. I am not
9 aware of any major electric utility with such a low beta risk measure.

10 **Q. HOW DOES STAFF JUSTIFY ITS VERY LOW ROE COMPARED TO**
11 **THE AVERAGE ALLOWED ROE IN THE INDUSTRY?**

12 A. Staff argues that there are certain risk-mitigating features of New York regulation,
13 mainly the use of fully forecasted forward test years which justify these very low
14 returns.

15 **Q. DID YOU EXAMINE THE RETURN RESULTS OF UTILITIES**
16 **OPERATING IN JURISDICTIONS THAT SET RATES BASED ON A**
17 **FORECASTED FORWARD TEST YEAR?**

18 A. Yes, I did. Table 4 below displays the allowed returns for the companies from
19 Staff's proxy group that operate in forward looking test-year jurisdictions. The
20 average allowed return for companies operating in such jurisdictions is 10.6%,
21 well above Staff's recommended 9.0%.

22 Table 4

¹⁵ From the CAPM, a difference in return of 1.5% implies a difference in beta of 0.20 using Staff's market risk premium estimate of 7.3%.

COMPANY	DCF
ALLETE	10.74
Alliant Energy Corp.	10.41
Avista Corp.	10.33
Black Hills Corp.	10.71
CH Energy Group Inc.	10.00
Cleco Corp.	10.70
Con Edison Inc.	10.11
DTE Energy	11.00
Duke Energy Corp.	10.63
Edison International	10.66
FPL Group, Inc.	10.50
Hawaiian Electric	10.82
IDACORP, Inc.	10.18
MGE Energy Inc.	10.40
Northeast Utilities	9.72
PG&E Corp.	11.35
Portland General	10.80
Sempra Energy	11.46
Southern Co.	11.93
Wisconsin Energy	10.43
AVERAGE	10.64

1

2

CONCLUSIONS

3 **Q. WHAT RETURNS ARE INVESTORS EXPECTING FOR STAFF'S**
 4 **GROUP OF COMPANIES?**

5 A. As shown in Table 2, investors are expecting an average ROE of 10.6%.

6 **Q. WHAT IS THE AVERAGE AUTHORIZED ROE FOR STAFF'S GROUP**
 7 **OF COMPANIES?**

8 A. As shown in Table 1, the average authorized ROE for these comparable
 9 companies is 10.8%.

10 **Q. WHAT IS THE AVERAGE ALLOWED ROE FOR ELECTRIC**

Rebuttal Testimony of Roger A. Morin, PhD**1 UTILITIES IN RECENT ORDERS?**

2 A. The average authorized ROE for electric utilities in 2008, 2009, and 2010 is
3 10.5%, 10.5%, and 10.4%, respectively.

4 Q. WHAT ROE DOES STAFF RECOMMEND?

5 A. Staff's recommended ROE is 9.0%.

**6 Q. WHAT IS YOUR MAJOR CONCLUSION FROM STAFF'S ROE
7 RECOMMENDATION?**

8 A. Staff's recommended ROE is too low. Adjusted for the primary changes and
9 comments that I have outlined in my rebuttal, Staff's analysis indicates a return of
10 10.4% as follows: (1) Use of the mean instead of the median to determine the
11 average DCF result for its proxy group would raise Staff's DCF estimate by 32
12 basis points, from 9.14% to 9.46%. (2) Reliance on analysts' growth forecasts in
13 the DCF analysis would increase Staff's DFC estimate by another 80 basis points,
14 from 9.46% to 10.26%, even without flotation costs; (2) Recognition of the
15 appropriate risk-free rate in the CAPM/ECAPM analyses raises Staff's CAPM
16 estimates by 40 basis points, from 9.48% to 9.88% without flotation costs; (3)
17 Giving a two-third weight to the amended DCF result of 10.26% and a one-third
18 weight to the amended CAPM result of 9.88% brings Staff's recommendation to
19 10.1%; and (4) Adding the flotation cost adjustment of 30 basis points brings the
20 Staff recommendation to 10.4% from these primary changes alone.

21 Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

22 A. Yes, it does.

1 MR. MALONEY: With that, Your Honor,
2 Dr. Morin is available for cross-examination.

3 ALJ BOUTEILLER: Okay, thank you. And we'll
4 start with staff as the first cross-examiner.

5 CROSS-EXAMINATION

6 BY MS. DEAN:

7 Q Good morning, Dr. Morin.

8 A Good morning.

9 Q I'll be asking you the questions. Dr. Morin, did you
10 testify on behalf of Orange & Rockland Utilities in case
11 06-E-1433?

12 A Yes.

13 Q And did you testify in that case on the same issues
14 that you testified about in this case? And by that I mean
15 did you testify about the discounted cash flow mechanism,
16 the Capital Asset Price Model, also known as CAPM, and
17 that's how I'll be referring to it, and risk premium
18 methods?

19 A Yes.

20 Q In the Orange & Rockland proceeding did you testify
21 in support of using a proxy or surrogate group analysis to
22 estimate Orange & Rockland's cost of equity?

23 A I did.

24 Q Is that the same proxy group that you relied upon to
25 estimate Niagara Mohawk's cost of equity in this case?

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1 A The comparable group was derived using the same
2 screening criteria, and that is investment grade, at least
3 50 percent of revenues in regulated operations,
4 dividend-paying companies, so the same criteria were used.

5 Q Okay.

6 A In one of the groups. The other group was the
7 electric utilities that are a part of Standard & Poor's
8 electric utility index.

9 Q Okay. I wanted to show you a page from the
10 Commission's Decision in the 2006 O&R case. Would you
11 give it to him, just because I know you don't remember
12 every word of it.

13 A No, I don't.

14 Q This is actually page 11 from the Commission's
15 Decision in case 06-E-1433. And as that's being handed
16 out, I wanted to ask you to confirm the quote from that
17 Decision where the Commission described the proxy group as
18 "too risky because," and it listed three reasons. First
19 because it included companies that do not receive 70
20 percent or more of their revenues from utility operations;
21 second, it included companies that were not investment
22 grade, or third, it included companies involved in various
23 restructuring activities.

24 A That's what it says.

25 Q Okay. In the 2006 Orange & Rockland proceeding did

1 the Commission also accept staff's use of the median and
2 second stage growth rate in the DCF approach?

3 A Probably, yes.

4 Q Okay. Subject to check?

5 A Um-hum.

6 Q Also subject to check, did the Commission in the 2006
7 O&R proceeding also adopt the risk-free rate approach used
8 by staff in the CAPM?

9 A Yes, they did. Once again, the staff model produces
10 some of the lowest ROEs in the country.

11 Q In that same proceeding the Commission used the
12 discounted cash flow as a methodology for measuring the
13 cost of equity, is that correct?

14 A That's correct.

15 Q And the Commission's Decision as well was -- that
16 Decision was issued after a fully-litigated proceeding, is
17 that correct?

18 A That's correct.

19 Q Is it also correct that in that Decision the
20 Commission used staff's proposed DCF and CAPM estimation
21 to determine the cost of equity?

22 A Yes, again producing the lowest returns in the United
23 States.

24 Q In the Orange & Rockland proceeding did you also
25 recommend that the Commission use a risk premium

1 methodology to estimate the cost of equity?

2 A Yes. It's one of the standard methods that financial
3 scholars rely upon to estimate the cost of equity.

4 Q Did the Commission reject the use of a risk premium
5 methodology in case 06-E-1433?

6 A It's difficult to say because the CAPM is a risk
7 premium method, so from a generic point of view they have
8 endorsed risk premium. But if you're referring to the
9 empirical historical risk premium method that I also rely
10 on, then you're right.

11 Q More specifically, did the Commission reject your
12 risk premium methodology?

13 A One of them, yes.

14 Q In its Decision did the Commission use a two thirds
15 DCF and one third CAPM weighting in that Decision in the
16 Orange & Rockland to determine cost of equity?

17 A That has been the practice of the Commission in many,
18 many, many proceedings, again, producing some of the
19 lowest ROEs in the country.

20 Q So the Commission, in doing so, rejected your
21 testimony there of 50 percent DCF and 50 percent CAPM?

22 A As a matter of arithmetic, yes.

23 Q Did you also testify on behalf of Consolidated Edison
24 in case 07-E-0523?

25 A Yes.

1 Q And in that proceeding as well the Commission used
2 two thirds DCF and one third CAPM methodology for
3 estimating the company's cost of equity?

4 A Yes, the Commission has consistently relied on
5 one-third/two-thirds weighing of DCF and CAPM.

6 Q Am I correct that you estimated Niagara Mohawk's cost
7 of equity in part through the use of a proxy group of
8 companies?

9 A You are correct.

10 Q Can you please turn to page 22 of your direct
11 testimony, line 18, through page 23, lines 1 to 15?

12 A I have it.

13 Q Okay. You set out on these pages a number of
14 selection criteria that you used to establish two proxy
15 groups that you developed for this proceeding, is that
16 correct?

17 A That's correct.

18 Q Is merger acquisition criteria included on that list?

19 A No.

20 Q Do you agree that companies currently involved in
21 merger acquisition activity related to utility aspects, in
22 fact, should not be included in a proxy group?

23 A I think that's a reasonable procedure.

24 MS. DEAN: Your Honor, staff would like to
25 mark for identification an exhibit. It's the Capital

1 IQ report which is created by Standard & Poor's, and
2 we'll be handing out copies.

3 ALJ BOUTEILLER: For identification, if I'm
4 understanding the conventions we're employing, this
5 would be Exhibit Number 306.

6 (Exhibit No. 306 was marked for
7 identification.)

8 BY MS. DEAN:

9 Q Dr. Morin, you've received a copy of this report?

10 A Yes.

11 Q Under the heading "Status and Sell-side
12 Participants," does it show that First Energy is involved
13 in merger acquisition talks with Allegheny?

14 A Yes. I'm looking for the date of this document here
15 because let's not forget that my exhibits were prepared in
16 November of 2009, and we're talking about a current
17 transaction here, so at the time of initial preparation
18 this merger may not have been an issue.

19 Q The date -- the definitive agreement --

20 A February.

21 Q -- is February 10, 2010?

22 A Right.

23 Q Okay.

24 A I don't have a problem, though, with eliminating
25 First Energy from my sample. It would only increase the

1 average hourly, anyway, because First Energy's estimated
2 ROE is extremely low.

3 Q That's fine.

4 A But I agree with you, with your premise that
5 merger -- companies involved in mergers preferably should
6 be removed.

7 Q Okay. Excuse me one second. Now, Dr. Morin, on
8 footnote 1, page 3, of your rebuttal testimony you also
9 state -- and this is along the same lines -- that UIL
10 Holdings Corporation "apparently meets the criteria for
11 inclusion in staff's proxy group"?

12 A Yes.

13 MS. DEAN: And staff would like to mark for
14 identification an excerpt from Capital IQ reports
15 which is also created by Standard & Poor's, and we
16 will hand that out. This document is dated May 25,
17 2010. I'd like to mark this for identification.

18 ALJ BOUTEILLER: For identification, Exhibit
19 Number 307.

20 (Exhibit No. 307 was marked for
21 identification.)

22 BY MS. DEAN:

23 Q Dr. Morin, does this excerpt show that UIL Holdings
24 Corporation entered into a purchase agreement to acquire
25 Connecticut Energy Corporation, Connecticut Natural Gas

1 Corporation, and the Berkshire Gas Company from Iberdrola
2 USA for \$1.296 billion?

3 A Yes, but I'm not sure. As a qualifier, if at the
4 time of comparing past exhibits, if that merger had
5 already been consummated or not.

6 Q Turning to page 24, line 18, through page 25, lines 1
7 to 10 of your pre-filed direct testimony --

8 A I have it, page 24.

9 Q Thank you. Is it correct that you indicate you
10 applied your DCF analysis to two proxy groups?

11 A Yes.

12 Q And the first proxy group you devised for Niagara
13 Mohawk Power Corporation was a group of electric companies
14 reported on by Value Line, is that correct?

15 A Correct.

16 Q Is it correct that you eliminated from this proxy
17 group foreign companies, private partnerships, private
18 companies and companies below investment grade, and by
19 that I mean companies with a bond rating below Baa3 under
20 Moody's Investor Services and BBB- under S&P ratings?

21 A That is correct.

22 Q You included in your proxy groups in Exhibits RAM 2
23 to 14 of your direct testimony UniSource Energy,
24 CenterPoint Energy, Inc., CMS and Allegheny because these
25 companies are investment grade companies, is that correct?

1 A That's correct.

2 MS. DEAN: Staff would like to mark for
3 identification a notice from Moody's Investment
4 Services dated May 4, 2010.

5 ALJ BOUTEILLER: For identification, Exhibit
6 Number 308.

7 (Exhibit No. 308 was marked for
8 identification.)

9 BY MS. DEAN:

10 Q Dr. Morin, if you look at page 1 of this report, it
11 shows on that first page that CenterPoint Energy, Inc., is
12 rated at a BA1, is that correct?

13 A That's correct.

14 Q If you turn the page, the next -- I guess on the
15 second, third and fourth pages of this report, and that's
16 not including the back pages, it states that Moody's has
17 rated CMS Energy, UniSource Energy Corporation and
18 Allegheny a BA1, is that correct?

19 A That's correct.

20 Q The BA1 rating is below the rating of Baa3, is that
21 correct?

22 A That's correct. As of May 2010 that is correct, but
23 I was relying on AUS utility reports dated, I think,
24 November 2009 where they produced the bond ratings. And
25 I'm looking at it right now, and Allegheny was rated BBB+

1 at the time and BA1 by Moody's.

2 Q Would you then pull these companies out of the --

3 A No, I would not.

4 Q -- proxy group?

5 A No.

6 Q But you do agree they are below investment grade at
7 this time?

8 A The UAS doesn't seem to agree with the Moody's
9 assessment.

10 Q Okay, thank you. Who actually rates them, AUS or
11 Moody's?

12 A Well, Moody's, of course.

13 Q Okay, thank you.

14 A But sometimes there's confusion about the parent
15 company rating versus the operating subsidiary rating, and
16 here we're dealing with parent company data, so we have to
17 look at the parent company bond rating.

18 Q Did you testify on behalf of Central Hudson Gas &
19 Electric Corporation in cases 08-E-0887 and 08-G-0888?

20 A Yes.

21 Q And in the Central Hudson proceeding did the
22 Commission use a proxy group of companies in determining
23 Central Hudson's cost of equity?

24 A Yes.

25 Q Would you accept, subject to check, that the

1 Commission adopted staff's proxy group, which consisted of
2 30 companies, compared to the proxy group consisting of 34
3 companies in this proceeding?

4 A Yeah, I accept that. If I recall, the risk
5 complexion of that group is identical to the risk
6 complexion of my group as rated by beta.

7 Q Okay, thank you. In applying the proxy group cost of
8 equity to Central Hudson in that rate proceeding, did the
9 Commission reduce the proxy group cost of equity to
10 reflect the difference in credit quality between Central
11 Hudson and the proxy group?

12 A Yes, I believe it did.

13 Q Was this difference in credit quality between the
14 proxy group and Central Hudson quantified by analyzing the
15 difference between Central Hudson's bond rating and the
16 average proxy group bond rating?

17 A I believe so, yes.

18 Q In applying the proxy group cost of equity to Central
19 Hudson, did the Commission also reduce the proxy group
20 cost of equity to reflect its allowance of a revenue
21 decoupling mechanism for Central Hudson --

22 A Yes. I believe the allowed ROE was 10.2 percent.

23 Q Please turn to your Exhibit RAM 9. In that exhibit
24 you included 25 companies in your proxy group, is that
25 correct?

1 A I'm looking at page 1 and, indeed, there are 25
2 companies. If you look at RAM 10, I eliminated the ones
3 that have less than 50 percent of their revenues
4 regulated, so the sample is actually 20 as shown on RAM
5 10, page 1.

6 Q Okay, thank you. In determining which companies
7 derived 50 percent or more of their revenues from
8 regulated utilities, did you rely on the company's 2008 or
9 2009 annual 10-K reports?

10 A I relied on AUS utility reports dated November 2009.

11 MS. DEAN: Staff would like to mark for
12 identification an excerpt from Sempra Energy's 2009
13 10-K report.

14 ALJ BOUTEILLER: For identification, it will
15 be marked as Exhibit Number 309.

16 (Exhibit No. 309 was marked for
17 identification.)

18 BY MS. DEAN:

19 Q Dr. Morin, does this excerpt from Sempra's 2009 10-K
20 show, under the heading "Total Revenues," that Sempra
21 Energy earned total revenue of \$8.1 billion?

22 A Yes.

23 Q Does it show under the heading "Sempra Utilities"
24 earnings of \$6.2 billion just above it?

25 A Yes.

1 Q Do you agree, subject to check, that 6.2 billion is
2 76 -- approximately 76 percent of \$8.1 billion?

3 A Yes.

4 MS. DEAN: Your Honor, at this time staff
5 would like to mark for identification a May 14, 2010
6 interrogatory response from Dr. Morin to
7 interrogatory request PP/KD-33 DPS 497.

8 ALJ BOUTEILLER: For identification, Exhibit
9 Number 310.

10 (Exhibit No. 310 was marked for
11 identification.)

12 BY MS. DEAN:

13 Q If you could turn to your response, you state
14 there -- and I'm quoting in relevant part -- "Attached is
15 a list of companies that possess some form of revenue
16 decoupling and/or similar margin adjustment rider
17 mechanism."

18 A Yes.

19 Q To the best of your knowledge, is that still
20 accurate?

21 A Well, to the best of my knowledge, it is. Revenue
22 decoupling and risk-mitigating mechanisms and fixed cost
23 revenue -- excuse me -- fixed cost recovery mechanisms are
24 becoming sort of standard policy in the industry. I would
25 even go as far as saying they're becoming mainstream

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1 tools. So to the extent that that affects the data, it's
2 already reflected in bond ratings and in stock prices and
3 business risk scores and so on.

4 Q If you look at the attachment to the IR response
5 briefly, under "Allegheny Energy" on that first line is
6 anything listed under the heading "Electric Decoupling"?

7 A No.

8 Q On that same page is anything listed under the
9 heading "Electric Decoupling," and I have a list of
10 companies here, for Ameren Corp., Empire Distribution
11 Electric -- and they are in alphabetical order, so that
12 helps -- Exelon Corp., First Energy Corp., FPL Group, MGE
13 Energy, Northwestern Corp., NStar, Pinnacle West Capital,
14 Public Serve Enterprise, Southern Company, TECO Energy,
15 UniSource Energy or Wisconsin Energy?

16 A Well, that's why they're blanks, but they do have a
17 variety of fixed cost recovery types of mechanisms and
18 other depreciation trackers and overriding risk mechanisms
19 that accomplish the same thing.

20 Q All right. But they do not have a revenue decoupling
21 mechanism for electric?

22 A Per se, no.

23 Q Thank you.

24 A But they have other similar risk-reducing mechanisms.

25 Q Would you agree, Dr. Morin, that the cost of equity

1 is a cost similar to any other costs incurred by utility
2 in providing service to its ratepayers?

3 A I certainly agree.

4 Q In this proceeding am I correct that you have
5 estimated Niagara Mohawk's cost of equity as 10.85 percent
6 under a one-year rate plan?

7 A Yes.

8 Q If the Commission were to determine that Niagara
9 Mohawk's financial metrics in this proceeding were above
10 those necessary to achieve targeted bond rating -- a
11 targeted bond rating, would you recommend the Commission
12 establish rates below Niagara Mohawk's cost of equity?

13 A No. Risk of a bondholder's point of view is
14 concerned with creditworthiness. Risk from a
15 shareholder's point of view is concerned with variability
16 and risk and volatility.

17 COURT REPORTER: I'm sorry? Risk from a
18 shareholder's?

19 A Risk from a shareholder's perspective is considered
20 to be related to volatility and variability of returns, so
21 there's two different perspectives on risk from a
22 bondholder versus a shareholder point of view.

23 Q Earlier you mentioned that the companies I listed
24 that did not have electric decoupling mechanisms did have
25 risk-reduction mechanisms. Did you submit an exhibit to

1 support that statement, or do you have something that
2 supports that?

3 A In my rebuttal I think I cite an Edison Foundation
4 study of the prominence of risk-mitigating mechanisms in
5 the electric utility industry.

6 Q Okay. Can we just check? Since you're not sure, can
7 we just check?

8 A I'm almost sure I did. Edison Foundation report.
9 And the bottom line of that report is that 30 states have
10 such revenue -- or risk-reducing mechanisms. Let me see
11 if I can find the exact page.

12 MR. MALONEY: I think it's on page 34 of 41.

13 A Page 34.

14 Q We're checking that as well.

15 A Me, too.

16 Q Can you state the page again?

17 MR. MALONEY: 34 of 49 or page 116,
18 depending on how it's --

19 A Footnote 8.

20 MR. MALONEY: Footnote 8 is the cite.

21 A The bottom line is that the risk-mitigating
22 mechanisms are widespread in the industry, therefore, are
23 already reflected to a large extent in market data.

24 ALJ BOUTEILLER: Just for clarity on the
25 record, your footnote on the rebuttal page, does that

1 make reference, direct reference, to the companies
2 you've identified in your response to staff
3 interrogatory?

4 THE WITNESS: No, they're two separate
5 things.

6 ALJ BOUTEILLER: Okay, thank you.

7 THE WITNESS: The Edison study is a much
8 more comprehensive study of risk-mitigating
9 mechanisms across the entire industry.

10 ALJ BOUTEILLER: Did you hear my question
11 and answer?

12 MS. DEAN: I think I did. It's in the
13 record. That's all we have. Thank you.

14 THE WITNESS: Thank you very much.

15 ALJ BOUTEILLER: Who is the next
16 cross-examiner? Mr. Mager?

17 MR. MAGER: I guess I am, Your Honor. Your
18 Honor, if I can take a minute at this time, in some
19 of the cross I'm going to ask Dr. Morin to refer to
20 interrogatory responses, so I think before I start,
21 if it would be okay, I would like to have marked
22 Multiple Intervenors exhibit of IR responses.

23 ALJ BOUTEILLER: Let's go off the record as
24 you distribute that. We'll come back on the record
25 when you're ready.

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1 (Discussion off the record.)

2 ALJ BOUTEILLER: While we were off the
3 record, we received distribution of Mr. Mager's
4 interrogatory responses, and have you identified this
5 for the record, Mr. Mager?

6 MR. MAGER: Not yet, but I will, Your Honor.
7 Your Honor, what we'd like to have marked is a
8 216-page exhibit plus a cover sheet which includes
9 responses to Multiple Intervenors interrogatories
10 provided by the company and staff, and the cover page
11 identifies the responses included in the proposed
12 exhibit, and they are the same responses that were
13 identified to the other parties in a communication
14 that we sent out yesterday.

15 ALJ BOUTEILLER: For identification, Exhibit
16 Number 311.

17 (Exhibit No. 311 was marked for
18 identification.)

19 MR. MAGER: Thank you.

20 CROSS-EXAMINATION

21 BY MR. MAGER:

22 Q Good morning, Dr. Morin.

23 A Good morning.

24 Q Staff covered some of the ground I had planned to
25 cover, so I may jump around at points. If I lose you at

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1 any time, will you please let me know? And I'll try to
2 clarify my question.

3 A The same applies to you.

4 Q Thank you. Just real briefly, just, I think, to
5 clarify the record, you testified that you previously
6 testified in a Central Hudson rate case, and you said that
7 the Commission authorized a 10.2 percent ROE in that case.
8 Do you recall that?

9 A Yes, I do.

10 Q Would you accept, subject to check, that the
11 authorized ROE in that case was 10.0? And I'll refer you
12 to page 5 of your rebuttal testimony.

13 A Yeah, I think you're right. I was mistaken for
14 another case.

15 Q Okay. Staff went through with you that you had
16 testified in recent rate proceedings involving Central
17 Hudson and Orange & Rockland. Do you recall that?

18 A Yes.

19 Q Is it also true that you've provided ROE testimony in
20 recent Con Edison rate cases as well?

21 A Yes.

22 Q Is it fair to say that you have advanced essentially
23 the same methodologies for calculating ROE in those
24 utilities rate proceedings as you do here?

25 A Yes. I'm very consistent about that.

1 Q Do you advance the same methodology for calculating
2 ROE in other states?

3 A Yes, again, very, very consistent.

4 Q Okay. And so is it also fair to say that you do not
5 tailor your recommended ROE approach to the policies or
6 practices of the jurisdiction in which you are testifying?

7 A No. I provide an independent opinion based on
8 academic thinking, on empirical evidence and the finance
9 literature.

10 Q Okay. Is it fair to say that with minor changes the
11 Commission has generally followed the same basic
12 methodology for calculating ROE for a number of years,
13 specifically two thirds reliance on the DCF calculations
14 and one third reliance on CAPM calculations?

15 A The Commission has consistently relied on a
16 mechanical approach to determining ROE, the so-called GFM,
17 general financing model, and regardless of capital market
18 conditions and changes, they have stuck with this model.

19 Q Is it -- in your opinion, isn't it true that the
20 staff also followed this model for purposes of this rate
21 proceeding?

22 A Yes, they have been very consistent. They've made
23 some minor changes in terms of measurement period, six
24 months versus three months and the like, but they have
25 generally stuck to the robot, I call it, the mechanical

1 model.

2 Q The approved model? Withdrawn.

3 A The model that has produced the lowest ROEs in the
4 United States.

5 Q Is it also fair to state that the Consumer Protection
6 Board witness also generally followed the same methodology
7 that the Commission has employed?

8 A That is correct.

9 Q Okay. Can I ask you to turn to page 24 of your
10 direct testimony?

11 A I have it.

12 Q Okay. Starting on line 18 -- actually, starting on
13 line 16 you discuss how the Commission previously has
14 criticized your proxy groups because you employed a 50
15 percent floor with respect to regulated revenues instead
16 of a 70 percent, and you testified starting on line 18
17 that this criticism is not justified because the average
18 percentage of regulated electric revenues in my two
19 comparable groups of utilities are 71 percent and 74
20 percent respectively?

21 A Yes.

22 Q Do you see that?

23 A Yes.

24 Q Now, with respect to the 71 percent and the 74
25 percent, that's an average, correct?

1 A That's correct.

2 Q So there are some companies in your proxy group that
3 have a higher percentage and some are a lower percentage?

4 A By virtue of an average, that's correct.

5 Q Right. And if you take a look at page 125 of the
6 exhibit that I placed on your table, what's been marked as
7 Exhibit 311 --

8 A I have it.

9 Q Okay. If you could please turn to page 125.

10 A I have it.

11 Q Now, this is the company's response to an MI 144
12 interrogatory, and there you indicate that had you used
13 the 70 percent minimum threshold to your proxy groups, the
14 average percentage of regulated revenues, electric
15 revenues, would have been 81 percent and 85 percent
16 respectively; do you see that?

17 A That's correct. The more stringent the screenings
18 criterion, the smaller and smaller and smaller the group
19 gets, and then you lose statistical reliability. So you
20 have to make a trade-off between the number of
21 observations in the group versus the validity of the
22 screening criteria.

23 Q Well, the Commission previously has used the 70
24 percent screening threshold in numerous cases, and they
25 never found that it resulted in proxy groups that were too

1 small, did they?

2 A No, they have something like 30, 34 companies.

3 Q Okay. Can you turn back to page 124 of that same
4 exhibit?

5 A Yes, I have it.

6 Q There I understand someone else from the company
7 prepared that response to MI 143, but if you could read
8 the response, doesn't that show that in the case of
9 Niagara Mohawk its regulated revenues are 99 percent of
10 the company's total revenues?

11 A That's correct. So?

12 Q When you're talking about proxy group composition,
13 isn't an important criteria the comparability of the proxy
14 group to the utility that you're setting the ROE for?

15 A Absolutely. And the ultimate measure of risk is what
16 we call in finance the beta, and the beta -- my groups are
17 almost identical to the betas used by staff.

18 Q Just so we're following up on that, my recollection
19 of your rebuttal testimony is, though, that although you
20 took issue with a number of staff recommendations, you did
21 not necessarily criticize the composition of staff's proxy
22 groups?

23 A I don't have a problem with staff's group.

24 Q Okay. So the company would have no opposition if the
25 Commission relied on staff's proxy groups in this case?

1 A Not in that one singular case, no, I would not have a
2 problem of that because the beta of their sample is
3 identical to the beta of my sample.

4 Q Okay. Page 25 of your direct, please.

5 A I have it.

6 Q Okay. Starting, I believe, on line 15, you discuss
7 how you used current stock prices at the time you
8 calculated your recommended ROE. Is that correct?

9 A That is correct.

10 Q Am I correct that you advance the same approach in
11 the prior utility rate cases that you've sponsored
12 testimony in New York?

13 A I have always advocated the use of current data as
14 opposed to stale data.

15 Q Okay. And in those --

16 A And the reason for that is because of market
17 efficiency.

18 Q Those New York rate cases that were fully litigated,
19 specifically recent Central Hudson, Con Ed and O&R cases,
20 isn't it true that the Commission declined to adopt that
21 approach and relied instead on average stock prices over a
22 three- or six-month period?

23 A Yes, they have. They have stuck to the model, again,
24 that produces the lowest ROEs in the United States.

25 Q And starting on page 27 of your direct testimony on

1 line 20 and carrying over to page 28, you testified that
2 an average stock price dating back three to six months
3 reflects stale information and may not be representative
4 of current market conditions. Do you see that?

5 A Yes.

6 Q So under that reasoning would it also be correct that
7 the -- that your ROE calculations in your direct testimony
8 are now stale?

9 A Yes, they are.

10 Q Okay. And you would have no objections if the
11 Commission updated whatever methodology it chose at the
12 time of its final decision in this case?

13 A I strongly believe the Commission should rely on the
14 latest information at the time of making the decisions.
15 And, again, this is a real challenge nowadays because of
16 the tremendous volatility that we're experiencing
17 day-to-day in the equity markets, but the answer is yes.

18 ALJ BOUTEILLER: Let me just follow up on
19 that question. How would you -- what would you
20 recommend be the mechanism to stabilize, I guess,
21 day-to-day volatility that we're seeing in the
22 marketplace now if we were to do something shorter
23 and more current than the three- or six-month
24 interval?

25 THE WITNESS: The way to get around the

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1 volatility is to authorize a range of ROE, a range of
2 reasonableness like some jurisdictions do. For
3 example, you could say, well, as long as the ROE lies
4 between, you know, 10 and 10.5, for example, we're
5 okay and use the mid point for rate-making and no
6 rate activity is required as long as the ROE stays
7 within that range, so the idea of a range
8 accommodates volatility and other issues as well.

9 ALJ BOUTEILLER: And then the Commission
10 would employ the mid point of that range?

11 THE WITNESS: Perhaps, yes, or it may have
12 other reason to choose the lower bound or the upper
13 bound.

14 ALJ BOUTEILLER: I see. Okay. Thank you.
15 Please proceed, Mr. Mager.

16 MR. MAGER: Okay.

17 BY MR. MAGER:

18 Q Staff had asked you a number of questions in terms of
19 whether the Commission had adopted or rejected various
20 proposals you've advanced in other rate cases, and I want
21 to -- I don't want to be repetitive there, but can I turn
22 you to page 35 of your direct? And that's where you start
23 discussing your opposition to the use of dividend growth
24 forecast in the DCF. And my question is similar to those
25 other questions. Isn't it true that you've opposed the

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1 use of dividend growth forecasts in DCF calculations in
2 prior cases, and each and every time the Commission still
3 relied on those dividend growth forecasts?

4 A In past recent cases I have advocated the nonuse of
5 dividend growth forecast because utilities are in the
6 process of reducing their dividend payout in response to
7 the requirements for internal financing to finance all
8 kinds of capital expenditures. And the second and more
9 important reason, there's only one person that provides
10 dividend forecasts, some analyst at Value Line. I prefer
11 to the rely on the consensus of a variety of analysts as
12 opposed to just one person, so those are the two reasons.

13 Q Okay. But getting back to my question, you've
14 advanced that rationale in other cases and the Commission
15 has declined to adopt it?

16 A That's correct, but I find my rationale pretty
17 convincing.

18 Q I would find mine convincing, too.

19 THE WITNESS: I'm sorry, Your Honor.

20 Q I just want to clarify one thing. If you could turn
21 to page 128 of the large exhibit, Exhibit 311.

22 A I have it.

23 Q If you could look at the bottom of that page, and
24 it's your response to MI 146, the very bottom of page 128
25 there's a sentence that reads, "Dr. Morin is also aware of

1 any litigated proceeding," et cetera. I want to just make
2 sure that there should be a not?

3 A A not, yeah, correct.

4 Q Dr. Morin is also not aware?

5 A Not aware, that's correct.

6 Q Okay. Turning to page 41 of your direct testimony --

7 A I have it.

8 Q Okay. You rely on a 4.7 percent risk-free rate in
9 your CAPM analysis, correct?

10 A Yes, sir.

11 Q And that's based on 30-year U.S. treasury bond yields
12 as of December 2009?

13 A That's correct.

14 Q Okay. And am I -- okay. On page -- did I direct you
15 to page 41? I lost my place for a second.

16 A Yes, I'm on page 41.

17 Q Starting on line 7 you state, "Moreover, it is widely
18 expected that interest rates will rise in 2010 in response
19 to the recovering economy and record high federal
20 deficits." Do you see that?

21 A Yes.

22 Q That has not happened yet, correct?

23 A That has not happened because the Federal Reserve is
24 pursuing a very, very, very aggressive monetary policy,
25 checking \$2 trillion in the money supply to try to

1 jump-start the economy.

2 Q As a result of federal policies or other factors,
3 wouldn't you agree that the current yields on 30-year
4 treasury bonds are roughly 100 basis points less now than
5 they were back in December 2009?

6 A They've hovered around the 4 percent level in August,
7 so yes, I agree -- around 4 percent.

8 Q Okay. On page 44 of your testimony, starting on page
9 44, you take issue with the Commission's practice of
10 averaging 10-year and 30-year treasury bond yields to
11 determine the risk-free rate in the CAPM. My question is,
12 isn't it true that you have advanced those positions in
13 the prior rate cases we discussed previously and the
14 Commission declined to adopt your position on that issue?

15 A That is correct. Stock is a long-term instrument, so
16 I match it with a long-term bond.

17 Q Similarly, with respect to the Commission Decisions
18 in other rates cases that you've testified, on page 62 of
19 your direct testimony you advocate for a floatation cost
20 adjustment in this case, notwithstanding the fact that
21 there's no planned stock issuance during the rate year.
22 And my question is, have you not also advanced a similar
23 recommendation in the prior rate cases and each and every
24 time the Commission has declined to adopt your position on
25 that issue?

1 A That's correct, but equity is not free. And even
2 though you're not issuing stock in the future, you still
3 have to recover the floatation costs associated with past
4 issues, in the same way that if you're not building new
5 plants, you still continue to depreciate the old ones.
6 It's the same idea for floatation costs with equity
7 offers.

8 Q But you've raised that argument in prior rate
9 proceedings, and the Commission, nevertheless, has
10 declined to adopt your position on the issue?

11 A That's correct. They stick to the model.

12 Q Okay. Can you turn to page 5 of your rebuttal
13 testimony, please?

14 A Page?

15 Q 5 of your rebuttal.

16 A I have it.

17 Q Okay. On page 5 you have included a list of certain
18 allowed or proposed ROEs in New York. Do you see that?

19 A Yes, sir.

20 Q Now, there are a number of cases where you list
21 separate electric and gas case numbers separately, but
22 those involve a single rate proceeding, do they not? And
23 I'll draw your attention to the first two Central Hudson
24 references, the two New York State Electric & Gas
25 references, the two Rochester Gas & Electric references,

1 and the following two Central Hudson references. Those
2 were all individual proceedings, just they separate for
3 both electric and gas?

4 A That's correct, yes.

5 Q Okay.

6 A But investors are looking at this, and they're seeing
7 separate allowed ROEs that are above 10 percent.

8 Q Well, in those cases is it your understanding that
9 the Commission -- they didn't set a separate ROE for
10 electric and gas operations? They basically --

11 A Right.

12 Q -- they set one common ROE?

13 A I see your point. I agree with that, yes.

14 Q Okay. Is it also true that many of the cases listed
15 on that table involve multi-year rate settlements?

16 A Yes.

17 Q And, in fact, are you aware of any on that table that
18 do not involve multi-year rate settlements with the
19 exception of the 2008 Central Hudson rate case, the
20 08-E-0887 and 08-G-0888?

21 A I am not aware, you're right.

22 Q Okay. With the exception of those Central Hudson --
23 with the exception of the 2008 Central Hudson rate case,
24 if the other cases were settlements, wouldn't you assume
25 that there were stay-out premiums built into the ROEs that

1 were negotiated?

2 A I wasn't privy to all the various factors that could
3 have been involved in the settlement discussions, but what
4 you suggest is quite plausible.

5 Q Okay. Now, you mentioned you weren't privy to those
6 negotiations, so you're not aware, are you, of whether the
7 utilities may have given consideration in exchange for ROE
8 of a certain level?

9 A Yeah. There's a lot of horse trading that goes on,
10 inevitably, in a settlement discussion, give and take.

11 Q Okay. And, finally, the dates you have listed in
12 that, with the exception of the pending settlement in
13 NYSEG and RG&E, those rates are based on the Commission
14 Orders on the settlements, correct?

15 A That's correct, sir.

16 Q So those, the ROEs that were negotiated prior to
17 settlement may have been negotiated sometime prior to the
18 date listed here?

19 A They may have.

20 Q Now, you testified previously in response to staff
21 that the Commission has made certain credit quality
22 adjustments in rate proceedings, notwithstanding your
23 testimony. Do you recall that?

24 A Yes, I do.

25 Q Okay. And the way those credit quality adjustments

1 work is if the utility has a lower bond rating than the
2 proxy group, the ROE -- the adjustment is a negative, and
3 if the utility has a worse or lower bond rating than the
4 proxy group, the adjustment would be a positive?

5 A That's correct. That's the procedure.

6 Q Okay. Do you know whether the -- any of the
7 settlements in these cases, for instance, NYSEG and RG&E,
8 if it would be appropriate or normal to incorporate a
9 credit quality adjustment in the ROE negotiations?

10 A It is totally inappropriate to apply a credit
11 adjustment because that adjustment does not translate into
12 stocks.

13 Q Okay. My question was poorly worded. Let me
14 rephrase. Do you know whether -- do you know whether the
15 parties negotiating the settlements may have included or
16 reflected a likely credit quality adjustment?

17 MR. MALONEY: Your Honor, I'm going to
18 object. I believe Mr. Mager just asked him to
19 speculate on what parties may or may not have done in
20 settlement negotiations that Dr. Morin is not
21 personally familiar with.

22 MR. MAGER: Your Honor, I'll withdraw the
23 question.

24 ALJ BOUTEILLER: Thank you, Mr. Mager.

25 BY MR. MAGER:

1 Q Could you turn to the top of page 14 of your rebuttal
2 testimony?

3 A I have it.

4 Q At the top of page 14 you discuss how New York's
5 regulatory environment is viewed by credit rating
6 agencies. Do you see that?

7 A Yes.

8 Q And I believe you testified maybe eight or nine times
9 today that New York authorizes some of the lower ROEs in
10 the country.

11 A The lowest ROEs in the country.

12 Q The lowest, okay. Now, when the state's regulatory
13 environment is evaluated, isn't it true they look at more
14 than just authorized ROEs?

15 A Oh, yes, of course. They look at accounting
16 procedures. They look at the presence or absence of
17 various mechanisms such as forward test years, for
18 example, or other risk-mitigating measures like revenue
19 decoupling. They look at a variety of policies from the
20 Commission to arrive at a final judgment. But the point
21 I'm making here is they have declined over time in terms
22 of quality of regulation.

23 ALJ BOUTEILLER: Let me interject at this
24 point and let me just ask a follow-up question.
25 You're stating here that New York was the fourth

1 lowest of six categories. Has that been a stable
2 rating, or has there been volatility in that rating?
3 Can you just tell us over time what the consistency
4 of that rating has been?

5 THE WITNESS: It's been in the middle for a
6 long time, but it has declined in recent years in
7 light of the allowed ROEs mainly as stated directly
8 by Standard & Poor's and Moody's in various credit
9 rating reports, and that's not good for ratepayers or
10 anybody.

11 ALJ BOUTEILLER: Okay. I understand your
12 testimony.

13 Please proceed.

14 BY MR. MAGER:

15 Q Isn't it fair to say that the average credit rating
16 of a electric and gas utility in the United States is
17 something in the B+ plus range?

18 A Yes, it's Baal.

19 Q Okay. And isn't it also fair to say that New York's
20 major electric and gas utilities on average have higher
21 credit ratings than the national average?

22 A They have in the past, but they've been
23 systematically downgraded in the last three years in
24 response to rate orders.

25 Q But today, sitting here today, isn't it true that New

1 York's -- the outreach credit rating of a New York
2 electric and gas utility is higher than the national
3 average?

4 A It's very close to the average. I'm talking A3
5 versus Ba1. That's pretty close.

6 Q Okay. With New York being higher?

7 A Slightly at this time. I hate to hesitate what would
8 happen with a 9 percent allowed ROE.

9 Q Please turn to page 37 of your rebuttal.

10 A I have it.

11 Q There you -- I'm sorry. One moment, please. I'm
12 sorry. I had the wrong page number. You testified in
13 your rebuttal that you no longer support an adjustment for
14 a revenue decoupling mechanism?

15 A That's correct, because they have become mainstream
16 and pretty standard policy across the nation.

17 Q Okay. But I guess my question is you previously did
18 support an RDM adjustment, did you not?

19 A Yeah. Three years ago I did support an adjustment,
20 because at the time it was a novelty, and such mechanisms
21 and their impact on the risk were not recognized in bond
22 ratings and stock prices and assessments of business risk
23 and so on, but now they are.

24 Q Well, with respect to your prior testimony, you
25 recognized -- and I think you also did earlier today --

1 that RDMS are risk-mitigating or risk-reducing?

2 A Yes, they are. On an absolute basis they reduce
3 risk, but on a relative basis compared to other utilities
4 they do not, because it's already in the market data, so
5 you don't want to double-count the impact.

6 Q Well, isn't the appropriate analysis is to -- is the
7 comparison of -- with the proxy group utilities in terms
8 of whether they have similar revenue decoupling
9 mechanisms?

10 A That's one way of approaching it, but my cited
11 footnote 8 there about the Edison study, it's pretty
12 comprehensive and certainly makes the point that it's
13 standard policy in the industry.

14 Q Well, that quote -- it says 30 states, so 30 states,
15 that doesn't necessarily mean every utility in the state
16 has it?

17 A No, it doesn't.

18 Q And those 30 states you're talking about -- this is
19 on page 34 of your rebuttal testimony -- it says
20 "utilizing some form of revenue decoupling and/or lost
21 revenue adjustment mechanisms"?

22 A Right.

23 Q So these mechanisms can be much smaller in scope than
24 say, for instance, the revenue decoupling mechanism
25 proposed in this proceeding?

1 A Yes, or larger as in the Hawaii case.

2 Q Okay. But you haven't done any analysis of the
3 revenue decoupling or other mechanisms that are in the
4 specific utilities in your proxy groups or staff's proxy
5 groups, have you?

6 A Not a formal quantitative study, but I read a lot of
7 credit rating reports and equity research reports, and the
8 absence or presence of RDMs is not very high on the radar
9 screen of investors. The concerns really center around
10 demand, the risk and the economy and so forth, really not
11 on presence or absence of RDM. It's low on the radar
12 screen.

13 Q Okay. But in response to my question, you haven't
14 done any analysis of the specific utilities in either your
15 proxy groups or the company's proxy groups?

16 A Well, other than the Edison study that I cited, no.

17 MR. MAGER: I don't have anything further.
18 Thank you.

19 THE WITNESS: Thank you, sir.

20 ALJ BOUTEILLER: Thank you, Mr. Mager.

21 Mr. Walters, am I correct, did you decide to
22 not cross this witness?

23 MR. WALTERS: Right. We have no cross.

24 ALJ BOUTEILLER: Thank you. I recalled that
25 correctly. That's good.

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1 Is there any other party cross-examining
2 this witness? If not we'll employ our standard
3 convention. You can approach the witness either in
4 the room or outside to consider the need for
5 redirect.

6 MR. MALONEY: Could I ask that we take about
7 a 15-minute break, Your Honor, to consult with the
8 witness?

9 ALJ BOUTEILLER: Well, if you want to go
10 that route, let's go off the record and take our
11 lunch recess.

12 THE WITNESS: No. No. No.

13 MR. MALONEY: I'll do it in less than 15
14 minutes.

15 ALJ BOUTEILLER: Five minutes or we take a
16 lunch break.

17 MR. MALONEY: Five minutes will do it, I
18 guess.

19 ALJ BOUTEILLER: Okay. Let's go off the
20 record for five minutes. The clock has begun.

21 (Discussion off the record.)

22 ALJ BOUTEILLER: Let's turn to company
23 counsel and ask whether or not there's any redirect
24 for this witness.

25 MR. MALONEY: Your Honor, we have no

1 redirect.

2 ALJ BOUTEILLER: If there's no redirect for
3 the witness, we want to thank you for your attendance
4 today, and you are excused.

5 THE WITNESS: Thank you, sir.

6 ALJ BOUTEILLER: Unless there's any reason
7 why we shouldn't, I'd like to take our lunch recess
8 now. Let's go off the record.

9 (Discussion off the record.)

10 ALJ BOUTEILLER: We've talked about a couple
11 of housekeeping matters. We'll pay attention and
12 take care of them at the appropriate point in time,
13 but otherwise I'd like to take a 45-minute lunch
14 break at this time, and we will resume at 10 minutes
15 after 1:00.

16 MR. MALONEY: Thank you, Your Honor.

17 (Lunch recess.)

18 ALJ BOUTEILLER: Let's resume the hearing.
19 Let's turn to the company and ask the company to call
20 their next witness, please.

21 MR. MALONEY: Thank you, Your Honor. The
22 company calls Andrew E. Dinkel, III.

23 ALJ BOUTEILLER: Mr. Dinkel.

24 A N D R E W E . D I N K E L , I I I

25 having been first duly sworn by the Notary Public,

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1 was examined and testified as follows:

2 ALJ BOUTEILLER: Please for the record state
3 your name and business address.

4 THE WITNESS: My name is Andrew E. Dinkel,
5 III. My business address is One Metrotech Center,
6 Brooklyn, New York 11201.

7 ALJ BOUTEILLER: Now your counsel will
8 assist us in getting your testimony into the record.

9 MR. MALONEY: Thank you, Your Honor.

10 BY MR. MALONEY:

11 Q Good afternoon, Mr. Dinkel. Mr. Dinkel, do you have
12 before you a document consisting of 25 pages under a cover
13 sheet entitled "Direct Testimony of Andrew E. Dinkel,
14 III"?

15 A Yes, I do.

16 Q And was this testimony submitted as part of the
17 company's January 29, 2010 filing in this proceeding?

18 A Yes, it was.

19 Q Do you have any corrections or changes to your
20 prepared direct testimony?

21 A No, I do not.

22 Q If I would ask you the questions appearing in your
23 direct testimony today, would your answers be the same?

24 A Yes, they would.

25 Q Do you adopt this testimony as your sworn testimony

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1 in this proceeding?

2 A Yes, I do.

3 Q Am I also correct that as part of your direct
4 testimony you also sponsored three exhibits which have
5 been pre-marked for identification as Exhibit Numbers 15,
6 16 and 17?

7 A Yes.

8 Q And were these exhibits prepared by you or under your
9 direction and supervision?

10 A Yes, they were.

11 Q Mr. Dinkel, do you also have before you a document
12 consisting of four pages under a cover sheet entitled
13 "Supplemental Testimony of Andrew E. Dinkel, III"?

14 A Yes, I do.

15 Q Do you have any corrections or changes to this
16 testimony?

17 A No, I do not.

18 Q If I were to ask you the questions appearing in this
19 testimony today, would your answers be the same?

20 A Yes.

21 Q And do you adopt this testimony as your sworn
22 testimony?

23 A Yes, I do.

24 Q And I take it it's also correct that as part of your
25 supplemental testimony you also sponsored two exhibits

1 which have been pre-marked for identification as Exhibit
2 Numbers 18 and 19, is that correct?

3 A Yes.

4 Q And were these exhibits prepared or compiled by you
5 or under your direction and supervision?

6 A Yes, they were.

7 Q Mr. Dinkel, do you finally have before you a document
8 consisting of 19 pages under a cover sheet entitled
9 "Rebuttal Testimony of Andrew E. Dinkel, III"?

10 A Yes, I do.

11 Q Was this testimony prepared as part of the company's
12 rebuttal filing in this case?

13 A Yes, it was.

14 Q Do you have any corrections or changes to this
15 document?

16 A No, I do not.

17 Q If I were to ask you the questions appearing in this
18 document today, would your answers be the same?

19 A Yes, they would.

20 Q Do you adopt your prepared rebuttal testimony as your
21 sworn testimony in this proceeding?

22 A Yes, I do.

23 Q Finally, Mr. Dinkel, is it also correct that as part
24 of your rebuttal testimony you sponsor an exhibit that's
25 been pre-marked for identification as Exhibit 20?

1 A Yes.

2 Q And was this exhibit prepared by you or under your
3 direction and supervision?

4 A Yes, it was.

5 MR. MALONEY: With that, Your Honor, I'd ask
6 at this time that the testimony be copied into the
7 record following the procedure we've established.
8 And with that Mr. Dinkel will be available for cross.

9 ALJ BOUTEILLER: Okay, so beginning with the
10 exhibits first, I understand that we have identified
11 as the exhibits for this witness Exhibits 15 through
12 20. With respect to the witness' pre-filed
13 testimony, we have his direct testimony, we have his
14 supplemental testimony and we have his rebuttal
15 testimony. Absent any objection from the parties
16 present in the room, I will instruct the reporter to
17 copy into the record as if given orally today the
18 pre-filed testimony of this witness.

19 For clarity on the record I want to indicate
20 that we believe that the reporter has been provided a
21 PDF electronic version of the witness' pre-filed
22 testimony and, in fact, that is what will be copied
23 into the record that will be created today.

24 MR. MALONEY: That's our understanding as
25 well, Your Honor.

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1 ALJ BOUTEILLER: Okay, thank you.

2 (The referenced testimony is included as
3 ordered.)

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Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL GRID

Direct Testimony

of

Andrew E. Dinkel III

Director of Cost of Capital

Dated: January 29, 2010

Testimony of Andrew E. Dinkel III

1 **Q. Please state your name and business address.**

2 A. My name is Andrew E. Dinkel III. I am the Director of Cost of Capital of
3 the U.S. Regulation and Pricing Organization of National Grid USA, Inc.
4 My business address is 1 MetroTech Center, Brooklyn, NY 11201.

5

6 **Q. Please describe your educational and professional background.**

7 A. I received a Bachelor of Science degree in Electrical Engineering from the
8 Polytechnic Institute of Brooklyn in 1975. In 1983, I successfully
9 completed the Power System Engineering Course given by General
10 Electric. In addition, I have attended various industry seminars addressing
11 advanced engineering economics and financial and accounting issues. I
12 joined the Long Island Lighting Company as an engineer in the
13 Distribution Engineering Section in 1977. Since then I have held various
14 managerial positions within LILCO and its successor companies KeySpan
15 Corporation (“KeySpan”) and National Grid plc (“National Grid”),
16 including Manager of the Financial Analysis Division and later, Manager
17 of Financial Planning. In September 2001, I became Director of Financial
18 Strategy at KeySpan reporting to the Assistant Treasurer. In 2006, I
19 transferred to the position of Director of Revenue Requirements in the
20 Regulation and Pricing – Gas Distribution organization. In May 2009, I
21 became the Director of Cost of Capital in the U.S. Regulation and Pricing

Testimony of Andrew E. Dinkel III

1 organization of National Grid’s United States-based operations. In my
2 current position, I am familiar with the financing of Niagara Mohawk
3 Power Corporation d/b/a National Grid (“Niagara Mohawk” or “the
4 Company”)

5

6 **Q. Have you previously testified or submitted prepared testimony in a**
7 **regulatory proceeding?**

8 A. Yes, I have previously testified and submitted testimony before the New
9 York Public Service Commission (“Commission”) in Cases 28252, 29029,
10 29484, 89-G-030, 90-E-1185, 91-G-0112, 91-G-1328, 93-G-002, 93-E-
11 1123 and 96-E-0132, presenting the Long Island Lighting Company’s
12 historic and projected rate year cost of capital, capitalization, financial
13 statistics, ratemaking principles and quality indicators. More recently, I
14 testified before the Commission in Case 08-G-0609 presenting Niagara
15 Mohawk’s historic and projected rate year cost of capital, capitalization
16 and financial statistics. I have also submitted testimony before the Federal
17 Energy Regulatory Commission in Docket Nos. ER04-112-000 and ER09-
18 628 on issues pertaining to National Grid Generation LLC’s cost of
19 service and cost of capital.

20

21 **Q. What is the purpose of your testimony?**

Testimony of Andrew E. Dinkel III

1 A. In support of Niagara Mohawk's electric base rate filing, the purpose of
2 my testimony is to present the Company's proposed capital structure and
3 overall cost of capital in this proceeding. My testimony provides
4 information for both the historic test or base year ending September 30,
5 2009 and the forecast rate years ending December 31, 2011, December 31,
6 2012 and December 31, 2013. All forecast material has been developed
7 from the historical base. Also, due to the continuing turmoil in the debt
8 auction markets, I am recommending that a variable rate debt true-up
9 mechanism applicable to the Company's variable rate pollution control
10 revenue bonds issued through the New York State Energy Research and
11 Development Authority ("NYSERDA") be implemented for variable rate
12 debt interest expense and associated fees allocated to the Company's
13 electric operations. Under this mechanism, the Company would fully
14 reconcile its actual interest costs, insurance premiums and remarketing
15 fees associated with the NYSERDA auction rate debt to the corresponding
16 costs, premiums and fees that are reflected in the Company's electric
17 revenue requirements in this proceeding. Cost increases or decreases
18 compared to the levels reflected in the revenue requirement would be
19 deferred and included in the Electric Delivery Adjustment Mechanism to
20 be recovered from or passed back to customers as explained in the
21 testimony of the Revenue Requirements Panel.

Testimony of Andrew E. Dinkel III

1 **Q. Do you sponsor any exhibits as part of your testimony in this**
2 **proceeding?**

3 A. Yes. I sponsor the following exhibits, which were prepared or compiled
4 under my supervision and direction: (i) Exhibit __ (AED-1), entitled
5 “Niagara Mohawk Power Corporation – Capitalization And Weighted
6 Average Cost Of Capital;” Exhibit __ (AED-2) which are the workpapers
7 supporting Exhibit __ (AED-1); and (iii) Exhibit __ (AED-3), which
8 consists of the most recent evaluations of Niagara Mohawk by Standard &
9 Poor’s (“S&P”) and Moody’s Investors Service (“Moody’s”).

10

11 **Q. Please describe Exhibit __ (AED-1).**

12 A. Schedule 1 of Exhibit __ (AED-1) sets forth Niagara Mohawk’s historic
13 cost of long-term debt and preferred stock. Schedule 2 contains the
14 projected capitalization and weighted average cost of capital that I am
15 proposing be adopted for Niagara Mohawk in this proceeding. Schedule 3
16 sets forth a forecast Sources and Uses of Funds statement and projected
17 financial statistics for the rate years ending December 31, 2011, 2012 and
18 2013, respectively. Workpapers supporting this Exhibit have been
19 provided as Exhibit __ (AED-2).

Testimony of Andrew E. Dinkel III

1 **Q. What are the weighted average costs of capital that you are proposing**
 2 **be adopted for Niagara Mohawk for each of the three rate years in**
 3 **this proceeding?**

4 A. The Company's proposal in this case is to establish rates for three years,
 5 the calendar years ending 2011, 2012 and 2013. The Weighted Average
 6 Costs of Capital that I am proposing, as shown on Schedule 2, Pages 5, 6
 7 and 7 of Exhibit __ (AED-1) are 8.03% for the 2011 rate year, 8.27% for
 8 the 2012 rate year and 8.50% for the 2013 rate year. These overall rates of
 9 return are based on the following capitalization ratios and cost rates:

10

NIAGARA MOHAWK OVERALL COST OF CAPITAL

	2011			2012			2013		
	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>
	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>
Long-Term Debt	48.0	5.03	2.42	46.9	5.58	2.62	44.8	6.12	2.74
Short-Term Debt	0.8	2.21	0.02	1.9	3.28	0.06	4.2	4.28	0.18
Customer Deposits	0.6	2.45	0.02	0.6	2.45	0.02	0.6	2.45	0.01
Preferred Stock	0.5	3.62	0.02	0.5	3.62	0.02	0.5	3.62	0.02
Common Equity	<u>50.0</u>	11.10	<u>5.55</u>	<u>50.0</u>	11.10	<u>5.55</u>	<u>50.0</u>	11.10	<u>5.55</u>
Total	100.1		8.03	100.0		8.27	100.0		8.50

11

12 In calculating the capitalization ratios shown above, all of the goodwill
 13 recorded on Niagara Mohawk's books was excluded from the Company's
 14 total capitalization and common equity balances.

15

16 **Q. How did you determine Niagara Mohawk's capitalization ratios?**

Testimony of Andrew E. Dinkel III

1 A. Niagara Mohawk's weighted average cost of capital for each of the three
2 rate years reflects a capital structure comprising 50% common equity
3 exclusive of goodwill. This approximates Niagara Mohawk's current
4 capital structure and is the targeted structure that the Company plans on
5 maintaining going forward to minimize its overall cost of capital, maintain
6 the Company's current "A" range credit/bond rating, and provide it with
7 ready access to the financial markets at a reasonable cost.

8

9 **Q. Has the Company modified its capital structure since its acquisition**
10 **by National Grid in 2002?**

11 A. Yes. Since its acquisition by National Grid in 2002, the Company's
12 common equity ratio exclusive of goodwill has increased from
13 approximately 25% at the end of the first quarter immediately following
14 the transaction, to approximately 50% as of September 30, 2009. This
15 significant achievement was accomplished by using virtually all of the
16 Company's cash earnings and other sources of internally generated cash to
17 increase the Company's common equity balance, pay down debt and fund
18 construction expenditures. Since the acquisition, the Company has
19 increased its common equity exclusive of goodwill by \$1.0 billion and
20 reduced its total debt outstanding by \$2.3 billion.

Testimony of Andrew E. Dinkel III

1 **Q. Has the improvement in the Company's capital structure since its**
2 **acquisition by National Grid improved Niagara Mohawk's credit**
3 **ratings?**

4 A. Yes. The steady and continuing reduction in the Company's leverage that
5 has occurred since its acquisition by National Grid has been one of the key
6 factors that has prompted Moody's to upgrade Niagara Mohawk's
7 corporate credit rating twice; from Baa3 prior to the acquisition to Baa1 in
8 October 2004, and from Baa1 to A3 in November 2007. In its February 1,
9 2008 Credit Opinion on the Company, Moody's stated that the significant
10 reduction in debt levels that Niagara Mohawk was able to achieve over the
11 past three years and the corresponding favorable improvements in key
12 credit metrics that resulted were major factors in its decision to upgrade
13 the Company's credit rating from Baa1 to A3 in November 2007.
14 Furthermore, in announcing the upgrade to A3 in November 2007,
15 Moody's also stated that in addition to the improvement in the Company's
16 financial profile that has occurred, the rating action was also premised on
17 Moody's belief that this trend could be sustained and the fact that the
18 Company agreed to adopt a version of the regulatory financial protections
19 that apply to KeySpan's New York-based utility subsidiaries. In a more
20 recent Credit Opinion on the Company issued on July 22, 2009, Moody's
21 again points out that the Company's use of its free cash flow to

Testimony of Andrew E. Dinkel III

1 significantly reduce its debt level over the last several years has
2 contributed to corresponding favorable improvements in key credit
3 metrics. Moody's also states in this Opinion that they view the financial
4 protections put in place at Niagara Mohawk as a "credit positive."

5

6 **Q. Please outline the financial protections you just alluded to.**

7 A. When it was acquired by National Grid in 2002, the Company agreed to a
8 number of financial protections that were adopted by the Commission
9 when it approved the Merger Joint Proposal in Case 01-M-0075. These
10 protections are designed to financially insulate or "ring fence" Niagara
11 Mohawk from National Grid and its other affiliates. Except for its
12 participation as a borrower or lender in the corporate money pool, these
13 protections prohibit the Company from providing any financial assistance
14 to its affiliates through loans, loan guarantees, letters of credit or other
15 commitments, as well as using its assets to collateralize affiliate debt.
16 These protections also prohibit the Company from paying dividends under
17 certain circumstances. More recently, in approving the merger between
18 National Grid and KeySpan, the Commission ordered that the Company
19 adopt additional protections to further insulate it from National Grid and
20 its affiliates. One of these new protections is that there can be no cross
21 default provisions that would require Niagara Mohawk to indemnify any

Testimony of Andrew E. Dinkel III

1 lender, supplier or other counter-party for or as a result of a default of any
2 affiliate. Also, if any cross default provisions currently exist that cannot
3 be eliminated, National Grid is required to obtain indemnification from an
4 investment grade entity that fully protects Niagara Mohawk from the
5 effects of such existing cross default provisions, the cost of which will not
6 be borne by customers. In addition, the Company will modify its
7 certificate of incorporation to establish a golden share to prevent a
8 bankruptcy of National Grid, National Grid USA or any affiliate from
9 automatically triggering a bankruptcy of Niagara Mohawk without the
10 approval of the holder of the golden share, an entity that is charged with
11 acting in accordance with the best interests of New York. These new
12 protections also require that National Grid create separate regulated and
13 unregulated money pools and further require that the regulated money
14 pool expressly prohibit its participants from directly or indirectly loaning
15 or transferring funds borrowed from the money pool to National Grid
16 USA, National Grid and all non-participants in the regulated money pool.
17 Another new restriction prohibits the Company from paying common
18 dividends without Commission approval if its or National Grid's bond
19 rating on their least secure form of debt falls below investment grade as
20 determined by one or more U.S. nationally recognized rating agencies, or
21 either entity's bond rating falls to the lowest investment grade rating and is

Testimony of Andrew E. Dinkel III

1 on negative watch or review for a further downgrade. Finally, no debt
2 associated with the KeySpan merger may be reflected as an obligation of
3 Niagara Mohawk or on its regulatory or US GAAP books and records.

4

5 **Q. Since the acquisition by National Grid has Niagara Mohawk’s credit**
6 **rating from Standard & Poor’s (“S&P”) also improved?**

7 A. Yes. Just prior to the acquisition, Niagara Mohawk’s credit rating from
8 S&P was BBB. Today, it is A-.

9

10 **Q. Is the maintenance of a low “A” credit rating consistent with the**
11 **results of the so-called “Generic Financing Proceeding” that is often**
12 **referred to by the Commission in determining the cost of capital for**
13 **utilities in New York?**

14 A. Yes. The so-called “Generic Financing Proceeding” – Case 91-M-0509 –
15 resulted in a 1994 recommended decision that, although never acted upon
16 by the Commission, has often been referred to by it when determining the
17 cost of capital to be used in setting rates. In that proceeding, the electric
18 and gas group, which included utilities, Commission Staff, the Consumer
19 Protection Board and Multiple Intervenors, agreed that while a “BBB”
20 rating was most often the least costly on a purely quantitative basis, the
21 cost of a slip from “BBB” to “BB” was substantial, while the increased

Testimony of Andrew E. Dinkel III

1 cost of achieving an “A” rating was only slightly greater than that of a
2 “BBB” rating. Thus, the group concluded that the “A” rating goal was the
3 more cost effective, when qualitative factors were added to the equation.
4 The recommended decision in the “General Financing Proceeding”
5 proposed that the Commission continue to offer utilities ratemaking
6 support for an “A” rating.

7

8 **Q. Is there other evidence that supports the use of the Company’s stand-**
9 **alone capital structure for the purposes of setting electric rates in this**
10 **proceeding?**

11 A. Yes. Exhibit __ (AED-3) sets forth the most recent evaluations of Niagara
12 Mohawk by S&P and Moody’s. The fact that these evaluations reflect
13 higher unsecured debt ratings for Niagara Mohawk than National Grid
14 demonstrates that these rating agencies take into account Niagara
15 Mohawk’s credit quality on a stand-alone basis, separate and distinct from
16 National Grid. If the credit rating agencies determine that the Company
17 on a standalone basis is significantly less risky because of ring fencing,
18 stronger credit metrics and/or other factors, they will rate the Company
19 higher than its parent, National Grid.

20

Testimony of Andrew E. Dinkel III

1 **Q. Does Niagara Mohawk have higher unsecured debt ratings than**
2 **National Grid?**

3 A. Yes. The Company's senior unsecured debt ratings assigned to it by
4 Moody's and S&P are both one notch higher those assigned to National
5 Grid. The Company's senior unsecured debt is currently rated A3 by
6 Moody's and A- by S&P whereas National Grid's ratings are Baa1 and
7 BBB+, respectively. Also, the issuer rating assigned to the Company by
8 Moody's is one notch higher than that assigned to National Grid. The
9 current issuer ratings of Niagara Mohawk and National Grid are A3 and
10 Baa1, respectively. As will be discussed below, the Company's standalone
11 credit strength, which has contributed to its higher credit ratings compared
12 to National Grid has provided significant benefits to customers in terms of
13 lower financing costs.

14

15 **Q. Under certain circumstances, the Commission has used the capital**
16 **structure of the parent company in determining the overall cost of**
17 **capital for utilities under its jurisdiction that are owned by holding**
18 **companies. Do you believe it is appropriate for the Commission to use**
19 **National Grid's capital structure to set rates for Niagara Mohawk in**
20 **this proceeding?**

Testimony of Andrew E. Dinkel III

1 A. No, I do not. National Grid's common equity ratio under Generally
2 Accepted Accounting Principles recognized in the United States ("US
3 GAAP") for the fiscal year ending March 31, 2009 was 31.7%. The
4 capital structure of Niagara Mohawk bears no relationship to that of
5 National Grid, nor will it going forward. In addition, National Grid's
6 capital structure has been significantly affected by several recent
7 transactions that have had no impact on the Company's stand alone capital
8 structure. These transactions included the National Grid/KeySpan merger
9 that was consummated in August 2007, the sale of National Grid's
10 wireless communications business that was completed in April 2007 and
11 the sale of the Ravenswood generating station that was completed in the
12 summer of 2008. National Grid's US GAAP capital structure is
13 influenced by a variety of factors, including the nature of National Grid's
14 international businesses and changes in foreign exchange rates that have
15 nothing to do with Niagara Mohawk or its standing in the financial
16 community.

17
18 In addition, the financial community recognizes that there is financial
19 separation between National Grid and Niagara Mohawk. The financial
20 protections that were adopted by the Commission when it approved the
21 National Grid/KeySpan merger prohibit the pushdown or assignment of

Testimony of Andrew E. Dinkel III

1 responsibility of any merger-related debt to the Company. It would be
2 inappropriate for the Commission to reflect any impact of parent company
3 transactions in the Company's revenue requirements through the
4 imputation of the parent company's capital structure when it cannot be
5 demonstrated that these transactions have any bearing on the Company. It
6 is my understanding that in establishing the proper capital structure for
7 ratemaking purposes, the Commission seeks to determine the amount of
8 debt and equity capital that the Company is dedicating to public service in
9 order to be assured that customers are paying only the costs to support
10 regulated operations. The capital structure that I am proposing is one that
11 will ensure that Niagara Mohawk's customers receive the benefits of the
12 Company's improved financial profile and pay rates that reflect the capital
13 actually being used to support Niagara Mohawk's regulated operations.

14

15 **Q. Are there any other reasons that a capital structure other than that**
16 **proposed by the Company should not be used to set electric rates in**
17 **proceeding?**

18 A. Yes. A capital structure with a common equity ratio of less than 50%
19 would contain a level of debt in excess of that required to support Niagara
20 Mohawk's current credit rating based on the benchmarks used by S&P in
21 the credit rating process. According to S&P, Niagara Mohawk has an

Testimony of Andrew E. Dinkel III

1 “excellent” business risk profile and a “significant” financial risk profile.
 2 Based upon the business and financial risk matrix published by S&P that
 3 is shown below, a company with “excellent” business and “significant”
 4 financial risk scores would be assigned an A- rating.

BUSINESS AND FINANCIAL RISK PROFILE MATRIX

<u>Business Risk Profile</u>	<u>Financial Risk Profile</u>					
	<u>Minimal</u>	<u>Modest</u>	<u>Intermediate</u>	<u>Significant</u>	<u>Aggressive</u>	<u>Highly Leveraged</u>
Excellent	AAA	AA	A	A-	BBB	-
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair	-	BBB-	BB+	BB	BB-	B
Weak	-	-	BB	BB-	B+	B-

5 And indeed, Niagara Mohawk has an A- corporate credit rating (“CCR”)
 6 from S&P, which is compatible with an “excellent” business profile and a
 7 “significant” financial profile. Niagara Mohawk’s unsecured debt
 8 issuances are also rated “A-” by S&P.

9

10 **Q. What is the degree of debt leverage that is associated with this rating**
 11 **under S&P’s benchmark?**

12 A. According to the indicative ratios expected by S&P for a company with a
 13 “significant” financial risk score, the total debt, including short- and long-
 14 term debt, should be in the range of 45% to 50%. These indicative values
 15 are shown below.

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FINANCIAL RISK INDICATIVE RATIOS (CORPORATE)

<u>Financial Risk Profile</u>	<u>FFO/Debt (%)</u>	<u>Debt/EBITDA (x)</u>	<u>Debt/Capital (%)</u>
Minimal	greater than 60	less than 1.5	less than 25
Modest	45-60	1.5-2	25-35
Intermediate	30-45	2-3	35-45
Significant	20-30	3-4	45-50
Aggressive	12-20	4-5	50-60

FFO/Debt is the ratio of the Company's funds from operations to its total debt.

Debt/EBITDA is the ratio of total debt to earnings before interest, taxes, depreciation and amortizations.

Debt/Capital is the ratio of total debt to total capital.

1 Based upon the debt ratios shown above, equity ratios (including common
2 equity and preferred stock) for companies with A- credit ratings should be
3 within the range of 50% to 55%. This is one of the key parameters that
4 should be used to gauge the reasonableness of the common equity ratio
5 proposed in this case. The Company's proposed common equity ratio of
6 50% is already at the low end of this range and anything lower would not
7 be consistent with its current credit rating.

8

9 **Q. If the Commission wishes to consider whether to use National Grid's**
10 **capital structure to set rates in this proceeding, how should the equity**
11 **component of its capital structure be determined?**

12 A. As discussed more fully below, the effect of using National Grid's capital
13 structure to set rates in this proceeding will be to jeopardize Niagara
14 Mohawk's ability to maintain its current credit ratings. Moreover, there

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1 are a number of differences between National Grid and Niagara Mohawk
2 that must be recognized before the Commission can even consider using
3 National Grid's capital structure. First, differences in the methodology
4 used to set rates for National Grid's regulated businesses in the United
5 Kingdom ("UK") compared to that used in New York make it
6 inappropriate to use National Grid's capital structure as determined in
7 accordance with US GAAP to establish the Company's revenue
8 requirements in this proceeding. The regulator of National Grid's UK
9 businesses does not utilize the level of capital represented in its US GAAP
10 accounts when setting rates. These accounts, in turn, do not reflect the
11 value of the UK businesses on which the UK regulator allows them to earn
12 a return. In the UK, rates are set based on a Regulatory Asset Value
13 ("RAV"), rather than a rate base based on book value per US GAAP.
14 RAV has no direct relationship to the book value of these businesses and
15 was initially derived from a combination of replacement cost and market
16 value. In addition, under the UK regulatory framework, the RAV is
17 increased by inflation every year. Thus, the equity component as
18 determined in accordance with US GAAP must be adjusted to recognize
19 the difference between the RAV and the US GAAP book value of the UK
20 regulated businesses. This is necessary to ensure that National Grid's
21 consolidated capital structure reflects the regulatory value of assets in both

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1 the US and UK on an equal and consistent basis. This adjustment
2 increases National Grid's consolidated common equity ratio determined in
3 accordance with US GAAP by 6 percentage points from 31.7% to 37.8%.

4

5 **Q. Are there any other factors that affect National Grid's capital**
6 **structure which need to be taken into account if the Commission**
7 **wishes to consider using it to set rates in this proceeding?**

8 A. Yes. Changes in currency exchange rates which are beyond the control of
9 the Company and National Grid can have a significant impact on National
10 Grid's capital structure and thus its capitalization ratios as determined in
11 accordance with US GAAP. The reason for this is that approximately
12 two-thirds of National Grid's outstanding debt has been issued in US
13 dollars and thus its weighting in the overall capital structure of National
14 Grid is heavily dependent on the currency exchange rate between the US
15 dollar and the British pound. Over the course of National Grid's last fiscal
16 year ending March 31, 2009, the exchange rate from US dollars to British
17 pounds decreased by approximately 27% from 1.98 US dollars per British
18 pound at fiscal year end 2008 to 1.44 US dollars per British pound at fiscal
19 year-end 2009. Had the exchange rate remained the same as at fiscal year
20 end 2008, National Grid's common equity ratio after adjusting for RAV
21 would have been 40.9% as compared to 37.8% as noted above. For

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1 comparative purposes, National Grid's US GAAP common equity ratio at
2 fiscal year end 2008 after adjusting for RAV and based on the actual
3 exchange rate at that time of 1.98 US dollars per British pound was 43.7%.
4 Because the Company and National Grid cannot control currency
5 exchange rates it would be inappropriate for the Commission to consider a
6 common equity ratio of less than 40.9% for National Grid.

7

8 **Q. Please outline the financing activity and dividend payment policy that**
9 **you used in developing Niagara Mohawk's projected costs of capital**
10 **for the 2011, 2012 and 2013 rate years**

11 A. Current projections indicate that the Company will need to issue \$350
12 million of additional long-term debt in June 2010, \$400 million in October
13 2012 and \$500 million in June 2013 to fund its capital expenditure
14 program, redeem maturing long-term debt and maintain a capital structure
15 comprised of 50% common equity exclusive of goodwill. The projected
16 costs of capital for each of the three rate years assume that the Company
17 will issue this debt as 10-year senior unsecured debt at forecasted interest
18 rates of 5.0% in 2010, 5.6% in 2012 and 6.3% in 2013. It has been
19 assumed that the costs to issue this debt will be 1% of the principal
20 amounts issued and that these costs will be amortized over the lives of the
21 debt which effectively increases the interest rates on these securities by 10

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1 basis points. Pursuant to the Commission Order in Case 08-M-1352, the
2 Company currently has authorization to issue \$750 million of this debt
3 through March 31, 2012.

4
5 **Q. Have customers benefited from the Company's higher senior
6 unsecured debt ratings compared to those of National Grid?**

7 A. Yes. In the summer of 2009 the Company issued a total of \$1.25 billion
8 of new long-term debt. The Company's higher credit ratings resulting
9 from its stronger credit profile (its higher equity ratio and the financial
10 protections described above), coupled with the fact that the \$1.25 billion
11 of new debt was issued by Niagara Mohawk and thus placed closest to the
12 assets it is funding, resulted in a lower cost to customers than would have
13 been the case if National Grid had issued comparable debt. Based on
14 interest rate spreads at the time of issuance, had National Grid issued the
15 \$750 million of 10-year debt instead of Niagara Mohawk, it is estimated
16 that interest rate on this debt would have been about 50 basis points
17 higher. Similarly, the interest rate on the \$500 million of 5 year debt
18 issued by the Company would have been about 40 basis points higher had
19 it been issued by National Grid. Thus, by having the Company issue the
20 \$1.25 billion of new debt, customers will save an estimated total of \$47.5
21 million in interest expense over the lives of the debt compared to its

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1 issuance by National Grid. This cost differential is a clear benefit of the
2 financial separation between the Company and National Grid. This
3 benefit justifies the use of Company's stand alone capital structure for
4 ratemaking purposes in this proceeding.

5

6 **Q. How were the projected cost rates of long-term debt for Niagara**
7 **Mohawk shown on Exhibit __ (AED-1) derived?**

8 A. The long-term debt component of Niagara Mohawk's capital structure
9 consists of long-term notes payable to Niagara Mohawk's parent company
10 Niagara Mohawk Holdings, Inc., fixed rate taxable bonds and fixed and
11 variable rate tax-exempt bonds issued through NYSERDA that are
12 currently supporting electric and gas transmission and distribution
13 investments. Included in the costs of these bonds are the direct coupon
14 expense, as well as the amortization of debt discounts or premiums, and
15 the amortization of issuance costs where applicable. Furthermore, it was
16 assumed that the variable rate bonds would continue to be supported by
17 direct pay letter of credit facilities in order to obtain the most
18 advantageous interest rates for these bonds. The associated fees for these
19 letters of credit, the amortization of debt discounts or premiums, the
20 amortization of issuance costs, and the remarketing fees are added to the
21 direct interest expense when computing the cost of debt for these issues.

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1 Because of the ongoing turmoil in the auction rate bond markets caused by
2 the financial crisis that continues to cause numerous remarketing auctions
3 to fail, it is difficult at this time to make reliable projections of the interest
4 rates that the Company's variable rate Pollution Control Revenue bonds
5 will pay during the rate years. Therefore, for the time being, I have
6 assumed that the interest rates on these bonds will be set at the rates they
7 would revert to if auctions continue to fail during the rate years. I propose
8 to update these rates if market conditions normalize by the time a decision
9 is about to be reached in this proceeding.

10

11 In the event that markets do not return to normal, I recommend that the
12 interest expense on auction rate debt that is allocated to electric operations
13 be fully reconciled whereby differences between the actual expense and
14 the level reflected in rates are deferred for future disposition by the
15 Commission. This true-up mechanism would be identical to that approved
16 by the Commission in Case 08-G-0609 for interest expense on the same
17 variable rate debt that is allocated to the Company's gas operations.

18

19 Also included in the cost of the Company's long-term debt are the
20 amortizations of call premiums and debt discounts and expenses (DD&E)
21 associated with several debt issues that were retired before maturity

Testimony of Andrew E. Dinkel III

1 because it was economically advantageous to do so. These costs are being
2 amortized over the remaining life of the respective bonds as if they had
3 not been retired early. It is estimated that on a present value basis, the
4 early retirement of these bonds will save in excess of \$75 million net of
5 the recovery of call premiums and unamortized DD&E.

6
7 Dividing the total interest, fee and amortization expense for the notes and
8 bonds by the average principal outstanding yields an effective rate of
9 5.03% for the long-term debt component of Niagara Mohawk's
10 capitalization for the 2011 rate year, 5.58% for the 2012 rate year and
11 6.12% for the 2013 rate year.

12
13 **Q. How were the projected cost rates of preferred stock and short-term**
14 **debt shown on Exhibit __ (AED-1) derived?**

15 A. The Company currently has three perpetual issues of preferred stock that
16 will remain outstanding during the three proposed rate years. The total
17 annual dividend requirement for these three issues was divided by the total
18 average net proceeds outstanding during the rate years, yielding an
19 effective rate of 3.62% for the preferred stock component of Niagara
20 Mohawk's capitalization. Also, during the rate years, it was assumed that
21 the Company would be charged National Grid's commercial paper rate on

Testimony of Andrew E. Dinkel III

1 the forecasted average balance of short-term debt borrowed from National
2 Grid's regulated money pool. Those rates are projected to be 2.21% for
3 the 2011 rate year, 3.28% for the 2012 rate year and 4.28% for the 2013
4 rate year.

5

6 **Q. How were the balances and the cost rate for customer deposits shown**
7 **on Exhibit __ (AED-1) determined?**

8 A. Niagara Mohawk's forecasted balances of customer deposits were
9 assumed to remain equal to the actual monthly balance as of September
10 30, 2009, the end of the test year. The cost rate is the customer deposit
11 interest rate currently mandated by the Commission in a memo on this
12 matter.

13

14 **Q. Do you believe that it would be appropriate for the Company to**
15 **update its projections of both new debt issuances and cost rates later**
16 **in this proceeding?**

17 A. Yes. Given the continuing uncertainty of the financial markets I believe
18 that it is in both the Company's and its customers' best interests for the
19 Company to update its filing to reflect the most recent information
20 available concerning both the Company's financial plans and its cost
21 projections near the time of a Commission decision in this case.

Testimony of Andrew E. Dinkel III

1 **Q. What cost rate are you using for the common equity component of**
2 **Niagara Mohawk's capital structure?**

3 A. I am using a required rate of return of 11.1% as supported by Dr. Morin in
4 his testimony consistent with a 50% common equity ratio in the capital
5 structure.

6

7 **Q. Does this conclude your direct testimony?**

8 A. Yes. It does.

Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL GRID

Supplemental Testimony

of

Andrew E. Dinkel III

Dated: May 3, 2010

Testimony of Andrew E. Dinkel III

1 **Q. Please state your name.**

2 A. My name is Andrew E. Dinkel III.

3

4 **Q. Are you the same Andrew E. Dinkel III who previously submitted**
5 **prepared direct testimony on behalf of Niagara Mohawk Power**
6 **Corporation (“Niagara Mohawk” or “the Company”) in this proceeding?**

7 A. Yes. I am.

8

9 **Q. What is the purpose of your supplemental testimony?**

10 A. As part of the Company’s “corrections and updates” filing, the purpose of my
11 supplemental testimony is to update the Company’s cost of capital, sources
12 and uses of funds statement and financial statistics for the 2011, 2012 and
13 2013 rate years to reflect changes in the Company’s projected external
14 financing needs resulting from corrections and updates being made elsewhere
15 in the filing and latest know events.

16

17 **Q. Do you sponsor any exhibits as part of your supplemental testimony?**

18 A. Yes. I sponsor the following updated exhibits that were prepared under my
19 direction and supervision:

20 (i) Exhibit __ (AED-1CU) entitled “Niagara Mohawk Power Corporation
21 – Updated Capitalization and Weighted Average Cost of Capital,” and

Testimony of Andrew E. Dinkel III

1 (ii) Exhibit __ (AED-2CU), which are the workpapers supporting Exhibit
2 __ (AED-1CU).

3

4 **Q. Please describe the corrections, updates and events that are impacting the**
5 **Company's external financing needs.**

6 A. First, the Company's projected capital expenditure budget over the 2010 to
7 2013 time horizon has been reduced by a total of approximately \$460 million
8 since the time I prepared my direct testimony and exhibits. Second, the
9 Company will be receiving a tax refund of approximately \$275 million in
10 April or May of this year. This tax refund has resulted from the Company
11 adjusting its prior period tax returns to reflect, for tax purposes, the expensing
12 rather than capitalizing of certain prior period capital expenditures made to
13 replace aging infrastructure. Under its interpretation of the IRS code, the
14 Company now considers these expenditures to be a repair of the system rather
15 than new plant investment. Third, updates and corrections to the Company's
16 cost of service sponsored by the Revenue Requirements Panel have reduced
17 Niagara Mohawk's projected cash expenses over the three rate years resulting
18 in higher cash flows from operations.

19

20 **Q. What is the impact of these corrections and updates on the Company's**
21 **cost of capital, external financing needs and its plan to maintain a**

Testimony of Andrew E. Dinkel III

1 **balanced capital structure that consists of 50% common equity and 50%**
2 **debt and preferred stock?**

3 A. As a result of the forecast improvement in its cash flow, the Company expects
4 it will not need to issue the \$350 million and \$500 million of new long-term
5 debt in June 2010 and June 2013, respectively, as indicated in my direct
6 testimony. Instead, Niagara Mohawk anticipates that it will now need to issue
7 \$800 million of new long-term debt in October 2012 instead of the \$400
8 million as originally planned. As a result, the effective cost rates of the
9 Company's outstanding long-term debt are now projected to be 5.02% in
10 2011, 5.65% in 2012 and 6.16% in 2013. To maintain a 50% common equity
11 ratio excluding goodwill, the Company expects that it will pay a common
12 dividend of \$200 million in 2010 and additional common dividends of \$98
13 million in 2011, \$14 million in 2012 and \$90 million in 2013. The
14 Company's updated overall cost of capital reflecting the above changes is as
15 follows:

Testimony of Andrew E. Dinkel III

NIAGARA MOHAWK UPDATED OVERALL COST OF CAPITAL

	2011			2012			2013		
	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>	<u>Capitalization</u>	<u>Cost</u>	<u>Weighted</u>
	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>	<u>Ratio (%)</u>	<u>Rate (%)</u>	<u>Cost (%)</u>
Long-Term Debt	46.7	5.02	2.34	47.1	5.65	2.66	46.3	6.16	2.85
Short-Term Debt	2.0	2.21	0.04	1.7	3.28	0.06	2.5	4.28	0.11
Customer Deposits	0.7	2.45	0.02	0.7	2.45	0.02	0.6	2.45	0.02
Preferred Stock	0.6	3.62	0.02	0.6	3.62	0.02	0.5	3.62	0.02
Common Equity	<u>50.0</u>	11.10	<u>5.55</u>	<u>50.0</u>	<u>11.10</u>	<u>5.55</u>	<u>50.0</u>	11.10	<u>5.55</u>
Total	100.0		7.98	100.0		8.30	100.0		8.54

1

2 **Q. Please describe Exhibit __ (AED-1CU) and Exhibit __ (AED-2CU).**

3 A. Schedule 2 of Exhibit __ (AED-1CU) contains the revised projected
 4 capitalization and weighted average cost of capital that I am now proposing be
 5 adopted for Niagara Mohawk in this proceeding. Schedule 3 sets forth a
 6 revised forecast Sources and Uses of funds statement and revised projected
 7 financial statistics for the rate years ending December 31, 2011, 2012 and
 8 2013, respectively. Workpapers supporting this exhibit are being provided as
 9 Exhibit __ (AED-2CU).

10

11 **Q. Does that conclude your supplemental testimony?**

12 A. Yes it does.

Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL

GRID

Rebuttal Testimony

of

Andrew E. Dinkel III

Director of Cost of Capital

Dated: August 6, 2010

Rebuttal Testimony of Andrew E. Dinkel III

1 **Q. Please state your name and business address.**

2 A. My name is Andrew E. Dinkel III. My business address is One MetroTech
3 Center, Brooklyn, New York, 11201.

4 **Q. Are you the same Andrew E. Dinkel III who previously submitted prepared**
5 **direct testimony in these proceedings?**

6 A. Yes. I am.

7 **Q. What is the purpose of your rebuttal testimony?**

8 A. I will address certain cost of capital proposals and assertions made by the Finance
9 Panel in this proceeding and explain why they are incorrect or should be rejected.
10 Specifically, I will address the Finance Panel's proposal to utilize a hypothetical
11 capital structure consisting of 46% common equity to establish Niagara Mohawk
12 Power Corporation's d/b/a National Grid's ("Niagara Mohawk" or the
13 "Company") revenue requirement in this proceeding and explain why that
14 proposal should be rejected. In connection with this discussion, I will discuss
15 recent changes in National Grid plc's ("National Grid") capital structure as well
16 as recent capital structure decisions by the Commission involving other New
17 York State utilities. In addition, I will explain why the Finance Panel's assertion
18 that Niagara Mohawk's dividend policy is irrational is not correct and does not
19 support the Finance Panel's capital structure recommendation. I will also
20 elaborate further on some of the findings in the Recommended Decision in the
21 Generic Financing Proceeding that the Finance Panel discusses in its direct
22 testimony. I also will address and rebut the Finance Panel's recommendation to

Rebuttal Testimony of Andrew E. Dinkel III

1 set the Company's short-term debt and variable-rate NYSERDA debt interest
2 rates at actual interest rates that exist today rather than forecast levels for the rate
3 year. Finally, I will discuss why I believe Staff's overall revenue requirement
4 proposal, if adopted by the Commission, would place the Company's "A" credit
5 ratings in jeopardy.

6 **Q. Do you sponsor any exhibits as part of your prepared rebuttal testimony?**

7 A. Yes. I sponsor Exhibit___ (AED-1R) which consists of three schedules. Schedule
8 1 shows a calculation of National Grid's current estimated common equity ratio
9 determined in accordance with Generally Accepted Accounting Principles
10 recognized in the United States ("US GAAP") and adjusted to reflect (1) the
11 regulatory asset value ("RAV") methodology used to set rates for National Grid's
12 regulated businesses in the United Kingdom ("UK"), (2) the impact of changes in
13 exchange rates on the determination of an appropriate US GAAP capital structure,
14 and (3) the recent common stock issuance by National Grid that was completed in
15 June 2010. Schedule 2 is a copy of Moody's most recent credit report on the
16 Company that was issued on July 8, 2010. Schedule 3, which is similar to Exhibit
17 ___ (PP/KD-13) sponsored by the Finance Panel, shows the Company's projected
18 stand-alone credit metrics and indicative credit ratings assuming Staff's overall
19 revenue requirement proposal is adopted by the Commission in this proceeding.

20 **Capital Structure**

21 **Q. Please describe the capital structure proposal put forth by the Finance Panel.**

Rebuttal Testimony of Andrew E. Dinkel III

1 A. The Finance Panel recommends that Niagara Mohawk's common equity ratio be
2 set at 46%. The Finance Panel asserts that this hypothetical equity level will be
3 sufficient to permit Niagara Mohawk to maintain its current single "A" credit
4 ratings assigned to it by S&P and Moody's assuming the Company's credit profile
5 is evaluated on a stand-alone basis and Staff's revenue requirement proposals are
6 adopted by the Commission in this proceeding.

7 **Q. What capital structure did you recommend be adopted for Niagara Mohawk**
8 **in your direct testimony?**

9 A. I recommended that a capital structure consisting of 50% common equity
10 exclusive of goodwill be adopted for the Company. This approximates Niagara
11 Mohawk's current capital structure and is the targeted structure that the Company
12 plans to maintain going forward through the implementation of the financing plan
13 described in my direct testimony and an appropriate dividend payment policy.

14 **Q. Why did the Finance Panel propose that your recommended capital**
15 **structure be rejected?**

16 A. The Finance Panel offers a number of claims in support of its recommendation.
17 First, the Finance Panel concludes (at p. 13), on the basis of its review of various
18 credit reports that the ratings agencies "have only partially recognized the benefits
19 of some of the ring fencing measures' that have been implemented by National
20 Grid/Niagara Mohawk. Second, the Finance Panel claims (at p. 17) that I failed
21 to address the possibility that the total bill for customers may be higher if Niagara
22 Mohawk is treated as a stand-alone entity. Third, the Finance Panel claims (at pp.

Rebuttal Testimony of Andrew E. Dinkel III

1 18-19) that the use of a stand-alone capital structure with a higher equity
2 component than the parent provides National Grid with the opportunity to
3 subsidize the parent company's earned return on equity. Fourth, the Finance
4 Panel claims (at pp. 20-21) that Niagara Mohawk's projected dividend payouts
5 are not consistent with what the Finance Panel claims would be the dividend
6 policy of a "rational stand-alone utility." Finally, the Finance Panel concludes (at
7 p. 22) that Niagara Mohawk's equity ratio will be determined by how National
8 Grid classifies its investment and does not necessarily represent how capital
9 markets would finance similar investments.

10 **Q. Do you have any comments concerning the Finance Panel's claim that the**
11 **ratings agencies have only partially recognized the benefits of some of the**
12 **ring fencing measures that have been implemented by National Grid/Niagara**
13 **Mohawk?**

14 A. While it is certainly the case that the credit reports issued by Moody's and
15 Standard & Poor's ("S&P") frequently discuss Niagara Mohawk and National
16 Grid in the same report, the facts from a financing perspective are:

- 17 (i) Niagara Mohawk's unsecured debt rating (A3/A-) is higher than National
18 Grid's unsecured debt rating (Baa1 and BBB+);
- 19 (ii) as the Finance Panel recognizes, Niagara Mohawk's ability to access the
20 capital markets on a stand-alone basis was demonstrated in 2009 when it issued
21 long-term debt at very favorable interest rates. Had National Grid issued such
22 debt, the rates would have been higher; and

Rebuttal Testimony of Andrew E. Dinkel III

1 (iii) the upgrade of Niagara Mohawk's bond ratings from BBB to A- by S&P
2 and from Baa3 to A3 by Moody's coincides with a period in which Niagara
3 Mohawk increased its equity ratio from approximately 25% to approximately
4 50%.

5 Thus, regardless of how Moody's and S&P actually write their credit reports, the
6 facts indicate that those rating agencies recognize a significant separation and
7 distinction between National Grid and Niagara Mohawk and the market does as
8 well.

9 **Q. Do you have any comments concerning the Finance Panel's assertion that**
10 **your capital structure fails to address the possibility that the total bill to**
11 **customers may be higher if Niagara Mohawk is treated as a stand-alone**
12 **entity?**

13 A. As I stated in my direct testimony, the capital structure that I am recommending is
14 the Company's projected actual rate-year capital structure, and is designed to
15 permit the Company to maintain its low "A" bond ratings. The Finance Panel
16 appears to agree that it is appropriate to establish a capital structure that will
17 permit the Company to maintain its low "A" bond ratings, but at the same time
18 appears to be attempting to set the equity component in that capital structure at the
19 lowest possible level that will achieve this result. The Finance Panel's
20 recommendation unreasonably ignores both the fact that the Company is
21 proposing to maintain a larger equity balance in the rate year in order to ensure
22 that its bond ratings are not downgraded, and the fact that in other regulatory

Rebuttal Testimony of Andrew E. Dinkel III

1 proceedings the Commission has approved capital structures for “A”-rated
2 utilities that contain more than 46% common equity. Specifically, in orders
3 issued June 22, 2009 in Case 08-E-0887 involving Central Hudson Gas & Electric
4 Corporation, and March 26, 2010 in Case 09-E-0428 involving Consolidated
5 Edison Company of New York, Inc., the capital structures approved by the
6 Commission contained common equity components larger than 46%. If it were
7 Commission policy that a utility’s capital structure should be set at the lowest
8 possible equity component necessary to maintain “A” bond ratings, it does not
9 seem likely that the Commission would have adopted capital structures containing
10 larger common equity components for other utilities that, like Niagara Mohawk,
11 are subsidiaries of holding companies.

12 **Q. The Finance Panel claims that the Commission has generally supported bond**
13 **ratings of between BBB and A for electric and gas companies and that the**
14 **Recommended Decision in the Generic Financing Case (Case 91-M-0509)**
15 **found that bond ratings in the BBB to A range provided the lowest overall**
16 **cost of capital. Do you have any comments concerning these claims?**

17 A. I believe that the Finance Panel is presenting a misleading characterization of the
18 Generic Financing Proceeding results. While it is true that some New York
19 utilities have bond ratings lower than “A,” the ALJs in the Generic Financing
20 Proceeding agreed with the parties to the proceeding that an “A” bond rating was
21 a cost-effective financial goal and should continue to be pursued. This finding
22 was based on studies that showed that over time a “BBB” rating was most often

Rebuttal Testimony of Andrew E. Dinkel III

1 the least costly or most cost-effective on a purely quantitative basis. However,
2 the parties concluded that the cost consequences of a single grade slip from
3 “BBB” to “BB” were substantial, while the increased cost of achieving an “A”
4 rating was only slightly greater than that of a “BBB” rating. Thus, it was
5 concluded that the “A” rating was more cost-effective when qualitative factors
6 were added to the equation.

7 **Q. Do you have any comments concerning the Finance Panel’s claim that**
8 **assigning to the utility subsidiary a capital structure with a higher equity**
9 **ratio than the parent company provides National Grid with the opportunity**
10 **to subsidize the parent company’s return on equity?**

11 A. Yes. I have several comments. First, the Finance Panel’s U.S. GAAP adjusted
12 common equity ratio for National Grid is out of date. As a result of National
13 Grid’s issuance of £3.2 billion of new common stock in June of this year,
14 National Grid’s *pro forma* U.S. GAAP common equity ratio adjusted for UK
15 RAV would increase to 47.1% at fiscal year end 2009. Adjusting this result to
16 normalize for the change in currency exchange rates that occurred during the 2009
17 fiscal year produces an equity ratio for National Grid of 51.6%. These results are
18 set forth on Schedule 1 of Exhibit __ (AED-1R).

19 **Q. Why did National Grid issue new common stock?**

20 A. The proceeds from the common stock issuance will be used first to pay down
21 short-term debt and the remainder will be held as cash to pay down maturing debt,
22 meet the cash needs of the business and refund debt early, if appropriate.

Rebuttal Testimony of Andrew E. Dinkel III

1 **Q. Why is it appropriate to adjust National Grid's U.S. GAAP common equity**
2 **ratio for RAV?**

3 On pages 17 and 18 of my direct testimony, I explained the basis of the UK RAV
4 adjustment. As set forth on Exhibit __ (AED-1R), I have continued to reflect the
5 RAV adjustment in the same manner following National Grid's issuance of £3.2
6 billion of additional common equity. The RAV adjustment was reflected in the
7 National Grid capital structure that I presented in the recent Niagara Mohawk gas
8 rate case in Case 08-G-0609.

9 **Q. Why is it necessary to adjust National Grid's capital structure for changes in**
10 **currency exchange rates that occurred over the course of 2009?**

11 A. I explained the need for this adjustment on pages 18 and 19 of my direct
12 testimony. As set forth on Schedule 1 of Exhibit __ (AED-1R), I have continued
13 to reflect the currency exchange adjustment in the same manner following
14 National Grid's issuance of £3.2 billion of additional common equity.

15 **Q. What is the impact of National Grid's issuance of additional common equity**
16 **on the Finance Panel's claim that using Niagara Mohawk's stand-alone**
17 **capital structure will somehow subsidize National Grid's return on equity?**

18 A. As National Grid's adjusted common equity ratio is properly considered to be
19 51.6%, it cannot be demonstrated that using Niagara Mohawk's stand-alone
20 capital structure would create the subsidy that the Finance Panel identifies.

21 **Q. Even if it is assumed that the common equity percentage reflected in Niagara**
22 **Mohawk's capital structure could be found to exceed the percentage of**

Rebuttal Testimony of Andrew E. Dinkel III

1 **equity in National Grid’s capital structure, would such a difference support**
2 **the Finance Panel’s claim that National Grid’s return on equity is being**
3 **subsidized?**

4 A. No. As long as the equity on Niagara Mohawk’s books is devoted to and
5 legitimately supports its public utility operations, no subsidy is being created.
6 The Commission does not regulate National Grid’s return. More significantly,
7 while the Finance Panel asserts that such subsidization would arise from the
8 increase in utility revenue requirements above what would be required for an
9 independent stand-alone utility, the fact of the matter is that if Niagara Mohawk
10 were a stand-alone utility with a capital structure containing a 50% equity
11 component, such a capital structure would fall squarely within the metric
12 identified by the Finance Panel for a low “A” rated utility. Contrary to the
13 Finance Panel’s assertion, Niagara Mohawk is not seeking to utilize a capital
14 structure for ratemaking purposes that is any different than what it would be if the
15 Company were a stand-alone utility.

16 **Q. Please comment on the Finance Panel’s assertion that the Company’s**
17 **common dividend policy covering the 2011 through 2012 rate years is**
18 **irrational?**

19 A. The Finance Panel’s assertion regarding the Company’s dividend policy is not
20 applicable to companies that are subsidiaries of holding companies such as
21 Niagara Mohawk. Subsidiaries of holding companies pay dividends to their
22 parent and not to external shareholders. Therefore, they do not need to maintain

Rebuttal Testimony of Andrew E. Dinkel III

1 the constant or uniformly growing dividend payout levels made at regular
2 intervals that are expected by external shareholders. Subsidiaries within holding
3 companies have more latitude to tailor their dividend payouts based on
4 maintaining a targeted capital structure and the cash needs of the business that can
5 change significantly over time. However, the fact that subsidiaries of holding
6 companies pay dividends differently from stand-alone entities provides no basis to
7 reject the use of the stand-alone capital structure for ratemaking purposes. The
8 Finance Panel's conclusion to the contrary is a *non-sequitur*. Niagara Mohawk's
9 dividend policy is quite rational in that its goal is to limit the Company's common
10 equity to 50% in order to maintain a cost efficient capital structure while still
11 preserving its "A" credit ratings.

12 **Interest Rates**

13 **Q. Why has the Finance Panel proposed using actual interest rates prior to the**
14 **rate year rather than a rate year forecast of interest rates to establish the**
15 **interest rates on the Company's projected rate year balances of short-term**
16 **debt and variable rate NYSERDA tax-exempt bonds?**

17 **A.** The Finance Panel basically states 3 reasons. First, it claims that the Company has
18 not provided evidence supporting the use of the forward curves that it used to
19 forecast the rates. Second, it asserts that the Commission has generally
20 recognized that current rates are the most accurate predictor of rate-year interest
21 rate levels. Third, it states that the rates forecast by the Company are significantly
22 higher than current rates and, therefore, may not be representative of future rates.

1 **Q. Please explain the methodology utilizing forward curves that the Company**
2 **used to forecast interest rates during the 2011 to 2013 rate years and why it is**
3 **appropriate for this purpose.**

4 **A.** A forward curve is an interest rate curve that is determined from the yield curve
5 prevailing on a particular date that shows what interest rates or yields are
6 projected to be at any point in the future. Both Bloomberg and Reuters publish
7 forward curves for LIBOR and treasury bonds that the Company uses as the basis
8 for forecasting short- and long-term borrowing rates. Forward curves are widely
9 accepted and used in the financial markets and the investment banking industry to
10 determine the interest rate at which interest rate hedges can be entered for future
11 periods. For example, if National Grid USA knows it will need to issue 90-day
12 commercial paper a year from now it can enter a hedge transaction today that will
13 lock in the interest rate upon which the commercial paper rate for that future
14 issuance will be based. The interest rate that can be locked in today for the 90-
15 day period one year from now is the rate indicated for that time period on the
16 forward curve published by Bloomberg or Reuters. To generate a forecast of
17 money pool interest rates, the Company used the current forward curve for the
18 London Inter Bank Offering Rate (“LIBOR”) at the time the rate filing was being
19 prepared to determine its projected level during each of the rate years and added
20 to it the then-current credit spread between LIBOR and the interest rate on
21 commercial paper, which is rated A2 by S&P and P2 by Moody’s -- the interest
22 rate paid by the Company -- which at that time was 40 basis points. The forecast

Rebuttal Testimony of Andrew E. Dinkel III

1 interest rates on the Company's variable rate NYSERDA debt were derived by
2 multiplying the projected LIBOR for each of the rate years by 2.5. This is the
3 formula that is used to establish the interest rates on the variable rate NYSERDA
4 debt when auctions fail, which has continually been the case since 2008.

5 **Q. Why was the credit spread between LIBOR and A2/P2-rated commercial**
6 **paper used to establish the Company's forecast of money pool interest rates?**

7 **A.** As explained by the Company in its response to Information Request PP/KD-29,
8 National Grid USA intends to revise the method it uses to determine the interest
9 rate it charges participants in the money pool so that such rate is more
10 representative of National Grid USA's actual borrowing costs. It expects to have
11 this revision in effect in early 2011. Under the current National Grid USA money
12 pool agreement, participants in the pool such as Niagara Mohawk are currently
13 charged the interest rate on high grade (A1/P1-rated), unsecured 30-day
14 commercial paper (CP) of major corporations as quoted in the *Wall Street*
15 *Journal*. This interest rate, however, is below the actual cost of the funds that
16 National Grid USA uses to fund the money pool. A primary source of those funds
17 is CP issued by National Grid USA which is rated A2 by S&P and P2 by
18 Moody's. Other sources of funds can include bank loans, medium-term notes and
19 other long-term debt that generally would be more expensive than CP. In
20 addition, it would not be less expensive for the Company to issue CP on its own
21 because its CP credit ratings are the same as those of National Grid USA. The
22 Finance Panel is mistaken when it states that the Company's CP ratings are

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1 A1/P1. Furthermore, utilizing a money pool is more cost efficient than
2 maintaining individual subsidiary CP programs because it allows for the sharing
3 of program costs among participants. Therefore, the Company's proposal to set
4 the interest rate on its money pool borrowings at National Grid USA's forecast
5 CP rates for the 2011 – 2013 rate years is conservative and more appropriate than
6 the Finance Panel's recommendation to use the current interest rate of 0.41%.

7 **Q. Please comment on the Finance Panel's assertion that the Commission's**
8 **preference is to set rate year interest rate levels at actual levels in effect prior**
9 **to the start of the rate year rather than use a forecast?**

10 **A.** While I recognize that the Commission has used actual interest rates in effect at
11 the time it issues its decisions to establish such rates in the past, it is nonetheless
12 the case that the tools that I have used to establish the forward looking rates in this
13 case are widely used in financial markets and consistent with the Commission's
14 policy of using a fully forecast test year to establish rates. There is a reasonable
15 and verifiable link between current interest rates and those forecast for the rate
16 year.

17 **Q. How can the Commission ensure that it sets interest rates at levels that will**
18 **most likely approximate those that will occur during the rate years?**

19 **A.** The Commission's best option is to use the forward curve methodology discussed
20 above updated at the time of its decision in this case. The forward curves
21 published at that time will reflect the financial market's most current view of
22 future capital costs. In the event the Commission decides to set the money pool

Rebuttal Testimony of Andrew E. Dinkel III

1 and NYSERDA debt interest rates at actual levels, it should use the levels in
2 effect at time of the Commission's decision in this case.

3 **Q. Now turning to Staff's overall revenue requirement proposal , what impact do**
4 **you believe it will have on the Company's credit ratings if adopted by the**
5 **Commission in this proceeding?**

6 **A,** I believe that if Staff's overall revenue requirement proposal is adopted, there is a
7 strong possibility that Moody's and/or S&P will downgrade the Company's credit
8 ratings from A3/A- to Baa1/BBB+ or, at a minimum, place the Company on
9 credit watch for a possible downgrade.

10 **Q. Why is there a strong possibility that the credit rating agencies will react in**
11 **this manner?**

12 **A.** First, from a qualitative perspective, one of the key factors that the rating agencies
13 take into consideration when evaluating a regulated utility's creditworthiness is its
14 ability to recover its costs and earn a fair return. While S&P does not explicitly
15 state how much weight it assigns to this factor, Moody's clearly indicates that
16 under its rating methodology (as shown in Finance Panel Exhibit___ (PP/KD-12)
17 25% of the overall credit rating it assigns to a regulated gas and/or electric utility
18 company is based on how it rates this factor alone. In its most recent credit report
19 on the Company, which was issued on July 8, 2010 and is provided in Schedule 2
20 of Exhibit ___ (AED-1R), Moody's assigned a "Baa" rating to this factor because
21 of the uncertainty about the outcome of this proceeding. In its report, Moody's
22 states that the "Baa" rating is "below the single A assigned to other National Grid

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1 USA subsidiaries, which benefit from recent rate case outcomes, reflecting the
2 pending rate case for electricity.” Unlike the outcomes of these recent rate cases,
3 Staff’s proposal in this case would be extremely detrimental to the Company in
4 that it completely disallows the Company’s requested revenue requirement
5 increase of \$369 million and proposes a return on equity at 9.0%, which is
6 significantly lower than any return on equity recently granted by the Commission
7 and would be among the lowest authorized rates of return for a major electric
8 utility in the United States. It is also important to note that Moody’s was
9 concerned about the potential outcome of this case even before Staff’s direct
10 testimony was filed as its credit report on the Company was published on July 8,
11 2010. As shown on page 2 of Schedule 2, Exhibit __ (AED-1R), a rating of
12 “Baa” rather than “A” for this factor lowers the Company’s implied overall credit
13 rating from A3 to Baa1 under Moody’s rating methodology, placing it one notch
14 below the A3 rating currently assigned to the Company. S&P most likely has
15 similar concerns about the Company’s prospects of recovering its costs and
16 earning a fair return.

17 Second, from a quantitative perspective, I estimate that the Company’s credit
18 metrics will deteriorate significantly in 2012 if Staff’s proposal is adopted and the
19 Commission does not address upfront the adverse impacts that this proposal will
20 have on the Company’s cash flow following the conclusion of the 2011 rate year.
21 As indicated on page 1 of Schedule 3 of Exhibit __ (AED-1R), the projected levels
22 of the Company’s credit ratios for 2012 will not support a single “A” rating based

Rebuttal Testimony of Andrew E. Dinkel III

1 on Moody's and S&P's benchmarks. Under its revenue requirement proposal,
2 Staff has the Company fully recovering its stranded costs by the end of the rate
3 year at the expense of not recovering its projected increases in cash operating
4 costs and earning an adequate return on common equity. If Staff's proposal is
5 adopted, Niagara Mohawk's electric revenues will automatically decrease by
6 approximately \$577 million in 2012, which is the revenue amount that Staff has
7 dedicated to fully recovering the Company's stranded costs during the 2011 rate
8 year. As a result, the Company's projected cash flow credit metrics will fall
9 below the levels required to maintain an "A" credit rating which would contradict
10 the Finance Panel's recommendation that "rates be established to provide Niagara
11 Mohawk with an opportunity to achieve overall credit metrics that, when
12 combined with its business and regulatory risks, will allow the Company to
13 maintain its A-/A3 bond ratings."

14 **Q. Please discuss the projections shown on Schedule 3 of Exhibit __ (AED-1R)**
15 **and how they were developed.**

16 **A.** To develop the credit ratio projections shown on Schedule 3 I first took the
17 financial data presented by the Finance Panel on Exhibit__(PP/KD-13) as
18 corrected in their response to Company Information Request NMPC-1 for the
19 2011 rate year and adjusted it to add back the negative cash flow impacts of the
20 operating costs that are still expected to be incurred by the Company but are
21 proposed to be disallowed by Staff. The costs proposed to be disallowed by Staff
22 but that the Company still expects to incur total approximately \$181.1 million and

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1 consist of the following: \$157.9 million of operation and maintenance expenses,
2 \$9.5 million of operating taxes other than revenue taxes and \$13.7 million of
3 interest expense. The \$157.9 million of operating expenses excludes the storm
4 fund of \$30 million under the conservative assumption that no major storms will
5 occur and \$12.5 million of other costs that the Company assumes will not be
6 necessary. Because these costs are projected to be incurred by the Company, the
7 Finance Panel has overstated the amount of cash that will be generated by
8 operations during the rate year by the after-tax amount of \$181.1 million or
9 \$108.7 million. Next, I developed a projection of the Company's 2012 credit
10 metrics under Staff's rate proposal which assumes that all of Niagara Mohawk's
11 stranded costs will be recovered in 2011. As a result, beginning in 2012 the
12 Company will cease collecting approximately \$557 million of revenue. This
13 revenue loss, coupled with the impact of the operating expenses that are not
14 reflected in the Finance Panel's projections, reduces the Company's internally
15 generated cash flow in 2012 by the after-tax amount of \$442.9 million. My
16 projections for 2012 reflect this impact. In addition, for the purposes of
17 developing the projections, I assumed that during 2012 transmission and
18 distribution revenues, capital expenditures and the operating costs disallowed by
19 Staff remained at the same levels as those projected by Staff for 2011.

20 As shown on Schedule 3, my projections indicate that Staff's revenue requirement
21 proposal would result in credit metrics that are indicative of bond ratings in the
22 "BBB/Baa" range.

Rebuttal Testimony of Andrew E. Dinkel III

1 **Q. Have there been recent instances in which the markets have concluded that**
2 **Commission decisions were not supportive of a utility's current credit**
3 **ratings?**

4 **A.** Yes. The credit ratings of Consolidated Edison, Inc. ("ConEd") and its
5 subsidiaries were downgraded on two occasions as a result of Commission rate
6 orders and anticipated Commission actions that were judged to make it difficult
7 for ConEd and its subsidiaries to achieve credit metrics supportive of their current
8 credit ratings at the time. The first downgrade occurred on March 25, 2008 when
9 S&P downgraded ConEd and subsidiaries' credit ratings from "A" to "A-." In its
10 announcing the downgrade, S&P stated that "the rating action reflects our
11 expectations that the firm's financial measures will be commensurate with 'A-'
12 after the recent New York Public Service Commission's \$425 million rate order
13 for subsidiary Consolidated Co. of New York Inc. ("CECONY") becomes
14 effective at month's end."

15 The second ratings action occurred on June 29, 2009, when Moody's downgraded
16 the ratings of ConEd and its regulated subsidiaries by two notches. ConEd and
17 Orange and Rockland Utilities were downgraded from "A2" to "Baa1" and
18 CECONY was downgraded from "A1" to "A3." Prior to the downgrades,
19 Moody's placed the companies' credit ratings on negative outlook in March 2008
20 stating that "the change to negative rating outlooks for the companies also takes
21 into account a more guarded view than we have had in the past about the extent to
22 which the New York regulatory environment will be supportive in future rate case

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1 decisions for CECONY and O&R In particular, Moody's notes the 9.1%
2 allowed return on equity used by the NYPSC in late 2007 for O&R's show cause
3 filing for its electric operations and the aforementioned fully litigated decision in
4 CECONY's electric rate case which only granted about 35% (\$435 million) of the
5 \$1.2 billion increase requested, also based on a very low 9.1% allowed ROE. We
6 view this outcome as an additional sign of the increasing propensity for the
7 NYPSC to base rate decisions on a much lower authorized ROE."

8 **Q. Does this conclude your rebuttal testimony?**

9 A. Yes.

1 ALJ BOUTEILLER: Very good. Does that make
2 the witness available for cross?

3 MR. MALONEY: Yes, Your Honor.

4 ALJ BOUTEILLER: And is staff the first
5 cross-examiner?

6 MS. DEAN: Yes, we are, Your Honor.

7 ALJ BOUTEILLER: Please proceed.

8 CROSS-EXAMINATION

9 BY MS. DEAN:

10 Q Good afternoon, Mr. Dinkel.

11 A Good afternoon.

12 Q If you -- we'd like to begin on page 11, line 1 of
13 your rebuttal testimony.

14 A Okay.

15 Q Do you recommend there that the Commission use the
16 forward interest rate curve to estimate Niagara Mohawk's
17 rate year cost of short-term debt?

18 A Yes.

19 Q Do you also recommend that the Commission use the
20 forward interest rate curve to estimate Niagara Mohawk's
21 rate year cost of the auction rate NYSERDA tax exempted?

22 A Yes, I do.

23 Q Are forward interest rates a function of the level of
24 interest rates and the slope of the yield curve?

25 A Yes, they are.

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1 Q Is it correct that as the level of interest rates and
2 the slope of the yield curve change, the forward interest
3 rates will also change?

4 A Yes.

5 Q Have you analyzed or reviewed any reports or data
6 that analyzes the accuracy of forward interest rates in
7 predicting future interest rates?

8 A No, I have not.

9 Q Is it correct that the estimation of forward interest
10 rates is based upon the assumption of what is commonly
11 understood in the industry as, I quote this, "an
12 informationally efficient and competitive market that is
13 free of restrictions on the inflow and outflow of funds"?

14 A Can you repeat that, please?

15 Q The estimation of forward interest rates is based
16 upon the assumption of "an informationally efficient and
17 competitive market that is free of restrictions on the
18 inflow and outflow of funds"?

19 A I'm not aware of that quotation.

20 Q Would you agree with the concept?

21 A Yes, I would. Yes.

22 Q Okay. Is it correct that the assumptions regarding
23 the debt markets being informationally efficient and
24 competitive is generally referred to as the unbiased
25 expectation hypothesis?

1 A I'm not aware of that terminology.

2 Q Do forward interest rates represent the market
3 consensus expectations of future interest rates?

4 A I would have to say yes.

5 Q Now, is it correct that when a company such as
6 Niagara Mohawk issues debt, it compares its expectations
7 of future interest rates to the market consensus?

8 A I'm not sure I understand the question.

9 Q If you replaced the forward interest rate curve with
10 market consensus, would it then make more sense? A
11 company issuing debt would compare its expectations of
12 future interest rates to the forward interest rate?

13 A Yeah, I believe I would make that comparison.

14 Q When the company's interest rate expectations are
15 above the market consensus, is it true that the company
16 will likely lock in its future debt cost at the forward
17 rate?

18 A Yes.

19 Q Likewise, if a company's expectation is that future
20 interest rates will be below the market consensus, it will
21 not lock in its future debt cost at the forward rates?

22 A Yes.

23 Q Does Niagara Mohawk examine forward interest rates
24 when it is planning to issue debt?

25 A Yes, it does.

1 Q In August of 2009 did Niagara Mohawk issue \$750
2 million of ten-year debt?

3 A Yes, it did.

4 Q Also in September of 2009 did Niagara Mohawk issue
5 \$500 million of five-year debt?

6 A Yes.

7 Q Did Niagara Mohawk price both of these debt issuances
8 just prior to when they were issued, or did it lock in or
9 hedge the interest rates prior to the issuances using
10 forward interest rates?

11 A I believe they waited just until -- they priced it
12 just prior to the issuances in those cases.

13 Q Would it be accurate to state, then, that the company
14 based its decision on its belief that the actual interest
15 rate when the debt was to be issued would be lower than
16 the forward interest rate consensus?

17 A I believe the company decided to do that because they
18 thought they were going to get a favorable rate compared
19 to the consensus.

20 Q Mr. Dinkel, could you please turn to page 18, lines 4
21 to 25, of your rebuttal testimony?

22 A Okay.

23 Q Is it your position that Con Edison was downgraded by
24 Moody's and S&P only because the Commission allowed a
25 return on equity of 9.1?

1 A And it was also because they only got 425 million out
2 of a \$1.2 billion rate increase request, which was 35
3 percent of the request, so that coupled with the ROE of 9
4 percent was the driving factor for that downgrade.

5 Q So is it true, then, they were downgraded due to
6 their overall financial metrics?

7 A Yes. That resulted from the Commission's Order in
8 that case.

9 Q Do you agree that Niagara Mohawk's allowed return on
10 equity should be set based upon the Commission's estimate
11 of Niagara Mohawk's equity cost rate?

12 A Yes, provided the appropriate models and methodology
13 are used to determine that number and that judgment is
14 used in setting -- to take into account what's happening
15 in the marketplace today with respect to volatilities.

16 Q Will you please turn to page 16, line 14, through
17 page 17, line 22, of your rebuttal testimony?

18 A What page is that again?

19 Q It would be page 16, line 14.

20 A Okay.

21 Q It goes through page 17, line 22.

22 A Right.

23 Q Is it correct that this testimony estimates Niagara
24 Mohawk's financial metrics under various adjustments to
25 staff's assumptions in this proceeding?

1 A Yes, it assumes that -- what this assumes is that
2 staff's proposal is adopted, yet the company cannot cut
3 the O&M expenses that staff believes it can cut and it
4 still must incur those expenses.

5 Q So is one of the adjustments to reflect \$157.9
6 million of operation and maintenance expenses that Niagara
7 Mohawk has included in its rate request that staff has
8 disallowed?

9 A Yes, that's one of the adjustments.

10 Q Are you familiar with the rebuttal testimony
11 submitted by Thomas King in this proceeding?

12 A Yes.

13 Q In that testimony -- excuse me one second. In that
14 testimony does Mr. King explain that company budget cuts
15 would be required if staff's position on operation and
16 maintenance expenses were adopted by the Commission?

17 A Yes.

18 Q Does your calculation of Niagara Mohawk's credit
19 metrics reflect the operation and maintenance reductions
20 that are expressed by Mr. King?

21 A My calculations reflect the fact that the company
22 agreed it can reduce its O&M by 12 million per year, so I
23 did not take in its entirety staff's adjustment of 200
24 million. I reduced it by 12.5 million. And I also
25 removed the storm fund from the adjustment, assuming that

1 we would incur no major storm costs, which is a very
2 conservative assumption. So I again, if you account for
3 those two adjustments, I have reflected room for that, for
4 Mr. King's testimony.

5 Q Did you also include an additional \$13.7 million of
6 interest expenses above the level in staff's
7 presentation --

8 A Yes, I did.

9 Q Okay. Is approximately \$12.1 million of the \$13.7
10 million total difference the result of the difference in
11 the assumed interest rate of Niagara Mohawk's auction rate
12 tax-exempt debt?

13 A Yes.

14 Q Am I correct that staff is recommending a full
15 true-up for the actual versus rate year level of interest
16 expense for Niagara Mohawk's auction rate tax-exempt debt?

17 A That's correct, but if you don't provide for it in
18 rates, I still have to -- I won't have the cash flow to
19 cover it, even though it's deferred through a true-up
20 mechanism.

21 Q In your adjustments to the post 2011 financial
22 parameters have you reflected the impact of the
23 collection, your assumed difference of auction rate
24 tax-exempt debt, through the true-up mechanism?

25 A No.

1 Q Is it correct that in rate proceedings the New York
2 Public Service Commission establishes rates based upon its
3 estimate of a company's costs during the rate year?

4 A Yes.

5 Q And in any rate proceeding a company's actual costs
6 can be above or below the level established by the
7 Commission when it sets rates?

8 A That's true.

9 MS. DEAN: That's all I have, Your Honor.

10 ALJ BOUTEILLER: Mr. Mager, anything?

11 MR. MAGER: No.

12 ALJ BOUTEILLER: Consumer Protection Board?

13 MR. WALTERS: No, Your Honor.

14 ALJ BOUTEILLER: Any other parties?

15 Do you want to approach the witness and
16 consider redirect.

17 MR. MALONEY: About ten seconds.

18 ALJ BOUTEILLER: Not such a rush.

19 MR. MALONEY: I beat my ten seconds. We
20 have no redirect.

21 ALJ BOUTEILLER: Okay, thank you. One
22 second, please.

23 (Discussion off the record.)

24 ALJ BOUTEILLER: We want to thank the
25 witness for your participation in the hearing, and

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1 you are excused.

2 MR. MALONEY: Thank you, Your Honor.

3 ALJ BOUTEILLER: We'll give you a couple
4 minutes before we call the company's next witness.

5 MR. MALONEY: So I can remove myself from
6 this table as well, Your Honor.

7 ALJ BOUTEILLER: You want to relinquish your
8 seat to Mr. Pond?

9 MR. MALONEY: I do.

10 (Discussion off the record.)

11 ALJ BOUTEILLER: Let's turn to company
12 counsel and ask you to call your next witness,
13 please.

14 MR. POND: Yes, Your Honor. The company
15 calls Mr. John E. Walter.

16 ALJ BOUTEILLER: Thank you, Mr. Walter.

17 J O H N E. W A L T E R,
18 having been first duly sworn by the notary public,
19 was examined and testified as follows:

20 ALJ BOUTEILLER: Please be seated. Please
21 for the record state your name and your business
22 address.

23 THE WITNESS: My name is John E. Walter,
24 Manager, Outdoor Lighting for National Grid.
25 Business address is 144 Kensington Avenue, Buffalo,

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1 New York 14214.

2 ALJ BOUTEILLER: Now we'll turn to your
3 counsel who will assist us in getting your testimony
4 and your exhibits into the record.

5 DIRECT EXAMINATION

6 BY MR. POND:

7 Q Mr. Walter, do you have before you a document
8 entitled "The Direct Testimony of John E. Walter"
9 consisting of a cover sheet and 136 pages? I'm sorry. 36
10 pages.

11 A 36 pages, yes, I do.

12 Q And do you have some corrections to that testimony?

13 A Yes, I do.

14 Q Could you give those corrections, please?

15 A Sure. On page 12 of 36 of the direct testimony, line
16 14, the last word, "three," should be stricken and
17 replaced with the word "two." And on page 25 of 36, line
18 12, the word "its," the second word should be removed in
19 its entirety. That's it.

20 Q And are you familiar with the contents of that
21 testimony?

22 A Yes, I am.

23 Q And if I asked you the questions contained therein
24 today, would your answers be the same as given?

25 A They would.

1 Q Do you adopt that testimony as your sworn testimony
2 in this proceeding?

3 A I do.

4 Q And did you also prepare seven exhibits which have
5 been marked for identification as Exhibits 21 through 27?

6 A I did.

7 MR. POND: Your Honor, at this time I move
8 that the direct testimony of John Walter be entered
9 into the record as if given orally, and I tender the
10 witness for cross-examination.

11 ALJ BOUTEILLER: Yes, Mr. Pond, we will
12 instruct the reporter to copy into the record as if
13 given orally today the direct testimony consisting of
14 36 pages of the witness, John E. Walter.

15 (The referenced testimony is included in the
16 record as ordered.)

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Before the Public Service Commission

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL GRID

Direct Testimony

of

John E. Walter

Manager, Outdoor Lighting

Dated: January 29, 2010

1 **Q. Please state your name, title and business address.**

2 A. My name is John E. Walter. I am the Manager Outdoor Lighting for
3 National Grid Service Company d/b/a National Grid (“National Grid”).
4 My business address is 144 Kensington Avenue, Buffalo, NY 14214.

5

6 **Q. By whom are you employed and in what capacity?**

7 A. I am the Manager Outdoor Lighting for National Grid USA, including
8 Niagara Mohawk Power Corporation (“Niagara Mohawk” or “the
9 Company”). Throughout this testimony, I will refer to National Grid USA
10 as “National Grid” and Niagara Mohawk as “the Company”.

11

12 **Q. Please describe your educational background and business
13 experience.**

14 A. I am a graduate of Clarkson College of Technology (presently Clarkson
15 University), located in Potsdam, New York, with Bachelor and Masters of
16 Science degrees in Civil and Environmental Engineering in 1979 and
17 1981, respectively. I received a Masters in Business Administration
18 degree from the State University of New York at Buffalo in 1996. I am a
19 registered professional engineer in the State of New York. I provided
20 civil, structural and geotechnical engineering and project management
21 services to D’Appolonia Consulting Engineers, Pittsburgh, PA (1981-

1 1983) and the Company (1983-1990). I transferred to a position of
2 Manager Construction, Inspection and Street Lighting in the Operations
3 organization of the Company's Western Division, (Buffalo, NY), having
4 managerial responsibilities of all field construction and maintenance
5 associated within these work groups from 1990 – 1999. In 1999, I took
6 the position of Director Outdoor Lighting for the Company, having
7 responsibilities for all outdoor lighting business related functions.
8 Following the merger of the Company and National Grid in 2002, I
9 retained the position and associated responsibilities of Director Outdoor
10 Lighting – NY. In 2008, I became Manager Outdoor Lighting, having
11 responsibility for all policies, processes, information systems, and
12 regulatory issues associated with the outdoor lighting business in National
13 Grid's New England and upstate New York service territories.

14

15 **Q. Have you previously testified before the New York State Public**
16 **Service Commission (“the Commission”) or any other regulatory**
17 **commissions?**

18 A. Yes. I have provided testimony in three cases before the Commission
19 relating to the Company's outdoor lighting business.

20

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

1 A. My testimony will describe the changes that the Company is proposing to
2 make to its Tariff P.S.C. No. 214 – Street Lighting (“the Lighting Tariff”).

3

4 **Q. Please summarize those changes.**

5 A. I will begin by explaining why the Company is proposing a general
6 revision to the format of the Lighting Tariff and why the Company is
7 proposing changes to the burning wattages of fixtures with various
8 different types of lamps. Then I will review the Company’s proposed
9 changes to each of the rate schedules contained in the Lighting Tariff.

10

11 **Q. Are these changes intended to increase the Company’s revenues from
12 outdoor lighting services?**

13 A. No. For the first year of the three-year rate plan proposed in this case, the
14 Company has designed its rates to recover its cost of providing outdoor
15 lighting service as determined in the Company’s cost of service study. All
16 of the changes to the Lighting Tariff proposed in my testimony for that
17 year will be implemented on a revenue-neutral basis. For years two and
18 three of this rate plan period, the Company’s proposed Revenue
19 Decoupling Mechanism will ensure that any increase or decrease in
20 revenues due to any of the changes to the Lighting Tariff proposed herein
21 will be returned to street lighting customers as a group. The Company’s

1 Revenue Decoupling Mechanism is explained in detail in the Testimony of
 2 Dr. Susan F. Tierney. Thus, to the extent that some lighting customers
 3 experience bill increases as a result of these changes, other customers will
 4 receive corresponding bill decreases.

5

6 **Q. Are you sponsoring any exhibits in support of your testimony?**

7 A. Yes. I am sponsoring the following exhibits:

8 Exhibit __ (JEW-1) Proposed Lamp Billable Wattage Rate Design

9

10 Exhibit __ (JEW-2) Proposed Street Lighting Circuit Charge Rate
 11 Design

12

13 Exhibit __ (JEW-3) Proposed Concrete Type Street Light Foundation
 14 Charge Rate Design

15

16 Exhibit __ (JEW-4) Proposed Pricing Exception Rate Design

17

18 Exhibit __ (JEW-5) Proposed Pole-Wood Charge Rate Design

19

20 Exhibit __ (JEW-6) Proposed Permanent Discontinuance Facility
 21 Service Life Terms

22

23 Exhibit __ (JEW-7) Work papers of John E. Walter

24

25 **Q. Please explain why a general clean-up of the Lighting Tariff is in the
 26 public interest and explain what that clean-up entails.**

27 A. The Lighting Tariff presently contains five Rate Schedules, referred to as

28 service classifications (SC), for unmetered service for outdoor lighting

29 services. Four of these rate schedules are structured in a similar manner in

1 that the Company recovers both its energy costs and its delivery revenues
2 on the basis of estimated current flows through various different outdoor
3 lighting services. The fifth Rate Schedule (SC-4) provides unmetered
4 service to traffic signals. The delivery charge for service under Rate
5 Schedule SC-4 is presently fixed on a per-installation basis.¹

6
7 Although the Lighting Tariff incorporates by reference many of the
8 standard terms and conditions of the Company's Electric Tariff P.S.C. No
9 220 ("the Electric Tariff"), many of the provisions of Rate Schedules SC-
10 1, SC-2, SC-3 and SC-6 are similar if not identical. We propose to
11 remove these provisions from the individual service classifications and to
12 consolidate them into a single set of standard terms and conditions at the
13 front of the Lighting Tariff.

14
15 **Q. What do you see as the benefits of this restructuring?**

16 A. Two fundamental benefits will flow from this restructuring. First, it will
17 make the Lighting Tariff shorter and more concise, which should benefit
18 all parties. Second, where minor differences in language have
19 accumulated over the years in tariff provisions that should be identical, we
20 will be able to eliminate those differences.

¹ Rate Schedule SC-5 is reserved for future use.

1 **Q. What other changes do you propose to make to the Lighting Tariff as**
2 **a whole?**

3 A. The Company proposes two other changes to the Lighting Tariff as a
4 whole: First, we propose changes to the Lamp Billable Wattages
5 associated with various types and wattages of lamps (bulbs) used within
6 outdoor lighting fixtures. Second, we propose to modify the line
7 extension provisions of all rate schedules in the Lighting Tariff to remove
8 the current 500 foot line extension credit.

9

10 **Q. Please describe the changes you propose to Lamp Billable Wattages.**

11 A. The Company's proposed changes to lamp billable wattages are shown in
12 Exhibit __ (JEW-1).

13

14 **Q. Why are these changes in the public interest?**

15 A. The lamp billable wattage figures currently contained in the Lighting
16 Tariff, which date from 1974, no longer accurately reflect the actual
17 electricity demands of street lighting facilities with the equipment listed
18 therein. The original values were specific to products from a single
19 equipment provider and reflect the vintage technology at that time. The
20 predominant changes which have caused the need for these lamp billable
21 wattage corrections include the Company's current use of multiple lamp

1 and luminaire providers, each utilizing the most current technology
2 available for the designated lamp. The Company's Engineering Standards
3 Group has performed an assessment of all approved providers of
4 comparable equipment and established the standard values which reflect
5 the composition of products in-service.
6

7 **Q. How will these adjustments change rates?**

8 A. The net effect of this change is not expected to have any significant impact
9 on the Company's total revenues. However, energy usage rates for some
10 lamps, such as 70 watt high pressure sodium will go up, while others such
11 as 400 watt high pressure sodium will go down.
12

13 **Q. How will these changes affect the Company's street lighting
14 customers?**

15 A. The changes proposed are relatively modest, ranging from a maximum
16 increase in energy usage of 5.8 percent for 250 Watt Mercury Vapor
17 Lamps to a maximum decrease in energy usage of 4.9 percent for 150
18 Watt High Pressure Sodium Lamps. Impacts on customer bills will be
19 substantially less than these figures for two reasons. First, only
20 approximately 38 percent of total lighting charges are collected on a
21 volumetric (per kWh basis). Second, most customers will have a variety

1 of lamp types, some of which will receive higher energy usage rates and
2 some of which will receive lower energy usage rates. Thus, increases and
3 decreases in charges due to these changes are likely to offset each other in
4 most if not all cases.

5
6 **Q. Please explain why elimination of the current 500 foot line extension
7 for new street lighting services is in the public interest.**

8 A. The public interest will be better served by addressing the construction of
9 such new facilities under Rule 28 (Special Services Performed by
10 Company for Customer at a Charge) of PSC 220. Such additional
11 facilities are for the sole benefit of the street lighting customer and as
12 such, should be paid for by the customers requesting such service rather
13 than spread over all of the Company's customers.

14
15 **CHANGES TO RATE SCHEDULE SC-1**

16 **Q. What substantive changes do you propose to make to Rate Schedule
17 SC-1 of the Lighting Tariff?**

18 A. The Company provides private lighting service under Rate Schedule SC-1
19 of the Lighting Tariff. This service is provided on an unmetered basis
20 using Company-owned equipment. Rate Schedule SC-1 presently
21 provides customers with the option of selecting either overhead service

1 from existing poles or underground service. However, underground
2 service is limited to those locations where a distribution system of
3 appropriate service voltage is maintained by the Company and where
4 installation of underground service is reasonable.

5
6 Unlike service from overhead facilities, which under this rate schedule is
7 restricted to the Company's existing distribution poles, new infrastructure
8 must be constructed for any request for new underground service under
9 this rate schedule. This infrastructure typically consists of an underground
10 distribution circuit, as well as the standards, foundations, arms, lamps,
11 luminaires and other required items to complete the lighting assemblies.
12 In some cases, customers have specified more expensive, non-standard
13 facilities to better harmonize with the design of the structures for which
14 they are seeking lighting services. The costs of all these facilities are
15 recovered in the first instance from the customer requesting such service
16 through the application of rates developed from a cost of service approach
17 maintaining a long term in-service period. However, the minimum term
18 of service under this rate is four (4) years.

19
20 Unfortunately, it has been the Company's experience that a significant
21 portion of the customers electing underground private lighting either go

1 out of business before the end of this four-year period or request
2 termination of service shortly thereafter. As a result, other customers are
3 forced to pick up the costs of private lighting systems that were not fully
4 paid for by the customers who requested them. To avoid this inequitable
5 result, the Company proposes to close the underground service option
6 under Rate Schedule SC-1 to new customers, while grandfathering
7 existing underground service. This will reduce the exposure of all
8 customers to such defaults going forward, without disturbing
9 arrangements with any of the Company's existing customers.

10

11 **Q. How would this change affect future customers interested in receiving**
12 **private area lighting?**

13 A. Customers desiring underground-served private lighting in the future
14 would be required to install and maintain their own lighting facilities and
15 to receive metered service from the Company under the Electric Tariff.
16 There are no barriers that would prevent customers from constructing their
17 own lighting facilities or contracting with suppliers other than the
18 Company for the installation, operation and maintenance of such facilities.
19 Indeed, the Company has many customers (predominately commercial
20 customers) who have already chosen this alternative.

21

1 **Q. Did you consider any other alternatives before proposing to close this**
2 **offering to new customers?**

3 A. Yes. The only other option that adequately protects customers from the
4 financial risks associated with customer default would be to require some
5 form of firm security such as a cash deposit, letter of credit or other
6 security.

7

8 **Q. Why did you decide not to propose that customers seeking new**
9 **underground private area lighting service from the Company be**
10 **required to provide such security?**

11 A. To the extent that a customer can afford to post four years worth of
12 security in order to obtain underground private lighting service from the
13 Company, that customer could just as easily afford to hire a contractor to
14 build its own private lighting facilities. Accordingly, we do not see any
15 benefit to imposing a security obligation rather than simply closing the
16 SC-1 underground service to new customers.

17

18 **CHANGES TO RATE SCHEDULE SC-2**

19 **Q. Please describe Rate Schedule SC-2 of the Lighting Tariff.**

20 A. Under Rate Schedule SC-2 of its Lighting Tariff, the Company provides
21 street lighting services using Company-owned facilities to municipalities,

1 street lighting districts, public agencies, public authorities and public
2 corporations. The Company provides overhead (OH), underground (UG)
3 and underground residential distribution (URD) service under this rate
4 schedule.

5

6 **Q. What changes is the Company proposing to make to Rate Schedule**
7 **SC-2?**

8 A. We are proposing five changes: First, we propose to restructure the
9 Annual Street Light Circuit Charge per unit established in Table 9 of Rate
10 Schedule SC-2. Second, we are proposing to simplify the Annual
11 Foundation Charge, specifically the concrete foundation types, per unit
12 established in Tables 8 and 16 of Rate Schedule SC-2. Third, we propose
13 to phase out the pricing exceptions from the standard provisions of Rate
14 Schedule SC-2 contained in Table 19 of Rate Schedule SC-2 over a two-
15 year period. Fourth, we are proposing to revise the Tariff to exempt SC-2
16 customers receiving OH lighting services from the Pole/Standard Charge
17 for additional wooden distribution poles established in Table 14 of Rate
18 Schedule SC-2. Finally, we are proposing to expand and clarify the
19 requirements that apply when a customer elects permanent discontinuance
20 of street lighting services prior to the end of the useful life of the street
21 lighting facilities which the Company has constructed for that customer.

1 **Q. Please explain why restructuring the Annual Street Light Circuit**
2 **Charge per unit is in the public interest.**

3 A. At present, Table 9 of Rate Schedule SC-2 establishes separate rates for
4 UG and URD circuits depending on whether the circuits in question are
5 Company-owned cable and conduit, Company-owned cable in customer-
6 owned conduit or direct buried cable. For new UG installations, the base
7 charge for each type installation covers up to 50 feet of cable, and there
8 are separate rates for each type of installation for cable runs in excess of
9 50 feet. For new URD installations, the base charge is lower and only
10 covers the initial 10 feet of cable. The rates for additional cable for each
11 type of installation are the same as for UG.

12
13 This rate design is further complicated by the fact that for UG, Table 9
14 also provides that to the extent that the amount of cable included in the
15 base charge was greater than 50 feet, the greater allowances in effect at the
16 time those installations were made will continue to apply to those
17 facilities. The complexities of these rates are illustrated by the following
18 chart:

1

NIAGARA MOHAWK POWER CORPORATION d/b/a NATIONAL GRID
PSC 214 Service Classification No. 2
Underground Street Lighting Circuit Rate Issues

Circuitry Type	Current Rate	Circuit Installation Date		
		Pre May 1, 1963	May 1, 1963 - February 14, 1974	Post February 14, 1974
Cable & Conduit				
Base (Unit Cost)	\$79.35	Unlimited	≤ 100 ft.	≤ 50 ft.
Excess Footage (Per Ft.)	\$1.59	NA	> 100 ft.	> 50 ft.
Cable Only				
Base (Unit Cost)	\$18.35	Unlimited	≤ 100 ft.	≤ 50 ft.
Excess Footage (Per Ft.)	\$0.37	NA	> 100 ft.	> 50 ft.
Direct Buried Cable				
Base (Unit Cost)	\$63.79	Unlimited	≤ 100 ft.	≤ 50 ft.
Excess Footage (Per Ft.)	\$1.27	NA	> 100 ft.	> 50 ft.
URD Cable				
Base (Unit Cost)	\$12.76	NA	NA	≤ 10 ft.
Excess Footage** (Per Ft.)	\$1.27	NA	NA	> 10 ft.

** URD are typically constructed as direct buried cable. Pricing is changed to reflect the type of circuit installed

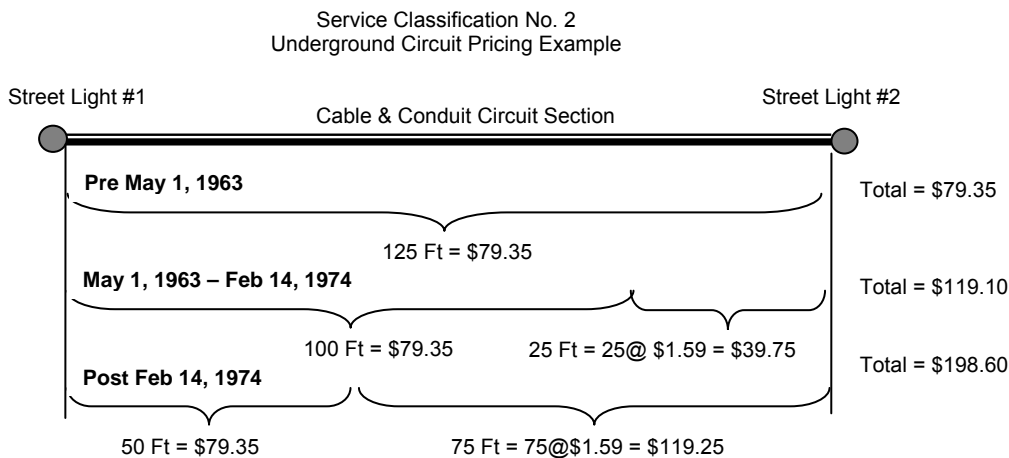
2

3 **Q. Please explain why changing these rates is in the public interest.**

4 A. This elaborate rate design is not found in any other area of the Company's
5 operations. Thus, while customers receiving metered service under the
6 Electric Tariff may be served by assets of widely varying vintages and
7 designs and, hence, widely varying original costs, the Commission long
8 ago concluded that all such services should be provided at uniform rates
9 based on the Company's overall average cost of service. The Company is

1 simply proposing to extend this well-established principle of rate setting to
 2 unmetered service under its Lighting Tariff.

3
 4 One of the reasons that the Commission has avoided setting different rates
 5 for the same service based on the vintage and/or type of facilities used to
 6 provide service in other contexts is that such rates invariably lead to
 7 disputes as to which rate should apply to particular customers. Such
 8 disputes have been common under the Lighting Tariff, as the passage of
 9 time tends to obscure both the actual installed length of the individual
 10 facilities in question as well as the date or dates on which they were placed
 11 in service. This problem is illustrated by the following chart:



12
 13 As you can see, the same facilities may qualify for an annual circuit
 14 charge of as much as \$198.60 and as little as \$79.35.

1 The second problem caused by this rate design involves Company-owned
2 cable in customer-owned conduit. When there is a failure in the
3 customer's conduit, it is the responsibility of the customer to excavate the
4 conduit, replace it, refill the trench and remediate the area. Because these
5 costs can be substantial, customers frequently take the position that the
6 Company should be responsible for these costs, since these tasks are also
7 required for the Company to replace its cable. Under the Company's
8 proposal, such disputes will be avoided in the future, as the Company will
9 accept responsibility for all repair costs regardless of the type of circuit
10 originally installed.

11

12 **Q. How are you proposing to restructure these rates?**

13 A. We propose to simplify the current rates in Table 9 by making a phased
14 transition to a simplified rate schedule under which all customers will be
15 charged the same rates regardless of the type of circuit used. To reach this
16 goal, the Company will also phase out the current grandfathering
17 provisions so that there will be only two types of underground services;
18 UG and URD. A maximum limitation length of 150 feet would be
19 established per section of installed underground circuit with any additional
20 length being compensated for through the application of Rule 28 of the
21 Electric Tariff. To make the transition to these new rules as smooth as

1 possible, we propose to phase these new rates in over a three-year period
2 as shown in Exhibit __ (JEW-2).

3

4 **Q. How will this phase-in be implemented?**

5 A. Consistent with other phase-ins proposed by the Company in this
6 proceeding, these changes will be phased in over a three year period. This
7 phase-in will coincide with the commencement of the three-year rate plan
8 period in this case. The Company has submitted tariff leaves providing
9 for the first year of the phase-in. Prior to the subsequent second and third
10 year of the rate plan, the Company will submit revised tariff leaves that
11 will simplify these rates as described above.

12

13 **Q. Will eliminating grandfathering and consolidating circuit types result**
14 **in unreasonable rates for any group of customers?**

15 A. No. The charges at issue in this case are extremely modest. The circuit
16 charge for the first 50 circuit feet of UG service ranges from \$79.35 per
17 year for Company-owned conduit to a low of \$18.35 for Company-owned
18 cable in customer-owned conduit. Thus the overall rate impact of this
19 change will be modest at best. Moreover, while customers that own their
20 own conduit will be faced with a modest increase in their circuit charges
21 phased in over a three year period, they will also be entitled on a going

1 forward basis to have all their conduit repair and replacement work
2 performed by the Company.

3

4 **Q. Will any customers be harmed by the phase-out of grandfathered line**
5 **allowances?**

6 A. The grandfathered line allowances cannot be justified on a cost-of-service
7 basis, since they permit some customers to receive more cable than others
8 at the same rates. Eliminating this rate disparity will place all SC-2 street
9 lighting customers on a comparable basis. The impacts of this transition
10 will be further mitigated by the three-year phase-in described above.

11

12 **Q. What changes to the Foundation Charges is the Company proposing**
13 **to make?**

14 A. We propose to consolidate the pricing of both cast-in-place and pre-cast
15 concrete foundation types utilizing a three year phase-in approach.

16

17 **Q. Please explain why restructuring the Annual Foundation Charge per**
18 **unit for concrete type foundations is in the public interest.**

19 A. Similar to the identification issues previously discussed with underground
20 circuitry, following installation, the physical character of the concrete
21 foundation is difficult to determine, making it difficult to verify that

1 customers are being appropriately billed. The only determination that can
2 readily be made is the nature of foundation material exposed at the base of
3 the lighting standard. Due to foundation longevity, multiple lighting
4 standards of various styles and sizes may utilize a single foundation,
5 thereby further confusing the billing issues arising from the present rate
6 structure. Prospectively, the proposed singular pricing of foundations
7 based upon material composition will alleviate disputes founded on
8 foundation size requirements associated with existing lighting standard
9 characteristics.

10

11 **Q. How are you proposing to restructure these rates?**

12 A. As previously described, the Company proposes to implement a transition
13 of rates to a common rate over a three year phase-in period as presented in
14 Exhibit __ (JEW-3). A target singular price was established based upon a
15 replacement cost analysis (Testimony and Exhibits of Rate Design,
16 Customer and Markets Panel) and the moderation of customer impacts.
17 The application of the staged rate implementation will be initiated with the
18 proposed filed tariff leaves which will be modified in compliance with the
19 exhibit through tariff filings to be effective at the beginning of each of the
20 prospective rate years in this case.

21

1 **Q. Will consolidating concrete foundation types result in unreasonable**
2 **rates for any group of customers?**

3 A. No. The two cast-in-place units representing the most significant in-
4 service quantities will be affected by a proposed reduction of \$9.94 in one
5 case and an increase of \$19.37 in the second case. The percentage change
6 in each case is -5% and 9.7%, respectively. As a function of normal
7 business, customers receiving foundation service typically employ a mix
8 of foundation types, minimizing the net impact of these proposed rate
9 changes. Several types of specialty facilities having limited usage would
10 experience greater pricing adjustments. Rate impacts associated with
11 these facilities are also considered to be minimal as individual customers
12 only utilize small quantities for unique applications. Thus the overall rate
13 impact of this change will be marginal given the application diversity by
14 most customers.

15
16 **Q. Will any customers be harmed by the consolidation of concrete type**
17 **foundation rates?**

18 A. The Company believes this to be an equitable solution to all customers
19 receiving foundation service both now and into the future. Prospective
20 billing simplicity and the avoidance of inventory disputes will be

1 favorably received. The three year phase-in plan as previously described
2 above will further mitigate any impacts of this transition.

3

4 **Q. What other changes should be made to Rate Schedule SC-2?**

5 A. We also propose to eliminate the pricing exceptions from standard tariff
6 pricing provided to twelve municipal customers in Table 19 of Rate
7 Schedule SC-12. Table 19 provides special pricing for certain street
8 lighting assets in 14 municipalities.² Interestingly, two of these
9 municipalities will actually receive lower overall charges for street
10 lighting services after elimination of these special pricing provisions.

11

12 **Q. Please identify these fourteen municipalities that will experience bill**
13 **changes as a result of the phase-out of this exception pricing.**

14 A. The fourteen municipal customers in question are the Amherst Central
15 School District No. 1, the Town of Amherst, the City of Buffalo,
16 Chautauqua Utility District, Village of Kenmore, Town of Tonawanda,
17 Village of Williamsville, NYS Syracuse Armory, City of Syracuse, City of
18 Glens Falls, City of Utica Department of Public Works, Town of
19 Queensbury, Village of Kinderhook and City of Schenectady.

20

² Table 19 erroneously shows only 12 exception customers.

1 **Q. How substantial will those changes be?**

2 A. The total bill impacts resulting from this change are presented in
3 Exhibit __ (JEW-4). This change results in increases in street lighting
4 bills for twelve customers ranging from 0.2% to 172.3% percent on an
5 annual individual account basis. Each of these customers also receives
6 other bills for other street lighting accounts served by the Company. On
7 an overall per-customer basis, this change results in bill increases ranging
8 from 0.2% to 38.4% as shown in Exhibit __ (JEW-4).

9

10 **Q. Why is elimination of these pricing exemptions in the public interest?**

11 A. These pricing exemptions have existed in the Company's Lighting Tariff
12 since the 1960s. Whatever justification may have existed for those special
13 rates half a century ago has long since ceased to exist. Accordingly, it is
14 unfair to the 752 other municipal customers served under Rate Schedule
15 SC-2 to continue to provide these preferential rates to these twelve
16 municipal customers.

17

18 **Q. What actions is the Company proposing to take to mitigate the impact
19 of this change?**

20 A. To mitigate the overall impact of this change on any customer, the
21 Company is proposing to implement a phased elimination of these

1 exception rates. In recognition of the challenges posed by current
2 economic conditions, the Company is proposing to begin this phased
3 transition in the second year of the three year rate plan proposed in this
4 case. As a result, customers with these exception rates will continue to
5 receive those rates in the first year of the Company's proposed rate plan.
6 In the second year, one-half of the benefits provided by these exception
7 rates would be eliminated, and in the third year, these exception rates
8 would be completely eliminated.

9
10 **Q. Please explain your proposed change to the pricing of wood poles**
11 **utilized for service within Rate Schedule SC-2.**

12 A. The Company proposes to eliminate the annual charge for wood poles
13 installed for the specific use to support lighting facilities under this service
14 classification. The intent of these poles is for the sole use of lighting for a
15 specific municipal customer. It has been determined that because of their
16 location within the public right-of-way, other communication utilities
17 attach to these poles without proper consent. The regular field auditing of
18 these facilities is not practical. This condition has resulted in numerous
19 customer disputes relative to the attachment of the third party upon a
20 facility, charged to a single customer, to be providing sole service to that
21 designated customer.

1 **Q. What is the general impacts will be experienced from this change?**

2 A. A significant number of customers will realize an initial savings which
3 relate to a revenue reduction for the Company as identified in Exhibit __
4 (JEW-5).

5

6 **Q. Why is the elimination of this wood pole charge in the public interest?**

7 A. These poles were installed per customer service requests, paid for through
8 their lighting bills and were intended to provide service only to support the
9 specified lighting facilities. Legislative mandates now allow other
10 telecommunications service providers to attach their infrastructure to
11 electric utility assets. This action has created a conflict in this situation.
12 Recent billing complaints have focused on the third party attachment use
13 of these poles for which the Company must comply. The Company is
14 usually unaware of the attachment as the third party is delinquent in
15 providing timely notification. Therefore, elimination of this charge will
16 relieve the cost burden on the singular customer and will allow the
17 Company to comply with applicable rules.

18

19 **Q. Please explain your proposed changes to the provisions of Rate**

20 **Schedule SC-2 dealing with permanent discontinuation of service.**

1 A. Under Rate Schedule SC-2, a customer may request permanent
2 discontinuance of the street lighting services provided by any Company-
3 owned street light at any time on thirty days notice. The tariff further
4 provides that the Company “shall have the right to remove said facilities”
5 and that the Customer shall be required to pay the applicable charges for
6 such facilities (other than energy) or the net book cost if the facilities to be
7 discontinued have been in service for less than 15 years.

8
9 The provision stating that the Company “shall have the right” to remove
10 its facilities has created disputes with some customers who have
11 misinterpreted this provision as requiring that the Company physically
12 remove all of its facilities – including underground facilities – after
13 discontinuation of service. This was never the Company’s intent and has
14 not been our practice, and we are proposing to modify Rate Schedule SC-2
15 to make clear that the Company may either physically remove its
16 underground facilities or permanently disable those facilities and retire
17 them in place.

18
19 Moreover, many of the lighting facilities retired by customer request
20 pursuant to this provision in the past have had service lives substantially in
21 excess of fifteen years. As a result, the costs of early termination of

1 lighting service agreements are passed from the terminating customer to
2 all of the Company's other lighting customers. To prevent such cost-shifts
3 from occurring in the future, the Company proposes to replace the uniform
4 fifteen year threshold for compensation with new thresholds based on the
5 expected useful lives of the lighting facilities in question shown in Exhibit
6 __ (JEW-6).

7
8 **Q. Please explain how the service lives you propose to use in this rate**
9 **schedule were developed.**

10 A. The Company began this process by seeking information on the useful
11 lives of outdoor lighting facilities from industry equipment manufacturers
12 and other public sources. This investigation did not yield any useful
13 information. Accordingly, the Company has developed this useful life
14 schedule based on its own experience.

15
16 The Company stated from the proposition that these useful lives should be
17 no more than one-half of the 50 year and 70 year average life term for
18 overhead and underground lighting equipment used in the Company's cost
19 of service study in this proceeding. I then broke outdoor lighting facilities
20 into certain key component groups and determined the age of the 50th
21 percentile age of all equipment in each group still in service. Where the

1 50th percentile age of facilities in any category was less than one-half of
2 the service life used in the cost of service study, I considered the 50th
3 percentile age as the useful life for facilities in that group.

4
5 Where information on specific asset types was not available, those
6 facilities were grouped with other facilities with similar useful lives. For
7 example, information on foundations and arms is only available back to
8 1998, because arms and foundations were both reported together as
9 “supports” prior to that date. Accordingly, I have assimilated components
10 having like applications into groups and defined consistent facility average
11 useful life terms for each group. The resulting values represent a fair and
12 realistic analysis of the average life of the Company’s outdoor lighting
13 facilities.

14

15 **Q. What additional changes do you propose to make to the permanent**
16 **discontinuance provision of this rate schedule?**

17 A. The Company proposes to simplify the determination of asset value for
18 facilities to be removed prematurely as requested by the customer through
19 the permanent discontinuance provision. The present provision provides
20 for the Company election of either a depreciated book cost less net salvage
21 value or the application of current charges for the remainder of the service

1 life term (currently up to 15 years). The Company proposes to eliminate
2 the first methodology and utilize the established rate times the remaining
3 service life duration calculation.

4

5 **Q. Please explain why you believe this change to be in the public interest.**

6 A. This singular asset valuation approach will be easier to communicate,
7 simpler for the customer to understand and can be consistently
8 implemented by the Company.

9

10 **CHANGES TO RATE SCHEDULE SC-3**

11 **Q. Please describe Rate Schedule SC-3 of the Lighting Tariff.**

12 A. Under Rate Schedule SC-3 of the Lighting Tariff, the Company provides
13 unmetered service to customer-owned lighting facilities.

14

15 **Q. What changes, if any, do you propose to make to Rate Schedule SC-3
16 at this time?**

17 A. We are proposing only one change to Rate Schedule SC-3 at this time.
18 Presently, the paragraph numbered "3" on Leaf 62 of the Lighting Tariff
19 provides that customers may install convenience outlets on the lighting
20 facilities they own, provided they obtain the approval of the Company and
21 pay for all electricity used from such receptacles. Because such service is

1 unmetered, it is generally impossible to know with any degree of accuracy
2 when they are being used, by whom, and how much electricity is taken
3 from such receptacles.

4
5 In light of the increasing cost of electricity – as well as the decreasing cost
6 of metering discussed later in my testimony – providing unmetered service
7 to customer-owned convenience outlets creates an unacceptable risk of
8 cost shifting from customers with access to such unmetered outlets to all
9 of the Company’s other customers. The best way to protect the
10 Company’s other customers from having to subsidize the cost of
11 electricity provided through such unmetered convenience outlets is to
12 convert such facilities from unmetered to metered service. In addition to
13 preventing cost shifting, this change will also spur conservation and
14 energy efficiency, as customers will be forced to pay for the electricity
15 they use.

16
17 At the present time, we are proposing only to close this service to new
18 requests, while permitting existing convenience outlets to remain in place
19 for the duration of the three year rate plan proposed in this proceeding.

20 After the expiration of that rate plan period, however, the Company may

1 request that the Commission modify Rate Schedule SC-3 to allow those
2 unmetered outlets to be either removed or converted to metered service.

3

4 **CHANGES TO RATE SCHEDULE SC-4**

5 **Q. Please describe the services that the Company provides under Rate**
6 **Schedule SC-4 of the Lighting Tariff.**

7 A. The Company provides unmetered electric service to traffic control
8 devices owned, installed and maintained by or for the State of New York,
9 its various municipalities and several private customers.

10

11 **Q. How is traffic control service provided under Rate Schedule SC-4?**

12 A. Unlike all of the other services provided under the Lighting Tariff, traffic
13 control service is priced largely on a fixed price basis. Specifically, the
14 Tariff establishes a Base Service Charge of \$23.14 per location per month.
15 In addition, the customer also pays for energy and a transmission charge
16 of \$0.00572 per kWh. The flat Base Service Charge applies to all traffic
17 signals receiving power from a single point of common control, regardless
18 of the complexity or number of such signals. Some intersections contain
19 only a limited number of lights, whereas other intersections include
20 multiple lights for multiple traffic and turning lanes, as well as for
21 pedestrian crossings, pedestrian alarms and traffic and surveillance

1 cameras. Energy charges are estimated separately for each location based
2 on the manufacturer's rated demand for all installed facilities operating on
3 a 24/7 basis.

4
5 **Q. Does the Company serve all traffic control facilities in its service**
6 **territory under Rate Schedule SC-4 of the Lighting Tariff?**

7 A. No. Approximately half of the traffic control facilities in the Company's
8 service territory are provided with metered service under the Electric
9 Tariff, while the remainder are provided with unmetered service under
10 Rate Schedule SC-4 of the Lighting Tariff.

11

12 **Q. What changes does the Company propose to make to Rate Schedule**
13 **SC-4?**

14 A. Rate Schedule SC-4 of the Lighting Tariff should be closed to new service
15 applications on the effective date of the tariff leaves at issue in this
16 proceeding. Existing traffic control facilities served under Rate Schedule
17 SC-4 should be grandfathered for the three-year term of the rate plan
18 proposed by the Company in this proceeding. Once this three-year rate
19 plan period has expired, the Company expects to make a filing with the
20 Commission seeking authority to eliminate this provision altogether.

21

1 **Q. Please explain why this change would be in the public interest.**

2 A. Traffic control facilities have evolved to the point where all new facilities
3 in the Company's service area should be supplied with metered service
4 rather than unmetered service. Several factors support this conclusion.
5 First, as previously noted traffic signaling systems have grown increasing
6 complicated in recent years, with audible and visual signals for pedestrians
7 as well as traditional signals for car traffic. Second, technological
8 developments such as LED lighting provide customers with incentives to
9 invest in new fixtures that consume less energy than traditional facilities.
10 Third, many municipalities are adding additional items whose functions go
11 beyond mere traffic signaling, such as red light cameras, surveillance
12 cameras and speed monitoring equipment. The only way to determine the
13 precise energy consumption of all these facilities is by installation of
14 meters. Moreover, the cost of installing and reading meters has decreased
15 substantially in recent years with the development of equipment that
16 allows the Company to poll meters remotely without physical access to the
17 meter.

18

19 **Q. Can't you estimate the usage of all these different facilities with a**
20 **reasonable degree of accuracy?**

1 A. Experience shows that such estimates are frequently inaccurate due to a
2 host of factors, including inaccuracies in manufacturer energy
3 consumption data, changes between the equipment specifications sent to
4 the Company and the facilities actually placed in service and the
5 installation of additional equipment, such as video cameras, without notice
6 to the Company. In addition, they can be time consuming to perform,
7 which translates into higher rates for street lighting services. While the
8 Company could inspect all traffic signals in its service area periodically to
9 detect these changes, the cost of such inspections would substantially
10 exceed the cost of installing and polling meters on those locations.

11

12 **CHANGES TO RATE SCHEDULE SC-6**

13 **Q. Please describe the services provided by the Company under Rate**
14 **Schedule SC-6 of the Lighting Tariff.**

15 A. The Company provides unmetered service to customer-owned, Company
16 maintained street lighting facilities under Rate Schedule SC-6. These
17 facilities may be served either from the Company's overhead distribution
18 system or by underground circuit. The maintenance services provided by
19 the Company under this rate schedule are limited to cleaning the fixture
20 and normal replacement of lamp and twist-lock photo control not caused

1 by vandalism or accident involving a third party. The customer is
2 responsible for all other aspects of maintaining its street lighting fixtures.

3

4 **Q. Please describe the changes that the Company proposes to make to**
5 **Rate Schedule SC-6.**

6 A. We propose to close Rate Schedule SC-6 to new installations and to
7 grandfather existing installations for the three year term of the rate plan
8 proposed in this proceeding, on the understanding that the Company will
9 propose to eliminate such service entirely as early as January 1, 2014.

10

11 **Q. How will SC-6 customers be served after January 1, 2014?**

12 A. Those customers would need to either maintain their own lighting fixtures
13 or hire a contractor to do so. The Company would then provide unmetered
14 service to such facilities under Rate Schedule SC-3 of the Lighting Tariff
15 or metered service under the Electric Tariff

16 .

17 **Q. Please explain why you believe this change to be in the public interest.**

18 A. The Company has experienced a wide variation in the quality and
19 condition of the customer-owned street lighting fixtures receiving service
20 under this rate schedule. Because customers are responsible for all aspects
21 of fixture maintenance other than replacement of lamps and photo

1 controls, Company personnel frequently encounter fixtures that have been
2 allowed to deteriorate to a point where they become unsafe for Company
3 personnel to work on due to a lack of routine preventative maintenance.
4 When this occurs, Company personnel are either unable to replace lamps
5 and photo controls or are exposed to unnecessary hazards in performing
6 such services.

7
8 We believe that for both safety and economy, responsibility for all repairs
9 on any particular customer-owned lighting fixture, including both routine
10 maintenance, replacement of lamps and photo controls and more extensive
11 repairs should belong to the customer. The Company cannot agree to
12 modify Rate Schedule SC-6 to make the Company responsible for all
13 these aspects of street lighting repair and maintenance due to the wide
14 variety of lighting fixtures installed by customers throughout its service
15 territory, which far exceed the types of fixtures for which the Company
16 can maintain a spare parts inventory and train its workforce to maintain.
17 Accordingly, we believe that in the case of privately owned street lighting
18 fixtures, these responsibilities should all be born by the customer.

19

Direct Testimony of John E. Walter

1 **Q. Will this change leave any existing or future street lighting customers**
2 **in a position where they will be unable to have their fixtures serviced**
3 **at a reasonable price?**

4 A. The Company's proposal will not harm any customers currently served
5 under Rate Schedule SC-6, since the proposal is to close that rate schedule
6 to new service requests while continuing to serve existing customers. In
7 the case of fixtures not currently served under Rate Schedule SC-6, it
8 should be noted that many private contractors are available to provide not
9 only the limited services provided by the Company under Rate Schedule
10 SC-6, but also any other maintenance or repair services that such fixtures
11 may require. In such circumstances, there is no need for the Company to
12 continue to offer maintenance services on a cost-of-service basis at
13 locations where such service is not already being provided.

14

15 **Q. Does this conclude your testimony?**

16 A. Yes it does.

1 ALJ BOUTEILLER: We will also note for the
2 record that we have now identified for the record
3 your -- the witness' exhibits, those being Exhibits
4 Numbers 21 through 27. And just for clarity on the
5 record, should anybody be looking here for guidance,
6 we have purposely not entered into the record the
7 pre-filed rebuttal testimony of the witness, John E.
8 Walter, correct?

9 MR. POND: That is correct, Your Honor.

10 ALJ BOUTEILLER: Does that make the witness
11 available for cross?

12 MR. POND: Yes, Your Honor.

13 ALJ BOUTEILLER: Is it you, Mr. Duthie?

14 MR. DUTHIE: I guess so, Your Honor.

15 ALJ BOUTEILLER: If you'll get the
16 microphone, please.

17 MR. DUTHIE: Your Honor, I've already
18 provided this to counsel and Mr. Walter earlier this
19 morning. It's simply an exhibit which I prepared
20 and, therefore, I would ask Mr. Walter to check my
21 arithmetic.

22 ALJ BOUTEILLER: Are we going to identify
23 this?

24 MR. DUTHIE: Yes, could we mark this?

25 ALJ BOUTEILLER: For identification, 312.

1 (Exhibit No. 312 was marked for
2 identification.)

3 ALJ BOUTEILLER: Can you just describe for
4 the record what this is?

5 MR. DUTHIE: Yes, Your Honor. This is an
6 exhibit that was prepared based upon discovery
7 obtained from the company, and the background
8 materials are the last five pages. The first page
9 shows the proposed effect of the company's three-year
10 filing. The second page shows the effect of the
11 one-year rate plan, again, as I interpret it.

12 CROSS-EXAMINATION

13 BY MR. DUTHIE:

14 Q And I would like to start with that, Mr. Walter. Did
15 I correctly interpret the company's position as it relates
16 to the street lighting?

17 MR. POND: Your Honor, before we go there,
18 and this is something that I did discuss with
19 Mr. Duthie beforehand, and that is in keeping with
20 the notion that this is a one-year case and that we
21 have agreed to not spend a lot of time belaboring the
22 issues of what happens in 2012 and 2013 -- I guess
23 the second 2012 is supposed to be 2013?

24 MR. DUTHIE: Yes.

25 MR. POND: I'm wondering if Mr. Duthie would

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1 agree to simply remove the first page of this exhibit
2 and start on page 2, which really deals with the
3 issues in the rate year 2011.

4 MR. DUTHIE: Your Honor, I have no objection
5 to that. We can discard the first page. It's really
6 the second page that I'm asking Mr. Walter to agree
7 that this represents the company's one-year rate plan
8 litigated on the basis of the information we've
9 obtained in the referenced discovery.

10 A I would disagree. First of all, with regard to
11 accuracy, in the time that I've had to review it, I would
12 offer that in the representation of the second grouping of
13 values under the term "pricing exceptions" that we should
14 also include the term "architectural luminaires" as they
15 are two distinct elements that are represented in that
16 grouping. As a fact of clarity, under the City of
17 Buffalo, for the -- approximately the middle of the page
18 the values there under "present rates," it reads today as
19 336,586. It should be represented as 335,638, just a
20 numerical error, and that is for both values in that row.

21 And lastly, what is referred to in the bolded heading
22 of "Total Impact" is incorrect, that those numbers do not
23 reflect the total impact of the rate changes proposed by
24 the company, and, actually, the total impact is in the
25 first category under the heading "Municipality."

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1 Q Let me be clear, then. So the top part of the
2 exhibit is correct?

3 A That is true.

4 Q Are you also proposing at this point in time for
5 litigation review to increase the architectural luminaire
6 charges?

7 A Yes, we are.

8 Q What would I have to do to correct the bottom part of
9 this exhibit under "Total Impact"?

10 A It can be deleted in its entirety, as the
11 representation of total impact taken from our exhibits
12 provided in the referenced documents at the bottom would
13 actually be the numbers at the top of your page.

14 Q Okay.

15 MR. DUTHIE: Your Honor, I have no further
16 cross-examination.

17 ALJ BOUTEILLER: Does any other party have
18 cross-examination for this witness? If not, is there
19 any redirect?

20 MR. POND: No redirect, Your Honor.

21 ALJ BOUTEILLER: In that case the witness is
22 excused, and we thank you for your testimony. Let's
23 go off the record.

24 (Discussion off the record.)

25 ALJ BOUTEILLER: We've concluded our

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1 activity for today. We're clearly on schedule. We
2 are scheduled to resume the hearings a week from
3 tomorrow. The hearing will resume on that Thursday
4 at 10:30 a.m. At that time we will receive the
5 testimony of the next scheduled company witness.

6 With that we'll stand adjourned for today,
7 and we will resume the hearing in due course. Thank
8 you.

9
10 * * * 1:40 p.m. * * *

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C E R T I F I C A T E

I, Kay Trigilio, a Shorthand Reporter and Notary Public in and for the State of New York, do hereby certify that the foregoing record taken by me is a true and accurate transcript of the same, to the best of my ability and belief.

Kay Trigilio, Notary Public
State of New York

DATE: September 18, 2010