STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Case 07-E-0949 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Orange and Rockland Utilities, Inc. For Electric Service

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Evidentiary Hearing
Three Empire State Plaza
Albany, New York 12223

Wednesday, February 6, 2008
9:00 a.m.

PRESIDING:

GERALD L. LYNCH,
Administrative Law Judge

ORIGINAL

Appearances:

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JUDGE LYNCH: When we left off yesterday the next witness was Jane J. Quin and I see she's assumed the position. The other thing was: Following the cross of staff's accounting panel I asked a question about where Staff was at revenue requirement. At the end of the day I repeated the question to the Company informally.

I had asked originally if they knew roughly where they were, and then I withdrew the question and after I got an answer from the Staff I asked the Company again off the record.

And this morning I was advised and I have a sheet--I don't know if copies are available or I can have copies made--that as of yesterday the company is at $44.364 million.

And the other thing is that I have been advised in the change that the return on equity is equal to roughly ~~$43,000,~~ $430,000 which I think is a number different than the number that was discussed on the record, and it's actually closer I think to what Mr. Burke testified to.

So, I am more comfortable that the difference is only $30,000 rather than $100,000. Again, I can make copies of the sheet available. I haven't

looked at it, but those are the results.

And again, I asked that primarily just to get a sense of where the parties are at the end of the hearing.

So, with that, are there any preliminary matters?

MR. CARLEY: No, Your Honor.

MR. VAN ORT: No, Judge.

JANE J. QUIN, after first having been duly sworn, was examined and testified as follows:

JUDGE LYNCH: Thank you.

Mr. Carley.

MR. CARLEY: Thank you.

DIRECT EXAMINATION

BY MR. CARLEY:

Q. Miss Quin, you previously submitted 10 pages of prefiled written direct testimony in this proceeding. Do you have a copy of that testimony before you?

A. Yes, I do.

Q. Now, was this testimony prepared by you or under your direction?

A. Yes, it was.

Q. Do you have any corrections to make to your direct testimony?

A. No, I don't.

Q. If I were to ask you the questions set forth in your prefiled direct testimony your answers would be the same?

A. Yes, they would.

MR. CARLEY: Your Honor, I would ask that Miss Quinn's prefiled direct testimony be written into the record as if given orally.

JUDGE LYNCH: The motion is granted.

(The following is the direct testimony of Jane J. Quin:)

ORANGE AND ROCKLAND UTILITIES, INC.
DIRECT TESTIMONY OF
JANE J. QUIN
NYPSC CASE NO. _____

Q. Please state your name and business address.

A. Jane J. Quin, 390 W. Route 59, Spring Valley, New York 10977.

Q. By whom and in what capacity are you employed?

A. I am Director – Retail Access and Energy Services for Orange and Rockland Utilities, Inc. ("O&R", "Orange and Rockland" or the "Company").

Q. Please briefly outline your educational and business experience.

A. I received a Bachelor of Arts degree from the University of Michigan in 1977 and a Juris Doctorate degree from the University of Tulsa, College of Law, in 1985. My first employment was as an associate with the energy group of the Hall, Estill law firm in Tulsa, Oklahoma in 1985. I was subsequently employed as a senior associate with the energy group of the Baker & Botts law firm in Washington, D.C. from 1989 to 1993. I joined Orange and Rockland in 1994 as Attorney responsible for the Company's gas regulatory matters. In 1999, I accepted a position with the legal department at Consolidated Edison Company of New York, Inc. ("Con Edison") after the merger of Orange and Rockland and Con Edison, Inc. I represented both Orange and Rockland and Con Edison in gas and electric regulatory matters, including retail access issues, as Senior Attorney and Associate Counsel. In May 2005, I accepted the position of Director – Retail Access and Energy Services for Orange and Rockland. I have participated in the preparation of

testimony and exhibits in rate cases and regulatory proceedings in New York and Pennsylvania and at the Federal Regulatory Energy Commission. I previously testified before the New York State Public Service Commission ("NYPSC") in Case No. 05-G-1494 and Case No. 06-E-1433.

SUMMARY OF TESTIMONY

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

A. In my testimony, I will discuss the following topics:

- The addition of a discount factor to the Company's current purchase of receivables program;
- The Company's proposal to add two positions to the Energy Services/Retail Access group to assist with administrative work, outreach and education, and the Company's participation in regulatory proceedings concerning the continuation and development of customer programs; and
- The initiation of a surcharge mechanism for the recovery of costs associated with the development, implementation, marketing and evaluation of energy efficiency programs as proposed in Case 06-E-1433.

RETAIL ACCESS AND PURCHASE OF RECEIVABLES

Q. Please describe the current status of the Company's retail choice program.

A. Since 1995, O&R's customers have been able to choose a competitive provider of electric supply. As of July 31, 2007, 27% of the Company's electric customers (*i.e.*, 59,473) are provided electric commodity service supplied by 15 energy service companies ("ESCOs") doing business in the Company's service territory. Of these customers, 85% are residential. The

total peak load for retail access customers is 348 MW, representing 32% of the Company's system requirements.

Q. Does the Company propose any changes to its retail access programs?

A. Yes. Since commencing its electric retail access program in 1995, the Company has offered a single consolidated bill option under which O&R purchases the marketers' undisputed receivables without recourse at cost. The Company has found this to be a highly successful billing model for both its customers and the ESCOs participating in its retail access program. Beginning July 1, 2008, and during the term of the electric rate plan resulting from this filing, the Company proposes to modify its existing purchase of receivable single consolidated bill option to include a discount on the purchased receivable ("POR"). Consistent with the discount applicable to gas ESCOs implemented by the Company on November 1, 2006, pursuant to the Commission-approved Joint Proposal in Case 05-G-1494, the discount factor would be incorporated into the O&R Consolidated Billing and Assignment Agreement that is executed by all electric ESCOs selecting the single consolidated bill option for their customers. The POR program, with this discount feature, will be offered to all ESCOs who are authorized by the NYPSC to provide electric supply service to customers in O&R's service territory.

Q. Please explain how the discount will impact O&R's single consolidated bill option.

A. Under the POR program, the Company will continue to purchase undisputed electric supply service accounts receivable, without recourse, on the accounts of the Company's delivery service customers who receive a single consolidated bill from the Company that includes electric supply service provided by an ESCO and delivery service provided by the Company. However, in order to appropriately address the Company's risk of uncollectibles, including uncollectibles on the sales tax component of the receivables, the Company will purchase customers' receivables from the ESCO at a discount beginning July 1, 2008. O&R will continue to pay the ESCO for the customers' receivables net of the discount pursuant to the Consolidated Billing and Assignment Agreement by the 20th day of each calendar month for customer accounts billed during the preceding calendar month.

Q. How will the discount rate be calculated?

A. We will take the Company's uncollectible rate for all residential and commercial electric and gas customers eligible for retail access for the 36-month period ending June 30 and add 20 percent of the uncollectible rate to compensate the Company for its financial risk that the actual uncollectible rate for the purchased receivables may be higher than the prior period rate. The Company proposes to utilize the same discount calculation schedule currently utilized for its purchase of gas receivables, which has a rate year commencing November 1 and ending October 31 of the following year. In order to position the electric POR discount to track the gas POR discount, the

Company would place in effect on July 1, 2008, the same discount factor then in effect for gas *(i.e.*, the rate that will be implemented on November 1, 2007). The discount rate will be 0.372%, or the sum of:

(i) 0.310 percent, which is the Company's uncollectible rate for all residential and commercial electric and gas customers eligible for retail access for the 36 months ending June 30, 2007; and

(ii) 0.062 percent, which is 20 percent of the 0.310 percent uncollectible rate and is designed to compensate the Company for its financial risk that the actual uncollectible rate for the purchased receivables may be higher than 0.310 percent.

The Company's costs of credit and collections associated with customers taking ESCO service under the POR Program will not be recovered through the discount rate, but rather will be assessed through the competitive credit and collection related component of the Merchant Function Charge, as discussed in the testimony of Company witness Maureen Nihill.

Q. When would the discount rate change?

A. The Company would change the discount rate effective November 1, 2008, when it changes the discount rate under this POR program for gas ESCOs. For annual periods beginning November 1, 2008, and continuing thereafter, the discount rate applicable to purchased receivables would be adjusted to reflect (i) changes in the Company's actual uncollectibles experience for all residential and commercial electric and gas accounts eligible for retail access, including uncollectibles attributable to ESCO customers participating in the

POR Program during the 36 months ending in the prior June; and (ii) an associated adjustment to the risk factor. For example, the rate applicable for November 1, 2008, through October 31, 2009, would be calculated on the Company's actual uncollectible experience for the 36-month period ending June 30, 2008.

Q. Please explain why you are including sales tax in the discount of POR.

A. When the Company determines that an account receivable has become uncollectible, thereby writing it off, the write-off is net of the sales tax. The sales tax, which the Company has already prepaid to the State, is recovered by netting the amount against future tax payments. However, when the receivable represents ESCO charges purchased by the Company pursuant to the Company's Consolidated Billing and Assignment Agreement, the State taxing authority's rules do not permit the Company to net the sales tax amount on the ESCO commodity sale from the Company's sales tax remittances because the sales tax liability is the ESCO's, not the Company's.

Q. What is the Company's proposal to address this problem?

A. The Company proposes to purchase the sales tax at the same discounted rate as the purchase of the ESCO charges receivable. With this change, the Company would recover the uncollectible sales taxes through the discount rate.

Q. Does the Company propose any other changes to its retail choice program?

A. No.

ADDITIONAL STAFF POSITIONS

A. Please describe your plans to add two new staff positions to the Energy Services/Retail Access department.

Q. The Energy Services/Retail Access department has witnessed a surge in workload over the past year and, consequently, the Company proposes to add a Regulatory Analyst and a Customer Programs Analyst to the department.

. Although retail access migration statistics have been relatively stable, the Company has been enrolling new ESCOs at a rate not seen since the beginning of the Company's retail choice program. Each new enrolling ESCO must progress through two phases of the Electronic Data Interchange testing prescribed by the NYPSC – a process that can be laborious and time-consuming depending upon the skills of the ESCO or its testing agent. Additionally, the department has participated in a number of on-going generic proceedings initiated by the Commission within the past several months, including the Commission's review of retail access policies in Case 07-M-0458, the Commission's proceeding on issues associated with the future of the natural gas industry and the role of local gas distribution companies in capacity planning and reliability in Case 07-G-0299, and the Commission's proceeding on gas curtailment plans in Case 06-G-0059. With respect to Energy Services, along with managing the Company's low income programs for both gas and electric service, the department has increased substantially its

energy efficiency outreach and education efforts over the past year. The department has developed outreach materials on weatherization and using appliances efficiently, has partnered with the Company's Corporate Communications department is promoting the Company's "Change a Light, Change the World" campaign and has given dozens of presentations to schools, community organizations and civic groups on energy efficiency. These efforts are critical to the Company's goal of maintaining customer satisfaction levels, particularly in view of increasing energy costs related to the volatility of the commodity markets. Currently, the department is actively participating in the Commission's Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard in Case 07-M-0548 and the Company's efforts to develop an energy efficiency plan tailored to its service territory in Case 06-E-1433. This increase in regulatory work load, the demand of keeping current on the day-to-day responsibilities and the challenges faced with developing new programs in the critically important area of energy efficiency and demand response necessitate the addition of two staff positions in the energy services/retail access department.

Q. Are these positions in addition to the positions proposed in Case 06-E-1433?

A. Yes, they are. In my Supplemental Testimony filed on March 16, 2007, in Case 06-E-1433, I proposed adding two people experienced in developing, managing, and evaluating energy efficiency and demand response programs to the Energy Services department staff. These positions would be devoted to running the programs approved as part of the Company's Energy Efficiency

Plan as proposed in that proceeding. Consistent with the Company's proposal for recovering costs associated with its Energy Efficiency Plan, the Company proposed that these two positions be funded through the Societal Benefits Charge ("SBC") or a similar surcharge designed to recover program costs. In contrast, the staff positions proposed in Case 06-E-1433 would not be responsible for the Company's Energy Efficiency Plan specifically, but would be assigned tasks associated with regulatory functions for both energy services and retail access. They also would be responsible for the on-going outreach and education efforts of the department and day-to-day responsibilities as departmental needs require as the Company's involvement in energy efficiency issues continues to expand.

Q. What is the cost of these two new staff positions?

A. The Company anticipates that the expense associated with these additional staff positions will be approximately $135,000 on a consolidated basis. The allocation of these costs are included in direct labor expense and outlined further in the testimony of Company Witness Ken Kosior.

SURCHARGE FOR ENERGY EFFICIENCY

Q. What is the Company's position with regard to cost recovery of its energy efficiency efforts?

A. In my Supplemental Testimony in Case 06-E-1433, I noted that the Company proposes to use $1,351,000 in deferred funds to develop its Energy Efficiency Plan ("Plan") and to fund the programs during the implementation phase. However, to continue programs beyond the implementation phase will require

additional sources of funding. The Company proposed that once the deferred balance is fully expended, the Company would either divert funds from the SBC to finance the Plan, recover the expenses for the continuation of the Plan through increases to the SBC, or initiate a new surcharge to its delivery rates to recover these expenses. The level of funding would be determined in the Plan, based on the projected level of participation in the programs and the costs of program administration. The Administrative Law Judge in Case 06-E-1433 issued a procedural ruling on July 30, 2007, establishing a second phase in that case for the consideration of a revenue decoupling mechanism and O&R's energy efficiency proposal. That second phase will commence with a filing to be made by the Company on September 6, 2007. Taking into consideration the timing for resolution of issues regarding the Company's energy efficiency proposal, including the associated cost recovery mechanism, the Company anticipates that whatever energy efficiency cost recovery mechanism is eventually approved by the NYPSC in Case 06-E-1433 will continue in place for the duration of the rate plan approved in this proceeding as well.

Q. Does this conclude your testimony?

A. Yes.

BY MR. CARLEY:

Q. Miss Quin, you also in this case submitted rebuttal testimony, specifically eight pages of prefiled rebuttal testimony.

Do you have a copy of that before you?

A. Yes, I do.

Q. I take it that this testimony was prepared by you or under your direction?

A. Yes, it was.

Q. Do you have any corrections to make to your rebuttal testimony?

A. No, I don't.

Q. If I were to ask you the questions set forth in your prefiled rebuttal testimony would your answers be the same?

A. Yes.

MR. CARLEY: Your Honor, I would ask that Miss Quinn's prefiled rebuttal testimony be written into the record as if given orally.

JUDGE LYNCH: The motion is granted.

(The following is the prefiled rebuttal testimony of Jane J. Quin:)

ORANGE AND ROCKLAND UTILITIES, INC.
REBUTTAL TESTIMONY OF
JANE J. QUIN
NYPSC CASE NO. 07-E-0949

Q. Please state your name and business address.

A. Jane J. Quin, 390 West Route 59, Spring Valley, New York 10977.

Q. Have you previously testified in this proceeding?

A. Yes. I submitted direct testimony in this proceeding on behalf of Orange and Rockland Utilities, Inc. ("Orange and Rockland", "O&R" or the "Company"). I submitted my credentials as part of my direct testimony.

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

A. I will respond to certain statements contained in the direct testimony of Staff witness Karen Tuczinski regarding the Company's proposal (1) to add two new staff positions to its Retail Access/Energy Services department and (2) to carry forward into this rate plan whatever energy efficiency cost recovery mechanism is approved by the New York Public Service Commission ("Commission") in either Phase Two of Case 06-E-1433, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Orange and Rockland Utilities, Inc. for Electric Service, and/or in Case 07-M-0548, Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard.

Request for Additional Staffing

Q. What is Ms. Tuczinski's position regarding the Company's proposal to add two new staff positions to its Retail Access/Energy Services department?

A. Ms. Tuczinski testified (p. 5) that "it is premature to determine whether an additional two positions will be needed as a result of this proceeding". Ms.

Tuczinski further provides that her opinion is based on the fact that the Company's prior request for two positions in Case 06-E-1433 "is being considered by the Commission."

Q. Do you agree with this position?

A. No, I do not. First, Ms. Tuczinski statement that the two energy services positions requested in Case 06-E-1433 are still being considered by the Commission reflects a misunderstanding of the Company's request in this proceeding and/or a misunderstanding of the status of that proceeding. In its Order Setting Permanent Rates, Reconciling Overpayments During Temporary Rate Period, and Establishing Disposition of Property Tax Refunds (p. 29), issued on October 18, 2007 in Case 06-E-1433, the Commission ruled that the Company should proceed to hire two additional staff people in contemplation of implementing a future energy efficiency program. These positions, which are for two people experienced in developing, managing, and evaluating energy efficiency and demand response programs, are separate and apart from the two positions requested in this proceeding.

Q. Please explain the purpose of your request in this proceeding for two additional staff positions.

A. The two additional staff positions I discussed in my direct testimony, a Regulatory Analyst and a Customer Programs Analyst, are necessary to address the current demands of the Retail Access and Energy Services department notwithstanding the addition of any new energy efficiency and demand response programs. These two positions will provide services for

currently ongoing Retail Access and Energy Services activities that are expected to continue in the rate year and beyond. In fact, to recognize the manner in which these departments are currently being managed, with employees cross-functioning in both groups, the groups have been combined into a single department which is now called "Customer Energy Services." The Customer Energy Services department staff perform a multitude of roles, including handling customer enrollments under the Company's retail choice PowerSwitch program; electronic data interchange ("EDI") testing; energy services company ("ESCO") billing for energy deliveries; ESCO scheduling and balancing for energy deliveries; accounting for the remittance of Societal Benefits Charges ("SBC") to the New York State Energy Research and Development Authority ("NYSERDA"); accounting for the Company's low income programs; and customer outreach and education on retail choice and energy efficiency.

Q. Why does the Customer Energy Services department need additional staffing?

A. As noted in my direct testimony (pp. 7-9), the department needs additional staffing to address current work demands. In the last year, fourteen new ESCOs have applied to participate in the Company's retail choice program. For each applicant, the Company must respond to inquiries, process applications and agreements, examine creditworthiness and complete EDI testing. Pursuant to the Commission's Order Modifying Electronic Data Interchange (EDI) Testing Protocols issued on September 13, 2006, in Case 98-M-0667, EDI testing with a new ESCO must be

commenced within 45 calendar days of the receipt of an ESCO test request. In most cases ESCOs should be able to complete their application, EDI testing and production requirements necessary to begin serving customers within three months. The surge of ESCO participation in O&R's service territory, combined with the Commission's mandated deadlines, has increased considerably the workload of the department. ESCOs also have requested more training from the Company to avoid delays, misunderstandings and inefficiencies in the application process and, while the department has tried to accommodate ESCOs whenever possible, frequently meetings cannot be attended by all necessary staff members because of the press of other business. The department's development of a comprehensive ESCO training program has been delayed due to lack of staff. Additionally, as new ESCOs begin doing business in the service territory, ESCO marketing efforts also increase. These efforts result in increased PowerSwitch (O&R's ESCO referral program) enrollments and customer inquiries regarding ESCO solicitations, all of which place additional demands on department staff.

Q. Is staffing needed for other retail access functions?

A. Yes. Changes in the New York Independent System Operator ("NYISO") settlement and balancing scheduling have placed increased demands on staff by collapsing the amount of time that employees have to complete delivery reconciliations each month. This makes it more difficult to complete all required tasks within the month utilizing the same number of staff. The current demands on the department have prevented the staff

from engaging in any cross-training, thereby making the group even more vulnerable to the potential of failing to meet deadlines due to the expected or unexpected absence of staff members. The additional Customer Programs Analyst would assume some of the responsibilities of current staff and allow for back-up for the existing responsibilities within the department, including EDI testing and ESCO scheduling and balancing. The position also would assist with the Company's energy services, retail choice and low income outreach and education efforts.

Q. What has been the extent of the department's outreach and education efforts recently?

A. Within the past two years, the Company has participated in over three dozen events throughout its New York service territory. These events vary from multi-day home shows, which take weeks of preparation and planning and are attended by thousands, to local community meetings that are attended by 10 to 25 people and offer the Company an opportunity to make detailed presentations on subjects like PowerSwitch, eBids (O&R's online ESCO price proposal program) and energy efficiency. These and other outreach efforts have been successful, as evidenced by the Company's recently completed Customer Survey on Retail Access Awareness and Understanding. That Survey, completed in November 2007, demonstrated that about three quarters of the electric customers surveyed were aware of their ability to select an alternate supplier and almost 80% of the customers surveyed who were aware of electric and gas deregulation were able to answer at least seven out of nine questions

on retail choice correctly. Effective retail choice outreach and education have played an important role in Orange and Rockland achieving the highest percentage of retail choice customer migration in the State. With regard to energy efficiency, customer interest has been heightened in recent months by the heavy emphasis on conservation and environmental impact from the national and local media, advocacy groups, and public leaders. As a result, the Company is more frequently asked to provide public presentations in a variety of venues including forums for low income customers and senior citizens, schools, business groups and community-based organizations. The volume of requests can be difficult to accommodate at present staffing levels and offers have had to be turned down due to lack of adequate staffing.

Q. Please describe the responsibilities of the proposed Regulatory Analyst.

A. The primary responsibility of the Regulatory Analyst would be to provide support for the department by monitoring and participating in regulatory proceedings related to retail choice, energy efficiency, demand response, and low income issues.

Q. Does the department currently have a regulatory analyst?

A. No, it does not, yet the department's primary responsibility is the implementation and administration of regulatory programs. Because the department lacks a regulatory analyst, regulatory assignments are sometimes made on an ad hoc basis depending upon who is available and sometimes to staff lacking regulatory or subject matter expertise. In certain instances, such as Case 07-M-0548, the department simply does

not have sufficient staff to participate in all aspects of the proceeding. Regulatory expertise is required by the department: (i) to track numerous Commission and Federal Energy Regulatory Commission proceedings on subjects as diverse as advanced metering infrastructure and customer enrollment issues for retail choice; (ii) to assess the potential impact of these proceedings on the functions of the department and to assist in formulating positions in these proceedings; (iii) to provide support to the Company's law department; (iv) to interface with other departments within the Company regarding regulatory issues; and (v) to participate in proceedings on an as needed basis. Because of the scope of issues that impact the department (*i.e.*, from EDI testing, to ESCO creditworthiness, to incentives for curtailment of peak load), the number of active regulatory proceedings and the current day-to-day responsibilities of the department's staff, it is sometimes not possible for the department to actively participate in all proceedings of interest. The addition of a Regulatory Analyst to the department would assist in addressing this shortcoming. In addition, the Regulatory Analyst would provide back up to the Customer Energy Services staff in submitting required reports to the Commission.

Energy Efficiency Surcharge

Q. Does Ms. Tuczinski support the Company's implementation of an energy efficiency surcharge?

A. No. Ms. Tuczinski recommends that Orange and Rockland defer any costs incurred for energy efficiency programs during the 2008 rate year

until such time as a more permanent recovery mechanism is established through Case 06-E-1433 and/or Case 07-M-0548.

Q. Do you agree?

A. While I agree that cost recovery issues for the Company's proposed Energy Efficiency Plan likely will be addressed in Case 06-E-1433 and/or Case 07-M-0548, I do not agree that the deferral of costs for energy efficiency programs, as part of the rate plan approved by the Commission in this proceeding, is appropriate. The period over which the costs of energy efficiency programs are recovered should be closely aligned with the period over which programs are implemented. Additionally, it is critical for the Company to know that it will be allowed to recover on a current basis the legitimate costs of implementing an Energy Efficiency Plan before commencing its implementation. Deferral of the Company's costs incurred to implement an Energy Efficiency Plan is inconsistent with achievement of the state's ambitious energy efficiency goals. Therefore, the Company requests that the there be no deferral of any costs incurred for energy efficiency programs during the rate year; once a cost recovery mechanism is approved in Case 06-E-1433 and/or Case 07-M-0548, the Company will apply that cost recovery mechanism during the rate plan approved by the Commission in this proceeding. Finally, the Company reiterates its position that the most appropriate cost recovery mechanism is a volumetric surcharge based on the electric deliveries.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

MR. CARLEY: Your Honor, Miss Quin is available for cross-examination.

JUDGE LYNCH: My understanding is that the county had indicated a desire to cross this witness. Are there others?

MR. WALTERS: CPB had some cross, too, Your Honor.

MR. VAN ORT: Judge, we had indicated we would probably be foregoing the cross of Miss Quin. Depending on what other questions are asked we may have follow up questions, but at this point we may forego it.

JUDGE LYNCH: Okay.

MR. ST. LAWRENCE: I don't have any questions at this time, but I may have some questions at the close.

JUDGE LYNCH: Fine. Would the county like to start?

MR. KLUCSIK: Thank you, your Honor.

CROSS EXAMINATION

BY MR. KLUCSIK:

Q. Good morning, Miss Quin.

A. Good morning.

Q. At page 8 of your rebuttal testimony you state that you disagree with DPS Staff's proposal to defer the

costs incurred by the Company for energy efficiency programs during the 2008 rate year; is that correct?

A. That is correct.

Q. Can you explain briefly why you disagree with the Staff's proposal?

A. We believe it's appropriate, once we start implementing energy efficiency programs, demand response programs, that a mechanism be put in place to recover the cost of those programs on a going forward basis, and we propose that that mechanism be a surcharge.

Q. Could you explain what your criteria for determining appropriateness of the recovery mechanism is?

A. It's appropriate to be spread across appropriate customer classes. To the extent energy efficiency programs benefit all customers it's appropriate all customers contribute to those, but we haven't proposed those precise mechanisms at this time. We suggested a volumetric surcharge.

Q. Do you have criteria or have you adopted or applied criteria for determining the appropriate duration of the recovery period?

A. It would coincide with the duration of the plan, but probably not precisely. There would be

reconciliations that would follow the period of the plan.

Q. Am I correct then in understanding that your criteria for a deferral period would have some relationship to the implementation of the plan; is that correct?

A. I am not sure I follow the question. We are opposed to deferring. We are opposed to recovering as we are operating the plan.

Q. Could you repeat that or maybe I will ask the reporter to read that answer back. I want to make sure I understood you correctly.

(Answer read by reporter.)

A. We propose to recover as we are operating the plan.

Q. Thank you. You also state at page 8 of your rebuttal testimony that deferral of these energy efficiency program costs is inconsistent with the achievement of the state's energy efficiency goals; is that correct?

A. That is correct.

Q. Why do you take that position?

A. In order to meet the goals, and I believe we have stated this in other instances, in order to meet the

goals we are going to need an all hands on deck approach. For the utility to be encouraged to participate, real-time recovery, not deferral of recovery, would be an important factor.

Q. Isn't it true that deferral of energy efficiency expenditures is really all about how quickly the Company recovers the cost that it expends?

A. That is correct.

Q. Would you agree with me then that the state energy efficiency goals are largely or all about reducing electric consumption per customer?

A. By a date certain. I mean there are targeted dates for accomplishing that, too.

Q. And doesn't the company routinely defer other types of costs?

A. I am not a rate expert.

Q. Can you help me understand the connection between achievement of the state's energy efficiency goals and the deferral of expenditures incurred to promote energy efficiency?

A. I answered that question. To the extent that achievement of the goals requires an all hands on deck approach, including the utilities being motivated and incentivized to participate to the full est extent possible,

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real-time recovery of those costs is an important factor for the utility.

Q. When you say an all hands effort, do you mean you will require additional personnel positions to accomplish the promotion of the energy program?

A. We will, and we already have two approved by the Commission.

Q. Can you tell me how deferral of energy efficiency program cost is different from deferral of other Company costs?

MR. CARLEY: Your Honor, I would object. The witness already responded to the previous question she is not a rate expert.

JUDGE LYNCH: Any response?

MR. KLUCSIK: If the witness doesn't know she can say she doesn't know.

A. I am not in a position to discuss other deferrals the Company may have at this time.

Q. Miss Quin, you testify on page 8 of your rebuttal testimony that it is critical for the Company to know that it will be allowed to recover on a current basis the legitimate cost of implementing its energy efficiency plan before that implementation; is that correct?

A. That is correct.

Q. Could you tell me what is the basis for your view that current recovery of these costs is critical to the Company.

MR. CARLEY: Your Honor, I would object. This ground has already been gone over in great detail and I would ask the county move on to a new area, please.

JUDGE LYNCH: I am going to overrule the objection.

A. The Company isn't interested in taking a risk on the recovery of the costs, so to the extent that a deferral could create such a risk it would not be incentivized to proceed with energy efficiency plans.

Q. I guess that would take me back to an earlier question of why these costs are any different in terms of their deferral from other costs. As I understand your answer you told us you are not competent to answer that question.

A. That is correct.

Q. Has the Company considered other cost recovery mechanisms for the recovery of energy efficiency program costs, other than a surcharge?

A. No. That's not to say that there wouldn't be

other recovery mechanisms that we might not consider, but at this point we have proposed through a surcharge, either in addition to the SBC, which is the current surcharge for energy efficiency programs run by NYSERDA, or a separate surcharge.

Q. Do I understand you to say that you have not proposed in this proceeding the details of such a surcharge?

A. That is correct. In fact, this issue isn't in this proceeding and my testimony here was proposing to continue the surcharge to the extent one was approved, either through the EPS proceeding or through our prior rate proceeding where we did propose an energy efficiency plan.

Q. Miss Quin, in your testimony, your rebuttal testimony, I believe you have suggested that it is not appropriate, as DPS staff suggests, to defer the energy efficiency program costs during the 2008 rate year until a permanent mechanism for those recoveries is in place; is that correct?

A. That is correct.

Q. Can you explain briefly why you believe that's inappropriate, especially in light of your answer indicating that these matters will be decided in other

proceedings?

A. We anticipate that when they are decided will coincide with when we actually start to implement the energy efficiency plan, so there would be no need for a deferral mechanism or any other type of ~~temp~~ temporary mechanism.

MR. KLUCSIK: Thank you, Miss Quin.

Nothing further, Your Honor.

JUDGE LYNCH: CPB.

BY MR. WALTERS:

Q. Good morning, Miss Quin.

A. Good morning.

Q. I would like to direct your attention to the first two pages of your rebuttal testimony, pages one and two, wherein you outline a request the Company's made in this case that the Commission approve two new positions for your energy services retail access department; is that correct?

A. That is correct.

Q. The retail access portion speaks for itself. Could you just briefly describe what the energy services portion of that office does or proposed that it would do with these new positions.

A. The energy services, with these new positions as

it stands now, absent implementing energy efficiency programs, would assist in outreach and education efforts.

Q. That is the energy services portion would be solely devoted to outreach and education?

A. At this time.

Q. If you know, what portion or what percentage of each of those energy services or retail access is that department devoted to? Can you put a percentage number on that?

A. I am sorry. Could you repeat the question?

Q. Sure. The name of the department is the energy services/retail access department. My question is: To what portion of each of those energy services and/or retail access is the department devoted to?

In other words what--on a percentage level or in a ratio or however you want to present it, what does that department do? Is it more retail access or is it more outreach and education vis-a-vis energy services?

A. We are calling the department now customer energy services, and the proportion is difficult to define because it varies with the workload.

I did state these new positions, in terms of energy services, would be assisting in outreach and

education. I do want to correct that.

They would also be assisting in our efforts to develop and implement an energy efficiency plan, but they would be working with the two other positions that we are looking towards that were approved in the prior case that will actually have expertise in that.

So, they may assist in those efforts, but the current workload in terms of energy services for the new positions would be outreach and education.

That's not all that energy services is involved in. We oversee the accounting of the SBC recoveries for NYSERDA. We oversee the low income, the accounting for the low income programs, that the Company has in place as a result of its prior rate cases.

Q. Has that reorganization taken place--you said that's what we are calling it now--or is that part of your proposal?

A. No. That's what we are calling it now as of January 1st, it is the customer energy services department. It includes retail access, energy efficiency, demand response, low income.

Q. If you could direct your attention now to page 3, lines 18 to 20 of your rebuttal testimony, wherein you state, "In the last year 14 new ESCOs applied to

participate in the Company's Retail Choice Program."

Do you see that?

A. Yes.

Q. These 14 new ESCOs, are they currently participating in the retail access program?

A. They are in various stages of being approved. I believe since I wrote this three have actually completed going into production and are marketing or have obtained customers.

The rest are in various stages of the application process. Some are actively EDI testing, electronic data interchange testing, and some are still in the process of completing paperwork, the application process.

Q. So, of the 14, three have completed the entire process?

A. I believe that that's correct.

Q. In addition to whoever was serving customers eligibility wise, whoever was serving customers in your service territory, you just added three to that?

A. Right. I believe in my direct testimony I said we had 15 ESCOs currently serving electric customers. As of the end of the year it was 17, and I believe there is one more now, so 18 are eligible. They may not all have lined up customers yet but...

Q. Eligible under PSC guidelines?

A. No. Eligible, have completed everything. I mean they are actively marketing for customers. They have done the EDI testing, they have done the production, they completed the application process, and they are eligible with the state.

Q. Are you familiar with the Public Service Commission's website?

A. Power to Choose or the general website?

Q. The Power to Choose section on the retail access.

A. Yes, I am.

MR. WALTERS: Your Honor, I would like to present the witness a document from that website and ask a few questions, if I have permission to approach the witness.

JUDGE LYNCH: Sure.

MR. WALTERS: Just as a little background, this is from January 31, 2007. As Mr. Carley pointed out to me as I was handing it out, it indicates that there are three pages to the document but the third page was just flotsam, for lack of a better word.

Q. So, as a representative of that website, Miss Quin, are you familiar with this set up? Have you referenced a similar page before?

A. I have never referenced this particular page. I have referenced putting in the zip code and looking at the price comparisons, but I have never referenced this page.

Q. And as you can see, it lists--at least it purports to list the energy service companies' ESCOs that have met Public Service Commission and utility requirements to provide service in New York State, and it says on the first page that there are seven companies that are currently eligible.

Is it your testimony that this document is incorrect?

A. I couldn't say for certain. This only includes the residential and we have multiple ESCOs that only serve the C&I load, and they are not on this list.

Q. So, I think we ball parked sort of about 17?

A. Yes.

Q. Would it be safe to say that there are 10 that strictly do C&I, that's why they are not listed on this document?

A. I couldn't say for certain that it's 10, but there are multiple that only do commercial and industrial. I couldn't say for certain whether this list is up to date. I would have to have my own list in

front of me.

Q. If you reference page 4 of your rebuttal testimony, line 4, the sentence that begins with "the surge".

You state, "The surge of ESCO participation in O&R's service territory, combined with the Commission's mandated deadlines, have increased considerably the workload of the department".

Do you see that?

A. Yes.

Q. Could you define the term "surge" as you used it in that sentence?

A. I don't have comparative numbers, but 14 in one year to be processed is pretty significant. We have never reached that level in one year before.

Q. But even with this surge of activity, for lack of--you didn't give me a definition, but would you accept the definition as a sudden increase?

A. Sudden increase in marketers applying and going through EDI testing, various stages of the application process, and also actively marketing in the service territory via direct mail marketing or door-to-door campaigns.

Q. You stated that of these new ESCOs, which we will

call them, they are all in various stages of either actively marketing at this point or going through EDI testing or at another level.

They are all in different stages of getting these requirements fulfilled, correct?

A. That is correct.

Q. Do you have a general idea, or could you give us a general idea of when each of these--again, in generalities because I know it's hard to specify with each utility with each ESCO, but when each of them applied to O&R for purposes of providing service to the territory?

A. By month, I mean of the 14 that I referenced in the testimony, which was submitted in 2007, the majority of them submitted their applications in 2007. I couldn't tell you exactly when. There were a few that had submitted applications in 2006 and they ~~are~~ were still being processed in 2007.

GLL/ALJ

Q. Do you know off the top of your head the name of the three ESCOs that are through the process, of the new ESCOs?

A. I believe that Major Energy is one of them. I believe that Juice is one of them. And the third I'm not certain.

Q. But even with this surge of activity, as you put it, you would agree, wouldn't you, that ESCO participation in O&R's service territory has been relatively stable over the last several years?

A. Prior to 2007 I would say that's correct, it has been stable. We have had testing and retail access work required as a result of ESCOs setting up separate entities to do business.

So, in prior years some of the issue was the separate entity to provide fixed price services, a separate entity to provide variable rate services, a separate entity to provide gas services.

So we were occupied going through testing for separate entities of the same ESCO, in essence, but this year it has been new ESCOs.

Q. I am going to present you an IR response, CPB number 1, and I will take a minute to pass these out.

JUDGE LYNCH: You can establish her familiarity with it and so forth, and then we will mark it and then you can ask your series of questions.

Q. Miss Quin, are you familiar with this IR request and response, CPB set number 1, O&R's response to CPB request number 1?

A. Yes, I am.

Q. Did you prepare this response?
A. By me and under my direction?
Q. Was it prepared by you or under your direction?
A. That is correct.
Q. If you look to your response on 1A specifically and the attachment is included as the third page.
JUDGE LYNCH: Did you want to get this marked?
MR. WALTERS: Yes. I would like to move the document be marked for identification.
JUDGE LYNCH: That's number 56.
(Exhibit 56 marked for identification.)
BY MR. WALTERS:
Q. Earlier I believe you stated that you believe that, in fact, retail access participation numbers were relatively stable up until 2007.
As you look at this information that was provided, specifically on 1A, do you see what the retail access level of participation was for December of 2007?
A. Okay. A correction. I believe that my testimony was as to the participation by ESCOs and not as to the participation by customers. Perhaps I misunderstood your prior question.
Q. I think we were miscommunicating. I will ask the

question again.

Would you say even with this surge of activity that retail access participation by customers has remained relatively stable over the last several years?

A. That is correct.

Q. Just taking a step back and going back to the new ESCOs, are you familiar with or have you ever been exposed to what's known as the PSC's voluntary statement of principals?

A. Yes.

Q. Are you familiar with whether any of these new ESCOs, either the ones that are actively participating already in the market, or that are proposed to be participating in the market, have agreed to enter into this document or agree to the principals in this document?

A. I could not tell you which have and which have not.

Q. Okay. Does the Company, as part of this rate case, propose to continue its Power Switch Program?

A. It hasn't made a proposal, so the program would still--

Q. Would continue?

A. Would continue.

Q. Could you give just a brief explanation for the record as to how the Power Switch Program operates?

A. The Power Switch Program, which the Commission now refers to as ESCO referral programs, is an introductory program for customers to try retail choice with guaranteed savings.

The way it works is a customer can choose an ESCO from a list of participating ESCOs, or a customer could have one randomly assigned to them. They are guaranteed seven percent discount off of the Company's commodity rate for two billing periods of participation.

Before they begin the program, the ESCO that they choose or the ESCO that's chosen for them submits an agreement to them and that agreement contains the terms and conditions going forward.

There are certain terms and conditions that are mandated by the Commission. For instance, it's month to month, so if they don't choose to continue after the introductory period they can switch back to the utility or they can switch to another ESCO.

Q. Thank you. I had two questions just on sort of the structure of the program.

First is with regard to the--I will call it the initial phase of the sign up. When a customer calls O&R

and either expresses an interest in participating in the program or has referred to the program in some manner, you said that they have a choice as to whether they would be randomly assigned or whether they would directly choose their ESCO that they choose to participate with; is that correct?

A. That is correct.

Q. If they don't indicate whether or not they have a specific choice, are they randomly assigned or are they told they can go out and choose the ESCO, that they want to educate themselves and come back and make a valid choice? Do you follow what I am saying?

If I am a customer and call up, and I don't know anything about the program, and I don't know anything about any ESCOs, I don't even know what ESCO is, am I told that I have a choice that I can go investigate and look into different ESCOs, or am I randomly assigned?

A. They would be told that they have a choice, and there is a list of participating ESCOs to choose from, and they would be told if they don't want to make that choice we will choose from the list for them and randomly assign one.

Q. In a series of IRs we asked some information about what happens to these customers post-intro period,

post the two billing periods, and the Company indicated that a lot of that information is not tracked by the Company; is that correct?

A. That is correct. We do the Power Switch enrollment so we track as customers are enrolling, but after the two month discount period they become retail access customers, and we are not separately tracking them any longer as Power Switch customers.

Q. Earlier you stated that you were familiar with the Power to Choose section where you put in a zip code and corresponding offers are put up that the Company or, I am sorry, the ESCOs can offer through the Company.

I want to show you this and approach you for a moment.

JUDGE LYNCH: Where is this taken from?

MR. WALTERS: The PSC website.

MR. CARLEY: At this time point in time I would object because the Company--this is a rate case. We haven't asked for any money relating to retail access in this case.

The programs are what they are. They have been approved by the Commission. I fail to see any relevance it has to the ongoing rate case.

I would ask Mr. Walters to explain to us

what the connection is. If there is none, that we move forward.

MR. WALTERS: The connection is, in fact, it is a rate case, and although there isn't a specific proposal from the Company, they did state that they plan on continuing the Power to Choose or the Power Choice program.

It's a main component. I don't think they would argue with that. It's a main component of their retail access program. And in fact they are asking for additional staffing in areas involved in retail access. So, I think they are asking for additional funds.

Whether those funds are going to be used for the purpose of the Power Choice program or not it's not clear, but I think you certainly could argue that this is directly related to a program that is going to continue, that ratepayers are going to be funding in some manner.

JUDGE LYNCH: I am going to overrule the objection on the grounds that, even though the Company hasn't made a proposal to change anything, it's still a ripe area for inquiry.

So, why don't you proceed.

BY MR. WALTERS:

Q. Are you familiar with this general set up, Miss Quin?

A. Yes.

Q. And just taking a step back, when we were talking about customers and post-introduction period and what happens to them, does the Company--or does the PSC place any guidelines on what type of contracts these ESCOs can offer after the two month period?

Do they have to be month to month or can it be for a fixed price or can it be for a variable price?

JUDGE LYNCH: Why don't you ask one at a time.

Q. I'm sorry. Does it have to be month to month?

A. My recollection was that it did, and that you would subsequently have to get customer consent to convert that to a fixed term contract with a fixed rate.

Q. And does O&R provide any information on its website, or any other place, whereby customers are made aware of pricing options that ESCOs may offer similar to this?

A. We have an interactive site on our Internet where you could get proposals from ESCOs. You can anonymously request a proposal. You could get pricing information.

GLL /ALJ

Q. From a specific ESCO or from all the ESCOs that are participating?

A. From specific ESCOs. We don't post ESCO prices like Power to Choose does on our website.

Q. I am not going to go through each of these, but based on this document--and basically what it purports to show is the prices that ESCOs can offer customers, assuming in some cases it only shows that--this is not your realm, I know this is a PSC document--but in some cases it only shows what the Power Switch price is.

So, customers, would you agree, would have very little information going into the post-introductory period as far as what prices they might be offered when shopping around?

A. The information is supposed to be provided by the ESCO at the point in time when the customer is being enrolled in Power Switch.

Q. But if you are randomly assigned to an ESCO it's possible that customer A might be randomly assigned to one ESCO, customer B to another ESCO, and they would get a totally different price after the introductory period?

A. After the introductory period, that's correct. They don't have to continue beyond the introductory period and there is no fees or charges for switching

back to the utility or switching to another ESCO.

MR. WALTERS: Your Honor, I move to mark this for identification, this document that I just handed out.

JUDGE LYNCH: I don't think you have established who prepared this or what it shows. You have asked her some questions relative to what Orange & Rockland does, but I mean if somebody prepared this and you wanted to ask them questions about it I would be happy to do that.

MR. WALTERS: I will move on.

JUDGE LYNCH: Just I don't think it's generally a good idea to hand people a document that they didn't prepare and try and elicit information from them.

MR. WALTERS: I understand.

JUDGE LYNCH: Ask her what she knows.

BY MR. WALTERS:

Q. Are the Power Switch numbers that the Company is experiencing, have they been declining over the past several years, as far as participation is concerned?

Is residential customer--I guess residential are the only ones in the program?

A. No. The commercial can as well. Yes, we have.

I believe we provided that data to you.

And with regard to that question, previously you stated the opinion it was a main part of our retail access program and I would differ somewhat on that. At this point I wouldn't call Power Switch a main part of our retail access program.

We have had ~~Power Choice~~ PowerSwitch or a form of PowerSwitch ~~Choice~~ in place for several years now. The numbers are declining. It's an introductory program only. You can only do it once for each service. So, at some point it's a declining class of customers that can take advantage of it. GLL/ALJ

MR. WALTERS: This is an IR response from CPB set number 1, Orange & Rockland's reply to the request number 2, and I will ask that this be marked for identification after I hand it out and establish a foundation.

Q. Are you familiar with this request, Miss Quin?

A. Yes, I am.

Q. Was this response prepared by you or under your direction?

A. Yes, it was.

Q. As you stated, 2C specifically, the numbers show--

JUDGE LYNCH: Do you want to get this marked?

MR. WALTERS: Yes. I move to mark this for identification, Your Honor.

JUDGE LYNCH: Number 57.

(Exhibit 57 marked for identification.)

Q. As you stated previously you had replied that you provided this information and it clearly shows that the numbers in the 2C specifically, the numbers for the Power Switch enrollment, have been reduced drastically over the last five years; is that correct?

A. Gradually reduced over the last five years.

Q. If you could focus your attention on 2A, wherein CPB requested total annual expenditures related to the Power Switch Program, do you see your response where you stated the Company did not expense funds solely to promote electric Power Switch? Are there any additional costs involved in Power Switch operations perhaps, or is it just solely a promotional aspect to it?

A. There are certain functions associated with running the program, handling the enrollments. They are handled by my staff on a day-to-day basis. I wouldn't call them significant.

Q. Those costs would be involved in what's known now

as the energy services retail access department?

A. Customer energy services department.

Q. Just one more line of questioning, Miss Quin.

If you could focus your attention on page 4, line 17, of your direct testimony. Specifically just to give it some context, you are answering a question based on what the Company's proposed new discount rate for uncollectibles would be.

You mention or you state that a 20 percent adder of the uncollectible rates that compensate the Company for financial risks, that the actual uncollectible rate for the purchase receivables may be higher than the prior period rate.

How did the Company come up with the 20 percent in conjunction with the risk analysis, if you know?

A. It did a historical evaluation of the swings ~~and~~ in the uncollectible rate from year to year. Based on that, 20 percent seemed to be a reasonable number to cover the risk.

Q. So, the uncollectibles--take a step back. I am not sure I followed your answer.

You are saying that there was a 20 percent variance in what the uncollectible numbers were on a year to year basis?

A. No. I said it looked at it from a historical standpoint. We are looking at a three-year window here so to some extent that mitigates the yearly swings, but we did look at the level of the swings from year to year to come up with a rate that we believe was reasonable to cover the risk.

I am not saying that it could have been 40 percent in one year and nine percent in another year. We looked at the trend.

Q. What years were used, if you know?

A. I do not.

MR. WALTERS: Thank you, Miss Quin.

I have no more questions.

JUDGE LYNCH: Mr. St. Lawrence.

MR. ST. LAWRENCE: Thank you, Your Honor. I just have a couple questions.

BY MR. ST. LAWRENCE:

Q. My first statement is--

JUDGE LYNCH: Just questions. No speechifying.

Q. Miss Quin, are you aware that in 2007 that Orange & Rockland had an outreach program on Live from Ramapo Town Hall on the Switch program?

A. Yes, I am.

Q. And do you know that Orange & Rockland came on every Thursday night for I think it was 12 straight weeks promoting this program and other energy efficiency programs that were offered?

A. We discussed ~~the~~ a number of the programs: Energy efficiency, billing, low income. I was there.

GLL/ ALJ

Q. Yes, you were. I thank you for your participation.

One of the things that I realized, and I don't know sometimes if you can lead a horse to water but you can't make them drink sometimes, if people realize what a great advantage the switching program is, and there's also a blended rate and fixed rate where people could lock in rates, correct, in this program, with some of the ESCOs?

A. In the retail access program many of our ESCOs are offering fixed rates. That's not part of Power Switch, but for the Retail Choice Program, yes, many of our ESCOs are offering fixed rates.

Q. As I recall when we were on T.V., at that time we had just witnessed the natural gas rates going from $14 back down into the $6 range. Do you remember that?

A. May have been mitigating after some of the rises from Katrina.

Q. It became--to me, the first time that I became aware of the blended and fixed rates, and we recommended to people that they could lock in these rates and you could do a hedge as a retail could do and the residential can do that as well, correct?

A. Yes. I didn't make recommendations. I simply pointed out this was an option that was available.

Q. That's correct. I think I made that recommendation to people.

JUDGE LYNCH: Can I interrupt for a second. From where I sit this sounds close to friendly cross. Is this friendly cross? I am asking you straight out.

MR. ST. LAWRENCE: At this time, yes, Your Honor.

JUDGE LYNCH: You are finished. No friendly cross.

MR. ST. LAWRENCE: Then I will continue without friendly cross?

JUDGE LYNCH: Sure. If you have questions.

MR. ST. LAWRENCE: I do. I just wanted to ask--

JUDGE LYNCH: Nobody is allowed friendly cross. It's just a basic rule.

MR. ST. LAWRENCE: I am not an attorney,

your Honor, so I didn't know that.

JUDGE LYNCH: Okay. Go ahead.

BY MR. ST. LAWRENCE:

Q. On the last document that was brought up on the schedule 2A where it talks about the annual enrollments.

JUDGE LYNCH: This is Exhibit 57.

Q. It shows that there has been less annual enrollments. Is that due to the fact that people have already enrolled? Would that be one of those reasons?

A. For the Power Switch Program it is possible that it's due to the fact that you can only do it once. So, any customer that's already tried it can't try it again.

Q. Could you tell me approximately how much money comes from our service district, or from Orange & Rockland, to NYSERDA for the energy programs, either in a yearly or a plan basis or whatever time frame you choose?

A. I couldn't give you an exact number, but I believe it's approximately $5 million a year right now.

JUDGE LYNCH: I'm going to ask: What area are we talking about, the Company's service territory or your town?

MR. ST. LAWRENCE: The service territory, Orange & Rockland, the entire district.

Q. Do you have any idea about how much funds come back from that $5 million to the service territory?

A. It's substantially less, but I couldn't give you an exact number.

MR. ST. LAWRENCE: Thank you, Your Honor.

JUDGE LYNCH: Thank you.

Staff?

MR. VAN ORT: Yes, Judge.

BY MR. VAN ORT:

Q. Miss Quin, I have a few questions based upon prior questions that have been asked. And in particular, I want to ask you a question with respect to the new positions that you are proposing, regulatory analyst and customer programs analyst.

These programs, I believe you indicated, are in addition to the two positions that were authorized in the Commission's October 18, 2007 order, correct?

A. That is correct.

Q. If I heard you correctly earlier you indicated that the functions of these individuals at present may change down the road; is that correct?

A. Responsibilities could be added, but there are certain functions right now that we are looking to while we are looking for staffing, certain functions that need

to be accomplished now.

Q. Have you prepared detailed job descriptions for each of these positions?

A. No. One of them would be very similar to the job description we currently use for our specialists within our department.

Q. Who currently performs the functions of the regulatory analyst at this time?

A. Everyone in the group. These responsibilities are spread out over the group.

Q. How about the customer programs analyst?

A. The retail access specialist and the retail access energy delivery specialist perform those functions.

Q. What is the current staffing level of--I believe you called it customer energy services department?

A. The current staffing allocated to New York?

Q. Correct.

A. We have eight on our staff.

Q. Now, did the staffing level change with the change in the department title?

A. No.

Q. It was eight before?

A. Yes, correct.

Q. Mr. Walters asked you about the surge in workload. How has Orange & Rockland been handling the surge in workload this year?

A. We have handled it, to some extent, with overtime. We have handled it by assigning tasks that aren't typically done by staff members to staff members as time allows them to complete tasks. And we have had delays in completing work that we historically haven't had, particularly in the area of EDI testing.

Q. Now, do you track the number of hours of overtime that have been required by the surge?

A. I have tracked the hours of overtime by those that are compensated for it.

Q. Approximately how many hours are indicated by--

A. Approximately 470.

JUDGE LYNCH: I have to ask: Over what period of time is that?

THE WITNESS: Over 2007.

MR. VAN ORT: We are talking about the year prior to that.

Q. You mentioned part of the surge is due to the department's participation in three proceedings. You reference 07-M-0457 regarding the future of the gas industry, 07-G-0299 regarding the gas capacity planning,

and 06-G-0057 regarding curtailment plans.

Can you tell us how many of your staff or staff of this department have participated in each of these proceedings?

A. Participated or contributed to participation, those are--all three you listed were gas proceedings.

Q. I am looking for active participation at this point.

A. Two.

Q. Is one of those yourself?

A. Yes.

Q. Now, as part of that participation did you prepare testimony and participate in hearings in any of these cases?

A. No. These proceedings didn't have testimony or hearings. They had conferences and comments.

Q. And did you prepare any documents including comments for any of these cases?

A. Assisted in the preparation of comments, yes.

Q. Approximately how many--you mentioned the conferences. How many meetings or conferences did you participate in?

A. I don't recall at this time. There were a number of internal, coordinating our efforts with different

departments within the Company and within Con Edison, and there was preparation of comments to be submitted.

I don't remember exactly how many joint conferences we had with interested parties. Also telephone calls with staff.

Q. You mentioned comments were submitted by Con Edison. Did Orange & Rockland independently submit comments in each of those proceedings?

A. In certain cases we submitted our own proposals. I know in the curtailments proceeding we submitted our own proposal and our own tariffs. In the case where comments were filed they were typically filed jointly.

Q. Just one last question. You spoke earlier about the EDI process. Can you tell us how long it takes to undergo the complete EDI process start to finish?

A. It can vary greatly. It's depending on the competency of the person you are testing with or the entity we are testing with. It could probably be completed as quickly as three weeks to a month. It could go on for months depending on the attentiveness and competence of the counter party.

Q. Is there any average? I'm not asking for a standard deviation or anything.

A. Three to four months. To complete the process of

EDI testing and the application process, three to four months.

MR. VAN ORT: Thank you. That's all I have.

JUDGE LYNCH: Redirect?

MR. CARLEY: I have one or two short follow up questions.

REDIRECT EXAMINATION

BY MR. CARLEY:

Q. Miss Quin, during his cross-examination Mr. Van Ort asked about the overtime that was put in by members of your department, and in response you referred to the overtime that was compensated for during calendar year 2007.

And just refresh my recollection. How many hours was that, approximately?

A. Approximately 470.

Q. Now, were there other members of your department who put in overtime that it's not compensated for?

A. Yes. Three out of the eight don't get compensated for overtime.

Q. Why is that?

A. Their level, the band level.

Q. They are management employees?

A. Yes.

Q. That would include you?
A. Yes.
Q. And two other individuals?
A. Correct.
Q. During calendar 2007 can you estimate the overtime that you and these other two individuals put in?
A. Cumulatively?
Q. Yes.
A. Probably close to a thousand hours.

MR. CARLEY: I have no further questions, Your Honor.

JUDGE LYNCH: Thank you very much. You are excused.

(Witness excused.)

MR. CARLEY: We would like to put on Mr. Perkins before Dr. Morin if that's acceptable.

MS. JOSS: That's fine with staff.

JOHN PERKINS, after first having been duly sworn, was examined and testified as follows:

DIRECT EXAMINATION:

BY MR. CARLEY:

Q. Mr. Perkins, you previously submitted 24 pages of prefiled written direct testimony in this proceeding.

Do you have a copy of that testimony before you?

A. I do.

Q. Now, was this testimony prepared by you or under your direction?

A. Yes, it was.

Q. Do you have any corrections to make to that testimony?

A. I do not.

Q. If I were to ask you the questions set forth in your prefiled written direct testimony would your answers be the same?

A. Yes, they would.

MR. CARLEY: Your Honor, at this point in time I would ask Mr. Perkins' prefiled written direct testimony be written into the record as if given orally.

JUDGE LYNCH: Motion is granted.

(The following is the prefiled testimony of John Perkins:)

JOHN PERKINS -

Q. Please state your name and business address.

A. My name is John Perkins and my business address is 4 Irving Place, New York, NY 10003.

Q. By whom are you employed and in what capacity?

A. I am Director, Corporate Finance for Consolidated Edison Company of New York, Inc. ("Con Edison"). I am also Treasurer of Orange and Rockland Utilities, Inc. ("Orange & Rockland" or the "Company").

Q. Briefly describe your educational background.

A. I graduated from MIT in 1972 and received B.S. degrees in Economics and Civil Engineering. I received M.A. and M.Phil. degrees in Economics from Yale University in 1974 and 1975, respectively. I took several additional graduate courses in Finance from New York University.

Q. Please summarize your professional background.

A. I joined Con Edison in 1982. My previous positions have been as Director, Financial Administration, Director, Corporate Planning, Director, Financial Services, and Manager, Financial Services. Prior to joining Con Edison, I was employed by Chase

Econometrics/Interactive Data from 1980-1982 and by the Graduate School of Business of Columbia University (1976-1979), where I taught courses in economics and transportation.

Q. Please describe your current responsibilities.

A. My responsibilities include preparing the cash forecast and planning and executing financing for Consolidated Edison, Inc. ("CEI"), and its subsidiaries, including Orange & Rockland. In addition, I manage the relationships with credit rating agencies and undertake various financial analyses.

Q. Have you previously sponsored testimony before regulatory bodies?

A. Yes. I have sponsored testimony on capitalization and cost of capital for Orange & Rockland in Case 06-E-1433 and Case 05-G-1494, in the matter of the securitization of certain deferred balances and testimony on capital structure and rates of return for Rockland Electric Company ("RECO")(a New Jersey public utility subsidiary of Orange & Rockland) before the New Jersey Board of

Public Utilities, and have sponsored testimony on rates of return and capital structure for Pike County Light & Power Company ("Pike")(a Pennsylvania public utility subsidiary of Orange & Rockland) before the Pennsylvania Public Utility Commission.

I have also sponsored testimony concerning the impact of rate recovery on ratings and thus on costs in the latest Con Edison steam and gas cases.

Q. Please summarize your testimony.

A. My testimony discusses the historic and projected capital structure of Orange & Rockland and the cost of capital, the current credit ratings of Orange & Rockland, the methodology used by the rating agencies to determine these ratings, the comments that have been made as to the strength of key financial ratios of Orange & Rockland, and the potential impact of reduced ratings.

CAPITALIZATION AND COST OF CAPITAL

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

A. I recommend the use of the consolidated capitalization of Orange & Rockland in this proceeding.

Q. Please describe the consolidated capitalization.

A. Consolidated capitalization refers to the consolidated capital structure of Orange & Rockland and its wholly-owned utility subsidiaries, RECO and Pike. The consolidated capital structure is presented on Exhibit E-8 and consists of the following Schedules:

1. Schedule 1 - Forecasted Consolidated Capitalization and Cost Rates
2. Schedule 2 - Long Term Debt - Actual At March 31, 2007
3. Schedule 3 - Long-Term Debt - Forecast - Thirteen Months Ended June 30, 2009

Q. Please describe any projected changes in long-term debt and how such changes have been incorporated into your forecasted data for the thirteen months ended June 30, 2009.

A. The forecasted balance of long-term debt for these months includes the contemplated issuance, in September 2007, of the Series A 2007 debentures, $60

million, 6.13%, due September 1, 2017, and the Series A 2008 debentures, $50 million, 6.63% due September 1, 2038. We project a mix of 10- and 30-year maturities because of the large size of the financing program and our concern with having significant maturities to deal with in the period 2017 to 2020 if we use only 10-year debt.

Q. Please describe how you developed the cost of long-term debt, and explain the change in the cost of long-term debt between the actual historic data and the projected cost for the forecast period (i.e., the thirteen months ended June 30, 2009).

A. Exhibit E-8, Schedules 2 and 3, present the detailed calculation of the cost of the long-term debt at March 31, 2007 and for the thirteen months ended June 30, 2009, respectively. These schedules detail each issue of long-term debt outstanding and calculate an effective annual cost for each issue, taking into consideration the original net proceeds to the Company and annual interest costs. The sum of the effective annual cost for all issues is divided by the gross

amount of debt outstanding to derive the weighted average cost of long-term debt. The change in the weighted average cost of long-term debt is the result of the actual and contemplated issuances of debentures during from September 2007 through September 2008, as described above.

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

A. We have used forecasts (based on the consensus of more than fifty economists) of Treasury rates from the publication Blue Chip Financial Forecasts, plus a spread to Treasuries based on the relatively stable spreads of recent months. This approach provides more stable results than simply using the most current Treasury rates plus the spread from the most recent issue. The spreads used do not incorporate the sharp increases due to the current turmoil in credit markets and may need to be revisited.

Q. Do you have other concerns about using the spreads from the most recent issue?

A. Yes. Orange & Rockland is at risk for downgrades in

its debt ratings based on inadequate nominal and cash rates of return. The Company may very well find itself incurring substantially higher interest costs by issuing "BBB" rated debt when customer rates were set assuming an "A" credit rating.

Q. How should this contingency be handled?

A. If, during the course of this proceeding, the Company's credit rating is jeopardized, we will so inform the parties and request an update to our interest expense and related costs forecast.

Q. Please describe the method used to project the equity balance through June 30, 2009.

A. The average consolidated equity of Orange & Rockland and its utility subsidiaries at June 30, 2009, excluding all non-utility subsidiaries and Other Comprehensive Income was projected from March 31, 2007 using the following steps:

1. It was assumed that CEI would make the following equity investments in Orange & Rockland: $40 million in May 2007 (this has occurred), and

forecasted $20 million investments in June 2008, December 2008, June 2009, respectively.

2. The forecast earnings for March 31, 2007 to June 30, 2009 were added to the March 31, 2007 Equity balance; and

3. Dividends per year of $31 million for 2007, $32.8 million for 2008, $34.2 million for 2009, respectively, were subtracted from the balance.

Q. What capital structure results from the calculations that you described?

A. Exhibit E-8, Schedule 1, shows the forecasted capital structure for the 13 months ended June 30, 2009 of 50.00% long-term debt, 1.41% of customer deposits, and 48.59% common stock equity

Q. Mr. Perkins, using your forecasted capital structure and cost of long-term debt and the return on equity, what overall rate of return results?

A. The overall rate of return is 8.79% as shown on Exhibit E-8, Schedule 1.

CAPITAL NEEDS AND INVESTOR CONCERNS

Q. Please describe the financial challenges facing the

Company over the proposed rate period?

A. During the proposed rate period, the Company will require an amount of capital from investors that far exceeds that raised in any previous period. Other Company witnesses have detailed the investment needed to maintain the Company's infrastructure, to maintain service reliability, to support economic growth, and to attend to other policy goals.

Q. Please describe the Company's capital needs.

A. Orange & Rockland currently has a capital expenditure program, determined by the need to update and expand the electricity delivery infrastructure, which far exceeds that of any comparable period. In turn, the amount of capital that must be raised far exceeds the levels of the past.

The Company will have to raise $110 million in debt between September 2007 and September 2008. To put this in context, Orange & Rockland's total debt as of March 31, 2007 was $437 million. The Company will have to issue, within a period of one year, debt equal to almost 25% of its debt balance as of March 31, 2007.

In turn, Orange & Rockland will need equity infusions from its parent, CEI, of $60 million from June 2007 to June 2009, in addition to the $40 million infusion already made in May 2007. This $100 million of equity represents 27% of the Company's equity balance as of March 31, 2007.

Q. What is the ultimate source of this equity capital?

A. The equity will be raised from investors by CEI.

Q. What is the implication of these large capital needs?

A. To raise this capital at a reasonable cost Orange & Rockland, and its parent, CEI must remain attractive investments to both debt and equity investors. To remain attractive to these investors, Orange & Rockland must continue to receive fair and reasonable treatment from its regulators.

Q. How do bond investors evaluate Orange & Rockland?

A. For most investors, the credit ratings assigned by the [SEC-recognized] credit rating agencies are the threshold basis for evaluating individual corporate credits such as Orange & Rockland.

Q. What are the current ratings on Orange & Rockland

debt?

A. The long-term debt ratings are A2, A, and A+ by Moody's, Standard and Poor's ("S&P"), and Fitch, respectively. The Outlook is Negative for S&P and Stable for Moody's and Fitch. The short-term debt is rated P-1, A-2, and F1, respectively.

Q. Please describe the credit evaluation process undertaken by the rating agencies.

A. Credit ratings reflect an agency's independent judgment of the credit-worthiness of a company based on the business and financial risks of that entity. Of the agencies, S&P has documented their analytical methods in the greatest detail, and we have had extensive discussions with that agency about specific aspects of their process. It is my understanding that the process employed by other credit agencies is generally similar in nature.

Q. Please continue.

A. S&P looks at several qualitative factors that they reflect in their determination of a utility's business risk. These include regulation, markets, operations,

competitiveness, and management. The relative importance of each category depends on the nature of the utility's business as stated recently by S&P in Standard & Poors' New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised (page 6):

> The emphasis placed on each category may be influenced by the dominant strategy of the company or other factors. For example, for a regulated transmission and distribution company, regulation may account for 30% to 40% of the business profile score because regulation can be the single-most important credit driver for this type of company. Conversely, competition, which may not exist for a transmission and distribution company, would provide a much lower proportion (e.g., 5% to 15%) of the business profile score.

The final result of this qualitative business risk analysis is a business profile score, ranging from 1 to 10, with 1 indicating the least risky profile and 10 the most.

Q. What is Orange & Rockland's business profile score?

A. Its score currently is 2.

Q. Do the other rating agencies look at business risk as well?

A. Yes, though they do not quantify that risk in the same manner as S&P does. For example, Moody's looks at several dimensions of risk, including the degree of government support, the percentage of non-regulated business, and the nature of regulation. In "Rating Methodology: Global Regulated Electric Utilities" (March 2005, page 4) Moody's states:

> The second step in the methodology is to assess the credit support that is gained from operating within a particular regulatory framework. Moody's considers each regulatory system and assesses whether there is a high or low expectation of predictability in the system and whether operators can reasonably expect to recover their costs and investments through regulator-approved revenue increases.

And on the same page they state:

> We also classify entities into the following four categories based on a comparative assessment of the predictability and stability of regulated cashflows for a company operating under a particular regulatory framework...

Q. Are there specific risks that the agencies are likely to address in this year's review of the Company's credit protections?

A. Yes. There are industry wide risks such as the need for new generation, a growing need by all companies

for new capital that will mean competition for investor money and higher costs, and potential problems arising in the wholesale electric markets and in their regulation by the federal government. There are also issues that are specific to the state of New York such as the potential for a return to long-term energy contracting, and mandated efficiency programs that would raise per-unit costs.

Q. Do you have any indications as to where the agencies see risk at present?

A. Moody's, in its "Industry Outlook- US Electric Utilities", (December 2006, page 3) listed the following:

> Rating drivers likely to increase credit risk for issuers in 2007 include:
>
> • Increasing regulatory pressures, with some regulators seeking to delay rate increases for cost recovery due to rate shock concerns;
>
> • Political intervention in the regulatory process by state and local government officials;
>
> • Uncertainty resulting from the end of transition or market development periods;
>
> • Higher debt burdens at utilities due to cost deferrals and regulatory delays of cost recovery;

- Significant increases in capital spending, particularly for environmental compliance;

- A substantial need for investment in new generation, as well as transmission and distribution system improvements; and

- Overly biased shareholder reward strategies.

Thus, Moody's attributes significant risk to the regulatory and political environment, combined with the high level of investment needed. On page 4 they reiterate the key role of regulation in determining credit quality:

> The industry also faces substantially higher capital expenditure pressures over the next several years, much of it for environmental compliance, but also for new generation and for expansion and improvement of transmission and distribution systems. As a result, we expect to see more rate filings in coming years, with a utility's regulatory environment becoming an increasingly important determinant of overall credit quality.

Q. Has Moody's addressed Orange & Rockland's rate agreements in their published reports?

A. Yes. In their "Rating Action: Moody's Places Orange & Rockland Utilities And Rockland Electric (Both A1) Under Review For Possible Downgrade; Affirms

Consolidated Edison And CECONY (May 1, 2006, page 1)

> The rating action also reflects concerns about the terms of the company's electric and gas rate structure after the current rate plan terminates on October 31 of this year.

And again on page 1:

> While the companies' relationships with the relevant regulators: FERC, the New York Public Utility Commission, the New Jersey Board of Public Utilities and the Pennsylvania Public Utility Commission have been generally constructive, the future results of both companies will be dependent on the final terms of the next rate plan.

Thus Moody's has expressed concern for the rating implications of the Commission's actions.

Q. What quantitative financial indicators do the agencies use to determine their credit ratings?

A. S&P uses a variety of financial indicators. They have indicated that the most important ones are those related to cash flow coverage of interest and debt, and the ratio of total debt to total capital. The specific key ratios that are considered by S&P are:

1. Funds from Operations/Average Total Debt;
2. Funds from Operations Interest Coverage; and
3. Total Debt/Total Capital.

Q. Does Moody's use similar ratios?

A. Yes. They use six core ratios:

1. (Funds from Operations-Dividends)/Debt;

2. Funds from Operations/Debt;

3. FFO/Interest;

4. Debt/Asset Value;

5. EBITDA Margin; and

6. (Funds from Operations-Dividends)/Capital Expenditure.

They have indicated that the first four ratios are the primary ratios, and the second two are the secondary ratios.

Q. How do the business risk positions affect the quantitative measures used by the rating agencies?

A. The higher the business risk the more rigorous the target level for a given rating. For example, S&P would look for higher Funds from Operations Interest Coverage ratios for companies that have a "2" business profile than for companies with a "1" business profile. Regulation, as an important component of the qualitative analysis that leads to a business risk

profile, is thus a key determinant of the level of financial ratio targets that are used in determining a company's debt rating.

Q. What does Moody's say currently about the strength of Orange & Rockland's credit ratios?

A. In "Rating Action: Orange and Rockland Utilities, Inc." (September 5, 2006 at page 1) Moody's says:

> The downgrades of O&R and RECO reflect financial performance that is weaker than average for the rating category. In comparison to other regulated electric utilities with similar risk profiles, actual 2005 financial performance, and projected financial metrics for 2006 to 2008, are more consistent with the lower rating. O&R's interest coverage and total debt coverage from cash flow were 3.9x and 14% respectively in calendar 2005. RECO's cash flow to interest was 3.8x and cash flow to debt was 16.5% in calendar year 2005. The ratings also consider the potential for lower operating resilience given the relatively small scale of the companies' stand-alone operations and revenue generating capacity.

Q. What does S&P say currently about the strength of CEI's credit ratios?

A. S&P, as opposed to Moody's, treats ratios on a consolidated basis. S&P has stated that the near-term ratios are weak for the ratings that are currently on the debt securities. For example, in "Orange and

Rockland Utilities Inc." (June 1, 2007, at p. 2) S&P says:

> As of March 31, 2007, Con Edison's total debt, including capitalized operating leases and tax-effected pension and postretirement obligations, was $9.7 billion, with adjusted debt to capital of about 55%, adjusted funds from operations (FFO) interest coverage of 2.6x, and adjusted FFO to total debt of 16%. Although leverage and interest coverage ratios are weak for the current rating, Standard & Poor's Ratings Services expects improvements in 2007 through equity issuances and regulatory rate relief. However, maintaining the current ratings hinges on a favorable rate agreement for CECONY, CECONY's ability to recover outage-related costs, and continued improvements in total leverage. O&R's cash flow measures are somewhat stronger than the consolidated entity with 2006 FFO interest coverage of 3.5x and FFO to total debt of 19%, although adjusted debt to capital is materially higher at 66%.

I would note that ratios are not directly comparable between Moody's and S&P, as they calculate the ratios differently and include different adjustments from accounting numbers.

Q. Fitch (which treats ratios on an individual-company basis) has maintained a Stable rating on Orange & Rockland. Does that imply that they are satisfied with the Company's financial position?

A. No. The agency has adopted a wait and see attitude, as stated in a press release "Fitch Revises Outlook on ConEd & ConEd of New York to Negative" (April 4, 2007):

> While O&R's financial ratios are somewhat weak relative to those of other 'A' credits, the outlook for O&R remains stable, pending results of an electric base rate proceeding.

Q. What is the impact of the regulatory process on the credit ratios you detailed above?

A. Net income is a key component in determining the strength of the credit ratios. Revenues increase the funds from operations by increasing net income. This effect will increase the Funds from Operations to Total Debt and the Funds from Operations coverage ratios directly by increasing the numerators. Because the increased net income also reduces the need for financing (and the associated interest), there will be a second positive impact on all three ratios.

Q. Are there particular reasons for the importance of net income (and thus revenue) in the case of Orange & Rockland?

A. Yes. Relative to many other utilities, Orange and

Rockland's capital additions for the foreseeable future significantly exceed its current depreciation. In addition, the levels of deferred tax that contribute to cash flow are expected to remain low due to the end of accelerated methods of tax depreciation. Thus, cash flow for Orange & Rockland will rely to a greater extent on earnings than would be the case for other utilities

Q. Why are allowed returns on equity and allowed equity as a proportion of the capital structure important to debt investors as well as equity investors?

A. Debt investors are concerned about the amount of equity subordinate to them in the capital structure and the returns available for stockholders for two primary reasons. First, if a company is able to attract new stock investment, it increases the debt investors' likelihood of being paid interest and principal when due. Second, returns for stock investors provide a cushion when the business is struggling. In difficult times, cash payments to this part of the Company's capital can be suspended until

the business improves.

Q. How does New York compare to the average state in terms of supporting the debt and equity investors?

A. Over the last several years New York has consistently offered lower returns on equity to its electric utilities and has allowed a smaller proportion of equity in the capital structure. Regulatory Research Associates, a service of SNL Financial, reports on regulatory decisions across the US. Using their data, plots of authorized equity capitalization and allowed equity returns are shown for the period 1992 through 2006 (Exhibit E-9 Schedules 1 and 2). Allowed equity as a percentage of total capital has increased modestly over the period, but other jurisdictions have moved more aggressively to improve their utilities' balance sheets. Authorized returns on equity have declined over the period in the US generally. Allowed returns in New York have been lower than the national average throughout the period and have increasingly departed from typical practice.

Q. Why is the availability of reasonably-priced capital so important to utilities?

A. First, because of the dramatically lower returns on the historic book investment made by investors in the business (see Exhibit E-9, Schedule 3), utilities have much less internally generated cash with which to replace assets that have reached the end of their useful lives. An additional difference between the regulated utilities and industrial businesses is that timely capital investment is much less voluntary for the utility. Increased maintenance and service improvements are required to meet increasing expectations of customers and other constituents and myriad new and growing regulatory requirements. This is in addition to the statutory requirement that a utility accommodate new businesses, even when the utility faces financial stress. Debt issued during difficult times will result in increased costs for the customers for at least several years. Equity sold at a low price reduces stock investor returns forever.

Q. How do credit ratings affect customers?

A. Credit ratings impact both the cost and availability of long and short term financing. The exact level of the impact will vary with the amount of financing needed and the financial climate. In times of crises (whether related to a company, industry, or the market), the costs will be significantly higher for lower-rated companies.

A second effect, which is particularly important in these times of high fuel and purchased power costs, is the need to post additional collateral for energy transactions if credit ratings fall. This collateral, in turn, would have to be financed at higher interest rates for lower-rated companies.

Q. Does this conclude your testimony?

A. Yes, it does.

BY MR. CARLEY:

Q. Mr. Perkins, along with your prefiled written direct testimony you also submitted two exhibits which were premarked as Exhibit E-8 and Exhibit E-9; is that correct?

A. That is correct.

Q. And these exhibits were prepared by you or under your direction?

A. That is correct.

Q. Do you have any changes to make to those?

A. I do not.

MR. CARLEY: Your Honor, at this point in time I would ask that these two exhibits be marked for identification, and according to my list, E-8 would be Exhibit 58 and E-9 would be Exhibit 59.

JUDGE LYNCH: You are correct, and the motion is granted.

(Exhibits 58 and 59 marked for identification.)

Q. Mr. Perkins, you also prefiled written rebuttal testimony in this proceeding, specifically 47 pages of rebuttal testimony.

Do you have a copy of that handy?

A. I don't.

Q. This testimony was prepared by you or under your direction?

A. That is correct.

Q. Do you have any corrections to make to your rebuttal testimony?

A. I don't have a correction. I have an additional comment.

Q. We will get to that. Thank you.

If I were to ask the questions set forth in your prefiled rebuttal testimony would your answers be the same?

A. They would.

MR. CARLEY: Your Honor, I would ask at this time Mr. Perkins' prefiled rebuttal testimony be written into the record as if given orally.

JUDGE LYNCH: Motion is granted.

(The following is the prefiled rebuttal testimony of Mr. Perkins:)

Case 07-E-0949

JOHN E. PERKINS - REBUTTAL
ELECTRIC

Q. Please state your name.

A. My name is John Perkins.

Q. Are you the same John Perkins who previously submitted direct testimony in this case?

A. Yes, I am.

Q. What is the purpose of this rebuttal testimony?

A. I will respond to certain statements contained in the direct testimony of Mr. Augstell and Mr. Henry ("Finance Panel" or "Panel") on behalf of the New York State Department of Public Service Staff ("Staff").

Q. Please describe how your rebuttal testimony is organized.

A. My rebuttal testimony is organized in ten sections. I first address the Finance Panel's discussion of Orange and Rockland Utilities, Inc.'s ("Orange and Rockland", "O&R", or the "Company") capital structure and their calculation of a hypothetical equity ratio. Second, I discuss the Staff's comments on debt costs and the possible impacts of the demolition of the Lovett Generating Station ("Lovett") on the outstanding tax-exempt issues. Third, I discuss the Staff's weighting of methodologies. Then, I discuss the Panel's discounted cash flow methodology. Fifth, I discuss

the Panel's capital asset pricing model methodology. Sixth, I discuss the Panel's purported credit quality adjustment to their model results. Seventh, I address the Panel's adjustment to reflect the potential risk-reducing attributes allegedly associated with Staff's proposed revenue decoupling mechanism ("RDM"). Eighth, I comment on various credit quality and rating agency issues. Ninth, I discuss the Panel's criticism of the study of comparable rates of return in different jurisdictions in my direct testimony. I conclude with a discussion of past history vs. present challenges.

CAPITAL STRUCTURE

Q. Does the Finance Panel make a proposal with respect to calculating capital structure?

A. Yes. The Panel begins with the actual book capitalization of Orange and Rockland as of June 30, 2007, and then proposes several adjustments to that capitalization that for reasons I will identify are not appropriate.

Q. Please explain the Finance Panel's proposal.

A. The Finance Panel (pp. 15-16) used the publicly-filed financial statements of Consolidated Edison, Inc.

("CEI") and Consolidated Edison Company of New York, Inc. ("CECONY") and the financial statements of O&R to determine the capital structure of the regulated utilities, and of CEI and the competitive energy businesses by taking the total consolidated structure and subtracting the balance sheets of the regulated utilities to approximate the capital structure of the parent and the competitive energy businesses. They then adjusted the competitive energy businesses' capital structure by adding $140 million of equity and subtracting $140 million of debt, to reflect a 61.5% equity ratio at the competitive companies. The Finance Panel then resolved the capital imbalances it created by reversing the entries for the regulated company capital structure, subtracting $140 million of equity and adding $140 million of debt. The Finance Panel then used projected changes to the regulated companies' debt and equity to arrive at a rate year capital structure for the regulated companies (see Exhibit __ (FP-3), page 1 of 2). Finally, they justify a below-average proportion of equity in the capitalization by rejecting current capital trends in the industry and substituting a backwards-looking

measure.

Q. Do you agree with the Finance Panel's proposal?

A. I do not. For several reasons discussed below, the Panel does not establish a reasonable basis for the Public Service Commission ("Commission") to establish rates and returns on any basis other than O&R's "stand-alone" capital structure (i.e., the actual sources of invested funds in O&R) assessed in the context of current information as to utility capitalizations.

In addition, they have not taken into account the changes in the non-regulated capital structure that will come about because of the sale of the generating plants by CEI. I will address the policy issues first, and then the expected changes in capital structure.

Q. What is the most important failure in the Panel's effort to justify an adjustment to Orange and Rockland's capitalization?

A. The capitalization and rate of return for a profit-regulated entity such as a New York utility will determine (among other things) who the investors in the business will be, what the nature of their

ownership will be, and what the rewards of their investment will be. It is thus critical that treatment of the utilities in the state be consistent among the utilities and over time so that the capital the Commission wants its utilities to attract (and the utilities need to attract) can be attracted on reasonable and equitable terms. The Commission has established a new policy direction in its National Grid/Keyspan merger order (Case 06-M-0878, Order issued August 23, 2007). In that order the Commission excluded consideration of both the consolidated United States group capital structure and the global group capital structure in its determination of the utility subsidiaries' capitalization, so long as the utility subsidiaries maintain an investment-grade rating. Whether this decision arose from a litigated case or a settlement agreement is irrelevant. It is a watershed in New York regulation and regulators should not allow it to drive a wedge between the opportunities afforded to these new investors and those available to traditional New York utilities and their investors.

Given the modest equity returns available to utilities as compared to companies not subject to

profit-regulation, as discussed later in my rebuttal, this decision is critical for the other New York utilities' ability to compete successfully for new sources of capital. These new investors, like National Grid Transco, structure their investments differently than historic investors in New York utilities. If the Commission applies a less favorable capitalization analysis to O&R, it will not be able to attract capital on competitive terms. This will be at the expense of its customers. The Panel's testimony did not offer a basis for such discriminatory treatment. Regardless of which capitalization policy the Commission adopts, investors will provide capital on the most reasonable terms if the policy is clear and uniformly and consistently applied over time.

In fact, because Staff continues to raise this alternative analysis, the capital costs incurred by O&R and other New York utilities will be higher than that of utilities subject to clear rules about stand-alone capitalization. Investors will necessarily increase their required returns for O&R and the other New York utilities which, in turn, will raise costs for customers.

Q. Why else do you believe that it is appropriate to use O&R's capital structure?

A. Separate and apart from the discriminatory aspects of the proposed treatment discussed above, the Panel properly dismisses the oft-raised concept of "double-leverage"—which is effectively permitted by the National Grid Transco merger order—with reference to O&R. As the Panel states (p. 13), there is no double-leverage in the case of CEI's investments in O&R. The equity dollars that have been raised by CEI have been invested in the regulated infrastructure of CECONY and O&R in the same manner as the debt raised by the two utilities. CEI's need for new capital can be attributed entirely to the needs of its regulated utilities, and therefore the need for a strong capital structure, with sufficient equity, arises from these same needs.

The Finance Panel does propose to adjust CEI's capitalization based on a different theory. Specifically, the Panel proposes a debt rating for CEI's competitive businesses equal to that of the utility which produces a supposed need for 61.5% equity ratios for each of the competitive energy

businesses. The Panel's analysis, however, ignores observable market practice for the financing of independent competitive electricity companies. The Panel does not provide evidence of the commonness of "A"-rated competitive generation businesses, because such ratings are very uncommon. Competitive electricity businesses generally have non-investment grade ratings with substantially higher levels of book leverage than those proposed by the Panel. For instance, the largest public generation businesses, Dynegy, Mirant, NRG Energy and Reliant, have average net debt balances of nearly 60% of total book capitalization. Since the Panel did not apply a comparative analysis to the capital structure of the competitive parts of CEI, the proposed adjustment in effect proposes to regulate the capitalization and financing of these other subsidiaries. The Panel's testimony did not establish the basis for its regulation of the capitalization of CEI's competitive businesses whether directly or through an adjustment to the utilities' actual capital investments in support of their customers.

Evidence of Staff's ad hoc approach to attempting to regulate the competitive businesses' capitalization can be inferred from the absence of a standardized analysis. In the O&R "show cause" proceeding (Case 06-E-1433, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Orange and Rockland Utilities, Inc. for Electric Service) the Staff used a 50% equity ratio (as opposed to the 61.5% applied in this proceeding), with no more reasonable basis for the determination. Based on the Staff methodology in Case 06-E-1433, there would be no adjustment in this case. They say (p. 24) that they have "given greater consideration to the actual risks posed by these investments" than in the earlier case, but all the information about the non-regulated businesses and all the Standard & Poor's numbers were available earlier. It is hard not to believe that they adjusted the methodology to get the result of a reduced equity ratio in this case as well. If the Panel believed that this type of adjustment was justified, it would offer a consistent and defensible analysis to which the utilities in the state could manage their capital investments.

Q. Do rating agencies base their ratings on the parent company's capital structure?

A. Two of the three major rating agencies that rate O&R securities (i.e., Moody's and Fitch) use stand-alone financial ratios (including measures of capital structure strength) in their analyses and rating decisions.

Q. Do you believe the CEI non-regulated subsidiaries significantly affect the financial strength of the regulated entities?

A. No. From the point of view of the rating agencies, there is no significant extra risk arising from CEI's non-regulated subsidiaries. For example, the Standard & Poor's Business Profile rating of 2 is applied to both O&R and its parent, CEI. Moreover, as discussed below, CEI has recently announced the sale of almost all of its generation assets. The resulting proceeds will allow a large reduction in holding company debt.

Q. Do you believe the Finance Panel's adjustment of the non-regulated capital structure to be a sound reallocation?

A. No. Leaving aside my disagreement with the essential validity of their approach, Staff assumes that the

equity and debt in the non-regulated portion of CEI's business will not change from the levels at June 30, 2007. That assumption is incorrect. The capital structure of the non-regulated entities changes over time just as the regulated companies' capital structure changes. In fact, if Staff's Exhibit ___ (FP-3) were produced using the 2002 10K SEC filing, the non-regulated subsidiaries would have shown an equity ratio of 59%.

Q. Leaving aside for the moment your concerns about the methodology used by Staff in proposing their capital structure, do you have any problems with the numbers used on their Exhibit ___ (FP-3)?

A. Yes. I reiterate my concern as expressed above that they incorrectly assume that the equity and debt in the non-regulated portion of CEI's business will not change from the levels at June 30, 2007. CEI had started this process by calling and retiring $325 million of holding company debt in May 2007. An additional $200 million of debt will mature in August 2008. Moreover, CEI has announced the sale of the bulk of the generation assets owned by its Con Edison Development ("CED") subsidiary. This sale is expected

to close in two tranches during the first half of 2008. Therefore, we will retire debt at the non-regulated subsidiaries and the holding company before and during the rate year. Consistent with Commission policy, capitalization analysis should reflect the best information available about what the test year capitalization will be rather than what historically it has been.

Q. What is the trend in allowed equity ratios?

A. Based on the data in my Exhibit (E-9, Schedule 1), the three-year trend in average equity ratios in the United States rose from 46.96% in 2004 to 50.07% in 2006. In light of this trend towards increased allowed ratios, our request for an equity ratio of 48.68 % is outmoded and could be increased in subsequent rate filings.

Q. Does the Panel discuss the view of the rating agencies towards the proper debt ratio?

A. Yes, they do. However, by concentrating on the debt ratio they neglect to mention that such ratio is not, in itself, a key analytical ratio. Far more important is the ratio of Funds from Operations to Debt. This ratio is weak, as mentioned in my discussion of

Moody's analysis of the O&R financial condition in my initial testimony. This ratio, which would be harmed by the imposition of a lower equity (and thus higher debt) ratio, was a key factor leading to Moody's downgrading of O&R debt. It is also the ratio that must be improved to maintain the Company's debt rating in the future.

Q. Do you agree with the Panel's statement (p. 10) that the Company did not "demonstrate the reasonableness of these projections [of its capital structure] by linking them to an overall forecast of its cash flows, particularly its construction expenditures, refunding requirements and other internally generated sources [of] funds."

A. No. The Company has provided detailed analyses of the needed construction expenditures. There are no debt maturities requiring refunding during this period. It also should be noted that the Panel has provided no foundation for this statement. The Panel has presented no analysis that contradicts our own, nor has the Panel asked us for these cash flow analyses in their interrogatories.

Q. Does the Panel recognize that the sale of the generating assets can have a significant impact which should be recognized and accounted for?

A. I believe that they do. On pages 22 and 23 of the Panel testimony the following exchange occurs:

> Q. Your analysis implicitly assumes that the magnitude of CEI's non-regulated investments remain at June 30, 2007 levels, or about 7.5% of the consolidated capital structure. What would you recommend if it appears that the investment level will materially change?
>
> A. Assuming that particular details of such an event became available during the course of this proceeding, further discovery would be necessary and supplemental testimony may be needed to insure the reasonableness of the capitalization upon which rates are ultimately set.

Given that "such an event" has occurred, we believe that the reasonableness of Staff's proposed capitalization must be reassessed.

Q. Have you prepared an exhibit demonstrating the likely impact of the sale of the generating assets?

A. Yes. My Exhibit _ (JEP-1) shows the potential impact of the sale of the assets and the subsequent retirement of debt on the combined capital structure of the non-regulated activities of CEI. The capital

structure will consist overwhelmingly of equity. Applying the adjustment as used by Staff to this capital structure would, interestingly, imply a reversal of what Staff has recommended in that about $380 million of equity could be attributed to the regulated utilities from the non-regulated activities and an equal amount of debt attributed from the utilities to the non-regulated activities. This would achieve Staff's hypothetical 61.5% equity level for the non-regulated activities.

COST OF DEBT

Q. The Panel has suggested adjustments to your debt cost testimony. Do you agree with these adjustments?

A. I do not. The Panel (pp. 27-29) has adjusted the debt cost by using current Treasury rates and a spread over these rates that recognize a part, but the not the full, impact of the sea change in the debt markets.

Q. Are the spreads used by the Staff equal to actual spreads in the market today?

A. No. Spreads have continued to widen in the markets. As of early January, we would expect the spread on 10-year debt for Orange and Rockland to be approximately

1.82% (versus the spread in Staff testimony of 1.53%), and the spread on thirty-year debt to be approximately 1.97% (versus the Staff's 1.64%). Thus, the advantages from lowered Treasury rates have been counteracted by increased spreads. The issue of interest rates, spreads, and forecasts can be revisited as we get closer to the final resolution of this case.

Q. Are there any other issues relating to debt costs that should be brought to the attention of the Commission?

A. Yes. As discussed in the rebuttal testimony of Company witness Regan, Mirant Lovett, L.L.C. ("Mirant") has notified O&R that it is actively considering the demolition of the Lovett generating plant. There are two issues of O&R tax-exempt debt that were used to finance the pollution control equipment associated with this plant. O&R has discussed with its tax counsel and the tax counsel for the New York State Energy Research and Development Authority ("NYSERDA"), the Company's ability to leave the tax-exempt bonds outstanding in light of this news. It is possible that we would be obligated to call these debt issues.

Q. What are the costs associated with calling these issues?

A. There are two types of costs: the costs to terminate the existing issues and the costs of the replacement debt.

Q. What are the costs to call the existing issues?

A. Each of the existing issues has unamortized issuance costs (representing underwriting fees and other costs from the time of issuance) associated with them. In the case of the Series 1994A issue, the remaining costs, as of December 31, 2007, were $675 thousand. For the Series 1995A issue they were $440 thousand. When these issues are called, we believe that the issuance costs will be amortized over the shorter of the remaining life of the refunded issues or the life of the new issues.

In addition, both the Series 1994A and Series 1995A issues have letters of credit which expire in August 2010 and July 2011, respectively. The discounted present value of the remaining fees, after the call of the Series 1994A issue, will have to be paid to the bank which issued the letter of credit. We estimate that these fees would be approximately $400 thousand. The letter of credit related to the Series 1995A would not require that the Company pay similar termination

fees, provided that certain stipulations are met. The Company believes that the circumstances under which we would redeem these bonds meet these stipulations. One additional cost of the call of the tax-exempt debt would be the cost of terminating the interest-rate swap on the Series 1994A issue.

Q. Please describe this swap.

A. In 1992 O&R entered into a forward-starting swap which served to convert the floating rate Series A when it was issued in 1994 to a fixed rate of 6.09% for the life of the issue. This was done to lock-in an attractive tax-exempt rate before issuance. In fact, the 1994 issue was used to refund a previous tax-exempt issue which had a rate of 10¼%, generating approximately $2 million per year in interest savings to ratepayers over the term of the new issue. The swap was described in detail to the Commission at that time and an order was issued by the Commission in September, 1992 authorizing O&R to issue the bonds and to enter into the swap agreement.

Q. What is the estimated cost of terminating the swap?

A. The swap termination cost at any given point in time depends on the remaining life of the swap and on the

level of interest rates at the time of termination. As of December 31, 2007 we estimate the swap termination cost at approximately $11 million. This cost would have to be paid immediately to the swap counter-party if the bonds were called.

Q. What are the costs of the new issues to replace the called bonds?

A. Since the new issues would not be tax-exempt, their cost would be on the same basis as for the other projected debt issues. Assuming that the issues are called in December 2008, the issuance cost would be approximately $1 million, assuming a 10-year issuance of an estimated $111 million, the amount of which accounts for the total $99 principal payment for the Series 1994 A and Series 1995 A and the costs related to the interest rate swap termination and new bond issuance.

Q. What would be the impact on the interest costs of the refunding of the old debt and the issuance of replacement debt?

A. The interest cost of the new debt would be the then-current cost of $111 million fixed-term taxable debt.

Q. How do you intend to recover the costs of the debt

refunding, should it be required?

A. The costs of the old issues and swap and of the new issue (both upfront costs, and in terms of any increased interest costs incurred until the next rate case) that may ultimately result from the potential early redemption of the NYSERDA Pollution Control Debt should be deferred for future recovery.

WEIGHTING OF METHODOLOGIES

Q. The Staff has recommended using a 2/3, 1/3 weighting of the discounted cash flow ("DCF") and capital asset pricing ("CAPM") methodologies, respectively. Do you agree with this weighting?

A. I do not. Dr. Morin's testimony gives a detailed rebuttal of this proposal. I will only add that the Staff's reasoning appears to be based on two flawed premises.

First, they state that the CAPM methodology is flawed because it is based on measures such as estimates of market return, which can change rapidly. It should be noted that Staff is the party which chooses to use short-run market risk premium estimates from a single

source (i.e., Merrill Lynch) which can change rapidly. Dr. Morin uses as his source long-term historical numbers which are stable and reflect market expectations over long periods of time. In essence, Staff is choosing a flawed input measure and then condemning a well-founded methodology based on their poor choice of inputs.

Second, Staff attacks the CAPM measure because of the results it produces. Staff bemoans the fact that utility betas (including those in their own proxy group) are increasing over time. It implies that New York utilities are immune to this risk increase and questions and therefore underweights the results from their own proxy group, which is made up companies which have very little (10.7% on average, per Staff testimony) non-utility exposure. Staff does this rather than accept the recognition by the market that all utilities have increased in risk (including O&R and CECONY). Staff is ignoring a trend in actual market risk by inadequately weighting the results of the CAPM analysis.

Staff advocates blind acceptance of a weighted combination of methods that arise from a recommended

decision in a generic financing case that is more than 10 years old. They do this in the face of increasing evidence that the most heavily-weighted component (the DCF) is subject to serious theoretical flaws, highly restrictive assumptions, and severe measurement challenges (as illustrated by the vastly different results which are arrived at by different parties or for different utilities in a single proxy group). Following their methodology leads Staff to a rate of return which is lower than any existing electric, gas, or steam allowed ROE in the country, and in fact is .5% lower than any non-New York electric ROE. They suggest applying this ROE to a utility which faces a large construction program and commensurate financing needs when that utility must compete for financing in a deteriorating market that is more credit sensitive than any we have seen in the last several years.

DCF METHODOLGY

Q. Please comment on the Panel's DCF methodology.

A. Dr. Morin's rebuttal has identified several of the problems with the Panel's application of the DCF methodology, so I will confine my comments to the essential flaw in the Panel's analysis. That flaw is

the direct application of market-derived values to the book measures upon which the Commission sets returns. These financial concepts are vastly different, yet the Panel appears to be unable to recognize or account for the difference. Absent some methodology for translating its market returns into book returns, the analysis provides no basis on which to establish returns. We are not claiming that returns on book value are the wrong target for regulation. We are saying that Staff's approach understates the required return on book value because all its analyses of required return are based on market variables, including the significantly higher market price of equity.

Q. How unrelated are the concepts in the Panel's DCF testimony?

A. These concepts are completely unrelated, as demonstrated in the organization and substance of the Panel's testimony. The only mention of the book value of equity—the basis upon which the Commission sets returns for the utilities whose profits it regulates—is found on line 11 of page 39. There the Panel notes that book values per share for its proxy group are

available from its data source, Value Line. The testimony does not indicate that this book value information for the proxy group is factored into the Panel's analysis in any way. In fact, all of the other references in this section of the Panel's testimony either explicitly or implicitly refer to market values for equity, not book values. For instance, on page 39 alone the Panel refers to the price of the stock used in calculating the required return five times. Each time, the price is, of course, the market price. And on lines 19 to 23 of the same page the Panel states "By calculating the discount rate required to turn the string of dividend payments into the current stock price, one can determine the rate of return investors are expecting for each company." Just as the price referred to is the market price, the return is a market return on that market price. Numerous times over the following pages the Panel uses the word "return", without acknowledging that the calculated return that investors are expecting is a market return, not a book return on book equity. Yet the Panel converts this market return into a required book return without once acknowledging the inconsistency or

justifying this transformation.

Q. How significant is this transformation to the results the Panel produces?

A. As a simple example, and to avoid the circularity problems in looking only at the regulated utility sector, please consider the data presented in the Panel's Exhibit_ (FP-9), Merrill Lynch's periodical report entitled Quantitative Profiles dated November 8, 2007. On the last line of page 44, the aggregate estimated data about the S&P 500 index are provided. CEI is a constituent of the S&P 500, so the S&P 500 should be a reasonable peer group for the purposes of measuring the impact of the Panel's transformation of a market required return into a book return. Page 44 shows that Merrill Lynch's models estimate an aggregate implied market return for the S&P 500 of 10.6% per year and a required market return of 10.7%. Merrill Lynch also attributes to the S&P 500 index an aggregate market value that is 2.9 times its historic book equity investment (including goodwill and other intangible assets) as is shown in the column titled "Price/Book." Using the relationship of Price/Book to transform market returns into book returns would

produce the following results for the S&P 500:

10.6% implied market return * 2.9x Price/Book =

30.7% return on book investment, and

10.7% required market return * 2.9x Price/Book =

31.0% return on book investment.

Hence, it becomes clear why the Panel's testimony does not transform its conclusions about market returns into conclusions about the book returns the Commission must set. To do so would produce a proposed fair rate of return on book investment well in excess of what the Panel, the Staff, or the Commission would propose. To demonstrate the effects of this essential flaw in the Panel's cost of capital methodologies, I refer to Exhibit _ (E-9, Schedule 3) from my initial testimony which is an analysis of the returns on equity of the constituents of the S&P 500. The impact of the flawed methodologies used to set "fair returns" can be seen in the relative position of CEI, which is ranked 461st in terms of return on equity.

Through a different analysis Dr. Morin demonstrates that, due to the difference between market and book equity, their DCF model consistently and severely understates required return from this factor alone.

CAPM METHODOLGY

Q. Please comment on the Panel's CAPM methodology.

A. Again I will note that Dr. Morin has identified several problems with the CAPM methodology as implemented by the Panel, and will confine my observations to the same essential flaw identified in the DCF methodology. As with the DCF methodology, the inputs to the CAPM are entirely derived from the market. There is no aspect of this analysis that recognizes or accounts for book value or return concepts. On pages 43 to 45, "risk premium" is mentioned eight times, "beta" is mentioned several times, as is the risk-free rate. In each case, each of these key variables—whether identified as "market" or not--is in fact derived from market values not book values. And the resultant required rate of return from the model employing these variables is a **market** return on the **market** value of equity. The word "return" is used many times in this section of the Panel's testimony. In each case the calculated return is a market return. The Panel offers no explanation as to how or why the book concept that it recommends relates to the rest of the section, which is all based on

market variables and market calculations. As in the section on the DCF methodology, calculation of a market return and its application to a book value of equity is not justified and dramatically understates the fair rate of return which the Panel itself acknowledges is the Commission's responsibility to provide. In fact, the Panel's own analysis--when coupled with its Merrill Lynch reference data--demonstrates how far from this standard the Panel's proposed book equity return is.

As a final comment on the Panel's DCF testimony, the exhibits offered to support the Panel's position (FP #9, 12 and 13) in this section of their testimony actually only serve to undermine it. Merrill Lynch's Quantitative Profiles, filed as Exhibit FP-9, in its table on page 44 supports a return of book equity (including goodwill and other intangibles) of more than 30%. Wharton professor Jeremy Siegel's out-of-date 1999 article for The Journal of Portfolio Management entitled "The Shrinking Equity Premium", filed as Exhibit FP-12, not only never mentions or even alludes to book equity investments or returns, but also discusses real returns rather than the

nominal returns that the Commission sets for New York utilities. The more current research by Davison, Marsh and Staunton (2006), offered as Exhibit FP-13, similarly never references or alludes to book values or returns.

PROXY GROUP AND CREDIT QUALITY ADJUSTMENT

Q. What does the Panel say about the risk profile of their own proxy group?

A. The Panel states (p. 37) that it would prefer to use a proxy group composed of utilities with the same bond ratings as Orange and Rockland, but that the size of such a group would be too small, so they have included other utilities with lower ratings. They then use this group for a DCF analysis. In turn, they "adjust" the result of this DCF analysis downwards because the proxy group has a different rating than Orange and Rockland.

Q. Do you agree with this process?

A. I do not. As discussed below, the Panel puts forth no evidence of any relationship, let alone a causal relationship, between credit quality and required or observed equity returns even in the utility industry, with all the circularity problems that entails.

In his rebuttal testimony, Dr. Morin refutes this adjustment. I would only add that the Panel's own data contradict the proposed adjustment. As shown on my Exhibit __ (JEP-2), there is no correlation between the Panel's DCF results for the companies in their sample group and the credit ratings of these companies. Thus, the conclusion that the DCF result should be "adjusted" not only lacks a theoretical basis; it is not borne out by the Panel's own data.

RDM

Q. Does the Panel suggest a reduction in allowed ROE if an RDM is put in place for O&R?

A. Yes. The Panel states (p. 51) that "by eliminating this uncertainty, the Company's prospective cash flows and earnings will be more predictable. Consequently, equity investors will gain greater clarity with regard to the future dividend potential of the Company, and the Company's equity becomes a less risky investment." Therefore, the Panel recommends a reduction in the allowed return.

Q. Do you agree with this proposition?

A. I do not. There are several problems with this proposition, which I will address in turn.

First, the statement somehow implies that (a) there is a significant concern about the impact of weather and other RDM-related factors among investors and (b) concerns about the health of the Company will be alleviated by the imposition of an RDM, to such an extent that equity investors would rather accept a lower return that face these risks.

We meet extensively with both equity and fixed income investors and read the analyses of sell-side analysts. This concern that weather and growth rates will threaten the Company's dividend is not one that we have seen or heard expressed and we certainly have seen no evidence that the investors would welcome such a tradeoff.

The Panel appears to consider risk—or more correctly, volatility—as a bad thing that investors wish to avoid. In fact, equity investors consider naturally-occurring volatility (away from regulation) as bi-directional. To the extent that volatility produces a higher expected value, equity investors will prefer it relative to a less volatile investment with a lower expected return. What the Panel proposes is to lower

volatility that the investors already accept and replace it with the certainty of lower returns. For utilities where regulators already do not offer market-competitive returns on historic tangible book equity investments, the opportunities to make even modest increases in expected value through weather are critical to valuation. In early discussions with real investors, there is little appetite for the Panel's proposition.

The assumption that a significant risk reduction will occur with the imposition of an RDM is faulty. Cold weather and variability in usage are risks (volatilities) that are very seldom even mentioned in any analyst's (whether equity or fixed-income) review of key downside risks for Con Edison and its subsidiaries. They are extremely unlikely to lead to any long-term negative impact on earnings or stock price and extremely unlikely to affect the dividend. It is unclear why an investor would prefer a situation where the increased stresses of an unusually hot summer are not counterbalanced to some extent by the opportunity to earn correspondingly higher revenues.

Second, an RDM is likely to increase regulatory

risks, particularly the downside risk of the Commission denying timely recovery if deferred balances become too large. The Commission has yet to decide upon the specific features of any RDM (or indeed whether any RDM will be instituted at all). There has been no recent experience with RDMs in New York, and thus no history of their impact and the pressures that might be brought to bear to alter their operation to the detriment of the Company. The fact that RDMs may have been implemented for certain utilities' gas operations provides no dispositive evidence as to how they may operate in an electric operational context. None of these factors would reduce downside risk in the minds of investors.

Third, there is no evidence, and the Panel has supplied none, that the imposition of an RDM has led to credit ratings upgrades in other electric utilities or that it would do so (or somehow allow us to operate with less equity) in the case of Orange and Rockland. As described on page 52 of Staff's testimony, the impact of the RDM and the recommended ROE reduction is all assumption and speculation, using phrases like "not a lot of credit information available", "we see

no reason that", "absent details regarding the exact nature of the RDM", "believe it is reasonable to assume" and is put forth before the RDM is even fully formulated, let alone tested.

And fourth, as stated before, on theoretical grounds and in terms of the empirical record, there is no link, causal or otherwise, between any difference in credit rating and any need to make an adjustment in required return.

Q. The Panel has repeatedly claimed that O&R has a less-risky regulatory environment than other utilities. Has the Staff's rate case submittal included items that reduce the opportunity to earn extra returns and thus help offset unforeseen cost increases or other contingencies for O&R?

A. Yes. Over the years the Commission has almost entirely eliminated any possibility of higher earnings via incentives, and has imposed penalties in ever increasing amounts.

Moreover, Staff supports the continued implementation of an expanded productivity adjustment and the non-recovery of health care costs that are

greater than inflation.

All this adds to the risk, without any compensating upside potential, for the Company. The RDM, on the other hand, in particular an RDM that would make no adjustments to actual revenues for weather as Staff proposes, does not simply reduce the risk of variations between forecasted and actual sales. It reduces the possibility of increased revenues that has been endemic to O&R's rate structure, which would negatively impact how investors view O&R.

The approach taken by the Staff has been to misstate the real downside risk to O&R in order to force allowed returns lower. The real risk is that O&R will not be able to earn a competitive return as its return is reduced to bond-like levels. The RDM, along with the penalties and the lack of positive incentives and potential under-recovery of health care costs would in effect make the investment in O&R's equity a bond-with-downside. The rational equity investor will price this proposed offer at a dramatic discount to the value it would attribute to true equity, and even at a material discount to how it

would value a more ordinary utility rate of return with symmetric volatility in actual returns. The Panel's proposal creates a far riskier investment than one with a reasonable return with normally distributed results both upward and downward from the expected return.

FIXED-INCOME CREDIT QUALITY ISSUES

Q. Please discuss the Panel's comments concerning the rating agencies.

A. The Panel makes several assertions concerning the opinions and expected actions of the rating agencies. These include assertions about what the agencies are saying about O&R's current financial health and O&R's ability to continue to maintain its current ratings, and what might happen should O&R become subject to an RDM.

Q. Do you agree with the Panel's comments in these areas?

A. No. I believe that the Panel understates the risks to O&R and overstates and/or misstates the potential impact of an RDM on that risk. As stated in detail in my direct testimony (pp. 16-20), the agencies have mentioned the outcome of the current rate cases at O&R

and CECONY as key to the continued health of the credit ratings. It should be remembered that O&R has already been downgraded by Moody's and is on Negative Outlook at S&P.

Q. What did Moody's say about the strength of Orange & Rockland's credit ratios?

A. In "Rating Action: Orange and Rockland Utilities, Inc." (September 5, 2006 at page 1) Moody's says:

> The downgrades of O&R and RECO reflect financial performance that is weaker than average for the rating category. In comparison to other regulated electric utilities with similar risk profiles, actual 2005 financial performance, and projected financial metrics for 2006 to 2008, are more consistent with the lower rating. O&R's interest coverage and total debt coverage from cash flow were 3.9x and 14% respectively in calendar 2005. RECO's cash flow to interest was 3.8x and cash flow to debt was 16.5% in calendar year 2005. The ratings also consider the potential for lower operating resilience given the relatively small scale of the companies' stand-alone operations and revenue generating capacity.

COMPARABLE RATES OF RETURN

Q. Please discuss the Panel's comments concerning the data you presented in Exhibit __ (E-9 Schedules 1 and 2) showing the inadequacy of rates of return in New York State vs. other jurisdictions.

A. The Panel criticized the conclusion by stating (p. 69) that other factors such as credit ratings may have led to the consistently lower allowed rates of return granted by New York State vs. other jurisdictions.

Q. Do you agree with this criticism?

A. I do not. The Panel did not demonstrate that the data is biased by these other factors; it did not because it appears it could not. For example, the Panel has claimed that the failure to differentiate the companies in the sample by their credit ratings, led me to an incorrect conclusion that New York is allowing lower rates of return than other jurisdictions. I disagree with this conclusion on two grounds. First, as discussed above, debt ratings do not purport to measure or determine, nor do they measure or determine, equity returns. Second, I was unable to find evidence in the data provided of jurisdictions granting higher rates of return to companies with lower debt ratings.

Q. Have you prepared an exhibit demonstrating this point?

A. Yes, I have. Exhibit __ (JEP-3) (using the data previously included in my Exhibit __(E-9)) shows the allowed rates of return granted in 2005 and 2006 for

several utilities, including three New York electric companies, as compared with their bond ratings. As can be seen, there is no pattern of higher-rated utilities receiving a lower allowed rate of return.

Q. Have you also looked at another measure of risk?

A. Yes. In Exhibit __ (JEP-4) I have looked at allowed rates of return versus the percentage of equity in the regulatory capital structure. Again, there is no pattern that utilities with less equity were allowed a higher ROE. In fact, there is some evidence that the contrary is true.

Q. Do you agree with the Panel's characterization (p. 67) of New York regulation as "supportive"?

A. I believe that the public evidence I found indicated to the contrary, particularly when the focus was on equity holders, which is the group that we are concerned with when we discuss required returns. For example, the RRA ranking puts New York regulation squarely in the middle of the utility regulation spectrum, with an Average 2 ranking, the middle segment of average. RRA notes: "In the absence of a rate settlement, the Commission has, historically,

authorized ROEs that are relatively low versus nationwide averages. In addition, the authorized ROEs that have been incorporated in recent rate plan agreements have been significantly below industry averages".

Lehman Brothers also provides a ranking, most recently published in May 2007, entitled "Power and Utilities - Capital Complications." This publication ranks commissions by their degree of shareholder support. This ranking places the New York regulation 42nd out of the 48 commissions it ranked.

Q. Please summarize your testimony concerning the Finance Panel's comments on allowed returns and risk.

A. In my testimony, I have shown that the Panel's testimony is conceptually flawed in a way that significantly both misstates and understates what a fair return on historic tangible book equity is in the current economy. Further, I have demonstrated the extent to which the Panel's testimony is contorted to avoid a proper analysis of the subject upon which the Commission must rule. With respect to the adjustments proposed by the Panel, I noted that their own data do not support these adjustments and that the concepts of

adjusting equity returns based on debt metrics has no basis in theory, logic, or empirical evidence. In addition, I have refuted their claim that O&R is at low risk for rating agency action and their claim that proposals embedded in Staff's proposed rate result tend to further lower that risk. The Panel's position seems designed to offer the current and future providers of equity capital to O&R a bond-with-downside. As shown in Exhibit __ (E-9, Schedule 3) attached to my initial testimony, which compares S&P 500 data, CEI today offers a bottom-decile return potential as measured on the basis on which the Commission establishes returns: tangible book equity value. There is a limited market for such a modest return proposition—a market that relies on the very high current income offered and the continuing belief that because a business is regulated, it will be provided with fair returns and predictable regulatory behavior. The Panel's proposal if adopted would further reduce the potential pool of capital for O&R and push CEI further into the bottom-decile of its economy-wide peers.

PAST HISTORY VS. PRESENT CHALLENGES

Q. In its testimony (p. 68), the Panel stated that "We agree that it is important for the Company to have access to the financial markets on reasonable terms. To this end, we have recommended a capital structure and cost rates that are consistent with this objective" and "this Commission has never prohibited the Company from raising capital on reasonable terms." Do you agree with this statement?

A. No. Our concern is with our future need to raise capital, not past performance. This rate case sets prospective rates for O&R that are supposed to permit it to raise capital at reasonable rates in the future. As has been mentioned above, the rating agencies have expressed concern about our credit quality, and have pinned our ability to maintain our ratings on the granting of a reasonable rate increase consistent with the Company's infrastructure investment program.

A significant part of our projected capital raising is our ability to raise equity. As has been discussed above, debt ratings are not an indicator of risk to equity investors, nor are they indicative of the cost to raise equity. The most apt measure of the cost-effectiveness of equity issuance for an entity

whose return is set based on its historic book equity investment is the market/book ratio at which it sells stock. I provide a comparison of CEI to other companies in the economy (as evidenced by the S&P 500 which includes 80% of the market capitalization of the United States) as Exhibit __ (JEP-5) that demonstrates that CEI fares poorly. CEI is ranked 480 out of the 499 companies with positive market to book ratios on this Exhibit. I have also prepared an Exhibit which compares market to book ratios and free cash flow for CEI to those for other firms in the Finance Panel's proxy group (Exhibit __ (JEP-6)), a select group similarly subject to the impact of rate-of-return regulation.

As can be seen from the Exhibit, even within a group that is subject to significant circularity, Con Edison has a market/book ratio in the bottom 27% of the utilities in the Finance Panel's proxy group. A low market/book ratio means that issuing equity, which O&R must do to maintain its credit standing, is relatively more expensive, in spite of the Finance Panel's claims that its recommended cost rates are consistent with the objective of giving the Company

"access to the financial markets on reasonable terms". This comparison is made only against the proxy group which the Finance Panel selected. In line with my earlier comments on circularity, this means that we are only comparing our result to those of companies subject to similar regulation, not to companies of similar risk in other industries. As a further comparison, as described on page 15 above, Merrill Lynch's model implies that the S&P index itself will earn more than 31% on its book equity, versus the Staff's proposed 8.9%.

The poor relative health of CEI is also shown when looking at free cash flow, where it is second to last. Cash flow is the key to moderating financing needs and to maintaining credit quality.

Q. Please comment on recent events and how they have reinforced the need for a strong financial condition at O&R.

A. The recent turmoil in the financial markets, which has no source in the operations of the Company or of the utility industry, has shown how fragile access to the markets can be. Long-term bond spreads have widened by as much as 70 basis points for very good credits

and much more for poorer credits. On the short end of the maturity spectrum, access to commercial paper markets became difficult or sometimes impossible for all but prime borrowers, and we are on the edge of losing that status, with a split A-2/P-1 (Moody's/Standard and Poor's) rating for commercial paper. The last few months have demonstrated the importance of maintaining a strong credit rating and investor confidence can be.

Staff has suggested a rate of return lower than that of the rest of the industry, based on incomplete analyses and adjustments not supported by fact or theory. In addition, they have asked for penalties which could further reduce the return and increase the risk of the Company while not offering offsetting opportunities to earn when we perform well. As the Panel stated in its testimony (p. 6), the Commission's responsibility in setting capital returns is to provide a fair rate of return that assures the Company of access to the capital markets on reasonable terms. The Panel's testimony does not demonstrate that this standard has been met.

O&R respectfully submit that while we do not want to adopt the role of psychologist or mind reader, the Staff seems emboldened by the Company's past ability to continue to raise capital and that the Staff seems to be "pushing the envelope" on rate of return. At some point Staff needs to realize continually pushing down on rate of return will have undesired results.

The Company is very much focused on our future ability to raise capital not its past ability to do so. We emphasize that not only is our ability to raise capital critical solely in terms of sustaining the Orange and Rockland utility system but that it is also becoming increasingly apparent, as the Commission moves toward a regime of mandated utility contracts as a means of financing generation investment and evidences an intent to continue to have the utilities serve as the "strong link" in the industry as between competitive retail providers and wholesale merchants, that the maintenance of the utility's financial integrity is vital to the entire industry. Staff's continuing downward movement on capital costs is

inconsistent with the need to maintain the Company's financial integrity.

Q. Does this complete your rebuttal testimony?

A. Yes, it does.

BY MR. CARLEY:

Q. Now, along with your rebuttal testimony, Mr. Perkins, you also submitted six exhibits which are premarked as Exhibit JEP-1, which is a one-page document. One-page document marked as JEP-2. Another one-page document marked as Exhibit JEP-3. Another one-page document which is marked as Exhibit JEP-4. And a multi-page document marked as Exhibit JEP-5. And lastly a one-page document marked as JEP-6.

Do you have copies of those before you?

A. I do.

Q. These exhibits were prepared by you or under your direction?

A. Yes.

Q. Do you have any changes to make to these exhibits?

A. I do not.

MR. CARLEY: Your Honor, at this point in time I would ask that Exhibits JEP-1 through JEP-6 be marked as Exhibits 60 through 65.

JUDGE LYNCH: Motion is granted.

(Exhibits 60 through 65 marked for identification.)

Q. Mr. Perkins, just one additional update matter

that I would like you to speak to briefly on the record. In your rebuttal testimony you mentioned a transaction whereby Con Edison Development had agreed to sell the vast majority of its electric generating plants; is that correct?

A. That's correct.

Q. I have handed you a document, which is a Con Edison publicity release, dated December 10, 2007. Talking about this transaction--and do you have a copy of that before you?

A. I do.

Q. Although this was not prepared by you are you familiar with the comments? Have you seen them before?

A. Yes, to both questions.

Q. In that document which I have handed you which announces this transaction, the last sentence in the first paragraph says that the sale is expected to be completed in two stages during the first half of 2008; is that correct?

A. That is correct.

Q. As I said before, this document notes that the sale of Consolidated Edison Development's generating assets is scheduled to be completed during the first half of 2008.

My question to you, Mr. Perkins, is: To the best of your knowledge, and given the fact that the press release was dated December 10th and it's now February 6th, is it still your understanding that the schedule is to complete this transaction during the first half of 2008?

A. Yes.

MR. CARLEY: Your Honor, I would ask this document, which is the Con Edison press release dated December 10, 2007, which is a three-page document, be marked for identification as Exhibit 66.

JUDGE LYNCH: Let me ask: The witness is aware that the transaction is likely to take place in 2008, the first part of 2008, is that the important fact?

MR. CARLEY: Yes, Your Honor.

JUDGE LYNCH: I don't know what else is in here and he didn't prepare it, so I am a little nervous about that.

MR. CARLEY: He's familiar and he's read it and he agreed with its contents.

JUDGE LYNCH: He did. You agreed with its contents?

THE WITNESS: I did.

JUDGE LYNCH: This will be Exhibit 66 for identification.

(Exhibit 66 marked for identification.)

MR. CARLEY: Thank you, Your Honor.

Mr. Perkins is available for cross-examination.

JUDGE LYNCH: Okay. At this point I have got an indication from the Town of Ramapo and from DPS staff. Are there others?

Why don't we start with the town, the county, and then staff.

MR. ST. LAWRENCE: Thank you, Your Honor.

CROSS EXAMINATION

BY MR. ST. LAWRENCE:

Q. Good morning, Mr. Perkins.

A. Good morning.

Q. Mr. Perkins, I just want to ask a couple questions about the Lovett Generating Facility. Yesterday we had testimony from Mr. Regan that there were some shared facilities on that site, and the potential of that site being closed in April 2008.

Are you familiar with that?

A. Yes, I am.

Q. There are also two tax exempt issues that--the

1994 and 1995 A bonds that are part of the pollution control debt, correct?

A. That is correct.

Q. If that plant were to close in 2008 then those would have to be dealt with and refinanced or paid off?

A. We don't know that at this point. It's a question of the tax exemption and it's a question of how the IRS would view this.

We are pursuing trying to keep the bonds in place because they are a benefit to O&R and its ratepayers, so at this point we don't know the answer to that.

Q. In your rebuttal testimony you made an assumption or you spoke about if you did have to replace the bonds in 1994 it would cost about $400,000?

A. There is several costs involved. There is a cost involved in reissuing the debt.

Q. That's the '95, just on the '94 bonds.

A. The 1994 bonds also have a swap that has to be terminated. These bonds were swapped actually before issuance back in...

Q. '92?

A. 1992. They replaced a ten and a quarter percent bond. And in doing so, they were swapped ahead of issuance at what was an attractive fixed rate of 6.09

percent.

The swap has been in place since then, and the swap is mark to market monthly actually, and at this point in time the swap is approximately or at least at the point in time when I did the rebuttal testimony about $11 million. That cost would have to be incurred if the particular series of bonds was retired.

Q. If I understand, then, the '94s could be potentially about $400,000, and they then swap and the '95As that was kind of rolling up the debt would be about $11 million?

A. The swaps on the '94A.

Q. And that would be about $11 million on the swap?

A. Correct.

Q. If that plant were not closed up, then the swap--then those costs would not be incurred, they would just continue along at the market rate of the swap until the final maturity date?

A. There is a whole series of events here, and I can't simply say that that would work. That's one of the issues.

An issue that has arisen since then is an issue, and I think everybody is familiar with what's happening with the bond insurance--I am sorry--with the mortgage

market and the bond insurers that cover those mortgage markets.

These bonds are insured by a bond insurer. If the bond insurer's rating declined sufficiently a swap might have to be called as well. So, there are two issues involved--potentially two issues involved on the swap.

Q. Which one of the insurance companies--do you know which one has the backing, Ambac?

A. Either Ambac or FGIC. The two issues have two different insurance policies. Certainly can get it for you. I don't remember right now.

Q. That's fine. So there is a savings that goes on then with the swap that goes to the ratepayers each year?

A. In effect what happened was these were originally 10 and a quarter percent bonds. They were refinanced at 6.09 percent. That's the savings that goes to the ratepayer.

The swap cost represents a difference between the bond floating rate issuance and the rate that we are paying. We are basically locked. This is a fixed rate. We, the predecessor company O&R, locked it in back in '92.

Q. The 6.09?

A. That is correct.

Q. There has been a savings then from that spread?

A. Correct. Between that and the 10 percent. There has been four percent, roughly four percent savings every year on $55 million.

Q. And that would continue to the--do you know what the maturity is on those?

A. 2014, I am going to say.

Q. Now, if the Lovett plant were not to close, although it is scheduled to close, if it were not to close, and these would pretty much stay in place, other than the insurance that you spoke about, and the callability with the Ambac Insurance?

A. That, plus conceivably there would be issues with O&R's own rating. It's a complex agreement but, in effect, those are the two key issues, right.

JUDGE LYNCH: You just said Ambac Insurance. I thought he said it was one or the other.

Q. Whichever, generically I meant that.

So, you had stated in your rebuttal testimony that any of these costs would have to be put into future rate case, so if nothing were to happen other than what's happening in the subprime and those effects, then

this would all be status quo if the plant did not close?

A. Yes. Definitely if the plant did not close. Perhaps even if the plant closes. That's something we are working with the IRS on.

MR. ST. LAWRENCE: Just one more question, if I may, Your Honor.

Q. Let's say the plant were not to close.

A. I am sorry. I want to correct that. At the present time we are not working with the IRS. We are working with our own tax attorney, but will probably become an IRS issue at some point if we choose to pursue it, need to pursue it.

Q. Once again, the need to pursue would not happen if the plant remained open?

A. That is correct.

Q. That would be then a considerable savings to the ratepayers if that plant were not to close.

A. Correct.

Q. Am I doing the math right on saying it would be about $11,400,000?

A. Correct. Again, that assumes that the closing or something subsequent to closing would trigger this. At the present time, we don't believe it would trigger this, but it's an issue that we are bringing up with a

tax attorney.

MR. ST. LAWRENCE: Thank you very much.

JUDGE LYNCH: Mr. Klucsik.

BY MR. KLUCSIK:

Q. Mr. Perkins, I have got just a question with respect to your testimony on revenue decoupling mechanism.

A. Okay.

Q. At page 33 of your rebuttal testimony you suggest that the implementation of the revenue decoupling mechanism would result in the risk of the Commission would delay or deny the Company's recovery of deferred RDM balance; is that correct?

A. I said it was a possibility, correct.

Q. Why do you think that's a risk?

A. I think in any case where there is a deferral of any sort of revenue, there is an associated risk that it may not be recovered.

Q. And is that true with respect to other deferrals of the Company?

A. Do you mean is it true it's happened or is it true there is a risk? It's true there is always a risk with any deferrals because there is always the possibility of a decision not to let that revenue flow

through.

Q. Do you regard that risk as it relates to an RDM to be greater than the risk for other deferrals?

A. No. What I guess I would say, though, is that the RDM is a non-tested mechanism, so any untested mechanism conceivably could have a higher risk.

Q. The staff has cited an opinion from Moody's that local gas distribution companies that have or will have revenue decoupling stand a better chance than others in maintaining their credit ratings or stabilizing their credit outlook.

How does that influence your view as to whether the risk of RDM is greater or lesser than other deferrals, or has some experience to guide us on the risk of an electric RDM?

A. There is a couple issues here first. One is that gas companies have a different situation with an RDM. Gas companies are more driven by weather. Also, gas companies, to the best of my knowledge, have had a decline in usage per customer in recent years.

So, and as far as I know, many gas companies are strong supporters of RDM. They see it for themselves as a risk reduction mechanism.

There are very few electric companies that have

had it. There's very little experience and almost none or none maybe even in several years in New York State on the electric side. So I think we are talking about two different animals.

Q. Would you agree with me that the principal attraction of an RDM mechanism is to reduce the risk that's associated with declines in per customer usage?

A. To a gas company, yes, definitely.

Q. Why is that not true with respect to an electric company?

A. Because, for one thing, electric companies haven't been seeing this. It's not seen by their investors as a risk. And I think one of the issues with electric companies, and I can't speak to gas companies, is there is always concern that at times when there is heavier usage, let's say, due to weather conditions, there's also heavier costs inflicted.

So, again, absent any experience with electric companies, not much nationwide, almost none, and none in New York State, it's difficult for us to see exactly how this would work and how it would help us.

Q. Did I understand you to say that investors are not seeing a risk or not recognizing a risk from a reduction in per customer usage?

A. If there was per customer usage reduction, I have not seen--we haven't seen that as an issue with investors in electric companies, partially, I guess, or largely because it hasn't happened.

And, again, because they haven't--they haven't experienced nor do they see the risk. They see the risk in capital programs, in large capital programs, and recovery of large capital programs.

Q. If investors are not seeing or recognizing the risk related to decrease in per customer usage, doesn't that undercut the proposition that there is risk to the RDM program?

A. It sounds like a double--I am not sure what you are getting at. I think what you are saying is the investors aren't seeing risk in what the underlying problem, what the RDM is dealing with.

If they don't see risk in that, then they just don't see risk in that. They wouldn't see a need for an RDM.

Q. My point is--let me ask you this question: If investors don't see that risk, then would your position be the same relative to risk of deferral or denial on an RDM program, revenues covered by an RDM program?

A. I guess I don't make the connection because you

are asking about a risk in the underlying operations of the utility, and then you are saying does that reduce my concern with the risk of an untested program to deal with a problem that investors don't see.

I don't see how that reduces the risk to a utility on either side.

MR. KLUCSIK: Thank you, Mr. Perkins.

Nothing further, Your Honor.

JUDGE LYNCH: Staff.

MS. JOSS: Thank you.

BY MS. JOSS:

Q. Good morning, Mr. Perkins.

A. Good morning.

Q. On page 5 of your rebuttal testimony you state that the Commission has established a new policy direction in its National Grid/KeySpan merger order; is that correct?

A. Yes.

Q. You suggest specifically that that new policy direction is that consolidated capital structures will not be used in the determination of utility's subsidiary capitalization so long as the utility subsidiaries maintain an investment grade rating.

Is that your understanding?

A. What I'm saying--I think they have established--the Commission has established in different cases different directions. What I am saying is that in this particular case they have apparently said that under certain circumstances, at least under certain conditions, they are willing to not look at the consolidated structure.

Q. Isn't it correct that the disposition of the capital structure in the National Grid/KeySpan order was the result of a Joint Proposal?

A. That's my understanding.

Q. Mr. Perkins, while you don't expressly state it in your testimony, is it your position that the rate treatment afforded Orange & Rockland in this proceeding should result in the Company maintaining its A rating?

A. Are you saying that what we think should be the result of this proceeding is a rate order that allows us, Orange & Rockland, to keep our A rating? I agree.

Q. Thank you. You mention on page 2 of your direct testimony that you manage the relationships with credit rating agencies with respect to Consolidated Edison, Inc. and its subsidiaries.

So, is it fair to say that you are quite familiar with their analytic approaches?

A. I am reasonably. They keep certain things somewhat under wraps, or they change certain things, but reasonably acquainted.

Q. Turning to page 19 of your direct testimony.

A. Yes.

Q. You indicate and provide a quote from S&P concerning the Company's financial ratios, correct?

A. Correct.

Q. Do you know whether S&P looks at the consolidated financial ratios of electric utility holding companies when determining a utility company's rating?

A. S&P operates somewhat differently than Moody's and Fitch. They look at the consolidated numbers, correct.

Q. Turning to page 7 and 8 of rebuttal, you state that Staff did not factor in observable market practice for the financing of independent competitive electric companies.

Would you please explain what you mean by the term "independent competitive electric companies"?

A. Yes. It's companies that aren't associated with significant utility investments. I think I gave a couple examples, two or three examples.

I'm sorry. Which page?

MR. CARLEY: Page 8.

A. Page 8 of the rebuttal?

Q. Yes.

A. Yes.

Q. Does that include companies that own power plants and sell electricity in competitive markets in the US?

A. Correct.

Q. Continuing on page 8 of your rebuttal, is it correct that you state that the staff finance panel does not provide evidence of the commonness of A rated competitive generation business because such ratings are very uncommon?

A. Yes.

Q. You further indicate that such businesses generally do not have investment grade ratings. By that I assume you mean ratings in the BB category and lower; is that correct?

A. Correct.

Q. On page 14 of your rebuttal testimony you discuss the current costs in terms of spread requirement for the Company's debt securities if they were issued today; is that correct?

A. On page 14?

Q. On page 14.

A. Of the rebuttal?

Q. I am sorry. It's page 16.

A. Yes. When we say "today", that was today as of the date that I--roughly the date that I submitted the testimony, correct.

Q. So if we showed you the recent cost rates associated with actual issuances of similarly related utility debt you would expect that the spreads required to issue these securities would be reasonably close to your estimates; is that correct?

A. They would be reasonably close. O&R is the relatively small issuer. It is a 144(a) company so it doesn't issue normal. Normally is normal registered debt and it is an infrequent issuer, so there's going to be some difference.

Q. But it would be reasonably close?

A. Depends on what you mean by "reasonable", yes.

Q. I would like to show you a Moody's credit perspective, and I will pass it around as well.

Mr. Perkins, you are familiar with Moody's credit perspectives? You use them in the course of your business?

A. Yes.

Q. Would you agree then on January 7th Duke Energy,

whose Moody's rating is A2, the same as Orange & Rockland's, issued 10 year and 30 year debt securities, and that the spreads required issuing these obligations were 145 basis points for the 10 year debt and 165 basis points for the 30 year debt?

A. I do. I will point out several things. One is that the amount was the index eligible bond. It was a public issue as opposed to 144(a). It was a first mortgage bond and it's a frequent issuer.

Just as a starting point--so that would add quite a bit to those. I would also add that rating spreads have probably increased somewhat since that time, but I think the first point is even more important. There are several differences between these issues and an Orange & Rockland issuance.

JUDGE LYNCH: Since that time meaning January 7th--

THE WITNESS: Again, I can't tell you what a Duke spread would be today. But I said this: As I mentioned, I think the key differences are all the factors that I mentioned between the Duke Energy issue and an Orange & Rockland issue.

Q. So Orange & Rockland would probably be within 30 to 40 basis points of that?

A. My best guess on a 30 year would be a little bit wider than that. I would have to look at where it is today but, again, the 144(a), all the sizes and the first mortgage bond does make a big difference as well. Even with similar ratings there's differences between first mortgage bonds and debentures.

Q. Thank you. If you could turn to the second page, which I believe is page 61.

Would you also agree that on January 11th Southwestern Energy Company, a BA2 rated company, and thus a non-investment grade company, with a rating typical of the competitive generation business, issued 10 year debt obligation, and that the required spread was 368 basis points?

A. Yes.

Q. Would you then agree that, at least under current market conditions, the cost to issue 10 year BA2 rated securities is in the neighborhood of 200 basis points more than the cost to issue A2 rated utility obligations?

A. I will agree that these two have that much spread. And, again, A2, there is a series of things that I said that are different about different A2s that change as a result.

And also you are showing me two different numbers. I don't know the specific position of Southwestern. I will say that these two have a spread of that.

Q. Would you agree that they would at least be in the neighborhood of 200 basis points more?

A. I don't know what "neighborhood" means. Again, you are asking me to generalize on a basis of two specific issues with vastly different other factors besides ratings. All I can say is that that's what that is, it's a wide spread.

Q. Is it your position that Consolidated Edison Inc.'s investment in non-regulated businesses does not have to meet the guidelines that S&P has for such investments to achieve an A rating?

A. Could you rephrase that? I am not sure what you are saying.

Q. Can I restate the question?

A. Sure.

Q. Is it your position that Consolidated Edison, Inc.'s investment in non-regulated businesses does not have to meet the guidelines that S&P has for such investment to achieve an A rating?

A. Consolidated Edison is rated on a consolidated

basis, and there is very--existing conditions, very little of our asset base is non-regulated. They are looking at us as a particular risk class, which is basically the same risk class as our utilities, and their rating is on a consolidated basis. So they are not really rating--we don't have a rating on the non-regulated assets.

Q. So, would that be a yes, since there is no rating on them?

A. It's kind of neither, because what it's saying is that they are not rated so they are not looking at them. They have no basis for looking at them separately.

Q. Would you be willing to agree that, subject to check, that Mr. Hoglund had agreed with that statement in the Con Edison electric hearings?

A. Again, I don't know what the question was asked and the answer. Subject to check. I mean I would have to see what was said, sure.

Q. So you would accept it subject to check?

A. Yes.

Q. Yet isn't it true that you believe Orange & Rockland's ratepayers should support financial ratios strong enough to ensure an A rating from S&P even while Consolidated Edison, Inc.'s non-regulated investments

may be financed in such a way that would achieve an A rating if they were stand alone entities?

A. There is a couple of issues I would address with this. The first issue is--I think maybe one of the important ones is that during the peak rate year, as we have talked about, these assets will not--this large amount of these non-regulated assets will not exist.

It will not be the same level of debt. It's significantly lower debt for equity in the non-regulated business.

So, during the rate year, what we are projecting, they are not going to be supporting that. In fact, as I say in my rebuttal testimony, in some sense applying your methodology to the non-regulated will be supporting the regulated in terms of equity.

Q. Could you please turn to page 22 of your rebuttal testimony. You state that the essential flaw in the staff finance panel's cost of equity analysis is the application of market derived values to book values on which the Commission sets returns.

Is that an accurate statement?

A. Yes.

Q. Do you recall whether Dr. Morin's recommended ROE was based on market values or book values?

A. His methodology, while it differs in many ways from the staff methodology, is based on market values as well, but it is weighted different. The DCF is weighted less. It's another major change.

Q. But it is based on market values?

A. That is correct.

Q. Do you know whether company witness Kane applied that market based return to the book value of the Company or to the market value of the Company?

A. I am sure he applied it to the book value of the Company because that's the standard that it's applied to.

Again, we are not arguing that it shouldn't be applied to book. We are arguing that the staff inherently understates, because it's a market value calculation, understates the required return on book.

Q. Could you please turn to page 32 of your rebuttal testimony. You state that Staff's assumption that a significant risk reduction will occur with the imposition of an RDM is faulty; is that true?

A. That is correct.

Q. You are aware that in a December 17th credit opinion regarding Con Ed, Moody's stated that the RDM proposed in the Con Ed electric proceeding would be

considered credit positive because it would enhance the utility's ability to earn its regulated authorized ROE?

A. I agree that's what they said. And, again, if you look at it carefully, and you look at anything they publish, at no point does it actually say it will give us a higher rating.

And we believe as well, and we have had discussions after this publication with Moody's, that they are misinterpreting how an RDM would be applied. And we wait to see what they do when it's actually applied and whether it actually impacts any sort of rating decision.

Q. Could you turn to page 35 of your rebuttal testimony. You state that the RDM would reduce the possibility of increased revenues that has been endemic to O&R's rate structure and that would negatively impact how investors view O&R.

What do you mean by "endemic"?

A. Well, there is always the possibility with a warm summer and a warm summer there is always more expenses, there's more risk of things going wrong because you have more pressure on the system, that there is a compensation by higher revenues.

That's always been true, and in a normal

situation it would always be true. And the word "endemic" really means that in a normal situation they are going to have variances in weather. They are going to have warm summers and cold summers.

Q. Among other things, your sales forecast assumes normal weather; does it not?

A. It's my understanding. I am not an expert on it.

Q. Therefore, cooler than normal weather and resulting lower revenues are just as likely; are they not?

A. I don't know how forecasting works. I assume that there is a likelihood of cooler weather and also, especially in the summer, be somewhat lower cost I would assume, too.

MS. JOSS: Just one minute.

Q. I just have a few more questions for you.

You stated that with respect to RDM that deferral of revenues creates a risk of not recovering the revenues. Are you referring to deferrals that are later eliminated as part of a negotiated agreement in the rate case?

A. I wasn't specifically referring--I guess what I am saying in general, if there is a deferral of revenues, there is a possibility that for any of a

number of reasons there could be a--these revenues could not be collected in cash, they could be deferred for a further period of time.

One of the issues that we have looking at the rating agency side is always they are looking at cash. They are not looking at what we get on the books as profit.

So any time there is a risk of deferrals, there is a concern with that on our side that we wouldn't collect on the rating agency side.

Q. Could you please state under what circumstances the Commission would deny a recovery of revenues deferred as part of the RDM?

A. I don't know. Again, there could be any--there could be a circumstance that I can't anticipate. Certainly with any form of deferral there could be a reason.

There could be, I don't know, a disagreement with us over something in terms of the booking of the revenues. I don't know what it would be.

Q. Do you have any specific example that you could provide?

A. It could happen. Any of the number of reasons they could say that -- I don't know. I can't think of

specific reasons, but let's say the Commission was looking at it and thought there was some other issue and they decided to keep the deferral around until an issue was resolved. A measurement issue, an interpretation of the tariff, any of these things.

Q. Did I correctly hear you state that the RDM is untested with respect to electric utilities?

A. I think what I said is that there is very little experience with RDMs. In researching what I could research on it, there were only two or three utilities in the country.

There is previous experience I guess in New York State many, many years ago, but this particular RDM, which has not been codified yet, there's no experience with. So, there is little in one case and none in this specific case of this RDM.

Q. Are you familiar with any of the RDMs adopted by the Commission in the 1990s?

A. No.

Q. Didn't Con Edison and Orange & Rockland have RDMs for their electric operations in the 1990s?

A. I understand there were some forms of mechanism there. I am not familiar with them, and I don't know how they relate to any of the proposals in this case.

MS. JOSS: Thank you. We have no further questions for Mr. Perkins at this time.

JUDGE LYNCH: Redirect.

MR. CARLEY: Just a few short questions.

REDIRECT EXAMINATION

BY MR. CARLEY:

Q. Mr. Perkins, just following up on staff's questions about the possible circumstances that the Company would not be allowed to recover deferrals that accumulated as a result of the RDM.

It's possible, isn't it, that if the deferral levels get large enough that there might be political pressure brought to bear on the Commission to use various means to disallow certain of those costs?

A. Yeah, I really honestly wasn't thinking. I was thinking in terms of technical questions. Certainly, if it became a significant impact on ratepayers there might be pressure to do so, and there's past history with things like the NUG contracts where recoveries were deferred, so there are certainly those circumstances.

Again, I was thinking more of coming up with the answers to a technical question under which the Commission would do this.

Q. Isn't it true that certain people in the utility

industry view the disallowances in the past the Commission was involved in, regarding such things as nuclear plants or NUG plants, although they were justified on the grounds of prudence, really had more to do with political pressure being brought to bear on the Commission?

A. Yes, I mean that's one of the risks.

MS. JOSS: Objection, Your Honor. The witness really isn't an expert on politics.

MR. CARLEY: I asked him, your Honor, whether there was perception by certain people in the utility industry where this was the case.

Again, they are talking about risks here and particular perceptions by third parties, rating agencies, others, particularly in light of the things that happened not just in New York but also across the country.

JUDGE LYNCH: Why don't you confine your questions to rating agencies. Does that seem reasonable? The fact that anybody--

THE WITNESS: Investors?

MR. CARLEY: Fair enough, Your Honor.

BY MR. CARLEY:

Q. Mr. Perkins, if you could respond in light of the

views of investors in rating agencies.

A. I think there is always a concern with deferrals because deferrals always lead to the potential for a large rate increase in the future, or any rate case in the future over and above costs directly tied to let's say the new rate year there's always a concern on the part of people that analyze investments, whether they are rating agencies or investors, people will be politically motivated not to allow those deferrals to be collected, yes, definitely.

MR. CARLEY: We have no further questions, Your Honor.

JUDGE LYNCH: Okay. Thank you very much. You are excused. We are going to recess until five minutes after 11:00.

(Recess taken.)

JUDGE LYNCH: Mr. Carley.

MR. CARLEY: At this point I call Dr. Morin to the stand.

ROGER A. MORIN, after first having been duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. CARLEY:

Q. Dr. Morin, you previously submitted in this

proceeding 63 pages of prefiled written direct testimony.

Do you have a copy of that testimony before you?

A. Yes.

Q. Was this testimony prepared by you or under your direction?

A. Yes.

Q. Do you have any corrections to make to your direct testimony?

A. Yes. I have one minor correction and one major correction. The minor correction is on page 28, line 8. The .89 should read .91.

JUDGE LYNCH: This is your direct?

A. I am on the direct testimony, page 28, line 8, the number should read .91.

On line 9, the 7.2 percent should read 7.4 percent. This is a typographical error. The correct inputs were in fact used.

In terms of a more major change, since I prepared my testimony, which was based on data from last summer, there have been some appreciable changes in our capital.

Q. Dr. Morin, excuse me. I don't mean to be rude.

Why don't we get your rebuttal testimony in first and then go back to that.

A. All right.

Q. With those changes to your direct testimony, if I were to ask you the questions set forth in your direct testimony would your answers be the same?

A. Yes.

MR. CARLEY: Your Honor, I would ask that Dr. Morin's prefiled written direct testimony in this proceeding be written into the record as if given orally.

JUDGE LYNCH: Motion is granted.

(The following is the prefiled testimony of Dr. Morin:)

INTRODUCTION

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

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

Q. Please describe your educational background.

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

Q. Please summarize your academic and business career.

A. I have taught at the Wharton School of Finance, University of Pennsylvania, Amos Tuck School of Business at Dartmouth College, Drexel University, University of Montreal, McGill University, and Georgia State University. I was a faculty member of Advanced Management Research International, and I am currently a faculty member of The Management Exchange Inc. and Exnet, where I continue to conduct frequent national executive-level education seminars throughout the United States and Canada. In the last thirty years, I have conducted numerous national seminars on "Utility Finance," "Utility Cost of Capital," "Alternative Regulatory Frameworks," and on "Utility Capital Allocation," which I have developed on behalf of The Management Exchange Inc.

in conjunction with Public Utilities Reports, Inc.

I have authored or co-authored several books, monographs, and articles in academic scientific journals on the subject of finance. They have appeared in a variety of journals, including The Journal of Finance, The Journal of Business Administration, International Management Review, and Public Utility Fortnightly. I published a widely-used treatise on regulatory finance, Utilities' Cost of Capital, Public Utilities Reports, Inc., Arlington, Va. 1984. My second book on regulatory matters, Regulatory Finance, is a voluminous treatise on the application of finance to regulated utilities and was released by the same publisher in late 1994. A revised and expanded edition, The New Regulatory Finance, was published in 2006. I have engaged in extensive consulting activities on behalf of numerous corporations, legal firms, and regulatory bodies in matters of financial management and corporate litigation. Exhibit RAM-1 describes my professional credentials in more detail.

Q. Have you previously testified on cost of capital before regulatory bodies?

A. Yes, I have been a cost of capital witness before nearly fifty (50) regulatory bodies in North America, including the New York State Public Service Commission ("NYPSC"), the Federal Energy Regulatory Commission and the Federal Communications Commission. I have testified before regulatory bodies in the following states:

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

The details of my participation in regulatory proceedings are provided in Exhibit RAM-1.

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

A. The purpose of my testimony in this proceeding is to present an independent appraisal of the fair and reasonable rate of return on the common equity capital invested in Orange and Rockland Utilities, Inc.'s ("O&R" or the "Company") electric delivery operations in the State of New York. Based upon this appraisal, I have formed my professional judgment as to a return on such capital that would: (1) be fair to customers, (2) allow the Company to attract equity capital on reasonable terms, (3) maintain the Company's financial integrity, and (4) be comparable to returns offered on comparable risk investments. I will testify in this proceeding as to the basis for that opinion.

This testimony and accompanying schedules were prepared by me or under my direct supervision and control. The source documents for my testimony are Company records, public documents, and my personal knowledge and experience.

Q. Please briefly identify the schedules and appendices accompanying your testimony.

A. I have attached to my testimony Exhibit RAM-1 through Exhibit RAM-8 and Appendices A, B and C. These Schedules and Appendices relate directly to points in my testimony, and are described in further detail in connection with the discussion of those points in my testimony.

Q. Please summarize your findings and recommendation.

A. I recommend the adoption of a rate of return on common equity of 11.2% on O&R's electricity delivery operations. My recommendation is derived from studies that I performed using the Capital Asset Pricing Model ("CAPM"), Risk Premium, and Discounted Cash Flow ("DCF") methodologies. I performed two CAPM analyses, one using the plain vanilla CAPM and another using an empirical approximation of the CAPM ("ECAPM"). I performed two risk premium analyses: (1) a historical risk premium analysis on the electric utility industry, and (2) a study of the risk premiums allowed in the electric utility industry. I also performed DCF analyses on two surrogates for the Company's electricity delivery business. They are: a group of investment-grade electricity delivery utilities and a group consisting of the companies that make up Moody's Electric Utility Index.

My recommended rate of return reflects the application of my professional judgment to the indicated returns from my CAPM, Risk Premium, and DCF analyses.

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

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

I. Regulatory Framework and Rate of Return;

II. Cost of Equity Estimates; and

III. Summary and Cost of Equity Recommendation.

The first section discusses the rudiments of rate of return regulation and the basic notions underlying rate of return. The second section contains the application of CAPM, Risk Premium, and DCF tests. The third section summarizes the results from the various approaches used in determining a fair return.

I. REGULATORY FRAMEWORK AND RATE OF RETURN

Q. What economic and financial concepts have guided your assessment of O&R's cost of common equity?

A. Two fundamental economic principles underlie the appraisal of the Company's cost of equity, one relating to the supply side of capital markets, the other to the demand side. According to the first principle, a rational investor is maximizing the performance of his portfolio only if he expects the returns earned on investments of comparable risk to be the same. If not, the rational investor will switch out of those investments yielding lower returns at a given risk level in favor of those investment activities offering higher returns for the same degree of risk. This principle implies that a company will be unable to attract the capital funds it needs to meet its service demands and to maintain financial integrity unless it can offer returns to capital suppliers that are comparable to those achieved on competing investments of similar risk. On the demand side, the

second principle asserts that a company will continue to invest in real physical assets if the return on these investments exceeds or equals the company's cost of capital. This concept suggests that a regulatory commission should set rates at a level sufficient to create equality between the return on physical asset investments and the company's cost of capital.

Q. How does O&R's cost of capital relate to that of its parent company, Consolidated Edison, Inc. ("ConEd")?

A. I am treating O&R's electric delivery operations as a separate stand-alone entity, distinct from its holding company, ConEd, because it is the cost of capital for O&R's electric utility business that we are attempting to measure and not the cost of capital for ConEd's consolidated activities. Financial theory establishes that the true cost of capital depends on the use to which the capital is put, in this case O&R's electric delivery operations in the State of New York. The specific source of funding an investment and the cost of funds to the investor are irrelevant considerations.

For example, if an individual investor borrows money at the bank at an after-tax cost of 8% and invests the funds in a speculative oil extraction venture, the required return on the investment is not the 8% cost but, rather, the return foregone in speculative projects of similar risk, say 20%. Similarly, the required return on O&R is the return foregone in comparable risk electric delivery operations, and is unrelated to the parent's cost of capital. The cost of capital is governed by the risk to which the capital is exposed and not by the source of funds. The identity of the shareholders has no bearing on the cost of equity, be it either individual investors or a parent holding company.

Just as individual investors require different returns from different assets in managing their personal affairs, corporations behave in the same manner. A parent company normally invests money in many operating companies of varying sizes and varying risks. These operating subsidiaries pay different rates for the use of investor capital, such as for long-term debt capital, because investors recognize the differences in capital structure, risk, and prospects between subsidiaries. Thus, the cost of investing funds in an operating utility company such as O&R is the return foregone on investments of similar risk and is unrelated to the investor's identity.

Q. Under traditional cost of service regulation, please explain how a regulated company's rates should be set.

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

Funds can be obtained in two general forms, debt capital and equity capital. The cost of debt funds can be easily ascertained from an examination of the contractual interest payments. The cost of common equity funds, that is, investors' required rate of return, is more difficult to estimate. It is the purpose of the next section of my testimony to estimate O&R's cost of common equity

capital.

Q. Dr. Morin, what must be considered in estimating a fair rate of return on common equity capital ("ROE")?

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

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

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

1. Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

2. Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944).

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

"A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties ... The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties." (Emphasis added)

The Hope case expanded on the guidelines to be used to assess the reasonableness of the allowed return. The Court reemphasized its statements in the Bluefield case and recognized that revenues must cover "capital costs." The Court stated:

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

The United States Supreme Court reiterated the criteria set forth in Hope in Federal Power Commission v. Memphis Light, Gas & Water Division, 411 U.S. 458 (1973), in Permian Basin Rate Cases, 390 U.S. 747 (1968), and most recently in Duquesne Light Co. vs. Barasch, 488 U.S. 299 (1989). In the Permian cases, the Supreme Court stressed that a regulatory agency's rate of return order should:

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

Therefore, the "end result" of the Commission's decision should be to allow O&R the opportunity to earn a return on equity that is: (1) commensurate with returns on investments in other firms having corresponding risks, (2) sufficient to assure confidence in the Company's financial integrity, and (3) sufficient to maintain the Company's creditworthiness and ability to attract capital on reasonable terms.

Q. How is the fair rate of return determined?

A. The aggregate return required by investors is called the "cost of capital." The cost of capital is the opportunity cost, expressed in percentage terms, of the total pool of capital employed by the utility. It is the composite weighted cost of the various classes of capital (i.e., bonds, preferred stock, common stock) used by the utility, with the weights reflecting the proportions of the total capital that each class of capital represents. The fair return in dollars is obtained by multiplying the rate of return set by the regulator by the utility's "rate base." The rate base is essentially the net book value of the utility's plant and other assets used to provide utility service in a particular jurisdiction.

While utilities like O&R enjoy varying degrees of monopoly in the sale of public utility services, they must compete with everyone else in the free, open market for the input factors of production, whether they be labor, materials, machines, or capital. The prices of these inputs are set in the competitive marketplace by supply and demand, and it is these input prices that are incorporated in the cost of service computation. This item is just as true for

capital as for any other factor of production. Since utilities and other investor-owned businesses must go to the open capital market and sell their securities in competition with every other issuer, there is obviously a market price to pay for the capital they require, for example, the interest on debt capital, or the expected market return on common and/or preferred equity.

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

A. The concept of a fair return is intimately related to the economic concept of "opportunity cost." When investors supply funds to a utility by buying its stocks or bonds, they are not only postponing consumption, giving up the alternative of spending their dollars in some other way, they also are exposing their funds to risk and forgoing returns from investing their money in alternative comparable-risk investments. The compensation that they require is the price of capital. If there are differences in the risk of the investments, competition among firms for a limited supply of capital will bring different prices. These differences in risk are translated by the capital markets into price differences in much the same way that differences in the characteristics of commodities are reflected in different prices.

The important point is that the prices of debt capital and equity capital are set by supply and demand, and both are influenced by the relationship between the risk and return expected for the respective securities and the risks expected from the overall menu of available securities.

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

A. The funds employed by the Company are obtained in two general forms, debt capital and equity capital. The latter consists of preferred equity capital and

common equity capital. The cost of debt funds and preferred stock funds can be ascertained easily from an examination of the contractual terms for the interest payments and preferred dividends. The cost of common equity funds, that is, equity investors' required rate of return, is more difficult to estimate because the dividend payments received from common stock are not contractual or guaranteed in nature. They are uneven and risky, unlike interest payments. Once a cost of common equity estimate has been developed, it can then easily be combined with the embedded cost of debt and preferred stock, based on the utility's capital structure, in order to arrive at the overall cost of capital.

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

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

II. COST OF EQUITY ESTIMATES

Q. Dr. Morin, how did you estimate the fair rate of return on common equity for O&R?

A. I employed three methodologies: (1) the CAPM, (2) the Risk Premium, and (3) the DCF. All three items are market-based methodologies and are designed to estimate the return required by investors on the common equity capital committed to O&R.

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

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

As a general proposition, it is extremely dangerous to rely on only one generic methodology to estimate equity costs. The difficulty is compounded when only one variant of that methodology is employed. It is compounded even further when that one methodology is applied to a single company. Hence, several methodologies applied to several comparable risk companies should be employed to estimate the cost of common equity.

Q. Dr. Morin, are you aware that some regulatory commissions and some analysts have placed principal reliance on DCF-based analyses to determine the cost of equity for public utilities?

A. Yes, I am.

Q. Do you agree with this approach?

A. While I agree that it is certainly appropriate to use the DCF methodology to estimate the cost of equity, and I myself do rely on such evidence, there is no

proof that the DCF produces a more accurate estimate of the cost of equity than other methodologies. As I have stated, there are three broad generic methodologies available to measure the cost of equity: DCF, Risk Premium, and CAPM. All three of these methodologies are accepted and used by the financial community and firmly supported in the financial literature.

When measuring the cost of common equity, which essentially deals with the measurement of investor expectations, no one single methodology provides a foolproof panacea. Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the methodology and on the reasonableness of the proxies used to validate the theory and apply the methodology. The failure of the traditional infinite growth DCF model to account for changes in relative market valuation, and the practical difficulties of specifying the expected growth component, are vivid examples of the potential shortcomings of the DCF model. It follows that more than one methodology should be employed in arriving at a judgment on the cost of equity and that all of these methodologies should be applied to multiple groups of comparable risk companies.

There is no single model that conclusively determines or estimates the expected return for an individual firm. Each methodology has its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor. Absent any hard evidence as to which method outperforms the other, all relevant evidence should be used, without discounting the value of any results, in

order to minimize judgmental error, measurement error, and conceptual infirmities. I submit that a regulatory body should rely on the results of a variety of methods applied to a variety of comparable groups. There is no guarantee that a single DCF result is necessarily the ideal predictor of the stock price and of the cost of equity reflected in that price, just as there is no guarantee that a single CAPM or Risk Premium result constitutes the perfect explanation of a stock's price or the cost of equity.

Q. Does the financial literature support the use of more than a single method?

A. Yes. Authoritative financial literature strongly supports the use of multiple methods. For example, Professor Eugene F. Brigham, a widely respected scholar and finance academician, discusses the various methods used in estimating the cost of common equity capital, and states (see E. F. Brigham and M. C. Ehrhardt, Financial Management Theory and Practice, p. 311 (11th ed., Thomson South-Western, 2005):

Three methods typically are used: (1) the Capital Asset Pricing Model (CAPM), (2) the discounted cash flow (DCF) model, and (3) the bond-yield-plus-risk-premium approach. These methods are not mutually exclusive - no method dominates the others, and all are subject to error when used in practice. Therefore, when faced with the task of estimating a company' cost of equity, we generally use all three methods....

Another prominent finance scholar, Professor Stewart Myers, points out (see S. C. Myers, "On the Use of Modern Portfolio Theory in Public Utility Rate Cases: Comment," Financial Management, p. 67, Autumn 1978):

Use more than one model when you can. Because estimating the opportunity cost of capital is difficult, only a fool throws away useful information. That means you should not use any one model or measure mechanically and exclusively. Beta is helpful as one tool in a kit, to be used in parallel with DCF models or other techniques for interpreting capital market data.

Q. DOES THE BROAD USE OF THE DCF METHODOLOGY IN PAST REGULATORY PROCEEDINGS INDICATE THAT IT IS SUPERIOR TO OTHER METHODS?

A. No, it does not. Uncritical acceptance of the standard DCF equation vests the model with a degree of reliability that is simply not justified. One of the leading experts on regulation, Dr. Charles F. Phillips discusses the dangers of relying solely on the DCF model:

> *"[U]se of the DCF model for regulatory purposes involves both theoretical and practical difficulties. The theoretical issues include the assumption of a constant retention ratio (i.e. a fixed payout ratio) and the assumption that dividends will continue to grow at a rate 'g' in perpetuity. Neither of these assumptions has any validity, particularly in recent years. Further, the investors' capitalization rate and the cost of equity capital to a utility for application to book value (i.e. an original cost rate base) are identical only when market price is equal to book value. Indeed, DCF advocates assume that if the market price of a utility's common stock exceeds its book value, the allowable rate of return on common equity is too high and should be lowered; and vice versa. Many question the assumption that market price should equal book value, believing that the earnings of utilities should be sufficiently high to achieve market-to-book ratios which are consistent with those prevailing for stocks of unregulated companies."*
>
> *...[T]here remains the circularity problem: Since regulation establishes a level of authorized earnings which, in turn, implicitly influences dividends per share, estimation of the growth rate from such data is an inherently circular process. For all of these reasons, the DCF model suggests a degree of precision which is in fact not present and leaves wide room for controversy about the level of k [cost of equity].*[5]

Sole reliance on any one model, whether it is DCF, CAPM, or Risk Premium, simply ignores the capital market evidence and investors' use of the other theoretical frameworks. The DCF model is only one of many tools to be

[5] C. F. Phillips, The Regulation of Public Utilities Theory and Practice (Public Utilities Reports, Inc., 1988) pp. 376-77 [Footnotes omitted]

employed in conjunction with other methods to estimate the cost of equity. It is not a superior methodology that should supplant other financial theory and market evidence. The same is true of the CAPM.

Q. Does the DCF model understate the cost of equity?

A. Yes, it does under current capital market conditions. Application of the DCF model produces estimates of common equity cost that are consistent with investors' expected return only when stock price and book value are reasonably similar, that is, when the Market-to-Book (M/B) ratio is close to unity. As shown below, application of the standard DCF model to utility stocks understates the investor's expected return when the M/B ratio of a given stock exceeds unity. This item is particularly relevant in the current capital market environment where utility stocks are trading at M/B ratios well above unity and have been for two decades. The converse is also true, that is, the DCF model overstates the investor's return when the stock's M/B ratio is less than unity. The reason for the distortion is that the DCF market return is applied to a book value rate base by the regulator, that is, a utility's earnings are limited to earnings on a book value rate base.

Q. Can you illustrate the effect of the M/B ratio on the DCF model by means of a simple example?

A. Yes. The simple numerical illustration shown in the table below demonstrates the result of applying a market value cost rate to book value rate base under three different M/B scenarios. The three columns correspond to three M/B situations: the stock trades below, equal to, and above book value, respectively. The last situation (third column of numbers) is noteworthy and representative of the

current capital market environment. The DCF cost rate of 10%, made up of a 5% dividend yield and a 5% growth rate, is applied to the book value rate base of $50 to produce $5.00 of earnings. Of the $5.00 of earnings, the full $5.00 are required for dividends to produce a dividend yield of 5% on a stock price of $100.00, and no dollars are available for growth. The investor's return is therefore only 5% versus his required return of 10%. A DCF cost rate of 10%, which implies $10.00 of earnings, translates to only $5.00 of earnings on book value, a 5% return.

The situation is reversed in the first column when the stock trades below book value. The $5.00 of earnings is more than enough to satisfy the investor's dividend requirements of $1.25, leaving $3.75 for growth, for a total return of 20%. This item occurs when the DCF cost rate is applied to a book value rate base well above the market price.

Therefore, the DCF cost rate significantly understates the investor's required return when stock prices are well above book, as is the case presently.

EFFECT OF MARKET-TO-BOOK RATIO ON MARKET RETURN

	Situation	1	2	3
1	Initial purchase price	$25	$50	$100
2	Initial book value	$50	$50	$50
3	Initial M/B	0.50	1.00	2.00
4	DCF Return 10% = 5% + 5%	10%	10%	10%
5	Dollar Return	$5.00	$5.00	$5.00
6	Dollar Dividends 5% Yield	$1.25	$2.50	$5.00
7	Dollar Growth 5% Growth	$3.75	$2.50	$0.00
8	Market Return	20%	10%	5%

Q. Does the annual version of the DCF model understate the cost of equity?

A. Yes, it does. Another reason why the DCF methodology understates the cost of equity is that the annual DCF model usually employed in regulatory settings assumes that dividend payments are made annually at the end of the year, while most utilities in fact pay dividends on a quarterly basis. Failure to recognize the quarterly nature of dividend payments understates the cost of equity capital by about 30 basis points. By analogy, a bank rate on deposits which does not take into consideration the timing of the interest payments understates the true yield of your investment if you receive the interest payments more than once a year. Since the stock price employed in the DCF model already reflects the quarterly stream of dividends to be received, consistency therefore requires explicit recognition of the quarterly nature of dividend payments. One only has to think of what would happen to a company's stock price if the company was to suddenly announce that it is, from now on, paying dividends once a year at the end of the year instead of four times a year each quarter. Clearly, the stock price would decline by an amount reflecting the lost time value of money.

Q. Do regulators rely primarily on the DCF model?

A. A majority of regulatory commissions, including the NYPSC, do not, as a matter of practice, rely solely on the DCF model results in setting the allowed rate of return on common equity. According to the survey results posted in the Utility Regulatory Policy in the United States and Canada – 1994-1995 Compilation which was conducted by the National Association of Regulatory Utility Commissioners ("NARUC"), regulators utilize a variety of methods and rely on all the evidence submitted.

Q. Do regulators share your reservations on the reliability of the DCF model?

A. Yes, I believe they do. While a majority of regulatory commissions do not, as a matter of practice, rely solely on the DCF model results in setting the allowed ROE, some regulatory commissions have explicitly recognized the need to avoid exclusive reliance upon the DCF model and have acknowledged the need to adjust the DCF result when M/B ratios exceed one[2]. In a recent case involving Pacific Bell Telephone Company, the California Commission (Application No. 01-02-024, Joint Application of ATT Communications, Opinion Establishing Revised Unbundled Network Element Rates at VI.N, October 2004) declined to place any reliance on the DCF method, finding that it was "too dependent on one forecasted input."

My sentiments on the DCF model were echoed in a decision by the Indiana Utility Regulatory Commission (IURC). The IURC recognized its concerns with the DCF model and that the model understates the cost of equity. In Cause No. 39871 Final Order, the IURC states on page 24:

"....the DCF model, heavily relied upon by the Public, understates the cost of common equity. The Commission has recognized this fact before. In Indiana Mich. Power Co. (IURC 8/24/90), Cause No. 38728, 116 PUR4th 1, 17-18, we found:

The unadjusted DCF result is almost always well below what any informed financial analyst would regard as defensible, and therefore requires an upward adjustment based largely on the expert witness's judgment."

[2] See the Indiana Utility Regulatory Commission decision in Indiana Mich. Power Co. (IURC 8/24/90), Cause No. 38728, 116 PUR4th 1, 17-18. See also the Iowa Utilities Board decision in U.S. West Communications, Inc. Docket No. RPR-93-9, 152 PUR4th 446, 459 (Iowa 1994). See also the Hawaii Public Utilities Commission decision in Hawaiian Electric Company, Inc., 134 PUR4th 418, 479 (1992). More recently, see the Pennsylvania Public Utility Commission decision in

The Commission also expressed its concern with a witness relying solely on one methodology:

".....the Commission has had concerns in our past orders with a witness relying solely on one methodology in reaching an opinion on a proper return on equity figure." (page 25)

Even more convincing evidence that regulators have in fact not relied on the DCF model exclusively is the fact that M/B ratios have exceeded unity for over two decades. Had regulators relied exclusively on the DCF model, utility stocks would have traded at or near book value. Regulators have "corrected" for this M/B problem by considering alternative methods for estimating capital cost.

Q. Is the usage of the DCF model prevalent in corporate practices?

A. No, not really. The CAPM continues to be widely used by analysts, investors, and corporations. Bruner, Eades, Harris, and Higgins (1998) in a comprehensive survey[3] of current practices for estimating the cost of capital found that 81% of companies used the CAPM to estimate the cost of equity, 4% used a modified CAPM, and 15% were uncertain. In another comprehensive survey conducted by Graham and Harvey (2001), the managers surveyed reported using more than one methodology to estimate the cost of equity, and 73% used the CAPM.[4] Since its introduction by Professor William F. Sharpe in 1964, the CAPM has gained immense popularity as the practitioner's method of choice when estimating cost of capital under

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Pennsylvania-American Water Co., Docket R-00016339, Slip Opinion at http://www.puc.state.pa.us/PcDocs/304982.doc.

[3] Bruner, R. F., Eades, K. M., Harris, R. S., and Higgins, R. C., "Best Practices in Estimating the Cost of Capital: Survey and Synthesis," *Financial Practice and Education,* Vol. 8, Number 1, Spring/Summer 1998, page 18.

[4] Graham, J. R. and Harvey, C. R., "The Theory and Practice of Corporate Finance: Evidence from the Field," *Journal of Financial Economics*, Vol. 61, 2001, pp. 187-243.

conditions of risk.[5] The intuitive simplicity of its basic concept (that investors must get compensated for the risk they assume), and the relatively easy application of the CAPM are the main reasons behind its popularity.

Q. Do the assumptions underlying the DCF model require that the model be treated with caution?

A. Yes, particularly in today's rapidly changing electric utility industry. Even ignoring the fundamental thesis that several methods and/or variants of such methods should be used in measuring equity costs, the DCF methodology, as those familiar with the industry and the accepted norms for estimating the cost of equity are aware, is problematic for use in estimating cost of equity at this time.

Several fundamental structural changes have transformed the energy utility industry since the standard DCF model and its assumptions were developed. For example, deregulation, accounting rule changes, changes in customer attitudes regarding utility services, the evolution of alternative energy sources, highly volatile fuel prices, and mergers-acquisitions have all influenced stock prices in ways that have deviated substantially from the assumptions of the DCF model, which was first formulated in the mid-1970s. These changes suggest that (1) some of the fundamental assumptions underlying the standard DCF model, particularly that of constant growth and constant relative market valuation, for example price/earnings (P/E) ratios and M/B ratios, are problematic at this point in time for utility stocks, and (2) therefore, alternate methodologies to estimate the cost of common equity should be accorded at least as much weight as

[5] See practitioner surveys by Graham & Harvey (2001) and Bruner, et. al. (1988)

the DCF method.

Q. Is the constant relative market valuation assumption inherent in the DCF model always reasonable?

A. No, not always. Caution must be exercised when implementing the standard DCF model in a mechanistic fashion, for it may fail to recognize changes in relative market valuations over time. The traditional DCF model is not equipped to deal with surges in M/B and P/E ratios. The standard DCF model assumes a constant market valuation multiple, that is, a constant P/E ratio and a constant M/B ratio. Stated another way, the model assumes that investors expect the ratio of market price to dividends (or earnings) in any given year to be the same as the current ratio of market price to dividend (or earnings), and that the stock price will grow at the same rate as the book value. This item is a necessary result of the infinite growth assumption. This assumption is unrealistic under current conditions. The DCF model is not equipped to deal with sudden surges in M/B and P/E ratios, as was experienced by utility stocks in recent years.

Q. What is your recommendation given such market conditions?

A. In short, caution and judgment are required in interpreting the results of the standard DCF model because of (1) the effect of changes in risk and growth on electric utilities, (2) the fragile applicability of the DCF model to electric utilities stocks in the current capital market environment, and (3) the practical difficulties associated with the growth component of the standard DCF model. Hence, there is a clear need to go beyond the standard DCF results and take into account the results produced by alternate methodologies in arriving at a common equity recommendation.

Q. Do the assumptions underlying the CAPM require that the model be treated with caution?

A. Yes, as was the case with the DCF model, the assumptions underlying any model in the social sciences, including the CAPM, are stringent. Moreover, the empirical validity of the CAPM has been the subject of intense research in recent years. Although the CAPM provides useful evidence, it must be complemented by other methodologies as well.

Q. Are the assumptions underlying the CAPM any more or less confining than those underlying the DCF model?

A. I believe that the assumptions underlying the CAPM are far less stringent than those underlying the DCF theory. This becomes apparent if we view the CAPM as a special case of the Arbitrage Pricing Model (APM), where the market portfolio is the only factor affecting security prices. The assumptions underlying the APM are far less stringent than the assumptions required for the DCF model to obtain. The APM derives from only two major reasonable assumptions: that security returns are linear functions of several economic factors, and that no profitable arbitrage opportunities exist since investors are able to eliminate such opportunities through risk-free arbitrage transactions. The other assumptions required by the APM are that investors are greedy and risk averse, that they can diversify company-specific risks by holding large portfolios, and that enough investors possess similar expectations to trigger the arbitrage process.

As a tool in the regulatory arena, the CAPM is a rigorous conceptual framework, and is logical insofar as it is not subject to circularity problems, since its inputs are objective, market-based quantities, largely immune to regulatory

decisions. The data requirements of the model are not prohibitive. The CAPM is one of several tools in the arsenal of techniques to determine the cost of equity capital. Caution, appropriate training in finance and econometrics, and judgment are required for its successful execution, as is the case with the DCF and Risk Premium methodologies.

RISK PREMIUM ANALYSES

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

A. In order to quantify the risk premium for O&R, I have performed four risk premium studies. The first two studies deal with aggregate stock market risk premium evidence using two versions of the CAPM methodology and the other two studies deal directly with the electric utility industry.

A. CAPM ESTIMATES

Q. Please describe your application of the CAPM risk premium approach.

A. My first two risk premium estimates are based on the CAPM and on an empirical approximation to the CAPM (ECAPM). The 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:

EXPECTED RETURN = RISK-FREE RATE + 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:

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

This is the seminal CAPM expression, which states that the return required by investors is made up of a risk-free component, R_F, plus a risk premium determined by $\beta(R_M - R_F)$. To derive the CAPM risk premium estimate, three quantities are required: the risk-free rate (R_F), beta (β), and the market risk premium, ($R_M - R_F$). For the risk-free rate, I used 5.3% based on the current levelof long-term Treasury interest rates. For beta, I used 0.89 and for the market risk premium ("MRP"), I used 7.2%. These inputs to the CAPM are explained below.

7.4 9.1

Q. What risk-free rate did you use in your CAPM and risk premium analyses?

A. To implement the CAPM and Risk Premium methods, an estimate of the risk-free return is required as a benchmark. As a proxy for the risk-free rate, I have relied on the current level of 30-year Treasury bond yields.

The appropriate proxy for the risk-free rate in the CAPM is the return on the longest term Treasury bond possible. This is because common stocks are very long-term instruments more akin to very long-term bonds rather than to short-term or intermediate-term Treasury notes. In a risk premium model, the ideal estimate for the risk-free rate has a term to maturity equal to the security being analyzed. Since common stock is a very long-term investment because the cash flows to investors in the form of dividends last indefinitely, the yield on the longest-term possible government bonds, that is the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM. The expected common stock return is based on very long-term cash flows, regardless

of an individual's holding time period. Moreover, utility asset investments generally have very long-term useful lives and should correspondingly be matched with very long-term maturity financing instruments.

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

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

Among U.S. Treasury securities, 30-year Treasury bonds have the longest term to maturity and the yield on such securities should be used as proxies for the risk-free rate in applying the CAPM, provided there are no anomalous conditions existing in the 30-year Treasury market. In the absence of such conditions, I have relied on the yield on 30-year Treasury bonds in implementing the CAPM and risk premium methods.

Q. Dr. Morin, why did you reject short-term interest rates as proxies for the risk-free rate in implementing the CAPM?

A. Short-term rates are volatile, fluctuate widely, and are subject to more random disturbances than are long-term rates. Short-term rates are largely administered rates. For example, Treasury bills are used by the Federal Reserve as a policy vehicle to stimulate the economy and to control the money supply, and are used by foreign governments, companies, and individuals as a temporary safe-house for money.

As a practical matter, it makes no sense to match the return on common stock to the yield on 90-day Treasury Bills. This is because short-term rates, such as the yield on 90-day Treasury Bills, fluctuate widely, leading to volatile and unreliable equity return estimates. Moreover, yields on 90-day Treasury Bills typically do not match the equity investor's planning horizon. Equity investors generally have an investment horizon far in excess of 90 days.

As a conceptual matter, short-term Treasury bill yields reflect the impact of factors different from those influencing the yields on long-term securities such as common stock. For example, the premium for expected inflation embedded into 90-day Treasury Bills is likely to be far different than the inflationary

premium embedded into long-term securities yields. On grounds of stability and consistency, the yields on long-term Treasury bonds match more closely with common stock returns.

Q. What is the current level of U.S. Treasury 30-year bonds?

A. The yield on U.S. Treasury 30-year bonds prevailing in June 2007, as reported in Value Line and the Federal Reserve Bank Web site, was 5.3%. Accordingly, I use 5.3% as my estimate of the risk-free rate component of the CAPM.

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

A. A major thrust of modern financial theory as embodied in the CAPM is that perfectly diversified investors can eliminate the company-specific component of risk, and that only market risk remains. The latter is technically known as "beta", or "systematic risk". The beta coefficient measures the change in a security's return relative to that of the market. The beta coefficient states the extent and direction of movement in the rate of return on a stock relative to the movement in the rate of return on the market as a whole. The beta coefficient indicates the change in the rate of return on a stock associated with a one percentage point change in the rate of return on the market, and, thus, measures the degree to which a particular stock shares the risk of the market as a whole. Modern financial theory has established that beta incorporates several economic characteristics of a corporation which are reflected in investors' return requirements.

Technically, the beta of a stock is a measure of the covariance of the return on the stock with the return on the market as a whole. Accordingly, it measures dispersion in a stock's return which cannot be reduced through diversification. In abstract theory for a large diversified portfolio, dispersion in

the rate of return on the entire portfolio is the weighted sum of the beta coefficients of its constituent stocks.

O&R is not publicly traded and, therefore, proxies must be used for O&R. As a first proxy for the Company's beta, I have examined the betas of a sample of widely-traded investment-grade electric utilities designated as distribution utilities by S&P covered by Value Line and with at least 50% of their revenues from electric utility operations. This group is examined in more detail later in my testimony, in connection with the DCF estimates of the cost of common equity. As displayed on page 1 of Exhibit RAM-2, the average beta for the group is currently 0.91.

I also examined the average beta of the companies that make up Moody's Electric Utility Index as a second proxy for the Company. As shown on page 2 of Exhibit RAM-2, the average beta of the Moody's group is 0.93. If those companies with less than 50% of their revenues from electric utility operations are removed from the group, the average beta of the remaining companies is also 0.93, as shown on page 3 of Exhibit RAM-2. If American Electric Power's beta is removed, the average beta of the remaining Moody's companies is 0.91, the same as the electricity distribution group's beta. Based on these results, I shall use 0.91 as a beta estimate for O&R's electricity delivery operations.

Q. What MRP estimate did you use in your CAPM analysis?

A. For the MRP, I used 7.4%. This estimate was based on the results of both forward-looking and historical studies of long-term risk premiums. First, the Ibbotson Associates study, Stocks, Bonds, Bills, and Inflation, 2007 Yearbook, compiling historical returns from 1926 to 2006, shows that a broad market sample

of common stocks outperformed long-term U. S. Treasury bonds by 6.5%. The historical MRP over the income component of long-term Treasury bonds rather than over the total return is 7.1%. Ibbotson Associates recommend the use of the latter as a more reliable estimate of the historical MRP, and I concur with this viewpoint. The historical MRP should be computed using the income component of bond returns because the intent, even using historical data, is to identify an expected MRP. The more accurate way to estimate the MRP from historic data is to use the income return, not total returns on government bonds, as explained at pages 75-77 of Ibbotson Associates, Stocks, Bonds, Bills, and Inflation: Valuation Edition, 2007 Yearbook. This is because the income component of total bond return (i.e., the coupon rate) is a far better estimate of expected return than the total return (i.e., the coupon rate + capital gain), as realized capital gains/losses are largely unanticipated by bond investors. The long-horizon (1926-2005) MRP (based on income returns, as required) is specifically calculated to be 7.1% rather than 6.5%.

Second, a DCF analysis applied to the aggregate equity market using Value Line's aggregate stock market index and growth forecasts indicates a prospective MRP of 7.6%. The average of the historical (7.1%) and prospective estimates (7.6%), which is 7.4%, provides a reasonable estimate of the MRP.

Historical Market Risk Premium

Q. On what maturity bond does the Ibbotson historical risk premium data rely on?

A. Because 30-year bonds were not always traded or even available throughout the entire 1926-2005 period covered in the Ibbotson Associate Study of historical returns, the latter study relied on bond return data based on 20-year Treasury

bonds. To the extent that the normal yield curve is virtually flat above maturities of 20 years over most of the period covered in the Ibbotson study, the difference in yield is not material. In fact, the difference in yield between 30-year and 20-year bonds is actually negative. The average difference in yield over the 1977-2006 period is 13 basis points, that is, the yield on 20-year bonds is slightly higher than the yield on 30-year bonds.

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

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

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

To the extent that the estimated historical equity risk premium follows what is known in statistics as a "random walk," the best estimate of the future risk premium is the historical mean. Since I found no evidence that the MRP in common stocks has changed over time, that is, no significant serial correlation in the Ibbotson study, it is reasonable to assume that these quantities will remain stable in the future.

Prospective Market Risk Premium

Q. Please describe your prospective approach in deriving the MRP in the CAPM analysis.

A. For my prospective estimate of the MRP, I applied a DCF analysis to the aggregate equity market using Value Line's VLIA software. The dividend yield on the dividend-paying stocks that make up the Value Line Composite Index made up of over 7,000 stocks is currently 0.26% (VLIA 05/2007 edition), and the average projected long-term growth rate is 12.43%. Adding the dividend yield to the growth component produces an expected return on the aggregate equity market of 12.69%. Following the tenets of the DCF model, the spot dividend yield must be converted into an expected dividend yield by multiplying it by one plus the growth rate. This brings the expected return on the aggregate equity market to 12.72%. Recognition of the quarterly timing of dividend payments rather than the annual timing of dividends assumed in the annual DCF model brings the MRP estimate to approximately 12.92%. Subtracting the risk-free rate of 5.30% from the latter, the implied risk premium is 7.62% over long-term U.S. Treasury bonds. The average of the historical (7.1%) and prospective MRP (7.6%) is 7.4%.

As a check on the MRP estimate, I examined a 2003 comprehensive article published in Financial Management (see 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).

These authors provide estimates of the prospective expected returns for S&P 500 companies over the period 1983-1998. They 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. The prevailing risk-free rate for each year was then subtracted from the expected rate of return for the overall market to arrive at the market risk premium for that year. The table below, drawn from Table 2 of the aforementioned study, displays the average prospective risk premium estimate (Column 2) for each year from 1983 to 1998. The average MRP estimate for the overall period is 7.2%, which is very close to my own estimate of 7.4%.

Year	DCF Market Risk Premium
1983	6.6%
1984	5.3%
1985	5.7%
1986	7.4%
1987	6.1%
1988	6.4%
1989	6.6%
1990	7.1%
1991	7.5%
1992	7.8%
1993	8.2%
1994	7.3%
1995	7.7%
1996	7.8%
1997	8.2%
1998	9.2%
MEAN	**7.2%**

Q. What is your risk premium estimate of O&R's cost of equity using the CAPM approach?

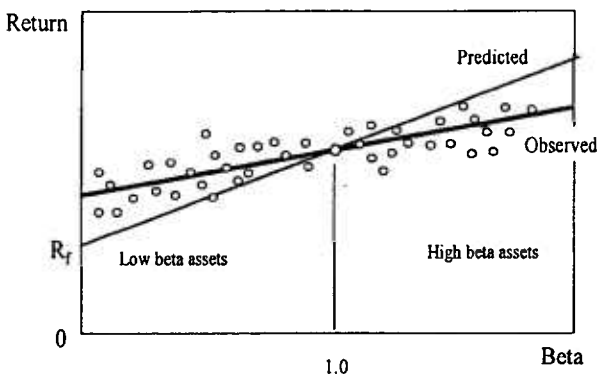
A. Inserting those input values in the CAPM equation, namely a risk-free rate of 5.3%, a beta of 0.91, and a MRP of 7.4%, the CAPM estimate of the cost of common equity for O&R is: 5.3% + 0.91 x 7.4% = 12.0%. This estimate becomes 12.3% with flotation costs. The need for a flotation cost allowance is discussed later in my testimony.

Q. What is your risk premium estimate using the ECAPM?

A. There have been countless empirical tests of the CAPM in the finance literature in order to determine to what extent security returns and betas are related in the manner predicted by the CAPM. This literature is summarized in Chapter 13 of my 1994 book, Regulatory Finance, and Chapter 6 of my latest book, The New Regulatory Finance, both published by Public Utilities Report Inc. The results of

the tests support the idea that beta is related to security returns, that the risk-return tradeoff is positive, and that the relationship is linear. The contradictory finding is that the risk-return tradeoff is not as steeply sloped as the predicted CAPM. That is, empirical research has long shown that low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted. A CAPM-based estimate of cost of capital underestimates the return required from low-beta securities and overstates the return required from high-beta securities, based on the empirical evidence. This is one of the most well-known results in finance, and it is displayed graphically below.

CAPM: Predicted vs Observed Returns



A number of variations on the original CAPM theory have been proposed to explain this finding. The ECAPM makes use of these empirical findings. The ECAPM estimates the cost of capital with the equation:

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

where $\acute{\alpha}$ is the "alpha" of the risk-return line, a constant, MRP is the market

risk premium ($R_M - R_F$), and the other symbols are defined as usual. Inserting the long-term risk-free rate as a proxy for the risk-free rate, an alpha in the range of 1% - 2%, and reasonable values of beta and the MRP in the above equation produces results that are indistinguishable from the following more tractable ECAPM expression:

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

An alpha range of 1% - 2% is somewhat lower than that estimated empirically. The use of a lower value for alpha leads to a lower estimate of the cost of capital for low-beta stocks such as regulated utilities. This is because the use of a long-term risk-free rate rather than a short-term risk-free rate already incorporates some of the desired effect of using the ECAPM. That is, the long-term risk-free rate version of the CAPM has a higher intercept and a flatter slope than the short-term risk-free version which has been tested. This is also because the use of adjusted betas rather than the use of raw betas also incorporates some of the desired effect of using the ECAPM. Thus, it is reasonable to apply a conservative alpha adjustment.

Q. Is the use of the ECAPM consistent with the use of adjusted betas?

A. Yes, it is. Some have argued that the use of the ECAPM is inconsistent with the use of adjusted betas, such as those supplied by Value Line. This is because the reason for using the ECAPM is to allow for the tendency of betas to regress toward the mean value of 1.00 over time, and, since Value Line betas are already adjusted for such trend, an ECAPM analysis results in double-counting. This argument is erroneous. Fundamentally, the ECAPM is not an adjustment,

increase or decrease, in beta. This is obvious from the fact that the observed return on high beta securities is actually lower than that produced by the CAPM estimate. The ECAPM is a formal recognition that the observed risk-return tradeoff is flatter than predicted by the CAPM based on myriad empirical evidence. The ECAPM and the use of adjusted betas comprised two separate features of asset pricing. Even if a company's beta is estimated accurately, the CAPM still understates the return for low-beta stocks. Even if the ECAPM is used, the return for low-beta securities is understated if the betas are understated. Referring back to the previous graph, the ECAPM is a return (vertical axis) adjustment and not a beta (horizontal axis) adjustment. Both adjustments are necessary. Moreover, the use of adjusted betas compensates for interest rate sensitivity of utility stocks not captured by unadjusted betas, as explained in Appendix A.

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

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

Inserting 5.3% for the risk-free rate R_F, a MRP of 7.4% for $(R_M - R_F)$ and a beta of 0.91 in the above equation, the ROE is 12.2% without flotation costs and 12.5% with flotation costs.

Q. Dr. Morin, please summarize your CAPM estimates.

A. The table below summarizes the common equity estimates obtained from my CAPM studies. The average CAPM result is 12.4%.

CAPM	% ROE
CAPM plain	12.3%
Empirical CAPM	12.5%
AVERAGE	12.4%

B. HISTORICAL RISK PREMIUM

Q. Please describe your historical risk premium analysis of the electric utility industry.

A. As a proxy for the risk premium applicable to the Company, I estimated the historical risk premium for the electric utility industry with an annual time series analysis applied to the industry as a whole, using *Moody's Electric Utility Index* as an industry proxy. The analysis is depicted on Exhibit RAM-3. The risk premium was estimated by computing the actual realized return on equity capital for Moody's Index for each year, using the actual stock prices and dividends of the index, and then subtracting the long-term government bond return for that year. Data for this particular index was unavailable beyond 2002 following the acquisition of Moody's by Mergent.

As shown on Exhibit RAM-3, the average risk premium over the period was 5.5% over historical long-term Treasury bond returns and 5.6% over long-term Treasury bond yields. Given that the risk-free rate is 5.3%, the implied cost of equity for the average electric utility from this particular method is 5.3% + 5.6% = 10.9% without flotation costs and 11.2% with flotation costs.

Q. How does the inclusion of recent risk premium data alter these results?

A. The historical risk premium analysis for the electric utility industry stops in 2002 because the market data on the Moody's Electric Utility Index were discontinued following the acquisition of Moody's by Mergent in 2002. In view of the rising risk premium allowed by regulators documented in the next section of my testimony, it would not be unreasonable to expect that the current utility risk premium exceeds the historical average. I did examine more recent historical bond return and equity return data based on the S&P Electric Utility Index instead of Moody's Electric Utility Index. The addition of 2002-2005 data does not alter the historical risk premium appreciably. This result is not surprising in view of the rising equity market and low interest rate environment in the 2003-2005 period.

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

A. Yes, they are. Risk Premium analyses are widely used by analysts, investors, and expert witnesses. Most college-level corporate finance and/or investment management texts including Investments by Bodie, Kane, and Marcus, McGraw-Hill Irwin, 2002, which is a recommended textbook for CFA (Chartered Financial Analyst) certification and examination, contain detailed conceptual and empirical discussion of the risk premium approach. The latter is typically recommended as one of the three leading methods of estimating the cost of capital. Professor Brigham's best-selling corporate finance textbook (Financial Management: Theory and Practice, 11th ed., South-Western, 2005), recommends the use of risk premium studies, among others. Techniques of risk premium analysis are widespread in investment community reports. Professional certified financial

analysts are certainly well versed in the use of this method.

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

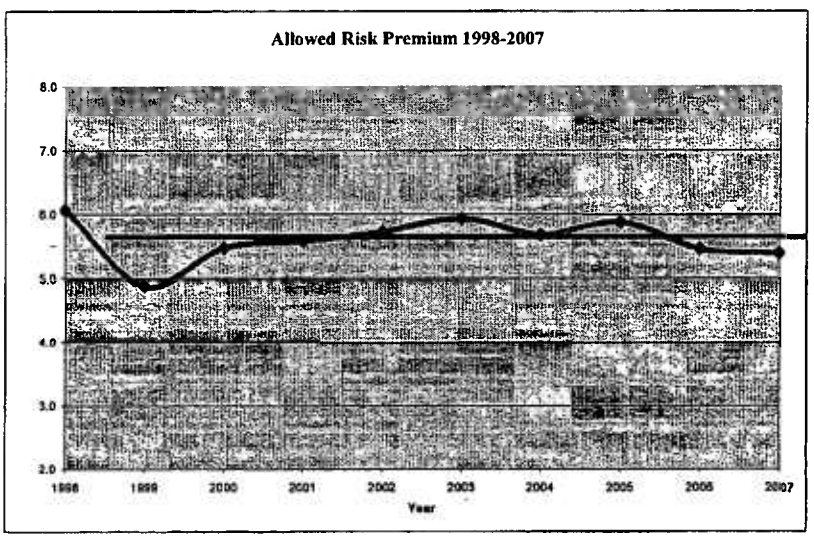
A. No, I am not, for they are no more restrictive than the assumptions that underlie the DCF model or the CAPM. While it is true that the method looks backward in time and assumes that the risk premium is constant over time, these assumptions are not necessarily restrictive. By employing returns realized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

C. ALLOWED RISK PREMIUMS

Q. Please describe your analysis of allowed risk premiums in the electric utility industry.

A. To estimate the Company's cost of common equity, I also examined the historical risk premiums implied in the ROEs allowed by regulatory commissions for electric utilities over the last decade relative to the contemporaneous level of the long-term Treasury bond yield. This variation of the risk premium approach is

reasonable because allowed risk premiums are presumably based on the results of market-based methodologies (DCF, Risk Premium, CAPM, *etc.*) presented to regulators in rate hearings and on the actions of objective unbiased investors in a competitive marketplace. Historical allowed ROE data are readily available over long periods on a quarterly basis from Regulatory Research Associates ("RRA") and easily verifiable from RRA publications and past commission decision archives. The average ROE spread over long-term Treasury yields was 5.6% for the 1998-2007 time period, as shown in the graph below. I note that this estimate is nearly identical to the one obtained from the historical risk premium study of the electric utility industry.



Given the current long-term Treasury bond yield of 5.3% and a risk premium of 5.6%, the implied allowed ROE for the average risk electric utility is 10.9%. No flotation cost adjustment is required here since the return figures are allowed book returns on common equity capital.

Q. Why did you rely on the last decade to conduct your allowed risk premium analysis?

A. Because allowed returns already reflect investor expectations, that is, are forward-looking in nature, the need for relying on long historical periods is minimized. The last decade is a reasonable period of analysis in the case of allowed returns in view of the stability of the inflation rate experienced over the last decade.

Q. Do investors take into account allowed returns in formulating their return expectations?

A. Yes, they do. Investors do take into account returns granted by various regulators in formulating their risk and return expectations, as evidenced by the availability of commercial publications disseminating such data, including Value Line and RRA. Allowed returns, while certainly not a precise indication of a particular company's cost of equity capital, are nevertheless an important determinant of investor growth perceptions and investor expected returns.

Q. Please summarize your risk premium estimates.

A. The table below summarizes the ROE estimates obtained from the three risk premium studies. The average risk premium result is 11.0%.

Risk Premium Method	**ROE**
Historical Risk Premium Electric	11.2%
Allowed Risk Premium	10.9%

D. DCF ESTIMATES

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

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

$$K_e = D_1/P_o + g$$

where: K_e = investors' expected return on equity

D_1 = expected dividend at the end of the coming year

P_o = current stock price

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

The standard DCF formula states that under certain assumptions, which are described in the next paragraph, the equity investor's expected return, K_e, can be viewed as the sum of an expected dividend yield, D_1/P_o, plus the expected growth rate of future dividends and stock price, g. The returns anticipated at a given market price are not directly observable and must be estimated from statistical market information. The idea of the market value approach is to infer 'K_e' from the observed share price, the observed dividend, and an estimate of investors' expected future growth.

The assumptions underlying this valuation formulation are well known, and are discussed in detail in Chapter 4 of my reference book, Regulatory

Finance, and Chapter 8 of my latest textbook, New Regulatory Finance. The standard DCF model requires the following main assumptions: a constant average growth trend for both dividends and earnings, a stable dividend payout policy, a discount rate in excess of the expected growth rate, and a constant price-earnings multiple, which implies that growth in price is synonymous with growth in earnings and dividends. The standard DCF model also assumes that dividends are paid at the end of each year when, in fact, dividend payments are normally made on a quarterly basis.

Q. How did you estimate O&R's cost of equity with the DCF model?

A. I applied the DCF model to two proxies for O&R's electric delivery operations: a group consisting of investment-grade dividend-paying electric distribution utilities with at least 50% of their revenues from regulated operations and a group consisting of those electric utilities that make up Moody's Electric Utility Index.

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

From a conceptual viewpoint, the stock price to employ in calculating the dividend yield is the current price of the security at the time of estimating the cost of equity. The reason is that current stock price provides a better indication of expected future prices than any other price in an efficient market. An efficient market implies that prices adjust rapidly to the arrival of new information. Therefore, the current price reflects the fundamental economic value of a security. A considerable body of empirical evidence indicates that capital markets are

efficient with respect to a broad set of information. This evidence implies that observed current prices represent the fundamental value of a security, and that a cost of capital estimate should be based on current prices.

In implementing the DCF model, I have used the current dividend yields reported in the latest edition of Value Line's VLIA software. Basing dividend yields on average results from a large group of companies reduces the concern that idiosyncrasies of individual company stock prices will result in an unrepresentative dividend yield.

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

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

As proxies for expected growth, I examined growth estimates developed by professional analysts employed by large investment brokerage institutions. Projected long-term growth rates actually used by institutional investors to determine the desirability of investing in different securities influence investors' growth anticipations. These forecasts are made by large reputable organizations, and the data are readily available to investors and are representative of the consensus view of investors. Because of the dominance of institutional investors in investment management and security selection, and their influence on individual investment decisions, analysts' growth forecasts influence investor growth expectations and provide a sound basis for estimating the cost of equity with the DCF model. Growth rate forecasts of analysts are available from published investment newsletters and from systematic compilations of analysts'

forecasts, such as those tabulated by Zacks Investment Research Inc. ("Zacks"). I used analysts' long-term growth forecasts contained in Zacks as proxies for investors' growth expectations in applying the DCF model. I also used Value Line's growth forecast as an additional proxy.

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

A. I have rejected historical growth rates as proxies for expected growth in the DCF calculation because historical growth patterns are already incorporated in analysts' growth forecasts that should be used in the DCF model, and are therefore somewhat redundant.

Q. Did you consider any other method of estimating expected growth in the DCF model?

A. Yes, I did. I considered using the so-called "sustainable growth" method, also referred to as the "retention growth" method. According to this method, future growth is estimated by multiplying the fraction of earnings expected to be retained by the company, 'b', by the expected return on book equity, 'ROE'. That is,

$$g = b \times ROE$$

where: g = expected growth rate in earnings/dividends

b = expected retention ratio

ROE = expected return on book equity

However, I do not generally subscribe to the growth results produced by this particular method for several reasons. First, the sustainable method of predicting growth is only accurate under the assumptions that the ROE is constant

over time and that no new common stock is issued by the company, or if so, it is sold at book value. Second, and more importantly, the sustainable growth method contains a logic trap: the method requires an estimate of ROE to be implemented. But if the ROE input required by the model differs from the recommended return on equity, a fundamental contradiction in logic follows. Third, the empirical finance literature demonstrates that the sustainable growth method of determining growth is not as significantly correlated to measures of value, such as stock prices and price/earnings ratios, as analysts' growth forecasts[6]. I therefore placed no reliance on this method.

Q. Did you consider dividend growth in applying the DCF model?

A. No, not at this time. This reason is that it is widely expected that utilities will continue to lower their dividend payout ratio over the next several years. In other words, earnings are expected to grow faster than dividends in the future.

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

Dividend growth rates are unlikely to provide a meaningful guide to investors' growth expectations for utilities in general. This result is because utilities' dividend policies have become increasing conservative as business risks

[6] *See* Vander Weide & Carleton, "*Investor Growth Expectations: Analysts vs. History*," Jrnl. of Portfolio Mgt., Spring 1988. Timme & Eiseman, "*On the Use of Consensus Forecasts of Growth in the Constant Growth Model: The Case of Electric Utilities*," Financial Mgt, Winter 1989.

in the industry have intensified steadily. Dividend growth has remained largely stagnant in past years as utilities are increasingly conserving financial resources in order to hedge against rising business risks. As a result, investors' attention has shifted from dividends to earnings. Therefore, earnings growth provides a more meaningful guide to investors' long-term growth expectations. Indeed, it is growth in earnings that will support future dividends and share prices.

Q. Is there any empirical evidence documenting the importance of earnings in evaluating investors' expectations in the investment community?

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

Q. Please describe your first proxy group for the Company's electric distribution business?

A. As a first proxy for the Company's electric distribution business, I examined a group of investment-grade utilities designated as electricity distribution utilities by S&P in a recent comprehensive analysis of utility business risks. The original

group is shown on Pages 1 - 2 of Exhibit RAM-4, and includes electricity distribution and natural gas distribution companies engaged in predominantly monopolistic distribution activities. Foreign companies and companies below investment-grade, that is, companies with a bond rating below BBB-, were eliminated as well as those companies without Value Line coverage. Page 3 of Exhibit RAM-4 narrows the group down to only include electricity distribution operating utilities. The final sample of 12 companies is made up of the parent company of these investment-grade operating electricity distribution companies with at least 50% of their revenues from regulated operations, as shown on Page 4 of Exhibit RAM-4. The initial group was utilized earlier in connection with beta estimates. The same group was retained for the DCF analysis.

Q. What DCF results did you obtain for the electricity distribution utilities group using the Value Line growth?

A. As shown on Column 2 of Exhibit RAM-5, the average long-term growth forecast obtained from Value Line is 6.3% for this group. Combining this growth rate with the average expected dividend yield of 3.7% shown in Column 3, produces an estimate of equity costs of 10.0% for the group, unadjusted for flotation costs. Adding an allowance for flotation costs to the results of Column 4 brings the cost of equity estimate to 10.2%, shown in Column 5. Removing CH Energy from the group on account of its cost of equity estimate being less than its cost of long-term debt, the average ROE is 10.6%.

Q. What DCF results did you obtain for the electricity distribution utilities group using the analyst's consensus growth forecast?

A. From the original sample of 12 companies shown on page 1 of Exhibit RAM-6,

CH Energy was eliminated as no analysts' growth forecasts was available from Zacks. For the remaining 11 companies, using the consensus analysts' earnings growth forecast published by Zacks of 7.9% instead of the Value Line forecast, the cost of equity for the group is 11.5%. Allowance for flotation costs brings the cost of equity estimate to 11.7%. This analysis is shown on page 2 of Exhibit RAM-6. In order to palliate the influence of the three companies with high growth estimates of 13% (Northeast Utilities, PPL Corp, and Public Service), the median estimate of 10.5% is a more reasonable estimate.

Q. What DCF results did you obtain for Moody's electric utilities group?

A. Page 1 of Exhibit RAM-7 displays the electric utilities that make up Moody's Electric Utility Index. No growth forecast was available for Progress Energy and Duke Energy, and these two companies were therefore eliminated from the group. As shown on Column 2 of page 2 of Exhibit RAM-7, the average long-term growth forecast obtained from Value Line is 7.3% for this group. Coupling this growth rate with the average expected dividend yield of 3.7% shown in Column 3 produces an estimate of equity costs of 11.0% for the group. Allowance for flotation costs brings the cost of equity estimate to 11.2%. Eliminating the companies with less than 50% of their revenues from regulated electricity operations, the average DCF result for the remaining fourteen companies is 10.5%, as shown on page 3 of Exhibit RAM-7.

Using the consensus analysts' earnings growth forecast of 6.8% from Zacks instead of the Value Line growth forecast, the cost of equity for the Moody's group is 10.5%. Allowance for flotation costs brings the cost of equity estimate to 10.7%. This analysis is displayed on Pages 1 and 2 of Exhibit RAM-

8. No growth projection was available for CH Energy, and that company was therefore eliminated from the group. The results remained unchanged at 10.7% when utility companies with less than 50% of their revenues from utility operations were eliminated from the Moody's group, as shown on page 3 of Exhibit RAM-8.

Q. Please summarize your DCF estimates.

A. The table below summarizes the DCF estimates. The average DCF result is 10.6%.

DCF STUDY	ROE
Electricity Distribution Utilities Value Line Growth	10.6%
Electricity Distribution Utilities Zacks Growth	10.5%
Moody's Electric Utilities Value Line Growth	10.5%
Moody's Electric Utilities Zacks Growth	10.7%

Q. Do DCF results understate the cost of equity for O&R?

A. Yes, they do. As discussed at length earlier, application of the standard DCF model to utility stocks significantly understates the investor's expected return when the M/B ratio of a given stock exceeds 1.0, as is the case presently.

Q. Dr. Morin, please now turn to the need for a flotation cost allowance.

A. All the market-based estimates reported above include an adjustment for flotation costs. The simple fact of the matter is that common equity capital is not free. Flotation costs associated with stock issues are exactly like the flotation costs associated with bonds and preferred stocks. Flotation costs are incurred; they are not expensed at the time of issue and, therefore, must be recovered via a rate of return adjustment. This treatment is done routinely for bond and preferred stock issues by most regulatory commissions, including FERC. Clearly, the common equity capital accumulated by the Company is not cost-free. The flotation cost

allowance to the cost of common equity capital is discussed and applied in most corporate finance textbooks; it is unreasonable to ignore the need for such an adjustment.

Flotation costs are very similar to the closing costs on a home mortgage. In the case of issues of new equity, flotation costs represent the discounts that must be provided to place the new securities. Flotation costs have a direct and an indirect component. The direct component is the compensation to the security underwriter for his marketing/consulting services, for the risks involved in distributing the issue, and for any operating expenses associated with the issue (printing, legal, prospectus, etc.). The indirect component represents the downward pressure on the stock price as a result of the increased supply of stock from the new issue. The latter component is frequently referred to as "market pressure."

Investors must be compensated for flotation costs on an ongoing basis to the extent that such costs have not been expensed in the past, and therefore the adjustment must continue for the entire time that these initial funds are retained in the firm. Appendix B to my testimony discusses flotation costs in detail, and 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; (2) why the flotation adjustment is permanently required to avoid confiscation even if no further stock issues are contemplated; and (3) that flotation costs are only recovered if the rate of return is applied to total equity, including retained earnings, in all future years.

By analogy, in the case of a bond issue, flotation costs are not expensed but are amortized over the life of the bond, and the annual amortization charge is embedded in the cost of service. The flotation adjustment is also 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 same way that the recovery of past investments in plant and equipment through depreciation allowances continues in the future even if no new construction is contemplated. In the case of common stock that has no finite life, flotation costs are not amortized. Thus, the recovery of flotation cost requires an upward adjustment to the allowed return on equity.

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

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

Sometimes, the argument is made that flotation costs are real and should be recognized in calculating the fair return on equity, but only at the time when the expenses are incurred. In other words, the flotation cost allowance should not continue indefinitely, but should be made in the year in which the sale of securities occurs, with no need for continuing compensation in future years. This argument is valid only if the Company has already been compensated for these costs. If not, the argument is without merit. My own recommendation is that investors be compensated for flotation costs on an on-going basis rather than through expensing and that the flotation cost adjustment continue for the entire time that these initial funds are retained in the firm.

There are several sources of equity capital available to a firm including: common equity issues, conversions of convertible preferred stock, dividend reinvestment plan, employees' savings plan, warrants, and stock dividend programs. Each item carries its own set of administrative costs and flotation cost components, including discounts, commissions, corporate expenses, offering spread, and market pressure. The flotation cost allowance is a composite factor that reflects the historical mix of sources of equity. The allowance factor is a build-up of historical flotation cost adjustments associated and traceable to each component of equity at its source. It is impractical and prohibitively costly to start from the inception of a company and determine the source of all present equity. A practical solution is to identify general categories and assign one factor to each category. My recommended flotation cost allowance is a weighted average cost factor designed to capture the average cost of various equity vintages and types of equity capital raised by the Company.

Q. Is a flotation cost adjustment required for an operating subsidiary like O&R that does not trade publicly?

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

III. SUMMARY OF COST OF EQUITY RECOMMENDATION

Q. Please summarize your results and recommendation.

A. To arrive at my final recommendation, I performed four risk premium analyses. For the first two risk premium studies, I applied the CAPM and an empirical approximation of the CAPM using current market data. The other two risk premium analyses were performed on historical and allowed risk premium data from electric utility industry aggregate data. I also performed DCF analyses on two surrogates for O&R: a group of investment-grade electricity distribution utilities and a group representative of the electric utility industry, namely, Moody's Electric Utility Index. The results from all the various tests are summarized in the table below.

METHODOLOGY	ROE
CAPM	12.3%
Empirical CAPM	12.5%
Historical Risk Premium Elec Utility Industry	11.2%
Allowed Risk Premium	10.9%
DCF S&P Elec Distribution Utilities Value Line Growth	10.6%
DCF S&P Elec Distribution Utilities Zacks Growth	10.5%
DCF Moody's Elec Utilities Value Line Growth	10.5%
DCF Moody's Elec Utilities Zacks Growth	10.7%

The average result from all the tests is 11.2%. The average results from each of the three principal methodologies is as follows:

CAPM	12.4%
Risk Premium	11.1%
DCF	10.6%
AVERAGE	11.3%

Q. Did you adjust these results to account for the fact that O&R's risk profile differs from the average electric utility?

A. No, I did not. In my view, O&R's lower business risk on account of its status as a pure "wires" utility unencumbered with the riskier power production function offsets its higher financial risk on account of its very small size. The cost of equity estimates derived from the various comparable groups reflect the risk of the average electric utility. To the extent that these estimates are drawn from a group of companies with significant power production operations and/or significant non-utility businesses, the expected equity return applicable to the O&R is upward-biased. I estimate this upward bias to be of the order of 20 basis points.

Q. Please comment on O&R's size related risks.

A. Because of its relatively small size, in my judgment, O&R's financial risks are higher than those of the industry. O&R possesses small revenue and asset bases, both in absolute terms and relative to other utilities. Investment risk increases as company size diminishes, all else remaining constant. The size phenomenon is well documented in the finance literature, and is fully discussed in Appendix C.

Small companies have very different returns than large ones and on average those returns have been higher. The greater risk of small stocks does not fully account for their higher returns over many historical periods. The average small stock premium is very significant over the average stock, more than could be expected by risk differences alone, suggesting that the cost of equity for small stocks is considerably larger than for large capitalization stocks. In addition to earning the highest average rates of return, small stocks also have the highest volatility, as measured by the standard deviation of returns.

Q. Dr. Morin, have there been any specific references to size as an element in O&R's risk?

A. Yes. Moody's, in its Credit Opinion of September 7, 2006 has made the following comment

> *Moody's also takes into consideration the potential vulnerabilities created by the small size of O&R's customer base and operating revenues. In accordance with Moody's methodology, limited size is a negative credit factor insofar as it reduces operating and financial resilience in the face of prolonged economic adversity or unforeseen event risk.*

On account of these size-related risks, I would normally increase my recommended return by at least 20 basis points in order to recognize O&R's very

small size. This adjustment, however, offsets the aforementioned risk decrement of 20 basis points on account of O&R's status as a pure wires utility.

Q. Dr. Morin, have you taken into account the added risk of a company operating under temporary rates, as is the case for O&R pursuant to the Commission's recent order in this case?

A. No. My recommended return does not take into account the higher risks associated with a company operating under temporary rates, which essentially strip a regulated company from investor protections against retroactive ratemaking. These risks almost certainly result in a higher cost of capital because investors necessarily have a less clear understanding of the financial fundamentals and prospects of a company whose revenues are subject to refund. As a result, my recommended return on equity is conservative.

Q. Dr. Morin, what is your final conclusion regarding O&R's cost of common equity capital?

A. Based on the results of all my analyses, the application of my professional judgment, and the risk circumstances of O&R, it is my opinion that a just and reasonable return on the common equity capital of O&R's electric distribution operations in the state of New York is 11.2%.

Q. Would you now discuss the implications for the allowed return on equity of a stayout for O&R?

A. The Company has informed me that it will be proposing a three-year rate plan. This exposes O&R to the risk that the cost of equity may go up during the course of the rate plan, without the Company having an opportunity to reset the allowed return to reflect such an increase. It seems likely that upward changes in interest

rates may be more likely than downward changes. I am informed that in the past, the Commission has used the differential between 3-year and 1-year Treasury securities to provide guidance as to what the "stayout premium" in such circumstances should be. More specifically, I am informed that the Commission has used one-half of the five-year average differential between (1) a Treasury security reflecting the length of the rate plan and (2) a 1-year Treasury security. The five-year average differential, through the end of June 2007, between 3-year and 1-year Treasury securities is approximately 50 basis points. Half of this differential is about 25 basis points. Thus, a stayout premium in the neighborhood of 25 basis points would be reasonable for O&R.

Q. Dr. Morin, what capital structure assumption underlies your recommended return on O&R's common equity capital?

A. My recommended ROE for O&R is predicated on the adoption of a test year capital structure consisting of approximately 48% common equity capital.

Q. Is there a relationship between financial risk and the authorized ROE?

A. There certainly is. A low authorized ROE increases the likelihood the utility will have to rely increasingly on debt financing for its capital needs. This creates the specter of a spiraling cycle that further increases risks to both equity and debt investors; the resulting increase in financing costs is ultimately borne by the utility's customers through higher capital costs and rates of returns.

Q. Is O&R's financial risk impacted by the authorized ROE?

A. Yes, it is. A low ROE increases the likelihood that O&R will have to rely on debt financing for its capital needs. As the Company relies more on debt financing, its capital structure becomes more leveraged. Since debt payments are a fixed

financial obligation to the utility, this decreases the operating income available for dividend growth. Consequently, equity investors face greater uncertainty about the future dividend potential of the firm. As a result, the Company's equity becomes a riskier investment. The risk of default on the Company's bonds also increases, making the utility's debt a riskier investment. This increases the cost to the utility from both debt and equity financing and increases the possibility the Company will not have access to the capital markets for its outside financing needs, or if so, at prohibitive costs.

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

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

Q. Does this conclude your direct testimony?

A. Yes, it does.

BY MR. CARLEY:

Q. Dr. Morin, along with your direct testimony you submitted a number of exhibits, specifically eight exhibits, which were marked RAM-1, RAM-2, RAM-3, RAM-4, RAM-5, RAM-6, RAM-7 and RAM-8; is that correct?

A. Yes.

Q. These exhibits were prepared by you or under your direction?

A. Yes.

Q. Do you have any changes to make to these exhibits?

A. No changes.

MR. CARLEY: Your Honor, I would ask that the exhibits, which I just referred to, RAM-1 through RAM-8, be marked as exhibits.

JUDGE LYNCH: 67 through 74.

(Exhibits 67 through 74 marked for identification.)

Q. Dr. Morin, in addition to your direct testimony you also submitted prefiled rebuttal testimony of 55 pages in this proceeding; is that correct?

A. Yes.

Q. Do you have a copy of that testimony before you?

A. I do.

Q. Do you have any corrections to make to that rebuttal testimony?

A. No corrections.

Q. Doctor, if I were to ask you the questions set forth in your prefiled rebuttal testimony would your answers be the same?

A. Yes.

MR. CARLEY: Your Honor, I would ask that Dr. Morin's prefiled rebuttal testimony be written into the record as if given orally.

JUDGE LYNCH: The motion is granted.

(The following is the prefiled rebuttal testimony of Dr. Morin:)

Case No. 07-E-0949

Orange And Rockland Utilities, Inc.
Rebuttal Testimony Of Dr. Roger A. Morin

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

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

Q. Did you file direct testimony in this proceeding on behalf of Orange and Rockland Utilities, Inc. ("O&R" or the "Company")?

A. Yes, I did.

Q. What is the purpose of this rebuttal testimony?

A. I will respond to certain statements contained in the direct testimony of the Staff Finance Panel ("Finance Panel") on behalf of the New York State Department of Public Service ("DPS Staff or "Staff").

Q. Please summarize Staff's rate of return recommendation.

A Staff recommends that the New York Public Service Commission ("Commission") grant O&R a Return on Equity ("ROE") allowance of only 8.9%. In determining O&R's cost of common equity capital, Staff applies a two-stage Discounted Cash Flow ("DCF") analysis to a group of 30 electric utilities. For

the first-stage growth component of the DCF analysis, Staff relies on Value Line's forecast dividend estimates over the next few years. For the more important second-stage growth component that drives the vast majority of the DCF results, Staff uses the earnings retention method, also known as the "sustainable growth" method, again using Value Line estimates as input data.

Staff also applies a Capital Asset Pricing Model ("CAPM") and an Empirical CAPM ("ECAPM") (also referred to as a "zero beta" CAPM) analysis to the same group of electric utilities, using an average of 10-year and 30-year Treasury bond yields as proxies for the risk-free rate and Value Line beta estimates. Staff's estimate of the market risk premium ("MRP") component of the CAPM is based on a single Merrill Lynch estimate. Applying a weight of two-thirds to the DCF results and one-third to the CAPM-ECAPM average result, Staff concludes that O&R's cost of common equity capital is only 8.9%, inclusive of a flotation cost allowance of 13 basis points and after a return decrement of 39 basis points in order to account for O&R's superior credit quality and risk-reducing revenue decoupling mechanism ("RDM"). It is not clear as to why the Finance Panel did not simply round their double precision recommendation of 8.9% to 9.0%, given the enormous amount of judgment employed throughout their testimony and the lack of scientific precision of the DCF methodology.

Q. What is your general reaction to Staff's cost of common equity recommendation?

A. My general reaction is that the testimony contains major infirmities. The single-digit ROE recommendation of only 8.9% would be the lowest in the country for a major investor-owned electric utility. Moreover, it rests heavily on the results of a DCF analysis and on a particularly fragile rendition of the DCF approach. The latter is largely based on the questionable results of the sustainable growth version of the DCF model. That method requires Staff to assume the investor's expected ROE. But the latter is precisely what we are trying to determine in this proceeding. It is therefore both illogical and circular to assume an ROE in order to determine an ROE. Not only has Staff relied heavily on a circular methodology but Staff also has put most of its eggs in the DCF basket, which causes Staff to recommend a return that is below investors' required returns. The CAPM and ECAPM analyses are also questionable because of an understated MRP component, as I discuss below.

Q. What are your basic conclusions regarding Staff's cost of equity testimony?

A. A proper application of cost of capital methodologies would provide results substantially higher than those obtained by Staff. As I will explain, several of Staff's errors alone result in Staff's understating O&R's cost of common equity by approximately 200 basis points (2.0%). Correcting these errors would bring the Staff recommended ROE to almost 11.0%.

Q. Please summarize your comments on Staff's testimony.

A. I stress from the start that I agree with certain of Staff's views and procedures. I agree broadly with: (i) the use of several methodologies in estimating a fair return on common equity, although I disagree with the weights accorded to the methodologies employed by Staff, (ii) the majority of the electric utility companies included in Staff's proxy group in the DCF and CAPM analyses; (iii) the magnitude of the risk-free rate in the CAPM analysis, and (iv) the magnitude of the beta estimates in the CAPM analysis.

Q. I have thirteen (13) specific disagreements with Staff's testimony:

1. Unreliable Recommendation. Staff's ROE recommendation is unreasonably low, and is not a reliable estimate of O&R's cost of equity capital given the heavy reliance on one particular and fragile cost of equity methodology (i.e., DCF methodology), which is known to understate investor returns.

2. Allowed returns. Staff's recommended return is completely outside the zone of currently allowed rates of return for its sample companies and would constitute, the lowest allowed ROE in the country for a major electric utility.

3. The DCF Model Understates the Cost of Equity. It is well-known that application of the DCF model to utility stocks understates the investor's expected return when the Market-to-Book ("M/B") ratio exceeds unity. This is particularly relevant in the current capital market environment where utility stocks, including Staff's sample companies, are trading at M/B ratios well above unity.

4. Comparable Group. Several companies in Staff's proxy group do not meet Staff's own screening criteria, casting doubt on the reliability of the DCF and CAPM estimates derived from such a group.

5. DCF Functional Form. Staff relies on the annual form rather than on the quarterly version of the DCF model, understating the cost of equity by 20 basis points.

6. The use of an average 6-month stock price in the DCF model. Staff's application of the DCF model violates market efficiency principles and mismatches stock price and expected growth.

7. DCF Sustainable Growth. Staff's principal, and in fact only, technique for estimating the long-term growth component of the DCF model is the sustainable growth technique. There is a logical inconsistency in this technique because Staff is forced to assume the answer to implement the method. From Staff's own evidence, investors expect substantially higher returns for utilities than what Staff recommends.

8. DCF Growth Rates: Analysts' Forecasts. Investors are expecting substantially higher growth rates than Staff's growth rates for the sample companies.

9. DCF Growth Rates: Long-term Economic Growth. Staff's long-term growth forecast for the comparable group of electric utilities, based on the

sustainable growth method, understates the long-term expected GDP nominal growth by approximately 140 basis points (1.4%).

10. CAPM Market Risk Premium. Staff's MRP is understated. Using the appropriate MRP, Staff's CAPM estimates are to be raised by 100 basis points from this correction alone.

11. Flotation Costs. Staff's DCF estimates of equity costs are downward-biased by approximately 17 basis points to the extent that not all the flotation costs associated with past equity issues have been expensed or recovered in the past.

12. Return Adjustments. Staff's downward ROE adjustments for credit quality differences and RDM should be rejected by the Commission.

13. Criticisms of my testimony. Staff's criticisms of my ROE recommendation are without foundation.

1. UNRELIABLE RECOMMENDATION

Q. Staff relies heavily on one methodology, namely the DCF methodology. Does this affect the reliability of Staff's results?

A. Yes, very much so. The 8.9% cost of equity recommended by Staff is unreasonably low and well outside reasonable limits of probability, and is not a reliable estimate of O&R's cost of equity capital.

There are four broad generic methodologies available to measure the cost of equity: DCF, Risk Premium, CAPM, which are market-oriented, and Comparable

Earnings, which is accounting-oriented. Each generic market-based methodology in turn contains several variants. Staff has chosen to rely heavily on the DCF methodology and to a much smaller extent on the CAPM, giving two-thirds weight to the DCF results, only one-third to the CAPM and ECAPM results, and no weight at all to the Risk Premium or Comparable Earnings methodologies.

As I discussed in my Direct Testimony, when measuring equity costs, which essentially deals with the measurement of investor expectations, no one single methodology provides a foolproof panacea. Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the methodology and on the reasonableness of the proxies used to validate the theory. The failure of the traditional infinite growth DCF model to account for changes in relative market valuation, and the practical difficulties of specifying the expected growth component, discussed in my original testimony, are vivid examples of the potential shortcomings of the DCF model. It follows that several methodologies should be employed in arriving at a judgment on the cost of equity and that these methodologies should be weighted equally.

There is no single model that conclusively determines or estimates the expected return for an individual firm. Each methodology possesses its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each method proceeds from different fundamental premises that

cannot be validated empirically. Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor.

There is no monopoly as to which method is used by investors. Absent any hard evidence as to which method outdoes the other, all relevant market-based evidence should be used and weighted equally, in order to minimize judgmental error, measurement error, and conceptual infirmities. There is no guarantee that a single DCF result is necessarily the ideal predictor of the stock price and of the cost of equity reflected in that price, just as there is no guarantee that a single CAPM or Risk Premium result constitutes the perfect explanation of that stock price.

Q. Does the financial literature support the use of several methodologies?

A. Yes, it does. As I discussed in my direct testimony, the financial literature strongly supports the use of multiple methods. While it is certainly appropriate to use the DCF methodology to estimate the cost of equity, there is no proof that the DCF produces a more accurate estimate of the cost of equity than other methodologies. Heavy reliance on the DCF model ignores the capital market evidence and financial theory formalized in the CAPM and other risk premium methods. The DCF model is one of many tools to be employed in conjunction with other methods to estimate

the cost of equity. It is not a superior methodology that supplants other financial theory and market evidence.

Q. Does the DCF model need to be applied with extreme caution?

A. Yes, it does. Caution has to be used in applying the DCF model to utility stocks for four reasons. The first reason is that the stock price used as input in the dividend yield component may be unduly influenced by structural changes and changing investor expectations in the utility industry. Stock prices can also be influenced by mergers and acquisitions possibilities, by speculation concerning asset restructurings and deregulation of certain assets, and by corporate takeover rumors.

The second reason is that the traditional DCF model is based on a number of assumptions, some of which may be unrealistic in a given capital market environment. For example, the standard infinite growth DCF model assumes a constant market valuation multiple, that is, a constant price/earnings ("P/E") ratio. In other words, the model assumes that investors expect the ratio of market price to dividends (or earnings) in any given year to be the same as the current price/dividend (or earnings) ratio. This must be true if the infinite growth assumption is made. This assumption is unrealistic given the surges in P/E ratios experienced by utility stocks in the last decade.

Several fundamental and structural changes have transformed the utility industry from the times when the standard DCF model and its assumptions were developed

by Professor Gordon. Increased competition triggered by national policy, such as FERC Order 888, re-prescription of capital recovery rates, changes in customer attitudes regarding utility services, the evolution of alternative energy and information sources, deregulation, and mergers-acquisitions have all influenced stock prices in ways vastly different from the assumptions of the DCF model developed in the early 1970s. These changes suggest that some of the raw assumptions underlying the standard DCF model are questionable, and that the DCF model should be complemented by several alternate methodologies to estimate the cost of common equity.

Contrary to the standard DCF assumption of a constant P/E ratio, stock prices may not necessarily be expected to grow at the same rate as earnings and dividends by investors. This is especially true in the short run. Investors may very well assume that the P/E ratio will in fact continue to increase in the short run, fueling the expected rate of return. The converse is also true. P/E ratios have proved volatile and unstable in recent years. The essential point is that the constancy of the P/E ratio required in the standard DCF model may not always be a valid assumption. To the extent that increases (decreases) in relative market valuation are anticipated by investors, especially myopic investors with short-term investment horizons, the standard DCF model will understate (overstate) the cost of equity.

In summary, caution and judgment are required in interpreting the results of the DCF model. There is a clear need to go beyond the DCF model, accord it the weight it deserves, and to examine the results produced by several alternate methodologies as I did in my direct testimony.

Q. Is there any evidence that Staff's DCF results are unreliable?

A. Yes, there is. I have examined Staff's DCF results on Exhibit __ (FP-8). The first-stage dividend growth rates are all over the place, ranging from 0.0% to 38.5%, while the second-stage growth rates range from 2.2% to 11.5%. The DCF results shown in the last column are per force scattered all over, ranging from a low of 7.14% to a high of 13.44%. Several estimates are barely above the cost of debt for these companies. The huge variability in the growth rates and final ROE results demonstrates the lack of reliability of the DCF approach and the need to employ, and rely more heavily upon, a variety of methodologies when estimating the cost of capital.

2. ALLOWED RETURNS

Q. Is Staff's rate of return recommendation compatible with currently allowed returns in the utility industry?

A. No, not at all. Allowed returns, while certainly not a precise indication of a company's cost of equity capital, are nevertheless important determinants of investor growth perceptions and investor expected returns. They also serve to

provide some perspective on the validity and reasonableness of Staff's recommendation.

I have examined the ROEs currently allowed for the 30 electric utilities in Staff's comparable group as reported in the AUS Utility Reports survey for November 2007. The currently authorized ROEs for Staff's sample of electric utilities, shown in Table 1 below, average 11.03% (median 11.0%).

Table 1 Authorized ROEs

	Company Name	Allowed ROE
1	ALLETE	11.60
2	Allegheny Energy	10.62
3	Alliant Energy	11.02
4	Amer. Elec. Power	10.93
5	Ameren Corp.	10.29
6	Cleco Corp.	11.25
7	Consol. Edison	10.34
8	DPL Inc.	11.00
9	DTE Energy	11.00
10	Duke Energy	10.93
11	Edison Int'l	11.60
12	Empire Dist. Elec.	10.90
13	Entergy Corp.	10.84
14	Exelon Corp.	10.05
15	FPL Group	11.75
16	Hawaiian Elec.	11.22
17	IDACORP Inc.	
18	MGE Energy	11.00
19	NSTAR	12.50
20	NiSource Inc.	11.33
21	Northeast Utilities	9.87
22	PG&E Corp.	11.35

Case No. 07-E-0949

Orange And Rockland Utilities, Inc.
Rebuttal Testimony Of Dr. Roger A. Morin

	Company Name	Allowed ROE
23	Pinnacle West Capital	10.75
24	Portland General	10.80
25	Progress Energy	12.42
26	Southern Co.	11.93
27	Vectren Corp.	10.53
28	Westar Energy	10.00
29	Wisconsin Energy	11.20
30	Xcel Energy	10.83
	AVERAGE	**11.03**

Source: AUS Utility Reports 1/2008

The average ROE currently allowed for the overall combination gas & electric industry is 10.8% and 11.0% for the overall electric utility industry, well above Staff's anemic recommendation of 8.9%.

In short, Staff's ROE recommendation is well outside the mainstream of the allowed rates of return that were current during the period in which Staff performed its analysis, lies outside the zone of recently authorized ROEs for electric utilities and for its own sample of companies, and would constitute the lowest ROE allowance in the country for a major utility. The Commission is not bound by decisions of other regulators regarding allowed ROE, but one cannot overlook the glaring difference between Staff's recommendation and the returns currently allowed for the very same firms that Staff deems comparable in risk. Unreasonable rate treatment for a New York utility, if implemented, may have serious public policy implications and repercussions for the State of New York, which are not mentioned in Staff's testimony. For example, the quality of

regulation and the reasonableness of rate of return awards clearly have implications for regulatory climate, economic development and job creation in a given territory. The consistency of regulation in a given state has similar implications. It is my belief that Staff's recommended return has serious negative implications on these grounds and is not consistent with the economic well-being of the State.

3. DCF Model Understates the Cost of Equity

Q. Do Staff's DCF results understate the cost of equity?

A. Yes, they do, and so does my own DCF results for that matter. Application of the DCF model produces estimates of common equity cost that are consistent with investors' expected return only when stock price and book value are reasonably similar, that is, when the M/B ratio is close to unity. The simple numerical illustration shown in my direct testimony (p. 20) demonstrated that when the DCF cost rate is applied to a book value rate base well below the market price, the DCF cost rate understates the investor's required return. This is particularly relevant in the current capital market environment where utility stocks are trading at M/B ratios well above unity and have been for two decades. The converse is also true, that is, the DCF model overstates the investor's return when the stock's M/B ratio is less than unity. The reason for the distortion is that the DCF market return is

applied to a book value rate base by the regulator, that is, a utility's earnings are limited to earnings on a book value rate base.

Therefore, the DCF cost rate understates the investor's required return when stock prices are well above book, as is the case presently, and Staff's DCF results understate O&R's cost of common equity capital.

Q. Do regulators share these reservations on the reliability of the DCF model?

A. Yes, I believe they do. As I indicated in my direct testimony, while a vast majority of regulatory commissions do not rely solely on the DCF model results in setting the allowed rate of return on common equity, some regulatory commissions have explicitly recognized the need to avoid excessive reliance upon the DCF model and have acknowledged the need to adjust the DCF result when M/B ratios exceed one[1].

4. Comparable Group

Q. Please describe Staff's comparable group of companies.

A. In order to apply the DCF and CAPM methodologies, Staff develops a group of 30 electric utilities based on two principal criteria. First, the companies had to be investment-grade electric utilities, and second, these utility companies had to derive 70% or more of their revenues from regulated operations.

[1] See the Indiana Utility Regulatory Commission decision in Indiana Mich. Power Co. (IURC 8/24/90), Cause No. 38728, 116 PUR4th 1, 17-18. See also the Iowa Utilities Board decision in U.S. West Communications, Inc., Docket No., RPR-93-9, 152 PUR4th, 459. See also the Hawaii Public Utilities Commission decision in Hawaiian Electric Company, Inc., Docket No. 6998, PUR4th, 134.

Q. Are Staff's comparable companies consistent with these screening criteria?

A. No, they are not. Table 2 below displays Staff's comparable companies along with the percentage of regulated revenues as reported by AUS Utility Reports in its December 2007 edition. As can be seen from the table, eight companies do not meet the 70% minimum regulated revenues requirement. Two of the companies, NiSource and Vectren, have only 20% or less of their revenues regulated. Such inconsistencies in constructing a proxy group of companies cast serious doubt on the validity of the group and on the results of methodologies applied to such a group.

Table 2 Staff's Comparable Group
Percentage of Regulated Revenues

	Company Name	Allowed ROE
1	ALLETE	85
2	Allegheny Energy	81
3	Alliant Energy	71
4	Amer. Elec. Power	90
5	Ameren Corp.	83
6	Cleco Corp.	96
7	Consol. Edison	61
8	DPL Inc.	100
9	DTE Energy	51
10	Duke Energy	63
11	Edison Int'l	80
12	Empire Dist. Elec.	86
13	Entergy Corp.	80
14	Exelon Corp.	58
15	FPL Group	77
16	Hawaiian Elec.	83

	Company Name	Allowed ROE
17	IDACORP Inc.	100
18	MGE Energy	63
19	NSTAR	79
20	NiSource Inc.	17
21	Northeast Utilities	83
22	PG&E Corp.	71
23	Pinnacle West Capital	82
24	Portland General	98
25	Progress Energy	89
26	Southern Co.	98
27	Vectren Corp.	20
28	Westar Energy	72
29	Wisconsin Energy	64
30	Xcel Energy Inc.	78

Source: AUS Utility Reports 1/2008

5. DCF Functional Form

Q. What is the appropriate form of the DCF model?

A. The annual DCF model used by Staff ignores the time value of quarterly dividend payments and assumes that dividends are paid once a year at the end of the year. Since investors are quite aware of the quarterly timing of dividend payments, this knowledge is reflected in stock prices. As I show in Chapter 11 of my book, *The New Regulatory Finance*, the use of the annual version of the DCF model understates the cost of equity by approximately 20 basis points, depending on the magnitude of the dividend yield component. Staff is totally silent on the dividend timing issue.

By analogy, a bank rate on deposits that does not take into consideration the timing of the interest payments understates the true yield if you receive the interest payments more than once a year. The actual yield will exceed the stated nominal rate. To illustrate, if an investor has a choice between investing $1,000 in a bank account which promises a return of 10% compounded annually and another bank account which promises a return of 10% but compounded quarterly, he will clearly select the latter. Due to the quarterly compounding of interest, the investor earns an effective return of 10.38% on the latter bank account versus 10% on the former. The same is true for the return on common stocks. Staff has thus understated investor return by 20 basis points in its DCF analysis from this source alone.

6. DCF Stock Price

Q. Please comment on Staff's stock price in its DCF model?

A. In the implementation of the DCF model, shown on Exhibit __ (FP-8), Staff uses the average stock price over the six months ended October 2007. I disagree with the use of such a stale stock price reaching as far back as May 2007. The stock price to employ is the current price of the security at the time of estimating the cost of equity, rather than some historical average stock price reaching back six months. The reason is that the analyst is attempting to determine a utility's cost of equity in the future, and since current stock prices provide a better indication of

expected future prices than any other price according to the basic tenets of the Efficient Market Hypothesis, the most relevant stock price is the most recent one. The Efficient Market Hypothesis, which is widely accepted, states that capital markets, at least as a practical matter, incorporate into security prices relevant publicly available information, such that current security prices reflect the most recent information and thus are the best representation of investor expectations. Use of any other price violates market efficiency principles.

There is yet another justification for using current stock prices. In measuring the cost of equity as the sum of dividend yield and growth, the period used in measuring the dividend yield component must be consistent with the estimate of growth with which it is paired. Since the current stock price is caused by the growth foreseen by investors at the present time and not at any other time, it is clear that the use of spot prices is preferable. Staff has essentially mismatched a stale average stock price reaching as far back as May 2007 with a current estimate of expected growth. This not only violates market efficiency principles, but also constitutes a mismatch in the application of the DCF model. A stock price dating back six months reflects stale information and is not representative of current market conditions.

An analogy with interest rates will clarify this point. If, for example, interest rates have climbed from 5% to 6% over the past six months, it would be incorrect to

state that the current interest rate is in the range of 5% to 6% just because this is the interest rate range for the past six months. Analogously, it is incorrect to state that the cost of equity, which has also risen along with interest rates, is in some given six-month range. Just as the current interest rate is 6%, the cost of equity estimate is that which is obtained from the standard DCF using current spot prices.

7. Sustainable Growth Method

Q. What specific DCF methodology did Staff employ to determine the cost of equity?

A. Staff applied a two-stage DCF analysis to a sample of 30 electric utilities, using the sustainable growth method as a proxy for the expected long-term growth component in the second stage. Using an average sustainable growth rate of 4.7% [Column W of Exhibit __ (FP-8) page 2] produced a median DCF cost of equity estimate of 8.58% reported on the last column of the same exhibit.

Q. Please comment on Staff's growth estimate in the DCF model.

A. Staff relies exclusively on the sustainable growth method in the crucial second stage of its DCF analysis, where the growth rate is based on the equation g = b(ROE), where b is the percentage of earnings retained and ROE is the expected ROE as reported by Value Line. The impact of external stock financing on growth is also accounted for by adding an external growth term (g = sv).

I seriously disagree with the sustainable growth technique for four reasons: 1) the method is logically circular, 2) the method is inconsistent with the academic empirical evidence, 3) the potential lack of representativeness of Value Line's forecasts as proxies for the market consensus, and 4) a technical error.

Q. Are the growth rates used by Staff consistent with its rate of return recommendation?

A. No, they are not. Staff's sustainable growth methodology contains a puzzling logical contradiction. This is because the method requires an explicit assumption on the ROE expected from the retained earnings that drive future growth. Staff bases its ROE estimate on Value Line's forecast ROE for the 2011 period (Column O on Exhibit __ (FP-8) page 2). But the ROEs used by Staff in calculating the sustainable growth rate do not match Staff's ROE recommendation. Table 3 below replicates the ROE forecasts used by Staff in deriving the sustainable growth rates.

The median expected ROE of 10.74% used in Staff's sustainable growth computation and reported on Exhibit __ (FP-8) exceeds the recommended 8.9%. Staff is assuming in effect that the sample companies will earn a ROE exceeding 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 implicit in Staff's

sustainable growth method may be imaginable for an unregulated company with substantial market power, it is implausible to assume for a regulated company whose rates are continually re-set by its regulator at a level designed to permit the company to earn a return equal to its cost of capital, and because the regulator may take steps to halt and/or recapture such earnings, as is currently the situation confronting O&R in Case 06-E-1433. I consider this logical flaw damaging to the integrity of Staff's analysis, and consider it to be a sufficient basis for rejecting Staff's results produced by this method, which constitute the cornerstone of its ROE recommendation. In essence, Staff is using an ROE that differs from its final recommended cost of equity, and is requesting the Commission to make two inconsistent findings regarding ROE. I am perplexed as to why Staff assumes that its group of comparable electric utilities is expected to earn 10.74% forever, while at the same time it recommends a ROE of only 8.90% for O&R. The only way that these utilities can earn a ROE of 10.74% is if rates are set so that they will in fact earn 10.74%. The only logical conclusion to be drawn from the data is that the group's cost of equity is 10.74%, since these are the returns implied in Staff's sustainable growth analysis.

Q. Is the sustainable growth rate technique consistent with the empirical evidence?

A. No, it is not. The second difficulty with the sustainable growth rate approach is that the empirical finance literature demonstrates this particular method of

determining growth is a very poor explanatory variable of market value, and is not as significantly correlated to measures of value, such as stock price and price/earnings ratios.

Q. Are Value Line's ROE and retention ratio estimates representative of the market consensus?

A. No. The third difficulty with Staff's sustainable growth rates is that exclusive reliance on a Value Line forecast of ROE and retention ratio runs the risk that Value Line forecasts are not representative of investors' consensus forecast. As discussed below, averages of analysts' growth forecasts are reliable estimates of the investors' consensus expectations likely to be impounded in stock prices.

Table 3 Staff's Forecast ROE

1	ALLETE	13.95
2	Allegheny Energy	18.98
3	Alliant Energy	10.13
4	Amer. Elec. Power	9.35
5	Ameren Corp.	12.98
6	Cleco Corp.	9.74
7	Consol. Edison	8.80
8	DPL Inc.	21.24
9	DTE Energy	9.41
10	Duke Energy	8.33
11	Edison Int'l	10.92
12	Empire Dist. Elec.	11.26
13	Entergy Corp.	14.14
14	Exelon Corp.	25.10
15	FPL Group	14.28
16	Hawaiian Elec.	10.97
17	IDACORP Inc.	7.40

18	MGE Energy	14.01
19	NSTAR	7.40
20	NiSource Inc.	10.53
21	Northeast Utilities	15.65
22	PG&E Corp.	11.21
23	Pinnacle West Capital	8.63
24	Portland General	9.29
25	Progress Energy	9.50
26	Southern Co.	13.07
27	Vectren Corp.	10.56
28	Westar Energy	9.41
29	Wisconsin Energy	11.77
30	Xcel Energy Inc.	10.35
	MEDIAN	**10.74%**

Source: Staff Exhibit _ (FP-8) Page 2

Q. Please discuss the fourth problem with Staff's sustainable growth estimates.

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

$$r_a = r_t \quad \frac{2\,B_t}{B_t + B_{t-1}}$$

Where: r_a = return on average equity

r_t = return on year-end equity as reported

B_t = reported year-end book equity of the current year

B_{t-1} = reported year-end book equity of the previous year

The result of this error is that Staff's DCF estimates are understated by some 10-20 basis points, depending on the magnitude of the book value growth rate.

8. DCF Growth Rates: Analysts' Forecasts

Q. What does the published academic literature say on the subject of growth rates in the DCF model?

A. Published studies in the academic literature demonstrate that growth forecasts made by security analysts are reasonable indicators of investor expectations, and that investors rely on analysts' forecasts.

Q. Do you see any dangers in relying solely on value line as an exclusive source of forecasts in applying the DCF model?

A. Yes, I do. Staff relies exclusively on Value Line forecasts for its major inputs into the DCF analysis, including short-term dividend forecasts, expected ROE, new stock issues, and expected retention ratio. Staff's heavy reliance on Value Line growth forecasts runs the real risk that such forecasts are not representative of investors' consensus forecast. One would expect that averages of a myriad of analysts' growth forecasts such as those contained in First Call, Thomson, Multex, and/or Zacks Web sites, rather than one particular analyst's forecast, are more reliable estimates of the investors' consensus expectations likely to be impounded in stock prices.

Q. Are investors expecting growth rates equal to Staff's range?

A. No. The best evidence shows that investors are expecting growth rates higher than Staff has found. For its group of 30 electric utilities, Staff has found [see Columns N and W of Exhibit __ (FP-8) page 2] median growth rates of 3.9% and 4.7% (midpoint 4.3%) for the first and second stage of the DCF analysis, respectively. Table 4 below reports the consensus analysts' long-term growth forecast from both Value Line and Zacks Investment Research, as reported in the Value Line Investment Analyzer data base. The median long-term growth forecast for the group from Value Line and Zacks are 5.5% and 6.2%, respectively (midpoint 5.9%). This is almost 160 basis points (1.6%) above Staff's long-term growth estimate of 3.9% - 4.7% (midpoint 4.3%).

Q. How would Staff's DCF result change using analysts' growth forecast instead of the ill-fated sustainable growth method in the DCF analysis?

A. Using Value Line's growth forecast and/or the consensus growth forecast of 5.5% - 6.2% (midpoint 5.9%) instead of Staff's 3.9% - 4.7% (midpoint 4.3%) in Staff's Exhibit __ (FP-8) would increase the DCF estimate of the cost of common equity by approximately 160 basis points (5.9% - 4.3% = 1.6%), that is, from 8.58% to 10.18%.

Table 4 Staff's Comparable Companies
Growth Forecasts

	Company	Value Line Projected EPS Growth	Zacks Analysts Growth	Value Line Projected DPS Growth	Staff Projected DPS Growth
1	ALLETE	10.5	5.0	13.0	6.1
2	Allegheny Energy	22.0	22.3		38.5
3	Alliant Energy	5.0	6.0	5.5	2.8
4	Amer. Elec. Power	6.5	5.0	7.5	8.6
5	Ameren Corp.	2.5	6.2		0.0
6	Cleco Corp.	4.0	9.5	5.0	10.1
7	Consol. Edison	4.0	3.7	1.0	0.9
8	DPL Inc.	8.5	8.0	3.5	3.6
9	DTE Energy	5.5	6.0	2.5	2.9
10	Duke Energy		6.2		4.3
11	Edison Int'l	6.5	10.3	7.5	6.0
12	Empire Dist. Elec.	11.0		1.5	3.0
13	Entergy Corp.	9.5	13.0	10.0	6.1
14	Exelon Corp.	10.5	12.0	6.0	4.1
15	FPL Group	11.0	10.6	10.0	12.0
16	Hawaiian Elec.	1.5	4.5		0.0
17	IDACORP Inc.	2.0	5.0		0.0
18	MGE Energy	6.5		1.5	1.6
19	NSTAR	8.5	6.5	7.0	2.8
20	NiSource Inc.	2.5	2.8	1.5	5.7
21	Northeast Utilities	17.0	12.7	6.5	7.0
22	PG&E Corp.	4.5	8.5	17.0	7.2
23	Pinnacle West Capital	3.5	6.7	4.0	3.5
24	Portland General				9.5
25	Progress Energy	3.5	5.5	1.0	0.8
26	Southern Co.	3.0	4.4	4.0	3.7
27	Vectren Corp.	4.5	4.5	3.0	3.0
28	Westar Energy	4.5	4.5	6.0	3.3
29	Wisconsin Energy	8.0	9.4	10.5	14.0
30	Xcel Energy Inc.	5.5	5.2	4.5	5.0
	MEDIANS	**5.5**	**6.2**	**5.3**	**3.9**

Source: Value Line Investment Analyzer 12/07; Zacks 12/07; Staff Exhibit __ (FP-8).

Q. Did you find any data inconsistencies in Staff's DCF growth rates?

A. Yes, I did. Table 4 above replicates Staff's first-stage dividend growth rates calculated from Value Line dividend growth projections as shown on Exhibit __ (FP-8) page 2, column N. On the same table, I show Value Line's projected dividend growth rates, obtained directly from the Value Line data base, December 2007 edition. The median growth rate reported by Value Line is 5.3% versus Staff's 3.9%. I was unable to replicate or reconcile Staff's growth rate calculations with the current data reported by Value Line.

Q. Does Merrill Lynch provide long-term growth rate projections?

A. Yes, it does. Staff relies on a Merrill Lynch publication (Quantitative Strategy November 2007) for a key input into its CAPM analysis, as discussed more fully later. However, Staff chose not to rely on Merrill Lynch for the inputs into its DCF estimates for electric utilities. On page 46 of the aforementioned publication, also replicated as Staff Exhibit __ (FP-9), a long-term growth projection of 7.9% is reported for electric utilities. Once more, this growth rate far exceeds Staff's 3.9% - 4.7% growth range.

Q. How would Staff's DCF result change using Merrill Lynch's growth forecast instead of the Staff's 3.9% - 4.7% range in the DCF analysis?

A. Using Merrill Lynch's growth forecast of 7.9% instead of Staff's 3.9% - 4.7%

(midpoint 4.3%) would increase the DCF estimate of the cost of common equity by approximately 360 basis points (7.9% - 4.3% = 3.6%), that is, from 8.58% to above 12%.

Q. What would be the result of a simple DCF analysis using the Merrill Lynch data?

A. Performing a simple DCF analysis with the Merrill Lynch dividend yield (2.9%) and growth (7.9%) data, a DCF estimate of 10.8% (2.9% + 7.9%) is obtained, without flotation cost. This stands in sharp contrast to Staff's 8.58% DCF estimate. If Staff is willing to rely exclusively on Merrill Lynch as a basis for their CAPM analysis, they should be willing to acknowledge this result as well.

9. DCF Growth: Long-Term Economic Growth

Q. Is Staff's choice of growth rates consistent with the long-term growth of the U.S. economy?

A. No, it is not. Staff's average growth rates of 3.9% - 4.7% are quite inconsistent with the very long-term growth of the economy. Because the growth term of the DCF model is perpetual in nature, it is quite reasonable to assume that a utility's long-term growth profile will match the overall growth of the economy.

Long-term forecasts of nominal growth in GDP are available from commercial sources, such as Standard & Poor's, DRI, and Blue Chip Forecast. Additionally, a long-term forecast of nominal growth in GDP can be formulated by combining a long-term inflation estimate with a long-term real growth rate forecast

as follows:

GDP Nominal Growth = GDP Real Growth + Expected Inflation

The growth rate in U.S. real GDP has been reasonably stable over time. Therefore, its historical performance is a reasonable estimate of expected long-term future performance. The growth in real GDP for the 1929-2006 period was approximately 3.4%. The long-term expected inflation rate can be obtained by comparing the yield on long-term U.S. Treasury bonds with the yield on inflation-adjusted bonds of the same maturity. The current yield on 20-year Treasury bonds is 4.7%, and the yield on inflation-adjusted bonds ("Treasury Inflation Protected Securities," or "TIPS") for the same maturity is 2.1%. The difference between the two securities yields an approximate inflation rate of 2.6% (4.7% – 2.1% = 2.6%).

Using the above formula, the long-term expected GDP nominal growth is approximately 6.0% (3.4% + 2.6% = 6.0%). In sum, Staff's growth forecast of 3.9% - 4.7% (midpoint 4.3%) for its comparable group of electric utilities understates the long-term expected GDP nominal growth by approximately 170 basis points (1.7%).

Q. How would Staff's DCF result change if a more reasonable GDP growth forecast is used in its second DCF analysis?

A. Using the projected long-term growth of GDP of 6.0% instead of Staff's 3.9% -

4.7% (midpoint 4.3%) in Staff's Exhibit _ (FP-8) would increase the DCF estimate of the cost of common equity from 8.58% to 10.28% from this flaw alone.

In short, all the growth data, including Staff's updated Value Line data, the Merrill Lycnh data, analysts' growth forecasts, and GDP growth rates, indicate DCF growth rates in the 5.5%-6.0% range rather than Staff's meager 3.9%-4.7% range.

10. CAPM: Market Risk Premium (MRP)

Q. What inputs does Staff use in its CAPM analysis?

A. Three inputs are required in order to implement the CAPM: the risk-free rate, the beta risk measure, and the MRP. For the risk-free rate, Staff uses 4.77%. For beta, Staff uses 0.91, based on Value Line beta estimates for its sample of electric companies. For the MRP, Staff uses 5.88%, based solely on a Merrill Lynch estimate. (See Finance Panel testimony, p. 44, ln. 13-23).

Q. Do you agree with Staff's risk-free rate?

A. Yes, I agree with the magnitude of Staff's risk-free rate estimate.

Q. Do you agree with Staff's beta estimates?

A. Yes, I do.

Q. How does Staff estimate the MRP component of the CAPM?

A. In order to determine the MRP component of the CAPM, Staff relies on Merrill Lynch's in-house forecast of 10.65% for the overall equity market. Subtracting Staff's risk-free rate of 4.77%, a MRP of 5.88% is obtained.

Q. Is Merrill Lynch's estimate of the MRP representative of the market consensus?

A. No. The major difficulty with Staff's MRP estimate is that exclusive reliance on Merrill Lynch's in-house forecast may not be representative of investors' consensus forecast.

Q. Is Staff's assessment of the MRP of 5.9% consistent with the gyst of the vast literature on the subject?

A. No, not quite. Ibbotson's *Stocks, Bonds, Bills, and Inflation 2007 Yearbook* is a primary source of data on U.S. capital market returns. This annual publication compiles monthly returns to various asset classes from 1926 to date. From Ibbotson 2007, a broad market sample of U.S. common stocks outperformed long-term U.S. government bonds by 6.5%. The historical MRP over the income component of long-term Treasury bonds rather than over the total return is 7.1%. It has been common practice to assume that this historical result provides an adequate basis for the expected MRP.

In their widely-used textbook, Brealey, Myers & Allen state:

We have no official position on the exact market risk premium, but we believe a range of 6 to 8 percent is reasonable for the United States[2].

[2]Brealey, R., Myers, S., and Allen, P., *Principles of Corporate Finance,* 8th edition, New York: McGraw-Hill, 2006.

Published work by Dimson, Marsh, and Staunton[3] report returns over the period 1900 to 2000 for twelve countries, representing 90% of today's world market capitalization. They report an average risk premium over long bond returns over all countries of 5.6%, with the U.S. at 7.0%. Staff correctly points out that the Dimson et. al. study has been updated and includes returns for the period 1900-2005. The U.S. risk premium now stands at 6.5% in the updated study. What Staff does not point out, however, is that the premium was generally higher for the second half century than for the first. For example, the U.S. had 5% in the first half, compared to 7.5% in the second half, again in excess of Staff's 5.9% estimate. Brealey, Myers, and Allen op. cit. updated the Dimson study and found an average MRP of 6.5% for the U.S.

Although one must rely on periods long enough to smooth out short-term aberrations when using historical return data, an obvious question is whether data on capital market behavior from the 19th century is relevant for estimating return in the 21st century. The Dimson et. al. study examines historical return data going back to 1900. The Jeremy Siegel[4] study also cited by Staff examines historical data over very long time periods, including data prior to 1926, some dating back to 1802. The major concern with the Siegel data for a period beginning in 1802 is

[3]Dimson, Elroy, Paul Marsh and Mike Staunton (2000) "Risk and Return in the 20th and 21st centuries." *Business Strategy Review* 11(2): 1-18.
[4] Siegel, Jeremy (1999) "The shrinking equity premium." Journal of Portfolio Management 26(1): 10-17.

the reliability of the data. The stock market of the early 1800's was severely limited, embryonic in scope, with very few issues trading, and few industries represented. Dividend data were unavailable over most of this early period and stock prices were based on wide bid-ask spreads rather than on actual transaction prices. The difficulties inherent in stock market data prior to the Great Depression are discussed by Schwert.[5]

In terms of the most recent credible research on the issue, in the latest edition of Ibbotson Associates' (now Morningstar) widely-used Valuation Yearbook, 2007 edition, Ibbotson and Chen have updated their study of the prospective MRP and conclude:

"Contrary to several recent studies on equity risk premium that declare the forward-looking equity risk premium to be close to zero, or even negative, Ibbotson and Chen have found the long-term supply of equity risk premium to be only slightly lower than the straight historical estimate."

In other words, prospective estimates of the MRP are comparable to historical estimates. I therefore disagree with Staff's dismissal of historical MRP studies.

Q. Do you agree with Staff's criticisms of the prospective MRP study cited in your testimony?

[5] Schwert, G. W., "Indexes of U.S. Stock Prices from 1802 to 1987," Journal of Business, 1990, Vol. 63, no. 3.

A. No, I do not. A second approach to estimate the MRP is prospective in nature and consists of applying the DCF model to an aggregate equity index. A prominent prospective study cited in my direct testimony (p. 36) and published in *Financial Management* by Harris, Marston, Mishra, and O'Brien ("HMMO") provides estimates of the ex ante expected returns for S&P 500 companies over the period 1983-1998.[6] From that study, the average MRP estimate for the overall period is 7.2%, again in excess of Staff's 5.9% estimate.

Staff criticizes the HMMO study on the grounds that it covers too short a period. I disagree. While it is appropriate to rely on long periods whenever using historical return risk premium data in order to smooth out short-term aberrations and in order to ensure that investor return expectations match return realizations, that is not necessary when using prospective data.

Q. Dr. Morin, do survey techniques provide reliable estimates of the MRP?

A. No, they do not. Surveys of academics and investment professionals, for example the Welch surveys[7] or the Duke CFO Outlook surveys cited on page 62 of Staff's testimony, provide another technique of estimating the MRP. While this technique has the benefit of being forward-looking, it is subject to the well-known

[6] Harris, R. S., Marston, F. C., Mishra, D. R., and O'Brien, Henry. 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.

[7] Welch, Ivo (2000, 2001), "Views of Financial Economists on the Equity Premium and on Professional Controversies," *Journal of Business* 73(4): 501-537.

shortcomings of survey techniques. There are several reasons to place little weight on survey results relative to the results from other approaches. First, return definitions and risk premium definitions differ widely. Second, survey responses are subject to bias. Third, subjective assessments about long-term market behavior may well place undue weight on recent events and immediate prospects.

Q. Is Staff's MRP estimate consistent with regulatory decisions?

A. No, it is not. It is useful to examine the "reverse" MRP estimates implicit in regulatory ROE decisions. The CAPM framework can be used to quantify the MRP implicit in the allowed risk premiums for regulated utilities. According to the CAPM, the risk premium is equal to beta times the market risk premium:

$$\text{Risk Premium} = \beta\,(R_M - R_F)$$

$$\text{Risk Premium} = \beta \times \text{MRP}$$

Solving for MRP, we obtain:

$$\text{MRP} = \text{Risk Premium} / \beta$$

I examined the MRPs implied in 178 regulatory decisions for electric utilities in the United States over the period 1997-2006. Using the allowed average risk premium of 5.6% in these decisions over the last decade and an average beta of 0.80 for U.S. electric utilities during that period, the implied market risk premium is 7.0%, again in excess of Staff's estimate of 5.9%.

Q. What do you conclude on Staff's MRP estimate?

A. All and all, the textbooks and historical evidence point to a MRP estimate of at least 7% versus Staff's 5.9% estimate. The net result is that Staff's CAPM estimate of O&R's cost of common equity is understated by almost 1.0%, which is the difference between 7.0% and 5.9% times Staff's beta estimate of 0.91. That would raise Staff's CAPM estimate shown on page 3 of Exhibit __ (FP-8) by about 100 basis points, that is, from 10.12% – 10.25% to almost 11.12% - 11.25%.

11. Flotation Costs

Q. In your direct testimony, you stated that the ROE should be adjusted to include an allowance for flotation costs. Please comment on flotation costs.

A. Flotation costs are very similar to the closing costs on a home mortgage. In the case of issues of new equity, flotation costs represent the discounts that must be provided to place the new securities. Flotation costs have a direct and an indirect component. The direct component represents monetary compensation to the security underwriter for marketing/consulting services, for the risks involved in distributing the issue, and for any operating expenses associated with the issue (printing, legal, prospectus, etc.). The indirect component represents the downward pressure on the stock price as a result of the increased supply of stock

from the new issue. The latter component is frequently referred to as "market pressure."

Flotation costs for common stock are analogous to the flotation costs associated with past bond issues which, as a matter of routine regulatory policy, continue to be amortized over the life of the bond, even though no new bond issues are contemplated. In the case of common stock, which 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.

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

Q. What flotation cost treatment did Staff recommend in this case?

A. Both Staff and I agree on the need for a flotation cost adjustment, but we disagree on its magnitude. Staff recommends an allowance of only 13 basis points versus my 30 basis points. The magnitude of the flotation cost adjustment formula used by Staff is only correct if the flotation costs associated with all past common equity issues have been recovered. The standard flotation cost allowance used in my direct testimony is designed to recover the flotation costs associated with <u>all</u> past issues that were not expensed, but rather written off against common equity.

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

To the extent that O&R's flotation costs associated with past common equity issues have not been recovered, the only recovery mechanism available for

the recovery of such costs is an upward adjustment to the ROE as was used in my direct testimony.

In short, Staff's DCF estimates of equity costs are downward-biased by approximately 17 basis points to the extent that the flotation costs associated with past equity issues have not been expensed or recovered in the past.

12. Return Adjustments

Q. Did Staff propose a return adjustment to their ROE results to account for credit quality differences?

A. Yes, it did. On pages 47-48 of its testimony, Staff proposes that O&R's ROE be reduced by 29 basis points (0.29%) to account for credit quality differences between O&R and the proxy group. Staff argues that O&R is less risky than the comparable group because its bond ratings are slightly higher than those of the comparable companies.

Q. What is the basis for Staff's downward ROE adjustment?

A. The adjustment is based on the yield differentials between utility bonds rated A and BBB over the past six months.

Q. Do you agree with Staff's 29 basis points downward return adjustment?

A. No, I do not. First, it is based on bond yield differentials and not on common stock return differentials. Second, Staff is quite insensitive to the fact that O&R's bonds have been teetering on the edge of a downgrade for some time, and, in fact,

have already been downgraded once by Moody's. Moreover, nowhere in its testimony does Staff allude to O&R's deteriorating credit rating. O&R's credit ratings are already fragile as indicated by the "negative outlook" status of its bonds due in part to weak financial ratios. O&R has a substantial construction program in the future. The Company's ability to tap capital markets and attract funds on reasonable terms occurs at a crucial point in time when O&R has an ambitious capital expenditures program and will require external financing. O&R's large capital expenditure program over the next several years increases its dependence on capital markets which have become volatile and more unpredictable. This is certainly no time to apply a return decrement and reduce the Company's return relative to its industry peers.

Third, if we take Staff's adjustment of 29 basis points at face value and apply it to the Company's bonds, we end up with an implausible scenario. According to Staff, the yield on the Company's long-term bonds is 6.18% at this time (See Finance Panel testimony, p. 47, ln. 23).

If we apply Staff's downward adjustment of 29 basis points to the yield on the Company's bonds, we end up with a yield of 5.89%. That would be less than the yield on utility bonds rated AA, which is 6.1% as reported by Staff on Exhibit __ (FP-10) , a highly improbable situation given that O&R's bonds are rated single A and are already on negative outlook with a strong possibility of a

downgrade to the BBB level. This scenario is unlikely and quite outside the bounds of reasonableness. An upgrade to the AA level is all that more unreasonable and unlikely given that Staff recommends a ROE of only 8.9%, which would be the lowest ROE in the country for a major energy utility. In short, Staff's downward ROE adjustment of 29 basis points should be rejected by the Commission.

Q. Is the same true for Staff's downward adjustment for the RDM?

A. Yes, Staff's downward ROE adjustment of 10 basis points to account for what it considers to be the risk-reducing effect of the RDM relative to the comparable companies is also unwarranted. Not only is this 10 basis points adjustment arbitrary, but most, if not all, electric utilities in the industry are under some form of adjustment clause/cost recovery/rider mechanisms. The approval of adjustment clauses, riders, and cost recovery mechanisms by regulatory commissions is widespread in the utility business and is already largely embedded in financial data, such as bond rating and business risk scores. While adjustment clauses, riders, and cost tracking mechanisms may mitigate (on an absolute basis but not on a relative basis) a portion of the risk and uncertainty related to the day-to-day management of a regulated utility's operations, there are other significant factors to consider that work in the reverse direction for O&R, for example, a huge capital spending program requiring external financing and weak financial metrics,

that offset the presence of the aforementioned mechanisms. The experience with the operation of RDMs in general is very scant at this time, let alone the specific RDM variant that the Commission may adopt. Revenue accounting and rate incentive mechanisms are complex and fraught with the risks of unintended consequences. In addition, the Staff Rate Panel recommends a mechanism that would preclude the Company from adjusting actual revenues for weather before reconciling forecasted revenues with actual revenues. While Staff attempts to brush aside the Company's arguments regarding investor expectations of weather-related revenues due to the absence of a formal study or analysis, it does not and cannot refute the fact that this would be a material change in revenue retention practice for O&R, that has, in some years, provided material benefit to the Company as part of an overall comprehensive rate plan. To suggest that the investor community would not take notice of this change is not rational. Adjusting the ROE downward for the RDM, as Staff recommends, borders on the inexplicable.

Moreover, a RDM can actually increase regulatory risks, particularly the risk of the Commission denying timely recovery if deferred balances get too large. Again, the recent O&R temporary electric rate case (Case 06-E-1433) is an example of actions the Commission may choose to take based upon its view of the Company's current earnings as compared with deferred balances. Therefore, it is

speculative as to whether, and if so how, a RDM will affect the Company's risk profile. Any RDM-related credit adjustment therefore is plainly premature.

12. Response to Staff's Criticisms

Historical Risk Premium

Q. Do you agree with Staff's first criticism of your historical risk premium study?

A. No, I do not. On page 65, Staff argues that I have not demonstrated whether O&R is more or less risky than the companies that make up Moody's Electric Utility Index over the 1926-2005 period. I disagree. Over most of the long period that covers my historical risk premium study, 1926-2005, the electric utility industry was relatively homogenous in risk and under the umbrella protection of regulation for all of its functions (i.e., power generation, transmission, distribution).

Q. Do you agree with Staff's second criticism of your historical risk premium study?

A. No, I do not. On pages 66, Staff critiques the risk premium method on the grounds that the method assumes that the risk premium is constant over time, that is, that the risks of Treasury securities have remained at the same level relative to the risks of the electric utility stocks.

This criticism is unwarranted. To the extent that the historical equity risk premium estimated follows what is known in statistics as a random walk, one should expect the equity risk premium to remain at its historical mean. The best estimate of the future risk premium is the historical mean. As I explained in my

direct testimony, since I found no evidence that the market price of risk or the amount of risk in common stocks has changed over time, that is, no significant serial correlation in the successive market risk premiums from year to year, it is reasonable to assume that these quantities will remain stable in the future.

Q. Is the risk premium methodology consistent with financial theory?

A. It certainly is. The Risk Premium approach is conceptually sound and firmly rooted in the conceptual framework of Capital Market Theory. It is widely used by analysts, investors, and expert witnesses. Most college-level corporate finance and/or investment management texts contain detailed conceptual and empirical discussion of the risk premium approach.[8] The latter is typically recommended as one of the three leading methods of estimating the cost of capital.[9] Techniques of risk premium analysis are widespread in investment community reports. Professional certified financial analysts are certainly well versed in the use of this method.

Data requirements to implement the method are not prohibitive. The methodology is responsive to changes in capital market conditions and provides a timely signaling device for current interest rate trends in contrast to the DCF method, which may be sluggish in detecting changes in return requirements, especially when based on historical data. One advantage of risk premium over DCF

[8] 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.
[9] See Brigham and Erhhardt (2005), Corporate Finance: A Focused Approach, 2nd ed., Thomson 2006.

is that the former takes a broader time-series perspective rather than a snapshot point-in-time viewpoint, and is therefore less vulnerable to the vagaries of any one particular capital market environment.

Allowed Returns

Q. Please respond to Staff's criticism of allowed risk premiums by regulators.

A. On pages 66-67 of its testimony, Staff argues that the determination of an allowed return is flawed because I have not factored in particular features associated with past ROE decisions, such as multi-year rate plans and stayout premiums. I note that several ROE awards are part of incentive mechanisms with substantial upside potential, so that the allowed risk premium is more often than not understated. In other words, my allowed risk premium estimate is very likely a conservative one.

DCF Growth Rates

Q. Please comment on Staff's criticism of your DCF analysis.

A. On page 57, Staff criticizes my DCF earnings growth rates on the grounds that I have not addressed how these earnings growth estimates relate to the dividend payout policies of my companies and whether they are sustainable over time. I totally disagree with this point of view. One of the key assumptions that underlies the DCF model is that earnings, dividends, book value, and market price all grow at a constant rate forever. In other words, the dividend payout ratio remains constant over time. That is the assumption I made, and that is the assumption that

Staff also made in the second stage of its DCF analysis. In my direct testimony and earlier in my rebuttal, I discussed the merits of using consensus analysts' earnings growth forecasts in the DCF model and the supportive empirical literature.

Q. Do you agree with Staff's views on dividend growth?

A. No, I do not. Staff, moreover, argues on page 42 that the DCF calculation requires dividend growth rather than earnings growth because dividends constitute the cash flows received by the investor, and that I should have relied on dividend growth instead of earnings growth. I disagree. First, it is clear that dividend growth can only be sustained if there is growth in earnings. Since the ability to pay dividends stems from a company's ability to generate earnings, growth in earnings per share can be expected to strongly influence the market's dividend growth expectations.

Second, from a practical perspective, casual inspection of the Zacks Investment Research, IBES, First Call Thompson, and Multex Web sites, among others, reveals that earnings per share forecasts dominate the information provided. There are few, if any, dividend growth forecasts. Only Value Line to my knowledge provides comprehensive long-term dividend growth forecasts. The wide availability of earnings forecasts is not surprising. There is an abundance of evidence attesting to the importance of earnings in assessing

investors' expectations. The sheer volume of earnings forecasts available from the investment community relative to the scarcity of dividend forecasts attests to their importance. The fact that these investment information providers focus on growth in earnings rather than growth in dividends indicates that the investment community regards earnings growth as a superior indicator of future long-term growth.

Q. Do earnings growth or dividend growth provide a meaningful guide to investors' growth expectations for utilities

A. Dividend growth rates are unlikely to provide a meaningful guide to investors' growth expectations for utilities in general. This result is because utilities' dividend policies have become increasing conservative as business risks in the industry have intensified steadily. Dividend growth has remained largely stagnant in past years as utilities are increasingly conserving financial resources in order to hedge against rising business risks. As a result, investors' attention has shifted from dividends to earnings. Therefore, earnings growth provides a more meaningful guide to investors' long-term growth expectations.

One only has to examine Staff's own data source, namely Value Line, and look at the earnings growth and dividend growth projections for Staff's comparable group of companies to see that, indeed, the decline in dividend payout is expected to continue. Going back to Table 3 above shows projected earnings

growth and projected dividend growth for Staff's sample of 30 companies. The dividend growth of 5.3% is less than both Value Line's projected earnings growth of 5.5% and the analysts' consensus growth projection of 6.2%. In short, Staff should have relied on long-term earnings growth forecasts in its DCF analysis.

DCF Weight

Q. Is it correct that you only assign the DCF a one-third weighting?

A. As shown on the summary of results table on page 59 of my testimony, of the eight results reported, four are DCF results, that is, a weight of 50%.

Beta trends

Q. Dr. Morin, is it illogical that cost of equity estimates derived from the CAPM methodology have approached those of the market as a whole?

A. No, it is not illogical. On page 33 of its testimony, Staff argues that it is illogical the beta estimates of the electric utility industry have increased in recent years and are approaching the beta of the market as a whole. I disagree. The fact is that utility beta estimates have escalated steadily over the past years in response to heightened investment risk perceived by investors, and they are rising for utilities with largely regulated operations. Staff is unwilling to accept the fact that the utility industry as a whole, including New York utilities, whose betas are rising as well, is being perceived by investors as more risky and that the required return is increasing. Having adopted the use of proxy groups to calculate a utility's ROE,

Staff cannot then unilaterally disregard market data regarding market data simply because such data does not comport with certain of their preconceptions.

In short, Staff's claims of "beta creep" fail to provide the Commission with a reasoned basis for continuing its over reliance on the DCF methodology in calculating a utility's ROE.

In fact, the Finance Panel contradicts itself later in its direct testimony. In one breath, Staff claims that the increase in beta risk of the electric utilities is illogical, yet in another breath on page 37 Staff laments the steady decline in credit quality of U.S. corporations over the past 25 years, including that of electric utilities. I am unable to reconcile these two statements. Finally, I would note that Staff seems quite comfortable with its use of proxy groups for purposes of its DCF calculations, but not for purposes of its CAPM calculations. Staff has failed to justify this inconsistency.

Q. How do you respond to Staff's comment that the Harris-Marston study cited in your testimony shows a lower risk premium for regulated utilities than you have employed?

A. On page 62, Staff argues that the Harris-Marston study on which I relied for my estimate of the MRP, shows a risk premium of 4.15% which is lower than my estimate. Staff errs again. The study from which Staff obtained this figure dates from the 1983 – 1998 period. As one would expect, the utility industry ranks with

a lower risk premium and a lower beta for the period 1983 – 1998. Of course, as a result of restructuring, deregulation, increased investor risk perception, and the introduction of competition in the revenue stream, there has been a steady escalation in utility betas since 1998 reaching the level of almost 1.00 in 2007. The electric utility risk premium has escalated as well over the past decade, reaching approximately 5.6% currently.

CONCLUSIONS

Q. What returns are investors expecting for Staff's group of companies?

A. As shown in Table 3, investors are expecting an average ROE of 10.74%.

Q. What is the average authorized ROE for Staff's group of companies?

A. As shown in Table 1 of my rebuttal testimony, the average authorized ROE for these comparable companies is 11.0%.

Q. What ROE does Staff recommend?

A. Staff's recommended ROE is 8.9%.

Q. What ROE should Staff's analysis produce when adjusted for the reasons you have explained?

A. Applying the various changes and corrections I have outlined in my rebuttal testimony, Staff's analysis indicates a conservative return of 11%, as shown below.

Q. What do you conclude from Staff's cost of capital testimony?

A. My general conclusions are:

1. Unreliable Recommendation. Staff's ROE recommendation is unreasonably low, and is not a reliable estimate of O&R's cost of equity capital given Staff's heavy reliance on one particular and fragile cost of equity methodology, which is known to understate investor returns.

2. Allowed Returns. Staff's recommended return is well outside the zone of currently allowed rates of return for its sample companies and would be by far the lowest ROE award in the country for a major energy utility.

3. The DCF Model Understates the Cost of Equity. It is well-known that application of the standard DCF model to utility stocks understates the investor's expected return when the M/B ratio exceeds unity. This is particularly relevant in the current capital market environment where utility stocks, including Staff's sample companies, are trading at M/B ratios well above unity.

4. Comparable Group. Several companies in Staff's proxy group do not meet Staff's own screening criteria, casting doubt on the reliability of the DCF and CAPM estimates derived from such a group.

5. DCF Functional Form. Staff relies on the annual form rather than on the quarterly version of the DCF model, understating the cost of equity by 20 basis points.

6. Stock Price in the DCF Model. Staff's application of the DCF model

violates market efficiency principles and mismatches stock price and expected growth.

7. DCF Sustainable Growth. There is a logical inconsistency in the sustainable growth technique because Staff is forced to assume the answer to implement the method. From Staff's own evidence, investors expect substantially higher returns for utilities than what Staff recommends.

8. DCF Growth Rates: Analysts' Forecasts. Investors are expecting substantially higher growth rates than Staff's 3.9% first-stage growth rate and 4.7% second-stage growth rate for the sample companies. Using Value Line's growth forecast and the analysts consensus growth forecast increases Staff's DCF estimates by 160 basis points.

9. DCF Growth Rates: Long-term Economic Growth. Staff's long-term growth forecast for its comparable group of electric utilities based on the sustainable growth method understates the long-term expected GDP nominal growth by approximately 170 basis points (1.7%).

10. CAPM Market Risk Premium. Staff's MRP is understated. Using the appropriate MRP, Staff's CAPM estimates would be raised by 100 basis points from this correction alone.

11. Flotation Costs. Staff's DCF estimates of equity costs are downward-biased by approximately 17 basis points to the extent that not all the flotation costs associated with past equity issues have been expensed or recovered in the past.

12. Return Adjustments. Staff's downward ROE adjustments for credit quality differences and RDM should be rejected by the Commission.

13. Criticisms of my testimony. Staff's criticisms of my direct testimony are without foundation.

Q. What is your major conclusion from Staff's ROE recommendation?

A. Staff's recommended ROE is vastly understated. Recognition of the proper functional form of the DCF model (20 basis points) and a much greater emphasis on analysts' growth forecasts in the DCF analysis (160 basis points) would raise its DCF estimate from 8.58% to 10.38% without flotation costs. Recognition of the appropriate MRP in the CAPM analysis raises Staff's CAPM estimates from 10.12% - 10.25% to 11.12% - 11.25% (midpoint 11.19%) without flotation costs. Giving a two-third weight to the amended DCF result of 10.38% and a one-third weight to the amended CAPM result of 11.19% brings Staff's recommendation to 10.65% without flotation costs and 10.78% inclusive of Staff's 13 basis points flotation costs allowance. All and all, correcting for the various flaws in Staff's testimony would suggest much higher returns that are quite close to my own ROE recommendation for O&R. I consider my critique conservative, for it does not

reflect the consistent tendency of the DCF to understate the cost of equity, nor does it reflect the understatement of the cost of equity, which results from the plain vanilla annual form of CAPM analysis used by Staff.

Q. Does this complete your rebuttal testimony?

A. Yes, it does.

BY MR. CARLEY:

Q. Dr. Morin, I believe you also have some update material that you would like to present at this point in time?

A. Yes, I do.

Q. Would you go ahead, please.

A. Yes. Since I prepared the direct testimony based on August and July data 2007, there have been some appreciable changes in capital market conditions, notably a decrease in long term Treasury rates, and this has a major impact on a variety of risk premium tests that I have conducted in my direct testimony.

The best way to see this, Your Honor, is to go to page 59 of my direct testimony, which is a summary of the results of all the tests that I have relied upon.

So, if you go to page 59, there is a summary table on the top. The first four results that are shown there are driven by the risk free rate.

When I prepared my testimony, the risk free rate was 5.3 percent and today it's 4.4 percent, so that's quite a significant decrease in interest rates which affects the first four results that you see on this summary table.

Moreover, the betas, which is a risk measure of

electric utilities, have declined from .91 to .86, which also influences the CAPM and empirical CAPM results, the first two that are shown on the summary table. The market risk premium has remained essentially unchanged.

With regard to DCF results, they have either stayed the same or have increased slightly in response to lower stock prices, higher dividend yields, and also higher growth rates.

The bottom line is that if you look at line 3 of my direct testimony, the average result is now 10.8 instead of 11.2. If you look at line number 8, the average result from all the tests is no longer 11.3, but is now 10.8.

Therefore, I conclude that the fair and reasonable rate of return on O&R's common equity at this time is 10.8 and not the original 11.2 that I recommended.

JUDGE LYNCH: That's exclusive of issuance costs?

THE WITNESS: That is inclusive of issuance costs. In other words, I have replicated the exact same test with the exact same number of companies with the revised updated input data.

Q. Dr. Morin, one other update matter. Throughout

your testimony, particularly your rebuttal testimony, you testified to authorized returns on equity for other utilities in New York State, as well as in other states in the union.

I am going to show you a three-page document, Dr. Morin, which is based on an RRA database, which sets forth the authorized return on equity for the previous--for the last five years, including authorized returns through the end of January 2008.

And are you familiar with this document?

A. Yes, very much so.

Q. As far as you know, the data that's set forth here in terms of the authorized return is consistent with your understanding of what's been authorized by various Commissions in the union?

A. Yes.

Q. And that it essentially updates some of the material which is set forth in the testimony?

A. It's essentially an update of Table 1 of my rebuttal entitled "Authorized ROEs" on page 12.

MR. CARLEY: Your Honor, I would ask this document be marked for identification as Exhibit 75.

JUDGE LYNCH: That's correct, 75.

(Exhibit 75 marked for identification.)

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

JUDGE LYNCH: As far as I know, Staff is the only one with questions. Are there others that have questions of this witness?

MR. KLUCSIK: County has none, your Honor.

MR. ST. LAWRENCE: No, Your Honor.

MR. WALTERS: No, Your Honor.

JUDGE LYNCH: Does Staff have an estimate?

MS. JOSS: Roughly 45 minutes.

JUDGE LYNCH: Okay. Thank you.

CROSS EXAMINATION

BY MS. JOSS:

Q. Good morning, Dr. Morin.

A. Good morning.

Q. Staying on page 12 of your rebuttal testimony you provide a table that purports to show the allowed ROEs for each of the companies in the finance panel's proxy group.

Isn't it true that except for Portland General the Company's and Staff's proxy group are all holding companies?

A. That is correct. And the numbers you see there are the weighted averages of allowed returns for each of

the operating subsidiaries, so they are.

Q. For nearly all of the companies in Staff's proxy group we are talking about companies that hold the stock of utility companies and those regulated operating units of the holding companies that are actually authorized returns on equity; is that correct?

A. No, that's not correct. Returns that are authorized are for the operating electric utility companies, not for the consolidated companies that include, for example, unregulated activities.

The allowed return pertains only to the regulated entities of the consolidated families.

Q. That was my question. Isn't it also true that many of the holding companies have more than one utility subsidiary and operate in more than one state?

A. That is correct. In my home state of Georgia Southern Company has five major operating utility companies--Georgia Power, Alabama Power, Delta Power, Savannah Power and Mississippi Power--so the answer is yes.

Q. Would you agree that at least half of these holding companies also have subsidiaries that provide gas service?

A. Yes, I would.

Q. Dr. Morin, your table also shows Cleco Corp. as having an allowed ROE for 11.25 percent.

A. I see it.

Q. Do you know when that return was authorized?

A. Approximately several years ago.

Q. Would you accept, subject to check, that the last time the Company's utility subsidiary was authorized a base rate increase was 1985?

A. Yes, I would. Of course, if the Louisiana Commission perceived that this return was inadequate, it would initiate a show cause order on the grounds that this return was too high or too low. So there has been no show cause order in the Cleco jurisdiction.

Q. Dr. Morin, do you know how many of the other returns in your table reflect ROEs that were authorized more than two years ago?

A. Probably a lot of them. Again, if those were considered inappropriate, a show cause order could be initiated to correct an apparent deficiency.

Q. Dr. Morin, are you aware that the 12.5 percent ROE you have ascribed to NSTAR is in fact the earnings level at which NSTAR's operating utility level shares earnings?

A. Where is NSTAR?

Q. 19.

MR. CARLEY: Page 12.

A. Yes. Same answer as the previous question.

Q. Do you know how many of the other ROEs you have characterized as allowed are actually earnings sharing thresholds?

A. No. I would suspect three or four. The Louisiana one certainly would be characterized as such, but I point out that in most of the instances where there is incentive mechanisms, upside potential, the numbers you see here, if anything, understate that the returns contribute to the extent that there's upside potential to earn more than what's allowed.

Q. Could you please turn to page 16 and 17 of your rebuttal testimony.

A. Have it.

Q. You show a table that also utilizes AUS Utility Reports as the source. The purpose of that table is to demonstrate your contention that eight of the companies in Staff's proxy group do not meet Staff's minimum criteria with regard to percentage of regulated revenues; is that correct?

A. Correct.

Q. I would like to show you a copy of the AUS

Utility Report you used, and I have copies for everyone.

Dr. Morin, you are familiar with the AUS Utility Report?

A. Yes.

Q. And you used it in preparation of your testimony?

A. Yes.

MS. JOSS: At this time, your Honor, I would like to have this admitted into evidence or marked as Exhibit 76.

JUDGE LYNCH: I will mark it, but I am also going to ask you to provide copies where the high lighted area is more legible. I don't know if we are going to need it today or I am hoping we won't. I can make out some of it but not all of it even with my glasses on. The main thing is I would like to be able to read everything on the page.

With that, this is Exhibit 76 for identification. This is a two-page excerpt, pages 8 and 12, of the document you referred to.

(Exhibit 76 marked for identification.)

Q. Dr. Morin, isn't it true that the AUS report only shows the percentage of electric revenues for each of Staff's holding companies?

A. Yes.

Q. So the 61 percent of regulated revenues in your table for Con Edison only represents the parent company's revenues from electric operations?

A. That is correct, which is the major source of their revenues.

Q. You are aware, of course, that Con Edison also has gas and steam operations that are rate regulated?

A. Yes.

Q. So the 83.3 percent amount of regulated revenues that Staff determined for Con Edison is probably a more accurate representation; is that correct?

A. If it includes gas, yes, but we are talking about an electric utility here.

Q. Again, we are talking about regulated revenues that would include gas and steam.

A. That's correct, but Orange & Rockland is an electric utility.

Q. O&R is an electric and gas company.

A. Yes, but this is a rate setting hearing for electric rates.

Q. But isn't it correct that Staff's criteria was for regulated revenues?

A. Yes. It should have been for electric.

Q. Thank you.

A. But I agree with you.

Q. Since many of the other holding companies in Staff's proxy group also have regulated gas operations, the figures shown in your table do not accurately depict the percentages of regulated revenues for these companies either?

A. They depict the proportion of the electric regulated revenues. This is an electric rate-making case.

Q. We are talking about regulated revenues, again.

MR. CARLEY: Your Honor, at this point in time it's getting argumentative. The record is clear as to the diverse views of the parties here.

JUDGE LYNCH: I don't know what the objection is, though. Are you objecting to her asking the question?

MR. CARLEY: It's redundant and argumentative after awhile.

MS. JOSS: It's misquoted in his testimony.

JUDGE LYNCH: What's misquoted?

MS. JOSS: On page 16 of his testimony, line 3, he says percentage of regulated revenues as reported by AUS Utility Reports in its December 2007 edition.

We are just tying to establish that he was

referring to electric revenues while Staff's referring to regulated revenues.

JUDGE LYNCH: My understanding is you agree with that.

THE WITNESS: I agree with that.

BY MS. JOSS:

Q. Thank you. Could you please turn to page 19 of your rebuttal testimony.

A. Have it.

Q. With respect to the appropriate price to use in the DCF model, you advocate the current or spot price because, as you say, current security prices reflect the most recent information and thus are the best representation of investor expectations; is that correct?

A. That is correct. One of the paradigms of financial theory is what we call the efficient market hypothesis, which essentially states that the current price reflects all that's knowable.

Q. Thank you. Could you please turn to page 36 of your rebuttal testimony.

A. I have it.

Q. As an indication of the expected market return, the staff finance panel presented the results of a

survey that, among other things, asked around 500 Chief Financial Officers of US companies what they expected the average annual S&P 500 return would be over the next 10 years.

On page 36 of your rebuttal testimony you criticize the usefulness of that survey because, in your words, subjective assessments about long term market behavior may well place undue weight on recent events and immediate prospects.

Dr. Morin, would you please explain why the current assessment of this large group of CFOs is any less relevant than the current assessments of common stock investors.

A. Portfolio managers and CFOs in particular tend to be myopic and tend to weigh current events a lot more heavily than they would in the long term picture.

In contrast, the efficient market hypothesis says that the current stock price or bond price, for that matter, reflects all the relevant information about the future prospects of a stock or a bond.

Q. Dr. Morin, in your DCF model you rely on the growth forecast of securities analysts; is that correct?

A. That is correct.

Q. Isn't it true that the forecasts of these

analysts are essentially the subjective assessments of these analysts about the future based upon their understanding or interpretation of recent events?

A. It's that, but a lot more than that. It's also based on the understanding of expected events in the future over the long term.

For example, the long term dividend policies of utilities, the long term strategy positioning of these utilities. So it's based on long term perceived expectations, prospective estimates of industry trends, and company trends and company policies.

Q. You also testified recently in the ongoing Consolidated Edison of New York electric rates proceeding; is that correct?

A. Yes.

Q. Do you recall saying, in essence, that the steady escalation in the betas of electric utilities, having increased from about .7 at the beginning of the 1990s to their present levels, which is about .91, means that they look more and more like industrial, like the average risk investment in the stock market?

A. That is correct.

Q. Do you still agree with that statement?

A. Yes. Slightly less than I said originally.

The betas have declined slightly to slightly below .9, but if you look at the long term trend, it's still a very steady upward trend in utility betas over the last 10 years. There are no longer widows and orphan stock.

Q. Would you agree with the assessment of company witness Perkins on page 21 of his rebuttal testimony where he concludes that, as a whole, the risk of utilities has increased?

A. Definitely. Look at all the bond rating declines over the last--or downgrades over the last five years. Look at the escalation in betas.

Q. Could you turn to page 41 of your rebuttal testimony.

A. Have it.

Q. You characterize O&R's credit ratings as fragile. Would you agree that the Company's current credit ratings place it higher than roughly 71 percent of its peers in the electric utility industry?

A. I would agree with that, but also with the strong caveat that the bonds are on a negative outlook by major rating agencies. All three agencies lament the weak financial ratios or financial metrics that are normally applied to A rated utilities.

And the outcome of this rate case will have a major, major impact on the financial metrics, and on the probabilities of a downgrade to the B level, BBB level.

Q. Sticking with the credit quality theme, would you agree with the staff finance panel's characterization on page 37 of its testimony as there has been steady decline in credit quality of US corporations in general over the past 25 years?

A. I agree with that.

Q. Would you agree that the majority of corporate debt rating, excluding utilities and financial institutions, are now in B and BB categories?

A. For non-utilities, yes.

Q. Would you be willing to accept that, subject to check, only about 30 percent of corporate debt, excluding utilities and financial, carries an investment grade rating?

A. I agree with that.

Q. Again, subject to check, would you be willing to accept that of those corporate debt ratings that are investment grade, the lion's share are in the BBB category?

A. For utilities?

Q. No. For corporate debt.

A. I would have to check that one.

JUDGE LYNCH: You are saying you are taking that one subject to check?

A. Yes, I will. Non-utilities are rated BBB on average is what I am going to check.

Q. Sorry. Could you repeat what you just said?

A. I think I will check your claim that non-utilities, in other words, industrials on average have a BBB rating.

Q. Of those that are in the investment grade.

A. I will do that.

Q. Dr. Morin, yes or no, strictly in terms of credit risk.

A. Don't put me in a box.

Q. Isn't it true that A rated O&R is considerably less risky than the typical industrial company?

A. As would be true for all utilities, yes.

Q. Would you agree that the credit rating agencies consider both business risk and financial risk when they determine a company's credit rating?

A. Yes.

Q. Isn't it true that the relative size of a company is a component of the business risk?

A. Yes.

Q. Do you agree that the lower rated a company's bonds are the less likely they are to be paid and thus the higher the return requirements these debt obligations will carry?

A. No. The credit risks of a bond do not directly translate to the risks of a common stock of equity. And my testimony talks about stocks. We are talking about bonds.

So, you cannot really transfer or equate the risks associated with bonds which have to do with creditworthiness, and transfer those risks to equity risks which have to do with volatility. There's no one to one connection here necessarily.

Q. Would you agree that if debt holders are less likely to be paid then the likelihood of shareholders receiving dividends is decreased?

A. I would agree with that, everything else being constant.

Q. Dr. Morin, is it correct that you testified previously to an ROE of 11.2 plus .25, which was roughly translated to 11.5, and then corrected it today to 10.8, which approximately would be adjusted to 11.1 percent ROE for a three year case?

A. That is correct.

JUDGE LYNCH: The 11.1 includes a premium then; is that what you are saying, for a three year rate plan? I am just trying to make sure we are not--I am still confused about the issuance cost because I understood your testimony differently before today than what you said.

THE WITNESS: Can I clarify it?

JUDGE LYNCH: I don't want to interfere with her cross.

MS. JOSS: That's fine.

THE WITNESS: The 10.8 is business as usual recommended ROE.

MS. JOSS: For a one year ROE.

THE WITNESS: Right. It does not include a stay out premium but it does include flotation costs.

JUDGE LYNCH: What's the stay out premium that you are proposing? What is it?

THE WITNESS: It's in my direct testimony at the very end, 25 basis points.

JUDGE LYNCH: Thank you.

BY MS. JOSS:

Q. Dr. Morin, do you know what ROE is used in the Company's revenue requirement calculation?

A. No.

Q. Would you accept, subject to check, that the 11.5 percent ROE that the Company used was applied to the book value of common equity?

A. I would accept that.

Q. Doctor, were the returns you calculated based on book value or market value?

A. Market value.

Q. In several places in your testimony you reference your book "New Regulatory Finance"; is that correct?

A. Of course. It's a very authoritative reference.

Q. Is it true that you explain on page 451 of that book that it is almost universal practice in the regulated field to apply market based cost of equity calculation to book values of equity?

A. That is correct. What is also correct in that book is that DCF chronically or structurally understates returns when market to book ratios are above one.

Q. Do you also state in that section of your book that applying market derived returns to book value is not unreasonable for the purpose of setting fair and reasonable utility rates?

A. That I agree of course. It is appropriate practice with the awareness that the DCF piece of the recommended return understates returns.

MS. JOSS: Thank you. I have no further questions at this time.

THE WITNESS: Thank you very much.

JUDGE LYNCH: Redirect?

MR. CARLEY: If I could approach the witness, Your Honor.

The Company has no redirect for Dr. Morin.

JUDGE LYNCH: Thanks very much. You are excused.

(Witness excused.)

CRAIG E. HENRY and MICHAEL J. AUGSTELL, after first having been duly sworn, were examined and testified as follows:

DIRECT EXAMINATION

BY MS. JOSS:

Q. Panel, do you have before you the 69 typewritten pages which is referred to as the prepared testimony of the staff finance panel?

A. (Henry) Yes, we do.

Q. Was that testimony prepared by you or under your direction?

A. (Henry) Yes, it was.

Q. Do you have any corrections to that testimony?

A. (Henry) Yes.

Q. Can you please explain what corrections you have.

A. (Henry) I gave the corrections to counsel. I don't recall what page it was. I gave you the corrections. I forget which page it was.

Q. Page 38.

A. (Henry) 38. Perhaps you can remind me what the correction was because--I know it's line 21.

Q. Line 21 from a correction for 10.7 to 11.4 percent?

A. (Henry) That is correct.

Q. Do you adopt that testimony as corrected as the testimony of the staff finance panel for this proceeding?

A. (Henry) Yes, we do.

Q. If I were to ask you these questions today would your answers as corrected be the same?

A. (Henry) Yes.

MS. JOSS: Your Honor, at this time Staff asks this testimony as corrected be copied into the record as if orally given, and the corrections to the page are in ink.

JUDGE LYNCH: Yes. The motion is granted.

(The following is the prefiled testimony of Craig Henry and Michael Augstell:)

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

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

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

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

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Arts Degree in Economics from the University of Rochester in 1992. Since that time I have worked in commercial loan banking and thereafter as a financial analyst for General Electric Power Systems. In the five years prior to joining the Department I was employed at UHY Advisors NY, Inc. (UHY) in Albany, New York. I worked in the valuation and litigation services department at UHY, conducting business valuations, financial

analysis and forensic accounting, and, class action claims administration. I joined the Department of Public Service in December 2006.

Q. Are you a member of any professional societies?

A. Yes. I am a candidate member in the American Society of Appraisers (ASA). I am working towards becoming accredited in business valuation.

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

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

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

A. Yes. In Case 06-G-1332, Consolidated Edison Company of New York, Inc. - Gas Rates and Case 07-E-0523, Consolidated Edison Company of New York, Inc. - Electric Rates, I provided

testimony to the Commission as part of the Staff Finance Panel on the appropriate capital structure and cost of debt for Consolidated Edison Company of New York, Inc.

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

A. I am employed by the New York State Department of Public Service as a Principal Utility Financial Analyst in the Office of Accounting, Finance and Economics.

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Science Degree in Business Administration from the University of Florida in 1981. In 1985 I received a Master's Degree in Business Administration with a concentration in Finance from the School of Management at the State University of New York at Binghamton. Before joining the Department of Public Service in August 1988, I was employed by Norstar Bank, N.A. as a Manager Trainee.

Q. What are your responsibilities in the Office of Accounting, Finance and Economics?

A. My primary areas of responsibility include

analyzing and making recommendations to the Public Service Commission concerning rate of return levels and financing requests. I also examine and make recommendations with regard to other utility finance-related activities, such as merger requests.

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

A. Yes. I have testified in numerous electric, gas and water rate cases before the Commission since 1988, most recently in Case 06-E-1433, Orange and Rockland Utilities, Inc. (Electric Rates).

PURPOSE OF TESTIMONY

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

A. The purpose of our testimony is to establish the fair rate of return that is used in the determination of the revenue requirement for Orange and Rockland Utilities, Inc. (Orange and Rockland or the Company) for the rate year ending June 30, 2009. We will also respond to the testimony of Company witnesses Morin and Perkins.

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

A. We are sponsoring fourteen exhibits, identified as Exhibit___(FP-1) through Exhibit___(FP-14).

SUMMARY

Q. Please summarize your testimony.

A. We recommend an overall rate of return of 7.45%, as opposed to the Company's request of 8.79%. The difference is primarily due to our use of a 47.93% common equity ratio and an 8.9% return on equity (ROE), as opposed to the Company's 48.59% common equity ratio and 11.5% ROE. Among other things, our proposed capital structure assures that ratepayers will not subsidize its parent's riskier non-regulated investments, while our ROE recommendation was determined using two different equity costing methodologies, each weighted as the Commission approved in the last Orange and Rockland electric case as well as other prior litigated cases. We also explain why our recommended rate of return provides the Company with a financial profile that will allow it continued access to reasonably priced capital.

FAIR RATE OF RETURN DISCUSSION

Q. What is a fair rate of return for a regulated utility?

A. A fair rate of return for a regulated utility is one that enables it to provide safe and adequate service to its customers, while assuring it continuing support in the capital markets for both its debt and equity securities, at terms that are reasonable given the company's risk. Investors in debt securities enter into contractual obligations with the utility and receive relatively fixed income streams. Common equity investment, on the other hand, is non-contractual. Common equity investors may share in, but are not guaranteed, a portion of the utility's residual earnings. The fair rate of return, therefore, allows the utility to recover its prudently incurred cost of debt, while providing its common equity investors with the opportunity to earn a return commensurate with the risk of their investment.

Q. How is a fair rate of return calculated?

A. Generally, in New York State, the fair rate of return for a utility company is calculated

through a weighted average of the individual cost components of its expected capitalization during the rate year. Determining the proper capital structure for setting rates thus involves forecasting and reconciling a company's sources of capital together with its capital requirements.

Turning to the cost rates of the individual components, the cost of the long-term debt component is relatively easy to compute. This is because in return for lending money to the company, debt holders receive returns in the form of contractual payments of interest and principal. Additionally, forecasting the cost rates for other components such as customer deposits and gas supplier refunds is simply a matter of applying cost rates that are prescribed by the Commission.

As previously mentioned, the common equity component is neither contractual nor prescribed by the Commission. Its calculation is further complicated by the fact that it can not be directly observed. It is important to remember that while both debt and equity holders supply

the utility with the funds it needs to build and operate its system, the equity investors only earn a return after the payment of all other expenses. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by equity investors is usually higher than that of the utility's debt holders. We say "usually" because in periods of volatile inflation and high interest rates such as 1980-82, utility bonds had yields that were at least as high as the returns the New York Commission allowed and far above the returns most Commissions allowed.

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

CAPITAL STRUCTURE

Q. What is the overall rate of return you recommend be allowed for the rate year?

A. We recommend an after-tax overall rate of return

of 7.45%, compared to the Company's originally filed 8.79%. Our proposed pro forma cost of capital can be seen in Exhibit__(FP-2).

Q. What was Orange and Rockland's projected rate year capital structure for its electric operations?

A. In Exhibit E-8, Schedule 1, Company witness Perkins forecast a long-term debt ratio of 50.00%, a common equity ratio of 48.59% and a customer deposits ratio of 1.41%.

Q. How did Orange and Rockland develop this capitalization?

A. The rate year capitalization was developed based upon an approach that began with Orange and Rockland's as-reported "stand-alone" capital structure as of March 31, 2007. This "stand-alone" capitalization was then projected for the rate year based upon actual and contemplated debenture issuances through the end of the rate year, as well as assumptions regarding the level of the Company's future earnings and the amounts and timing of equity-related transactions with its parent, Consolidated Edison, Inc. (CEI), specifically equity contributions from the

parent and dividend payments to it.

Q. Did the Company demonstrate the reasonableness of these projections by linking them to an overall forecast of its cash flows, particularly its construction expenditures, refunding requirements and other internally generated sources funds?

A. No.

Q. Please describe what you mean by the term "stand-alone" capital structure.

A. A utility holding company reports its overall capital structure as part of its consolidated balance sheet in various reports to the Securities and Exchange Commission (SEC) as well as in its Annual and Quarterly Reports to Shareholders. The consolidated balance sheet reflects the financial position of all of the holding company's operations. A holding company with utility subsidiaries also presents individual financial statements for major subsidiaries. The stand-alone capital structure is the capitalization reported for each individual subsidiary.

Orange and Rockland is a wholly-owned

subsidiary of CEI. CEI also owns both Orange and Rockland and Consolidated Edison Company of New York, Inc.(Con Edison), and has investments in several competitive ventures. CEI reports its consolidated financial position in its annual 10-K and quarterly 10-Q reports to the SEC; it also presents stand-alone financial statements for both Orange and Rockland and Con Edison.

Q. Do you agree with the use of the reported stand-alone capital structures for utilities that are subsidiaries of larger holding companies?

A. While there may be instances in which such an approach may be warranted, a careful analysis of the holding company's financing practices is necessary to determine its appropriateness. Stand-alone capital structures for utility subsidiaries of holding companies may not reflect either rational capitalization policies or actual common equity employed, and therefore may not be suitable for establishing a utility's rate of return.

Q. Explain why the use of a stand-alone capital structure may not be reasonable.

A. The stand-alone common equity balance reported by a utility subsidiary of a holding company may not, in fact, be financed by common equity at the holding company level. Rather, some of the utility common equity balance may instead be proceeds from debt issued at the holding company level and classified on the utility subsidiary's books as common equity at the time the proceeds were invested in the utility subsidiary. This is referred to as double leverage.

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

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

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

A. No, we do not believe so.

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

A. Yes. While CEI's non-utility businesses face much greater business risk than its regulated utility operations, the non-utility investments are funded with proportionately the same amount

of common equity as the utility operations. This is not only unreasonable given the wide disparity in the risks of these activities, but is also inconsistent with Standard & Poor's (S&P) guidelines for financing these various types of energy companies and illuminates the inconsistency of the parent's financial policies. While both Orange and Rockland and Con Edison profess the importance of a strong financial profile when putting forth positions to the Commission, their parent pursues riskier financial profiles where it must compete for profits and sales.

Q. Define what you mean by the term business risk.

A. Business risk is the risk inherent in a company's operation and reflects the risk that it will fail to achieve its expected financial performance. It is affected by items such as a company's sensitivity to the overall economy, the level of competition it faces and its reliance on a large customer or supplier. Size is also factored into the equation because it implies less diversification and less financial flexibility. Finally, even within a given

industry, the level of business risk can vary greatly depending on the particular market segment or sub-sector in which the company operates.

Q. Do non-utility operations typically have more or less business risk than utility operations?

A. Non-utility activities nearly always have greater business risk than utility operations. This is because non-utility investments are unregulated, face competition from other entities, and are not subject to "cost-plus" recovery of their expenses. In addition, the products or services of an unregulated company may have alternatives that customers may switch to should their prices change dramatically. In response to Staff IR DPS-87, Dr. Morin agreed that non-utility investments have "generally higher" business risk than utility investments.

Q. What are the current financial profiles of CEI's utility and non-utility subsidiaries?

A. Exhibit___(FP-3), Page 1, presents a condensed balance sheet for CEI, Con Edison and Orange and Rockland based on CEI's 10-Q report for the period ending June 30, 2007 and its Orange and

Rockland-specific financials. Column 1 presents CEI's consolidated balance sheet results for all of its operations. Column 2 shows balance sheet information for Con Edison. Column 3 shows balance sheet information for Orange and Rockland. Column 4 is the sum of columns 2 and 3 and thus reflects the combined balance sheet of CEI's two utility subsidiaries. Column 5 represents the financial profile of CEI's non-utility operations. It is effectively the residual balance sheet of the parent after removing the stand-alone balance sheets of its two utility subsidiaries.

Q. What does this information indicate?

A. This information indicates that as of June 30, 2007, CEI's unregulated assets are financed with approximately 50.4% equity and its utility operations are funded with approximately 50.1% equity.

Q. What types of assets does the non-utility capital structure support?

A. According to CEI's June 30, 2007 10-Q, it has three active competitive subsidiaries: Con Edison Solutions, Inc - a retail energy services

company; Consolidated Edison Development, Inc. - an owner and operator of generation and infrastructure investments; and Consolidated Edison Energy, Inc. - a wholesale supply company. While each of these investments falls within the broader utility and power company industry, they operate within its riskiest segment. S&P classifies these high risk ventures as the "energy merchant and developer" business. The non-utility capitalization also supports any remaining non-earning goodwill booked by CEI as a result of its acquisition of Orange and Rockland.

Q. Is it reasonable for CEI to finance its assets that are devoted to the relatively low-risk provision of transmission and distribution (T&D) service with approximately the same ratio of common equity as its high-risk competitive ventures, and to then utilize the inflated common equity ratios of its utilities' stand-alone capitalizations for setting rates?

A. No, it is not. For a given credit rating, it is axiomatic that assets exposed to greater business risk must employ less financial risk

(i.e. a higher equity ratio). In this case, CEI's non-utility operations face considerably greater business risk than its T&D assets. Thus, CEI should be offsetting the additional business risk faced by its non-utility investments, by financing them with considerably more equity than its T&D assets, if it expects the Commission to accept the stand-alone ratios of its utility subsidiaries for setting rates.

Q. Are there any independent analyses from the financial community that can be used as a basis to quantify a rational financing policy for CEI's non-utility operations?

A. Yes. There is a fairly recent study performed by S&P entitled "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised", included as Exhibit___(FP-4). This report specifically illustrates target financial ratios for a variety of utility and competitive energy-related companies based upon their given debt rating and "business profile."

S&P utilizes a ranking system from "1" to "10" to distinguish the relative amount of

business risk facing a particular company, with those company's facing the least amount of business risk assigned a business profile score of "1" and those subject to the most business risk assigned a business profile score of "10."

According to the report, an average T&D company, such as Orange and Rockland and Con Edison, faces relatively little business risk, and as such has a business profiles ranking between "2" and "3." Meanwhile, energy merchants and developers, such as CEI's non-regulated businesses, are found to be subject to much greater business risk and consequently have, on average, business profile rankings of between "8" and "9."

Q. How did you use this information to reflect a more rational financing policy for CEI's non-regulated investments?

A. According to S&P's guidelines, a company with a business profile of "8" would need to maintain its total debt to total capital at about 38.5% in order to sustain S&P's "A" rating of CEI. Therefore, as illustrated in Column 6 of Exhibit___(FP-3), Page 1, we adjusted the mix of

debt and equity supporting these riskier operations such that the resulting capitalization consisted of 38.5% debt and 61.5% common equity. In effect, we reduced the non-utility operations' debt by $140 million, while simultaneously increasing the amount of common equity supporting these operations by $140 million.

Q. How did you use the adjusted non-utility capitalization to derive the appropriate utility capitalization?

A. We subtracted the adjusted non-utility capitalization amounts from CEI's consolidated capital structure (Column 1) to arrive at a residual capital structure that reflects an appropriate debt/equity mix for CEI's regulated operations, including Orange and Rockland. This result can be seen in Column 7 of Exhibit___(FP-3), Page 1.

Q. Given that the appropriate utility capitalization that you developed is as of June 30, 2007, please explain how you reflected the impact of such things as construction expenditures, refunding needs and internal cash

flows to develop the appropriate capitalization for the rate year?

A. As illustrated on page 2 of Exhibit___(FP-3), we developed average rate year balances for both common equity and long-term debt based upon the financial forecast of Company witness Perkins, both in this case and in the concurrent Con Edison steam rates proceeding, Case 07-S-1315. Specifically, we reflected all of Company's assumptions with regard to its financing activities through the end of the rate year.

With respect to the common equity balance we forecast an additional $1.5 billion for Con Edison and about $101 million for Orange and Rockland. Beginning with Staff's June 30, 2007 adjusted utility common equity balance, we calculated quarterly ending balances from September 2007 to June 30, 2009. We determined the average rate year balance of common equity by averaging the five quarterly ending balances beginning June 30, 2008 and ending June 30, 2009. We used the resulting balance of $9.157, billion shown in Column 9 of Exhibit___(FP-3), Page 1, to determine the capitalization ratios

used in Exhibit___(FP-2).

For the long-term debt component, we reflected all of the Company's projected retirements and issuances; for Con Edison the net change in long-term debt through June 30, 2009 is about $1.9 billion, and for Orange and Rockland the net increase is $110 million. Beginning with Staff's June 30, 2007 adjusted utility long-term debt balance, we calculated month ending balances from July 2007 to June 2009. We then calculated the average rate year balance by averaging the thirteen month ending balances from June 2008 to June 2009. The resulting balance of $9.501 billion is shown in Column 9 of Exhibit___(FP-3) page 1, and is used in the capitalization ratios shown in Exhibit___(FP-2).

Q. Your analysis implicitly assumes that the magnitude of CEI's non-regulated investments remain at June 30, 2007 levels, or about 7.5% of the consolidated capital structure. What would you recommend if it appears that the investment level will materially change?

A. Assuming that particular details of such an

event became available during the course of this proceeding, further discovery would be necessary and supplemental testimony may be needed to insure the reasonableness of the capitalization upon which rates are ultimately set.

Q. Given your adjustments, what rate year capitalization do you recommend the Commission apply to Orange and Rockland?

A. We recommend that the Commission employ a long-term debt ratio of 49.73%, a common equity ratio of 47.93%, a preferred stock ratio of 1.12% and a customer deposit ratio of 1.22% as the rate year capitalization for Orange and Rockland. This can be seen in Column 9 of Exhibit___(FP-3), Page 1.

Q. Are there any differences between the approach Staff used in Case 06-E-1433 and the approach you used in this case, to derive the appropriate utility capitalization?

A. There is one noteworthy difference. In Case 06-E-1433 Staff adjusted the mix of debt and equity supporting the riskier non-utility operations such that the resulting capitalization consisted of 50.0% debt and 50.0% common equity. We have,

quite simply, given greater consideration to the actual risks posed by these investments, and have reflected these views accordingly.

Q. Can you substantiate that your recommended capitalization ratios are consistent with Orange and Rockland's overall risk profile?

A. Yes. As measured by its debt rating, Orange and Rockland has one of the strongest financial profiles among electric utilities; thus it has relatively low financial risk. The Company's debt (specifically its senior unsecured obligations) is rated "A" by S&P, and "A2" by Moody's Investors Service or Moody's. In relative terms, the Company also has very low business risk, as evidenced by its S&P business profile score of "2."

S&P's capitalization guidelines call for "A" rated electric utilities with a business profile of "2" to maintain total debt in the range of 52% to 58% of total capital. Our recommended long-term debt ratio of 49.73% thus compares very favorably. We recognize of course that S&P looks beyond the traditional balance sheet at items such as deferred pension and OPEB

obligations, which it views as increasing a company's effective leverage. However, given the large increase in pension and OPEB allowances in Case 06-E-1433, and the recommendations of Staff witness Burke, with respect to the recovery of the Company's deferrals for these items, we believe that our capital structure recommendations are consistent with its current risk profile and should not, in themselves, result in a rating change.

Q. Are your recommended capitalization ratios in line with those of other utilities?

A. Yes. As can be seen in Exhibit___(FP-5), our proxy group companies are projected, on average to have a common equity ratio of 48.9%, which is only slightly higher than our recommended common equity ratio of 47.93%. With an average "business profile" of "5", the proxy group companies have greater business risk than Orange and Rockland. It is therefore not unreasonable to expect these companies to employ higher levels of common equity to mitigate the added business risk.

COST RATES

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

A. As illustrated in Exhibit___(FP-2), there are four separate cost rates we employed together with their respective capitalization ratios to formulate our overall rate of return recommendation. Beginning with the cost rate of the long-term debt component, we reviewed the 6.30% cost rate determination of Company witness Perkins and made a few adjustments that resulted in our 6.19% cost rate recommendation. Exhibit___(FP-6) shows how this cost rate was derived. With respect to the 5.34% cost of preferred stock we used the cost rate determined by Con Edison in Case 07-E-0523.

The third cost rate shown in Exhibit___(FP-2) is the cost of customer deposits. The 3.76% customer deposits rate is the rate prescribed by the Commission in October 2007 for use beginning January 1, 2008. The fourth and final rate is the cost of common equity. As we will demonstrate, the Company's 11.5% proposed cost rate for common equity is excessive and should be rejected. We have developed a recommended

8.9% cost of equity for the rate year ending June 30, 2009.

Q. Regarding the cost of the long-term debt component, would you please explain why you adjusted the 6.30% cost rate submitted by Company witness Perkins, as illustrated in Exhibit E-8 Schedule 3.

A. As we explained earlier, Orange and Rockland submitted its actual long-term debt outstanding as of March 31, 2007, along with the 6.26% actual cost rate of its embedded debt. However, its rate year cost of debt determination includes estimates of the amounts, timing and cost rates associated with two new issuances of debentures, planned to occur prior to the end of the rate year. We have found the estimated cost rates of these new issuances to be excessive. Consequently, our cost of debt determination reflects a more reasonable forecast of these costs.

Q. Please elaborate.

A. As illustrated in Exhibit E-8 Schedule 3, Company witness Perkins forecasted a 10-year, $60 million issuance of debentures in late 2007,

and a 30-year, $50 million issuance in late 2008. His forecasted cost rates are based on estimates of future Treasury rates from the publication Blue Chip Financial Forecast, plus spreads to treasuries in recent months. Mr. Perkins correctly noted that the spreads required of all types of issuers, including Orange and Rockland, has increased considerably since the last time the Company issued securities in October 2006.

Based upon this methodology, Mr. Perkins forecasted that the 10-year $60 million series would be issued at a coupon rate of 6.13%, with an all-in cost, including issuance expenses, of 6.29%. Similarly, the 30-year $50 million issuance was forecast at rates of 6.63%, and 6.74%, respectively.

While we share Mr. Perkins concerns regarding the use of the Company's most recent debt issue as a guide for determining appropriate spreads for the new issues, we find his use of forecasted treasury rates (between 5.15% and 5.25% for 10-year notes and between 5.3% and 5.35% for 30-year notes) produces

unreasonable estimates compared with today's actual treasury rates of 4.02% for 10-year notes and 4.48% for 30-year notes.

Instead, based upon current treasury rates and the current spread requirements for A-rated utility issuers, we computed a coupon rate of 5.55% for the 10-year debt (based upon the December 6, 2007 yield on 10-year treasury notes of 4.02% plus a spread requirement of 1.53%) and a coupon rate of 6.12% for the 30-year debt (based upon the December 6, 2007 yield on 30-year treasury notes of 4.48% plus a spread requirement of 1.64%). Including Mr. Perkins estimated issuance expenses resulted in all-in cost rates of 5.71% for the 10-year debt and 6.23% for the 30-year debt.

Q. Why did you use the most recent Treasury rates as a proxy for future interest rates?

A. The Commission has long recognized that interest rates can not be reliably forecast, and that the best estimate of future interest rates are the most recent ones.

Q. Do you recommend that your cost of debt be updated at the time of the Commission's decision

in order to reflect the most recent market conditions (actual treasury rates and spreads required for utility debt with Orange and Rockland's debt rating) for the proposed debt issues?

A. Yes.

SUMMARY OF ROE RECOMMENDATION

Q. What methodology did you use to determine your recommended return on equity (ROE)?

A. We followed the same methodology that Staff advocated, and the Commission adopted in its Order in the recent Orange & Rockland electric rate proceeding, Case 06-E-1433. Broadly speaking, we estimated the cost of equity for a proxy group of electric utility companies, using a DCF analysis, which we weighted two-thirds, and a CAPM analysis, which we weighted one-third. We then adjusted this result to reflect: 1) the difference in financial and business risks currently facing Orange and Rockland versus those of the proxy group on average; 2) common equity issuance expenses expected during the rate year; and 3) the potential risk-reducing attributes associated with Staff's

proposed Revenue Decoupling Mechanism.

Q. Would you please elaborate on the appropriateness of your proposed weightings; specifically your recommendation that the DCF methodology be accorded a two-thirds weighting and your CAPM result one-third.

A. The DCF has long been the principle equity costing methodology in New York. In fact, over the past 13 years the Commission has consistently preferred cost of equity determinations with 2/3 DCF and 1/3 CAPM weightings. While utility witnesses continue to disparage its use because it produces lower estimates than other methodologies, there are numerous good reasons why it should continue to be the preferred methodology, and if anything, we would advocate a higher weighting for the DCF approach.

The fact of the matter is that estimating the cost of equity requires using methodologies that are not perfect. We believe that of all the approaches available, the DCF and the CAPM are by far the least flawed and, that between those two, the DCF is clearly superior. It is

noteworthy that when Orange and Rockland raised identical concerns about the weighting accorded the DCF methodology in the last electric rate case, the Commission itself remarked on the relative strengths of the DCF. On page 14 of its Order issued October 18, 2007 in Case 06-E-1433, the Commission stated that: "…the method offers the significant benefit of reliance on readily available, objective data to measure an indicator of real importance to investors."

We will demonstrate the reasonableness of our two-stage DCF method, and show that while we have concerns with the CAPM methodology in general, our application of this approach produces a reasonable check on our DCF methodology, and as such should be accorded no more than a 1/3 weighting.

One of the reasons that the Commission has never relied principally on the results of the CAPM methodology is that it relies heavily on estimates of market return and premiums that can be flawed and have a tendency to change rapidly. While these uncertainties remain today, there is a trend which has developed in recent years

which we believe portends that greater caution be used when relying on CAPM results for setting regulated returns for our low-risk T&D companies. The trend we are referring to is the increase in beta estimates of the electric utility industry over the past 13 years, from around .6 to .9. It strikes us as illogical that the cost of equity estimates using this approach for New York's electric utilities, whose business risks have generally declined as a result of their divestiture of riskier generation assets, now approach return estimates for the market as a whole.

USE OF PROXY GROUP

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

A. First, the use of a proxy group to determine Orange and Rockland's cost of equity is necessary because its stock is not publicly traded, and thus a direct DCF analysis of the Company is impossible. Equally important is that DCF and CAPM analyses for an individual company rely on analysts' estimates of growth and beta and those estimates are sometimes

biased or inaccurate. However, by employing a sufficiently large group of similarly situated companies in our analysis, we can largely diminish the undesirable effects of biased (both upward and downward) or inaccurate estimates for any one company.

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

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

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

order that we may have sufficient confidence in its results.

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

A. We selected a group of 30 companies; all, like Orange and Rockland, classified as electric utilities. Because of its robust size, we are confident that our proxy group will produce reliable estimates of the Company's cost of equity. Just as importantly we also believe that we have carefully selected companies whose risks are substantially similar to those faced by Orange and Rockland. The list of companies we used, including their credit ratings, S&P business profile, percentage of utility revenues, and their equity ratios, is shown in Exhibit___(FP-5).

Q. How did you develop your proxy group?

A. We began with the 60 companies that Value Line categorizes as electric utilities as the appropriate group of peer companies from which our proxy group could be drawn. In order to match this group's risks with those of Orange and Rockland, we considered two variables, or

screening criteria; credit quality (debt rating) and percentage of regulated revenue.

Orange and Rockland's debt is rated "A" by S&P and "A2" by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only five out of the 60 electric utility holding companies followed by Value Line had debt rated A/A or higher, and nearly all derived some revenue from unregulated investments.

Mindful of our goals of achieving a group of companies that is both sufficiently large and with similar risks to Orange and Rockland, we included in the proxy group only those dividend paying companies whose debt was at least investment-grade, and whose operating revenues from regulated operations were at least 70% of its total revenue. In instances where the parent holding company was not rated, the utility subsidiary had to be investment grade. Finally, we excluded companies that were involved in merger-related or corporate restructuring activities. Excluding these

companies is reasonable because of the potential for such activity to distort their stock prices and hence their individual cost of equity estimates.

Q. In addition to the achievement of your goals, would you please elaborate on the reasonableness of your screening criteria?

A. In the past Staff has relied on proxy groups consisting of only "A" rated utility companies that derived a significant portion of their operating revenues from regulated operations. In the early 90s there were anywhere between 25 and 33 such companies. Today that number has dwindled to between three and five depending upon the specific interpretation of what is implied by "substantial" with respect to regulated revenues.

The preeminent event has been the steady decline in credit quality of U.S. corporations in general over the past 25 years. This broader trend, together with an orientation in the electric utility industry towards consolidation through mergers and an increase in unregulated activities, means that a lowering of the credit

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

In this case, just as in the last Orange and Rockland electric rate case, and consistent with recommendations by Staff in other recent cases, we have determined that the most reasonable proxy group for determining Orange and Rockland's cost of equity is one whose debt ratings are at least investment-grade and whose operating revenues are at least 70% of its total revenue.

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

A. As illustrated in Exhibit___(FP-5), the average debt rating of the proxy group is between "BBB+" and "BBB" for S&P and between "Baa1" and "Baa2" for Moody's. In addition, the group's average business profile is a 5.0; it receives, on average, about ~~10.7%~~ 11.4% of its revenues from non-regulated businesses, and has a common equity ratio of 48.9%.

DISCOUNTED CASH FLOW METHODOLOGY

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

A. The calculation of the DCF for the proxy group is shown on pages 1-2 of Exhibit___(FP-8). For each company in the proxy group, there is a six-month average stock price, calculated by averaging the high and low price for each month. We have used the six-month period ending October 2007. The model also contains *Value Line* data for the beta, earnings per share, dividends per share, book value per share and the forecasted amount of outstanding common stock for each company.

This data is used to estimate the dividends that can be expected for each company in the future. The price investors are paying for the stock, the average stock price over a six-month period, is seen as the present value of that dividend stream. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, one can determine the rate of return investors are expecting for each company. The median result, which we calculate to be an 8.58%

return, is used as the DCF methodology result.

Q. How are dividends projected to change over time?

A. Consistent with the approach Staff has used for many years, we employed a two-stage DCF method. In the near-term, the estimates of *Value Line* are used. For the second stage, 2012 and beyond, a "sustainable growth" rate is calculated for each company in the proxy group based on its projected retention of earnings and growth in common stock balances.

Q. What was the median sustainable growth rate for the proxy group?

A. 4.7%.

Q. How does this growth rate estimate compare with growth estimates of the overall economy?

A. It is very close to the current long-range consensus growth rate in Nominal GDP. According to the October 10, 2007 edition of Blue Chip Economic Indicators, the consensus long-range estimates are 5.0% for 2009-2013 and 4.9% for 2014-2018.

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

A. As shown on page 2 of Exhibit___(FP-8), the

median return on equity of the proxy group is 8.58%. This figure is the appropriate measure of the DCF-derived cost of equity of the proxy group.

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

A. While most of the individual company results appear reasonable, we would not recommend a cost of equity based upon any of the individual results themselves because of the potential for biased or inaccurate beta and growth estimates to influence the result. Furthermore, we do not recommend tossing out individual results that appear unreasonable because we use the median return of our individual results, as opposed to the average. Use of the median is a widely employed statistical tool intended to diminish any undue impact that outliers may have on the average result.

Q. Dr. Morin advocates using future earnings growth estimates ranging from 6.3% to 7.9%, based on information from *Value Line* and *Zacks Investment*, as the measure of the growth in the DCF model. Is this appropriate?

A. No. The DCF is a calculation which determines investors' return expectations based on current stock prices and future cash flows. Those cash flows are the dividends a company is expected to pay out in the future. Dr. Morin has provided no evidence that projected earnings growth is equal to future dividend growth.

CAPITAL ASSET PRICING MODEL METHODOLOGY

Q. Please describe the methodology used to determine your CAPM results.

A. The principle behind the CAPM theory is that the level of systematic risk for an asset determines the level of return that investors will require to invest in that asset. Consistent with the approach Staff has employed for many years, we used two different CAPM methods (the traditional and "zero beta") to estimate the cost of equity. The CAPM result is the average of the two estimates.

Q. Why are two CAPM methods used?

A. Research has shown that the CAPM can possibly underestimate the required return when betas are below 1.0. By using a "zero beta" methodology as well, such a tendency can be addressed by

averaging in a result which is only partially determined by the beta used.

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

A. The traditional CAPM method calculates a required return based on three inputs: The rate of return on a risk-free investment (Rf), the level of systematic risk for an investment (B, known as the "beta"), and the expected risk premium of the market. (Rp). The calculation can be represented as:

Required Return = Rf + (B * Rp)

Q. How did you determine the risk-free investment rate and what was your result?

A. We have averaged the 10-year and 30-year Treasury bond yields for a recent six-month period. The result for the six-month period ending November 2007 is 4.77%.

Q. Is this how Dr. Morin calculated the risk-free rate?

A. No, it is not. Dr. Morin used only the 30-year Treasury bond yield purportedly prevailing in June 2007. We say "purportedly" because his risk-free rate is 10 basis points higher than

the June 2007 average for 30 year treasury bonds in the Federal Reserve Statistical Release. It is also higher than any treasury yields since, and results in a higher CAPM result.

Q. How did you determine the beta for the CAPM?

A. We used the average beta of the proxy group, as reported by *Value Line*. The average beta of our proxy group is 0.91.

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

A. The risk premium is the difference between what the expected return on common stock is and the rate on a risk-free investment. In order to determine the expected market return, we have utilized Merrill Lynch's November, 2007 *Quantitative Profiles*. As illustrated on page 46 of (Exhibit___(FP-9), that publication currently estimates the required return for the market to be 10.65% (using an average of Merrill Lynch's "Implied Return" and "Required Return" methods). Given our risk-free rate of 4.77%, a market risk premium (MRP) of 5.88% is calculated.

Q. Using your stated inputs, what was your

"traditional" CAPM result?

A. 10.12%, calculated as follows:

4.77% + [0.91 * (10.65% - 4.77%)] = 10.12%

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

A. The same inputs described for the traditional CAPM methodology were used. Instead of multiplying beta by the risk premium as shown in the calculation of the traditional CAPM methodology, we determined the risk premium for the proxy group by multiplying .75 times beta times the risk premium and adding .25 times the risk premium. This can be shown as: Required return = Rf + (.75*B*Rp) + (.25*Rp)

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

A. 10.25%, calculated as:

4.77% + [.75*.91*(10.65%-4.77%)] + [.25*(10.65%-4.77%)] = 10.25%

Q. What CAPM result did you use in your calculation of the required ROE for the proxy group?

A. We averaged the results of the two CAPM methods to arrive at a result of 10.19%.

RETURN ON EQUITY CONCLUSION

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

A. We weighted the DCF result (8.58%) as two-thirds of the total and the CAPM average (10.19%) as one-third of the total, which resulted in a 9.12% cost of equity. These calculations can be seen on page 3 of Exhibit___(FP-8).

Q. You explained earlier in your testimony that proposed three adjustments to this cost rate. Please describe these adjustments, beginning with your adjustment to reflect the fact that there is a quantifiable difference between the risks faced by Orange and Rockland and the proxy group.

A. The rationale for this adjustment is based upon the fundamental concept that the return requirements of common equity investors are commensurate with the riskiness of their investment. While our proxy group selection process sought out companies whose risks were "substantially similar" to those faced by Orange and Rockland, the fact is that differences do exist and should be reflected in the cost of equity determination accordingly.

The major credit rating agencies such as Moody's and S&P regularly assess both the business and financial risks of the utilities they rate and assign their credit ratings accordingly. As we discussed earlier, Orange and Rockland is rated "A2" by Moody's and "A" by S&P, while as illustrated in Exhibit___(FP-7), the average Moody's rating for the proxy group is somewhere between the "Baa1" and "Baa2" (2.4 notches lower), and the average S&P rating is somewhere between "BBB+" and "BBB" (2.2 notches lower).

To calculate the discount required by Orange and Rockland's debt holders as compared to the cost requirements of the proxy group's debt holders, we calculated six-month average spreads for "A" rated debt versus "Baa" rated debt, using Moody's monthly data for seasoned utility bonds with remaining maturities of at least 20 years. Based upon this data, and given their respective debt ratings, we calculated implied yields for both Orange and Rockland and the proxy group. The result was 6.18% for the Company and 6.37% for the proxy group, implying

that return required by the Company's debt holders is about 19 basis points less than the return investors would require for proxy group debt.

In order to translate that debt discount into the return requirements of the Company's equity investors, we took the ratio of Orange and Rockland's implied debt cost to the proxy group's implied cost of debt (6.18%/6.37% = 96.87%) and applied it to the proxy group's 9.12% cost of equity and determined that the appropriate discount is 29 basis points. Our calculations are illustrated in Exhibit___(FP-10).

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

A. While Dr. Morin utilized proxy groups with overall credit risks that are somewhat higher than ours, he concluded that no adjustment was necessary. While he conceded that Orange and Rockland has lower business risk than the companies from which his cost of equity estimates are drawn, he concluded that no adjustment is necessary because of what he

alleges is Orange & Rockland's small-size.

Q. Do you agree with Dr. Morin's conclusion with respect to Orange and Rockland's size?

A. Absolutely not. First of all, as we already discussed, the relative size of a company is already factored into its business risk assessment, and thus reflected in its credit rating and our proposed adjustment. Second, given that Orange and Rockland is a wholly-owned subsidiary of CEI, with its $16.1 billion capitalization and conservative business approach, any suggestion that investors would question the Company's financial flexibility by virtue of its size is simply ridiculous on its face.

Q. Please explain your second adjustment, the one you made to reflect the costs associated with the Company's proposed infusion of $40 million of common equity during the rate year.

A. Our review of both Con Edison's and the Company's financial forecasts indicate that CEI will be issuing common equity during the rate year and that $40 million of those proceeds will be supplied to Orange and Rockland to finance

its electric and gas and utility operations. It has been Commission policy to allow recovery of such expenses when they are reasonably expected to be incurred. Based upon an average of the actual issuance expenses incurred by the parent in its last three public offerings, of about 1.5% of the gross proceeds, we estimate Orange and Rockland's share of these costs to be about $600,000 ($40 million * 1.5%). Given the Company's projections that it will have about $480 million of common equity on its balance sheet on average during the rate year, an upward adjustment to the cost of equity of 13 basis points is necessary ($600,000/$480 million). Doing so allows Orange and Rockland to recover expected equity issuance costs in the rate year. Until rates are reset they would provide such recovery for future issuance expenses as well.

Q. Please explain your final adjustment; the one you made to reflect the potential risk-reducing attributes associated with Staff's proposed Revenue Decoupling Mechanism (RDM).

A. Staff is proposing an RDM which would reconcile Orange and Rockland's actual rate year sales to

the amount forecasted by the Company's Forecasting Panel. This would eliminate the risk of weather-related sales variation from the sales forecast, as well as non-weather related usage per customer variations, and customer growth variations. By eliminating this uncertainty, the Company's prospective cash flows and earnings will be more predictable. Consequently, equity investors will gain greater clarity with regard to the future dividend potential of the Company, and the Company's equity becomes a less risky investment.

Q. How have you attempted to quantify the degree to which the Company's risk will be reduced with the implementation of Staff's proposed RDM?

A. We have noted that with respect to the Local Gas Distribution industry, Moody's has opined that "LDCs that have, or soon expect to have, revenue decoupling stand a better chance than others in being able to maintain their credit ratings or stabilize their credit outlook in face of adversity." (See Exhibit___(FP-11)).

Currently, only one of the companies in the proxy group, PG&E Corp., has an operating unit

with an RDM, so there is not a lot of credit information available regarding electric T&D companies. Nonetheless, we see no reason that the rating agencies wouldn't view revenue decoupling favorably for electric T&D companies such as Orange and Rockland. Absent details regarding the exact nature of RDM itself, we believe it is reasonable to assume that the reduction in business risk associated with the increased predictability of the Company's cash flows, is equivalent to a one-notch credit rating upgrade, which our analysis shows is equal to about a ten basis point change in the expected return for its shareholders.

Q. Does your adjustment imply that the implementation of an RDM would necessarily result in an upgrade?

A. Not necessarily. It is possible that CEI could use this reduction in business risk to increase the leverage employed in its utility operations. In such circumstances, the benefit of the reduction in business risk would be conveyed to ratepayers via a lower overall cost of capital, as a result of the lower common equity ratio.

Q. In its position paper to the Commission, dated October 19, 2007, in Case 06-E-1433, the Company alleged that an RDM would increase its regulatory risk, and as a result its cost of equity would be higher. Would you please comment on this argument?

A. The crux of Orange and Rockland's argument is that because of the periodic updating and modifications inherent with an RDM that it would be at risk for the delay or denial of unrecovered, deferred costs. Belying this argument are the facts; the use of true-ups reduces risk and the Company has never been denied the recovery of any of its prudently incurred costs.

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

A. As illustrated on page 3 in Exhibit___(FP-8), we adjusted the proxy group's 9.12% ROE accordingly: 1) we reduced it by 29 basis points to reflect the Company's superior credit quality; 2) we increased it by 13 basis points to reflect reasonably anticipated common equity

issuance expenses; and 3) we reduced it by 10 basis points to reflect the forward-looking reduction in risk associated with the implementation of Staff's proposed RDM. As a result of these adjustments, we recommend that Orange and Rockland be allowed the opportunity to earn an 8.9% return on its average common equity during the rate year. Our recommendation is rounded to the nearest tenth of a percent.

Q. Do you recommend updating the cost of equity?

A. Yes. Prior to a decision by the Commission in this case, we recommend that our methodology be updated.

DISCUSSION OF COMPANY ROE AND FINANCING PRESENTATIONS

Q. You have stated that Dr. Morin's recommended ROE is excessive and should be rejected. Would you please summarize the approach followed by Dr. Morin?

A. To arrive at his recommendation, Dr. Morin performed a total of four DCF analyses using two different proxy groups for Orange and Rockland. He also performed four risk premium analyses; two using CAPM estimates and two using historical and allowed risk premium data from

electric utility industry aggregate data. He then averaged the results of all three methodologies, according each an equal weight, to arrive at an 11.3% cost of equity determination.

Based upon his professional judgment and assessment of the risk circumstances of Orange and Rockland he then concluded an ROE recommendation of 11.2%. The Company's revenue requirement, however, reflects an 11.5% cost of equity to reflect its assessment of the added risk associated with its proposed three-year rate plan.

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

A. To begin with, Dr. Morin only assigns the DCF a one-third weighting while assigning his higher cost of equity risk-premium approaches a two-thirds weighting. He makes the same arguments that the Commission already considered and rejected in the last Orange and Rockland electric proceeding. Therefore, his approach, which places additional weight on methodologies that have consistently been found to be

inferior, should be rejected.

Q. You explain that Dr. Morin, like Staff, relied on proxy groups to determine the cost of equity. Do you have any concerns with Dr. Morin's proxy group selection process?

A. Not only are Dr. Morin's proxy groups considerably smaller than Staff's proxy group and thus less reliable, but both of Dr. Morin's proxy groups contain companies that may not be suitable surrogates for Orange and Rockland's utility operations. Specifically, only 7 of the 12 companies in the electric distributors group and 11 out of the 15 companies in the Moody's group receive 70% or more of their operating revenues from utility operations. Additionally, he electric distributors group includes Energy East which is involved in merger-related activity. And, his Moody's group includes one company (TECO Energy) that is not investment grade. For these reasons his proxy groups are inferior to Staff's and should be rejected.

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

A. Dr. Morin performed four separate DCF analyses;

he performed two using a proxy group consisting of 12 parent companies of investment-grade operating electric distribution utility companies (electric distributors), and repeated the same two analyses using the 15 companies comprising the Moody's Electric Utility Index (Moody's group).

For both of these flawed proxy groups he calculated two average ROE estimates, all of which relied upon current dividend yield information. In one analysis he used Value Line earnings per share growth estimates and in the other Zack's long-term earnings growth estimates. Among the problems with these estimates is that the Commission has long accepted the premise that sustainable long run utility dividend growth is a product of a company's future expected returns on equity and its dividend payout policy. Dr. Morin's testimony, however, fails to address how these relatively short-term earnings growth estimates relate to the dividend payout policies of his companies and, even more troubling, to demonstrate whether or not they are even

sustainable over time.

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

A. In order to quantify the risk premium for Orange and Rockland, Dr. Morin performed a total of four risk premium analyses. For the first two risk premium studies he submitted, his "CAPM Estimates," he applied the CAPM and an empirical approximation of the CAPM using current market data. The other two risk premium analyses were performed on historical and allowed risk premium data from electric utility industry aggregate data.

Q. Please explain how Dr. Morin performed the two CAPM analyses to determine the incremental return required by investors of Orange and Rockland versus the risk free rate.

A. Dr. Morin began with a traditional CAPM methodology. For his inputs he used: a risk-free rate of 5.3% based upon the current level of 30-year Treasury bonds yields; a beta of .91 based upon the Value Line betas of the electric utility companies used in his DCF analyses; and a market risk premium of 7.4% based upon the

results of both forward-looking and historical studies of long-term risk premiums. He then used these inputs and determined that the CAPM estimate of the cost of common equity for Orange and Rockland is 12.0% ((5.3%+(0.91*7.4%), which he adjusted to 12.3% for a flotation cost allowance. In his Empirical CAPM approach, he adjusted this result even further upward, to 12.5%, because he believes that for betas less than 1.0 the CAPM underestimates the cost of equity.

Q. What concerns do you have with Dr. Morin's CAPM approaches?

A. Our principle concern is the manner in which he determined his 7.4% risk premium. This premium was the result of blending two estimates for the market risk premium; a historical market return (ex post) using Ibbotson Associates data (7.1%), and a forward-looking return (ex ante) using Value Line stock data (7.6%).

Dr. Morin's use of a 7.1% historical risk premium (based on Ibbotson Associates financial data that goes back to 1926) does not reflect the current investing climate. It is an average

of return differentials between bonds and the stock market over periods much different than today. Many in the financial community believe that the equity risk premium has been decreasing over time and is currently very low. For instance, Jeremy Siegel, in "*The Shrinking Equity Premium*", The Journal of Portfolio Management, Fall 1999, articulated this view (See Exhibit___(FP-12)). As a result, there is a debate concerning the relevance of the Ibbotson data in today's markets.

Q. Did Dr. Morin consider any other historical or forward looking market return studies that estimate the MRP?

A. Yes. In response to Staff IR DPS-97, Dr. Morin referenced some studies, including a 2000 published work by Dimson, Marsh and Staunton that reported historical risk premium returns for many countries. They reported an average risk premium over long-term bonds for 12 countries for the period 1900-2000 of 5.6%, with the United States at 7.0%.

Q. Are you familiar with this work done by Dimson, Marsh and Staunton?

A. Yes. However, there is more current research from 2006 by Dimson, Marsh and Staunton titled, "*The Worldwide Equity Premium: A Smaller Puzzle,*" that includes market returns for the period, 1900-2005. As illustrated on page 19 of Exhibit___(FP-13), this report concludes an average risk premium over long-term bonds of 6.08% for a group of 17 countries, and an average risk premium of 6.49% for the United States. This recent research is more relevant for developing a current market risk premium for the U.S., since it contains market return data through 2005. The impact of the more recent data is significant; the MRP for the U.S. for the 1900-2005 period is fully 50 basis points less than the MRP for the 1900-2000 period.

Q. Were there any other risk premium studies referenced by Dr. Morin?

A. Yes, Dr. Morin used a paper titled, *Ex Ante Cost of Equity Estimates of S&P 500 Firms: The Choice between Global and Domestic CAPM.* Dr. Morin averaged the ex ante market risk premium (MRP) for each year from 1983-1998, which was 7.2% and compared this to his own estimate of 7.4%.

Q. Did you review this study?

A. Yes, and it is interesting that on page 17-18 of the study, there is a table that shows the breakdown of the full period ex ante risk premium estimates by broad industry groups. The ex ante MRP for the utility industry is 4.15%, substantially lower than what Dr. Morin is using.

Q. Are there other historical or forward looking MRPs that you are aware of?

A. There are many studies and surveys that attempt to estimate the market risk premium for the United States. A study from November, 2006 by Glen Donaldson, Mark Kamstra and Lisa Kramer entitled *Estimating the Ex Ante Equity Premium*, concluded that the true MRP for the United States lies within 50 basis points of 3.5%.

Two well known, forward looking approaches for estimating the MRP are Duke University's CFO Outlook Survey and Merrill Lynch's *Quantitative Profiles*. Duke University's Fuqua School of Business in conjunction with *CFO* magazine compile the CFO Outlook Survey by interviewing Chief Financial Officers (CFOs) of companies and

subscribers to CFO magazine around the world every March, June, September and December. Among the many questions in this comprehensive survey are several that ask CFOs what their expectations are for the S&P 500 return over the next ten years. The December, 2007 survey summarized responses from 1,275 U.S. and international CFOs. As illustrated on page 49 of Exhibit___(FP-14), the mean return expected by these CFOs for the S&P 500 for the next ten years is 8.34%. Given that the annual yield on the 10-year Treasury note was 4.1% at the time of this survey, the expected MRP is therefore 4.24% (8.34% - 4.1%).

Merrill Lynch uses a multi-stage dividend discount model to calculate an expected return for the S&P 500 in its monthly *Quantitative Profiles* publication. As illustrated on page 46 of Exhibit___(FP-9), the expected return for the S&P 500, according to the November 2007 issue, is 10.65%. Using Dr. Morin's risk free rate of 4.6% only results in a MRP of 6.05%. Merrill Lynch's *Quantitative Profiles* provides a more accurate and up-to-date assessment of what

today's investors require because it is based upon the current expected market return, which takes into account only the current business climate.

Q. Has the Commission ever discussed the use of the Merrill Lynch estimate versus Ibbotson's historical data for calculating risk premiums?

A. Yes, in Case 95-G-1034, Central Hudson Gas & Electric Corporation, the Commission recognized the use of the Merrill Lynch estimate. On page 14 of Opinion 96-28, dated October 3, 1996, the Commission stated, "…the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problems of stale data in the Ibbotson estimate, or the circularity of the implied risk premium approach in relying on other commissions' return allowances."

Q. On page 35 of his testimony Dr. Morin described his use of a forward looking market risk premium. Please comment on his approach?

A. For some reason, Dr. Morin is not willing to use expected dividend growth rates in his DCF methodology to determine future cash flows, but

is willing to use them to estimate expected returns in his CAPM analysis. While using dividend growth forecasts can be a reasonable approach, Dr. Morin is using exceedingly high forecasts of dividend growth (12.43% per year) to set the expected market return.

Once again, as with the Ibbotson Associates data, Dr. Morin has used a MRP that is far beyond what most independent researchers estimate. We believe that informed investors would weigh all of the information available and make investment decisions based on that data, rather than relying on the one or two methods which result in the highest premium.

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

A. There are several reasons why this approach should be rejected. First, Dr. Morin makes no attempt to determine the extent to which Orange and Rockland is more or less risky than the average electric utility contained in the Moody's electric utility common stock index for

the period 1932 to 2002. He also provides no evidence about whether the risks of the bonds used to calculate the yield for Moody's composite index have remained at the same level relative to the risks of the electric utility stocks comprising the Moody's electric utility common stock index, for the 1932 to 2002 study period. Finally, Dr. Morin has not provided evidence indicating that the risks of utility bonds have remained at the same level relative to Treasury securities over this time period.

Q. Please comment on the suitability of Dr. Morin's analysis of allowed return risk premiums in the electric utility industry?

A. Dr. Morin's use of Regulatory Research Associates *Regulatory Focus* to determine an average allowed return is seriously flawed, primarily because he makes no attempt to assure the comparability of those returns with the particular risks facing Orange and Rockland and the return that those risks imply. Specifically, Dr. Morin makes no attempt to factor in the particular company risks associated with any of these ROE decisions, nor

does he differentiate for ROEs that are for multi-year rate plans and as such, likely include stayout premiums.

Q. Finally, would you please comment on Dr. Morin's statement that a low ROE increases the possibility that the Company will not have access to the capital markets for its outside financing needs, or if so, at prohibitive costs.

A. As we have demonstrated, our cost of equity recommendation represents a reasonable estimation of the Company's equity investors. As such we do not believe it can appropriately be characterized as either "too low" or "too high." Moreover, given the Company's strong financial profile, its conservative management and supportive regulatory environment, any suggestion of our cost of equity recommendation resulting in prohibitive financing costs is pure fantasy.

Q. Referring to the financial challenges faced by Orange and Rockland, Company witness Perkins noted that the Company has a capital expenditure program, determined by the need to update and expand its electric delivery infrastructure that

is significantly higher than levels in the recent past. He also suggests that "sub-standard return" authorizations could impair its ability to raise the necessary capital to fund its operating requirements at reasonable terms. Do you share his concerns?

A. No. We agree that it is important for the Company to have access to the financial markets at reasonable terms. To this end, we have recommended a capital structure and cost rates that are consistent with this objective, while other Staff witnesses have concluded that all of the proposed infrastructure-related capital expenditures are reasonable, and will thus be fully recovered in our overall revenue requirement. Finally, we note that our ROE recommendation is based upon an approach the Commission has endorsed in the past and that this Commission has never prohibited the Company from accessing capital at reasonable terms.

Q. The basis for Mr. Perkins characterization of the Commission's return authorizations as substandard is a comparison he made of New York allowed returns versus other jurisdictions from

1992 through 2006. Do you believe that Mr. Perkins data provides any meaningful basis for comparing authorized returns?

A. No. A meaningful comparison of returns would require adjustments to reflect the risk underlying each of the referenced rate plans. As we explained earlier, a fundamental concept in financial theory is that investors return requirements are directly linked to the riskiness of their investment. Thus, Mr. Perkins failure to account for such critical elements of these rate plans as the credit ratings of these utilities, whether or not they were for multi-year periods, what levels of expense reconciliation were allowed, how robust the sales forecasts were relative to historic growth, or whether the test periods were historic or fully forecast, completely undermines the reliability of his conclusion, and it should be rejected.

Q. Does this conclude your testimony?

A. Yes it does.

BY MS. JOSS:

Q. Did you also prepare the exhibits currently referred to as FP-1, FP-2, FP-3, FP-4, FP-5, FP-6, FP-7, FP-8, FP-9, FP-10, FP-11, FP-12, FP-13 and FP-14?

A. (Henry) That is correct.

Q. Do you have any corrections to these exhibits?

A. (Augstell) FP-5, under the regulated utility revenue column, if you go down to line 15, FPL group, where it says 99 percent regulated utility revenue should be 76.3 percent.

And then at the bottom, the staff proxy group average, instead of 89.3 percent it should be 88.6 percent.

Q. Do you have any additional corrections?

A. (Augstell) FP-8, on the first page, under the second column, percent utility revenue. Again, on line 15 for FPL group, instead of 99 percent it should be 76.3 percent.

Q. Are those all your corrections?

A. (Augstell) Yes, that's it.

MS. JOSS: Your Honor, Staff asks these Exhibits FP-1 through FP-14 be marked.

JUDGE LYNCH: It's 77 through 90.

MS. JOSS: Thank you.

(Exhibits 77 through 90 marked for identification.)

MS. JOSS: Your Honor, at this time this panel is ready for cross-examination.

JUDGE LYNCH: I have on my chart that the Company estimated about an hour, and that no one else had indicated. Is there anybody in the back that has questions?

MR. ST. LAWRENCE: No, Your Honor.

MR. KLUCSIK: No.

MR. CARLEY: Your Honor, in light of the events that have transpired throughout the course of this proceeding, I think our estimate has lowered a bit. I think it's probably no more than half an hour.

JUDGE LYNCH: That's completely up to you. I was trying to find out who was in the que, and it's you.

CROSS EXAMINATION

BY MR. CARLEY:

Q. Gentlemen, on pages 19 and 20 of your prefiled direct testimony you state that you have reduced non-utility operation debt by $140 million, while simultaneously increasing the amount of common equity supporting these operations by $140 million. This

results in capitalization consisting of 38.5 percent debt and 61.5 percent common equity.

That's correct; is it not?

A. (Henry) That is correct.

Q. This adjustment is also set forth on what you prefiled as Exhibit FP-3, page 2, which is now marked as Exhibit 79.

A. (Henry) I am sorry. You said that that was on page 2. I think you are referring to page 1 of that exhibit. You are referring to the 61 and a half percent equity ratio. I believe that's in column six.

Q. That is correct. Thank you.

Now, have you reviewed the rebuttal testimony of company witness Perkins?

A. (Henry) Yes, we have.

Q. I take it you gentlemen were here when Mr. Perkins testified earlier this morning?

A. (Henry) Yes, we were.

Q. Both in his rebuttal testimony and in his testimony during cross-examination he discussed the sale of the bulk of the generation assets owned by Con Edison Development, and the sale was scheduled to close sometime during the first half of 2008; is that correct?

A. (Henry) Yes, we heard that.

Q. Now, on page 22 and 23 of your testimony you state that you would consider adjusting your recommended rate year capitalization for the Company if the investment level in CEI's non-regulated subsidiary changed materially; is that correct?

A. (Henry) Can you point us to the specific?

Q. It's on page 22, I believe the question begins on line 21 and the answer continues onto the next page.

A. (Henry) On my copy here there is a question at line 18 on page 22.

Q. Right. The second sentence of the question says, what would you recommend if it appears the investment level will materially change?

A. (Henry) Yes, I see that. And we said that assuming that particular details of such an event became available during the course we would pursue further discovery and supplemental testimony if necessary.

I believe what you are suggesting is based upon the information that you presented today what our response would be. Obviously we have seen the 8K that the Company issued. We have seen the press release.

Certainly if the sale became imminent and if details came--worked out much the way you are talking about, that might require an adjustment, but at this

point in time it's not clear when the deal would close or even necessarily would close. So, we believe it's probably a little premature at this time to make any adjustments.

Again, if this transaction appeared imminent and we had concrete details, then we might pursue--we might reflect that accordingly in our recommendation.

Q. Because if indeed the Commission--if indeed the Company sold off the debt associated with Con Edison Development, according to the formula that you proposed, strictly applying it, there would be no need to make the adjustment that you proposed in your testimony; isn't that correct?

A. (Henry) Of course that presumes that the Company does what it stated it intends to do. As you know, the Commission has no authority over what CEI does with the proceeds. It's entirely up to them.

Q. Understood. Following up on a statement that was made by Mr. Perkins earlier today, in the event that CED's generating assets were sold and the proceeds of that were applied to retire CED's debt, such that the unregulated subsidiary's equity would far outweigh its debt, is it Staff's position that this sort of adjustment that you proposed is symmetrical, so that if,

arguably, the Company's unregulated subsidiary equity levels are high enough that they could be deemed to be supporting the regulated company's capital structure, there should be a similar adjustment?

A. (Henry) I believe we stated our position in the testimony, that the purpose of this is to ensure that the unregulated operations are not benefitting in terms of their ability to attract capital for riskier investments, and having utility ratepayers essentially support those operations that are indeed riskier.

If the investment in the non-regulated operations was adequately financed and did not appear as risky, then perhaps such an adjustment would not be deemed necessary.

Q. So, you don't view this sort of adjustment as a symmetrical one that could go both ways?

A. (Henry) Well, I believe certainly there is an interest in management there to benefit its shareholders, and I can understand that there would always be the temptation to try and take--I won't say take advantage of, but certainly try to gain opportunities where they can to use the funds from captive ratepayers to support riskier investments.

Q. That's all very interesting, but it's a simple

question. Is your adjustment a symmetrical one?

A. No, it is not.

Q. Getting on to another issue that was discussed this morning. To your knowledge, have the rating agencies voiced any concern regarding any significant business risk arising from CEI's unregulated subsidiaries?

A. (Henry) If you are saying specifically, at this point in time, my recollection is they viewed the magnitude of those investments to be relatively minimal. As a result, they have not had a material impact on the credit ratings themselves.

So, if that's what you are getting at, I would say that the investments as they are today have not negatively impacted the credit ratings in and of themselves.

Q. Thank you. Moving on to the issue of RDM, which has been to a certain extent beaten to death today, in your testimony isn't it correct that you recommend a 10 basis point adjustment to the Company's return based upon implementation of a revenue decoupling mechanism, which is referred to as an RDM?

A. (Henry) That's correct.

Q. It's a downward adjustment, correct?

A. (Henry) Correct.

Q. Now, isn't it true that the Commission has not imposed an RDM on an electric utility in New York in approximately 20 years?

A. (Henry) That could change next month but...

Q. Talking historically.

A. (Henry) I believe your statement is correct.

Q. Now, have you read the staff rate panel testimony?

A. (Henry) Yes, I have.

Q. Isn't it true that one of the issues that the Commission still has to decide is whether an RDM will be implemented on a revenue per customer basis?

A. (Henry) That is correct.

Q. Has the Commission authorized an RDM for any New York gas utility?

A. (Henry) I believe they recently implemented the one for National Fuel Gas.

Q. And that decision was issued within the past month or two, as I recall?

A. (Henry) I recall I believe it was sometime in December.

Q. So, there is not any actual experience to date with the operation of the RDM by NFG; is that correct?

A. (Henry) Could you please restate the question.

(Question read by reporter.)

A. (Henry) If your question is whether there is historical experience to see how the RDM works in practice as opposed to in theory then, yes, your statement is correct.

Q. Thank you. On page 52 of your testimony, starting on line 18, you state that in the event that the Commission implements an RDM it is possible that CEI could use this reduction in business risk to increase the leverage employed in its utility operations.

Do you see that?

A. (Henry) Yes.

Q. But you can't say with any degree of certainty, can you, what CEI will do if the Commission imposes an RDM on Orange & Rockland?

A. (Henry) No.

Q. So this is just essentially so much speculation on your part?

A. (Henry) I wouldn't say speculation so much as relates to financial theory. The implication being that the lower the business risk the more financial risk a company can utilize and maintain the same credit rating, if you will.

Q. On page 67, line 15 of your testimony, you mention that the Company is characterized by conservative management.

Do you see that reference?

A. (Henry) Yes.

Q. And I take it you still believe that to be true?

A. (Henry) I still believe that to be true.

Q. In light of that conservative management it seems likely, doesn't it, that management might wait to see what an RDM--or to see that an RDM actually reduced its business risk before increasing its leverage?

A. (Henry) They may well do that. I certainly would not want to put myself in the place of management here, but certainly seems like a reasonable possibility.

Q. How long do you think they might want to wait to see whether, indeed, all the wonderful benefits that Staff has indicated will transpire or actually come to fruition?

A. (Henry) I believe the purpose of the RDM, as we all know, was to make the utility indifferent to implementing energy efficiency.

I understand the utility, at least on the electric side, has enjoyed reasonably strong sales and is not inclined to think that the RDM is necessarily to

their benefit.

In fact, once energy efficiency programs are undertaken with some sort of zeal, if you will, the RDM may turn out to be a very positive attribute.

Q. You raise an interesting point about the energy efficiency programs. It was my understanding, and I would like your thoughts on this, that the state is awaiting the Commission's decision in the generic energy efficiency case before utilities such as Orange & Rockland are allowed to move forward with programs where they indeed may be allowed the opportunity to make certain--earn certain incentives; is that your understanding?

A. (Henry) My impression is probably the same as yours, where it appears to me there is sort of a wait and see to see what the outcomes of that proceeding are before jumping out ahead. That would be my personal perception.

Q. And do you have any idea when, indeed, the Commission might finally issue its ruling in that case?

MS. JOSS: Objection, Your Honor. This witness isn't a party to that case. It's an ongoing energy efficiency case. It's a separate case. This witness doesn't have direct knowledge.

JUDGE LYNCH: The fact that he's not in the case, I will accept that. Whether he knows or not, only he could say. So, why don't we just hear it from his mouth.

A. (Henry) I believe it was initially at least sometime in the middle of 2008.

Q. But that's just a guess on your part?

A. (Henry) This is what I have heard. Whether--how long the proceeding actually takes, I am not involved with all the details of what's involved.

Clearly there are many, many parties with many interests that may or may not delay any resolution of those issues, but I am not personally aware of everything that's going on in that proceeding.

I only know what I hear in terms of when we can expect some sort of resolution, and the hope was mid-2008.

Q. Just so that I am clear: Staff hasn't proposed that the Company can earn any incentives related to energy efficiency in the case it put in in this proceeding; is that correct?

A. (Henry) That is correct.

Q. Turning, if we might, to a study which was referred to previously, and I think which has been

marked as Exhibit 90. This has to do with the Duke University CFO Outlook Survey, I believe is what it's called?

A. (Henry) Is there a certain page?

Q. Eventually, but I would like to ask more general questions on the front end.

Page 62 of your testimony you state that a forward looking approach for estimating the market risk premium for the United States is indeed this Duke University CFO Outlook Survey, the December 2007 edition, which has been marked as Exhibit 90; is that correct?

A. (Henry) Yes, I believe that's correct.

Q. Now, just so the record is clear: Did either you or your colleague attend the Duke University?

A. (Henry) I have to regret, no, I did not get to attend Duke University.

Q. Let me ask you this: Were either of you gentlemen involved in the preparation of the survey?

A. (Henry) No.

Q. Now, on page 63 of your testimony you cite to page 49 of this exhibit, which indicates that the mean expected--mean return expected by the CFOs or the S&P 500 for the next 10 years is 8.34 percent; is that

correct?

A. (Henry) Yes.

Q. Do you have any idea what formed the basis for the expectations for the 1,275 US and international CFOs that allegedly responded to this survey?

A. (Henry) Do we know the basis?

Q. Yes.

A. (Henry) Of how they were chosen?

Q. No. How they came up with their purported expectations.

A. (Henry) Looking at the survey itself there is--you see the question. You see the number of respondents and how they answered. So, to me at any rate, it looks like a pretty relatively straightforward question.

Q. But the survey, as I understand it, didn't specify a specific formula or methodology that each CFO was to employ in calculating the average annual S&P 500 return; is that correct?

A. (Henry) That would be correct.

Q. In fact, I have to admit I found this whole survey somewhat confusing and I was hoping that you perhaps could remove my confusion.

On page 4 of the document--

JUDGE LYNCH: This is now Exhibit 90?

Q. Yes. In talks about the number of CFOs that were--whose responses were asked for. And it says in the--it's the paragraph that begins about the survey. This is on page 4 of 62.

It says that there were--1275 responses from CFOs were generated, including 573 from the United States, 191 from Europe, 203 from Asia, not including China, and three from China.

And then it goes on and it's unclear to me whether the results that are set forth in this document, which has been marked as Exhibit 90, actually reflect the opinions of all 1,275 CFOs, or whether it's limited to those in the United States?

A. (Augstell) That's something we could find out, but I think there is a requirement that they can't just pick and choose certain questions to answer. I am assuming that people cannot take the survey and choose to answer the question and pick certain questions they want to answer and other ones they do not want to answer.

Q. I guess if you go down to the--two sentences down it says results in this release are for US companies unless otherwise noted. I mean it's unclear to me who

exactly is responding to this.

And following up on that, do we know how many people in total these surveys were provided to? I mean it says here they got 1275 responses. Do we have any idea how many people chose not to respond?

A. (Augstell) No. I don't know if we could find that out. It varies every quarter.

Q. In fact, as mentioned at the bottom of that paragraph, it says it has a rate base of 450,000, which I guess might mean 450,000 CFOs read this magazine?

A. (Augstell) Where is that?

Q. It's at the bottom of that same paragraph, about four lines up from the bottom.

A. (Augstell) The survey is done in conjunction with the CFO magazine, so I am sure it has something to do with--it's not all done entirely by the Duke School of Business.

Q. That's all well and good, but I mean it's--let me repeat the question I asked before.

Do you have any idea how many CFOs may have been approached to fill out the survey but for whatever reason did not?

A. (Augstell) No. As I stated, I could find that out. I know it changes on a quarterly basis because

they conduct the survey every quarter.

Q. I take it that you didn't have the opportunity to review the individual responses submitted by these 1275 CFOs?

A. (Augstell) They wouldn't let you look at that.

Q. The answer is no?

A. (Augstell) Right. I mean that's for the CFOs--I am sure they would get a lot less responses if people know that everybody would see what your answers are.

Q. So, let me just understand. At the end of the day, according to this survey, we are really not sure who it was sent to, we are really not sure who may have responded to it, really not sure what methodology that may have been used to come up with their answers, in fact, for all we know they could have called a palm reader in Houston?

A. (Augstell) We can find out who responded. We can't find out what method. I would think each method, you know, a CFO I would think would have to know their expectations of the S&P or market--some proxy for a market return when evaluating projects. It's not something that they can just not determine what they think it's going to be, and that's what this answer reflects.

Q. I understand, but as I understand the survey, it's not as if the survey specified the criteria that they were to use to come up with their answers?

A. (Augstell) I wouldn't know how they could do that. I mean they would have to ask them if they are using CAPMs, they are using several questions on what they expect the return to be.

MS. JOSS: Your Honor, we object. These aren't really questions as much as Mr. Carley testifying himself.

MR. CARLEY: I think they are very much at issue, your Honor. The Staff witnesses have put forward what purports to be an authoritative survey result and I am well within my rights to find out exactly what's behind the curtain, if you will.

JUDGE LYNCH: It goes to the weight that should be accorded Exhibit 90, so I am going to allow the questions.

MR. HENRY: I believe you established the point in your rebuttal that surveys--that there is always, as far as not knowing the exact design of the surveys, that you are--there is a tendency that--as to how much weight you would want to accord it.

We were simply--put it this way: We noted

that at least 500 CFOs responded to the survey, and we can say with 95 percent confidence what the median of their expected return was.

To the extent that some of these may be CFOs from overseas, they are still going to have relied upon estimates of the growth of the strongest economy in the world.

So, I believe there's some merit to what their opinions are, at any rate, but your question about how they exactly interpreted the growth in the economy or, I'm sorry, the growth in the S&P 500, is certainly a matter of what approach they would use.

But we are merely presenting what this survey showed, and over 500 CFOs responded and came up with an estimate that we believe is representative of approximately what the market is going to grow at according to them.

BY MR. CARLEY:

Q. Doesn't this entire discussion lend credence to Dr. Morin's criticism of reliance on surveys like this as being speculative and less than transparent?

A. (Henry) I think just looking at--you raised some concerns as far as how the respondents were selected. We understand your concern there, and certainly note

that.

We think that the question on that page, and the responses of the 512 CFOs that did respond, speak for themselves.

(Augstell) We are using it in conjunction with this other--just to establish the subjective nature of the market risk premiums. There is a lot of current data out there shows it's not--using 7.1 and Dr. Morin's DCF 7.6 blends it to 7.4 is on the higher side.

We also mention on the previous page a recent study where it was determined the ex ante premium for the US is within 50 basis points of three and a half percent. So it's not--and you also requested--there is several studies.

Q. I am ready to move on.

JUDGE LYNCH: I have to ask you a clarifying question, though. I thought I just heard Mr. Henry refer to 512 responses, and I am wondering if I heard it right, but where that number came from?

MR. HENRY: Your Honor, the final column on page 49 of 62 showed the total of 512. It's my understanding that was the number of respondents to the particular question.

JUDGE LYNCH: Okay. Thank you.

BY MR. CARLEY:

Q. Now, there has been some talk during the proceedings today of the increase in betas for the electric utility industry over the past decade. Dr. Morin I think spoke to that.

A. (Henry) Correct.

Q. It's my understanding that this is not simply a phenomenon that affects utilities outside New York. Betas in New York's utilities have increased as well; is that correct?

A. (Henry) The betas of what we call electric utility holding companies, which is--our proxy group is essentially a group of electric utility holding companies.

Yes, the betas of holding companies in general have been increasing, as well as the holding companies for the New York operating companies.

Q. Now, it's my understanding that one of the criteria used in selecting your group of proxy companies was that they had to have operating revenues from regulated operations that were at least 70 percent of the revenue total; is that correct?

A. (Henry) 70 percent of their revenue needed to be from regulated sources.

Q. So that would exclude revenues if they had investments in unregulated generation, for instance?

A. (Henry) Again, the revenue figures that we utilized were from the 10Ks of the various holding companies, and I believe represent their opinion as to which portion of the revenues are regulated.

Certainly there are some markets in this country where it may be a little bit gray as to whether the commodity cost is fully recovered in rates or not, but these are the statements of these companies in their 10K report to the Securities and Exchange Commission that we relied upon.

Q. So the answer is yes?

A. (Henry) So the answer is yes--you have to back track the question there.

Q. I was just trying to establish, or confirm, if you will, that in selecting your proxy group--and granted there may have been reliance on your part on various SEDC documents or other reports that in order to make the grade and be included at least 70 percent of the operating revenues had to be from regulated operations?

A. (Henry) That's a true statement.

Q. Thank you. Now, in this case you recommended

that the Company be granted by the Commission an ROE of 8.9; is that correct?

A. (Henry) That's what we recommended, yes.

Q. Do you have any modifications or changes to that recommendation as of today?

A. (Henry) We have not updated our methodologies, so there are no changes to date.

Q. It would be your understanding that whatever number the Commission ultimately utilized would be updated at the time it rendered its decision?

A. (Henry) We recommended as much.

Q. It's true, isn't it, that this 8.9 that you are recommending is calculated based upon the approach set forth in the recommended decision in the generic finance case?

A. (Henry) I would say loosely so. Much of the framework of what we are recommending is consistent with positions that staff put forth in recent years, and I would say it loosely follows that methodology.

Q. That's an interesting view of reality. In terms of loosely interpreted, tell me how your interpretation has changed from what was set forth in the RD, because I would like to know.

A. (Henry) What I am referring to is that if you

look at the generic finance case recommended decision, conditions today are very much different. There are changes that have taken place due to necessity which would not follow the recipe, if you will, in that RD to the letter.

What I am suggesting is we follow essentially the spirit of that recommended decision with modifications that have been necessitated by events that have occurred since then.

Q. Again, I would ask you specifically what those modifications are.

A. (Henry) A very good example would be the generic finance proceeding used a proxy group of A rated utilities, electric utilities.

Here we have expanded that to include electric utility holding companies whose bond ratings are at least investment grade.

So, and the reason for that was the credit decline that we have seen over the past however long you want to say--20 years, 25 years, but clearly there are many, many fewer A rated electric utility holding companies than there would have been of electric utilities at the time of the generic finance RD.

Q. That's one. What else?

A. (Henry) There have been adjustments over time that requires computing the CAPM, because there was the time period there which the RD had required an average of the 10 and 30 year Treasury securities.

There was a period there were there were no 30 year Treasury securities, so there was a change made to utilize the 10 and the 20. Now we are back to the 10 and 30.

Q. That's not a change then.

A. (Henry) Well, it was a change--I was referring to changes that Staff implemented over time. There may be other minor changes that have occurred, which don't occur to me off the top of my head, but if I were to go and look at the RD, and to look at our testimony, I might find a few changes due to necessities that have transpired over that time.

Q. But in terms of the guts, if you will, of the generic finance methodology, particularly the weighting of the DCF and CAPM results, that hasn't changed?

A. (Henry) I believe we said that the spirit is certainly within our testimony. So, yes, the weighting that you are referring to, the two-thirds for the DCF and the one-third for CAPM, that was in the GFC recommended decision and that's the same weighting we

are proposing in our testimony.

Q. You are not proposing--strike that.

The generic finance methodology also didn't recommend utilization of other methodologies besides CAPM and DCF, and that also carries through in your presentation of this proceeding; is that not correct?

A. (Henry) That is correct.

Q. Just so that I am clear: The 8.9 ROE that staff is recommending in this proceeding I take it it doesn't reflect any penalties for poor service or substandard performance?

A. (Henry) The ROE reflects the overall rate plan and is consistent, as we mention in our testimony, with the ROE or the methodology, if you will, mostly.

There are, obviously, again, minor changes but very much similar to the methodology that we proposed and the Commission adopted in the '06 Orange & Rockland electric case. There are, again, a few minor differences, but it's essentially the same recommendations.

Q. Mr. Henry, it appears that you didn't hear my question. I would ask that it be reread and perhaps you can answer it this time.

(Question read by reporter.)

A. (Henry) You are right. I went on too long about other things.

It is consistent with the last proceeding. There was the same penalties in the last case that there is in this case in terms of the revenues at which the Company is at risk.

Q. I'm sorry. Perhaps I am at fault for not being as clear in my questions as I might be.

8.9 percent, it's not as if that result was initially a higher number that was lowered to reflect certain penalties or substandard performance that in Staff's view should be imposed on the Company because of its failure to do the right thing, if you will?

A. (Henry) The 8.9 ROE reflects all the risks that is inherent in the rate plan, including the penalties, if you will, if you want to refer to those as penalties.

Q. No. I understand there is--in theory it reflects the total risk to the Company in the event that we are exposed to these things.

I guess my point is: The 8.9 isn't the result of taking a higher number which you calculated and reducing because of certain penalties that you felt should be imposed for the Company.

For instance, there are other cases in the past

where the Commission--and I think Jamaica Water may have been one--where they determined that although using the methodology that would normally be employed, the ROE would be set at a certain level because of certain bad things they did or certain misdeeds that the Commission or Staff was recommending that that calculated ROE be lowered to reflect that sort of as a lesson to a utility to be a better citizen going forward.

There's nothing like that here, is there?

A. (Henry) No. There is nothing like that here.

Q. I take it you have seen what was marked as Exhibit 75 in this proceeding. This was marked when Dr. Morin was testifying. This sets forth the authorized returns.

Now looking at that list--and I turn your attention to the last page, if we can go down about halfway where it says, over on the left-hand corner, says South Carolina, and it indicates that for South Carolina Electric and Gas Company a decision was rendered on December 14, 2007 and that the authorized ROE was 10.7; is that correct?

A. (Henry) I see that.

Q. The next line it says for Vista Corporation, which is located in North Carolina, that on December 19,

2007 the authorized ROE was 10.2?

A. (Henry) I see that.

Q. On the next line--I'm sorry. The last one was for Duke Energy.

The next line after that is Maine, Bangor Hydroelectric Company, there was a decision rendered on December 20, 2007 of 10.2; is that correct?

A. (Henry) I see that.

Q. The line after that in the fair State of Idaho, for Pacific Corp., on December 28, 2007 the authorized ROE was 10.25; is that correct?

A. (Henry) I see that.

Q. On the following line for the State of Georgia, Georgia Power Company.

JUDGE LYNCH: Let me ask a question. These numbers are all in evidence so...

MR. CARLEY: I guess we can cut to the chase here, Your Honor.

JUDGE LYNCH: Thank you.

MR. CARLEY: I don't want to waste your time.

Q. It's fair, isn't it, that looking at this list, if the Commission were to grant Staff's recommended 8.9 percent ROE, it would be the lowest ROE that has been

granted in some time, in a number of years?

I can't find a number on this list which goes back to 2003 which is lower than that; is that correct?

A. (Henry) As far as comparing it to these authorized returns, is that ROE that we are recommending lower than any of these other authorized ROEs. Clearly, it is.

Q. Isn't it significantly lower, to a great extent, more than at least half a percent?

A. (Henry) Certainly it's significant--it may be significantly lower than some of them in there, but I think, as we pointed out in our direct testimony, without knowing all of the specifics of the case we really--it's not necessarily an apples to apples comparison.

Q. I understand, but that would be the case, indeed, if you were comparing one company to another, but given the vast discrepancy here between what you are recommending and what's been authorized--

MR. ST. LAWRENCE: Your Honor, I object. I think these questions have been asked and answered. They are in evidence. And I would object and if there is still confusion by the questioner he could consult a palm reader in Houston.

JUDGE LYNCH: The objection is overruled. There is a major question in the case about whether Staff's return on equity is so far out of line with everything else going on in the country.

And Staff has a response to that, but if this goes to fact finding a determination will have to be made about whether that's a shortcoming in Staff's proposal. So, I can't see cutting off cross on it.

MR. CARLEY: Thank you, Your Honor.

Q. Don't these results indicate that the generic finance methodology, even if you are only abiding by its spirit--and again, it's a model which was developed about 15 years ago--is just woefully out of date and just irretrievably broken as to the result is ROE recommendations that are so far out of line with what's being granted in the rest of the country?

A. (Henry) I don't see it that way. Again, for instance, I am saying I have looked at a few returns around the country to see how the rates were set. And certainly if the approach that Staff has been employing, you would see utilities earning woefully less than other utilities around the area.

And certainly Con Edison has been, and Orange & Rockland and in particular in their electric operations,

has been doing just fine with that methodology.

Again, my biggest concern with making this comparison really is we don't know whether it was a fully forecast rate year which, as you well know, when you are growing your rate base it's a significant detriment to be operating in an environment where you know you are not going to earn your authorized ROE.

We are fully forecasting the rate base, fully forecasting the expenses for the rate year. You have a much better opportunity to earn your authorized ROE than many other jurisdictions.

MR. CARLEY: We have no further questions, Your Honor.

JUDGE LYNCH: Redirect?

MS. JOSS: Just one moment, Your Honor.

We just have a few questions on redirect.

JUDGE LYNCH: Okay.

REDIRECT EXAMINATION

BY MS. JOSS:

Q. Did you rely on the results of the Duke CFO study when calculating your ROE?

A. (Henry) No, it was just a check.

Q. For Exhibit 75 are the companies comparable in terms of risk?

A. (Henry) Orange & Rockland's business risk is clearly very low and has a very--relatively strong financial risk compared to most of the utilities out there. So, we don't know the underlying risk of the plans.

Judge, we also point out on page 69 of our testimony many of our concerns about--just to remind you again that that's where we outline many of our concerns with comparing it. There's plenty of reasons to look at these, whether they are for multi-years, whether they are a negotiated ROE or if it's litigated.

Again, we pointed out the test period and so on, but, again, we have many reservations about the comparability of these ROEs.

MS. JOSS: That's all. We have no further questions.

JUDGE LYNCH: Okay. Thanks very much. You are excused.

(Witnesses excused.)

JUDGE LYNCH: Off the record.

(Discussion held off the record.)

JUDGE LYNCH: Back on the record. It's approximately 16 minutes to 1:00 p.m., according to the clock in the back of the room, and we are going to take

a 30 minute lunch recess and we will reconvene at the end of that.

I had also indicated previously if anybody wanted a copy of the Company's latest calculation of its revenue requirements, to pick that up. I have extras. If someone still wants it and doesn't have it, do that.

The other thing I want to do at the end of the day is to make sure everybody has a list of what has to be checked, what exhibits have to be replaced, and so forth, kind of a to do list, so we are all on the same page.

I will be counting on everyone. I have mine. It's all spread through my notes, but I will go through and just make sure that everything that has to be done is.

Okay, we are adjourned until 1:15 p.m.

(Recess taken.)

JUDGE LYNCH: Back on the record.

Staff has some additional testimony and exhibits to introduce?

MR. VAN ORT: Yes, Judge. The two remaining panels that we had were the Staff rate panel and testimony of Michael Rieder, and we wish to admit both of those by affidavit.

I will begin with the Staff rate panel. We discovered through an error in this exhibit, as well as Mr. Rieder's affidavit, and the error is that we didn't reference the fact that the testimony was amended in the closing paragraphs of it.

With that correction, these are new copies as of today's date.

Beginning with the staff rate panel, our affidavit indicates that the staff rate panel, consisting of Marco Padulo, Liliya Randt and Michael Rieder, prepared a document entitled the prepared testimony of the staff rate panel, which consists of a title page plus prepared exhibits, and the prepared exhibits, there are six of them, and they are designated SRP-1 through SRP-6.

The affidavit further goes on to explain that there was an amendment since the preparation of the prefiled testimony that the staff determined an amendment to the testimony is warranted. That amendment is to insert a question and answer on page 22 after line 9, and I will read it for you.

The question would be: Would this proposed mechanism also apply in circumstances when the actual revenues are less than forecasted amounts, or when

actual customer numbers are less than forecasted. The answer is: Yes. It is our intention that this mechanism be applied symmetrically.

The affidavit closes by stating that each of the answers to the questions in the prefiled testimony as amended are true and accurate to the best of the Staff's knowledge and belief.

I have a copy of the amended testimony marked up, as indicated, with the Staff's change for the reporter.

JUDGE LYNCH: I am not aware of it. I don't have a copy of the change.

MR. VAN ORT: I have individual pages. If you would like a full set I can provide that.

JUDGE LYNCH: I have page 22 as it was filed.

MR. VAN ORT: Correct. I have the new and improved version of that.

JUDGE LYNCH: Has counsel for the Company seen this?

MR. CARLEY: Yes, Your Honor. We have no objection.

JUDGE LYNCH: Okay, so, at this point in time I think what's in order is that the prefiled Staff

rate panel direct testimony of 22 pages, including the handwritten change that's been added, handwritten additional question and answer that's been added on page 22, should be marked as Exhibit 98 for identification.

(Exhibit 98 marked for identification.)

MR. VAN ORT: I'm providing the reporter with the original affidavit, which I believe will be designated as 99.

JUDGE LYNCH: That is correct.

(Exhibit 99 marked for identification.)

MR. VAN ORT: And lastly are the exhibits, which I believe brings us to an even 100.

JUDGE LYNCH: Okay. You want them all marked as one exhibit?

MR. VAN ORT: That would be fine with us, Judge.

JUDGE LYNCH: Let me just ask also: For SRP-6, the copy you are handing the reporter includes the copy of the attachment that was not originally prefiled but that came around later?

MR. VAN ORT: Good point, Judge. I have that copy here and will provide that also. I will provide that before the reporter leaves.

JUDGE LYNCH: Just to make sure the record

is clear: Documents that were prepared by the Staff rate panel that were previously identified as SRP-1 through SRP-6 are collectively marked as Exhibit 100 for identification.

(Exhibit 100 marked for identification.)

I assume if it's referred to in brief it would be referenced Exhibit 100 and then you would have to give the SRP number.

MR. VAN ORT: Correct.

JUDGE LYNCH: Like a schedule.

MR. VAN ORT: Judge, lastly we have Mr. Rieder's testimony and his affidavit. Reading from the affidavit it indicates that Mr. Rieder had prepared testimony for this proceeding which consists of 15 pages plus title page, and two exhibits which consist of 10 pages.

Mr. Rieder's affidavit also indicates that there are five minor changes to it, the first being on page 1, line 7, to insert the word "electric" between "the" and "rates".

The second change being on page 1 also, line 8, replacing "electricity and environment" with "electric, gas and water". The third change being on page 5, line 5, replace "12" with "34".

The fourth change on page 5, line 7, to replace "8" with "12". And the fifth change on page 5, line 7, to replace "4" with "22".

Mr. Rieder's affidavit concludes that as amended his prefiled testimony--his answers to the questions contained therein are true and accurate to the best of his knowledge and belief.

I am providing a copy of the testimony. We made the edits for the reporter.

JUDGE LYNCH: Thank you. That will be Exhibit 101 for identification.

(Exhibit 101 marked for identification.)

MR. VAN ORT: I am now providing the reporter with the original of Mr. Rieder's affidavit we are marking.

JUDGE LYNCH: That's fine. That will be 102.

(Exhibit 102 marked for identification.)

MR. VAN ORT: That concludes the Staff witnesses, Judge. His exhibits would be?

JUDGE LYNCH: 103. Why don't we agree you will provide me the originals and I will mark them before I send it down to central files.

MR. VAN ORT: If you give me one moment,

Judge. This is number 103.

JUDGE LYNCH: 103 for two exhibits together. So the documents MJR-1 and MJR-2 with the cover page are together marked as Exhibit 103 for identification.

(Exhibit 103 marked for identification.)

MR. VAN ORT: We have that attachment, Judge.

JUDGE LYNCH: Hand that to the reporter and that's the last page of Exhibit 100 for identification.

As I understand it, then, Staff's completed the presentation of its case.

MR. VAN ORT: Correct, Judge.

JUDGE LYNCH: So, the next order of business is we have had marked for identification 103 exhibits. Are there objections to any of these exhibits?

MR. CARLEY: Not on the part of the Company, Your Honor.

MR. ST. LAWRENCE: Not on the part of the town.

JUDGE LYNCH: Staff?

MR. VAN ORT: No, Judge.

Before we conclude you had asked Staff yesterday--in response to Mr. Walters' question, you had asked Staff to provide a copy of the historical load

growth that was discussed in Orange & Rockland's eastern and western division, and the years that you were looking for--that Mr. Walters was looking for was 2004 through 2007. We can provide that now if that's your preference.

JUDGE LYNCH: There were two exhibits reserved yesterday. 4 was reserved for a response to CPB's set 2, request number 3, including an affidavit.

The second one, Exhibit 6, was reserved for peak load growth for '04 to '07 for eastern and western division. So, this would be Exhibit 6 that you have. Now, does this have an affidavit with it?

MR. VAN ORT: Yes, it does, Judge.

JUDGE LYNCH: I appreciate it.

MR. VAN ORT: I will provide the original to the stenographer.

JUDGE LYNCH: Are there any objections to anything that's been marked? I thought I heard nothing.

MR. WALTERS: None from CPB.

MR. KLUCSIK: None from the county.

MR. ST. LAWRENCE: None from the town.

JUDGE LYNCH: At this point then I'm going to assume the parties that presented them want them moved into evidence and Exhibits 1 through 103 are

hereby accepted into evidence.

(Exhibits 1 through 103 received in evidence.)

Before we get to the to do list, I have one other question that I don't know if anybody can answer.

Does anyone know when the last PSC-sponsored management or operations audit report was issued for Orange & Rockland?

MR. CARLEY: As Mr. Kane informs me, certainly be more than 10 years ago. It's been awhile. You mean a formal audit. Certain people are of the opinion that there is a continuous audit ongoing.

JUDGE LYNCH: Right. I am not going to get going on that. I am looking for one they hired somebody, a consultant.

MR. CARLEY: I think the Company would admit it's been awhile.

JUDGE LYNCH: Okay, thank you.

Now, with respect to the to do list for today, I have that I think Mr. Perkins accepted one question subject to check, Dr. Morin accepted one question subject to check, and Staff is to provide a legible copy of Exhibit 76. Does anybody have anything else that came about as a result of today's proceedings?

For yesterday, I have Exhibit 4 remains blank. Is it the Company that has to respond to that, provide that?

MR. CARLEY: Yes, Your Honor.

JUDGE LYNCH: The other thing that I had asked is what if anything do the parties expect me to be looking at in terms of the record from the last case concerning the RDM issue, and naturally the less the better.

I mean if it's nothing at all, that's fine, but if there are parts I am supposed to be familiar with I would like to know if there's agreement on that or if not that we can resolve it.

Does anybody have anything else from yesterday?

MR. CARLEY: Aside from the Exhibit 32 issue, Your Honor, that was on the updated schedules 1 and 2, I owe you the schedules themselves and an affidavit from Mr. Regan.

JUDGE LYNCH: Okay. I hadn't listed that so that's another one.

Anything else? Okay, I want to ask also--I always enjoy at the hearing, everything starts over here and ends up over here. There are a few things still on

the left I want to ask about.

Yesterday we talked about the status of the tariff filing itself and the cover letter. I think we agreed it's part of the case record and it's not in evidence.

There is also, as part of the Company's updates, there were two other attachments. The calculation of earnings during the temporary rate period is the cover on one and the other is an O&R electric case company update November 15, 2007. Has a list, two-page list, of bullets.

I think it's a summary, really, of what was covered by that filing. And I would like to get on the record what the status of these documents will be or should be going forward.

MR. CARLEY: Your Honor, we had provided them, but it wasn't our intention to make them part of the record in this case, unless of course you want to do that.

JUDGE LYNCH: No. I just don't want to not bring it up.

MR. CARLEY: The only part that we need to make part of the record is--

JUDGE LYNCH: 32.

MR. CARLEY: Aside from that, I think we are set. Thank you.

JUDGE LYNCH: Fine. The last thing I have is that under the schedule that's been adopted, it's my understanding that initial briefs are due on February the 29th and reply briefs are due on March 12th.

Is that everyone else's understanding as well?

MR. CARLEY: Yes, Your Honor. I don't have anything else.

JUDGE LYNCH: Does anyone else have any business to bring up today?

MR. VAN ORT: Nothing from Staff, Judge.

MR. CARLEY: Nothing for the Company.

JUDGE LYNCH: Okay. Thank you very much. The hearing is adjourned subject to reopening for public statement hearings that are going to be scheduled in the service territory.

Thank you all very much for your cooperation and have a good day.

(Hearing concluded.)

INDEX OF WITNESSES

INDEX OF EXHIBITS

78	FP-2	826
79	FP-3	826
80	FP-4	826
81	FP-5	826
82	FP-6	826
83	FP-7	826
84	FP-8	826
85	FP-9	826
86	FP-10	826
87	FP-11	826
88	FP-12	826
89	FP-13	826
90	FP-14	826
91-97	Not marked	
98	Staff rate panel direct testimony	861
99	Affidavit of rate panel	861
100	SRP-1 through SRP-6	862
101	Testimony of Michael Rieder	863
102	Affidavit of Michael Rieder	863
103	MJR-1 and MJR-2	864