BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Orange and Rockland Utilities, Inc.

Case 14-E-0493 and Case 14-G-0494

March 2015

Prepared Testimony of:
Staff Finance Panel

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

A. Our names are Kristine A. Prylo and Andrew Hale. We are employed by the New York State Department of Public Service (Department). Our business address is Three Empire State Plaza, Albany, New York 12223.

Q. Ms. Prylo, what is your position at the Department?

A. I am employed as an Associate Utility Financial Analyst in the Office of Accounting, Audits and Finance.

Q. Please describe your educational background and professional experience.

A. I graduated from Siena College in 1999 and received a Bachelor of Science degree in Finance. From August 1999 until May 2006 I worked in various positions at The Ayco Company, L.P., a Goldman Sachs company. My duties included monitoring various aspects of individual equity and fixed income portfolios, reviewing laddered high net worth municipal bond portfolios for additional yield opportunities, preparing income tax returns, advising clients on various tax, estate planning and asset allocation issues as well as providing clients with multiple cash flow scenarios for determining appropriate long-term financial plans. In May 2006, I joined Robert Half International, a financial recruiting firm. At Robert Half International, I was responsible for interviewing and placing potential candidates in accounting and finance positions at local companies. I joined the Department in January 2008.

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

A. I am responsible for analyzing the financial condition, financing mechanisms, risk, cost of debt, cost of equity, diversification and relative business positions of utilities and their holding company parent(s). My assignments involve rate cases, financing proposals and special projects.

Q. Have you previously testified in a proceeding before the New York State Public Service Commission (Commission)?

A. Yes. I have been involved in a variety of rate cases since my arrival at the Department and have testified before the Commission in Case 11-E-0408, Orange and Rockland Utilities, Inc., as well as Cases 08-E-0539, 09-E-0428, 09-S-0794, 09-G-0795, 13-E-0030, 13-G-0031 and 13-S-0032, Consolidated Edison Company of New York, Inc.

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

A. I am employed as a Senior Utility Financial Analyst in the Office of Accounting, Audits and Finance.

Q. Please describe your educational background and professional experience.

A. I graduated from Siena College in 1991 with a Bachelor of Arts in Political Science. In 1999 I received a Master’s Degree in Business Administration with a concentration in Finance and Management Information Systems from the State University of New York at Albany. Prior to joining the Department, I was employed for nine years in various positions at The Ayco Company, L.P., a Goldman Sachs company. My initial duties included general financial planning for employees of client companies. I then moved to the Fixed Income department of Ayco Asset Management in July 2001, where my duties included monitoring and review of client fixed income portfolios and culminated in the position of Fixed Income Trader/Portfolio Manager in 2005. In this position, I purchased bonds and constructed fixed income portfolios customized to clients' individual tax situations, state of residence, and cash flow needs. I joined the Department in December 2012.

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). My assignments involve rate cases, financing proposals and special projects.

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

A. Yes. I testified in Cases 13-E-0030, 13-G-0031 and 13-S-0032, Consolidated Edison Company of

New York, Inc.

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

A. The purpose of our testimony is to recommend a fair rate of return to be used by Staff witness Wang to determine the revenue requirements for Orange and Rockland Utilities, Inc.'s (Orange and Rockland, O&R or the Company) electric and gas operations for the Rate Year ending October 31, 2016. We will also respond to the testimony of Company witnesses Saegusa and Hevert.

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

A. We are sponsoring 32 exhibits, identified as Exhibit__FP-1 through Exhibit__FP-32.

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

A. We recommend an overall after-tax rate of return of 6.85%, as opposed to the Company's request of 7.80%. Our proposed pro forma rate of return is provided in Exhibit__FP-2.

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

A. The major difference between our recommended overall rate of return of 6.85% and the Company’s overall rate of return of 7.80% is due to our 8.5% return on equity (ROE) recommendation, compared to the Company’s proposed ROE of 9.75%. In addition, we are recommending a 5.41% cost of long-term debt, as opposed to the Company’s proposed cost rate of 5.54%.

Our testimony will explain why our recommended capital structure is reasonable and consistent with Commission policy. We will also demonstrate the reasonableness of our ROE recommendation and explain how we developed the recommendation using two different equity costing methodologies, each weighted consistent with how the Commission has repeatedly weighted them in litigated cases over the past 18 years. Finally, we will address the reasonableness of our cost of long-term debt recommendation.

FAIR RATE OF RETURN

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

A. In the context of Commission rate proceedings, the revenue requirement is the dollar amount required by a company to provide service during the rate year. It is the amount that will allow the company to recover all of its reasonably expected operating costs, including taxes and depreciation. In addition, the revenue requirement includes a fair return that will allow the utility the opportunity to recover the cost of funds supplied to it by investors. The funds provided by the investors are needed in order for the company to finance its long-term utility assets and working capital requirements, which in the rate-setting context are referred to as its "rate base."

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

A. A fair rate of return for a regulated utility is one that enables it to provide safe and adequate service to its customers, while at the same time assuring the utility continuing support in the capital markets for both its long-term debt and common 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 long-term debt, while providing its common equity investors the opportunity to earn a return that is commensurate with the risk of their investment.

Q. How is a fair rate of return calculated?

A. The fair rate of return for a utility company is calculated through a weighted average of the individual cost components of its expected capitalization during the rate year. The two primary sources are long-term debt and common equity. Customer deposits, while typically a very small component, are almost always reflected in the expected capitalization, as well, because they are a relatively permanent and stable source of capital employed by utilities. It should be noted that preferred stock is sometimes a source of capital as well, although generally in much smaller proportions than either long-term debt or common equity.

Since the Commission uses a fully forecasted rate year, it is also important that the rate year capitalization reflects the utility's projected capital requirements and is consistent with the goal of achieving the optimal cost of capital, particularly as it relates to the use of leverage.

Q. How are the cost rates of the individual cost components typically calculated?

A. The cost rates associated with a utility's long-term debt, preferred stock and customer deposits are relatively simple to determine. The embedded costs of both the long-term debt and preferred stock components can be readily calculated by examining their contractual terms, i.e., the interest payments for the long-term debt and the preferred dividends for the preferred stock. The projected impact of the cost of any new or incremental long-term debt or preferred stock issuances, however, requires estimates using relevant market data. The cost rate for customer deposits is simply a matter of applying the cost rate that is currently prescribed by the Commission.

The cost of common equity is neither contractual nor prescribed by the Commission. Its calculation is further complicated by the fact that it cannot be directly observed, and, instead, requires estimation and the opinion of analysts.

Q. Is the cost of common equity typically more expensive than the cost of long-term debt for a utility?

A. Yes. Even though both lenders and common equity investors supply the utility with the funds it needs to build and operate its system, the common equity investors only earn a return after the payment of all other expenses. Because these investors run the risk that their achieved returns will not equal their expectations, the return required by common equity investors is usually higher than that of the utility's long-term debt holders. Exceptions may exist during periods of disturbances in the market, such as during the recessionary period of 1980-1982, at which point the economy was beset with very high inflation and volatile interest rates. During that time, utility bond yields were at least as high as the equity returns the Commission allowed and far above the returns allowed by most state regulatory commissions.

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

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

CAPITAL STRUCTURE

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

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

Q. What capital structure does O&R propose for its Rate Year electric and gas operations?

A. Company witness Saegusa recommends use of the Company’s stand-alone capitalization.

Q. How does Ms. Saegusa describe the Company’s stand-alone capitalization?

A. She states that it is the actual investment to provide service to Orange and Rockland’s customers.

Q. Do you have any observations with respect to her characterization of the Company’s stand-alone capitalization?

A. Yes. The stand-alone capitalization to which she refers is actually the consolidated capital structure of the Company and its two wholly-owned subsidiaries, Rockland Electric Company and Pike County Light & Power Company. While this important distinction is not clear in her testimony, her exhibits clearly indicate that this stand-alone capitalization is actually that of the Company and its subsidiaries.

Q. What is the Rate Year mix of capital proposed by Ms. Saegusa?

A. As illustrated in her February 13, 2015 update of Exhibit__YS-1, Schedule 1, Ms. Saegusa forecasts a long-term debt ratio of 51.04%, a customer deposits ratio of 0.96% and a common equity ratio of 48.00% for the Rate Year.

Q. Briefly explain how Company witness Saegusa developed this capitalization.

A. According to Ms. Saegusa, the Company’s projected Rate Year consolidated capitalization is based upon its actual expected investment during that period. In her response to Department Staff’s Information Request (IR) DPS-377, included in Exhibit__FP-1, she indicated that the financing activities during the linking period and Rate Year were predicated upon maintaining a consolidated common equity ratio of 48.50%.

Q. Why is the Company proposing a 48.00% common equity ratio even though Exhibit__YS-1, Schedule 1, appears to indicate that the Company’s projected financing activities will result in a

48.07% common equity ratio?

A. According to Company witness Saegusa's testimony, the Company is proposing a lower common equity ratio than the one forecast in order to minimize the controversial issues in this proceeding, and to facilitate a multi-year rate plan through settlement.

Q. Please explain Ms. Saegusa's Rate Year forecasted consolidated capitalization in further detail.

A. With respect to the Company's long-term debt component, she forecasts a $140 million 30-year debt issuance during the linking period, the period between the historical test year and the rate year, which essentially refinances the $139 million of consolidated long-term debt that matures during that period. For the Rate Year, she forecasts a $100 million issuance at the beginning of the Rate Year, and another $75 million issuance at the end of the Rate Year to refinance a $75 million issuance maturing at that time.

Her Rate Year balance of customer deposits was projected based upon a 13-point average calculation of actual monthly balances for the year ending December 31, 2014. She is forecasting a balance of approximately $13.004 million during the Rate Year. Based upon historical trends in the Company's customer deposit balance, this appears to be reasonable.

Finally, her projection of the common equity component is largely premised upon her assumptions regarding the level of earnings during the linking period and Rate Year, as well as the amounts and timing of equity-related transactions with its parent, Consolidated Edison, Inc. (CEI); specifically, equity contributions from CEI and dividend payments to it from O&R.

Q. Do you believe that Ms. Saegusa's proposed capitalization ratios of 51.04% for long-term debt, 0.96% for customer deposits, and 48.00% for common equity are reasonable for the purpose of establishing the Company's overall rate of return and its electric and gas revenue requirements for the Rate Year?

A. We do. However, the reasons for our acceptance of those capitalization ratios, all of which address the reasonableness of the 48.00% requested common equity ratio, are threefold. First, we find it to be reasonable based upon our own analysis of the parent company's financing practices, which we will discuss shortly. Second, we also find it to be reasonable because O&R has demonstrated both the willingness and the ability to manage its consolidated equity component to its rate authorized levels. Finally, as we will discuss later in our testimony, we believe that authorization of a 48.00% common equity ratio will be sufficient to maintain the Company's financial integrity.

Q. Please explain why it is necessary, for rate-setting purposes, to conduct an analysis of the holding company's financing practices before ascertaining the reasonableness of a utility subsidiary's stand-alone capital structure.

A. It has typically been the established practice of Staff and the Commission to employ a "consolidated approach," which begins with the consolidated capital structure of the utility's parent company, in this case CEI, and to adjust it, if need be, to reflect the relative business and financial risks of the various subsidiary companies. In short, the primary purpose of this analysis is to ascertain whether the stand-alone capital structures of the utility subsidiaries reflect rational financing policies and if their common equity components reflect actual common equity at the parent level.

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

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

Specifically, when we refer to rational financing policies, we are referring to the concept that investments or activities with greater business risk must be offset with less financial risk in order to achieve the same credit rating as those investments or activities that have lower risk. Our goal is to determine whether or not these higher business risk non-regulated subsidiaries are being capitalized with sufficient common equity such that they could achieve the same credit rating on a stand-alone basis as the utility operations.

Q. Please explain the concept of business risk and financial risk in general, and how it is typically assessed.

A. Business risk is the risk inherent in a company’s operation and reflects the risk that it will fail to achieve its expected financial performance. It is affected by factors such as a company’s sensitivity to the overall economy, the level of competition it faces and the diversity of its customer and/or supplier bases. Financial risk, on the other hand, is the risk a company faces from the uncertainty of the amount of leverage used to finance its investments.

Both of the major credit rating agencies, Standard & Poor’s (S&P) and Moody’s Investors Service (Moody’s), routinely assess the level of business risk in tandem with the financial risk profiles of debt issuers whenever credit ratings are reviewed and/or assigned.

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

A. With respect to its assessment of business risk, S&P examines the relative strength of a company’s business position and assigns it one of six distinct business risk profiles, or categories. In descending order, the six categories range from “Excellent,” for companies with relatively very little business risk, to “Vulnerable” for companies with extremely high levels of business risk. Similarly, its assessment of financial risk utilizes six distinct financial risk profiles that descend from “Minimal,” for companies with little to no debt on their balance sheets, to “Highly Leveraged” for companies financed very aggressively with debt.

Nearly all regulated utilities and holding companies that are heavily utility-focused fall in the top two business risk categories, “Excellent” and “Strong.” In fact, according to a recent S&P report entitled “U.S. Regulated Utilities on Stable Trajectory Amid Moderate Economic Growth,” Exhibit__FP-11, 71% of utility business risk profiles, including O&R, are in the “Excellent” category. In this article, S&P explains that it sees only a modest influence on utilities’ creditworthiness from economic fluctuations due to “the essential nature of the services that they provide, the rate-regulated character of the business, and the generally supportive posture of regulators toward cost recovery for incremental capital investments.” As a result, S&P claims that “most ratings should remain relatively stable even if economic conditions worsen in the near term.”

Q. What is S&P’s assessment specifically regarding the risk profile for O&R?

A. S&P, in its May 7, 2014 “Summary: Orange and Rockland Utilities, Inc.” report, Exhibit__FP-12, attributes an “A-” rating to O&R, largely due to its “fully regulated low-risk electric transmission and natural gas distribution operations,” as well as its predominantly residential and commercial customer base which “limits susceptibility to economic cyclicality and provides for stable cash flows.”

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

A. Over the past year, Moody’s upgraded most of the U.S. investor-owned utilities, and many of their holding companies, due to improvement of the U.S. regulatory environment in recent years. According to a recent Moody’s report entitled “U.S. Utility Sector Upgrades Driven By Stable and Transparent Regulatory Frameworks,” Exhibit__FP-13, Moody’s states that “U.S. regulated utilities appear financially secure, thanks to their suite of transparent and timely cost and investment recovery mechanisms.” In addition to discussing the relatively stable and predictable revenue and cash flows associated with utilities, as well as their maintenance of conservative capital structures and strong, stable access to the capital markets, Moody’s explains that “the overall regulatory environment for U.S. utilities has steadily improved over the past few years and is expected to remain supportive and constructive for at least the next 3-5 years.”

Q. What is Moody’s assessment specifically regarding the risk profile for O&R?

A. Moody's, in its July 31, 2014 "Credit Opinion: Orange and Rockland Utilities, Inc." report, Exhibit__FP-14, states that O&R's "A3" rating reflects the "moderate but very stable credit metrics produced by its low-risk, regulated T&D operations" and that it "benefits from a supportive regulatory environment, adequate cost recovery mechanisms, and the resources available as part of a large, strong parent company."

Q. Given the variances in business risk between utilities and unregulated companies, what capitalization differences would be expected between utility subsidiaries and unregulated subsidiaries?

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

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

A. No. Both our analyses and independent research confirm this is not the case.

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

A. We recently reviewed two *SNL Energy* research reports that clearly confirm this practice. Illustrated in Exhibit__FP-15 and Exhibit__FP-16, respectively, are the reports by *SNL Energy*, entitled “Quality Measures – Utility Parent

Companies; 12 Months Ended September 30, 2014 and Calendar Years 2011-2013" and "Quality Measures – Utility Subsidiaries; Years 2010-2013 and 12 Months Ended September 30, 2014." *SNL Energy* regularly reports on the financial performance of its "RRA Index," which is currently comprised of 45 utility holding companies, 38 of which are electric utility holding companies, and the remaining seven are gas utility holding companies. Of these companies, 23 are also in our 30 company proxy group. As shown in Table X of Exhibit__FP-15, the 45 holding companies in the RRA Index had an average common equity ratio of 45.50% as of September 30, 2014, and a three-year average common equity ratio of 44.90% for the 2011-2013 period. By contrast, as shown on the last page of Exhibit__FP-16, the utility subsidiaries of these holding companies had an average common equity ratio of 49.40% as of September 30, 2014, and a three-year average common equity ratio of 48.90% for the 2011 to 2013 period. Thus, it appears that these holding companies have elected to capitalize their less risky rate-regulated utility companies with layers of common equity that exceed the common equity ratios of the parent by approximately 4.0%.

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

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

Q. Without the presence of the utility assets, would the holding companies be able to capitalize their riskier unregulated operations in this way?

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

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

A. To determine whether or not this is the case, we examined CEI’s past and present financing practices, in light of the higher business risk of its unregulated investments.

Q. On what basis do you conclude that the level of business risk faced by CEI’s non-regulated subsidiaries is substantially greater than that faced by the parent’s utility operations?

A. First and foremost, we believe that, because these businesses face competition and do not benefit from all the regulatory attributes and safeguards afforded O&R, such a conclusion is fairly self-evident. Nonetheless, we note that in S&P’s May 21, 2014 Credit Opinion on CEI, illustrated on page 6 of Exhibit__FP-17, S&P states that the “unregulated businesses are significantly riskier than the regulated utility operations due to greater variability in cash flow generation." In fact, S&P goes on to state that it views "these operations as unfavorable for creditworthiness because of this potential volatility and, as such, they detract from the consolidated business profile, though not materially given their small size." In our view, it is clear that S&P's point about the materiality of these risks is due to their relatively modest scale at this time.

Q. Does S&P mention the unregulated subsidiaries specifically in its analysis of O&R?

A. Yes. In its May 7, 2014 analysis, referenced in Exhibit__FP-12, S&P notes that O&R has a stable outlook and claims that, fundamental to this forecast, is its expectation that "the unregulated business contribution will not grow materially beyond current levels." S&P has noted that one of the factors that could contribute to downside pressure on O&R's ratings is "if the riskier unregulated businesses become more of a meaningful percentage of the overall company." Moody's echoed this same opinion when conducting a review of CEI in its “Credit Opinion: Consolidated Edison, Inc.,” referenced as Exhibit__FP-18. Moody’s stated “a downgrade could also occur if competitive businesses grow to much more than the 5% of operating income that we anticipate, making the company’s financial performance less predictable.”

Q. What do you glean from S&P and Moody’s analyses of CEI’s unregulated businesses?

A. Both S&P and Moody’s are unequivocal that CEI’s unregulated businesses are considerably riskier than either Orange and Rockland or Con Edison. Equally clear is that at this time, because the unregulated businesses only constitute a relatively small portion of the overall capitalization of CEI, and due to the fact that in recent years they have been financed with materially thicker common equity layers than the utility companies, they do not pose a material risk to Orange and Rockland’s credit ratings.

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

A. We found that, in the not too distant past, CEI had employed common equity ratios for its unregulated businesses that we consider inadequate. As Exhibit__FP-4 shows, the unregulated businesses only had common equity ratios ranging from 33% to 43% for the three-year period ended 2008. However, we find the common equity ratios employed over the past four years to be sufficient. As illustrated in Exhibit__FP-4, we found that CEI's unregulated entities were supported by an average common equity ratio of approximately 61.5% for the 2011 to 2013 period. Additionally, as shown on page 29 of Exhibit__FP-23, the unregulated businesses were capitalized with a 67.0% common equity ratio at the end of 2014.

Q. Why do you find the recent average equity ratio of approximately 61.5%, as well as the 67.0% equity ratio at year end 2014, supporting CEI's non-regulated subsidiaries to be reasonable?

A. One of the tenets of our consolidated approach is that the non-regulated businesses be financed in a manner that is commensurate with the significantly higher degree of business risk inherent in their operations, and consequently, in such a manner that there are no ratings drags on either Orange and Rockland or Con Edison. We base our conclusion that the parent has generally succeeded in doing so over the past several years by comparing the common equity ratios of the non-regulated businesses with the equity ratios that are typical of “A” rated industrial issuers. As illustrated on pages 2 and 3 of Exhibit__FP-19, entitled “2013 Adjusted Key U.S. and European Industrial and Utility Financial Ratios,” the median or “typical” debt ratio for “A” rated industrial issuers was 30.7% for the 2011 to 2013 period. The corresponding 69.3% common equity ratio thus supports the reasonableness of the 61.5% to 67.0% layer of common equity supporting Orange and Rockland’s riskier unregulated affiliates.

Q. Do you have any other observations regarding the reasonableness of a 48.00% common equity ratio for the purposes of establishing the Company’s overall rate of return and its electric and gas revenue requirements for the Rate Year?

A. While we believe that it is incumbent upon management of the parent company to allocate its common equity in a rational manner, inherent in our conclusion regarding the appropriateness of a given ratemaking capital structure is our expectation that the mix of capital deployed also be done so in an optimal or most cost-effective manner. For at least the past decade, the Commission has consistently found that an authorized common equity ratio for Orange and Rockland of no higher than 48.00% was sufficient for this purpose, and for the Company to continue to attract capital at terms that are reasonable. Simply put, we have seen no evidence that a higher common equity ratio is either optimal or necessary for the Company to continue attracting capital at favorable terms. We recommend that the Commission continue to authorize a common equity ratio of 48.00% in order to optimize the Company’s overall cost of capital.

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

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

COST RATES

Q. Please explain how you derived the cost rates shown in Exhibit__FP-2.

A. As illustrated in Exhibit__FP-2, there are three separate cost rates we employed, together with their respective capitalization ratios, to formulate our overall rate of return recommendation. Beginning with the cost rate of the long-term debt component, we reviewed

Company witness Saegusa’s 5.54% cost rate determination and made a few adjustments that resulted in our 5.41% cost rate recommendation. Exhibit__FP-3 shows how this cost rate was derived.

The second cost rate shown in Exhibit__FP-2 is the cost of customer deposits. The Commission’s current Rules and Regulations require an annual calculation of the customer deposits rate. That rate is updated by the Commission on January 1 of each year. In October 2014, the Commission prescribed the 1.15% customer deposit rate for use beginning January 1, 2015.

The third and final rate is the cost of common equity. As we will demonstrate, the Company’s 9.75% proposed cost rate for common equity is excessive and should be rejected by the Commission. Our recommendation of an 8.5% ROE is included in our overall capitalization for the Rate Year ending October 31, 2016.

Q. Please explain why you adjusted Company witness Saegusa’s projected 5.54% consolidated cost of long-term debt for the Rate Year, as illustrated in Exhibit__YS-1, Schedule 5.

A. As we explained earlier, O&R's forecasted Rate Year consolidated cost of long-term debt largely reflects its current actual or "embedded" cost of long-term debt. It also reflects projections regarding the amounts, timing, maturities and cost rates for three new issues anticipated during the linking period and Rate Year, as well as the effect of its maturing debt obligation during the Rate Year. Our 5.41% forecasted rate year cost of consolidated long-term debt differs from the Company's determination in regards to the cost rates associated with the three new issuances projected during the linking period and Rate Year. While we do not take issue with the amounts, timing, and maturities of the Company's debt forecast, we acknowledge that the Company may endeavor to issue 10-year, or even 5-year debt, for that matter. It is solely with the Company's forecasted cost rates that we take issue as we do not believe the forecasted rates will reach the levels anticipated by the Company during the rate year.

Q. Please describe how O&R forecasted the costs rates for its three new consolidated long-term debt issuances.

A. O&R forecasted the cost rates of the future issuances based on guidance from knowledgeable underwriters with respect to required spreads to Treasuries expected on the future issuances and on estimates of future benchmark Treasury interest rates over the next two years, which can be found in the *Blue Chip Financial Forecast*. The current required spread estimates are added to the forecasted benchmark Treasury yields to arrive at the cost rates for the new issuances.

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

A. The Company's forecast assumes a spread estimate of approximately 1.50%-1.53% for new 30-year long-term debt issuances based upon estimates provided by underwriters at the time the Company's February 2015 update was prepared. When the Company originally prepared its rate filing, it used a spread estimate of 1.40% for new 30-year long-term debt issuances based upon estimates from similar underwriters. Taking into consideration a comparison of these spread estimates, with the actual spread to Treasury of 1.50% that the Company obtained in its most recent 30-year issuance in August 2010, we find a spread estimate of 1.50% to be a reasonable estimate for use in the forecast of its new 30-year debt issuances during the linking period and Rate Year.

Q. Please explain how you adjusted the cost rates associated with the three new long-term debt issuances projected during the linking period and Rate Year.

A. The Company projected cost rates of 4.52% for its two new long-term debt issuances during 2015, based upon the assumption that the yield on the 30-year Treasury would rise from the current three-month average levels of 2.71% to about 3.00% during 2015. Likewise, the Company projected a cost rate of 5.45% for its long-term debt issuance toward the end of the Rate Year, in September 2016, based upon the assumption that the yield on the 30-year Treasury would rise to about 3.95% during 2016.

Our cost of long-term debt calculation, however, assumes that the 30-year Treasury yield will approximate its recent level throughout the end of the Rate Year. Specifically, we used the three-month average, beginning in mid-November 2014 through mid-February 2015, and arrived at an average 30-year Treasury rate of 2.71%. We then added the underwriters' estimated spread requirement of 1.50% to arrive at estimates of 4.21% for all three of the projected long-term debt issuances. Our overall cost of debt calculation is illustrated in Exhibit__FP-3.

Q. Why do you recommend the use of the most recent actual Treasury yield or, in this instance, the average three months of the most recent actual Treasury yield?

A. We recommend the use of the most recent three-month average Treasury yield to smooth out any particularly high or low rates one might obtain by employing spot prices. More importantly, however, is that recent actual Treasury yields are employed, rather than future estimated yields, as used by the Company. The reason for this is because relatively short-term movements in long-term interest rates are difficult to forecast. Such forecasts are not only poor predictors of the magnitude of the expected change in interest rates, they are not even reliable with respect to the direction of the change. Instead, the best estimate of future long-term interest rates is no-change; in other words, the current rates of these debt instruments.

Q. Is there other support for the Panel's use of recent actual Treasury yields?

A. Yes. This is discussed in a study entitled, "On Forecasting Long-Term Interest Rates: Is the Success of the No-Change Prediction Surprising?," by Dr. James E. Pesando in the Journal of Finance, September 1980, included as Exhibit__FP-20. In addition, in Cases 13-E-0030, 13-G-0031 and 13-S-0032, Con Edison predicted that interest rates would increase over the rate year when, in fact, they decreased overall. Specifically, Con Edison predicted future 30-year Treasury yields would be 3.65% in 2014; however, yields fell from a high of 3.77% in January 2014 to a low of 2.83% in December

2014, with an overall average yield of 3.34%. Staff, on the other hand, recommended the use of the most current actual rate of 3.14% during May 2013, which appeared to be a better indicator overall of actual rates considering the rates were significantly lower than the Company forecasted.

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

A. Each of the projected 30-year issuances should be updated to reflect the most recent three-month average 30-year Treasury yield plus 1.50% to reflect the underwriters' required spread estimate. In addition, the actual amount and cost rate of the projected August 2015 issuance should be reflected in the Company's actual cost of debt upon update. Finally, if the Commission prefers a more recent estimate of the underwriters' estimated spread requirement in order to more reliably project the cost rates of the projected Rate Year issuances, the Company should be directed to provide that estimate, which should be added to the rate of the latest known average three-month 30-year Treasury rate.

Q. In the Order Adopting Terms of Joint Proposal with Modification, and Establishing Electric Rate Plan, issued June 15, 2012, in Case 11-E-0408 (the 2012 Electric Rate Plan) and the Order Adopting Joint Proposal and Implementing a Three-Year Rate Plan, filed October 16, 2009, in Case 08-G-1398 (the 2009 Gas Rate Plan), O&R was authorized to true-up costs associated with its consolidated long-term debt obligations. Specifically, it was authorized to true-up the costs of its variable rate tax-exempt debt in the 2012 Electric Rate Plan, and it was authorized to reconcile the costs of its consolidated long-term taxable and tax-exempt debt in the 2009 Gas Rate Plan. Do you recommend that either of these reconciliations continue?

A. No. The conditions that existed during those rate plans warranting such reconciliations are no longer present.

Q. Please explain.

A. First, with respect to the reconciliation of the costs of the Company’s variable rate tax-exempt debt, the Commission first authorized O&R to true-up these costs in its Order Establishing Electric Rate Plan For Orange and Rockland Utilities, Inc., issued July 23, 2008, in Case 07-E-0949. In that case, Staff had concurred with the Company that a true-up of the costs was warranted as a result of the sub-prime mortgage crisis that, at the time, had unsettled the variable rate tax exempt market. On page 42 of the Order, the Commission agreed, noting that "it is reasonable to allow the Company to reconcile actual interest and swap costs related to the Pollution Control Debt (including the use of a bank credit facility) to the levels reflected in rates due to the volatility in the market for that debt at this time." Since all of the Company's tax-exempt debt will have matured prior to the beginning of the Rate Year, the need for such a true-up no longer exists.

With respect to the reconciliation of the Company's consolidated long-term taxable and tax-exempt debt in the 2009 Gas Rate Plan, Staff and the Company submitted a Joint Proposal, later adopted by the Commission, that authorized reconciliation of the overall consolidated cost of long-term debt to the 6.81% cost rate reflected in the revenue requirements of that three-year rate plan. In support of this true-up, Staff noted, on page 12 of its Statement in Support of the Joint Proposal, dated July 15, 2009, that, while such reconciliations would generally not be considered for a one-year case, the unusual circumstances affecting the debt market at that time, namely the increase in volatility subsequent to the collapse of Lehman Brothers in the fall of 2008 and the uncertainty of the financial condition of several bond insurers, two of whom insured the Company’s tax-exempt issuances, warranted such a true-up. Due to the fact that those unique circumstances are no longer present, such reconciliation, particularly in a one year case, is unnecessary.

Q. What is Company witness Saegusa’s position with respect to the continuation of these reconciliation mechanisms?

A. With respect to the reconciliation of the costs of the Company’s variable rate tax-exempt debt, she agrees that it is no longer necessary since the debt will have all matured prior to the start of the Rate Year. She also indicates that a true-up of the costs associated with its forecasted new long-term debt issuances is not necessary provided that forecasted Treasury rates are used in the calculation of the cost of debt for its projected issuances.

Q. Why does the Company believe that forecasted Treasury interest rates would be used in this calculation?

A. The Company seems to be under the impression that the Commission has adopted the use of forecasted Treasury rates in the calculation of its interest rate forecasts for projected issuances from the most recent Con Edison rate proceeding in 2013. Company witness Saegusa specifically states, "Based on the Commission's adoption of forecasted Treasury rates in the calculation of interest rate forecasts in Con Edison's most recent base rate proceedings (i.e., Cases 13-E-0030, 13-G-0031 and 13-S-0032), I am not recommending a true-up of interest costs of the Company's fixed-rate debt portfolio." This statement is both unclear and incorrect on the Company’s part.

Q. Please explain why the Company’s statement is incorrect.

A. The agreement with the use of the Company’s forecasted rates in that proceeding was done in the context of settlement proceedings, during the course of confidential negotiations in which there were a number of moving parts, and give and take on both sides. Although the Commission ultimately adopted the Joint Proposal in that case, this in no way signifies the adoption by the Commission of forecasted Treasury rates in its future proceedings. It appears the Company is confused by items agreed to in the context of settlement, as opposed to those Ordered by the Commission directly.

Q. Why does the Company state that forecasted rates should be used?

A. The Company does not provide an explanation as to why the use of forecasted Treasury rates should be used in the calculation of its projected issuances other than claiming that they are more accurate than current Treasury rates. The Company did not provide any specific examples or a thorough explanation as to why its methodology is better than what Staff has continually recommended, and the Commission has adopted in its rate proceedings for many years.

SUMMARY OF ROE RECOMMENDATION

Q. Please explain the methodology you used to determine your 8.5% ROE.

A. We estimated the cost of equity for a proxy group of electric utility holding companies, using a DCF analysis, weighted two-thirds, and the average of two CAPM analyses, weighted one-third. As is Staff’s typical practice, in order to determine whether an adjustment to the proxy group’s cost of equity is warranted, we examined the differences in business risk and financial risk between O&R and our proxy group. We also examined whether or not an adjustment was necessary to reflect reasonably anticipated common equity issuance expenses during the Rate Year.

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

A. The DCF has long been the principal equity costing methodology in New York. In fact, for over 18 years, the Commission has consistently issued cost of equity determinations with the same two-third DCF and one-third CAPM weightings. During this time, Staff ROE testimony has consistently noted the numerous reasons why the DCF has been, and should continue to be, the preferred methodology. Its preferability over the CAPM methodology was particularly evident when a frequently used version of the CAPM began producing counterintuitive results in the wake of the volatility in the credit markets that followed the collapse of Lehman Brothers in September 2008.

Estimating the cost of equity requires using methodologies that are not perfect. Of all the approaches available, however, the DCF and the CAPM are by far the least flawed and, between the two, the DCF is superior. In fact, the Commission has noted the relative strengths of the DCF methodology in many of its previous rate orders. For example, on page 14 of its

Order Setting Permanent Rates, Reconciling Overpayments During Temporary Rate Period and Establishing Disposition of Property Tax Refunds, issued October 18, 2007, in Case 06-E-1433, the Commission stated that, “the method offers the significant benefit of reliance on readily available, objective data to measure an indicator of real importance to investors.”

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

USE OF PROXY GROUP

Q. Why is a proxy group used to estimate the Company’s cost of equity?

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

By employing a sufficiently large proxy group of similarly situated companies in our analyses, however, we can largely diminish the undesirable effects of biased, both upward and downward, or inaccurate growth estimates and beta measures for any one company. In addition, we further diminish the effect of any potential inaccuracies and biases by utilizing the median results in our analyses.

Q. What are the most important considerations for selecting a proxy group?

A. First, it is important to determine the specific industry classification of the company being examined in order to identify its true peers.

Second, once the appropriate group of peer companies is established, careful consideration must be given to determining appropriate screening criteria in order to achieve a group of companies that is sufficiently large and has similar risks to the company in question.

A careful balance must be struck between these two potentially conflicting goals. While the objective is to select a group of companies whose risks closely match those of the company being examined, it is also important that a group be selected which is also large enough to provide sufficient confidence in the results. The greater the number of suitable companies that can be found, the less sensitive the overall cost of equity estimate will be to the fluctuations or irregularities of the data from any one particular company.

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

A. We selected a group of 30 holding companies from a “universe” of 48 holding companies whose common stock is publicly-traded; all, like Orange and Rockland’s parent, CEI, are deemed by *Value Line* to be “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. We have carefully selected companies that face risks substantially similar to those faced by O&R. Illustrated on page 1 of Exhibit__FP-5 is the list of companies we used, including each company’s S&P and Moody’s credit ratings, year ending 2013 percentage of utility revenues, and last three years of common equity ratios. On pages 2 and 3, we show the same statistics for the entire *Value Line* Universe of companies and for Company witness Hevert’s proxy group, respectively.

Q. Please explain how you developed your proxy group.

A. Beginning with the 48 publicly-traded holding companies that *Value Line* categorizes as electric utilities, we automatically eliminated ITC Holdings Corp. because it is a FERC-regulated transmission-only company that is not fundamentally comparable to any New York regulated electric utility, as it does not serve retail customers. Then, in order to generally match the risks of the 47 remaining companies with those of O&R, we considered two variables, or screening criteria: the credit quality (long-term debt credit ratings) of the parent holding company and its percentage of revenue received from regulated operations.

O&R's senior unsecured debt is rated "A-" by S&P and "A3" by Moody's, and, as a utility operating unit of a holding company, 100% of its revenues are from regulated activities. By contrast, only 20 out of the 48 *Value Line* electric utility holding companies had senior unsecured debt ratings in the "A" categories by either S&P or Moody's, and nearly all derived some revenue from riskier unregulated investments.

Mindful of our goal of achieving a proxy group of companies that is both sufficiently large and with generally similar business and financial risks to Orange and Rockland, we selected only those dividend paying companies with investment-grade senior unsecured debt ("BBB-" and above by S&P and "Baa3" and above by Moody's) and at least 70% of total revenues from regulated operations. Of the 47 remaining companies in the *Value Line* Universe, 35 met these criteria; however, UNS Energy was eliminated because it was rated “Baa2” by Moody’s and not rated by S&P. Due to the company’s mid-“BBB” rating, we were not confident that, were S&P to rate the company, the resulting rating would be investment grade. In addition, five companies were eliminated because of their involvement in transformational transactions such as mergers or acquisitions. We also included MGE Energy Inc., which is unrated by Moody’s; however, its principal operating subsidiary is rated “A1” and the parent holding company carries an “AA-” rating by S&P.

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

A. Back in the early 1990s when Staff first began deploying proxy groups in its cost of equity analyses, an “A” rating was considered the industry standard. Accordingly, Staff advocated, and the Commission relied upon, proxy groups consisting solely of “A” rated utility companies. Further, in order to better match the proxy group companies with the subject utilities, Staff required that the proxy group companies derive a “substantial” portion of their operating revenues from regulated operations. Relying upon these two sound selection criteria, Staff was routinely able to produce robust-sized proxy groups consisting of anywhere from 25 to 33 companies. However, a transformation of the industry was well underway, and as a result, by the mid-2000s Staff was faced with somewhat of a dilemma regarding the selection criteria for its proxy group. Primarily due to a broad deterioration in electric utility credit quality at that time, the number of potential candidates for the proxy group had dwindled to as few as three companies, depending upon the specific interpretation given to “substantial” with respect to regulated revenues.

The larger picture is that, not only has the credit quality of the electric utility industry generally fallen, the preeminent event over the past three decades has been the steady decline in the credit quality of, not just utilities, but U.S. corporations in general.

Coupled with an orientation in the electric utility industry in the 1990s and early part of the last decade towards consolidation through mergers and an increase in unregulated activities, this has meant that lowering the credit quality threshold is the most logical and reasonable response to maintain an adequate number of candidate companies.

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

A. We have determined that the most reasonable proxy group for determining Orange and Rockland's cost of equity is one in which all of the parent holding companies serve retail customers, have investment-grade senior unsecured debt ratings, and receive a minimum of 70% of total revenue from regulated operations. This is consistent with all recent O&R electric and gas rate cases and Con Edison electric, gas and steam rate cases, and also consistent with recommendations by Staff in other recent cases involving combination electric and gas utilities.

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

A. Yes. In fact, in all of the recent fully litigated rate cases involving O&R and Con Edison, the Commission has found the composition of Staff's proxy group to be superior to the proxy groups advocated by Company witnesses and, accordingly, has employed Staff's proxy group to derive its ROE determinations.

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

A. As illustrated on page 1 of Exhibit__FP-5, the average S&P rating of the proxy group is "BBB+", and for Moody's, it is "Baa1". On average, the group receives about 92.5% of its revenues from regulated operations.

DISCOUNTED CASH FLOW METHODOLOGY

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

A. The DCF approach can be applied to any investment instrument that has an intrinsic value. The DCF approach, as it relates to common stock, recognizes that companies create value for their stockholders by using their earnings in a number of ways. The most important of which, by far, is through the payment of cash dividends.

Alternatively, earnings that are retained by companies can be used to create value by investing in capital projects designed to increase future profits. The retained earnings can also create value by retiring debt, which reduces interest expense, thereby resulting in a greater cash flow available to stockholders, and by buying back some of the Company’s common stock, which increases future earnings on a per share basis.

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

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

The main reason that the DCF methodology continues to be the preferred approach for determining a utility’s cost of equity is that investors’ immediate return requirements, as observed in current stock prices and dividends, are readily quantifiable. The other principle methodology, the CAPM, only relies tangentially, through the use of utility beta values, upon direct observations of actual utility investor behavior. The primary challenge in applying the DCF is determining the rate of growth in future dividends that investors expect.

Given the relatively mature and stable nature of the utility industry, such estimates can be derived with a reasonable degree of certitude. Also, rational utility investors expect the growth in future dividends to generally track the changes in output, or growth in the overall economy, as measured by growth in the nominal Gross Domestic Product (GDP). We say “generally track” due to the fact that, as we will explain later in our testimony, the U.S. economy continues to move away from a manufacturing economy to a service economy, and, as a result, retail electric sales growth should not be expected to grow quite as fast as the economy as a whole.

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

This intuitiveness is a primary reason that the Commission has regularly found this methodology to be the best tool for estimating the cost of equity for a regulated utility. In its Order Setting Electric Rates, issued April 24, 2009, in Case 08-E-0539, the Commission stated that, among the reasons it accords a two-thirds weighting to the DCF methodology, is that, “the DCF relies on readily available data to make objective estimates of investors’ return requirements. While the DCF has one input of primary controversy (growth), two CAPM inputs (beta and the market risk premium) are dependent on estimates which are contested and volatile.”

Q. Please describe your discounted cash flow methodology and its result.

A. We developed DCF estimates using a two-stage "dividend discount" model. Financial theory dictates that the value of a company's stock is equivalent to its future cash flows. Our dividend discount model forecasts those cash flows out into the future and discounts them back to their present value. This model embodies less restrictive assumptions than the traditional constant growth DCF methodology. Such a model is preferred, especially when growth rates in the near-term and long-run might reasonably be expected to diverge, thus making it superior to the traditional DCF model with its assumption of constant growth.

The calculation of the DCF for our proxy group is shown on pages 1 and 2 of Exhibit__FP-6. For each company in the proxy group, a three-month average stock price was calculated by averaging the high and low price for each month for the period ending December 2014. The model also contains *Value Line* data for earnings per share, dividends per share, book value per share and forecasted amounts of outstanding common stock for each company.

This data is used to estimate the future dividend payments that investors expect for each of the companies. The price that investors are currently willing to pay for that future stream of dividends, represented in this instance by the average stock price taken over the three-month period ending December 2014, is essentially the present value of those expected dividends. By calculating the discount rate required to turn the string of expected dividend payments into the current stock prices, we determined the rates of return that investors expect for each company.

Q. How are dividends projected to change over time?

A. Consistent with the approach Staff has used for many years, we employed a two-stage DCF method. In the near-term, we used *Value Line's* forecasted dividends. For the second stage, essentially 2020 and beyond, a "sustainable growth" rate was calculated for each company in the proxy group, primarily based upon the product of its expected earned return on average common equity and its projected retention of earnings. Our sustainable growth rate also incorporates growth resulting from the increase in common share balances over time at prices above book value.

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

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

Q. What are the average and median sustainable growth rates of your proxy group?

A. The average sustainable growth rate is 4.64% and the median is 4.60%.

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

A. Yes. As we typically do, we compared the sustainable growth rate of our proxy group with the most recent consensus long-range growth estimate of nominal GDP. As illustrated in Exhibit__FP-21, according to the October 10, 2014 edition of *Blue Chip Economic Indicators*, the consensus long-range estimate of nominal GDP growth is 4.7% for the 2016-2020 period and 4.4% for the most distant period forecast, 2021-2025. Thus, as expected, our sustainable growth rate is quite close to the projected growth rate in the overall economy.

It should be noted that the 4.4% nominal GDP growth rate estimate is comprised of two components: real GDP growth of 2.3% and an inflation rate of 2.1%. The long-run projections generally show annual real GDP steadily tapering from a high rate of 2.9% in 2016 to the aforementioned 2.3% growth rate, while inflation is forecasted to hold steady at 2.1% from 2016 and beyond into the long-run.

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

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

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

A. As shown on page 2 of Exhibit__FP-6, the median return on equity of the proxy group is 8.09%. The median result is the appropriate measure of the DCF-derived cost of equity of the proxy group.

Q. Do the individual company results within the proxy group appear reasonable?

A. While most of the individual company results appear reasonable, we would not recommend a cost of equity based solely on any of the individual results because of the potential for biased or inaccurate *Value Line* growth estimates to improperly influence the result. The simple fact remains that earnings forecasts, even in the relatively stable utility industry, can be very difficult to predict because of the impact of important unpredictable events. For instance, many earnings forecasts in the early part of the last decade turned out to be wide off the mark because of difficulties in forecasting the course of deregulation and the extent of competition.

Further, our approach eliminates the need to inject personal judgment and to toss out any of the individual results that appear unreasonable because our proxy group is of sufficiently large enough size and we advocate the use of the median return of individual company results, as opposed to the average. Use of the median is a widely employed statistical tool that largely diminishes any undue impact that outliers may have on the average result. In other words, by using the median return for the proxy group, individual results that might otherwise be rejected, are effectively marginalized.

CAPITAL ASSET PRICING MODEL METHODOLOGY

Q. Would you please describe the basic theory underlying the CAPM?

A. The basic logic behind the CAPM is that there is no premium, in terms of an expected return, for bearing risks that can be eliminated through diversification. According to the CAPM, rational investors will hold a portfolio of stocks (generally 60 or more) such that the overall risk of that portfolio, in terms of the variability of its returns, is identical to that of the market as a whole. Thus, the only risk that matters in the CAPM equation is said to be “systematic” risk, or risk that cannot be diversified away.

“Unsystematic” risk, on the other hand, is risk that is specific to a particular stock. While it is assumed that most stocks tend to go along with the general market, at least to some extent, factors that are specific to an individual stock are said to affect its “unsystematic” risk.

According to the CAPM, the appropriate way to measure an individual stock’s risk is through a correlation of its return relative to the market as a whole, known as beta. A stock with a beta of 1.0 has a return that mirrors the return of the “market,” usually the S&P 500, as a whole. Betas of less than 1.0, which are typical for utility stocks given the moderating influence of regulation and the accompanying perception of reduced risk, indicate that the stocks are less volatile than the market as a whole. Therefore, the CAPM informs us that investors will only be compensated for their actual risk, as measured by beta. In other words, their return requirements will reflect the degree to which they are less volatile than the market as a whole.

Q. Please describe how a CAPM result is calculated using the Traditional CAPM method.

A. The Traditional CAPM method calculates a required return based on three inputs: the rate of return on a risk-free investment (Rf), the level of systematic risk for an investment (B for beta), and the expected market risk premium (MRP). Typically, the MRP is calculated by subtracting the risk-free rate from the expected market return (Rm). The form that the Traditional CAPM takes is as follows:

Required Return = Rf + (B * MRP)

Q. How did you begin the CAPM analysis?

A. Consistent with the approach Staff has employed and the Commission has used for more than 18 years, we used two different CAPM methods, the Traditional approach, as we just described, and a Zero Beta calculation. Our 9.23% CAPM-derived ROE estimate is the average of the results of these two analyses.

Q. Please describe how you calculated a return on equity using the Zero Beta CAPM method.

A. We used the same inputs as in the Traditional CAPM methodology. However, instead of multiplying beta by the MRP, as shown in the calculation of the Traditional CAPM methodology, we determined the MRP for the proxy group by multiplying .75 by beta by the MRP and adding .25 times the MRP. This can be expressed as: Required return = Rf + (.75 * B * MRP) + (.25 * MRP)

Q. Why do you employ two CAPM methods?

A. We employ two CAPM methods because a considerable body of research has shown that the Traditional CAPM may underestimate required returns when betas are below 1.0. Therefore, it is appropriate to use a Zero Beta methodology as well. By averaging in the result of the Zero Beta approach, which is only partially determined by the beta used, this tendency is addressed and corrected for, and ultimately enhances the accuracy of our overall CAPM ROE determination.

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

A. We averaged the 10-year and 30-year Treasury bond yields for the most recent three-month period. The result, for the three-month period ending December 2014, is 2.63%.

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

A. We use the yields for two different Treasury securities because utility investors generally have both intermediate and long-term investment horizons, so the use of both the 10-year and 30-year Treasury securities is appropriate. In the past, the Commission has adopted our approach. Specifically, on page 75 of its Order Establishing Rates for Electric Service, issued June 17, 2011, in Case 10-E-0362 (2011 O&R Electric Plan Order), in adopting this approach, the Commission noted that “using a combination of treasury yields is consistent with our practice and supported by the varying nature of investor holding periods.”

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

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

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

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

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

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

As we explained earlier in our testimony, the use of the median is a widely employed statistical tool that should be used in circumstances where one or more extreme observations bias the overall conclusion. Furthermore, the Commission determined, in the 2011 O&R Electric Plan Order, that the median beta was appropriate.

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

A. As we already explained, the MRP is best expressed as the difference between the expected market return on common stock and the return required on a risk-free investment. Because the cost of equity is, by its nature, a forward-looking concept, we employed an *ex-ante* analysis, relying upon required market return estimates published monthly by Merrill Lynch in its *Quantitative Profiles* report. Specifically, we used the October 2014, November 2014 and December 2014 editions of *Quantitative Profiles*, and averaged the required and implied market returns of each of the three point-in-time estimates, to arrive at an appropriate required return for the market of 11.07%. We have illustrated the appropriate pages from each of these reports in Exhibit__FP-22. The full reports are available upon request. Finally, given our risk-free rate of 2.63%, we calculated the expected MRP to be 8.44% by subtracting the risk-free rate from the 11.07% expected market return.

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

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

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

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

Q. Why didn't you rely on an *ex-post* method to derive the appropriate MRP?

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

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

A. Yes. Specifically, in its Opinion and Order Concerning Revenue Requirement and Rate Design, issued October 3, 1996, in Case 95-G-1034, the Commission stated that "the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problem of stale data in the *Ibbotson* estimate."

Q. Would you briefly summarize your main concerns with applying the CAPM methodology to determine a utility's cost of equity?

A. To begin with, unlike the DCF methodology, the

CAPM methodology only relies tangentially, through the use of utility beta values, on direct observations of actual utility investor behavior. Furthermore, the calculation of two of its principle inputs, the beta and the MRP, is highly problematic.

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

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

Another, and perhaps more significant, shortcoming of beta calculations is the often wide disparity of betas between the various firms that report this measure. For instance, Staff has typically relied on *Value Line* reported betas, as they are calculated over a five-year period, which is long enough to produce reliable estimates. Moreover, *Value Line* “smoothes” the “raw betas” to reflect the theory that betas have a natural tendency to gravitate to 1.0. Other firms, such as *Bloomberg,* however, employ less reliable, shorter periods, and others do not adjust the “raw” betas as *Value Line* does. Our concern is that, depending upon the source, betas can be quite different, and thus can produce very different cost of equity estimates.

Our greatest concern with the CAPM methodology, however, remains the derivation of the MRP. The MRP should be the expected average premium of the market over the risk-free rate. However, just like beta, the expected MRP is unknown and, because it is unknown, many adherents to this methodology advocate use of an *ex-post* MRP. The view of these practitioners is that the MRP is essentially a mean-reverting time series, which may be volatile over the short-run, but over the long-run exhibits a stable long-run average.

The alternative to a historically-derived

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

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

A. 8.96%, calculated as follows:

2.63% + [.75 * (11.07% - 2.63%)] = 8.96%

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

A. 9.49%, calculated as:

2.63% + [.75 *.75*[11.07%-2.63%)] + [.25*(11.07%-2.63%)] = 9.49%

Q. Please explain how you used the results of these two CAPM methods in your calculation of the required ROE for the proxy group.

A. We averaged the results of the two CAPM methods to arrive at a determination of 9.23%. This is the same approach that has been used by the Commission in rate cases for many years.

RETURN ON EQUITY CONCLUSION

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

A. By weighting the 8.09% DCF result two-thirds and the 9.23% CAPM result one-third, and rounding that result to the nearest tenth of a percent, we determined the proxy group’s cost of equity to be 8.50%. Our calculations are shown on page 3 of Exhibit__FP-6.

Q. You stated previously that it is your typical practice to examine the differences in financial and business risk between the company and the proxy group in order to determine whether or not an adjustment is warranted. Please explain how you conducted this examination and your conclusion with respect to the need for an adjustment.

A. S&P and Moody’s regularly assess the full breadth of risks facing the utilities they rate;

hence the combined effect of all the business and financial risks faced by those utilities are incorporated into the credit ratings they assign. O&R’s long-term, senior unsecured debt ratings are “A-” and “A3”, respectively, and both have stable outlooks. The comparable average credit ratings for our proxy group, and for Company witness Hevert’s proxy group for that matter, are approximately one notch weaker. Both proxy groups have average S&P ratings of “BBB+” and average Moody’s ratings of “Baa1”.

Q. Do you recommend an adjustment to your 8.50% ROE given this modest risk differential?

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

Q. Would you please explain why your 8.50% recommendation is significantly lower than the Company's currently authorized ROEs?

A. To begin with, O&R's currently authorized ROEs are quite stale as both the Company's electric and gas operations are operating under rate plans established several years ago. The Company's electric operations are currently authorized a 9.6% ROE that dates back to the 2012 Electric Rate Plan, which called for ROEs of 9.4%, 9.5% and 9.6% in rate years one, two and three, respectively. The Company's current authorized ROE of 10.4% for its gas operations dates back even earlier to the 2009 Gas Rate Plan. In both cases, the ROEs reflect the considerably different underlying economic conditions that existed when the parties entered into the respective Joint Proposals, which were later adopted by the Commission. Additionally, as is the case with nearly all New York multi-year rate plans, each of the ROEs also reflects a premium in recognition of the added financial and business risk associated with the resulting stayout provision.

Q. Compared to today, what were economic conditions when the Company entered into the Joint Proposal, adopted in the 2009 Gas Rate Plan, over five years ago in June 2009, and the Joint Proposal, adopted in the 2012 Electric Rate Plan, approximately three years ago in February 2012?

A. As illustrated on page 1 of Exhibit__FP-10, when the Company entered into the gas Joint Proposal in June 2009, which was later adopted by the Commission in the 2009 Gas Rate Plan, economic conditions were such that investors were requiring yields of 6.20% for long-term “A” rated utility debt and 4.51% for 20-year Treasury securities. Several years later, when the Company entered into its latest electric Joint Proposal, in February 2012, which was later adopted by the Commission in the 2012 Electric Rate Plan, economic conditions were such that investors were requiring yields of 4.36% for long-term “A” rated utility debt and 2.75% for 20-year Treasury securities. Currently, investors’ yield requirements for each of those instruments are at least 230 basis points lower from June 2009 levels and at least 55 basis points lower from February 2012 levels, indicating the lower return requirements of investors at this time. Specifically, as of January 2015, investors currently require a yield of 3.58% for long-term “A” rated utility debt and a yield of 2.20% for 20-year Treasury securities.

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

A. Not too many months ago, on November 19, 2014, Con Edison, for the first time in its history, was able to issue $750 million of unsecured debt with a 40-year maturity. This is the longest maturity in Con Edison’s debt portfolio. This unprecedented issuance was offered at a coupon of 4.625% and immediately began trading in the secondary market at an even lower yield. By January 2015, demand for its debt in the secondary market had driven investors yield requirements down to levels below 4.00%. This signifies robust demand for Con Edison’s debt offerings, even at these historically low yields.

Q. How does the 8.5% ROE recommendation compare to the current yield requirements of investors of long-term “Baa” rated utility debt and 20-year Treasury obligations?

A. As can be observed from viewing the data illustrated in Exhibit__FP-7, our 8.5% ROE recommendation is 411 basis points higher than investors 4.39% current yield requirements for long-term “Baa” rated utility debt and 630 basis points higher than the 2.20% current yield requirement on 20-year Treasuries. We compare our recommendation with the long-term “Baa” rated utility debt because the majority of utilities are in this ratings category.

Q. How does the 411 basis point spread above current long-term “Baa” rated utility debt obligations implied by the 8.5% ROE recommendation compare with historical spreads between authorized ROEs and the yields on long-term “Baa” rated utility debt?

A. As illustrated in Exhibit__FP-7, over the past 20 years, the average spread between nationally authorized electric ROEs and long-term “Baa” rated utility debt has been 394 basis points. Over the past 15 years, the spread has been 411 basis points, which is identical to our 411 basis point spread.

Q. How does the 630 basis point spread above current 20-year Treasury obligations implied by your 8.5% ROE compare with historical spreads between nationally authorized ROEs and the yields on 20-year Treasuries?

A. As illustrated in Exhibit__FP-7, over the past 20 years, the average spread between nationally authorized electric ROEs and 20-year Treasury securities has been 580 basis points. Over the past 10 years, however, the spread has been 636 basis points, which is quite similar to the current 630 basis point spread that results from our 8.5% ROE recommendation.

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

A. No. Rational investors are well aware of the Commission’s preference for a formulaic approach to the cost of common equity and are also aware that recent authorized ROEs are closer to our 8.5% ROE recommendation.

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

A. Yes. The Company’s Chief Financial Officer, Robert Hoglund, makes several presentations to the investment community each year. A key segment of his presentations is a discussion of the regulatory framework in New York, including the Commission’s preferred approach to ROE. For instance, Mr. Hoglund recently made a presentation at the *Credit Suisse Energy Summit* on February 25, 2015, a copy of which is presented in Exhibit__FP-23. On pages 43 through 46 of his presentation, Mr. Hoglund not only describes the mechanics of the Commission’s preferred methodology, but he indicates that actual authorized ROEs, most of which were for multi-year rate plans, have remained in the low 9.00% range over the past several years. He also noted that Staff’s recommendation in the most recent Central Hudson Gas and Electric Proceeding, Cases 14-E-0318 and 14-G-0319, was 8.7%.

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

A. Yes. There are numerous examples of equity research reports acknowledging this information. We will cite from two recent reports, full copies of which are illustrated in Exhibit__FP-24 and Exhibit__FP-25. First, is a report by *Wolfe Research* dated February 2, 2015, which states that “the NYPSC’s formulaic ROE implied an 8.7% last quarter.” Second, is a report by *UBS* dated February 24, 2015, which states, “Even though Central Hudson recently settled in the State for 9.0% ROE (+30bp premium already embedded for a 3-year deal), we estimate the ROE per the PSC’s own formula approaches an even lower 8.4% based on peer group analysis.” Therefore, our recommendation of an 8.5% ROE should not come as any surprise to the Company or investors alike.

Q. Do you have any other supporting evidence indicating minimal concern on the part of the Company and investors with regard to an authorized ROE in the 8.5% range?

A. Yes. The parent company’s Board of Directors was clearly not deterred when it raised its quarterly dividend on January 15, 2015. This amounted to an annualized increase of eight cents over its previous annualized dividend of $2.52 a share. For over a decade, CEI had been increasing its annual dividend by four cents a share. However, a year ago, CEI increased its annual dividend by six cents, and most analysts were expecting a six cent raise this time as well. That CEI has conveyed such optimism with respect to its future cash flows in the current low ROE and interest rate environment is noteworthy.

FINANCIAL INTEGRITY

Q. Have you examined the financial metrics implied by Staff's recommendations in this proceeding to ascertain their impact on the Company's financial integrity?

A. Yes. As illustrated in Exhibit__FP-8, we looked at a number of metrics for the Company based on our recommendation of an 8.5% ROE and a 48.00% equity ratio to see the effects, if any, there would be on the Company's coverage ratios. Specifically, we looked at the Earnings Before Interest and Taxes (EBIT) and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) coverage ratios because these are two ratios utilized by both S&P and Moody's in developing a Company's overall financial risk profile.

Q. How do the EBIT and EBITDA interest coverage ratios implied by your 8.5% ROE and 48.00% common equity ratio, and Staff's recommended depreciation and amortization figures compare to both the Company's projected metrics with its requested ROE of 9.75% and five-year averages?

A. As illustrated in the third column in

Exhibit__FP-8, granting the Company's requested ROE of 9.75% would produce financial metrics that exceed, in some instances quite substantially, those of its actual performance over the past five years, and those of the proxy group as well. If the Commission were to adopt the Company's requested ROE of 9.75%, its 3.76 times Rate Year EBIT interest coverage would exceed its 3.71 times five-year average. Similarly, it's 5.76 times Rate Year EBITDA would substantially exceed its 5.20 times five-year average.

Our recommendations, however, would result in an EBIT interest coverage ratio of 3.41 times, which exceeds its 2013 EBIT coverage ratio and exceeds the five-year average EBIT coverage ratio of the proxy group. In addition, our 5.27 times EBITDA interest coverage exceeds the 5.20 times ratio average achieved by the Company over the past five years, and the 4.87 times average EBITDA interest coverage of the proxy group over the last five years as well. We also note that the figures shown in the column labeled "Staff 2016" reflect Staff's adjustments to the Company's rate base and proposed capital expenditures, as well as Staff's estimate of the cash flow impact of net deferred income taxes during the Rate Year.

Therefore, adopting our recommendations should result in strong financial metrics in line with O&R's historical numbers and stronger than the historical numbers of the proxy group overall. This will continue to support strong investment-grade ratings, such as the Company's current "A-" S&P and "A3" Moody's ratings.

DISCUSSION OF COMPANY ROE AND FINANCING PRESENTATIONS

Q. You have stated that Company witness Hevert's 9.75% recommended ROE is excessive and should be rejected. Would you please summarize the approach followed by Mr. Hevert?

A. To arrive at his recommendation, Mr. Hevert performed two multi-stage DCF analyses, one a two-stage model and the other a three-stage version of the model. He also performed 12 separate CAPM analyses, essentially by employing both the Traditional and "Zero-Beta" forms of this approach under three separate sets of beta determinations and under two separate market-derived MRPs. He then weighted his 9.88% average DCF result two-thirds and his 11.02% average CAPM result one-third to comply with the Commission’s stated preference, added 0.03% for hypothetical flotation costs, resulting in a 10.29% cost of equity, with a range which he deemed reasonable of 9.75% to 10.50%. Mr. Hevert states that the Company’s proposed ROE of 9.75% is reasonable, if not conservative, but notes that up to a 50 basis point upward adjustment would be appropriate if a three-year rate settlement were to be reached between Company, Staff and the other parties.

Q. What are your principal points of contention with Mr. Hevert’s analyses?

A. Overall, we are concerned with the composition of his proxy group, the use of excessive growth rates in his DCF analyses, the use of flawed approaches to establish the various inputs employed in his CAPM analyses, principally his excessive market return estimates, but also the risk-free rate and beta, and the inclusion of flotation costs.

Q. Please explain the concerns you have regarding the composition of Mr. Hevert’s proxy group.

A. Although the selection criteria for the development of Mr. Hevert’s proxy group on the surface seems similar to ours, a closer examination reveals that there are substantial differences in the composition of his proxy group that seem to contribute to the difference between his ROE recommendation and ours. While the two proxy groups have 23 companies in common, there are eight companies in Mr. Hevert’s proxy group that should have been excluded based on the criteria the Commission has repeatedly expressed a preference for in recent cases. Conversely, there are seven companies that were excluded from Mr. Hevert’s proxy group that should have been included.

Q. Please elaborate and provide examples of how the proxy groups differ in composition and how those differences have played a part in the DCF results.

A. Some of the differences in proxy group composition can be attributed to a number of recent mergers within the electric utility universe that have led to some companies being excluded from consideration. Presumably, Mr. Hevert selected the companies in his proxy group prior to the announcement of these recent mergers. However, because Mr. Hevert uses a different selection criteria when determining how much of a utility’s operations are regulated, it is possible that some of the companies he includes within his proxy group have a higher inherent risk profile, given that they have significant unregulated revenue. Specifically, Mr. Hevert uses the amount of average regulated income generated by the utility over the last three years, with a 70% benchmark, as a cut off for inclusion in his proxy group. In contrast, Staff uses regulated revenue for the previous year with a 70% cut off. Consequently, Mr. Hevert includes two companies, Otter Tail Corporation and Vectren Corporation that, based upon their slim percentage of regulated utility revenues, only 36.88% and 57.37% in 2013, respectively, do not appear to be suitable surrogates. In addition, two other companies included in Mr. Hevert’s proxy group, FirstEnergy and Centerpoint Energy, have regulated revenues that are significantly under the 70% mark.

In contrast, Mr. Hevert has excluded a number of companies that fit the Commission's established criteria. Three companies, Northwestern Corp, TECO Energy and UIL Holdings, were excluded because they were identified by Mr. Hevert as being party to a merger. While UIL had announced the intention of purchasing Philadelphia Gas Works, this transaction was cancelled in December 2014. Additionally, while TECO and Northwestern Corp both recently completed acquisitions, both acquired companies that were substantially smaller in size. Therefore, it would be inappropriate to identify them as "transformative."

We also note that he injects unnecessary subjectivity into his selection process, as two of the seven suitable surrogates that he excludes from his proxy group, specifically CEI and Edison International, meet all of his selection parameters. He asserts that the reason he removes CEI from his proxy group is because it is his usual practice to avoid the alleged circular logic that would arise by including the subject company in his proxy group. Even if we disregard the fact that he presents no evidence indicating that including CEI in the proxy group introduces circularity, the fact remains that CEI is not the subject company here. In fact, by excluding CEI from his proxy group, his results fail to capture the data of a company that by virtue of its relatively rare T&D nature and geographic location is, in fact, the most comparable electric utility holding company to O&R.

With respect to Edison International, Mr. Hevert stated that he removed the company from his proxy group because it had a significant amount of unregulated losses during the 2011 to 2012 period. Given that these losses occurred several years ago, it begs the question as to when this company would be a viable candidate for Mr. Hevert’s proxy group. Therefore, just like CEI, its results should be reflected in his proxy group. After all, the whole reason for employing screening criteria in the first place is to remove any unnecessary subjectivity. At the very least, if Mr. Hevert felt that the inclusion of either of these two companies could conceivably skew his results, he could, as we do, employ the median result.

Q. Are there any significant differences in the characteristics of your proxy group and that of Mr. Hevert?

A. In terms of the percentage of revenue that comes from riskier non-regulated operations, there is a notable difference between the two groups. For the year ending 2013, the utility holding companies that comprised our proxy group received, on average, 7.54% of their revenue from riskier non-utility activities. In contrast, the utility holding companies comprising Mr. Hevert's proxy group received nearly twice as much of their revenue from such ventures. As illustrated in Exhibit__FP-5, his companies received, on average for 2013, about 13% of their revenues from their non-utility operations.

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

A. The difference in revenue from regulated operations in the two proxy groups could be an indication that, overall, the holding companies which comprise Mr. Hevert's proxy group have a marginally higher risk profile than those of our proxy group. If this were the case, a reasonable investor would naturally be inclined to require a higher rate of return on their equity investment to compensate for the perception of increased risk.

Q. Given that Mr. Hevert incorporates companies with a higher presence of non-utility business operations into his proxy group, in your opinion, is his proxy group a good representation of O&R's operations?

A. Although Mr. Hevert's intention is for his proxy group to be similar in risk to O&R, the fact that he has incorporated companies with a higher percentage of non-utility businesses suggests that his proxy group is actually riskier, and, therefore far less representative, of O&R, which does not receive any revenue from such risky sources. Therefore, it stands to reason that our proxy group is more closely representative of O&R as opposed to Mr. Hevert’s proxy group.

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

A. Mr. Hevert performed a two-stage DCF model, somewhat similar in form to ours, and a three-stage version as well. While we can understand and appreciate the rationale he used to support the use of a three-stage model, in practical terms it does not appear that the alleged benefits of this model make much of a difference. Specifically, the 9.97% result of the three-stage model was not significantly different from the 10.01% result of his two-stage model. These minor differences lead us to the conclusion that there is no added value gained by using this additional approach. In sum, we do not have serious concerns with the forms of the DCF model he employs, but we do find serious flaws in the manner in which he has employed them. It is because of the numerous faulty assumptions underpinning his DCF analyses that we strongly recommend they be rejected.

Similar to our own approach, both forms of

Mr. Hevert's DCF analyses define the cost of equity as the discount rate that sets the current stock price of his proxy group companies equal to the discounted value of their projected dividends. Likewise, similar to our rationale for employing a two-stage dividend discount model, Mr. Hevert also acknowledges that growth rates in the near-term and long-run might reasonably be expected to diverge. Specifically, he notes that expected dividend payout ratios for utilities may decrease during periods such as now when utilities are undergoing a cycle of relatively high capital expenditures. This can readily be seen by looking at the average *Value Line* projected payout ratios of his proxy group, which are forecast to decline from about 62.70% in 2013 to about 60.00% in 2018.

In both of his models, Mr. Hevert projects dividends through 2018, or the near-term, as the product of the average of earnings growth rate estimates provided by *Zacks, ValueLine* and *Thomson First Call* and *Value Line* projected payout ratios. Both the two-stage and three-stage models then assume that, beginning in 2019, the earnings of the proxy group companies will all grow at a rate equal to the projected nominal GDP calculated by Mr. Hevert. Further, both models assume that their dividend payout ratios will revert to 67.23%, the ratio Mr. Hevert professes to be their long-term norm.

In the case of the two-stage model, the transition from the *Value Line* projected 2018 payout ratio of each of the individual companies in Mr. Hevert's proxy group to his assumed 67.23% long-term norm ratio occurs at once in 2019. In his three-stage model, however, he smoothes this transition over a five-year period. As a result, in the case of his two-stage model, the impact on the projected dividends also occurs in 2019, such that any abrupt change resulting from the use of Mr. Hevert's assumed long-term ratio is also reflected in that particular dividend. Finally, the model assumes that all subsequent dividends grow at Mr. Hevert's nominal GDP rate.

For the three-stage model, the change in the payout ratios from their *Value Line* projected 2018 levels to his 67.23% long-term norm payout ratio is transitioned through the years 2019 to 2024, and his projected dividends during those years reflect this convergence accordingly. He then assumes that, beginning in 2024, all dividends will grow at his nominal GDP rate.

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

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

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

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

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

Q. What concerns do you have with Mr. Hevert's assumption that the long-term norm payout ratio of the electric utility industry is 67.23%?

A. We find that Mr. Hevert has not adequately substantiated his 67.23% payout ratio. We agree that the 67.23% may very well represent the actual average of the annual median payout ratios of his proxy group companies under the prevailing economic conditions over approximately the past 20 years; however, his analysis is lacking because he presents no evidence connecting how the economic conditions anticipated in the future would lead investors to assume the average industry payout ratio over the past 20 years would be applicable. Given that the past 20 years has been a particularly transformative period for the electric utility industry, it is questionable whether investors would find that historic payout ratio to be a suitable surrogate for the future.

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

A. In order to calculate his estimate of nominal GDP, which can best be thought of as the long-term growth rate of the economy as a whole, including expected inflation, Mr. Hevert incorporated two separate elements. First, he utilized the 3.27% historical growth in real GDP for the period 1929 through 2013, which was calculated as the compound growth rate in the chain-weighted GDP for that period. He then calculated his 5.6% forecasted nominal GDP rate by taking this historical figure, together with his expected inflation rate of 2.26%, which Mr. Hevert explained was calculated based upon the compound annual Consumer Price Index (CPI) growth rate and the compound annual GDP Price Index, averaged with the yield spread between the 30-year Treasury Inflation-Protected Securities (TIPS) and nominal 30-year Treasury bonds.

As we will explain, both of these components are flawed. His 2.26% expected inflation rate is inappropriate because of his reliance on expected price changes in the Consumer Price Index (CPI). The CPI measures changes in the price level of a basket of consumer goods and services, and, unlike the GDP deflator, does not measure inflation over the entire economy. Additionally, his use of the 3.27% historical real GDP growth rate from 1929 through 2013 is inappropriate because historical averages, while instructive, are simply poor indicators of future economic activity. As we explained earlier, the *Long-Range Consensus U.S. Economic Projections* provided by *Blue Chip Economic Indicators* is a much better source regarding future economic growth because it builds upon historical trends, and, most importantly, takes into account current economic conditions. Not only does this report venture out into the future twice as far as nearly any other reputable source of economic data, it also reflects the consensus of the views of some 50 of the financial community’s most prominent economists.

According to the October 10, 2014

publication, as illustrated in Exhibit__FP-21, the consensus long-run nominal GDP growth rate is 4.4%, which includes both real GDP and expected inflation components. Thus, the consensus view of leading economists is considerably less robust about the future growth rate in the economy than Mr. Hevert, and, in our view, clearly indicates that the 5.6% nominal GDP growth rate employed by Mr. Hevert in his analyses is excessive.

Q. Do you agree with Mr. Hevert’s assumption that the long-term nominal GDP rate is a reasonable proxy for the long-term dividend growth rate in multi-stage DCF analyses?

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

Q. Please elaborate.

A. As pointed out on page 21 of a research article by *UBS Investment Research,* dated July 12, 2010, which is shown in its entirety in Exhibit__FP-26, the electric utility industry was a growth industry back in the 1950s and 1960s. Beginning sometime in the 1980s, however, with the move away from a manufacturing economy to a more service-oriented one, electricity sales have grown more slowly than the overall economy. Our own research, contained in Exhibit__FP-9, clearly demonstrates the impact of this transformation. Indeed, while the average real GDP growth rate over the past 30 years has been 2.84%, the growth in total retail electric sales has only averaged 1.84%.

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

A. Exhibit__FP-27 supports our assertion that the electric utility industry will continue to grow in the future at a rate slower than the overall economy. In projections contained on page 161 of its April 2014 *Annual Energy Outlook 2014,* the U.S. Energy Information Administration (EIA) calls for annual growth rates in purchased electricity between 2013 and 2040 of 0.7% for the residential sector, 0.8% for the commercial sector and 0.9% for the industrial sector. We note, as well, that, on page 129 of its report, the EIA states that its base case "projects 2.4% average annual GDP growth from 2012 to 2040, consistent with trends in labor force and productivity growth."

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

A. Companies such as electric utilities with lower retention ratios, because they pay out substantial portions of their earnings in the form of dividends, cannot be expected to have the same "headroom" to grow their dividends in the future as do companies that retain a majority of their earnings, presumably to fund future growth opportunities.

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

Indeed, when one considers that the electric utility industry’s base rates are, by and large, set on an original cost or book value basis, it is readily apparent that Mr. Hevert’s 5.6% long-run growth rate estimate is not sustainable given his assumed long-run industry payout ratio of 67.23%. In order for the industry to maintain a long-run growth rate of 5.6%, while at the same time retaining only 32.77% of its annual earnings, the industry would have to achieve an improbable annual return on the average book value of its common equity of 17.09%. Given the industry’s high historical payout ratios, together with the fact that the average authorized ROE for the past 20 years has only been about 10.76%, it is extremely difficult to imagine how a rational investor would conceive of a long-run growth rate anywhere near as high as Mr. Hevert’s 5.6% growth rate.

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

A. Mr. Hevert provided a total of 12 ROE estimates using the same CAPM methodologies that we use. He calculated six using the Traditional CAPM methodology and another six using the Zero-Beta CAPM methodology. The reason that he calculates 12 different ROE estimates, however, is because he elects to use three different beta determinations in combination with two different MRP estimates.

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

A. As we explained earlier, both the Traditional and Zero Beta CAPM methods require three major inputs: the risk-free rate, beta and the MRP, which itself requires an estimate of the expected market return. Both Mr. Hevert’s Traditional and Zero-Beta CAPM methodologies use a risk-free rate of 3.27% based on the three-month average yield on 30-year Treasury bonds. To arrive at his 9.99% and 9.43% MRP estimates, he subtracts the 3.27% three-month average yield of the 30-year Treasury bond from two individual estimates of the market return, one at 13.25% and the other at 12.69%, both derived from constant growth DCF analyses of the S&P 500 Index.

As previously mentioned, Mr. Hevert opted to utilize three different beta determinations within each of his CAPM methodologies. For his first beta calculation, he used the .748 average of the *Value Line* betas of his proxy group. For his second beta calculation, he used his proxy group’s .81 average *Bloomberg* beta. Finally, for his third beta calculation, he took the covariance of the proxy group’s mean weekly returns and the S&P 500’s weekly returns over the past 12 months and adjusted it using Bloomberg’s methodology of multiplying the raw beta coefficient by .67 and then adding .33, to arrive at a beta estimate of .753.

Given these respective inputs, Mr. Hevert then developed six traditional CAPM estimates of the cost of common equity for Orange and Rockland, ranging from 10.32% to 11.35%, and six Zero-Beta estimates of the cost of equity ranging from 10.91% to 11.83%. By averaging all 12 of these results, Mr. Hevert’s CAPM methodology produced a cost of equity estimate of 11.02%.

Q. Please state your principal concerns with Company witness Hevert’s CAPM analyses.

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

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

A. To begin with, the Commission has always utilized *Value Line* betas, and one of the principal reasons for doing so is because *Value Line* calculates its betas over a five-year period, thereby mitigating the inherent volatility of using beta estimates calculated over shorter time periods. While Mr. Hevert’s first beta determination uses *Value Line* beta estimates, his second determination uses *Bloomberg* beta estimates that are only calculated over a two-year period, and his third beta estimate is his own, calculated over only a 12-month period. Coincidentally, Mr. Hevert’s own 12-month beta calculation currently produces a beta estimate that is generally consistent with *Value Line* estimates. However, his Bloomberg beta calculation of .81 differs substantially from both our beta and the other two beta methodologies that he employs. An example of the inconsistency of betas calculated over short time periods to produce reliable results is evident in Cases 13-E-0030, 13-G-0031 and 13-S-0032. At that time, Mr. Hevert employed a Bloomberg beta of .69, which is substantially lower than its current level of .81. Because Mr. Hevert’s Bloomberg beta and his own beta calculation rely on such short time periods, they cannot be counted on to consistently produce reliable results over the long-run. Additionally, as the Commission noted on page 77 of the Order Establishing Rates for Electric Service, issued June 17, 2011, in Case 10-E-0362, “any alteration in this method should be done in a manner that avoids increasing the volatility of the CAPM.” Mr. Hevert has once again introduced an unwarranted alteration to a component of the CAPM, in this case the beta component, and, like the outcome in Case 10-E-0362, his methodology should be rejected.

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

A. Mr. Hevert argues that the yield on the 30-year Treasury is appropriate because, in his view, utility companies represent long-duration investments. However, as we have explained, it has long been Commission policy to rely on the average of the 10- and 30-year Treasuries to arrive at the risk-free rate, as we have done in our calculation. Mr. Hevert, however, argues that the Commission’s preferred approach is flawed because it does not address the Company’s asset life, the equity duration of the utility industry, or what *Morningstar* suggests is “the horizon of whatever is being valued.”

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

As clearly shown in Company witness Saegusa’s Exhibit__YS-1, O&R has generally found it best to issue long-term debt securities with maturities of both 10 and 30 years, in nearly equal parts. The fact that there are so many willing investors for utility debt at both of those maturity points is a strong indicator that the Commission’s practice is sound, and that Mr.

Hevert's recommendation should be rejected.

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

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

The only difference in his two approaches appears to be the source of the projected earnings growth estimates used. One analysis uses Bloomberg's projected earnings growth estimates while the other uses *Value Line* growth estimates. The Bloomberg analysis employs an average long-term growth rate of 11.27%, an expected yield of about 1.89%, and results in estimated market return of 13.25%. The *Value Line* analysis employs an average long-term growth rate of 10.98%, an expected yield of 1.82%, and results in an estimated market return of 12.66%. By subtracting his risk-free rate of 3.27% from these estimated market returns, Mr. Hevert calculated MRPs of 9.99% and 9.43%, respectively, with the resulting difference presumably due to rounding.

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

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

The folly of using a constant growth DCF calculation to estimate the required market return is perhaps best illustrated by considering the fact that 22 of the companies in the *Bloomberg* growth rate model and 30 of the companies in the *Value Line* growth rate model have near-term earnings growth estimates in excess of 20%. It is plainly unreasonable that investors would assume that those companies would be able to maintain those extraordinary growth rates forever.

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

A. Yes. His 10.26% cost of equity conclusion includes .03%, or 3 basis points, for what he refers to as flotation costs.

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

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

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

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

Q. Is the Company’s parent, CEI, planning a common equity issuance during the Rate Year to which some of the proceeds would be down-streamed to O&R?

A. No. The Company’s cash flow forecasts indicate that no common equity issuance is planned for the Rate Year.

Q. Given that no common equity issuance is planned for the Rate Year, do you believe that Mr. Hevert’s flotation cost adjustment should be rejected?

A. Yes. Such an adjustment has repeatedly been rejected by the Commission in the past. For instance, in the Order Setting Permanent Rates, issued October 18, 2007, in Case 06-E-1433, the Commission stated, “The Company’s attempt to reach back to past issuances is supported only by a hypothetical statement that such costs may not have been collected, rather than any proof to that effect.” Likewise, Mr. Hevert’s proposal in this case, to compensate O&R’s investors for costs incurred for all past issuances, should be rejected.

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

A. Yes. Explaining that the mean results of his proxy group analyses do not necessarily provide an appropriate estimate of the Company’s ROE, he noted two additional factors that are discussed by Company witness Saegusa that should be considered. Specifically, Mr. Hevert believes that the Commission should consider the Company’s extensive capital expenditure plans, and what he characterizes as the Company’s relatively weak cash flows, “which are at least partially the result of a low ratio of amortization and depreciation to capital assets.” Finally, he suggests that the Commission should consider the “additional risk associated with New York’s changing regulatory structure and increasing penetration of distributed generation.”

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

A. No, but, in any event, we will respond to the additional factors he and Company witness Saegusa reference. We will explain how they are properly factored into our analysis and recommendations. In addition, we will explain how the Company’s relative regulatory risk should be viewed, and how it is properly reflected in our ROE methodology as well.

Q. What observations did Ms. Saegusa make regarding the financial challenges faced by the Company as a result of the capital intensive nature of its business?

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

As a result of this general characteristic of the electric utility industry, Ms. Saegusa contends that one of O&R's primary challenges arises from the fact that its depreciation rates are low relative to its ongoing capital expenditure programs. One of the principal effects of this dynamic, she contends, is that not only have the Company's cash flow metrics been weak for quite some time, but they will remain so.

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

A. Absolutely not. Such a comparison fails to take into account the very positive attributes afforded electric utilities as a result of their regulated nature. For instance, on page 10 of its August 29, 2014 report entitled CreditStats: 2013 Adjusted Key U.S. And European Industrial

And Utility Financial Ratios, included as Exhibit__FP-19, S&P makes it very clear that the pronounced difference in ratio medians between industrial and utility issuers is largely attributable to the utilities' much lower business risk, as well as their voracious need for fixed-capital improvements and long-established practice of using dividends to return value to their shareholders.

As a result of their very stable cash flows, a comparison of the utilities metrics with their industrial counterparts clearly shows that, all across the ratings spectrum, utilities are able to achieve ratings similar to the industrials with far weaker cash flow metrics. For instance, as shown on page 2 of Exhibit__FP-19, the median EBITDA interest coverage for "A" rated industrials for the 2011-2013 period was 14.1 times, while "A" rated utilities over that period only needed to achieve EBITDA interest coverage of 5.1 times.

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

A. As we discussed earlier, we conducted our own independent analysis of Orange and Rockland’s financial performance, including its capital recovery rates. As illustrated in Exhibit__FP-8, the Company’s depreciation recoveries were indeed notably weaker than its peers in the earlier part of the last decade. However, recent differences in depreciation recovery rates are far less pronounced, and, in 2013, the 41.5% rate achieved by the Company was only modestly weaker than the 43.9% average recovery rate of its peers.

Additionally, with respect to the Company’s ability to generate sufficient amounts of cash flow to meet its interest requirements, the fact is that O&R has, by and large, outperformed its peers. As illustrated in the three far-right columns of Exhibit__FP-8, over the past three-, five- and ten-year periods, O&R’s average EBITDA Interest Coverage has been 5.35 times, 5.20 times and 5.35 times, respectively. Measured over each of these same time periods, the proxy group medians were only 5.04 times, 4.87 times and 4.89 times, respectively. Based upon this performance, we do not believe it is accurate to portray the Company as having weaker cash flows than its peers.

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

A. It appears that Mr. Hevert is suggesting that such an adjustment could be warranted, although he is not making such an adjustment in this instance, because he and we both assess the ROE requirements of investors using market-based methodologies, while the ratemaking process applies that market-derived ROE to a book value capital structure. His premise is misguided, however, because reasonable investors are well aware of the fact that the Commission, like almost every other public utility commission around the country, sets rates based upon an original cost rate base. Because rational investors understand how the rates of the underlying utility operating subsidiaries are set, their insight is already reflected in the market prices of the electric utility holding companies that we and Mr. Hevert both used in our respective proxy group DCF analyses. Accordingly, there is no basis to adjust these ROE requirements.

In fact, it should be noted that Mr. Hevert's argument is actually an old one that has consistently been rejected by the Commission. For instance, on page 123 of its Order Establishing Rates for Electric Service, issued March 25, 2008, in Case 07-E-0523, the Commission stated, "We find no merit in Con Edison's claim that the DCF method and the Generic Finance Case approach are flawed and should not be used without an upward adjustment applied to the indicated equity return allowance. The Company is correct that market-to-book ratios for many electric utility companies are currently, and have been for a time, substantially above unity. However, the existence of higher market prices does not necessitate an adjustment, in any way, to the calculation of the equity return estimate applied to the regulated company's book value for ratemaking purposes. The Company's argument suggests that it wants its rates set on the market price of its stock and not its rate base. This not only goes against the foundation of historical cost rate base regulation, but it creates the potential of upward or downward spirals depending on whether stock prices are above or below book value."

Q. Does Company witness Hevert express concern regarding the potential effects of the Commission's Reforming the Energy Vision (REV) on Orange and Rockland's ability to earn its ROE and maintain sufficient cash flow?

A. Yes. Mr. Hevert suggests that the level of uncertainty regarding the REV initiative and its implementation could impact the Company's future earnings. He claims that this merits consideration of an "incrementally higher" ROE than would otherwise be authorized. However, as the Commission is only in the early stages of developing this policy direction, it would be both inappropriate and speculative to presume any negative effect upon the regulated utilities at this time. After all, no other utility commission is addressing the disruptive challenges in the industry in a manner similar to the REV proceeding, and, as we will point out later, many analysts see REV as a positive for utility companies within the State. With the goal of proactively positioning New York’s utilities more positively in the long run, the Commission’s approach will likely be more evolutionary than revolutionary.

Q. The Company references the REV proceeding as a potential risk to the Company’s credit ratings and cost of capital in the future. Please describe the reaction from the credit agencies in regards to the effects this proceeding will likely have on the Company.

A. Initial reaction from the credit agencies seem to be overall positive in regards to the REV proceeding. In an article dated October 22, 2014, as illustrated in Exhibit__FP-28, Fitch states, “implementation of the REV framework may also lead to greater regulatory predictability and reduced rate case frequency through design of rate plans that span over multiple years." Moody's acknowledges that it is uncertain what specific changes will result from this proceeding; however, in discussing the effect on O&R's credit ratings in its "Credit Opinion: Orange and Rockland Utilities, Inc.", Exhibit__FP-14, Moody's states that "our ratings assume that any change in the state regulatory framework will be implemented over a number of years with a credit-neutral result for O&R." Therefore, it appears the overall sentiment from the credit agencies is that the REV proceeding will likely have a positive result, if not credit-neutral result, due to greater regulatory predictability.

Q. Company witness Saegusa states in her direct testimony that the changes resulting from the REV proceeding could be "challenging" to the Company. She also claims that the fact that the Company must continually raise capital increases risk for existing and prospective investors. What does the Panel think about Ms. Saegusa's assertions?

A. To begin with, despite the Company’s potential concern with the REV proceeding, O&R’s sister company, Con Edison, recently issued debt with a 40-year maturity. If investors were greatly concerned about the impact of the REV proceeding and the difficulty of the New York State regulatory environment, or even the need for the Company to continually raise capital for that matter, then it would be highly unlikely for Con Edison to be able to successfully issue 40-year long-term debt with such ease. Such investor confidence should dispel any notion that distributed generation is perceived as any sort of threat.

Q. What aspects of the current capital market environment does Company witness Hevert assert may have an impact on O&R’s cost of equity going forward?

A. There is one particular aspect which relates to the current capital environment that Mr. Hevert asserts should be factored into the determination of the Company’s ROE. As Mr. Hevert points out, since the financial crisis, which began during the latter part of 2008, the Federal Reserve has embarked on a number of policy initiatives to help bolster the overall U.S. economy. Among these have been three rounds of what has commonly become known as Quantitative Easing (QE). The last round of QE (QEIII), which began in September 2012, involved the purchase by the Federal Reserve of over $3 trillion in US Treasury bonds, mortgaged-backed securities, and other fixed income instruments in the open market as a way to infuse further liquidity into the economy. As indications of strength in the U.S. economy have emerged, the Federal Reserve has recently concluded this program and is no longer making purchases of these securities in the open market. As would be expected, the infusion of this capital into the U.S. economy has resulted in reduced market volatility, as demonstrated by the VIX index, a measure of the implied volatility of the S&P 500 index options representative of the market’s expectation of stock market volatility over the next 30-day period, which Mr. Hevert illustrates on page 65, Chart 1, of his testimony. Based upon the assumption that the Federal Reserve is no longer purchasing assets, Mr. Hevert asserts that the result will be a reversion to a higher volatility environment and higher interest rates. He claims this should be reflected in the ROE that O&R is authorized in this proceeding.

While a reversion to an interest rate environment where rates are above their current historically low levels is a rational expectation, the timing of such an interest rate increase is impossible to foresee. At any rate, all such uncertainty should already be factored into stock prices and debt yields. Therefore, we cannot justify making an ROE adjustment based on that possibility.

In addition, although there was a marked decrease in volatility, as measured by the VIX Index between the onset of the financial crisis in late 2008 and the conclusion of the Federal Reserve’s asset purchase program known as QEIII, it should be noted that, in the five years prior to the financial crisis, the VIX index was within a very similar range to where it has resided from late 2012 until now. This is evidenced in the chart illustrated on page 2 of Exhibit__FP-10. Although it is certainly rational to conclude that the QE played some role in the reduced volatility, it is not entirely clear that the asset purchases by the Federal Reserve were the primary driver in the overall reduction of market volatility.

Q. The Company continually mentions the "restrictions" that regulation places on its business. Why should regulation be looked at as a positive?

A. Competitive businesses do not have the same advantages and safeguards as regulated businesses. As we previously stated, unregulated businesses are clearly riskier than utilities, as they face competition and do not benefit from rates being set to recover all of their prudent costs. In addition, competitive businesses do not have the benefit of cost recovery mechanisms. In fact, S&P discusses the riskier nature of CEI's competitive businesses in its review of "Consolidated Edison, Inc.," illustrated as Exhibit__FP-17. S&P states, "unregulated businesses are significantly riskier than the regulated utility operations due to greater variability in cash flow generation." Also, as we previously discussed, Moody's upgraded most of the U.S. utilities in January 2014. As noted in Exhibit__FP-14, Moody's acknowledged that one of the reasons which lead to this upgrade, specifically for Con Edison and O&R, is the recognition of "the stabilizing features of their cost recovery mechanisms and low business risk as a T&D utility."

Q. On page 37 of her direct testimony, Company witness Saegusa states that both equity and debt investors perceive the New York regulatory environment as a difficult environment in which to operate. What proof has she provided to support this statement?

A. Company witness Saegusa does not have any concrete evidence to support this statement. The only statement Company witness Saegusa makes in support of this argument is that, if this "perception" continues, it will "make financing needed expenditures more expensive in normal times and less certain in times of financial crises.” In order to avoid this outcome, she claims that the Commission needs to grant a “fair and equitable rate of return, competitive with those available elsewhere in the market, and a reasonable chance to actually earn that return.”

Q. Has the Company been able to earn its allowed return in recent rate cases?

A. Yes, the Company has continually been able to earn its allowed return, as evidenced in its annual compliance filings. These compliance filings provide the Commission with a status update of the Company’s rate plans currently in effect. As illustrated in Exhibit__FP-29, in its most recent three-year electric rate plan, Case 11-E-0408, the Company was allowed to earn, on average, a 9.5% return on equity. The Company’s actual earned return, thus far, has resulted in a 10.7% average return on equity, earnings that significantly exceed its allowed return.

Similarly, in the Company’s most recent three-year gas rate plan, Case 08-G-1398, illustrated in Exhibit__FP-30, the Company also exceeded its allowed return. The Company was authorized a return of 10.4% during the term of the rate plan. On average, over the course of the three years, the Company exceeded the allowed return by earning a return of 10.79%.

Q. Therefore, considering Company witness Saegusa’s statement in her direct testimony that the Company should be allowed a reasonable chance to actually earn its return, do you believe the Company has been given a reasonable chance to earn its allowed return in the past?

A. Absolutely. One of the benefits of New York State regulation is that we allow for fully forecasted test years, which reduces regulatory lag and, in turn, helps the Company with its ability to earn its allowed return. This is echoed in Regulatory Research Associates’ (RRA) evaluation of New York State regulation, illustrated in Exhibit__FP-31. The report states, “rate cases in New York incorporate fully forecasted test periods that improve the utilities’ opportunity to earn the authorized ROE.” In fact, Moody’s acknowledges this as well. In its "Credit Opinion: Consolidated Edison, Inc.," included as Exhibit__FP-18, Moody's states that, "unlike many of its peers that suffer from regulatory lag, [Con Edison] and O&R earn returns that are close to what is allowed."

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

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

Indeed, the positives of New York regulation have been recognized by each of the different credit agencies. As illustrated in Moody's "Credit Opinion: Orange and Rockland Utilities, Inc.," referenced as Exhibit__FP-14, Moody’s states, “The current regulatory scheme in New York State has a number of credit-positive features. In rate case filings, utilities file for a future test year, which reduces regulatory lag. Rate cases conclude on a timely basis, in 11 months. The NYPSC has granted multi-year plans, which provide revenue certainty over its course. O&R has full revenue decoupling for both electric and gas services and weather normalization for gas, which protects its margins from variations in sales volumes.” In addition, they go on to state, “O&R does procure power for its full-service electric delivery customers. . . however, these activities entail limited commodity price risk since these fuel costs are fully and automatically trued up within a year’s time.” S&P, in its “Summary: Orange and Rockland Utilities, Inc.,” illustrated as Exhibit__FP-12, acknowledges that “revenue decoupling and weather normalization mechanisms help to insulate the company from variations in revenues.” Even Fitch, in its “Full Rating Report: Orange and Rockland Utilities, Inc.”, illustrated in Exhibit__FP-32, comments on New York's constructive regulatory mechanisms, stating that "[O&R] and RECO's operating cash flows benefit from full and timely recovery of fuel and purchased power expenses under their New York and New Jersey regulatory jurisdictions. The New York tariff structure applies forward-looking test years and the inclusion of a revenue decoupling mechanism for both the electric and gas business that insulates ORU from changes in sales volume due to weather, energy conservation and efficiency, and power demand."

In addition to the credit agencies, RRA has also commented on the positives associated with New York regulation. In its review of New York regulation, illustrated in Exhibit__FP-31, RRA mentions that, although New York may have provided below-average ROEs in recent rate cases, "these decisions were based on multi-year settlements that incorporated increasing rate bases over the term of the plan, revenue decoupling mechanisms, and deferral accounting for increases in such items as net plant, pension expense, and labor costs. Additionally, rate cases in New York incorporate fully forecasted test periods that improve utilities' opportunity to earn the authorized ROE. Regarding industry restructuring, the electric utilities, for the most part, divested their generation assets, and the companies are protected from commodity price risk, given their use of automatic mechanisms that allow timely recovery of power procurement costs from provider-of-last-resort customers."

Q. Taking into consideration the fact that O&R has consistently been able to meet, if not exceed, its allowed return, and the benefits of New York regulation as stated previously in your testimony, why does Company witness Saegusa claim that both debt and equity investors perceive the New York regulatory environment as difficult in which to operate?

A. It is difficult to understand why Company witness Saegusa makes the claim that the New York regulatory environment is difficult in which to operate. She has provided no concrete proof of this assertion. As we just discussed, in addition to the credit agencies, RRA and other reputable sources to which investors turn, acknowledge the benefits and predictability of New York regulation.

Q. Does this conclude your testimony at this time?

A. Yes it does.