BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Consolidated Edison Company of New York, Inc.

Case 07-E-0523

September 2007

Prepared Testimony of:
Staff Finance Panel

Michael J. Augstell
Senior Utility Financial Analyst

Jeffrey S. Hogan
Principal Utility Financial Analyst

Office of Accounting, Finance and Economics
State of New York
Department of Public Service
Three Empire State Plaza
Albany, New York 12223-1350

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

A. Michael J. Augstell and Jeffrey S. Hogan. We are employed by the New York State Department of Public Service (Department). Our business address is Three Empire State Plaza, Albany, New York 12223.

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

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

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Arts Degree in Economics from the University of Rochester in 1992. For approximately three years I was engaged in the sale and purchase of late 19th and early 20th century American Art. I worked for three years in the commercial loan department at two local banks. I was also employed as a financial analyst in sourcing accounts payable for General Electric Power Systems. My last position, for over five years, was at UHY

Advisors NY, Inc. (UHY) in Albany, New York. I worked in the valuation and litigation services department. While at UHY, I executed business valuations, performed financial analysis and forensic accounting and worked on class action claims administration. I joined the Department of Public Service in December 2006.

Q. Are you a member of any professional societies?

A. Yes. I am a candidate member in the American Society of Appraisers (ASA). I am working towards becoming accredited in business valuation.

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

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

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

A. Yes. In Case 06-G-1332, Consolidated Edison Company of New York, Inc. - Gas Rates, I offered testimony as part of the Staff Finance Panel as to the appropriate capital structure and cost of debt for Consolidated Edison Company of New York, Inc.

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

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

Q. Please describe your educational background and professional experience.

A. I received a Bachelor of Arts Degree in Economics and Political Science from Syracuse University in 1991. In 1993 I received a Masters Degree in Business Administration with a concentration in Finance from the State University of New York at Albany. I joined the Department in February 1994 and subsequently took additional college courses in Accounting.

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

A. My areas of responsibility include analyzing

rate of return and operation and maintenance (O&M) expense levels. I also work on financing requests from utilities and regulatory review of the formation of utility holding corporations. In addition, I assist in analyzing legislative proposals affecting the utility industry.

Q. In what previous rate cases have you analyzed the appropriate capital structure and/or cost of equity for a utility?

A. In Case 05-S-1376, Consolidated Edison Company of New York, Inc. -Steam Rates, Case 04-E-0572, Consolidated Edison Company of New York, Inc. - Electric Rates and Cases 03-G-1671 and 03-S-1672, Consolidated Edison Company of New York, Inc. - Gas and Steam Rates, I offered testimony on the appropriate capital structure and cost of capital. In Case 02-W-1564, Sea Cliff Water Company - Rates, I testified on the capital structure and cost of capital, as well as on certain O&M expenses. In Case 01-M-0075, Niagara Mohawk/National Grid Merger, I analyzed the capital structure and cost of equity. In Case 94-W-0157, New Rochelle Water Company - Rates, I assisted in the development of Staff's

recommended capital structure and cost rates. In Case 94-G-0885, National Fuel Gas Distribution Corporation - Rates, I analyzed the capital structure and assisted in the calculation of Staff's recommended return on common equity. In Case 95-G-0761, Brooklyn Union Gas, I assisted in the formation of the capital structure as it formed a holding company, as well as assisted in the calculation of Staff's recommended return on equity.

PURPOSE OF TESTIMONY

Q. Panel, what is the purpose of your testimony in this proceeding?

A. Our testimony consists of two parts. First, we develop the fair rate of return used in the determination of the revenue requirement for Consolidated Edison Company of New York, Inc. (Con Edison or the Company) for the rate year ending March 31, 2009. Second, we respond to the testimony of Company witnesses Morin and Hoglund.

Q. Will the Panel refer to, or otherwise rely upon, any information produced during the discovery phase of this proceeding in its testimony?

A. Yes. We will refer to, and have relied upon, several responses to Staff Information Requests. They are attached as Exhibit___(FP-1).

SUMMARY

Q. Please summarize your testimony.

A. We recommend an overall rate of return of 7.25%, as opposed to the Company's request of 8.53%. The difference is primarily due to our use of a 47.98% equity ratio and an 8.9% return on equity (ROE), as opposed to the Company's 48.68% equity ratio and 11.5% ROE. Our capital structure adjustment imputes a reasonable level of equity investment to the Company's non-utility assets, while our ROE recommendation was determined using two different equity costing methodologies, each weighted as the Commission has approved in prior litigated cases. We also explain why our recommended rate of return provides the Company with a financial profile that will allow the Company continued access to reasonably priced capital.

RATE OF RETURN RECOMMENDATION

CAPITAL STRUCTURE

Q. What is the after-tax rate of return you

recommend be allowed for the rate year?

A. We recommend an after-tax overall rate of return of 7.25%, compared to the Company's originally filed 8.53%. Our proposed pro forma cost of capital can be seen in Exhibit___(FP-2).

Q. What is a fair rate of return for a regulated utility?

A. A fair rate of return for a regulated utility is one that enables the utility to provide safe and adequate service to its customers, while assuring continuous support in the capital markets for the utility's stocks and bonds at reasonable terms. Investors in debt enter into a contractual obligation with the utility and receive a relatively fixed income stream. Common equity investment, on the other hand, is non-contractual. Investors may share in, but are not guaranteed, a portion of the utility's residual earnings. The fair rate of return allows the utility to recover its prudently incurred cost of debt, as well as providing common equity investors the opportunity to earn a return commensurate with the risk of their investment.

Q. How is a fair rate of return calculated?
A. Generally, a fair rate of return is calculated through a weighted average of the individual cost components of a company's capital structure. Cost rates on long-term debt are generally fixed on a historical basis and are readily quantified. Additionally, the cost of customer deposits is prescribed by the Commission. The cost of common equity, however, depends upon investor expectations and, therefore, it requires the application of one or more methodologies such as the Discounted Cash Flow (DCF) methodology or the Capital Asset Pricing Model (CAPM) to estimate the return required by equity investors.
Q. Please describe how your capital structure and cost rate recommendations differ from those of the Company's Accounting Panel.
A. The main difference is that our analysis results in a common equity ratio of 47.98% (as opposed to the Company's 48.68%), and therefore the long-term debt ratio increases from 48.88% to 49.65%. In addition, we are using a cost of equity rate of 8.9%, as opposed to the 11.5%

rate recommended by Company witness Morin (for a three-year rate case), which the Company's Accounting Panel reflects in their schedules and revenue requirement.

Q. What was Con Edison's projected rate year capital structure for its electric operations?

A. In Exhibit___(AP-11), the Company's Accounting Panel used a long-term debt ratio of 48.88%, a common equity ratio of 48.68%, a preferred stock ratio of 1.21% and a customer deposit ratio of 1.23%.

Q. Has the Company updated the capitalization to reflect its latest financial forecasts?

A. No it has not.

Q. How did the Company develop this capitalization?

A. The rate year capitalization was developed based upon an approach that began with Con Edison's as-reported "stand-alone" capital structure for the test period. This "stand-alone" capitalization was then projected through the end of the rate year based upon the Company's assumptions about construction expenditures, refunding needs and internal cash flows. This projection was then used to develop the average

capitalization for the rate year.

Q. Please describe what you mean by the term "stand-alone" capital structure.

A. A utility holding company reports its overall capital structure as part of its consolidated balance sheet in various reports to the Securities and Exchange Commission (SEC) as well as in its Annual and Quarterly Reports to Shareholders. The consolidated balance sheet reflects the financial position of all of the holding company's operations. A holding company with utility subsidiaries also presents individual financial statements for major subsidiaries. The stand-alone capital structure is the capitalization reported for each individual subsidiary.

Con Edison is a subsidiary of a holding company parent, Consolidated Edison, Inc. (CEI). CEI owns Con Edison and Orange and Rockland Utilities, Inc. (O&R), and has investments in a number of competitive ventures. CEI reports its consolidated financial position in its annual 10-K report and quarterly 10-Q reports to the SEC; it also issues stand-alone financial

statements for Con Edison and O&R.

Q. Do you agree with the use of the reported stand-alone capital structures for utilities that are subsidiaries of larger holding companies?

A. Not necessarily. Stand-alone capital structures for utility subsidiaries of holding companies do not necessarily reflect rational capitalization policies or actual common equity employed and therefore may not produce reasonable results.

Q. Explain why the use of a stand-alone capital structure does not necessarily produce a reasonable result?

A. The stand-alone common equity balance reported by any utility subsidiary of a holding company may, in fact, not be financed by common equity at the holding company level. Rather, some of the utility equity balance may instead be proceeds from debt issues at the holding company level that were classified on the utility subsidiary's books as common equity at the time they were invested in the utility subsidiary. This is referred to as double leverage.

In addition, the use of a stand-alone subsidiary structure may obscure the fact that a

holding company parent has financed riskier competitive non-utility operations with less equity and more debt than the utility subsidiaries. Therefore, it is not possible to address this issue by merely accepting, in isolation, the stand-alone capital structure for the purpose of setting utility rates.

Q. Does it appear that CEI has double leveraged Con Edison's common equity?

A. No, we do not believe so.

Q. Does it appear that CEI has used the strength of its utility operations to fund unregulated non-utility investments with less equity than would be required for the unregulated investments to achieve the same credit rating as the utility?

A. Yes. While CEI’s non-utility investments face greater business risks than regulated utility investments, CEI's non-utility investments are funded with approximately the same equity ratio as CEI's utility investments. This is not only unreasonable given the relative risks of these operations but also inconsistent with Standard & Poor’s (S&P) views of the risks faced by various types of energy utilities. It also points out

an inconsistency in Con Edison's financial policies. While the Company professes the importance of a strong financial profile when putting forth positions to the Commission, it pursues riskier financial profiles where it must compete for profits and sales.

Q. Define the term business risk as you use it in this testimony.

A. Business risk is the risk inherent in a company's operation and reflects the risk that the company will fail to achieve its expected financial performance. It is affected by items such as a company's sensitivity to the overall economy and a company's reliance on a large customer or supplier. It is also affected by the industry a company is in.

Q. Do non-utility operations typically have more or less business risks than utility operations?

A. In general, non-utility activities have greater business risk than utility operations. This is because non-utility investments are unregulated, face competition from other entities, and are not subject to "cost-plus" recovery of their expenses. In addition, the products or services

of an unregulated company may have alternatives that customers may switch to should their prices change dramatically. In response to Staff IR DPS-237, Dr. Morin agreed that non-utility investments have “generally higher” business risk than utility investments.

Q. What are the financial profiles of CEI's utility and non-utility subsidiaries?

A. Exhibit___(FP-3), Page 1, presents a condensed balance sheet for CEI, Con Edison and O&R based on CEI's 10-Q report for the period ending June 30, 2007 and its O&R-specific financials. Column 1 presents CEI's consolidated balance sheet results for all of its operations. Column 2 shows balance sheet information for Con Edison. Column 3 shows balance sheet information for O&R. Column 4 is the sum of columns 2 and 3 and thus reflects the combined balance sheet of CEI's two utility subsidiaries. Column 5 is the difference between columns 1 and 4. This column reflects CEI's balance sheet after removing the stand-alone balance sheet for each of CEI's utility subsidiaries. Thus, the information in Column 5 reflects the financial

profile of CEI's non-utility operations and assets, as reported by CEI.

Q. What does this information indicate?

A. This information indicates that as of June 30, 2007, CEI's unregulated assets are financed with slightly more than 51% equity, while the utility operations are funded by slightly less than 52% equity.

Q. What types of assets does the non-utility capital structure support?

A. CEI’s June 30, 2007 10-Q states at page 44 that it has three active unregulated subsidiaries: Con Edison Solutions, Inc – a retail energy services company, Consolidated Edison Energy, Inc. – a wholesale supply company, and Consolidated Edison Development, Inc. – owner and operator of generation and infrastructure investments. None of these companies are subject to rate regulation by the Commission and they all operate in competitive markets. The non-utility capitalization also supports any remaining non-earning goodwill booked by CEI as a result of its acquisition of O&R.

Q. Is it reasonable to expect utility companies to

finance assets devoted to the provision of transmission and distribution (T&D) service with approximately the same equity as used to finance non-utility investments and then have those higher equity ratios used for setting rates?

A. No it is not. Assets that are exposed to greater business risks generally require higher equity ratios than assets that are exposed to less business risks. In this case, CEI's non-utility operations face the risks of competition while its T&D assets are primarily subject to rate of return regulation. Thus, CEI should be financing its non-utility assets with more equity than its T&D assets if it expects regulators to accept the stated ratios for setting rates.

Q. Is there evidence from the financial community that supports this viewpoint?

A. Yes. This can be seen in the S&P publication "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised", included as Exhibit___(FP-4). This report lists target financial ratios for various utility bond rating levels and

"business profile" ratings. This report classifies utilities according to their business profile, with a business profile score of "1" being the strongest and a position of "10" being the weakest. A review of the various ratios analyzed by S&P in the report indicates that lower-risk companies (for instance, water operations, gas distribution and electric transmission) at a given bond rating can take on more debt and have less common equity than can higher-risk companies (for instance, merchant power generation, oil and gas exploration and production, and energy trading and marketing) that wish to maintain the same bond rating.

Q. Please summarize the results of your analysis thus far.

A. We have reviewed the reported capitalization ratios for Con Edison, O&R, CEI and CEI's non-utility operations. Our review indicates that CEI's utility operations, as of June 30, 2007, have an equity ratio of 51.7% while CEI's non-utility operations have an equity ratio of 51.3%. Given the higher risks of CEI's non-utility operations, one would expect that they

would be financed with significantly higher levels of equity. As a result, it is necessary to adjust Con Edison's, and CEI's non-utility subsidiaries, rate year capitalization to reflect a more appropriate allocation of capital between utility and non-utility operations.

Q. How did you allocate capital between utility and non-utility operations?

A. We reviewed S&P's debt ratio requirements for an "A" bond rating in its latest financial guidelines (Exhibit___(FP-4)), based on a business profile score consistent with the risks of CEI's non-utility operations (which we estimate would have a business profile score of “8”, since most of the investment is in non-utility power generation). We used this information to develop appropriate capitalization ratios for CEI's non-utility operations. This is seen in Column 6 of Exhibit___(FP-3), Page 1. We then subtracted the adjusted non-utility capitalization amounts from CEI's consolidated capital structure (Column 1) to arrive at a residual capital structure that reflects an appropriate

debt/equity mix for CEI's regulated operations, including Con Edison. This result can be seen in Column 7 of Exhibit___(FP-3), Page 1.

Q. Your calculations are based on balances as of June 30, 2007. Do you expect similar levels throughout the rate year?

A. No. As seen in Exhibit___(AP-12), Con Edison expects to issue approximately $1.07 billion of net additional debt and $600 million of equity over the course of the rate year to meet capital needs. Also, Con Edison expects to issue debt and equity in the period between the end of the test year and the start of the rate year.

Q. How did you adjust your capital structure to account for this information?

A. On Page 2 of Exhibit___(FP-3) we have calculated estimated average rate year balances for debt and equity using information available in the Company Accounting Panel’s workpapers as well as exhibits submitted in O&R's rate filing in Case 06-E-1433 (as shown in Exhibit___(FP-5)). For Con Edison's equity, we have used the quarterly changes in equity expected by the Company per the Company’s Accounting Panel’s workpapers.

For O&R, we have assumed the capital structure and total capitalization projected by O&R in Exhibit___(E-11) in Case 06-E-1443.

Once we determined the average rate year balances for each type of capital, we used that in Column 9 of Exhibit___(FP-3), Page 1, to determine the capitalization ratios used in Exhibit___(FP-2).

Q. Given your adjustments, what rate year capitalization do you recommend the Commission apply to Con Edison?

A. We recommend that the Commission employ a long-term debt ratio of 49.65%, a common equity ratio of 47.98%, a preferred stock ratio of 1.13% and a customer deposit ratio of 1.24% as the rate year capitalization for Con Edison. This can be seen in Column 9 of Exhibit___(FP-3), Page 1.

Q. Can you substantiate that your recommended capitalization ratios are reasonable for a company with Con Edison’s level of business risk?

A. Yes. S&P's financial guidelines for an A-rated utility, which Con Edison is, with a business profile of "2", which Con Edison has, are for

total debt to be in the range of 52% to 58% of total capital. Our recommendation is for long-term debt to be 49.65%. Even when short-term debt and off-balance sheet debt is included in the debt ratio (which S&P does), this total debt-to-capital ratio will be less than 53% and is on the strong end of the range that is recommended by the guidelines for a utility with Con Edison's credit rating and business profile score.

Q. Are your recommended capitalization ratios in line with those of other utilities?

A. Yes. We are recommending an equity ratio of approximately 47.98% for Con Edison, which has a business profile of "2". As can be seen in Exhibit___(FP-6), for 2008 our proxy group companies are expected to have an estimated average common equity ratio 49.3%. The proxy group companies have, on average, an S&P business profile of "5" and thus would be expected to have higher equity ratios, per S&P's guidelines. Dr. Morin's proxy group has an expected average common equity ratio of 46.9% in 2008.

Q. Please continue.

A. The companies in our proxy group derive, on average, approximately 10.6% of their revenue from non-utility businesses. Holding companies that have such investments would be expected to have higher levels of common equity relative to investments in only regulated utilities. Our capital structure recommendation is for a utility business. Even so, it is in-line with the actual capital structure of the proxy group companies that are holding companies that also have riskier non-utility businesses.

COST RATES

Q. Please explain how the cost rates shown in Exhibit___(FP-2) were derived.

A. There are four cost rates we use in formulating our recommended cost of capital. We are using the same cost rates for long-term debt, preferred stock, and customer deposits proposed by the Company's Accounting Panel in Exhibit___(AP-11). The fourth rate is the rate of return on common equity. The Company's proposed cost rate for common equity (11.5%, which includes a stayout premium) is excessive.

We have developed a cost of equity of 8.9% for the rate year ending March 31, 2009.

Q. What methodology did you use to determine your recommended ROE of 8.9%?

A. Our methodology averages the results of two costing methodologies, a discounted cash flow method and a capital asset pricing model, weighting the results as the Commission has in past decisions. The methodologies are used to estimate the cost of equity for an electric utility proxy group. We then adjusted this result to account for credit quality differences between Con Edison and the proxy group, equity issuance expenses, as well as the risk reduction provided by Staff's recommended revenue decoupling mechanism (RDM).

USE OF PROXY GROUP

Q. Why are you using a proxy group to estimate the cost of equity?

A. By using a group of proxy companies, the impact of any irregularities in any one company's data is diminished.

Q. What companies are included in your proxy group?

A. We have 29 companies. The list of companies we

used, including their parent company credit ratings, S&P business profile, percentage of utility revenues, and their equity ratios, is shown in Exhibit___(FP-6).

Q. How did you develop your proxy group?

A. We began with the dividend paying electric utility companies included in *Value Line*. To be included in the proxy group, the companies' parent had to be investment grade rated by S&P and Moody's and had to derive over 70% of their revenues from regulated utility operations. If the parent was not rated, the utility subsidiary had to be investment grade. Further, the companies could not be involved in any merger-related activity related to their utility assets.

Q. Why did you use the parent company credit rating?

A. The methods we use for estimating the cost of equity are based upon the stock prices of, dividends paid by, and financial ratios reported by the parent. Equity investors do not purchase ownership of the individual utility subsidiaries; they purchase ownership of the

entire holding company, which includes the utility subsidiaries, the holding company parent and any non-utility operations. Equity investors will logically base their return requirements on the risk level of the entire company, rather than its strongest individual components.

The price investors are willing to pay for a share of stock is based on expectations concerning the future of the entire company and its associated risks. While an individual utility subsidiary may be judged by rating agencies to be worthy of approximately an "A" rating, higher risks of non-utility operations may make the risk level of the entire enterprise closer to that of a "BBB" rating, several notches lower.

Q. How did you devise this range of credit ratings?

A. We devised the selection criteria to try and achieve two goals: 1) To develop a proxy group with utilities whose risk is similar to that of Con Edison and 2) To maintain a reasonable number of utilities in the proxy group. Exhibit___(FP-7) also shows the frequency of

each rating in our proxy group. As can be seen, overall the proxy group has a slightly lower credit rating on average than Con Edison. The proxy group averages between Baa1 and Baa2 for Moody's and BBB+ and BBB for S&P. This is nearly three notches lower than Con Edison's. Con Edison's current rating is "A" for S&P and A1 for Moody's, which is the equivalent of "A+" for S&P. However, tightening the range to only A-rated companies would result in most of the proxy group companies being discarded, leaving only seven. A balance must be struck between selection criteria designed to achieve a proxy group that perfectly reflects the risk of the utility we are determining the appropriate ROE for and the size of the proxy group. Twenty nine companies, rather than seven, allow for a better representation of a fair regulated return as individual companies' vagaries are smoothed out more.

Q. Is your proxy group a perfect match for Con Edison in relation to the level of business risk investors face?

A. No, it is not. As we mentioned earlier, the

proxy group derives nearly 10.6% of its revenues from unregulated investments. And, as we mentioned, the average credit rating of the proxy group is nearly three notches lower than that of Con Edison. In addition, several of the proxy group companies have investments in regulated activities with higher levels of business risk than the activities Con Edison is engaged in. For instance, some of the utilities in the proxy group own nuclear power plants. Due to these additional risks, the average S&P business profile score for the proxy group is 5.0, as compared to Con Edison's 2. The proxy group is obviously riskier than Con Edison.

Q. Why is the fact that the proxy group companies are, on average, riskier than Con Edison important?

A. As the Company's witness Dr. Morin pointed out on page 8, lines 9 through 16 of his testimony, Con Edison's cost of equity should compensate investors for the specific business and financial risks of the Company's regulated operations. By contrast, Con Edison's cost of equity should not compensate investors for the

risks faced by CEI's unregulated operations. In a perfect world, the risks of a proxy group would perfectly match Con Edison's risk, rather than CEI's risks. This desirable result is currently unattainable given the relatively small number of utility companies with A-ratings.

Q. Do you propose an adjustment to your recommended cost of equity to account for the fact that the proxy group companies are riskier than Con Edison and that some of the proxy group companies have nuclear generation assets?

A. Yes we do. We will discuss this adjustment in greater detail after we discuss the DCF and CAPM methodologies.

Q. Is the proxy group used by Dr. Morin in his DCF methodology, seen in Exhibit___(RAM-5), riskier than Con Edison as well?

A. Absolutely. Dr. Morin's proxy group has an average bond rating of between BBB and BBB+ and an average business profile score of 4.9. Approximately half of his companies derive less than 70% of their revenue from regulated utility operations, with some getting most of their

revenue from non-utility operations.

DISCOUNTED CASH FLOW METHODOLOGY

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

A. The calculation of the DCF for the proxy group is shown on pages 1-2 of Exhibit___(FP-8). For each company in the proxy group, there is a six-month average stock price, calculated by averaging the high and low price for each month. We have used the six-month period ending June 2007. The model also contains *Value Line* data for the beta, earnings per share, dividends per share, book value per share and the forecasted amount of common stock shares for each company.

This data is used to estimate the dividends that can be expected for each company in the future. The price investors are paying for the stock, the average stock price over a six-month period, is seen as the present value of that dividend stream. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, one can determine the rate of return investors are expecting for each company. The median

result, which we calculate to be an 8.33% return, is used as the DCF methodology result.

Q. How are dividends projected to change over time?

A. We have employed a two-stage DCF method. In the near-term, the estimates of *Value Line* are used. For the second stage, 2012 and beyond, a "sustainable growth" rate is calculated for each company in the proxy group based on its projected retention of earnings and growth in common stock balances.

Q. What average sustainable growth figure was used in your model?

A. 5.02%.

Q. Dr. Morin advocates using future earnings growth estimates ranging from 6.4% to 7.0%, based on information from *Value Line* and *Zacks Investment*, as the measure of the growth in the DCF model. Is this appropriate?

A. No. The DCF is a calculation which determines investors' return expectations based on current stock price and future cash flows. Those cash flows are the dividends a company is expected to pay out in the future. Dr. Morin has provided no evidence that projected earnings growth is

equal to future dividend growth.

Q. Dr. Morin states, on page 52 of his testimony, that utilities' dividend policies have become increasingly conservative, dividend growth has been stagnant, and utilities are expected to lower their dividend payout ratio over the next several years. Do you agree with these findings and believe that they support abandoning expected cash flows (dividends) as a component of the discounted cash flow methodology?

A. No, we do not. While dividend payout ratios may have declined over time, Dr. Morin has provided no evidence that such a trend will continue into the future. In response to Staff IR DPS-243, Dr. Morin stated that he has no idea what Con Edison's dividend policy will be in the future. Given his stated uncertainty whether Con Edison, a utility with one of the highest dividend payout ratios of all utilities, will be lowering its payout ratio, it is unclear how it can be assumed for all utilities in general. Further, in response to Staff IR DPS-244, Dr. Morin provided a study which shows that dividend per share growth has been 7.1% per year over the

past five years and 3.1% over the past ten years. These results indicate that dividend growth has not been stagnant. The expected dividends of each utility in the proxy group should be used in the DCF calculation.

Q. On page 20-21 of his testimony, Dr. Morin states that the DCF model understates the cost of capital due to dividend timing issues. Is that a concern with your methodology?

A. No. The first year of dividends in our model is assumed to be 2008. Given that we used stock prices from the first half of 2007, the dividends we assumed in the first year would be collected approximately one year in the future.

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

A. Yes they do. The average and the median are similar, and all except one of the 29 results fall within two standard deviations of the average.

CAPITAL ASSET PRICING MODEL METHODOLOGY

Q. Please describe the methodology used to determine your CAPM results.

A. The principle behind the CAPM theory is that the

level of systematic risk for an asset determines the level of return that investors will require to invest in that asset. We have used two different CAPM methods (the traditional and "zero beta") to estimate the cost of equity. The CAPM result is the average of the two estimates.

Q. Why are two CAPM methods used?

A. Research has shown that the CAPM can possibly underestimate the required return when betas are below 1.0. By using a "zero beta" methodology as well, such a tendency can be addressed by averaging in a result which is only partially determined by the beta used.

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

A. The traditional CAPM method calculates a required return based on three inputs: The rate of return on a risk-free investment (Rf), the level of systematic risk for an investment (B, known as the "beta"), and the expected risk premium of the market. (Rp). The calculation can be represented as:

Required Return = Rf + (B * Rp)

Q. How did you determine the risk-free investment rate and what was your result?

A. We have averaged the 10-year and 30-year Treasury bond yields for a recent six-month period. The result for the six-month period ending June 2007 is 4.83%.

Q. Is this how Dr. Morin calculated the risk-free rate?

A. No it is not. Dr. Morin used only the 30-year Treasury bond yield, which results in a somewhat higher risk-free rate and thus higher CAPM results.

Q. How did you determine the beta for the CAPM?

A. We used the average beta of the proxy group, as reported by *Value Line*. The average beta of our proxy group is 0.93.

Q. How did you determine what risk premium to use and what was your result?

A. The risk premium is the difference between what the expected return on common stock is and the rate on a risk-free investment. In order to determine the expected market return, we have utilized Merrill Lynch's *Quantitative Profiles* (Exhibit___(FP-9). That publication currently

estimates the required return for the market to be 10.85% (using an average of Merrill Lynch's "Implied Return" and "Required Return" methods). Given our risk-free rate of 4.83%, a market risk premium of 6.02% is calculated.

Q. Is this how Dr. Morin calculated the market risk premium?

A. No. Dr. Morin used a market risk premium of 7.6%. This premium was the result of blending two estimates for the market risk premium; a historical market return using Ibbotson Associates data (7.1%), and a forward-looking return using *Value Line* stock data (8.1%).

Q. Do you have any concerns regarding the use of those market risk premiums?

A. Yes. Dr. Morin’s use of a 7.1% historical risk premium (based on Ibbotson Associates financial data that goes back to 1926) does not reflect the current investing climate. It is an average of return differentials between bonds and the stock market over periods much different than today. Many in the financial community believe that the equity risk premium has been decreasing over time and is currently very low. For

instance, Jeremy Siegel, in "*The Shrinking Equity Premium*", The Journal of Portfolio Management, Fall 1999, articulated this view (See Exhibit___(FP-10). As a result, there is a debate concerning the relevance of the Ibbotson data in today's markets.

Q. Did Dr. Morin consider any other historical or forward looking market return studies that estimate the market risk premium?

A. Yes. In response to Staff IR DPS-246, Dr. Morin referenced some studies, including a 2000 published work by Dimson, Marsh and Staunton that reported historical risk premium returns for many countries. They reported an average risk premium over long-term bonds for 12 countries for the period 1900-2000 of 5.6%, with the United States at 7.0%.

Q. Are you familiar with this work done by Dimson, Marsh and Staunton?

A. Yes. However, there is more current research from 2006 by Dimson, Marsh and Staunton titled, "The Worldwide Equity Premium: A Smaller Puzzle," that includes market returns for the period, 1900-2005 (See Exhibit___(FP-11). This

research reports an average risk premium over long-term bonds for 17 countries at 6.1%, with the United States at 6.5%. This recent research is more relevant for developing a current market risk premium for the U.S., since it contains market return data through 2005. The market risk premium for the U.S. for 1900-2005 is 50 basis points lower than the risk premium for the U.S. for the period, 1900-2000.

Q. Were there any other risk premium studies referenced by Dr. Morin?

A. Yes, he also references work published in Financial Management by Harris, Marston, Mishra and O'Brien. This research estimated the market risk premium at 7.2% based on the period, 1983-1998. This is only a fifteen year period that does not incorporate any market returns subsequent to 1998. Given the large reduction in the risk premium due to recent market returns seen in the Dimson, Marsh and Staunton research cited earlier, this result is also suspect as a premium to apply in an equity costing model.

Q. Are there other historical or forward looking market risk premium studies that you are aware

of?

A. There are many research papers and surveys that attempt to estimate the market risk premium for the United States. Two well known and forward looking approaches are Duke University's CFO Outlook Survey and Merrill Lynch's *Quantitative Profiles*.

Duke University's Fuqua School of Business and *CFO* magazine compile the CFO Outlook Survey by interviewing Chief Financial Officers (CFOs) of companies and subscribers of CFO magazine around the world every March, June, September and December. This survey contains several questions that ask CFOs what their expectations are for the S&P 500 return over the next ten years. In the Spring 2007 survey, the mean expected return for the S&P 500 for the next ten years was 8.33%. Given that this was at a time when the annual yield on the 10-year Treasury bond was 4.8%, the resultant market risk premium is 3.5%. (See Exhibit___(FP-12).

Merrill Lynch uses a multi-stage dividend discount model to calculate an expected return for the S&P 500 in their monthly publication,

Quantitative Profiles. In the July 2007 issue the implied return for the S&P 500 was 10.8% (See Exhibit___(FP-9). Using a risk free rate of 4.8%, results in a market risk premium of 6.0%. Merrill Lynch's *Quantitative Profiles* provides a more accurate and up-to-date assessment of what today's investors require because it is based upon current expected market return, which takes into account only the current business climate.

Q. Has the Commission ever discussed the use of the Merrill Lynch estimate versus Ibbotson's historical data for calculating risk premiums?

A. Yes, in Case 95-G-1034, Central Hudson Gas & Electric Corporation, the Commission recognized the use of the Merrill Lynch estimate. In Opinion 96-28, dated October 3, 1996, the Commission said, "…the Judge's market return calculation based on Merrill Lynch data is a reasonable method of deriving a risk premium; and it avoids the problems of stale data in the Ibbotson estimate, or the circularity of the implied risk premium approach in relying on other commissions' return allowances." (page 14)

Q. On page 35 of his testimony Dr. Morin described his use of a forward looking market risk premium. Please comment on his approach?

A. For some reason, Dr. Morin is not willing to use expected dividend growth rates in his DCF methodology to determine future cash flows but is willing to use them to estimate expected returns. While using dividend growth forecasts can be a reasonable approach, Dr. Morin is using exceedingly high forecasts of dividend growth (11.27% per year) to set the expected market return. Once again, as with the Ibbotson Associates data, Dr. Morin has used a market risk premium that is far beyond what most independent researchers estimate. Informed investors would weigh all of the information available and make investment decisions based on that data, not rely on the one or two methods which result in the highest premium.

Q. Using your stated inputs, what was your "traditional" CAPM result?

A. 10.43%, calculated as follows:

4.83% + [0.93 * (10.85% - 4.83%)] = 10.43%

Q. Please describe how you calculated a rate of

return using the “zero beta” CAPM method.

A. The same inputs described for the traditional CAPM methodology were used. Instead of multiplying beta by the risk premium as shown in the calculation of the traditional CAPM methodology, we determined the risk premium for the proxy group by multiplying .75 times beta times the risk premium and adding .25 times the risk premium. This can be shown as follows: Required return = Rf + (.75*B*Rp) + (.25*Rp)

Q. What is the result of your zero-beta CAPM methodology?

A. 10.53%, calculated as follows: 4.83% + [.75*.93*(10.85%-4.83%)] + [.25*(10.85%-4.83%)] = 10.53%

Q. What CAPM result did you use in your calculation of the required ROE for the proxy group?

A. We averaged the results of the two CAPM methods to arrive at a result of 10.48%.

CREDIT QUALITY ADJUSTMENT

Q. Please describe the credit quality adjustment you propose.

A. Con Edison has a split rating, with an A1 Moody’s rating (which is equivalent to an A+

rating by S&P) and an A rating by S&P. The proxy group has an average rating of slightly higher than Baa2 (BBB for S&P). For the six months ended June 2007, we calculated the average bond yield for Aa, A, and Baa-rated long-term utility debt. The result was 5.84%, 6.00%, and 6.23%, respectively. We then assumed 5.97% for Con Ed (given its split rating) and 6.17% for the proxy group. Since Con Ed's debt cost is 96.76% of the proxy group's debt cost, we applied that ratio to the 9.04% ROE calculated for the proxy group as shown on page 3 of Exhibit___(FP-8). This resulted in an ROE of 8.75%, or 29 basis points lower than the proxy group return. The 29 basis points is our credit quality adjustment, which is approximately ten basis points per rating change notch.

Q. Did Dr. Morin propose a credit quality adjustment?

A. No he did not. Despite his proxy group having an average bond rating of between BBB and BBB+ and an average business profile score of 4.9, compared to Con Ed's A-rating and business

profile score of 2, he states on page 61 of his testimony that he assumed the risk of the proxy group was equal to the risk of Con Edison's electric operations.

Q. What justification did Dr. Morin provide for his failure to make a credit quality adjustment?

A. Dr. Morin states that although the Company has less business risk than the proxy group, Con Edison faces greater financial risk due to weak financial metrics and the need to raise capital.

Q. Is this reasonable?

A. No. As we discuss later, Con Edison's metrics, including the recommended debt ratio described earlier, are all within the A-rating range or better. Rating agencies have reviewed the risk of the companies in the proxy group and they are all riskier than Con Edison. In fact, Moody's has two of Dr. Morin's companies being rated below investment grade. These lower ratings are due to weaker financial metrics as well as other risks. If such risks lead bond holders to demand a higher return (as evidenced by higher debt costs for lower-rated debt), then surely stockholders would demand a higher return on

average.

ISSUANCE EXPENSES

Q. Do you agree with Dr. Morin's use of an issuance adjustment to cover the costs of issuing equity?

A. In this situation, we do. We are setting rates for the rate year ending March 31, 2009. Per Exhibit___(AP-12), $600 million of common stock issuances are planned during the rate year.

Q. Are you aware of any Commission rulings on this issue?

A. Yes. In an Order issued March 7, 2003 in Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation – Rates, the Commission stated, "…our policy has been to allow recovery of such expenses when they are incurred." (page 71) Since the expenses are reasonably expected to be incurred, we would allow recovery of such costs.

Q. Do you agree with Dr. Morin's methodology for calculating the issuance cost?

A. No, we do not.

Q. What adjustment do you propose?

A. The amount of equity the Company anticipates it will issue is $600 million. In previous

proceedings it has been estimated that issuance costs are approximately 3.0%. This is in-line with the amounts shown in Dr. Morin's Appendix B, page 3 and approximates such costs approved in previous Con Edison financings. Therefore, issuance costs of $18 million could be expected. $18 million is 0.20% of the common equity amount of $9.0 billion we believe supports CEI's utility operations (see Exhibit___(FP-3), Page 1, Column 9). Therefore, we propose to increase the cost of equity cost rate by 20 basis points. Doing so allows Con Edison to recover expected equity issuance costs in the rate year. Until rates are reset they would provide such recovery for future issuance expenses as well.

REVENUE DECOUPLING MECHANISM

Q. You have mentioned that you have an adjustment to the Company's ROE to account for the risk reduction provided by Staff's proposed RDM. Please explain why an adjustment is necessary.

A. Staff is proposing an RDM which would reconcile the Company's actual sales to the amount forecasted by Staff witness Liu. This would eliminate the risk of weather-related sales

variation from the sales forecast, as well as non-weather related usage per customer variations, and customer growth variations. By eliminating this uncertainty, the Company will have a safer risk profile than it currently does. Most importantly, only some of the companies in the proxy group used to calculate the cost of equity have an RDM. Further, many RDM's that are in existence are not reconciliations of total revenue forecasts. Given that Staff's RDM proposal makes Con Edison's risk lower than that of the proxy group (for which the ROE has been calculated), an adjustment is required.

Q. Have you attempted to quantify how much risk is avoided by the proposal?

A. Staff has estimated that if the weather was similar to that of 2005, where the summer was warmer than normal, the Company's revenues would be approximately $55 million higher than assumed in Staff's forecast. In addition, usage per customer could be higher due to numerous non-weather factors and more customers than predicted could be added to the system.

Alternatively, weather could be colder than normal, usage lower than expected, and customer growth could be lower. While costs would also vary under either scenario, they would do so only as a fraction of the revenue change.

Q. What impact could such revenue variation have on the Company's ROE?

A. If net income varied by $64 million due to weather, usage and customer growth variations, the impact on the Company's ROE would be approximately 100 basis points, assuming $6.4 billion of equity. Clearly, shareholders are being shielded from volatility and this reduction in volatility is a reduction in risk to shareholders. Given less risk, investors require a lower return.

Q. What adjustment are you proposing?

A. We propose a ten basis point reduction to the ROE.

Q. How have you arrived at this level of adjustment?

A. We have considered multiple ways to quantify how the reduction in risk brought about by the RDM would lower the Company's required ROE. One

possibility reflects that since most of the risk of a large fluctuation in net income is removed, it is quite possible that there could be a credit rating upgrade. As we discussed earlier, a one-notch rating change is equal to approximately a ten basis point change in expected return for shareholders. So a one-notch rating change due to the risk reduction provided by the RDM would mean a reduction in ROE of approximately ten basis points, while a two-notch rating change would result in a 20 basis point reduction.

Q. What other ways have you considered to quantify the impact of an RDM on the return of the Company?

A. Instead of an ROE adjustment, we could lower the equity ratio since not as much of an “equity cushion” is needed when the volatility of earnings is reduced. Adjusting the debt ratio upward by 2.7%, to 52.35%, (and thus the equity ratio downward by that amount), to have the ratio be in the center of S&P’s recommended range for an A-rated utility with a business profile score of “2”, would lower the Company’s

overall required return by nine basis points (from 7.25% to 7.19%). Such a change is approximately equal to lowering the ROE by 20 basis points. Therefore, it is possible that the return on equity could be reduced even further, given the risk reduction resulting from the RDM.

Q. Given your methods of quantifying the risk reduction, how did you arrive at a ten basis point adjustment?

A. These approaches to quantifying the change in required return due to an RDM indicate that 20 basis points could be reasonable, and possibly even higher.

However, we must measure the difference between the risk of the proxy group companies and the risk of Con Edison given Staff's recommendation. As was mentioned, a few of the companies in the proxy group have an RDM. While the exact nature of each RDM differs, this fact means that the adjustment needed to modify the proxy group ROE to fit Con Edison's risk level is less than the total adjustment to risk that an RDM brings.

We have estimated that the amount of risk difference between the proxy group and the Company is at a minimum ten basis points, and have reflected this adjustment in our ROE methodology. Should the Commission be inclined, it is our belief that an adjustment greater than ten basis points could be supported.

RETURN ON EQUITY METHODOLOGY RESULT

Q. Please explain how you arrived at your overall ROE for the proxy group.

A. We weighted the DCF model (8.33%) as two-thirds of the total and the CAPM average (10.48%) as one-third of the total to develop a return of 9.04%. We subtracted 29 basis points from this based on the credit quality adjustment we described earlier and then added 20 basis points to cover equity issuance expenses expected during the rate year. We then subtracted ten basis points to account for the risk reduction provided by Staff's proposed RDM. The result, 8.85%, was rounded to 8.9%.

Q. Is there precedent for relying on such a methodology when determining a utility's cost of equity?

A. Yes, the weighting of a DCF result as two-thirds and a CAPM result as one-third of the total equity cost has been approved by the Commission in a number of cases.

For example, in Case 95-G-1034, Central Hudson Gas & Electric Corporation, the Commission set the cost of equity based on a two-thirds DCF, one-third CAPM methodology, specifically rejecting any use of a risk premium analysis or a comparable earnings approach. In Opinion No. 96-28 in that case, in adopting the recommendation of the Administrative Law Judge that the ROE be based on the two-thirds DCF, one-third CAPM methodology, the Commission said, "The weight he assigned to the DCF analyses—as compared with the CAPM, comparable earnings, and risk premium methods—properly reflects our settled policies concerning the relative merits of these approaches." (page 13)

In the Rate Order in Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation - Rates, the Commission again set the cost of equity based on a two-thirds DCF, one-third CAPM methodology.

Q. Do you recommend that your ROE results be updated?

A. Yes we do. Our results should be updated at the time of the Commission decision in this proceeding based on then-available data.

STAYOUT PREMIUM

Q. Dr. Morin recommends a stayout premium of 30 basis points for a three-year rate plan. Do you propose that a stayout premium be applied to your results?

A. No we do not. We are testifying to the rate of return appropriate for a one-year rate case, for the rate year ending March 31, 2009.

FINANCIAL INTEGRITY

Q. Given your recommended overall after-tax rate of return of 7.25%, will the Company be able to maintain its financial integrity?

A. Yes it will. As we explain in further detail later, this recommendation results in financial ratios appropriate for an A-rated utility per S&P's guidelines.

RISK PREMIUM APPROACH

Q. One of Dr. Morin's cost of equity models is a risk premium approach. Do you agree with the

use of such a methodology in this case?

A. No we do not. The Commission has specifically rejected the use of a risk premium approach in the past. In Opinion No. 96-28, the Commission stated: "…we have avoided reliance on the risk premium approach because it reflects allowed returns which are an inferior alternative to a direct estimate of a company's own cost of equity." (page 13) As we previously quoted, the Commission in that Opinion also discredited the methodology due to the circularity of using other commissions' return allowances in setting the return for a New York utility. Finally, because the CAPM relies on the market risk premium, it would be redundant to rely on another risk premium approach.

Q. Do you have any other comments regarding Dr. Morin's risk premium approach?

A. For both Dr. Morin's historical risk premium and allowed risk premium we have concerns that he is taking risk premiums of a group of companies and applying the results to Con Edison regardless of any differences in credit quality, regulatory environment or numerous other factors.

Q. Please explain your concern regarding Dr. Morin's use of a historic risk premium.

A. Dr. Morin has made the assumption that the actual returns from 1931 through 2002 for a group of electric utilities less the income return from long-term Treasury bonds over the same time period is a reasonable proxy for the return expected by investors in Con Edison's electric business in 2008-2009 relative to Treasury bonds. On page 23 of his testimony, Dr. Morin has described the electric industry as "rapidly changing". So much so that, in his estimation, the use of the DCF method is problematic at this time.

Dr. Morin offered no studies or analyses to determine the extent to which Con Edison is more or less risky than the average electric utility contained in *Moody's Electric Utility Index* for the period of 1931 to 2002. This is especially important given Con Edison's above-average credit rating.

Dr. Morin has provided no studies or analyses to determine the extent to which the risks of Treasury securities have remained at

the same level relative to the risks of the electric utility stocks contained in the Moody's data.

Q. Do you have similar concerns regarding Dr. Morin's allowed risk premium?

A. Yes. Dr. Morin's analysis is flawed on many levels. As can be seen in his response to Staff IR DPS-240, part B, there is no attempt to factor in the average risk level of each utility, such as looking at companies with similar credit ratings to Con Edison. Many of the returns listed could be for multi-year cases, not the allowed return in a one-year case. These multi-year cases no doubt contain stayout premiums, similar to the one advocated by Dr. Morin in his testimony. In addition, there are numerous variables that can lead to a company getting a higher return in a negotiated settlement, such as the level of expense reconciliations allowed or the sales forecast that is agreed to.

In summary, Dr. Morin has offered no support for the theory that the risk premium approach he advocates is applicable to Con

Edison and that the risk premium hasn't changed over time. We recommend that the Commission reject the use of such a risk premium approach to calculate the appropriate cost of equity for Con Edison.

CREDIT QUALITY ISSUES

Q. Company witness Hoglund states on pages 4 though 5 of his testimony that, "Raising capital will be challenging, particularly if the Company will be seeking these large amounts of capital from investors while offering weak credit protection measures for debt investors and substandard returns and prospects for stock investors." Do you believe the Company will face such challenges?

A. No we do not. We agree that it is important for Con Edison to have access to the financial markets at reasonable terms. Our capital structure and cost rate recommendations, along with other Staff recommendations, are consistent with this objective because they produce financial parameters consistent with an "A" bond rating. Further, our return recommendation is based on how such returns have been determined

by the Commission in the past. Such decisions have always allowed utilities to access capital at reasonable terms.

Q. On page 7 of his testimony, Mr. Hoglund states that credit rating agencies have "…recognized the risks in New York: weak underlying cash flows, a relatively smaller equity cushion for debt investors and equity returns that have consistently been below average and have been declining faster than in other states." Do you believe that such concerns will be applicable for Con Edison investors during the rate year?

A. No, we do not. As Con Edison has pointed out in response to a Staff IR DPS-263, the Company's financial ratios are expected to be in the A-rated to even AA-rated range during the rate year. The "equity cushion" for Con Edison has recently been larger than the U.S. average, per Mr. Hoglund's testimony, and our recommendation is in-line with other investment-grade utility equity ratios. Finally, equity returns in New York have been largely the product of Joint Proposals approved by the Commission and reflect the risks of each multi-year rate order as well

as the declining cost of capital throughout the economy as evidenced by historically low interest rates in recent years.

Q. Regarding cash flow ratios, please explain why you believe Con Edison's will be adequate to maintain access to reasonably priced capital.

A. As Mr. Hoglund points out on page 6 of his testimony, for each credit rating, utilities are allowed to have more debt and less cash flow than industrial businesses. Further, with S&P, the safer the utility investment, the more relaxed the requirements are. Mr. Hoglund points out on the same page that Con Edison's business profile score of "2" means that it is rated the safest of the 25 largest utilities in the U.S. For each credit rating and business profile score, S&P publishes recommended financial ratio ranges. Their most recent recommendations are included in Exhibit___(FP-4).

Q. What are those recommendations for a company such as Con Edison, which is A-rated and has a business profile score of "2"?

A. For the Funds From Operations (FFO)/Interest

Coverage ratio, the recommendation is 2.0x to 3.0x, with a higher number indicating a more credit-worthy company, all else equal. According to Mr. Hoglund's response to Staff IR DPS-263, in 2006 Con Edison had a ratio of 3.0x. For the rate year ending March 31, 2009, the Company's rate proposal would result in a ratio of 4.1x. So the ratio is already at the top of the A-rated range, and the Company's rate increase would put it above the AA-rated range (which is 3.0x to 4.0x for an AA-rated utility with a business profile score of "2").

For FFO-to-Total-Debt, Con Edison was at 13.8% for 2006 and is forecasting 18.1% for the rate year ending March 31, 2009. The guidelines for an A-rated company are 12%-20% (with the higher the number being considered more desirable). During the course of the rate year, S&P is predicting the Company will be at the top of the recommended A-range.

We fail to see how the Company's financial ratios would be considered weak by the investment community.

Q. You stated that your equity ratio recommendation

is reasonable. Please elaborate.

A. The third critical financial ratio S&P considers is Total Debt to Total Capital. According to Mr. Hoglund's response to Staff IR DPS-263, the Company's proposal would result in Con Edison having a ratio of 51.6%. Staff's proposed capital structure adjustment would increase this to approximately 52.3%.

As seen in Exhibit___(FP-4), S&P's guidelines call for an A-rated company with a business profile score of "2" to be in the 52% to 58% range, with the lower the number in that range, the better. An AA-rated company with the same business profile score is expected to be in the 45% to 52% range, which is what the Company is requesting.

Q. In his Exhibit RH-1, page 1, Mr. Hoglund has provided a chart showing the equity ratios allowed in cases throughout the country since 1992. How does the Finance Panel's recommendation compare to this data?

A. In response to Staff IR DPS-265, Mr. Hoglund stated that the authorized equity ratios for 2004, 2005 and 2006 were 46.96%, 46.58%, and

50.07%, respectively. The average equity ratio allowed over the previous three years was 47.87%. Our recommendation, 47.98%, is slightly higher than the three-year average. As Mr. Hoglund indicated in response to Staff IR DPS-265, the Commission set rates using a 48% equity ratio for each of the current Con Edison rate plans (electric, gas and steam).

Con Edison's current rate plan was approved in 2005, when the average equity ratio approved in the U.S. was 46.58%, according to Mr. Hoglund. We fail to see how investors in Con Edison securities were provided a lower "equity cushion" when the equity ratios approved for Con Edison's operations between 2004 and 2006 were higher than the U.S. average over the same time period.

Further, Con Edison was provided these 48% equity ratios despite the fact that the Company is one of the safest utilities in the country, as Mr. Hoglund has pointed out on page 6 of his testimony. As the S&P ratio guidelines show, the riskier the business, the more equity needed to maintain a given credit rating.

Our recommendation of a 47.98% equity ratio is in-line with what other utilities are currently expecting (as discussed in our capital structure testimony), is well-within S&P's guidelines for an A-rated company with Con Edison's business profile score, and a nearly identical equity ratio has been in place at Con Edison's utility divisions for several years with no resultant credit downgrade or loss of access to reasonably priced capital.

Q. You stated earlier that you do not believe that returns in New York are substandard. Please explain.

A. Mr. Hoglund provided information, in Exhibit RH-1, page 2, showing allowed returns on equity for utilities from 1992 though 2006. In response to Staff IR DPS-266, he stated that the data shows that New York's returns are below the national average and the spread between New York returns and the national average has increased by 29 basis points over the past 15 years.

However, in response to Staff IR DPS-267, Mr. Hoglund stated that for each of the allowed returns he graphed, he does not know the term of

the rate plan approved, any sharing thresholds allowed, what levels of expense reconciliation were allowed, how robust the sales forecasts were relative to historic growth, what the allowed debt cost was, nor the credit rating of the company.

Q. Why do you consider such information important?

A. On page 8 of his testimony, Dr. Morin explained a basic tenet of financial theory, the level of return an investor in a utility should expect is related to the level of risk in the investment. The return allowed for a BBB-rated company that enters into a five-year rate plan which provides no expense reconciliations, includes a 35% equity ratio, has extremely aggressive sales forecasts, and whose initial rate year revenue is equal to a historic test year should be higher than the return allowed for an A-rated company in a one-year rate case based on forecasted rate year expenses with several expense reconciliations, a 48% equity ratio, and with a sales forecast that is not very aggressive.

Knowing only the allowed return of a rate

plan and not the underlying risk of the plan ignores critical information needed to assess allowed returns and will not result in a rational conclusion about such allowed returns.

Q. Are there valid reasons why returns in New York might be below the average return in the U.S.?

A. Certainly. Regulatory support in New York may lead to New York utilities being considered less risky than other utilities by investors. In addition, the bond rating of New York utilities no doubt leads to lower capital costs. Of the sixty electric utilities followed by Value Line, only ten are rated above BBB+. Two of those companies, Con Edison and Central Hudson Gas and Electric, are New York companies. The other New York firm followed by Value Line, Energy East, has a BBB+ bond rating. All of the major electric companies in New York have a business profile score of “2” or “3”, indicating they are involved in the least risky of all utility operations. The New York utilities do not own substantial amounts of generation, which is considered riskier than just distribution assets.

Additionally, investors may feel that regulatory policies in New York lead to better protections against non-regulated activities having a negative impact on a utility, thus leading to lower required returns.

Q. Are there valid reasons why the gap between returns allowed in New York and those allowed in the rest of the country might have diverged over the past 15 years?

A. Absolutely. In 1992, most utilities in the US were at least A-rated. Now, less than 20% of parent companies are. While the national average bond rating has declined (thus indicating an increase in risk to investors), most New York companies are still A-rated. Since 1992, most generation assets, including all nuclear plants, have been sold off by New York utilities. This has resulted in New York companies which are less risky than they were in 1992. So the difference in risk between the average U.S. utility and New York utilities has grown. A rational result of this is that the amount of additional return required by investors in the non-New York utilities has

increased relative to the amount required by investors in New York utilities.

Q. Is there any other aspect of Staff's testimony which will impact the Company's creditworthiness?

A. Yes. Staff's proposed RDM lowers the risk profile of the Company. This may lead to a change in the Company's S&P business profile score to "1". It may also lead to a credit rating upgrade, as the risk to bondholders would be dramatically lowered should the RDM be adopted as proposed by Staff.

Q. On page 13 of his testimony, Mr. Hoglund discusses potential cost impacts if the Company is downgraded from an A-rating to a BBB-rating. Is this a cause for concern?

A. No, it is not. First, as we have previously discussed in detail, Con Edison's financial ratios will support an A-rating. Even if a rating downgrade were to occur, they usually occur in one-notch increments, for instance a change from "A" to "A-", or "A-" to "BBB+". The $6 million figure cited by Mr. Hoglund is approximately the impact of raising Con Edison's

allowed ROE by 6 basis points. So, if an 11.5% ROE is required in order to maintain an A-rating, customers will be paying more than $250 million more than they would with an 8.9% return. Maintaining an unnecessarily high ROE in order to maintain a bond rating is not cost efficient.

Q. Mr. Hoglund expressed concern, on page 16 of his testimony, that a "…continuing downward trend in the financial aspects of Commission adopted rate plans…" could lead to difficulties in raising capital. Do you find such concerns warranted?

A. No we do not. The financial aspects Mr. Hoglund is referring to are based on Commission-approved rate orders adopting Joint Proposals which reflect a balancing of many issues, including but not limited to financial matters. Further, while ROE's may have declined recently, this should be expected, as interest rates are in historically low ranges. Further, as Mr. Hoglund shows in his Exhibit RH-1, page 2, ROE's for utilities across the U.S. have been declining.

As Mr. Hoglund states in response to Staff

IR DPS-263, the Company has raised approximately $5.2 billion through external financing from 2004 to 2006. This was done at terms similar to the costs incurred by other utilities throughout the country. The Company has not shown that it is not able to raise capital at reasonable rates or that it will not be able to in the future.

Q. Does this conclude your testimony at this time?

A. Yes it does.