BEFORE THE NEW YORK STATE PUBLIC SERVICE COMMISSION

In the matter of:

APPLICATION OF CONSOLIDATED EDISON COMPANY OF NEW YORK, INC. FOR AN INCREASE IN ELECTRIC RATES	)))	CASE NO. 09-E-0428

REBUTTAL TESTIMONY

OF

ROGER A. MORIN, PhD

September 2009

CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.

REBUTTAL TESTIMONY OF DR. ROGER A. MORIN

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

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

Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.?

A. Yes, I did.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

A. I will respond to certain statements contained in the direct testimony of: 1) Ms. Prylo and Mr. Henry ("Finance Panel") on behalf of the New York State Department of Public Service ("DPS Staff or "Staff"), 2) Mr. Niazi on behalf of the New York State Consumer Protection Board ("CPB"), and 3) Mr. Liberty and Mr. Radigan on behalf of the County of Westchester ("Westchester").

Q. PLEASE DESCRIBE HOW YOUR REBUTTAL TESTIMONY IS ORGANIZED.

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

Q. PLEASE SUMMARIZE THE RATE OF RETURN RECOMMENDATIONS OF THE THREE WITNESSES YOU ARE REBUTTING IN THIS CASE.

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

Staff	10.1%
CPB	10.0%
Westchester	8.7%

My comments on the rate of return testimony offered by the panel of Messrs. Liberty & Radigan on behalf of Westchester are extremely brief, given that they did not perform any rate of return modeling and given that, as they admitted in Consolidated Edison Company of New York, Inc.'s ("CECONY" or the "Company") last electric case (i.e., Case 08-E-0539), neither author is an expert in the areas of either cost of capital or utility capital structure. Given that CPB witness Mr. Niazi's testimony is almost an exact duplicate of Staff's testimony, most of my rebuttal comments are directed to the latter and are applicable to Mr. Niazi's testimony as well.

I. COMMENTS ON MESSRS. LIBERTY & RADIGAN'S TESTIMONY

Q. PLEASE SUMMARIZE MESSRS. LIBERTY & RADIGAN'S RATE OF RETURN ON EQUITY RECOMMENDATION.

A. Messrs. Liberty & Radigan recommend that a return allowance of only 8.7% be applied to CECONY's common equity capital for ratemaking purposes. No rate of return evidence is presented other than a forecast of the Company's realized ROE if their recommendations are adopted by the Commission. Not only is this

approach highly circular, but it stands in sharp contrast with the estimation practices of expert witnesses on cost of capital who have provided detailed, factually supported, professional testimony setting forth the results of rigorous analysis. The Commission, investment analysts, finance experts, corporate analysts, and finance professionals normally rely on a variety of such scholarly financial analyses and models, employing methodologies such as DCF, Prospective Risk Premium, Historical Risk Premium, Comparable Earnings and the CAPM.

Q. DID MESSRS. LIBERTY & RADIGAN INDEPENDENTLY DEVELOP ANY SAMPLES OF COMPARABLE RISK COMPANIES IN ORDER TO ARRIVE AT THEIR RECOMMENDATION?

A. No, they did not.

Q. DID MESSRS. LIBERTY & RADIGAN PERFORM A DCF ANALYSIS IN ORDER TO ARRIVE AT THEIR RECOMMENDATION?

A. No, they did not.

Q. DID MESSRS. LIBERTY & RADIGAN PERFORM A CAPM ANALYSIS IN ORDER TO ARRIVE AT THEIR RECOMMENDATION?

A. No, they did not.

Q. DID MESSRS. LIBERTY & RADIGAN PERFORM AN INDEPENDENT RISK PREMIUM ANALYSIS IN ORDER TO ARRIVE AT THEIR RECOMMENDATION?

A. No, they did not.

Q DID MESSRS. LIBERTY & RADIGAN PERFORM A COMPARABLE EARNINGS ANALYSIS IN ORDER TO ARRIVE AT THEIR RECOMMENDATION?

A. No, they did not.

Q. WHAT DO YOU CONCLUDE FROM THE RATE OF RETURN RECOMMENDATION OF MESSRS. LIBERTY & RADIGAN?

A. In view of the deficiencies outlined above, the Commission should ignore their draconian recommendation.

II. COMMENTS ON MR. NIAZI'S TESTIMONY

Q. PLEASE SUMMARIZE MR. NIAZI'S RATE OF RETURN ON EQUITY RECOMMENDATION.

A. Mr. Niazi recommends that a return allowance of 10.0% be applied to CECONY's common equity capital for ratemaking purposes.

Q DO YOU HAVE ANY GENERAL COMMENT ON MR. NIAZI'S TESTIMONY?

A. In determining the cost of equity, Mr. Niazi's testimony is virtually identical to Staff's testimony in all respects, down to the number and identity of comparable companies. The only substantial difference between Staff's and Mr. Niazi's testimony is a downward risk adjustment to the ROE on the grounds that CECONY is less risky than the members of the proxy group. Specifically, Mr. Niazi (pp. 17-18) recommends a credit quality adjustment of 46 basis points, rather than the 31 basis points recommended by Staff (p. 85). Given the striking

similarity between the two testimonies, all the rebuttal comments directed at Staff are equally applicable to Mr. Niazi's testimony.

Also, both Mr. Niazi and Staff direct very similar criticisms of my own direct testimony, namely on the issue of the Risk Premium methodology and choice of comparable companies. Given the nearly identical nature of both testimonies, my responses to Staff's criticisms are equally applicable to Mr. Niazi's testimony.

III. REBUTTAL OF STAFF'S TESTIMONY

Q. PLEASE SUMMARIZE STAFF'S RATE OF RETURN RECOMMENDATION.

A. Staff recommends that a ROE allowance of 10.1% be employed on the common equity capital of CECONY. In determining CECONY's cost of common equity capital, Staff applies a two-stage Discounted Cash Flow ("DCF") analysis to a group of thirty-three electric utilities. For the first-stage growth component of the DCF analysis, Staff relies on Value Line's forecast dividend estimates over the next few years. For the more important second-stage growth component that produces the majority of the value calculated by the DCF analysis, Staff uses the earnings retention method, also known as the "sustainable growth" method, again using Value Line estimates as input data.

Staff also applies a Capital Asset Pricing Model ("CAPM") and an Empirical CAPM ("ECAPM") (also referred to as a "zero beta" CAPM) analysis to the same group of companies, using an average of 10-year and 30-year Treasury bond yields as proxies for the risk-free rate, and Value Line beta

estimates. Staff's estimate of the market risk premium ("MRP") component of the CAPM is based on a Merrill Lynch estimate. Applying a weight of two-thirds to the DCF results and one-third to the CAPM-ECAPM average result, Staff concludes that CECONY's cost of common equity capital is 10.1%, inclusive of a flotation cost allowance of 8 basis points and after a return decrement of 31 basis points in order to account for CECONY's superior credit quality.

Q. WHAT IS YOUR GENERAL REACTION TO STAFF'S COST OF COMMON EQUITY RECOMMENDATION?

A. There is a degree of substantial agreement between Staff and myself and between our respective recommendations. Under current capital market conditions, I agree generally with: (i) the use of several methodologies in estimating a fair return on common equity; (ii) the sample of electric utility companies in the DCF and CAPM analyses; (iii) the magnitude of the beta estimates in the CAPM analyses; (iv) the magnitude of the estimate of the market risk premium (MRP) in the CAPM analyses under current market circumstances; and (v) the underweighting of the CAPM results in the current financial environment.

I have the following four major disagreements: 1) the second stage growth rate in Staff's Two-Step DCF approach, which would increase Staff's recommended ROE by 140 basis points; 2) the stale risk-free rate in Staff's CAPM analyses, 3) the downward return adjustment in order to account for credit quality differences between CECONY and the comparable group, which would increase Staff's recommended ROE by 31 basis points, and 4) the insufficient allowance for flotation costs, which would increase Staff's recommended ROE by

15-20 basis points.

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

A. Inclusion of a proper growth rate and flotation cost allowance into the DCF results, inclusion of a current risk-free rate into the CAPM analyses, and elimination of the inappropriate credit quality adjustment would bring Staff's recommendation very close to my own.

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

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

1. DCF Earnings Retention Growth. Staff's principal, and in fact only, technique for estimating the second-stage growth component of the DCF model is the earnings retention growth technique. There is a logical inconsistency in the retention growth technique because Staff is forced to assume the answer to implement the method. From Staff's own evidence, investors expect substantially higher returns for utilities than what Staff recommends.

2. DCF Growth Rates: Analysts' Forecasts. Investors are expecting substantially higher growth rates than Staff's growth rates for the sample companies. Using analysts' consensus growth forecast instead of Staff's would increase the DCF estimate of the cost of common equity by a minimum of 140 basis points (1.4%), that is, from 10.35% to 11.75%.

3. DCF Growth Rates: Long-term Economic Growth. Staff's long-term growth forecast for the comparable group of electric utilities, based on the earnings retention growth method, understates the long-term expected GDP

nominal growth by approximately 140 basis points.

4. CAPM Risk-Free Rate. Staff's risk-free rate proxy is not only stale but also relies on the yield on 10-year and 30-year Treasury bonds instead of just the yield on 30-year Treasury bonds. Using the appropriate risk-free rate, Staff's CAPM estimates must be raised by 78 basis points from this correction alone.

5. Flotation Costs. Staff's DCF estimates of equity costs are downward-biased by approximately 15-20 basis points to the extent that not all the flotation costs associated with past equity issues have been expensed or recovered in the past.

6. Return Adjustments. Staff's downward ROE adjustment for credit quality differences should be rejected by the Commission.

7. Criticisms of my testimony. Staff's criticisms of my ROE recommendation are without foundation.

1. EARNINGS RETENTION GROWTH METHOD

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

A. Staff applied a two-stage DCF analysis to a sample of 33 electric utilities, using the earnings retention growth method as a proxy for the expected long-term growth component in the second stage. Using a median retention growth rate of 4.1% [Column W of Exhibit _ (FP-5) page 2], and not the 4.75% reported by Staff (p. 59), produced an average DCF cost of equity estimate of 10.35% reported on the last column of the same exhibit.

Q. PLEASE COMMENT ON STAFF'S GROWTH ESTIMATE IN THE DCF MODEL.

A. Staff relies exclusively on the earnings retention growth method in the crucial second stage of the DCF analysis, where the growth rate is based on the equation g = b(ROE), where b is the percentage of earnings retained and ROE is the expected ROE. The impact of external stock financing on growth is also accounted for by adding an external growth term (g = sv).

I disagree with the earnings retention growth technique for four reasons: 1) the method is logically circular, 2) inconsistency with the empirical evidence as demonstrated in academic research, 3) the potential lack of representativeness of Value Line's forecasts as proxies for the market consensus, and 4) a technical error.

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

A. No, they are not. Staff's retention growth methodology contains a puzzling logical contradiction. The contradiction arises because the method requires an explicit assumption on the ROE expected from the retained earnings that produce future growth. Staff bases its ROE estimate on Value Line's forecast ROE for the 2013 period (Column P on Exhibit __ (FP-5) page 2). But the ROEs used by Staff in calculating the retention growth rate do not match Staff's ROE recommendation. Table 1 below replicates the ROE forecasts used by Staff in deriving the retention growth rates.

Table 1 Staff's Forecast ROE

1	ALLETE	9.62
2	Alliant Energy	10.54
3	Amer. Elec. Power	8.29
4	Ameren Corp.	10.79
5	Avista Corp.	8.26
6	Black Hills	8.3
7	Cleco Corp.	11.26
8	Consol. Edison	9.29
9	DPL Inc.	19.87
10	DTE Energy	9.88
11	Duke Energy	7.96
12	Edison Int'l	11.23
13	Empire Dist. Elec.	11.59
14	Entergy Corp.	13.72
15	FPL Group	13.83
16	FirstEnergy Corp.	14.67
17	G't Plains Energy	6.77
18	Hawaiian Elec.	10.43
19	IDACORP Inc.	7.92
20	MGE Energy	13.12
21	NSTAR	15.19
22	Northeast Utilities	9.17
23	PG&E Corp.	12.3
24	Pinnacle West Capital	8.9
25	Portland General	9.19
26	Progress Energy	9.96
27	Sempra Energy	12.04
28	Southern Co.	13.83
29	TECO Energy	12.22
30	Vectren Corp.	10.16
31	Westar Energy	8.14
32	Wisconsin Energy	12.24
33	Xcel Energy Inc.	10.77
	AVERAGE	**10.95%**
	MEDIAN	**10.54%**

Source: Staff Exhibit _(FP-5) Page 2 Column P

The average expected ROE of 10.9% used in Staff's retention growth computation and reported on Exhibit (FP-5) Page 2 Column P exceeds Staff's recommended 10.10%. Staff's analysis thus assumes that the earned returns (ROE) of the sample companies exceed what it has determined to be their cost of equity forever. That is, Staff is assuming that these companies will earn a ROE higher than that granted by their regulators and reflected in their rates.

While this scenario implicit in Staff's retention growth method may be imaginable for an unregulated company, it is implausible to assume for a regulated company whose rates are continually re-set by its regulator at a level designed to permit the company to earn a return equal to its cost of capital. This logical flaw compromises the integrity of Staff's analysis, and should be a sufficient basis for rejecting the results Staff produced by this method, which constitute the cornerstone of its ROE recommendation. In essence, by using an ROE that differs from its final recommended cost of equity, Staff requires the Commission to make two inconsistent findings regarding ROE. I am perplexed as to why Staff assumes that its group of comparable electric utilities is expected to earn 10.9% forever, while at the same time it recommends an ROE of 10.10% for CECONY. The only way that these utilities can earn an ROE of 10.9% is if rates are set so that they will in fact earn 10.9%. The only logical conclusion to be drawn from the data is that the group's cost of equity is 10.9%, since these are the returns implied in Staff's retention growth analysis.

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

A. No, it is not. The second difficulty with the retention growth rate approach is that the empirical finance literature demonstrates that this particular method of determining growth is a very poor explanatory variable of market value, and is not as significantly correlated to measures of value, such as stock price and price/earnings ratios.

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

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

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

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

common equity, which is the common regulatory practice:

$$r_a = r_t \frac{2 B_t}{B_t + B_{t-1}}$$

Where: r_a = return on average equity

r_t = return on year-end equity as reported

B_t = reported year-end book equity of the current year

B_{t-1} = reported year-end book equity of the previous year

The result of this error is that Staff's DCF estimates are understated by some 10-20 basis points, depending on the magnitude of the book value growth rate.

2. DCF GROWTH RATES: ANALYSTS' FORECASTS

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

A. Published studies in the academic literature demonstrate that growth forecasts made by analysts are reasonable indicators of investor expectations, and that investors rely on the analysts' forecasts.

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

A. Yes, I do. Staff relies exclusively on Value Line forecasts for its major inputs into the DCF analysis, including short-term dividend forecasts, expected return, new stock issues, and expected retention ratio. Staff's exclusive reliance on Value Line growth forecasts runs the real risk that such forecasts are not representative

of investors' consensus forecast. Staff's sole reliance on Value Line is surprising in light of its own admission (p. 62) that, "the simple fact remains that earnings forecasts, even in the relatively stable electric utility industry, can be very difficult to predict, because of the impact of important unpredictable events." One would expect that averages of a myriad analysts' growth forecasts such as those contained in First Call, Thomson, Multex, and/or Zacks, rather than one particular analyst's in-house forecast, are more reliable estimates of the investors' consensus expectations likely to be impounded in stock prices.

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

A. No. The best evidence shows that investors are expecting growth rates higher than Staff has found. For its group of 33 electric utilities, Staff has relied [see Columns N and W of Exhibit _ (FP-5) page 2] on median growth rates of 4.1% for both stages of the DCF analysis. Table 2 below reports the long-term growth forecast from Value Line and the consensus long-term growth forecast reported by Zacks Investment Research. It is transparent from the table that the expected growth rates lie in a 5.5% - 6.0% range, as evidenced from the average and median results. These growth estimates are 140-170 basis points (1.4% - 1.7%) above Staff's long-term growth estimate of 4.1%.

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

A. The Value Line growth forecast and the analysts consensus growth forecast range

from 5.5% to 6.0% versus Staff's 4.1% in Staff's Exhibit _(FP-5). Even if we take the bottom end of the reported growth range of 5.5%- 6.0% on Table 2 versus Staff's 4.1%, a difference of 1.4%, the DCF estimate of the cost of common equity increases from 10.35% to above 11.75%.

Table 2 Staff's Comparable Companies
Analysts' Growth Forecasts

Company	Value Line Projected Growth	Zacks Analysts Growth
1 ALLETE	-1.0	4.0
2 Alliant Energy	4.5	4.3
3 Amer. Elec. Power	3.0	3.8
4 Ameren Corp.	2.5	3.7
5 Avista Corp.	6.5	8.7
6 Black Hills	10.0	6.0
7 Cleco Corp.	9.5	14.5
8 Consol. Edison	3.0	3.8
9 DPL Inc.	8.0	4.5
10 DTE Energy	7.5	4.0
11 Duke Energy	5.0	4.5
12 Edison Int'l	3.5	6.0
13 Empire Dist. Elec.	8.5	
14 Entergy Corp.	6.0	6.3
15 FPL Group	7.5	8.7
16 FirstEnergy Corp.	4.0	6.0
17 G't Plains Energy	-0.5	3.0
18 Hawaiian Elec.	7.0	6.0
19 IDACORP Inc.	4.5	5.0
20 MGE Energy	4.0	5.0
21 NSTAR	8.0	5.7
22 Northeast Utilities	8.0	7.7
23 PG&E Corp.	6.5	7.0
24 Pinnacle West Capital	3.0	6.5
25 Portland General	3.5	
26 Progress Energy	6.0	4.6
27 Sempra Energy	5.5	6.5
28 Southern Co.	5.0	7.9
29 TECO Energy	4.5	10.3
30 Vectren Corp.	5.5	6.8
31 Westar Energy	4.0	5.7

32 Wisconsin Energy	8.0	8.5
33 Xcel Energy Inc.	6.5	5.2
Average	**5.4%**	**6.1%**
Median	**5.5%**	**6.0%**

Source: Value Line Investment Analyzer 08/09
Zacks Investment Research 08/09

Q. DOES MERRILL LYNCH PROVIDE LONG-TERM GROWTH RATE PROJECTIONS?

A. Yes, it does. Staff relies on a Merrill Lynch publication shown as Staff Exhibit__ (FP-13) for a key input into its CAPM analysis, namely, the MRP estimate. However, Staff chose not to rely on the same Merrill Lynch publication for the inputs into its DCF estimates for electric utilities. On page 46 of the aforementioned publication, a long-term growth projection of 6.0% is reported for electric utilities, the same estimate as the analysts' consensus growth rate reported in Table 3 above. Once more, this growth rate exceeds Staff's 4.1% growth estimate in both stages of the DCF analysis.

Q. HOW WOULD STAFF'S DCF RESULT CHANGE IF STAFF HAD USED MERRILL LYNCH'S GROWTH FORECAST INSTEAD OF STAFF'S 4.1% ESTIMATE IN THE DCF ANALYSIS?

A. Using Merrill Lynch's growth forecast of 6.0% for electric utilities instead of Staff's 4.1% would increase the DCF estimate of the cost of common equity by approximately 200 basis points (6.0% - 4.1% = 1.9%), that is, from 10.35% to above 12%.

Q. WHAT WOULD BE THE RESULT OF A SIMPLE DCF ANALYSIS USING THE MERRILL LYNCH DATA OF STAFF EXHIBIT FP-13?

A. Performing a simple plain vanilla DCF analysis on the electric utilities group

using the Merrill Lynch dividend yield (4.9%) and growth (6.0%) data, a DCF estimate of 10.9% (4.9% + 6.0%) is obtained, the same ROE requested by the Company, the same expected return by Value Line for Staff's group reported earlier in Table 2.

3. DCF GROWTH: LONG-TERM ECONOMIC GROWTH

Q. DO YOU AGREE WITH STAFF'S DCF GROWTH RATE COMPARISONS WITH THAT OF THE OVERALL ECONOMY?

A. No, I do not. In order to assess the reasonableness of its DCF growth rates, Staff (p. 60) compares its growth estimates with growth estimates of the overall economy, and bases the latter on the March 2009 Blue Chip Economic Indicators consensus economic projections of the five-year 2016-2020 period nominal GDP growth rate estimate of 4.9%.

Q. DO YOU AGREE WITH THOSE ESTIMATES?

A. No. Staff should have compared the utility growth rate forecasts with the historical long-term growth of the economy as a whole and/or the long-range growth forecasts in GDP projected for the very long-term. Staff's comparison to a short-term growth rate forecast (only five years) is inappropriate because the growth term of the DCF model is perpetual in nature.

As discussed below, a long-term forecast of nominal growth in GDP can be formulated by combining a long-term inflation estimate (2.1%) with a long-term real growth rate forecast (3.4%), and the long-term expected GDP nominal growth is approximately 5.5% (3.4% + 2.1% = 5.5%), which is the same as the analysts' consensus growth forecast discussed earlier. In other words, as was the case

earlier, Staff's long-term growth forecast of 4.1% for its comparable group of electric utilities understates the long-term expected GDP nominal growth by approximately 140 basis points.

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

A. Use of the GDP long-term growth forecast of 5.5% in Staff's second-stage DCF analysis instead of the medium-term forecast of 4.1% would raise Staff's DCF estimates by 140 basis points, from 10.35% to approximately 11.75%.

Q. IS STAFF'S CHOICE OF GROWTH RATES CONSISTENT WITH THE LONG-TERM GROWTH OF THE U.S. ECONOMY?

A. No, it is not. Staff's average growth rates of 4.1% are inconsistent with the very long-term growth of the economy. Because the growth term of the DCF model is perpetual in nature, it is quite reasonable to assume that a utility's long-term growth profile will match the long-term growth of the overall economy.

Long-term forecasts of nominal growth in GDP are available from commercial sources, such as Standard & Poor's, DRI and Blue Chip Forecast. Additionally, a long-term forecast of nominal growth in GDP can be formulated by combining a long-term inflation estimate with a long-term real growth rate forecast as follows:

GDP Nominal Growth = GDP Real Growth + Expected Inflation

The growth rate in U.S. real GDP has been reasonably stable over time. Therefore, its historical performance is a reasonable estimate of expected long-

term future performance. The growth in real GDP for the 1929-2008 period was approximately 3.4%. The long-term expected inflation rate can be obtained by comparing the yield on long-term U.S. Treasury bonds with the yield on inflation-adjusted bonds of the same maturity. The difference between the yield on 20-year Treasury bonds and the yield on inflation-adjusted bonds ("Treasury Inflation Protected Securities," or "TIPS") for the same maturity is 2.1% for August 2009, implying an approximate expected inflation rate of 2.1%.

Using the above formula, the long-term expected GDP nominal growth is approximately 5.5% (3.4% + 2.1% = 5.5%). In sum, Staff's growth forecast of 4.1% for its comparable group of electric utilities understates the long-term expected GDP nominal growth by approximately 140 basis points.

4. CAPM: RISK-FREE RATE

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

A. Three inputs are required in order to implement the CAPM: the risk-free rate, the beta risk measure, and the MRP. As shown on Exhibit __ (FP-5) Page 3, for the risk-free rate, Staff uses 3.74%; for beta, Staff uses 0.70, based on Value Line beta estimates for its sample of electric companies; and for the MRP, Staff uses 8.7%.

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

A. Yes, I do.

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

A. Yes, I agree with the magnitude (i.e., 8.7%), although not the derivation, of Staff's MRP.

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

A. No, I do not. As a proxy for the risk-free rate, Staff uses the average yield on 10-year and 30-year bonds over the April 2009 – June 2009 three-month period, which is 3.74%. I disagree for two reasons. First, only the yields on 30-year bonds are relevant proxies in the CAPM. Second, Staff's estimates are stale, with averages computed over a period reaching back to April 2009 and ending in June 2009 in a testimony dated August 2009.

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

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

Another reason for using the longest maturity Treasury bond possible is that common equity has an infinite life span, and the inflation expectations embodied in its market-required rate of return will therefore be equal to the inflation rate anticipated to prevail over the very long-term. The same

expectation should be embodied in the risk-free rate used in applying the CAPM model. It stands to reason that the yields on 30-year Treasury bonds will more closely incorporate within their yields the inflation expectations that influence the prices of common stocks than do short-term or intermediate-term U.S. Treasury notes.

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

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

A. On Exhibit __ (FP-5) page 3, Staff reports the average yield on 30-year Treasury bonds over the April 2009 – June 2009 period as being 4.2%.

Q. SHOULD STAFF HAVE RELIED ON THE 4.2% AVERAGE YIELD ON 30-YEAR TREASURY BONDS?

A. No, that estimate is stale, as it is based on a three-month old average reaching back three months to April 2009 in a testimony dated August 2009. In order to be current and in keeping with the tenets of market efficiency, Staff should have relied on the most current yield estimate reported on Exhibit __(FP-5) page 3, namely, the June 2009 estimate of 4.52%.

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

A. Use of the appropriate risk-free rate of 4.52% in Staff's CAPM analysis instead of

the 3.74% stale estimate based in part on 10-year Treasury yields raises Staff's traditional CAPM estimates by 78 basis points (4.52% - 3.74%), from 9.80% to 10.58%.

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

A. Use of the appropriate risk-free rate of 4.52% in Staff's Zero-Beta CAPM analysis raises Staff's Zero-Beta CAPM estimates by 78 basis points (4.52% - 3.74%), from 10.45% to 11.23%. Averaging the two CAPM estimates, Staff's final generic CAPM ROE reported on Exhibit __ (FP-5) page 3 becomes 10.91% and not the 10.13% reported.

5. FLOTATION COSTS

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

A. Flotation costs are very similar to the closing costs on a home mortgage. In the case of issues of new equity, flotation costs represent the discounts that must be provided to place the new securities. Flotation costs have a direct and an indirect component. The direct component represents monetary compensation to the security underwriter for marketing/consulting services, for the risks involved in distributing the issue, and for any operating expenses associated with the issue (e.g., printing, legal, prospectus). The indirect component represents the

downward pressure on the stock price as a result of the increased supply of stock from the new issue. The latter component is frequently referred to as "market pressure."

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

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

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

A. Both Staff and I agree on the need for a flotation cost adjustment, but we disagree on its magnitude. Staff recommends an allowance of 8 basis points versus my 30 basis points. The magnitude of the flotation cost adjustment formula used by Staff is only correct if the flotation costs associated with all past common equity issues have been recovered. The standard flotation cost allowance used in my direct testimony is designed to recover the flotation costs associated with all past issues that were not expensed, but rather written off against common equity.

By analogy, in the case of a debt issue, flotation costs are amortized over the life of the debt, and the annual amortization charge usually is embedded in the

cost of debt for ratemaking purposes. This is done whether the company intends to issue debt in the future or not and/or whether the company has issued debt in the past or not. The recovery of debt flotation expense continues year after year irrespective of whether the company issues new debt capital until recovery is complete, in the same way that the recovery of past investments in plant and equipment through depreciation allowances continues in the future even if no new construction is contemplated. In the case of common stock, which has no finite life, flotation costs are not amortized to a specific issuance as is the case for a bond. However, the recovery of flotation costs requires a similar upward adjustment to the return on equity that is allowed for ratemaking purposes. Unlike the case of bonds, common stock has no finite life so that flotation costs cannot be amortized and must therefore be recovered via an upward adjustment to the allowed return on equity. As in the case of bonds, the recovery continues year after year regardless of whether the utility raises new equity capital until the recovery process is terminated.

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

In short, Staff's DCF estimates of equity costs are downward-biased by approximately 15-20 basis points to the extent that the flotation costs associated with past equity issues have not been expensed or recovered in the past.

6. RETURN ADJUSTMENT

Q. DID STAFF PROPOSE A RETURN ADJUSTMENT TO THEIR ROE RESULTS TO ACCOUNT FOR CREDIT QUALITY DIFFERENCES?

A. Yes, it did. Staff proposes (pp. 82-85) that CECONY's ROE be reduced by 31 basis points (0.31%) to account for credit quality differences between CECONY and the proxy group. The details of the calculation are provided in Exhibit___ (FP-6). Staff argues that CECONY is less risky than the comparable group because its debt ratings are slightly higher than those of the comparable companies. My first reaction is that Staff was possibly not aware of Moody's downgrading of the Company's bonds on June 29, 2009 when Staff's testimony was prepared, and that such an adjustment is really a moot issue.

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

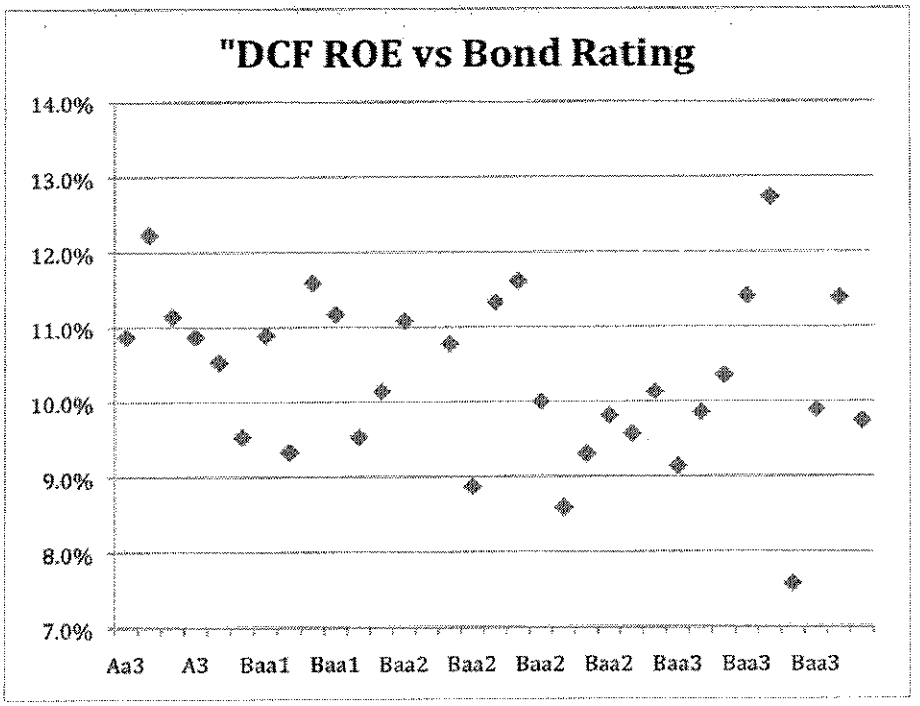
A. The adjustment is based on the yield differentials between utility bonds rated A and BBB over the past five years. I note that in past recent testimonies, the adjustment was based on a six-month period rather than a five-year period.

Q. DO YOU AGREE WITH STAFF'S 31 BASIS POINTS DOWNWARD RETURN ADJUSTMENT?

A. No, I do not. First, it is based on debt yield differentials and not on common stock return differentials. It should be noted that credit ratings and debt rate differentials are not directly related to required equity returns. Staff does not offer any evidence of any relationship, let alone a causal relationship, between credit quality and required or observed equity returns in the utility industry. Also, Staff

provides no evidence of a relationship between credit quality and observed returns in the market as a whole.

Staff's own data contradict the proposed adjustment. As shown on the graph below, there is no correlation between the Staff's DCF results for the companies in its sample group and the ratings of these companies.



The table below displays Staff's DCF results for each bond rating group, taken directly from Staff Exhibit___(FP-4) and Exhibit___(FP-5). If Staff were correct, one would observe a positive relationship between return and declining credit quality. No such relationship exists. There is no relationship at all between equity returns and bond rating.

Bond Rating	DCF Estimates	Beta Estimates
Aa3	10.87%	0.65
A2	11.69%	0.70
A3	10.70%	0.60
Baa1	10.31%	0.71
Baa2	10.67%	0.70
Baa3	10.22%	0.76

Thus, the notion that the DCF results should be adjusted not only lacks a theoretical foundation but it is refuted by Staff's own data. I also point out that there is no correlation between equity risk as measured by beta and the credit ratings of the companies in Staff's sample group as evidenced by the data in the last column in the above table.

Second, the Company's ability to tap capital markets and attract funds on reasonable terms occurs at a crucial point in time when CECONY has an ambitious capital expenditures program and will require external financing. CECONY's large capital expenditure program over the next several years increases its dependence on capital markets which have become volatile and more unpredictable. This is certainly no time to apply a return decrement and reduce the Company's return relative to its industry peers.

In short, Staff's downward ROE adjustment of 31 basis points should be rejected by the Commission.

7. RESPONSE TO STAFF'S CRITICISMS

Comparable Group

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

A. Staff expresses concern (p. 96-97) that my comparable group of electric utilities is riskier than CECONY on the grounds that CECONY's bond rating is superior to the average bond rating for my comparable groups. I disagree. Earlier, I showed that there is little correspondence between bond ratings and equity risk. Credit ratings examine risk from a bondholder viewpoint rather than from a shareholder viewpoint. The former is concerned mainly with ability to service debt and creditworthiness while the latter is concerned with variability and uncertainty of return. Moreover, I showed earlier that Staff's beta estimate for CECONY of 0.70 is virtually identical to the average beta of my two groups and, therefore, is comparable in risk to the two groups.

Staff also criticizes my two groups of companies on the grounds that I employed a 50% minimum regulated revenues screening criterion instead of 70%. Again, this criticism is vacuous given that the average percentage of regulated electric revenues in my two comparable groups of utilities are 71% and 74%, respectively, above the 70% threshold and within the Commission's 70% utility revenue criterion.

Historical Risk Premium

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

A. No, I do not. Staff argues (pp. 105-106) that I have not demonstrated whether CECONY is more or less risky than the companies that make up Moody's Electric Utility Index over the time period. I disagree. First, over most of the long period that covers my historical risk premium study, the electric utility was relatively

homogenous in risk and under the umbrella protection of regulation for all of its functions (power generation, transmission, distribution). Second, as previously stated, Staff's estimated beta for Consolidated Edison, Inc. ("ConEd") of 0.70 is virtually identical to the average beta of the two groups of electric utilities used in my direct testimony, suggesting that indeed ConEd's risk profile is comparable to the group averages.

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

A. No, I do not. Staff critiques (p. 105) the risk premium method on the grounds that the method assumes that the risk premium is constant over time, that is, that the risks of Treasury securities have remained at the same level relative to the risks of the electric utility stocks.

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

Moreover, my historical risk premium analysis provides a very conservative downward-biased estimate of the current risk posture of the industry

and CECONY given that the risk of the electric utility industry has intensified steadily in the past decade and given the devastating effect of the financial crisis on investor risk aversion.

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

A. It certainly is. The Risk Premium approach is conceptually sound and firmly rooted in the conceptual framework of Capital Market Theory. It is widely used by analysts, investors, and expert witnesses. Most college-level corporate finance and/or investment management texts contain detailed conceptual and empirical discussion of the risk premium approach.[1] The latter is typically recommended as one of the three leading methods of estimating the cost of capital.[2] Techniques of risk premium analysis are widespread in investment community reports. Professional certified financial analysts are certainly well versed in the use of this method.

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

[1] See Bodie, Z., Kane, A., and Marcus, A. J., *Investments*, McGraw-Henry Irwin, 6th ed., 2005, a recommended textbook for Chartered Financial Analyst certification and examination.
[2] See Brigham and Erhhardt (2005), Corporate Finance: A Focused Approach, 2nd ed., Thomson 2006.

particular capital market environment.

DCF Growth Rates

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

A. Staff criticizes (pp. 98-99) my DCF earnings growth rates on the grounds that I have not addressed how these earnings growth estimates relate to the dividend payout policies of my companies and whether they are sustainable over time. I totally disagree with this point of view. First, one of the key assumptions that underlies the DCF model is that earnings, dividends, book value, and market price all grow at a constant rate forever. In other words, the dividend payout ratio remains constant over time. That is the assumption I made, and that is the assumption that Staff also made in the second stage of its DCF analysis. Second, in my direct testimony and earlier in my rebuttal, I discussed the merits of using consensus analysts' earnings growth forecasts in the DCF model and the supportive empirical literature.

Q. DO YOU AGREE WITH STAFF'S VIEWS ON DIVIDEND GROWTH?

A. No, I do not. Staff, argues (p. 63) that the DCF calculation requires dividend growth rather than earnings growth because dividends constitute the cash flows received by the investor, and that I should have relied on dividend growth instead of earnings growth. I disagree. First, it is clear that dividend growth can only be sustained if there is growth in earnings. Since the ability to pay dividends stems from a company's ability to generate earnings, growth in earnings per share can be expected to strongly influence the market's dividend growth expectations.

Second, from a practical perspective, casual inspection of the Zacks Investment Research, First Call Thompson, and Multex Web sites, among others, reveals that earnings per share forecasts dominate the information provided. There are few, if any, dividend growth forecasts. Only Value Line provides comprehensive long-term dividend growth forecasts. The wide availability of earnings forecasts is not surprising. There is an abundance of evidence attesting to the importance of earnings in assessing investors' expectations. The sheer volume of earnings forecasts available from the investment community relative to the scarcity of dividend forecasts attests to their importance. The fact that these investment information providers focus on growth in earnings rather than growth in dividends indicates that the investment community regards earnings growth as a superior indicator of future long-term growth.

Third, Staff argues (p. 63) that I have discounted earnings, thus overstating stock value. This is completely erroneous. What I did is rely on earnings ***growth*** forecasts as proxies for dividend ***growth*** for the reasons stated above. In point of fact, the standard DCF model assumes that earnings and dividends grow at the same rate.

Staff argues (p. 63) that analysts' growth forecasts are notoriously inaccurate. No foundation, support, reference, study, or published literature is provided to back up this claim. Moreover, this claim is likely to be false for utility stocks. The magnitude of the bias for large rate-regulated companies in stable segments of an industry, if any, is likely to be very small. Empirically, the

severity of the optimism problem is unclear for regulated utilities, if a problem exists at all.

Q. HOW DO YOU RESPOND TO STAFF'S CRITICISM (PP. 98-99) THAT YOU DID NOT RELY ON THE SUSTAINABLE GROWTH APPROACH ENDORSED BY THE COMMISSION?

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

Q. DR. MORIN, DOES THE DCF METHODOLOGY RESULTS OVERSTATE INVESTOR RETURNS TO THE EXTENT THAT THEY REFLECT THE QUARTERLY COMPOUNDING OF DIVIDENDS?

A. No, of course not. Staff argues (p. 100) that my DCF estimates are overstated as a result of the quarterly compounding of dividends. Staff's criticism is misplaced. First, both Staff and I have relied on the annual version of the DCF model, rather than on the quarterly version of the DCF model. Second, failure to use account for the quarterly nature of dividend payments understates investor returns, contrary to Staff's view.

Q. WHAT IS THE APPROPRIATE FORM OF THE DCF MODEL?

A. The annual DCF model used by Staff and myself ignores the time value of quarterly dividend payments and assumes that dividends are paid once a year at the end of the year. Since investors are aware of the quarterly timing of dividend payments, this knowledge is reflected in stock prices.

As I show in Chapter 11 of my book, *The New Regulatory Finance*, the use of the annual version of the DCF model understates the cost of equity by approximately 20 basis points, depending on the magnitude of the dividend yield component. This is plain common sense. By analogy, a bank rate on deposits that does not take into consideration the timing of the interest payments understates the true yield if you receive the interest payments more than once a year. The actual yield will exceed the stated nominal rate. To illustrate, if an investor has a choice between investing $1,000 in a bank account which promises a return of 10% compounded annually and another bank account which promises a return of 10% but compounded quarterly, he will clearly select the latter. Due to the quarterly compounding of interest, the investor earns an effective return of 10.38% on the latter bank account versus 10% on the former. The same is true for the return on common stocks. Staff is plain wrong in its view that the DCF results are understated as a result of the quarterly compounding of dividends. In fact, the opposite is true; the annual version of the DCF model understates investor return by some 20 basis points.

Q. DR. MORIN, HOW DO YOU RESPOND TO STAFF'S CRITICISM THAT YOU HAVE RELIED ON SPOT STOCK PRICES IN YOUR DCF ANALYSIS?

A. Staff argues (p. 99) that the use of spot stock prices in implementing the DCF model is inappropriate because of the undue volatility that such a single point-in-time estimate injects into the DCF calculation.

The proper stock price to employ is the current price of the security at the time of estimating the cost of equity, rather than some historical average stock price reaching back three months, as Staff did. The reason is that the analyst is attempting to determine a utility's cost of equity in the future, and since current stock prices provide a better indication of expected future prices than any other price according to the basic tenets of the Efficient Market Hypothesis, the most relevant stock price is the most recent one. The Efficient Market Hypothesis, which is widely accepted, states that capital markets, at least as a practical matter, incorporate into security prices relevant publicly available information, such that current security prices reflect the most recent information and thus are the best representation of investor expectations. Use of any other price violates market efficiency principles.

There is yet another justification for using current stock prices. In measuring the cost of equity as the sum of dividend yield and growth, the period used in measuring the dividend yield component must be consistent with the estimate of growth with which it is paired. Since the current stock price is caused by the growth foreseen by investors at the present time and not at any other time, it is clear that the use of spot prices is preferable. In contrast, Staff has essentially mismatched a stale average stock price reaching as far back as April 2009 with a current estimate of expected growth. This not only violates market efficiency principles, but also constitutes a mismatch in the application of the DCF model.

An analogy with interest rates will clarify this point. If, for example, interest rates have climbed from 5% to 6% over the past three months, it would be

incorrect to state that the current interest rate is in the range of 5% to 6% just because this is the interest rate range for the past six months. Analogously, it is incorrect to state that the cost of equity, which has also risen along with interest rates, is in some given six-month range. Just as the current interest rate is 6%, the cost of equity estimate is that which is obtained from the standard DCF using current spot prices.

As to the volatility issue raised by Staff, the use of large groups of comparable companies mitigates the impact of possible measurement errors and vagaries in individual companies' market data.

ALLOWED RETURNS

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

A. No, it is not. Allowed returns, while certainly not a precise indication of a company's cost of equity capital, are nevertheless important determinants of investor growth perceptions and investor expected returns. They also serve to provide some perspective on the validity and reasonableness of Staff's recommendation.

I have examined the ROEs currently allowed for the 33 electric utilities in Staff's comparable group as reported in the AUS Utility Reports survey for August 2009. The currently authorized ROEs for Staff's sample of electric utilities, shown in Table 1 below, average 10.9%, the same ROE requested by the Company.

Table 3 Authorized ROEs
Staff's Comparable Group

	Company Name	Allowed ROE
1	ALLETE	10.74
2	Alliant Energy	11.02
3	Amer. Elec. Power	10.71
4	Ameren Corp.	10.64
5	Avista Corp.	10.20
6	Black Hills	10.71
7	Cleco Corp.	11.25
8	Consol. Edison	9.91
9	DPL Inc.	11.00
10	DTE Energy	11.00
11	Duke Energy	10.89
12	Edison Int'l	10.71
13	Empire Dist. Elec.	10.80
14	Entergy Corp.	10.76
15	FPL Group	11.75
16	FirstEnergy Corp.	10.67
17	G't Plains Energy	10.45
18	Hawaiian Elec.	10.82
19	IDACORP Inc.	10.50
20	MGE Energy	10.80
21	NSTAR	12.50
22	Northeast Utilities	9.72
23	PG&E Corp.	11.35
24	Pinnacle West Capital	10.75
25	Portland General	10.80
26	Progress Energy	12.42
27	Sempra Energy	11.46
28	Southern Co.	11.93
29	TECO Energy	11.00
30	Vectren Corp.	10.43
31	Westar Energy	10.00
32	Wisconsin Energy	10.75
33	Xcel Energy Inc.	10.74
	AVERAGE	**10.88%**

Source: AUS Utility Reports 08/2009

The average ROE currently allowed for the overall combination gas and electric industry and for the overall electric utility industry is 10.7% versus Staff's recommendation of 10.1%.

In short, Staff's ROE recommendation is outside the mainstream of the allowed rates of return that were current during the period in which Staff performed its analysis, lies outside the zone of recently authorized ROEs for electric utilities and for its sample of companies, and would constitute among the lowest ROE allowance in the country for a major utility. All but 8 of the 60 electric utilities covered in the AUS Utility Report had higher allowed ROEs than 10.1%. The Commission is not bound by decisions of other regulators regarding allowed ROE, but one cannot overlook the obvious difference between Staff's recommendation and the returns currently allowed for the same firms that Staff deems comparable in risk.

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

CONCLUSIONS

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

A. As shown in Table 1, investors are expecting an average ROE of 10.9%.

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

A. As shown in Table 3, the average authorized ROE for these comparable companies is 10.9%.

Q. WHAT ROE DOES STAFF RECOMMEND?

A. Staff's recommended ROE is 10.10%.

Q. WHAT ROE SHOULD STAFF'S ANALYSIS PRODUCE WHEN ADJUSTED FOR THE REASONS YOU HAVE EXPLAINED?

A. Applying the various changes and corrections I have outlined in my rebuttal, Staff's analysis indicates a return in excess of 11%, as shown below.

Q. WHAT DO YOU CONCLUDE FROM STAFF'S COST OF CAPITAL TESTIMONY?

A. There is a degree of substantial agreement between Staff and myself and between our respective recommendations. Under current capital market conditions, I agree generally with Staff's: (i) use of several methodologies in estimating a fair return on common equity; (ii) sample of electric utility companies; (iii) beta estimate in the CAPM; (iv) MRP estimate in the CAPM analyses under current market circumstances; and (v) underweighting of the CAPM results in the current financial environment.

My general conclusions are:

1. DCF Earnings Retention Growth. There is a logical inconsistency in the retention growth technique because Staff is forced to assume the answer to implement the method. From Staff's own evidence, investors expect substantially higher returns for utilities than what Staff recommends.

2. DCF Growth Rates: Analysts' Forecasts. Investors are expecting substantially higher growth rates than Staff's 4.1% first-stage growth rate and 4.1% second-stage growth rate for the sample companies. Using Value Line's growth forecast and the analysts' consensus growth forecast increases Staff's DCF estimates by a minimum of 140 basis points.

3. DCF Growth Rates: Long-term Economic Growth. Staff's long-term growth forecast of 4.1% for its comparable group of electric utilities based on the earnings retention growth method understates the long-term expected GDP nominal growth by approximately 140 basis points.

4. CAPM Risk-Free Rate. Staff's proxy for the risk-free rate is stale and relies on the wrong Treasury bond maturity. Using the appropriate risk-free rate proxy from its testimony, Staff's CAPM estimates would be raised by 78 basis points from this correction alone.

5. Flotation Costs. Staff's DCF estimates of equity costs are downward-biased by approximately 15-20 basis points to the extent that not all the flotation costs associated with past equity issues have been expensed or recovered in the past.

6. Return Adjustments. Staff's downward ROE adjustments for credit quality differences should be rejected by the Commission.

7. Criticisms of my testimony. Staff's criticisms of my direct testimony are without foundation.

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

A. Staff's recommended ROE is understated. Reliance on analysts' growth forecasts in the DCF analysis (140 basis points) would raise its DCF estimate from 10.35% to 11.75%, even without flotation costs. Recognition of the appropriate risk-free rate in the CAPM analysis raises Staff's CAPM estimates by 78 basis points, from 10.13% to 10.91% without flotation costs. Giving a two-third weight to the amended DCF result of 11.75% and a one-third weight to the amended CAPM result of 10.91% brings Staff's recommendation to above 11.0%.

Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.