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 Gas Service	Case 06-G-1332

DIRECT TESTIMONY AND

EXHIBIT

OF

TARIQ N. NIAZI

Dated: March 16, 2007
Albany, New York

MINDY BOCKSTEIN
CHAIRPERSON and EXECUTIVE DIRECTOR
NYS CONSUMER PROTECTION BOARD
5 EMPIRE STATE PLAZA
SUITE 2101
ALBANY, NY 12223-1556
http://www.nysconsumer.gov

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 (SBC) 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. I demonstrate that Consolidated Edison Company of New York's ("Con Edison" or "Company") requested return on equity of 11.25% for its gas business is overstated and that the Company's current cost of equity is 9.05%. I also respond to several assertions made by the Company in support of its return estimate and identify several errors in its presentation.

Q. Have you prepared an exhibit for this part of your testimony?

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

RATE OF RETURN ON EQUITY

Q. What return on common equity is Con Edison requesting?

A. Con Edison is requesting a return on common equity of 11.25%. Its recommendation is based on estimates from four different methods: 1) a range of 9.3% to 10.4% based on the discounted cash flow method ("DCF"); 2) a range of 10.4% to 12.2% based on the capital asset pricing model ("CAPM"); 3) a range of 10.6% to 10.8% based on the Risk Premium method and 4) a range of 16.0% to 17.0% based on the Comparable Earnings method. In addition, Con Edison has taken into consideration three other factors in reaching its recommendation; prospects for interest rate changes in the near future, issuance costs and a premium for an extended stay out. 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 and Comparable Earnings method should be discarded as the use of these methods has been repeatedly rejected by the Commission. Finally, the other three factors considered by Con Edison; the prospect of higher interest rates in the near future, issuance costs and a premium for an extended stay out, as I discuss later in my testimony, should also be rejected.

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

A. I recommend a total equity return of 9.05% 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 rated "Aa/AA", "A/A" and "A/B" split by Moody's and Standard & Poor's. This rating criterion is somewhat relaxed 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), but it is a relatively minor modification. As explained below, this rating standard relaxation is both 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 8.97%. The CAPM approach applied to the same proxy group produces an equity cost of 9.11% for the traditional CAPM and 9.33% for the zero-beta CAPM. The average of the two CAPM methods results in an equity return of 9.22%. The CAPM analysis is based on a 10.0% market return, a .83 proxy group beta, a risk free rate of 4.77% and a risk premium of 5.23%. Applying weightings of 2/3 to the median DCF result and 1/3 to 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

[1] See, most recently, Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric

equity return of 9.05% for Con Edison's gas operations.

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

A. I initially selected the proxy group companies using electric and combination electric and gas companies that are rated "A/A" by Moody's and Standard & Poor's. Seven companies satisfied these criteria. I discarded WPS Resources Corporation since it has significant unregulated operations. This left a proxy group of only six companies that is smaller than the appropriate sample size of at least 10 companies set in the Generic Finance Case for pure gas companies. To enlarge the proxy group, I relaxed the initial criteria and looked at companies rated above "A/A". Currently there is only one company, MGE Energy Incorporated, that is rated "Aa/AA" by Moody's and Standard & Poor's. I added MGE Energy Inc. to the proxy group. Additionally I looked at companies rated "A/A" by either Moody's and/or Standard & Poor's. Currently there are six companies, Alliant Energy Corporation, MDU Resources Group, Otter Tail Corporation, Vectren Corporation, Wisconsin Energy Corporation and Xcel Energy, Inc., that have a split rating of "A/B" from Moody's and Standard & Poor's. I added Alliant Energy Corporation, Vectren Corporation, Wisconsin Energy Corporation and Xcel Energy, Inc. to my proxy group. I

Corporation, Order Adopting Recommended Decision with Modifications, March 7, 2003, p. 72.

excluded MDU Resources Group and Otter Tail Corporation from the proxy group since they have significant unregulated operations. After including the five companies MGE Energy Incorporated, Alliant Energy Corporation, Vectren Corporation, Wisconsin Energy Corporation and Xcel Energy, Inc., the proxy group that I have used for my analysis is comprised of 11 companies as shown in Exhibit__ (TNN), Schedule 1.

A. 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. As shown in Exhibit__ (TNN), Schedule 1, page 3 of 3, this resulted in a median equity return of 8.97% 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:

$$P_o = \frac{D_1}{k-g}$$

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 August 1, 2006 to January 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 December 1, 2006, December 29, 2006, and February 9, 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 his method is 8.97%.

B. 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 9.11% for the traditional CAPM and 9.33% for the zero-beta CAPM approach. The average of the two CAPM approaches resulted in an equity return of 9.22%. Exhibit__ (TNN), Schedule 2 provides a detailed explanation of the calculations used to determine the equity return under the CAPM.

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 January 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 4.77%.

The beta of 0.83 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 10.0% which I have used is based on the February 2007 issue of Merrill Lynch Quantitative Profiles - Monthly Insights for Equity Management. The 10.0% estimate is the implied return for a portfolio of 1,171 firms.

The risk premium was derived by subtracting the risk-free rate from the market return. Subtracting the risk-free rate of 4.77% from the market return of 10.0% results in a risk premium of 5.23%.

Incorporating all variables in the respective formulas, indicates a required return of 9.11% for the traditional CAPM approach and 9.33% 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 9.22% ((9.11% + 9.33%)/2).

C. Overall Recommendation

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

A. I estimated an equity return by applying the 2/3 DCF – 1/3 CAPM weighting used by the Commission and also recommended by the Judges in the Generic Finance case. My median DCF estimate is 8.97% and my average CAPM estimate is 9.22%. With the DCF estimate given 2/3 weight and the CAPM estimate given 1/3 weight, the resulting return is 9.05% for Con Edison.

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's 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 stayout.

Q. Please comment on the Company's issuance cost adjustment.

A. Company witness Rosenberg makes a general reference stating that … "additional equity infusions may well be required in the near future." A footnote further suggests that Con Edison will also be issuing new shares of common stock over the next several years through its various stock options.

From Mr. Rosenberg's testimony, it is not clear when the Company will issue more equity and more importantly whether it will issue equity during the rate year. 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 and there has been no assertion by the Company in this case of an external equity issuance. (Order issued March 7, 2003, p. 71))

Since it is not clear from Mr. Rosenberg's testimony that a common stock issuance is planned for the rate year, I recommend that the Commission not allow any adjustment for such expenses.

Q. How would you treat this adjustment if the Company can show that it is planning common stock issuance during the rate year?

A. If the Company is planning a common stock issuance during the rate year, I

would agree that an adjustment is needed. However, I do not agree with the calculation proposed by the Company. Instead, I would support the methodology used by the Department of Public Service staff in the most recent Con Edison steam case (Case 05-S-1376).

Q. Mr. Rosenberg has taken the prospect of higher interest rates in the future into consideration in making his equity return recommendation. Do you agree with this approach?

A. No. To the best of my knowledge, the Commission has never made an adjustment for the prospect of higher interest rates in the future. Expectations of higher interest rates and changes in other economic factors are internalized by the markets and reflected in stock prices, growth projections and earnings forecasts. Therefore, they are implicitly included in the data I have used. There is no need for any explicit adjustment.

Q. Have you estimated the revenue impact of your 9.05% equity return recommendation as compared to the Company's 11.25% allowance?

A. Yes. My recommendation would save Con Edison’s gas customers approximately $46 million, without impairing the Company's ability to provide safe and adequate gas service.

D. Analysis of Con Edison's Equity Return Proposal

Q. Please briefly describe how the Company estimated its proposed cost of equity of 11.25%.

A. Company Witness Robert G. Rosenberg recommends an equity return of 11.25% based on the use of four different methods. The four methods he used were DCF, CAPM, Risk Premium and Comparable Earnings. According to Mr. Rosenberg, he applied all four methods to a proxy group of companies with both Aa/AA and A/A bond ratings. His proxy group includes six utilities. First, for the DCF approach, he used a two-stage model. As shown in Schedule 3 of his exhibit, Mr. Rosenberg estimated three different DCF equity returns using different combinations of growth rates. Mr. Rosenberg's DCF calculations resulted in equity returns ranging from 9.3% to 10.4%. Second, he used the CAPM approach that produced equity returns of 10.4% and 10.9% for the traditional and zero-beta CAPM, respectively, based on the Ibbotson risk premium, and equity returns of 11.7% and 12.2%, respectively, based on the S&P 500 risk premium. Mr. Rosenberg then added a 100 basis points size premium to his results, bringing his CAPM estimates to 11.4% and 11.9% for the Traditional zero-beta CAPM respectively based on the Ibbotson risk premium and 12.7% and 13.2% respectively based on the S&P risk premium. Third, Mr. Rosenberg used two Risk Premium analyses, resulting in estimates of 10.63% and 10.81% equity returns. Finally, he used the Comparable

Earnings approach to produce an equity return in the range of 16.0% to 17.0%. Based on all the different methods used by Mr. Rosenberg, his equity returns ranged from a low of 9.3% to a high of 17.0%.

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

A. No. Mr. Rosenberg's estimates should not be relied upon. His DCF analysis is not consistent with the Recommended Decision in the Generic Finance Case 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, Mr. Rosenberg's proxy group of six companies is considerably smaller than the appropriately sized sample of 10 companies set in the Generic Finance Case. Finally, the use of the two other methods he employs, Risk Premium and Comparable Earnings, was rejected by the ALJs in the Generic Finance Case and has been repeatedly rejected by the Commission.

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

A. No. While Mr. Rosenberg used the two-stage DCF approach applied to a proxy group, as adopted in the Recommended Decision in the Generic Finance Case, he did not use Value Line data as was clearly specified in that proceeding. Instead, he used an average of the Value Line projected 5-year

growth rates and First Call 5-year projected growth rates for the near term, and three separate projected growth rates for the long-term. The three estimates for long-term projected growth that Mr. Rosenberg used are the growth in the Gross Domestic Product ("GDP"), projected sustainable growth and industry growth. Interestingly, his estimate, which uses retention growth that is based partly on Value Line data, results in equity return that is the closest to my DCF estimate.[2] The use of the other two long-term growth projections, result in estimates that are overstated. I recommend that Mr. Rosenberg's estimates of long-term projected growth based on growth in GDP and industry growth be discarded. These are broad measures of growth while Value Line projections are analyst's forecasts of companies in the proxy group. Overall, all of Mr. Rosenberg's DCF estimates are overstated and should be rejected.

Q. Please comment on Mr. Rosenberg's CAPM analysis.

A. Mr. Rosenberg estimates two sets of equity returns based on the traditional and zero-beta CAPM approaches. First, he uses a risk premium of 7.1% based on the spread between common stock returns and returns on long-term government bonds from data reported in Ibbotson Associates' publication of

[2] The difference between my DCF estimate and Mr. Rosenberg's DCF estimate using Value Line based retention growth is mainly due to the different times that we did our analyses, the use of different proxy groups and the use by Mr. Rosenberg of First Call near term growth in addition to Value Line growth estimates.

Risk Premia Over Time Report: 2006, to estimate CAPM equity returns of 10.4% based on the traditional and 10.9% on the zero-beta approaches respectively. Since risk premium is the difference between market return and the risk free rate, Mr. Rosenberg's assumed market return is 12.2% based on the risk free rate of 5.1% he used in his CAPM analysis. This market return is 220 basis points above the 10.0% market return reported by Merrill Lynch for 1,171 firms as reported in its February 2007 issue of Quantitative Profiles – Monthly Insight for Equity Management.

Second, Mr. Rosenberg estimates CAPM equity returns of 11.7% and 12.2% for the traditional and zero-beta approaches respectively based on the use of S&P data to estimate expected risk premium. Mr. Rosenberg calculates a required market return of 13.9% for the S&P 500 and then subtracts the 5.1% risk-free rate that he has used in his CAPM analysis to arrive at a risk premium of 8.8%. The market return for the S&P 500 as reported in the February 2007 issue of Quantitative Profiles – Monthly Insight for Equity Management, is 10.1%. In other words, Mr. Rosenberg's estimate of the S&P 500 required market return of 13.9% is 380 basis points higher than the estimate of 10.1% provided by Merrill Lynch. The inputs to the CAPM formula are clearly excessive, resulting in equity returns that are also excessive and unrealistic.

Mr. Rosenberg estimates equity returns based on CAPM ranging from 10.4% to 12.2%. He then uses a 100 basis points size premium to account for mid- and small-market capitalization to further increase the range of his CAPM estimates to 11.4% and 13.2%. To the best of my knowledge, this Commission has never adopted such an adjustment, nor was this factor discussed or adopted in the Generic Finance Case where many different approaches were considered.

Q. What would Mr. Rosenberg's CAPM estimate of the equity return be if he used the correct market return of 10.1% for the S&P 500, as reported by Merrill Lynch, in his CAPM analysis?

A. Mr. Rosenberg's CAPM estimates would be 8.85% and 9.16% for the traditional and zero-beta approaches, respectively, or an average CAPM return of 9.01%. The risk premium would be 5.1%, instead of 7.1% and 8.8%. Mr. Rosenberg's 9.01% average CAPM equity return would be 21 basis points lower than my average CAPM estimate of 9.22%, although we use different risk free rates and betas. Mr. Rosenberg uses a risk free rate of 5.1% while I use 4.77%. Similarly, Mr. Rosenberg has used a beta of 0.75, while my beta estimate is 0.83.

Q. Please comment on the Risk Premium and the Comparable Earnings approaches used by Mr. Rosenberg.

A. The Commission has repeatedly rejected the use of the Risk Premium and the Comparable Earnings approaches as used by Mr. Rosenberg. 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.

The Comparable Earnings approach was also rejected by Judge Deixler and Mr. Ansaldo in the Generic Finance Case. The Recommended Decision said the following:

> A comparable earnings approach is not appropriate for development of the cost of equity and should not be included in the method adopted for that purpose by the Commission.
>
> Recommended Decision, Case 91-M-0509, issued July 19, 1994, page 48.

Q. What would be Con Edison's equity return estimate, based on the 2/3-1/3 weighting for the DCF and the CAPM approaches, with appropriate corrections for some of the flaws you have noted above?

A. Combining Mr. Rosenberg's median DCF estimate based on long-term sustainable retention growth that was used in the Generic Finance Case, as shown in his Schedule 3, Page 2 of 3, and his corrected CAPM estimates based on the 10.1% S&P 500 market return that I discuss above, would result in equity return of 9.20% for the proxy group of six companies. Mr. Rosenberg estimated a median DCF equity return of 9.3% using the long-term sustainable growth method relied upon in the Generic Finance Case. As discussed above, his average of the traditional and zero-beta CAPM returns based on the S&P 500 market return of 10.1% as reported by Merrill Lynch would be 9.01%. Assigning 2/3 weight to the DCF estimates, and 1/3 to the CAPM return, consistent with the methodology approved in the Generic Finance Case, results in equity return of 9.20% that is relatively close to my estimate of 9.05%. Thus, when adjusted for errors, Mr. Rosenberg's return generally agrees with my analysis.

Q. Does this conclude your testimony?

A. Yes.