STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Orange and Rockland Utilities, Inc. for Gas Service	Case 05-G-1494

DIRECT TESTIMONY AND

EXHIBIT

OF

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Dated: March 30, 2006
Albany, New York

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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. My Testimony has three parts. In Part I, I explain that Orange and Rockland Utilities, Inc. ("O & R" or the "Company") has requested a large rate increase at a time when consumers are facing significant increases in energy related costs. Under these circumstances, the CPB recommends that the Commission consider all reasonable ways to reduce the burden on consumers, including terminating or postponing programs that may not be essential to provide safe and reliable service and also considering any other measures to moderate any necessary rate increases.

In Part II, I demonstrate that O & R's requested return on equity of 11.0% for its gas business is overstated and that the Company's current cost of equity is 8.60%. 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 III, I address several other issues discussed in the Company's filing. First, the Company's has proposed a migration incentive to help grow its retail access program. We oppose ratepayer funding of any migration incentive especially at a time when ratepayers are facing high energy costs and the Company is proposing a large rate increase. Second, the Company has proposed to continue its purchase of gas supply service accounts receivables. We support O & R's proposal. Third, regarding the Company's PowerSwitch retail access program, CPB recommends that the program terminate 1 year from the date of the Commission's Order in this proceeding. Fourth, I discuss several concerns regarding the Company's proposed Outreach and Education budget. Fifth, I comment on the Company's proposed Orange County Expansion Project.

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

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

PART I – IMPORTANCE OF CONSUMER IMPACTS

Q. Please summarize Orange & Rockland's delivery rate increase request.

A. The Company has requested permission to increase natural gas delivery rates to produce an additional $20.64 million in revenue. The PSC calculated that this represents an increase in projected gas delivery rates of approximately 22%.

Q. What is the impact of this rate increase request on consumers?

A. Orange & Rockland's proposed delivery rate increase follows delivery rate increases of $9.25 million on November 1, 2003, $9.275 million on November 1, 2004 and $5.00 million on November 1, 2005. While the proposed delivery rate increase is being considered, high prices of natural gas and other heating fuels are expected to continue into the rate year. In particular, Orange & Rockland expects marginal gas commodity charges to exceed $11.00 per Dth for each month in the 2006 – 2007 heating season (Exhibit G-9, Schedule 13). That price is higher than ever previously experienced by Orange & Rockland customers, except for several months in the 2005 – 2006 heating season.

Q. What do you recommend in these circumstances?

A. Action should be taken to help alleviate the burden on consumers of high fuel prices, and repeated natural gas delivery price increases. That effort should extend to matters being addressed in this proceeding, including issues addressed by the CPB and other parties. In this testimony and the testimony of CPB consultant Mr. Hugh Larkin, we address some of the most significant factors underlying Orange & Rockland's delivery rate increase request. However, we have not conducted a comprehensive review of the Company's revenue requirement. As a general matter, utility programs that are not necessary to provide safe and reliable service at this time, should be terminated or postponed. Further, consideration should be given to phasing-in any required rate increase, to help alleviate customer impacts.

PART II - RATE OF RETURN ON EQUITY

Q. What return on common equity is O & R requesting?

A. O & R is requesting a return on common equity of 11.0%. Its recommendation is based on estimates from four different methods: 1) a range of 9.0% to 10.0% based on the discounted cash flow method ("DCF"); 2) a range of 10.0% to 11.0% based on the capital asset pricing model ("CAPM"); 3) a range of 10.0% to 10.1% based on the Risk Premium method and 4) a range of 16.0% to 18.0% based on the Comparable Earnings method. In addition, O & R has taken into consideration two other factors in reaching its recommendation;

prospects for interest rate changes in the near future 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 two factors considered by O & R; the prospect of higher interest rates in the near future 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 O & R?

A. I recommend a total equity return of 8.60% for O & R. 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 8.03%. The CAPM approach applied to the same proxy group produces an equity cost of 9.56% for the traditional CAPM and 10.02% for the zero-beta CAPM. The average of the two CAPM methods results in an equity return of 9.79%. The CAPM analysis is based on an 11.4% market return, a .73 proxy group beta, a risk free rate of 4.57% and a risk premium of 6.83%. 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 equity return of 8.62% for O & R'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. Eight companies satisfied these criteria. I discarded WPS Resources Corporation and MDU Resources Group, Inc. since they have significant unregulated operations. I also discarded the FPL Group, Inc. as it has recently

[1] See, most recently, Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation, Order Adopting Recommended Decision with Modifications, March 7, 2003, p. 72.

announced plans to merge with the Constellation Energy Group. This left a proxy group of only five companies, which is too small to obtain reliable results.

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 lower than “A/A” by either Moody’s and/or Standard & Poor’s. Currently there are four companies, Alliant Energy Corporation, Otter Tail Corporation, Vectren Corporation and Wisconsin Energy Corporation, that have a split rating of “A/B” from Moody’s and Standard & Poor’s. I added Alliant Energy Corporation, Vectren Corporation and Wisconsin Energy Corporation to my proxy group. I excluded Otter Tail Corporation from the proxy group since it has significant unregulated operations. After including the four companies MGE Energy Incorporated, Alliant Energy Corporation, Vectren Corporation and Wisconsin Energy Corporation, the proxy group that I have used for my analysis is comprised of 9 companies as shown in Exhibit__ (TNN), Schedule 1.

Q. Is this sufficient to meet the proxy group criterion established in the Generic Finance Case?

A. I believe that I have met the objective of that criterion. Given the changes in credit ratings in the recent past, this is the closest I can come to an appropriate-sized A-Rated proxy group. After excluding companies involved in mergers and those with significant unregulated operations, there are only 9 electric and combination electric and gas companies that are rated “Aa/AA”, “A/A” and “A/B” split by Moody’s and Standard & Poor’s.

A. Discounted Cash Flow Model

Q. How did you arrive at your DCF equity return estimate for O & R?

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 8.03% for O & R.

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 O & R?

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 September 1, 2005 to February 28, 2006. 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 2, 2005 and the December 30, 2005 issues of the <u>Value Line Investment Survey.</u> As shown in Exhibit__ (TNN), Schedule 1, page 3 of 3, the median equity return based on his method is 8.03%.

B. <u>Capital Asset Pricing Model</u>

Q. What were the results of your application of the CAPM methodology to estimate O & R's equity return?

A. The CAPM produced a required return on equity of 9.56% for the traditional CAPM and 10.02% for the zero-beta CAPM approach. The average of the two CAPM approaches resulted in an equity return of 9.79%. 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 February 28, 2006 of 20-Year and 10-year Treasury Bond Yields as reported by the Federal Reserve Board. (Federal Reserve Statistical Release, Historical Data) That average is 4.57%.

The beta of 0.73 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 11.4% I have used is based on the March 2006 issue of Merrill Lynch Quantitative Profiles - Monthly Insights for Equity Management. The 11.4% estimate is the implied return for a portfolio of 1,118 firms.

The risk premium was derived by subtracting the risk-free rate from the market return. Subtracting the risk-free rate of 4.57% from the market return of 11.4% results in a risk premium of 6.83%.

Incorporating all variables in the respective formulas, indicates a required return of 9.56% for the traditional CAPM approach and 10.02% 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 9.79% ((9.56% + 10.02%)/2).

C. Overall Recommendation

Q. What is your estimate of equity return for O & R?

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 8.03% and my average CAPM estimate is 9.79%. With the DCF estimate given 2/3 weight and the CAPM estimate given 1/3 weight, the resulting return is 8.62% for O & R.

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 O & R'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. 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 8.62% equity return recommendation as compared to the Company's 11.0% allowance?

A. Yes. My recommendation would save O & R's gas customers approximately $4.7 million, without impairing the Company's ability to provide safe and adequate gas service.

D. Analysis of O & R's Equity Return Proposal

Q. Please briefly describe how the Company estimated its proposed cost of equity of 11.0%.

A. Company Witness Robert G. Rosenberg recommends an equity return of 11.0% 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 eight utilities. First, for the DCF approach, he used a two-stage model. As shown in Schedule 3, 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 8.9 % to 10.2%. Second, he used the CAPM approach that produced equity returns of 9.7% and 10.2% for the traditional and zero-beta CAPM, respectively, based on the Ibbotson risk premium, and equity returns of 10.8% and 11.4%, respectively based on the S&P 500 risk premium. Mr. Rosenberg then added a 50 basis points size premium to his results, bringing his CAPM estimates to 10.2% and 11.3% for the Traditional CAPM and 10.7% and 11.9% for the zero-beta CAPM. Third, Mr. Rosenberg used two Risk Premium analyses, resulting in estimates of 10.0% and 10.1% equity returns. Finally, Mr. Rosenberg used the Comparable Earnings approach to produce an equity return in the range of 16.0% to 18.0%. Based on all the different methods used by Mr. Rosenberg, his equity returns ranged from a low of 8.9% to a high of 18.0%.

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, after Mr. Rosenberg filed his testimony, two companies in his proxy group would be discarded by his own criteria. Ameren Corporation has been downgraded by both Moody's and Standard & Poor's from A-rated to Baa/BBB and should no longer be in the proxy group. FPL Group Incorporated should also be discarded as it has announced plans to merge with the Constellation Energy Group. Discarding these two companies leaves only six companies in Mr. Rosenberg's proxy group which is too small a sample for reliable results. 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 using retention growth that is based partly on Value Line data results in an 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

[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.

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 7.2% based on the spread between common stock returns and returns on long-term government bonds from data reported in Ibbotson Associates publication of <u>Risk Premia Over Time Report: 2005</u>, to estimate CAPM equity returns of 9.7% based on the traditional and 10.2% 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 11.8% based on the risk free rate of 4.6% he used in his CAPM analysis. This market return is 40 basis points above the 11.4% market return reported by Merrill Lynch for 1,118 firms as reported in its March 2006 issue of <u>Quantitative Profiles – Monthly Insight for Equity Management</u>.

Second, Mr. Rosenberg estimates CAPM equity returns of 10.8% and 11.4% 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 13.3% for the S&P 500 and then subtracts the 4.6% risk-free rate that he has used in his CAPM analysis to arrive at a risk premium of 8.7%. The market return for the S&P 500 as reported in the March 2006 issue of Quantitative Profiles – Monthly Insight for Equity Management, is 11.6%. In other words, Mr. Rosenberg's estimate of the S&P 500 required market return is 170 basis points higher the estimate 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 9.7% to 11.4%. He then uses a 50 basis points size premium to account for mid and small market capitalization to further increase the range of his CAPM estimates to 10.2% and 11.9%. 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 11.6% for the S&P 500, as reported by Merrill Lynch, in his CAPM analysis?

A. Mr. Rosenberg's CAPM estimate would be 9.57% and 10.08% for the traditional and zero-beta approaches, respectively, or an average CAPM return of 9.83%. The risk premium would be 7.0%, instead of 7.2% and 8.7% used by

Mr. Rosenberg. Mr. Rosenberg's 9.83% average CAPM equity return would be only 4 basis points higher than my average CAPM estimate of 9.79%, although we use different risk free rates and betas. Mr. Rosenberg uses a risk free rate of 4.6% while I use 4.57%. Similarly, Mr. Rosenberg has used a beta of 0.71, while my beta estimate is 0.73.

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.

PART III -- OTHER ISSUES

A. Migration Incentive

Q. Please summarize Orange & Rockland's proposal regarding an incentive to encourage migration to ESCOs.

A. Under the Company's current rate plan, O & R can retain up to 16.67 basis points of earnings per year if a target number of customers commence service from an ESCO. The Company is eligible for this incentive in any rate year if at least 4,000 customers migrate in that year. It can earn the maximum incentive if 10,000 customers migrate to ESCO service in that year. The Company has earned a migration incentive in each year of the current rate plan.

Company witness Ms. Jane Quin recommends that Orange & Rockland be provided a financial incentive for encouraging retail access that includes both the migration of new customers to ESCOs and the retention of customers who already receive service from ESCOs. Under its proposal, the Company would receive an incentive, collected from customers through the Monthly Gas Adjustment, if at least 2,000 customers began taking gas service from an

ESCO during a rate year. If the 2,000 threshold is met, the Company would receive $50 for each new account that begins taking gas service from an ESCO during a rate year. It would also receive $25 for each additional gas account that takes service from an ESCO at the end of a rate year in comparison to the number of accounts taking service from an ESCO at the beginning of a rate year.

Q. Do you support that recommendation?

A. No. O & R has not adequately explained why this incentive is necessary or how it is consistent with just and reasonable rates for the Company's services. In fact, no migration incentive of any type is required for O & R to provide safe and reliable service. Moreover, as a general matter, incentives should align utility interests with those of customers who fund those incentives, whereas a customer migration incentive does not necessarily achieve that objective. The CPB opposes requiring ratepayers to fund any migration incentive in this instance, particularly in view of the high energy costs faced by ratepayers and the proposed rate increase in this proceeding.

In addition, I have several concerns with the specific incentive proposed by the Company. First, there is no upper limit on the amount that ratepayers would be required to pay under the Company's proposal. Such an open-ended incentive is not in consumers' interest. Second, the threshold level of migration for the Company to earn an incentive is too low, and would unduly reward the Company. Under its proposal, the Company would be entitled to an incentive even if only an additional 1.6% of customers migrated in a given year (calculated as 2,000 divided by 123,000, the number of O & R gas customers). Further, the 2,000 migration threshold is low by recent historical standards. For example, it is less than one-third of the number of new migrated accounts in 2005 (6,631 accounts, Response to DPS-89). Third, the Company has not identified any action to encourage customer migration that it would take only if the incentive were provided. In other words, it has not demonstrated that an incentive is required for the Company to take any specific action.

B. Purchase of Receivables Program

Q. Please summarize the Company's proposed changes to its purchase of receivables program.

A. O & R has offered to purchase ESCOs' receivables without recourse at cost for many years. In this proceeding, the Company proposes to continue to purchase gas supply service accounts receivable, without recourse, but at a discount to reflect the Company's risk of uncollectibles.

Q. What is your position on this proposal?

A. The CPB supports the Company's proposal to modify its purchase of receivables program to reflect a cost-based discount which considers the uncollectible rate and reasonable compensation for the risk that the actual uncollectible rate may increase. All incremental costs of the purchase of receivables program should be paid by ESCOs, who are the beneficiaries of that program.

C. PowerSwitch Program

Q. Do you have any overall recommendations regarding the Company's PowerSwitch retail access program?

A. Yes. I recommend that the program terminate 1 year from the date of a Commission Order in this proceeding.

Q. Please explain the reasons for your recommendation.

A. Under Orange & Rockland's PowerSwitch program, the Company performs marketing, call center, and customer acquisition services for ESCOs that should eventually be performed exclusively by the ESCOs themselves. This program has helped ESCOs over the initial hurdle of obtaining a "critical mass" of customers, and by giving customers a chance to gain experience in shopping for energy and interacting with an ESCO.

However, this program should not be allowed to become such a fixture in the energy landscape that marketing companies start to incorporate them into their long-term business plans. At some point, ESCOs must participate fully in the unsubsidized competitive marketplace. The PSC has recognized that this program should be temporary. In particular, in its August 24, 2004 Statement of Policy on Further Steps Toward Competition in Retail Access Energy Markets in Case 00-M-0504, the Commission stated on page 16 that programs such as PowerSwitch are

> a good transitional model that will help residential customers get acquainted with obtaining energy supply from a non-utility provider. In the long run, however, we believe that ESCOs should no longer need the support of the utilities to provide customer care services and should ultimately provide all customer services associated with the provision of commodity.

A PowerSwitch-type program has been operational in O & Rs service territory since 2000. Ample time has been provided for customers to "get acquainted with obtaining energy supply from a non-utility provider." Accordingly, the PowerSwitch program for O & R should terminate 1 year after the PSC issues an Order in this proceeding. This will provide ample time for ESCOs, who will have had their customer acquisition costs subsidized by O & R ratepayers for more than 7 years, to transition to the unsubsidized competitive marketplace.

D. Outreach and Education Budget

Q. Please summarize the Company's proposed Outreach and Education budget.

A. The Company proposes to include $300,000 of annual expenses for its Retail Access Outreach and Education Plan in its revenue requirement. This is $12,000 more than the amount for customer outreach and education and marketer incentive programs reflected in current rates.

Q. Do you have any concerns with this proposal?

A. Yes. As explained above, Orange & Rockland's customers are facing extremely high natural gas commodity prices, have endured delivery rate increases in each of the last three years, and are facing another proposed delivery rate increase. Especially in this environment, all ratepayer-funded spending by utilities should be scrutinized to ensure that it is cost effective and in consumers' interest.

The Company, however, has conducted no analyses or studies of the cost effectiveness of the retail access outreach and education efforts or marketer incentive programs that are part of its current rate plan. (Response to CPB 70) In these circumstances, ratepayers' subsidization of advertising, promotion and other customer acquisition activities that could and should be conducted by ESCOs, should decline substantially. I recommend that the Company's rates reflect $150,000 in annual spending on these retail access-related outreach and education programs, or one-half of the amount proposed by O & R. The Company should spend this money to provide balanced information on retail competition to consumers in the most cost effective manner possible. My recommendation balances the interests of ratepayers and ESCOs, and helps ESCOs begin the transition to the unsubsidized competitive marketplace.

Q. Do you have any other recommendations regarding customer outreach and education?

A. Yes. As previously explained, the price of natural gas in the rate year is expected to be very high by historical standards. Consumers should be provided accurate and timely information regarding the cause of high natural gas prices, actions they can take to manage their energy bills, and how to obtain assistance in paying their bills. The CPB and the Department of Public Service played key roles in delivering that information to consumers this past winter. In addition, the PSC augmented its normal winter energy outreach and education efforts (e.g., PSC Press Release, Commission Expands Winter

Outreach and Education Efforts, Press Release, September 21, 2005). However, there is no guarantee that the PSC will take such action again next winter. Utilities can, and should, also be instrumental in providing this important information to consumers.

O & R estimates that it spends $10,000 annually on such outreach and education:

> to explain the impacts of supply, demand, weather and the economy on the cost of natural gas supply in the competitive market; to encourage energy efficiency measures and budget billing enrollment as ways to reduce the affects of high winter heating costs; and to inform customers, especially low-income customers, of government and other payment assistance programs. (Response to CPB 62)

In these circumstances, O & R's budget for outreach and education on these issues should be increased substantially. The CPB recommends a budget of $50,000 for this purpose, including direct mail, bill inserts, information on the Company's web site, and participating in public events.

E. Orange County Expansion Project

Q. Please summarize the Company's proposal regarding the expansion of gas distribution service in Orange County.

A. Mr. Wayne J. Arnold addresses the Company's proposal to expand gas service in portions of Orange County in a "systematic, project-by-project manner." The Company would identify priority projects using town planning data and other information, conduct a financial analysis of each project including a project-specific rate base, and determine if the project is operationally and financially feasible. If so, the Company would ask the PSC to pre-approve the project, in which case it would ultimately be included in rate base for ratemaking purposes. The Company proposes that until the project is included in rate base, it would earn a carrying charge on the project-specific rate base, and would recover that carrying charge from customers through the modified gas clause adjustment until base rates are revised. The Company's testimony did not include an estimate of the rate base associated with this proposal, or the dollar value of the projected carrying charge.

Q. Please comment on that proposal.

A. Prudent expansion of Orange & Rockland's gas distribution service would benefit customers as well as the Company. The Company's proposal, however, would shift costs and risk from shareholders to customers, by requiring existing customers to pay carrying charges before the projects are added to rate base. That proposed change would be detrimental to O & R's customers and should be rejected.

Q. Does this conclude your testimony?

A. Yes.

EXHIBIT