STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York for Electric Service	Case 07-E-0523

DIRECT TESTIMONY AND

EXHIBIT

OF

TARIQ N. NIAZI

Dated: September 7, 2007
Albany, New York

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TABLE OF CONTENTS

Q. Please state your name, title and business address.

A. Tariq N. Niazi, Chief Economist, New York State Consumer Protection Board ("CPB"), Suite 2101, Five Empire State Plaza, Albany, New York 12223.

Q. Mr. Niazi, please summarize your background and experience.

A. I passed my candidacy examination, completed all required course work and passed all comprehensive examinations in the Doctoral Program in Managerial Economics at Rensselaer Polytechnic Institute. I have a Master's Degree in Economics from the State University of New York at Albany. I also received a Master's Degree in Public Administration from Punjab University in Pakistan and a Bachelor's Degree in Economics and Political Science at Forman Christian College in Pakistan.

I have been employed by the CPB since March 1981, first as an economic consultant and then as a rate analyst. Later, I was promoted to the position of Principal Economist. I was appointed to my present position in October 1990. I have worked on numerous issues in electric, gas, telephone and water proceedings. My responsibilities are in the areas of economic and financial analysis, rate design, policy analysis, cost of service, tariff analysis and cost of capital.

I serve as the CPB's representative at the New York Independent System Operator ("NYISO"). The CPB has been designated by the NYISO as the statewide consumer advocate and is a formal voting member of the NYISO's decision making committees. I also represent CPB on the Natural Gas Reliability Advisory Group as a consumer representative. I am also a member of the New York State Energy Research and Development Authority's System Benefit Advisory Group.

Q. Have you previously testified before the New York State Public Service Commission?

A. Yes. I have testified in numerous proceedings before the Commission.

Q. What is the purpose of your testimony?

A. My testimony has two parts. In Part I, I demonstrate that Consolidated Edison Company of New York, Inc.'s ("Con Edison" or the "Company") requested return on equity of 11.2% for its electric business is overstated and that the Company's current cost of equity is 9.0%. I also respond to several assertions made by the Company in support of its return estimate and identify several errors in its presentation.

In Part II, I address the Company's rate design proposal regarding customer charge increases to SC1 and SC 7, and recommend that these charges not be increased.

Q. Have you prepared an exhibit for your testimony?

A. Yes. I am sponsoring Exhibit ___ (TNN), consisting of two schedules.

PART I - RATE OF RETURN ON EQUITY

Q. What return on common equity is Con Edison requesting for its electric operations?

A. Con Edison is requesting a return on common equity of 11.2%. Its recommendation is based on averaging the results of multiple estimates from three different methods: 1) an average of 10.9% using the discounted cash flow method ("DCF") based on four different estimates ranging from 10.4% to 11.4%; 2) an average of 12.1% using the capital asset pricing model ("CAPM") based on two estimates of 12.0% and 12.2%; 3) and an average of 10.7% using the Risk Premium method based on two estimates of 10.7%. In addition, Con Edison is recommending a 0.3% premium for committing not to seek further rate increases for three years. As I discuss in my testimony, the equity returns based on the DCF and the CAPM methods are vastly overestimated and should be rejected, while equity returns based on the Risk Premium method should be

discarded as the use of this method has been repeatedly rejected by the Commission. Finally, a premium for an extended stay out, should also be rejected at this time.

Q. What is your recommended rate of return or capitalization rate for Con Edison?

A. I recommend a total equity return of 9.0% for Con Edison. My equity cost estimate is based on application of the DCF and CAPM methods to a proxy group of electric and combination electric and gas companies with investment grade debt ratings by Moody's and Standard & Poor's. This rating criterion is different from the "A/A" rated proxy group for combination electric and gas companies reflected in the Recommended Decision in the Generic Finance Case (91-M-0509). As explained below, this change in the rating standard is appropriate and necessary to arrive at a proxy group of sufficient size to obtain reliable results. In other respects, my approach is consistent with the Recommended Decision in the Generic Finance Case.

The DCF approach applied to the proxy group results in a median equity cost estimate of 8.28%. The CAPM approach applied to the same proxy group produces an equity cost of 10.06% for the traditional CAPM and 10.27% for the zero-beta CAPM. The average of the two CAPM methods results in an equity return of 10.17%. The CAPM analysis is based on a 10.9% market return, a .86 proxy group beta, a risk free rate of 4.87% and a risk premium of 6.03%.

Applying weightings of 2/3 to the median DCF result and 1/3 to the average of the CAPM results, in accordance with the Recommended Decision in the Generic Finance case and the Commission's decision in several cases,[1] I arrive at an equity return of 8.91% for Con Edison's electric operations.

A. Proxy Group

Q. How did you select the proxy group companies for your analysis?

A. I used the following criteria in selecting the electric proxy group: 1) each company must be listed by Value Line as an electric utility company composed of electric or combination electric and gas distribution companies; 2) each company must have investment grade debt rated by Moody's and Standard & Poor's; 3) over 70% of each company's total revenues must be derived from regulated utility operations; and 4) the company should not be involved in merger/acquisition activity.

Based on the stated criteria, I started the selection of the proxy group by looking at all 60 electric and combination electric and gas companies listed by Value Line. I used the latest issues of the Value Line Investment Survey dated June 1, 2007, June 29, 2007 and August 10, 2007 listing electric utility

[1] See, most recently, Case 05-E-1222, New York State Electric & Gas Corporation, Order Adopting Recommended Decision with Modifications, August 23, 2006, and Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation, Order Adopting Recommended Decision with Modifications, March 7, 2003, p. 72.

companies in the Eastern, Central and Western states respectively. In step two, I discarded any company that was rated below investment grade by either Moody's or Standard & Poor's. As a result of this screen, thirteen companies rated below investment grade were discarded, leaving 47 companies in the proxy group. Next, I reviewed the level of regulated operations of the 47 companies with an investment grade debt rating in the proxy group, discarding companies with less than 70% of total annual revenues derived from regulated utility operations. As a result of this criteria, an additional sixteen companies were excluded from proxy group, leaving 31 companies. I further discarded Energy East Corporation from the proxy group as it is in the process of being acquired by Iberdrola SA, as well as El Paso Electric since it is not paying any dividends. The proxy group that I have used for my analysis is comprised of 29 companies as shown in Exhibit__ (TNN), Schedule 1.

Q. Why did you not follow the criteria established in the Generic Finance Case for the selection of the proxy group?

A. It has become virtually impossible to follow the criteria for selecting proxy groups established in the Generic Finance Case. Since the Return on Equity

Consensus Document [2] (dated June 2, 1993) and the Recommended Decision

[2] Prepared by Signatory Members of the Electric and Gas Industry Group that included the

in the Generic Finance Case (dated July 19, 1994) were issued, significant changes have occurred in the electric industry in terms of debt ratings and the level of regulated utility operations. When the Return on Equity Consensus Document was issued, there were 33 electric and combination electric and gas companies that were rated "A/A" by Moody's and Standard & Poor's. That number has now dwindled to eight companies, three of which have regulated revenues less than 70% of total revenues. In other words, only five companies would make the proxy group based on "A/A" rating as established in the Generic Finance Case. That is not a large enough sample on which to establish a reliable estimate of the cost of equity.

Q. Did the Generic Finance Case establish a level of regulated operations for inclusion in the electric proxy group?

A. No. The only criteria established in the Generic Finance Case for the electric company proxy group was that all companies included must have senior debt rated in the "A" category by Moody's and Standard & Poor's.[3] Presumably, most electric utilities at that time had exclusively regulated operations; hence this was not an issue. However, the Generic Finance Case did address the issue of regulated versus unregulated operations in regards to the establishment of the

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Department of Public Service and all New York utilities including the Consolidated Edison Company of New York, Inc.

gas proxy group composed of "pure play" gas distribution companies. It required that over 96% of each company's total revenues must be derived from gas utility operations.[4]

B. Discounted Cash Flow Model

Q. How did you arrive at your DCF equity return estimate for Con Edison?

A. I applied a two-stage DCF growth model to the proxy group. This is the same model that was developed in the Generic Finance Proceeding and was adopted by the ALJs in their Recommended Decision. It has been consistently relied upon by the Commission for over a decade, including the recently concluded New York State Electric & Gas Corporation Proceeding (Case 05-E-1222). As shown in Exhibit__ (TNN), Schedule 1, page 3 of 3, this resulted in a median equity return of 8.28% for Con Edison.

Q. Could you please briefly describe the DCF method that you applied?

A. Yes. The DCF method is a market based approach that determines the return on equity from the investor's perspective. The familiar DCF formula is:

$$P_0 = \frac{D_1}{\quad}$$

[3] Id. , at 6.
[4] Id.

k-g

This fundamental equation states that a rational investor equates the current market price (P_0) of a stock to the expected future returns from that stock. Future returns from the stock are the expected stream of dividends discounted at the market-required return (k), net of the effect of growth (g). D_1 is the first year dividend.

Since the capitalization rate is not directly observable, the basic idea of the DCF approach is to derive the cost of equity from the observed share price and an estimate of investor expected future dividends. This is based on the intuitive concept that dividends plus capital appreciation reflect the investor's total expected return.

The DCF formula can be rewritten by solving the above equation for the cost of equity (k).

$$k = D_1/P_0 + g$$

In terms of the rewritten DCF formula, the cost of equity (k) is equal to the sum of the expected dividend yield (D_1/P_0) and the expected growth rate of future dividends (g).

Q. What is the first component of the DCF formulation [($k = D_1/P_0 + g$)]?

A. The first component of the DCF formulation is the expected dividend yield

(D_1/P_0). It is the quotient of the expected future dividends and the current stock price. A stock's dividend yield, in comparison with the dividend yield of other stocks, indicates whether it is an income or a growth asset. For example, bonds generally have high yields and low growth, and are hence considered income assets. Conversely, common stocks of growing firms have low yields and high growth, and are generally considered growth assets.

Q. What is the growth term (g) in the standard DCF formula?

A. The growth term in the DCF formula represents the growth in the value of the firm's common stock as reflected through dividend and stock price increases. The DCF approach assumes that the firm is operating in a "steady state." If the steady state holds, the growth rates in earnings per share, dividends per share and book value per share are the same, and are a product of the retention ratio and the expected return on equity.

In reality, it is not possible to achieve a “true” steady state. Thus, book value per share, dividends per share and earnings per share generally grow at different rates that may all differ from the growth rate indicated by the retention ratio and expected return on equity.

Q. How did you estimate the two-stage proxy group DCF equity return for Con Edison?

A. I estimated the two-stage proxy group DCF equity return, relying on the model

used in the Generic Finance Proceeding by the Electric and Gas Industry Group. The six-month average prices for the companies in the proxy group are the average of the monthly high and low closing price of each stock. I used the period February 1, 2007 to July 31, 2007. The other data, including dividends per share, earnings per share, book value per share and the shares of common stock, are all taken from the June 1, 2007, June 29, 2007, and August 10, 2007 issues of the Value Line Investment Survey. As shown in Exhibit__ (TNN), Schedule 1, page 3 of 3, the median equity return based on this method is 8.28%.

C. Capital Asset Pricing Model

Q. What were the results of your application of the CAPM methodology to estimate Con Edison's equity return?

A. The CAPM produced a required return on equity of 10.06% for the traditional CAPM and 10.27% for the zero-beta CAPM approach. The average of the two CAPM approaches resulted in an equity return of 10.17%. Exhibit__ (TNN), Schedule 2 provides a detailed explanation of the calculations used to determine the equity return under the CAPM.

Q. Have you used the same CAPM methodology that was adopted in the Generic Finance Case?

A. Yes. The only difference is the use of Merrill Lynch based expected return

rather than one based on historic data from Ibbotson Associates. Once again, the Commission adopted this change from the Generic Finance methodology over a decade ago and has consistently relied upon it. In Case 05-E-1222, the Commission said the following:

> As for the CAPM, NYSEG's reliance on the historic Ibbotson data and a DCF of the S&P 500 to estimate the market return is rejected. The historic Ibbotson data is inconsistent with more recent forward-looking Ibbotson estimates and the S&P 500 DCF relies upon the single growth DCF model which the Commission has not employed for over a decade.
>
> (Order Adopting Recommended Decision with Modifications, Issued and Effective August 23, 2006, at 96.)

Q. Please briefly describe the CAPM approach for estimating equity returns.

A. The CAPM formally describes the trade-off between risk and required return for securities. The equation below illustrates that the rate of return required by investors (Rc) consists of a risk-free return (Rf), plus a premium compensating investors for bearing the risk commensurate with the stock's market risk (Beta) and the market price of risk (Rm - Rf). The risk premium varies from stock to stock. The traditional CAPM formula is stated as:

$$Rc = Rf + Beta\ (Rm - Rf)$$

A basic premise underlying the CAPM is that there is less risk associated with an investment in a relatively stable stock than in the stock of a small

speculative venture. As a result, investors in a speculative venture stock will require higher returns than investors in a stable stock, because they are assuming additional risk. The CAPM quantifies the additional return investors require for accepting this higher risk.

Q. Please describe Exhibit__ (TNN), Schedule 2.

A. Exhibit__ (TNN), Schedule 2 consists of two pages. Page 1 shows the traditional CAPM formula used to derive the required return for the proxy group, while page 2 shows the zero-beta CAPM application. The required return is the sum of the risk-free rate and the market-risk premium adjusted using the proxy group average beta.

Q. How did you determine the risk free rate, market return and beta used in this analysis?

A. To determine the risk-free rate, I used a six-month average ending July 31, 2007 of 30-Year and 10-year Treasury Bond Yields as reported by the Federal Reserve Board. (Federal Reserve Statistical Release, Historical Data) That average is 4.87%.

The beta of 0.86 used to adjust the market risk-premium was derived from the proxy group as the average of the individual company betas as reported by Value Line. These are the same electric and combination electric

and gas proxy group companies used for the DCF analysis.

The market return of 10.9% I have used is based on the August 10, 2007 issue of Merrill Lynch Quantitative Profiles - Monthly Insights for Equity Management. The 10.9% estimate is the implied return for a portfolio of 1,168 firms.

The risk premium was derived by subtracting the risk-free rate of 4.87% from the market return of 10.9%, resulting in a risk premium of 6.03%.

Incorporating all variables in the respective formulas, indicates a required return of 10.06% for the traditional CAPM approach and 10.27% for the zero-beta CAPM approach, as shown in Exhibit__(TNN), Schedule 2, page 1 and 2 respectively. The average of the two CAPM approaches results in an equity estimate of 10.17% ((10.06% + 10.27%)/2).

D. Overall Recommendation

Q. What is your estimate of equity cost for Con Edison?

A. I estimated the cost of equity by applying the 2/3 DCF – 1/3 CAPM weighting consistently used by the Commission and also recommended by the Judges in the Generic Finance case. My median DCF estimate is 8.28% and my average CAPM estimate is 10.17%. With the DCF estimate given 2/3 weight and the CAPM estimate given 1/3 weight, the resulting return before any adjustment, is 8.91%.

Q. Did you make any adjustments to the estimated equity return for Con Edison?

A. Yes. I have adjusted the estimated return of 8.91% for credit quality. Con Edison is rated A by Standard & Poor's and A2 by Moody's both of which fall in the middle of the "A" rating. The median bond rating of the proxy group I have used is Baa2 by Moody's and BBB+ by Standard & Poor's. While the Baa2 rating by Moody's is in the middle of the "B" rating the BBB+ by Standard & Poor's is on the high end of the "B" rating. To account for the differences in the bond ratings of the proxy group and Con Edison, I have looked at the difference in A-rated and Baa/BBB-rated long term public utility bond yields. Over the six-month period from February 2007 to July 2007, A-rated utility bond yields averaged 6.05%, while Baa/BBB-rated utility bond yields over the same period averaged 6.23%. I have taken 12 basis points or two-thirds of the 18 basis points difference between A-rated and Baa/BBB-rated long-term utility bond yields as the basis of my credit quality adjustment. I have not used the entire difference in bond yields between "A" and "Baa/BBB" rated utility bonds recognizing that the Standard & Poor's rating of my proxy group is on the high end of the "B" rated category. Subtracting 12 basis points from my earlier estimate of 8.91% as Con Edison equity return results in an equity return estimate for Con Edison of 8.79% after applying the credit quality adjustment.

Q. Are you proposing an issuance adjustment for the costs of equity issuance during the rate year?

A. Yes. Company Exhibit_ (AP-12), shows that the company will be issuing $600 million of equity during the rate year. Based on the method approved in the Generic Finance Case and relied upon by the Commission in subsequent proceedings, I have estimated an equity issuance allowance of 21 basis points. Based on issuance costs of approximately 3.0% that is consistent with previous company equity financing, I have estimated an issuance cost of $18 million. The average common equity balance as reported by the Company in Exhibit_ (AP-11), Schedule is approximately $8.6 billion. The $18 million issuance cost is approximately 0.21% of the $8.6 billion common equity balance.

Adding 21 basis points to my equity return estimate after credit quality adjustment of 8.79% results in a final equity estimate of 9.0%.

Q. Have you made an adjustment to your equity return recommendation for a multi-year rate plan?

A. No, not at this time. I recommend that the Commission establish an equity return for one year. The CPB is not willing to suggest a longer-term return rate based on Con Edison filed plan, which it does not support as presented, and cannot speculate about the duration of any plan that may ultimately result from this proceeding. Should a comprehensive and balanced multi-year rate plan be

addressed in negotiations, the CPB would be willing to discuss the appropriateness of an adjustment to its calculated equity return for a multi-year stay out.

Q. Have you estimated the revenue impact of your 9.0% equity return recommendation as compared to the Company's 11.2% equity allowance request?

A. Yes. Based on the Company's response to NYC Interrogatory No. 6, an increase/decrease of 100 basis points in equity return has a revenue requirement impact of approximately $112 million. Since the difference between my equity return estimate of 9.0% and Con Edison's request of 11.2% is 220 basis points, Con Edison's electric customers would save approximately $246 million if my recommendation is adopted.

E. Analysis of Consolidated Edison's Equity Return Proposal

Q. Please briefly describe how the Company estimated its proposed cost of equity of 11.2%.

A. Company Witness Dr. Roger Morin recommends an equity return of 11.2% based on the use of three different methods. The three methods he uses are DCF, CAPM, and Risk Premium. As shown in Exhibits RAM-5, RAM-6, RAM-7 and RAM-8, Dr. Morin estimated four separate DCF equity returns using

different combinations of proxy groups and growth rates. Dr. Morin's DCF calculations resulted in equity returns ranging from 10.2 % to 11.2%. He then added 20 basis points for flotation costs to all four of his DCF estimates bringing his equity return estimates ranging from 10.4% to 11.4%. Second, he used the CAPM approach that produced equity returns of 11.7% and 11.9% for the traditional and zero-beta CAPM, respectively. Dr. Morin then added 30 basis points for flotation cost, bringing his CAPM estimates to 12.0% and 12.2% for the traditional and zero-beta CAPM respectively. Third, Dr. Morin used two Risk Premium analyses, both resulting in estimates of 10.4% equity return. He again added 30 basis points for flotation cost bringing his Risk Premium equity estimate to 10.7%

Q. Do you agree with the Company's approach in estimating its equity return?

A. No. Dr. Morin's estimates should not be relied upon. His DCF analysis is not consistent with the Recommended Decision in the Generic Finance Case, as well as the numerous PSC decisions based on that methodology, and results in estimates that are overstated. His CAPM estimate is based on the use of completely unrealistic market returns and is also overstated. Moreover, Dr. Morin's selection of proxy groups is arbitrary, flawed and inconsistent with the intent of the Generic Finance Case. Finally, the use of the Risk Premium method was rejected by the ALJs in the Generic Finance Case and has been

repeatedly rejected by the Commission.

Q. Please briefly describe how Dr. Morin selected his proxy groups.

A. Dr. Morin utilizes two different proxy groups, the first based on companies designated as distribution utilities by S&P and the second based on Moody's Electric Utility Index. As shown in Company Exhibits RAM-5 and RAM-7, the S&P based proxy group has 17 companies and the Moody's based proxy group has 20 companies.

Q. Please comment on Dr. Morin's selection of proxy groups.

A. The selection of Dr. Morin's proxy groups is arbitrary. It includes some electric and combination electric and gas utilities while excluding others. As he stated, two criteria are used to establish the proxy group; investment grade rating (Baa3 and above) and Value Line coverage. However, there are 39 electric and combination electric and gas utilities that he excludes from his S&P based proxy group and 34 companies that he excludes from his Moody's based proxy group. All of these companies meet both of his own criteria of inclusion in the proxy group; they all have investment grade rating and they all have Value Line coverage.

Q. Are you suggesting that Dr. Morin should have included all the 39 companies he

left out of his S&P based proxy group and all the 34 companies he left out of the Moody's based proxy group?

A. No. Even though the companies he left out meet his own criteria for inclusion, several of these companies have substantial unregulated operations and should not be included in a proxy group. Dr. Morin did not use the level of regulated utility operations as a criterion for inclusion is his proxy group. In fact, Constellation Energy, which is in both his proxy groups, has only 15.6% of regulated utility operations.

Applying a screen for regulated utility operations, similar to the one I used, i.e., include companies with over 70% regulated utility revenues, would still leave 21 companies that meet his other two criteria and should be included in his S&P based proxy group. Similarly, 16 companies would still meet his criteria, after applying this screen for regulated utility operations, and should be included in his Moody's based proxy group.

Q. Going back to Dr. Morin's original proxy groups of 17 S&P based and 20 Moody's based companies; did you find other problems with this selection?

A. Yes. Both of his proxy groups include companies that do not meet investment grade criteria by both S&P and Moody's. Three companies in his S&P based proxy group, CenterPoint Energy, Duquesne Light Holdings, Inc. and TXU Corporation, are rated below investment grade by Moody's. Similarly, TECO

Energy, Inc. that is part of Dr. Morin's Moody's based proxy group, is rated below investment grade by Moody's itself. Further, several utilities in both the S&P and Moody's based proxy group used by Dr. Morin should be excluded as they have substantial unregulated operations. As mentioned above, I have excluded companies with less than 70% of regulated operations from my proxy group. Based on that criteria; half a dozen companies should be excluded from both of Dr. Morin's proxy groups. Using a relatively lower threshold of 50% regulated utility operations would still exclude two companies from the Dr. Morin's S&P based proxy group and four companies from the Moody's based proxy group.

Q. What is your conclusion regarding Dr. Morin's proxy group selection?

A. As shown above, the selection of Dr. Morin's proxy groups is arbitrary. Instead of establishing a selection criteria and then applying it across the electric utility industry, he started with specified lists of companies used by S&P and Moody's that excluded dozens of companies that met his own criteria of being investment grade and having Value Line coverage. Further, as shown above his proxy groups included companies rated below investment grade and with significant unregulated operations. It is unreasonable to include such companies in a proxy group to determine the cost of equity for Con Edison.

Q. Please briefly describe Dr. Morin's DCF analysis.

A. Dr. Morin uses a single-stage model to perform four separate DCF analyses. He uses two different proxy groups and two different estimates of growth rates to perform these analyses. His first proxy group, based on companies designated as distribution utilities by S&P (S&P based proxy group), is composed of 17 electric utilities, while his second proxy group based companies in the Moody's Electric Utility Index (Moody's based proxy group) is composed of 20 companies. For both proxy groups, Dr. Morin estimates the DCF equity return alternatively using Value Line estimates of earnings per share growth and Zack's long-term earnings growth estimates. For the S&P based proxy group he estimates returns of 11.2% and 11.4% for the Value Line and Zack based growth rates respectively. For the Moody's based proxy group, Dr. Morin estimates DCF equity returns of 10.4% and 10.6% for the Value Line and Zack based growth rates, respectively.

Q. Is Dr. Morin's DCF analysis consistent with that adopted in the Recommended Decision in the Generic Finance Case?

A. No. Dr. Morin's DCF analysis makes a major departure from the methodology specified in the Generic Finance Proceeding. Dr. Morin rejects the use of the two-stage DCF model as recommended in the Generic Finance Case and consistently relied upon by the Commission and instead uses a single-stage,

DCF model. He discusses at length why he uses analysts' forecasts of growth contained in Zack's Investment Research, Inc. and Value Line while rejecting other measures of growth like sustainable growth. The question of whether to use a single-stage or two-stage DCF model along with numerous other issues, many of which have been raised by Dr. Morin, were discussed in great details in the Generic Finance Proceeding and a consensus methodology was agreed upon. After considering other methods Dr. Stewart Myers, of MIT concluded the following:

> Dr. Myers concluded that if dividend growth is expected to vary in the future, rather than remain constant, then the simplifying assumption that underlies the constant growth DCF model does not work. Hence, the single stage DCF model overestimates the cost of equity if immediate and near term growth is temporarily high, and underestimates the cost of equity if immediate and near term growth is temporarily low.
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> * * *
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> The Myers Report concluded that for companies that have not settled into steady state, there is no general rule for choosing the most accurate growth rate forecasting method. He did note, however, that the use of a two-stage DCF, or even a long form variable growth dividend discounting model could do a better job of capturing this type of situation than a single-stage model. Therefore, errors in estimated investors' forecasts of future growth are inevitable, and will occur even if all the DCF method's assumptions are satisfied.
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> (Return on Equity Consensus Document, issued June 2, 1993, Appendix A at 3, 4.)

Overall, all of Dr. Morin's DCF estimates are overstated and should be rejected.

Q. Please comment on Dr. Morin's flotation cost allowance.

A. Company witness Dr. Morin adds a 20 basis flotation cost adjustment to all four of his DCF equity cost estimates and 30 basis points to his two CAPM equity cost and his two Risk Premium estimates. There are two problems with this approach. First, there is no reason why Dr. Morin computes two different amounts for issuance costs, i.e., 20 basis points added to the DCF estimate and 30 basis points added to the CAPM and Risk Premium estimates. Second, issuance costs should be permitted when they are incurred and not on an on-going basis. The Commission in Cases 02-E-0198 and 02-G-0199 said the following:

> We agree with the Judge's recommendation to exclude a separate adjustment for selling and issuance costs, because our policy has been to allow recovery of such expenses when they are incurred … (Order issued March 7, 2003, p. 71))

I recommend that the Commission not allow a flotation cost adjustment in the manner proposed by Dr. Morin.

Q. Please briefly describe Dr. Morin's CAPM analysis.

A. Dr. Morin estimates two sets of equity returns based on the traditional and zero-beta CAPM approaches. For risk premium, he uses 7.6% based on an average of an Ibbotson Associates based calculation and a DCF analysis applied to the aggregate equity market using Value Line data. For the risk free rate, Dr. Morin

uses the U.S. Treasury 30-year bond yield of 4.8% for March 2007. Finally, for beta he uses .91, the average of the two proxy groups that he has utilized for his DCF analysis. Based on these inputs, Dr. Morin computes a traditional CAPM of 11.7% and an empirical or Zero-Beta CAPM of 11.9%. He adds 30 basis points for flotation to these estimates to arrive at final estimates of 12.0% and 12.2% for the traditional and zero-beta CAPM with an average of CAPM estimate of 12.1%.

Q. Do you agree with Dr. Morin's CAPM analysis?

A. No. Dr. Morin's risk premium of 7.6% is the average of a 7.1% Ibbotson Associates and an 8.1% DCF derived risk premium. Both these risk premiums are based on underlying market returns that are completely unrealistic and hence result in CAPM estimates that are vastly overstated. His first risk premium of 7.1% is taken from the Ibbotson Associates study, Stocks, Bonds, Bills and Inflation, 2006 Yearbook, and is based on the spread between common stock returns and the income component of returns on long-term government bonds. Since risk premium is the difference between market return and the risk free rate, Dr. Morin's assumed market return is 11.9% based on the risk free rate of 4.8% he used in his CAPM analysis. This market return is 100 basis points above the 10.9% market return reported by Merrill Lynch for 1,168 firms as reported in its August 10, 2007 issue of Quantitative Profiles – Monthly

Insight for Equity Management.

Second, Dr. Morin estimates a risk premium of 8.1% based on a DCF analysis applied to the aggregate equity market using Value Line aggregate stock market index and growth forecasts. Once again, the assumed market return underlying Dr. Morin's 8.1% risk premium derivation is completely unrealistic. Given a risk premium of 8.1% and a risk free rate of 4.8%, the underlying market return assumed by Dr. Morin is 12.9%. As stated above, the market return reported by Merrill Lynch for 1,168 firms as reported in its August 10, 2007 issue of Quantitative Profiles – Monthly Insight for Equity Management is 10.9%. Merill Lynch's estimate of market return for the S&P 500 is also 10.9%. In other words, Dr. Morin's estimate of market return of 12.9% is 200 basis points higher than the estimate of 10.9% provided by Merrill Lynch. The inputs to the CAPM formula are clearly excessive resulting in equity returns that are also excessive and unrealistic.

Q. Are there other flaws in Dr. Morin's CAPM analysis?

A. Yes. Dr. Morin has not used the approach recommended in the Generic Finance Case and relied upon by the Commission for computing the risk free rate. The Generic Finance Case recommended an average of 10-year and 30-year Treasury bond yields over a six-month period as the basis for computing

the risk-free rate. Dr. Morin used only the 30-year Treasury bond yield over a single month (March 2007) as the basis of his risk free rate. Although the risk free rate of 4.8% used by Dr. Morin is fairly close to my estimate of 4.87%, these rates can vary substantially. Over the last six-month period that I have used, monthly 30-year Treasury bond yields ranged from a low of 4.72% to high of 5.20%. Similarly, monthly 10-year Treasury bond yields over the last six months ranged from a low of 4.56% to a high of 5.10%.

Q. What would Dr. Morin's CAPM estimate of the equity return be if he used the correct market return of 10.9%, as reported by Merrill Lynch, in his CAPM analysis?

A. Dr. Morin's CAPM estimates would be 10.35% and 10.49% for the traditional and zero-beta approaches, respectively, or an average CAPM return of 10.42%. The risk premium would be 6.1%, instead of 7.6% used by Dr. Morin. Dr. Morin's 10.42% average CAPM equity return would be 25 basis points rather than 193 basis points (based on Dr. Morin's actual CAPM estimate of 12.1%) higher than my average CAPM estimate of 10.17%, although we use different risk free rates and betas. Dr. Morin uses a risk free rate of 4.8% while I use 4.87%. Similarly, Dr. Morin has used a beta of 0.91, while my beta estimate is 0.87.

Q. Please comment on the Risk Premium approach used by Dr. Morin.

A. The Commission has repeatedly rejected the use of the Risk Premium approach as used by Dr. Morin. In Cases 94-G-0885 and 93-G-0765, the Commission referenced the Recommended Decision and rejected the risk premium approach:

> … the Judge rejected two additional methods: the company's risk premium approach (whose results he deemed too volatile), and comparable earnings (presented by staff because it was included in the generic finance case consensus proposal).
>
> Opinion No. 95-16, National Fuel Gas Distribution Corporation, issued September 15, 1995, page 44.

More recently, in Case 05-E-1222, the Recommended Decision that was adopted by the Commission said the following:

> To begin, we find that, to the extent that the Company had departed from the generally accepted approach produced by the Generic Finance Case, it has not advanced the consideration of such matters in this proceeding. We recommend that very little weight, if any, be given to NYSEG's risk premium analyses and comparable earnings analysis that clearly depart from the Generic Financing Case approach. We also recommend that the Commission continue to use the DCF and CAPM methods as its principal means to determine the allowed equity returns for the utility companies it regulates.
>
> (Recommended Decision at 62, 63.)

PART II – RATE DESIGN

Q. Please briefly describe the Company's proposal regarding the customer charge

for Service Classification (SC) 1 – Residential & Religious Electric Service and SC 7 – Residential & Religious – Space or Space and Water Heating.

A. Con Edison is proposing to increase the SC1 and SC7 customer charge for electric service by approximately 29 percent. Under the Company's proposal, the customer charge for SC 1 and SC7 will increase by $3.43 per month from the current charge of $11.78 to a proposed charge of $15.21. On an annual basis, residential customers will pay an additional $41.16 for electric service as a result of this customer charge increase under the Company's proposal.

Q. Do you agree with the Company's proposal?

A. No. There is no good reason for the Company's proposal. In fact, there is no reason why the customer charge should be increased at all. The current customer charge of $11.78 per month is very close to the customer cost for serving SC1 customers. According to the study Company's latest Embedded Cost of Service (ECOS) study, the customer cost for SC1 is $12.20 per month.

Q. Isn't it true that the customer cost for SC7 is higher?

A. Based on the Company's ECOS, the customer cost for SC7 is $17.37 per month. This is higher than the Company's proposed customer charge of $15.21 per month for SC1 and SC7 customers. Although, there may be good reasons for having the same rates for both SC1 and SC7, since they are both residential customers, one cannot justify an increase to SC1 that has 2.6 million

customers, based on the need for parity with SC7 that has only 16 thousand customers.

Q. What is your proposal regarding the SC1 and SC7 customer charges?

A. I propose that the SC1 and SC7 customer charge not be increased at all since there is a small difference between the current customer charge and the customer cost based on the Company's latest ECOS. Cost studies are not an exact science and there is no need to set these charges precisely on the derived costs. Alternatively, if the customer charge must be increased, it should be no higher than the customer cost of $12.20 per month based on the Company's latest ECOS.

Q. Does this conclude your testimony?

A. Yes.

EXHIBIT