Q. Please state your name and business address.

A. My name is Ellen Lapson and my business address is 370 Riverside Drive, New York, New York 10025.

Q. Have you previously submitted testimony in this proceeding?

A. Yes. I previously submitted direct testimony as an expert financial witness on behalf of Consolidated Edison Company of New York, Inc. ("CECONY" or the "Company").

Q. What is the purpose of your update and rebuttal testimony?

A. My update and rebuttal testimony will address the following areas:

First, I will address recent legislation amending the New York Public Service Law that increases financial risks and uncertainty borne by CECONY investors. I also will refer to the consolidated impact of the Department of Public Service Staff's ("Staff") radically asymmetric set of proposals in these proceedings.

Second, I will respond to testimony presented by Staff Witness Henry and the Staff Capital Structure Panel ("Panel"). The key points covered in my rebuttal testimony are as follows:

- The Panel's arguments on behalf of their recommended equity-to-total capital ratio of 48% are not supported by the evidence that the Panel presents in its direct testimony. Furthermore, going forward CECONY needs to enhance the ratio of equity-to-capital in order to balance the greater risk and uncertainties that investors bear as a result of recent amendments to the New York Public Service Law, as well as Staff's proposals in these proceedings, if they are adopted by the Commission.

- Staff witness Henry alleges (p. 47) that the investment markets already contemplate a materially lower return on equity ("ROE") outcome, and that Staff's recommendation of an ROE of 8.7% is consistent with investor expectations and historical equity risk premiums. The evidence cited by Staff Witness Henry does not substantiate those assertions. Furthermore, I demonstrate based on data from Staff Witness Henry's Exhibit __ (CEH-6) regarding equity risk premiums relative to Baa Utility bond yields that a more appropriate result would be an ROE in the area of 10%.
- Staff has failed to refute my argument that CECONY's cash flow over the past decade was materially weaker than the cash flow of peer utilities. CECONY's cash

flow ratios improved in 2010-2011, but are likely to drop down below those of peers in 2014 and beyond if the Commission materially lowers CECONY's ROE beyond that which is included in its current rate plans and adopts the proposals of the Staff Depreciation Panel (p. 12), which are estimated by Staff to "decrease the Company's proposed electric, gas and steam depreciation expense by approximately $120.6 million, $18.0 million and $2.7 million, respectively." The proposed ROE and depreciation reductions would materially lower CECONY's cash flow, along with the termination of the U.S. bonus depreciation program.

- Staff Witness Henry alleges (pp. 53-54) that evidence regarding the effects of the Commission's ratemaking policies and practices upon the Company's cash flow and financial ratios should be derived from the financial results of parent holding companies and not based on comparisons of the financial results of the utility operating subsidiaries whose rates are set by regulatory commissions. That argument is contrary to logic and to reason. My testimony will explain that the use of the financial results of a broad sample of regulated utility operating companies is the most appropriate way to compare the results of regulatory ratemaking, and will present updated cash flow financial ratios for a group of operating utility companies owned by the same group of proxy companies used by Staff witness Henry.

- Staff witness Henry asserts (pp. 90-91) that CECONY’s and New York State utilities’ earned ROE has been closer to authorized ROE than for utilities nationally. However, the analysis that Staff Witness Henry has presented is deeply flawed and fails to support this assertion.
- In summary, Staff’s recommended equity-to-total capital recommendation of 48% fails to take into consideration the increased financial risk and uncertainty that investors in the Company will face as a consequence of 2013 changes in the New York Public Service Law, as well as Staff’s proposals in these proceedings if adopted by the Commission. Furthermore, Staff’s recommended ROE fails to capture the current and prospective risks of weakening cash flow at CECONY and the added risks that the Company

will face with a more punitive and unpredictable set of changes to the Public Service Law.

UPDATE

Q. Please address the recent amendments to the New York Public Service Law.

A. In April 2013 the New York State legislature enacted legislation (i.e., Bill No. S02607D) that made material changes to the Public Service Law ("Amendments"). The Amendments significantly increase risk for "combination gas and electric corporations", thereby negatively affecting CECONY as well as investors in CECONY's equity and debt securities.

Q. Please discuss the impact of the Amendments.

A. The Amendments (particularly Public Service Law Section 25-a) significantly expand the enforcement and penalty mechanisms available to the Commission. The Commission may assess civil penalties directly against combination gas and electric utilities and their officers, without requiring the Commission to seek recovery of such penalties in a court, as is required by Section 25 of the Public Service Law. Also, I have been advised by Company counsel that under Section 25-a, unlike Section 25, the Commission is not required to prove that the combination gas and electric utility violated a rule with intent. Rather, under Section 25-a, the Commission can assess penalties even if an unsafe condition or inadequate service resulted from circumstances outside the control of the utility and the utility had no intent to violate a service standard. The Amendments greatly increase the magnitude of potential penalties by basing the upper limit of penalties upon a percentage of the gross operating revenues of the utility (less any taxes paid to and revenues collected on behalf of government entities).

Q. Please explain the penalty regime under Section 25-a.

A. Under the Amendments, CECONY is subject to maximum penalties far greater than under prior rules as follows. Applying the upper limit percentages in the law, based upon CECONY's 2012 annual revenues, results in the following maximum exposures to civil penalties (by my calculations, based on CECONY's published financial results for 2012):

-- Up to two one-hundredths of one percent of the annual intrastate gross operating revenue of the corporation[1] (by

[1] For calendar year 2012, CECONY's annual electric gross operating revenue equaled $8,176 million and total gross operating revenues $10,187 million.

my calculation, an estimated $1.7 million[2] for failure to reasonably comply with a provision of the Public Service Law, Commission regulation or Commission order. CECONY’s exposure is further magnified by the fact that if a violation is deemed to be continuing, each day shall be deemed to be a separate and distinct offense.

-- Up to three one-hundredths of one percent of the annual intrastate gross operating revenue of the corporation (by my calculation, an estimated $2.5 million) for failure to reasonably comply with a provision of the Public Service Law, Commission regulation or Commission order adopted “specifically for the protection of human safety or prevention of significant damage to real property” if such safety violation caused or constituted a contributing factor in bringing about: (a) a death or personal injury; or (b) damage to real property in excess of $50,000. For purposes of this provision, each day of a continuing violation shall not be deemed a separate and distinct offense.

[2] The estimates of maximum penalties on pages 7 and 8 assume that the calculation will be based on gross electric operating revenues; if the penalties are based on gross corporate operating revenues, as stated in the law, the maximum penalty amounts would be 25% greater in each case.

-- And up to four one-hundredths of one percent of the annual intrastate gross operating revenue of the corporation (by my estimation $3.3 million) for failure to reasonably comply with a provision of the Public Service Law, Commission regulation or Commission order “designed to protect the overall reliability and continuity of electric service, including but not limited to the restoration of electric service following a major outage event or emergency.” For purposes of this provision, each day of a continuing violation shall not be deemed a separate and distinct offense.

Q. Are the civil financial penalties described above the entirety of the additional risk facing CECONY as a result of enactment of the Amendments?

A. No. In addition to the penalties described above, the Amendments empower the Commission to commence proceedings “to revoke or modify a combined gas and electric corporation’s certificate as it relates to such corporation’s service territory or any portion thereof” based on findings of repeated violations of the Public Service Law, or the Commission’s rules and regulations that “demonstrate a failure of such corporation to continue to provide safe and adequate service." As with so much of the Amendments, investors will find great uncertainty as a result of the vagueness of this language. How many violations constitute "repeated"? Two? Twenty? Must the violations be of a certain level of gravity to be deemed a repeat violation, or would a large number of very trivial violations, all related to a single larger event, warrant such harsh repercussions? Investors will wonder if an incident in the electric division will expose CECONY to fines based on the entire gross revenues of CECONY (including gas and steam revenues) or only the electric division gross revenues. Investors will wonder if an incident in the gas division, representing a smaller portion of CECONY's assets and business, will expose CECONY to fines based on the entire gross revenues of CECONY or only the gas division gross revenues. I would note that, while it is currently unclear how this provision may be applied to the Company, the mere threat that the Commission can revoke or modify a utility's certificate with a lower standard of evidence than under the prior law constitutes a significant new risk that will undermine investor confidence precisely at times when the Company needs access to capital and financial strength in order to restore its system from catastrophic events.

Q. Are there any features of the Amendments that provide any offsetting benefits to combined gas and electric corporations, such as CECONY, or safeguard their profitability to compensate for the increased exposure to penalties?

A. No.

Q. In your view, do the changes brought about by the Amendments constitute a major change in risks for CECONY?

A. Yes, especially in the light of CECONY's vulnerability to so many operational risks that are beyond the Company's intent or knowing control, including such events as hurricanes, flooding, transmission disruptions anywhere in the eastern United States, and terrorist acts, on the one hand, and the concentrated population it serves and the extremely high value of property in its service territory. I have been advised by Company Counsel that the "preponderance of the evidence" standard that the Commission must meet in order to impose the above listed penalties under Section 25-a is less stringent than the standard applicable to penalty actions brought under

Section 25 of the Public Service Law. One should expect that the Commission will find it easier to meet this less stringent standard, particularly since any outages that affect many voters are likely to create political pressure to penalize the utility. In addition, the vague standard incorporated in the new reliability related penalty, particularly in the context of major outage events or emergencies, exposes the Company to significant additional risk. For example, will the Company be deemed to have reasonably complied with this standard if an outage lasts four days, but not if it lasts five days?

Q. Have investors generally become aware of the increase in financial risk that you perceive as a result of the Amendments?

A. In my view, it is unlikely that investors are yet fully aware of these changes or of the resulting increase in risk. Few if any investment analysts dedicated to the study of the utility industry have focused on the potential impact of the Amendments, and investors are unlikely to be knowledgeable about this change or to have factored the increased risk into their valuation of CECONY or other New York State utilities.

Q. Are you aware of any examples of significant increases in risk that were not initially fully recognized and appreciated by the financial community?

A. One example that comes to mind is the passage of the federal Public Utility Regulatory Policy Act ("PURPA") in 1978 and the subsequent adoption of New York State Public Service Law Section 66-c, which established a minimum rate of six cents per kilowatt hour for utility purchases from PURPA qualifying generating facilities ("QFs"). These statutes ultimately resulted in massive unanticipated overpayments to the developers of these PURPA QFs by New York State utilities (and ultimately their ratepayers), including CECONY. I recall that investors did not recognize the risk to the financial condition of New York State utilities at the time of the initial passage of either PURPA or Section 66-c. Rather, investors grasped the full parameters of this risk only after a number of years as the financial impacts became visible, the equity of the most exposed companies fell below book value, and credit rating downgrades of the most exposed companies were explained as necessitated by the heightened risk of default.

Q. What compensation would investors expect to receive for additional exposure to stiffer monetary penalties and potential modifications and/or revocation of a utility’s franchise?

A. When investors become aware of these risks, equity investors will likely expect to be compensated by a higher ROE, commensurate with increased risk and the absence of any offsetting benefits under the new provisions. Fixed income investors and credit rating agencies would require the Company to increase its common equity-to-capital ratio in order to maintain ratings at the current level, absent which the Company’s credit ratings may be in danger of downgrade. The Amendments apply only to “combination gas and electric companies”, exempting companies that operate only as gas or electricity utilities; thus, the Amendments expose combination gas and electric companies to greater risk than those New York State utilities that provide only one or the other service. I conclude that investors likely will demand an equity return premium and/or higher equity capitalizations at combination utilities to mitigate this greater risk exposure.

Q. Are there any other updates to your earlier testimony?

A. Yes, I have provided updated financial ratio analyses in Exhibit __ (EL-12). Exhibits __ (EL-7) and __ (EL-8) in my direct testimony compared CECONY's financial ratios with those of a large national group of operating utility companies. Since filing my direct testimony with these exhibits, Staff witness Henry put forth the list of proxy companies used by the Staff in its imputed cost of equity studies (Exhibit __ CEH-1, page 2 of 3), and Mr. Henry presented financial ratios relating to his group of proxy studies in his Exhibit __ (CEH-12) and a chart regarding authorized and earned returns in his Exhibit __ (CEH-18), presumably based on the financial data of his proxy companies group.

In order to support my rebuttal testimony, I have formed a revised group of operating utilities that are subsidiaries of or correspond with Mr. Henry's group of proxy companies and provide financial ratios for this revised proxy group containing 69 operating utilities. Since 2012 financial data is now available and was used in Mr. Henry's Exhibits __ (CEH-12) and __ (CEH-18), I have included 2012 financial data and made my exhibit, Exhibit __ (EL- 12), match the period of his exhibits (i.e., 2003-

2012). I will discuss the implications of the proxy operating companies’ cash flow and other financial ratios later in my rebuttal testimony.

Q. Does that conclude the Update portion of your testimony?

A. Yes, it does.

REBUTTAL

Staff’s Recommended Equity-to-Capital Ratio

Q. The Panel (p. 32) contends that “...rating agencies and investors alike are expecting the Company to continue to manage the common equity ratio” at 48%. Is that contention accurate?

A. No it is not. The Panel has failed to substantiate this assertion. Based on the most recent credit reports on CECONY and Consolidated Edison, Inc. (“CEI”) by the three major credit rating agencies, i.e., Moody’s, Standard & Poor’s (“S&P”), and Fitch, I do not find support for the Panel’s assertion.

First, Moody’s predicts the future ratio of debt-to-capital for 12-18 months forward for the consolidated parent CEI to be 42-45% and for CECONY in the range of 45–50%. The range Moody’s indicates for CECONY is sufficiently broad as to be consistent with an equity-to-capital of 50% at CECONY as in

CECONY's filing, as well as with Staff's proposed 48%. However, the debt-to-capital ratio of 42-45% predicted by Moody's for CEI appears to support the expectation that CEI will maintain a 50% equity ratio for its largest subsidiary, CECONY.

Second, while S&P predicts a ratio of debt-to-capital of 55-56% for CEI and uses the same number for CECONY, S&P does not calculate debt-to-capital in the same way as the Commission or the other rating agencies; S&P capitalizes certain leases or contracts and some unfunded pension obligations as debt. While S&P does not provide details of its adjustments to the forecasted ratios to permit reconciling the S&P ratios with the Company's financial books, S&P's adjusted debt for CECONY at year end 2012 is approximately $3.4 billion greater than the explicit balance sheet debt, so the forecasted debt-to-capital ratio of CECONY absent the S&P adjustments is substantially lower. Finally, Fitch does not in its report provide a forecast for the ratio of debt-to-capital or equity to capital.

Thus, the Panel’s contention that the capital markets fully expect the Company to maintain only 48% equity-to-capital is not proven.

Q. Can you provide any other reason that the Company going forward will require an authorized ratio of equity-to-capital that is higher than the 48% ratio that the Panel advocates?

A. Yes, in the Update section of this testimony I presented my views on the increase in investment risk to shareholders and creditors that results from the Amendments, and the need to enhance the equity ratio as a result. In addition, as outlined in the rebuttal testimony of Company witness Muccilo, the presentation put forward by Staff in these three proceedings is radically asymmetrical and would significantly increase the Company’s regulatory and financial risk. As Mr. Muccilo notes, the totality of Staff’s proposals, if adopted by the Commission, would constitute a rate plan that subjects the Company to a dramatic increase in risk of non-recovery of necessary costs of providing safe and reliable service; significantly limits the Company’s flexibility to manage its business and operations in a cost-effective manner; and could limit the Company’s ability to achieve Commission objectives.

Q. Please explain why and how the Company may be required to enhance its equity ratio.

A. S&P’s rating methodology is one example of how investors and rating agencies calibrate capital structure in combination with different levels of risk. The Panel observes (pp. 18, 33, and Exhibit __ (CSP-2)) that S&P’s utility credit rating criteria permit CECONY to achieve investment-grade ratings in the high BBB to low A category despite “Significant” debt leverage because of an “Excellent” business risk assessment, an assessment that incorporates S&P’s evaluation of the regulatory jurisdiction. If future concerns about penalty assessments or potential license revocation, as well as the asymmetrical nature of Staff’s recommendations in these proceedings, cause S&P to revise CECONY’s business risk assessment downward by one ranking to “Strong” and if CECONY’s and CEI’s financial leverage then remains “Significant”, the indicative S&P rating for CECONY would no longer be A-, it would be BBB, indicating up to a two-notch decline. In order to remain within guidelines for the current A- rating from S&P, CECONY would have to bring its financial leverage into line with the benchmarks for “Intermediate” rather than “Significant”. The maximum debt-to-capital for “Intermediate” financial risk is 35-45, in contrast with the 45-50% debt-to-capital ratio applicable to “Significant” financial risk at the current business risk evaluation of “Excellent”, (as shown in S&P’s financial benchmarks in Exhibit __ (CSP-2), Table 2, page 4 of 6). The implication is that the equity-to-capital ratio would have to increase by at least 5%, with a corresponding reduction in debt, in order to avoid a potential downgrade of up to two notches. Thus, I think that the equity ratio of 50.1% requested by CECONY is a modest move in the correct direction. The Panel’s defense of a 48% equity-to-capital ratio fails to consider the implications of greater regulatory risk as a consequence of the Amendments and the probable decline in CECONY’s cash flow if the Commission adopts Staff’s proposed ROE, the proposals of the Staff Depreciation Panel, and numerous other Staff proposals in these proceedings that will expose CECONY to lower cash flow, asymmetrical risks, and potential future credit downgrades.

Staff's Recommended ROE Versus Investor Expectations

Q. Do you agree with Staff Witness Henry conclusion (p. 45 and Exhibit __ (CEH-6)) that his recommended ROE of 8.7% is consistent with investor expectations based on evidence regarding risk premiums?

A. No, Staff Witness Henry fails to demonstrate that his recommended ROE is consistent with market expectations and current norms. Staff Witness Henry implies that his recommended 8.7% ROE will compare favorably with investor expectations because it will produce spreads relative to the yield on Utility Baa bonds and 20-year US Treasury bonds that are: (i) greater than the average observed risk premiums of Authorized Utility ROEs over the past 20 years[3]; and (ii) consistent with the average observed risk premiums of Authorized Utility ROEs over the past ten years.

For example, he states (p. 46):

> As illustrated in Exhibit __ (CEH-6), over the past 20 years, the average spread between nationally authorized electric ROEs and long-term Baa rated utility debt has only been 374 basis points. Over the past ten years the average spread has been 422 basis

[3] As calculated by Regulatory Research Associates ("RRA"), a division of SNL Financial.

> points, virtually identical to my 421 basis point spread... As illustrated in Exhibit___CEH-6, over the past 20 years, from 1993 through 2012, the average spread between nationally authorized electric ROEs and 20-year Treasury securities has only been 556 basis points. Over the past ten years, from 2003 through 2012, the spread has been 615 basis points, the same as mine.

Staff Witness Henry correctly notes in these passages that the average risk premium of Utility Authorized ROE versus Utility Baa bond yields and 20-year U.S. Treasury bonds increased in the more recent ten-year period from the level that was characteristic of the prior ten years. However, by using historic 20-year and ten-year risk premium data, Staff Witness Henry has seriously understated investors' current expectations. He fails to note that investors' risk premium expectations changed significantly within the ten-year period 2003-2012. In fact, a significant market discontinuity occurred in 2008-2009, the period of major financial crisis and market disruption, with a spike in equity risk premium ("ERP") observed in early 2009.[4] The inverse relationship of investors' required risk premium relative to the level of interest

[4] Graham, John R. and Harvey, Campbell R., "The Equity Risk Premium Amid a Global Financial Crisis", May 14, 2009.

rates is consistent with financial theory and appears in articles on the topic of the market risk premium.[5] Table 1 and the related Chart 1 on Risk Premium Trends in the following pages rely upon data from Staff Witness Henry's Exhibit __ (CEH-6), data that he considers a valid and meaningful representation of market expectations, and I agree.

Table 1: Average Risk Premiums

Years	Interval	Ave. Risk Premium RRA v Baa (1)	Ave. Risk Premium RRA v 20T (2)
1993 – 2012	20 years	3.74%	5.56%
2003 – 2012	10 years	4.22%	6.15%
2008 – 2012	5 years	4.21%	6.61%
2009 – 2012	4 years	4.46%	6.74%
2010 – 2012	3 years	4.80%	6.87%
2011 – 2012	2 years	5.01%	7.15%
2012	1 year	5.29%	7.61%

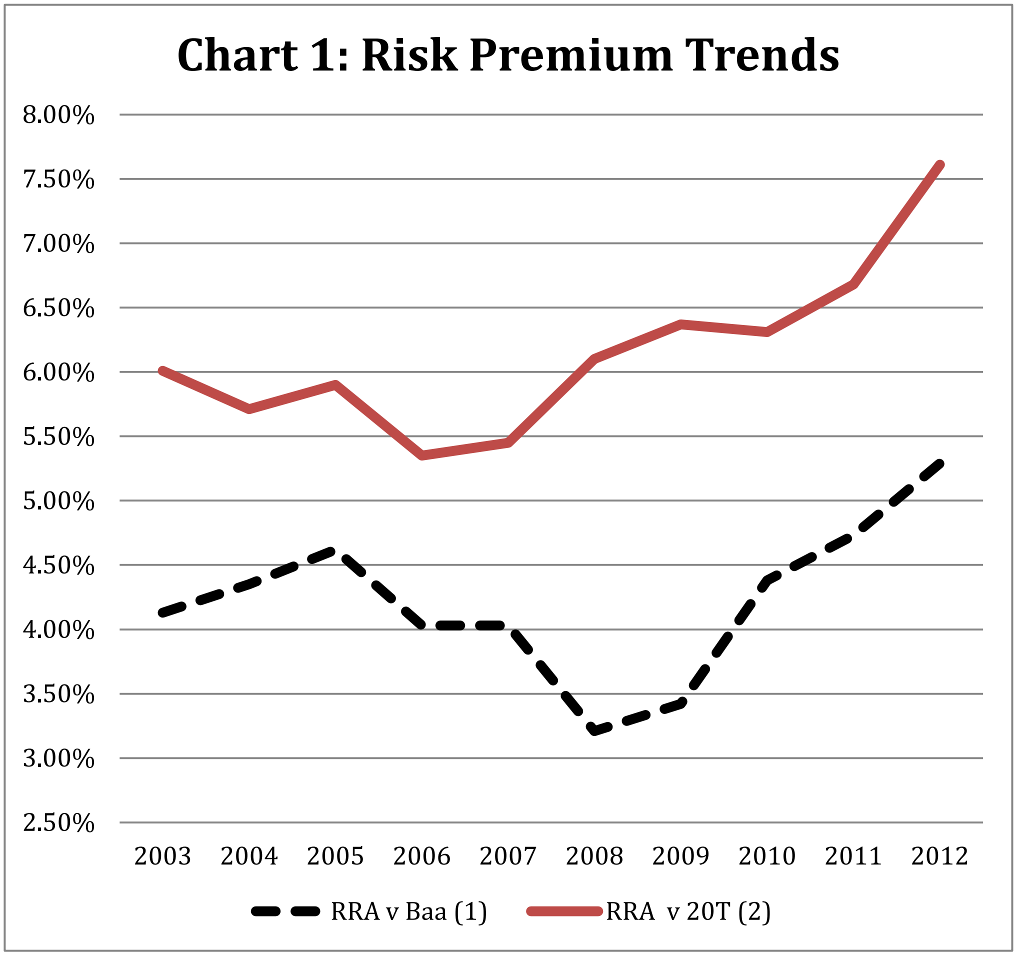
Notes:
1. RRA average state regulatory
ROE authorizations versus yield on Baa 30-year utility bonds
2. RRA average state regulatory
ROE authorizations versus yield on 20 year U.S. Treasury bonds

[5] Including, for example, Brigham, E.F., Shome, D.K., and Vinson, S.R., "The Risk Premium Approach to Measuring a Utility's Cost of Equity," Financial Management (Spring 1985); Harris, R.S., and Marston, F.C., "Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts," Financial Management (Summer 1992).

Source - Data from Henry Exhibit __ (CEH-6), page 1.

Q. What conclusions do you draw from Staff Witness Henry's Exhibit __ (CEH-6) regarding investor risk premium expectations?

A. Table 1 above and Chart 1 below provide evidence that disproves Staff Witness Henry's argument; investors are not likely to be satisfied with an equity return that matches the risk premium of the past ten years at a mere 4.22% over the Baa utility bond yield when the average risk premium of Authorized Utility ROEs versus Baa utility bonds on average for 2011- 2012 was approximately 5%, and for 2012 was approximately 5.9%, producing a range for investor expectations of 90 to 170 basis points greater than the Staff ROE recommended ROE (i.e., a range of 9.6 to 10.4% or approximately 10% on average.)



Staff Witness Henry has not presented any evidence to indicate that investors’ risk premium expectations have diminished and reverted to the level of the prior ten years. The evidence that Staff Witness Henry cites regarding risk premiums not only fails to corroborate Staff’s ROE recommendation but also points to the conclusion that current market conditions call for an ROE considerably higher than Staff's recommendation, i.e., in the range of 9.6% to 10.4%, and not 8.7%.

Q. Staff Witness Henry states (p. 47) in his testimony that information provided by the Company's management to investors in an investor presentation in February 2013 regarding the Commission's recent ROE determinations corroborate his position that investors expect the Company's ROE to be reduced to the level of Staff's recommendation. Is his conclusion accurate?

A. No. The Company's management disclosed to investors that recent Commission ROE decisions have been in the vicinity of 9.2-9.6%. (Exhibit __ (CEH-7), pp. 26-28.) Investors and investment analysts would assume that the Company would present its best case to the Commission and would make every reasonable effort to obtain an ROE determination equal to or superior to the levels shown for other utilities and would not assume based on that information that the Company's ROE would be lowered to 8.7%, as Staff Witness Henry has indicated.

Q. Staff Witness Henry quotes (pp. 48-49) from three investment reports to demonstrate that the investment market anticipates and will be satisfied by lower ROEs for

CECONY. Do the quoted investment reports justify the reduction of CECONY's ROE to the level recommended by Staff Witness Henry?

A. No, not at all. First, not one of the three bearish reports that he quotes predicts that CECONY's ROE will be reduced to the level that Staff is recommending. Generally, the reports Staff Witness Henry quotes contemplate adverse ROE outcomes that are 50 to 80 basis points higher than Staff's recommended ROE. Second, none of these reports opines that CECONY will maintain its financial strength and resilience if the ROE is reduced to the predicted levels, nor to Staff's recommended ROE; Staff's recommendation is below the analysts' most bearish prediction. The equity analysts quoted by Staff Witness Henry are providing forecasts and warning their investor readership of a possible outcome that they view as unfavorable to investor interests, not one that they welcome or conclude is sustainable. When the weather forecaster predicts a hurricane and urges the public to take shelter, it does not mean that the forecaster welcomes hurricanes or approves of them.

The Commission has an obligation to implement and support a regulatory regime, particularly allowed ROEs, that enables a utility under its jurisdiction to attract both debt and equity capital at reasonable terms, thereby allowing the utility to carry out its public service obligation in times of financial stress.

Use of Operating Company Data

Q. Please comment on Staff Witness Henry's rejection (pp. 52-53, 89) of your position that CECONY's cash flow financial ratios are weak as compared with those of a broad sampling of peer utility operating companies, on the grounds that such comparison should be performed at the consolidated parent company level, rather than at the utility operating company level.

A. In his testimony Staff Witness Henry fails to adequately address, let alone refute, my argument that the Commission's ratemaking practices cause CECONY to experience weaker cash flow than the ratemaking policies and practices used by other state regulatory jurisdictions. My direct testimony was focused in particular on weak cash flow financial measures of CECONY relative to more robust cash flow ratios of a broad sample of peer utilities.

Logically, this comparison can only be made by considering the cash flows of peer utility operating companies. The Commission performs Discounted Cash Flow (“DCF”) and Capital Asset Pricing Model (“CAPM”) analyses at the level of the corporate entity whose shares are traded in the public market; as the utility sector has undergone consolidation, that trend has increasingly necessitated the inclusion of parent holding companies, including those with other diversified business lines, among the proxy companies. In the Staff proxy group of 35 companies, only six companies (17% of the group) are themselves operating utilities, while 83% of the companies are parent holding companies. Despite the predominance of holding companies in a proxy group used for DCF and CAPM modeling, the consolidated financial ratios of parent holding companies are not relevant as a means to study the effects of state commissions’ regulatory ratemaking on the utilities whose rates they regulate. The effects of this Commission’s accounting and ratemaking policies and procedures upon CECONY’s cash flow cannot be tested in the manner Staff witness Henry employed in his Exhibit __ (CEH-12) by comparing the reported financial results of CECONY with consolidated parent-level financial results of other utility holding companies included in the proxy group. Among the parent holding companies in Staff Witness Henry's group of proxy companies there is considerable disparity in the amount and nature of their non-utility businesses; 23% of the companies in Staff Witness Henry's 35 company proxy group derive between 20% and 30% of their revenues from non-utility operations with quite different patterns of profitability and cash flow from the regulated electric, gas and steam utility operations. The consolidated financial data of the 35 member companies of the Staff Proxy Group incorporate a wide array of diversified businesses. Staff Witness Henry's data include the results of parent companies that recognized extraordinary losses or write-offs on unsuccessful diversified business ventures, including, in the case of Edison International, the write-downs and losses of its ailing and now bankrupt subsidiaries in the Edison Mission Group, the persistent under-performance of Ameren Corporation's Ameren Energy Generating Company, and other non-utility ventures.

The importance of using utility operating companies rather than diversified holding companies as comparators is consistent with statements in Staff Witness Henry's direct testimony that acknowledge that the financial measures for businesses outside of the regulated utility sector are materially different from the financial measures and ratios for utilities. For example, he quotes (p. 86) from an S&P report:

> For instance, on pages 10 and 11 of its August 30, 2012 report entitled *CreditStats: 2011 Adjusted Key U.S. And European Industrial And Utility Financial Ratios*, included in Exhibit___CEH-17, S&P makes it very clear that the pronounced difference in ratio medians between industrial and utility issuers is largely attributable to the utilities' much lower business risk as well as their voracious need for fixed-capital improvements and long-established practice of using dividends to return value to their shareholders.

This citation highlights why the financial ratios and cash flow measures of CECONY, a regulated utility operating company, should be compared with those of other regulated utilities, thereby eliminating the disparities that exist if data is captured from parent holding companies whose consolidated financial statements contain varying proportions of non-utility enterprises from an array of different industrial sectors. Those disparities are avoided by studying the financial statements of the utility operating companies. The operating companies' financial results are more akin in being predominantly derived from regulated utility operations that are directly under the control of a regulatory rate-setting regime. Thus, the results of the comparison at the operating company level are entirely relevant to the question of the risks of weak or inadequate cash flow that result from the Commission's rate-setting policies, and that are likely to arise if various adverse and asymmetrical proposals put forth by Staff witnesses are adopted by the Commission.

CECONY's Cash Flow Is Weaker Relative to National Peers

Q. What were the conclusions of your study regarding the cash flow measures of CECONY relative to those of a broad sample of peer utilities?

A. As I discussed in my direct testimony (pp. 42-48), and illustrated in my Exhibits __ (EL-7) and __ (EL-8), the study demonstrated that CECONY's relevant cash flow ratios[6] were weaker than the median ratios of a peer group of

[6] Cash Flow from Operations before Changes in Working Capital, called "Adjusted CFO", divided by Total Debt, a cash flow measure of leverage, and the ratio of Adjusted CFO plus Interest Expense to Interest Expense, a cash flow coverage ratio.

operating utility companies during the nine years 2003-2011. The results of that study were that CECONY's relevant cash flow ratios were especially weak in 2003-2009, but reached parity with the median in 2010 and exceeded the median of the peer companies in 2011. I concluded that important factors that led to the improvement in CECONY's 2010-2011 cash flow measures relative to those of the peer operating utilities were an electric rate increase that raised CECONY's electric ROE to 10% in 2010 and 10.15% in 2011, from a much lower 9.1% in 2009, and the cash flow benefits of two federal income tax circumstances that lowered CECONY's tax payments in the years 2009-2011; specifically, the two tax circumstances that provided a non-recurring boost to cash flows were bonus depreciation and changing the tax treatment of repair allowances. Such cash flow benefits will not be present in the rate year in which the rates set in this proceeding will apply (i.e., calendar year 2014) ("Rate Year"). In addition, a host of proposals by various Staff witnesses (such as lower depreciation rates and non-recovery of certain expenses) would if adopted by the Commission further reduce CECONY's future cash flow. Based on this analysis, I conclude that if the Commission were to lower CECONY's ROE to 9% or lower in 2014, consistent with Staff's recommendation, and adopt other Staff recommendations, CECONY's cash flow is likely be materially lower in the Rate Year, and will return to the weak cash flow pattern of 2003-2009.

Q. Has Staff Witness Henry refuted your testimony regarding CECONY's weak cash flow relative to peer utilities in other jurisdictions in his direct testimony?

A. No, he has not. He evades the issue of cash flow entirely in his direct testimony by presenting other interest coverage and financial leverage ratios that are not based on measures of cash flow from the Company's Statement of Cash Flows. The sole cash flow measure that he presents is a ratio of operating cash flow ("FFO") to capital expenditures.

At the core of my study were two well-known cash flow ratios of coverage and debt leverage: Adjusted CFO Interest Coverage[7] (also called "FFO Interest Coverage") and Adjusted CFO-to-Debt (also called "FFO-to-debt"). Mr. Henry does not include these two ratios in his Exhibit __ (CEH-12).

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[7] That is, the ratio of (FFO + Interest expense) / Interest expense. FFO is typically calculated as follows: Operating Cash Flow from the Statement of Cash Flow Before Changes in Working Capital.

Instead, Henry presents two non-cash interest coverage ratios in his exhibit: EBIT-to-Interest Coverage and EBITDA-to-Interest Coverage. Each of these ratios is based upon entries in the accrual income statement and not derived from actual cash flow data. (In my direct testimony, I showed EBITDA-to-Interest coverage as a supplement to Adjusted CFO Interest Coverage.) As a leverage measure, Henry also presents the ratio of Average Debt to EBITDA and does not show any cash flow based leverage ratios, such as Debt to Adjusted CFO (or Debt-to-FFO) in his table.

Furthermore, Staff Witness Henry's table compares the financial ratios of CECONY, an operating utility company, with the consolidated financial ratios of a group largely made up of parent holding companies, which, as I have discussed earlier, is not a valid comparison. The financial results that are most under the direction and jurisdiction of this Commission and other utility regulatory commissions are those of the operating utility companies.

Q. You are submitting a new exhibit, Exhibit __ (EL-12) comparing the financial ratios of CECONY with those of a revised group of utility operating companies. Would you please describe the contents of that exhibit.

A. As I explained earlier in the Update section of this testimony, the reason for adopting a revised set of companies as proxy operating utilities was to match to the extent possible the constituent operating utilities that relate to the companies included in Mr. Henry's proxy group. The great majority of the operating companies in my revised group (the "Proxy Opcos") were in the earlier group; approximately 15% changed. In total, there are 69 operating utilities included in the new Proxy Opco Group. The list of Opcos included in this group appears on pages 2 and 3 of Exhibit __ (EL-12). The test for including companies in the group is:

(i) The company is a regulated U.S. gas and/or electric utility that is owned by (or is) one of the companies in the Staff Proxy Group;

(ii) Financial statements are publicly available at a minimum for the most recent four years. (In fact, 65 of the 69 Proxy Opcos have financial statements available for all ten years.)

Using data from annual financial statements obtained from SNL Financial, LLC for the Proxy Opcos and CECONY, I replicated five financial ratios that Staff Witness Henry performed in his Exhibit __ (CEH-12) as well as two cash flow financial ratios that were central to my Exhibit __ (EL-7) but not addressed in Mr. Henry's exhibit or testimony. The two ratios that are important indicators of the adequacy of cash flow that I included and Mr. Henry failed to consider are:

a) "FFO + Interest Exp./Interest" (also known as "FFO Interest Coverage" or "Adjusted CFO Interest Coverage"); and

b) "FFO/Debt" (also known as "Adjusted CFO/ Debt".

The five financial ratios repeated from Mr. Henry's exhibit are:

c) "Return on Average Common Equity";

d) "EBIT Interest Coverage";

e) "EBITDA Interest Coverage";

f) "Average Debt/EBITDA"; and

g) "Depreciation & Amortization /Capital Expenditures"[8].

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[8] Mr. Henry uses the terminology of "Depreciation & Amort./Constr." for the same ratio.

After calculating the ratios above for all the Proxy Opcos including CECONY, I produced the table that appears on page 1 in my Exhibit __ (EL-12) that compares each financial ratio for CECONY as computed by Mr. Henry (if available from his exhibit), the median ratio for Staff's Proxy Group of 35 companies as computed by Mr. Henry (if available from his exhibit), and my own computation of the median ratio for the Proxy Opcos. In the case of the two cash flow-oriented ratios designated above as (a) and (b) that do not appear in Mr. Henry's Exhibit __ (CEH-12), I obtained the financial ratios for CECONY and for the 35 companies in the Staff Proxy Group from the financial database of SNL Financial, LLC.

Q. What conclusions did you draw from this study?

A. Mr. Henry compared the median financial ratios of the 35 companies in the Staff Proxy Group with those of CECONY, and he described (p. 52) his conclusion as follows:

> In order to test the premise of Company witnesses Lapson and Sanders that Con Edison generally has weaker metrics than its peers, I examined the Company's financial performance over the past ten years and compared it to the performance of its peers. The results of that study, which are summarized in Exhibit___CEH-12, indicate that Company's overall financial performance has generally exceeded that of its peers....

However, when the financial ratios of CECONY are compared with those of the Proxy Opcos, they do not support Mr. Henry’s conclusion. It is important to note that the Proxy Opcos as a group display more favorable financial ratios in most categories than the companies in the Staff Proxy Group (83% of which are parent holding companies). By comparing the financial ratios of CECONY, an operating utility or Opco, with a group largely consisting of parent holding companies, Staff witness Henry set up a false comparison that supported a false conclusion that CECONY’s financial condition is superior to that of its peers.

When CECONY’s cash flow credit ratios (i.e., FFO Interest Coverage and FFO/Debt) are compared with those of other Opcos, the results are quite consistent with the findings that I reported in my direct testimony (p. 43).

- FFO/ Debt: The median ratio of the Proxy Opcos exceeded that of CECONY in every year from 2003 through 2009, and most significantly in 2004-2009. In 2010, CECONY’s FFO/Debt increased and matched the median of the Proxy Opcos, and in 2011 exceeded the median of the Proxy Opcos, but in 2012, CECONY’s

FFO/Debt ratio again fell short of the median of the Proxy Opcos.

- <u>FFO Interest Coverage</u>: The median ratio of the Proxy Opcos exceeded that of the CECONY in every year except 2011, and generally by material amounts.

Another finding that emerges from analysis of the financial ratio study is that one factor in CECONY's weaker cash flow relative to the proxy utilities must stem from CECONY's depreciation practices. This can be seen by comparing EBIT Interest Coverage with EBITDA Interest Coverage. CECONY's EBIT Interest Coverage ratio is essentially the same as, or slightly better than, that of the Proxy Opco median, but CECONY's EBITDA Interest Coverage is materially weaker in all years than the median of the Proxy Opcos. Another evidence that CECONY's depreciation may be too low to sustain the utility's needs to restore and replace infrastructure is CECONY's ratio of Depreciation & Amortization/Capital Expenditures, which in nine of the ten years was materially lower than the median of the Proxy Opcos. It was only in the single year 2012 that CECONY's Depreciation & Amortization/Capital Expenditures matched or exceeded those of the Proxy Opcos. Thus, I find it alarming that the Staff Depreciation Panel is recommending reducing CECONY's depreciation rates (p. 12), cuts which are estimated by the Staff Depreciation Panel (p. 12) to "decrease the Company's proposed electric, gas and steam depreciation expense by approximately $120.6 million, $18.0 million and $2.7 million, respectively."

Q. Why do you emphasize cash flow ratios and the level of CECONY's cash flow?

A. Measures of cash flow stability and adequacy are far more important to credit rating agencies and investors in debt securities than the accrual accounting measures of profitability or financial condition. This is explicit in the rating criteria of Moody's, S&P, and Fitch, and is explained in my direct testimony (p. 43). However, the testimony of Staff witness Henry and the Panel reveals their lack of awareness regarding the importance of cash flow to credit rating agencies or to the debt capital markets. Thus, I give low credence to Staff Witness Henry's assertion that CECONY will maintain its current credit ratings if the Staff recommendations as to ROE and the equity capitalization ratio are adopted by the Commission, especially in combination with other Staff recommendations affecting depreciation and reduced recovery of expenses, as well as the recently adopted Amendments to the Public Services Law.

Comparison of Authorized versus Earned ROE

Q. Please comment on Staff Witness Henry's assertion (p. 95 and Exhibit __ (CEH-18)) that over the past ten years (i.e., 2003-2012) the ROE earned by utilities in New York State came closer to achieving the average authorized ROE than was the case for utilities nationally.

A. Staff Witness Henry's assertions are not supported by the evidence he provides in his Exhibit __ (CEH-18). The exhibit is not very explicit as to its source or the companies included, but Mr. Henry's work papers reveal that Exhibit __ (CEH-18) compares the median ROE earned by 109 utility operating companies whose financial information was available via S&P Capital IQ with data from RRA on ROE authorized in rate orders in the same years.

Q. Does the analysis in Exhibit __ (CEH-18) support Mr. Henry's hypothesis regarding authorized versus earned returns?

A. No, it does not. The data analysis that he performs does not in fact test whether utilities earned their authorized ROEs. The reason for this is that the exhibit does not match the ROEs authorized for specific utilities in specific states with the subsequently earned ROEs by the same companies. In any one year, only a limited number of utilities have decisions in rate proceedings. The rates determined in a case in the third or fourth quarter of 2011, for example, may have little or no effect until calendar year 2012. Other utilities may have had their rates determined in multi-year decisions in prior years, or may be subject to long “stay-out” agreements, in which case they would be unable to seek rate changes.

Mr. Henry’s testimony states (p. 91) that the source of his data on authorized ROE is RRA. I understand that RRA computes the average authorized ROE during a year in the following manner. During any one year, specific utilities in a limited number of states, but by no means all states, received rate decisions, and the authorized ROE shown for that year is the average of the determinations only in those specific cases and only for those individual utilities. Many operating utilities provide electric or gas service in multiple state jurisdictions, so a decision for a utility in an electric or gas rate proceeding in one state may affect only a small portion of the utility's total electric or gas revenues and income, rather than all of the revenues and income of such utility. Often, three or four decisions in various state jurisdictions affect one utility, while other utilities have no decisions in that year in any jurisdiction.

Thus, in any year, by no means all of the 109 utilities in Mr. Henry's sample have a rate case decision affecting ROE. RRA reported the following rate orders affected ROE in some recent years:

Table 2: Rate Decisions with ROE Determinations

	2008	2009	2010	2011
Electric	37	39	59	41
Gas	30	29	37	16

Source: RRA, "Major Rate Case Decisions - Calendar 2011", Jan. 10, 2012

The median of the ROEs actually earned by 50 other companies in other states or even in the same states, as those where there was a single case for a particular utility in which an ROE was determined, is not a meaningful test of a causal relationship between authorized and earned

ROEs. Therefore, I find that Exhibit __ (CEH-18) fails to support Staff Witness Henry's assertions and should not be relied upon in any way in this proceeding.

Q. Please summarize your testimony.

A. I find that CECONY as a combination gas and electric utility faces heightened risk as a result of the Amendments; these increased risks will likely necessitate higher equity capitalization and higher return on equity that is not recognized in any way in the Staff testimony. Furthermore, I note many flaws that seriously undermine the credibility of Staff's presentation. Staff's insistence that CECONY's financial statistics must be compared with the financial ratios of parent holding companies rather than operating utilities is illogical and incorrect. Also, Staff's attempt to demonstrate that New York utilities' earned ROEs are closer to their authorized ROEs than those of utilities in other jurisdictions is based on a flawed analytical method that is irrelevant to the Staff's assertion. Most important, Staff shows no awareness of the importance of adequate cash flow to maintain the Company in sound financial condition and retain the current healthy credit ratings.

The Commission’s rate-setting practices and policies have resulted in weak cash flow measures of CECONY relative to peer utilities for most of the past decade, and CECONY’s cash flow is likely to return to a weaker status in 2013-2014 with the termination of bonus depreciation at the end of 2012, especially if that is combined in the 2014 rate year with the Staff’s extremely low ROE recommendation, the reduced depreciation charges recommended by another Staff panel, and the numerous asymmetrical risk elements recommended by various Staff witnesses that have been highlighted by CECONY witness Muccillo in his rebuttal testimony. CECONY must maintain financial resilience and strong credit in order to fulfill its public service mandate and withstand the stresses of both natural and man-made shocks.

Q. Does this conclude your rebuttal and update testimony?

A. Yes, it does.