

BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of
Central Hudson Gas & Electric Corporation
Cases 09-E-0588 and 09-G-0589
November 2009

Prepared Testimony of:

Rate of Return Panel

Audrey L. Capers
Principal Utility Financial
Analyst

Paul Del Vecchio
Senior Utility Financial Analyst

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

1 Q. Panel, please state your names, employer and
2 business addresses.

3 A. Audrey Capers and Paul Del Vecchio. We are
4 employed by the New York State Department of
5 Public Service (Department) in the Office of
6 Accounting & Finance (OAF). Our business address
7 is Three Empire State Plaza, Albany, New York
8 12223.

9 Q. Ms. Capers, what is your position in the OAF?

10 A. I am employed as a Principal Utility Financial
11 Analyst. My responsibilities include analyzing
12 and making recommendations to the Commission
13 concerning rate cases, financings and ratemaking
14 policy issues for New York State public utilities.
15 I am also responsible for projects related to the
16 policy and administration of New York's retail and
17 wholesale power markets.

18 Q. Please describe your educational and professional
19 background?

20 A. I hold a Bachelor of Arts degree in Economics from
21 Binghamton University and a Masters degree in
22 Business Administration, with a concentration in
23 Finance from the University of Wisconsin at
24 Madison. I began my career with the Department in

1 1984 in the OAF. I am a member of the Consortium
2 for Graduate Study in Management and of the
3 Society of Utility and Regulatory Financial
4 Analysts.

5 Q. Have you testified in any regulatory proceedings
6 before the New York State Public Service
7 Commission or other jurisdictions?

8 A. Yes, I have testified before the Commission in the
9 last two Central Hudson Gas & Electric Corporation
10 (Central Hudson or the Company) rate proceedings
11 (Cases 05-E-0934 and 05-G-0935 and Cases 08-E-0888
12 and 08-G-0889), as well as numerous rate case
13 proceedings on the fair rate of return for
14 combination gas and electric, natural gas, steam,
15 telephone and water companies, as well as in
16 generic proceedings concerning policy and
17 financing. I have also testified before the
18 Connecticut Department of Public Utility Control.

19 Q. Mr. Del Vecchio, what is your position at the
20 Department?

21 A. I am employed as a Senior Utility Financial
22 Analyst and have been with the Department since
23 May 2008. My responsibilities include working on
24 utility financing requests and designing automated

1 spreadsheets to update certain metrics that the
2 OAF uses in its DCF and CAPM models. My
3 responsibilities for this case include analyzing
4 and making recommendations to the Commission
5 concerning Central Hudson's capital structure.

6 Q. Please describe your educational background and
7 professional experience.

8 A. I am a graduate of Union College with a Bachelor
9 of Arts in Managerial Economics and a Masters
10 degree in Business Administration, with a
11 concentration in Finance from the Graduate College
12 of Union University.

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

16 A. Yes. In Cases 08-E-0887 and 08-G-0888, Central
17 Hudson Gas & Electric Corporation, I offered
18 testimony as part of the Staff Rate of Return
19 Panel as to the appropriate Return on Equity and
20 methodologies employed in Staff's two-stage DCF &
21 CAPM Models

22 Q. Please identify the Panel's exhibits that support
23 your testimony.

24 A. We have prepared 18 exhibits; Exhibit__ (RRP-1)

1 through Exhibit__ (RRP-16) describe the details of
2 our analyses and are described in further detail
3 as they are discussed in our testimony.

4 Exhibit__ (RRP-17) provides copies of published
5 financial reports and Exhibit__ (RRP-18) contains
6 copies of the Company's responses to interrogatory
7 requests.

8 Purpose of Testimony

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

11 A. To recommend a fair rate of return to be used in
12 the revenue requirement for Central Hudson. Our
13 recommendation outlines the appropriate capital
14 structure for Central Hudson, as well as the
15 applicable cost rates for long-term debt, customer
16 deposits, preferred stock and common equity, for
17 the rate year ending June 30, 2011.

18 Summary of Recommendations

19 Q. Please summarize your recommendations for Central
20 Hudson.

21 A. We recommend that Central Hudson be allowed to
22 earn an after-tax rate of return (ROR) of 7.21%
23 and a pre-tax ROR of 10.31% based on an equity
24 ratio of 48.0% and a return on common equity (ROE)

1 of 9.60% (Exhibit__(RRP-1)), for the rate year
2 ending June 30, 2011. This differs from the
3 Company's proposed rate year after-tax ROR of
4 7.58% and its proposed pre-tax ROR of 10.80%,
5 based on an equity ratio of 48.0% and an ROE of
6 10.0% (Exhibit__(SAR-4), Schedule 1).

7 Q. Please summarize your testimony.

8 A. Our ROE recommendation was determined using two
9 different equity costing methodologies, each
10 weighted as the Commission has approved in prior
11 litigated cases. We also explain why our
12 recommended rate of return enables the Company to
13 maintain a financial profile that allows it to
14 access capital markets on reasonable terms. The
15 cost of long-term debt and the cost of common
16 equity should be updated at the time of the
17 Recommended Decision (RD) prepared by the
18 Administrative Law Judge (ALJ) and at the time of
19 the Commission's Order.

20 Capital Structure

21 Q. Please describe Central Hudson's organizational
22 structure.

23 A. Central Hudson is a regulated electric and natural
24 gas transmission and distribution (T&D) company

1 that is the principal operating subsidiary of CH
2 Energy Group, Inc. (CH Energy), which is a holding
3 company that also conducts unregulated business
4 activities through a different subsidiary, Central
5 Hudson Enterprises Corporation (CHEC). Such
6 unregulated activity includes investments in fuel
7 distribution, alternative energy projects (e.g.
8 ethanol, wind, biomass, landfill gas), and energy
9 related services. Central Hudson's senior
10 unsecured debt is currently rated A by Standard &
11 Poor's (S&P) and A3 by Moody's Investors Service
12 (Moody's). S&P assigns the Company an "excellent"
13 business risk profile and an "intermediate"
14 financial risk profile as shown in Exhibit__ (RRP-
15 17) - Standard & Poor's Issuer Ranking: U.S.
16 Regulated Electric Utilities, Strongest to
17 Weakest").
18 Currently, all of CH Energy's common stock is
19 traded at the parent level while all of its
20 preferred stock and approximately 90% its long-
21 term debt is attributable to Central Hudson. In
22 April 2009, CH Energy recapitalized its non-
23 regulated investments, resulting in such assets
24 being supported by approximately 70% equity (down

1 from 100%).

2 Q. What capital structure is the Company proposing
3 for Central Hudson in this proceeding?

4 A. Company witness Renner is proposing a capital
5 structure with a common equity ratio of 48% for
6 Central Hudson.

7 Q. Do you agree with their proposed capital
8 structure?

9 A. Yes, we do. We analyzed the Company's capital
10 structure on the basis of CH Energy's Securities
11 and Exchange Commission (SEC) 10-Q report for the
12 second quarter of 2009. We utilized CH Energy's
13 consolidated capital structure, its subsidiaries'
14 stand-alone capital structures (debt, preferred
15 stock and common equity balances), and the
16 Company's customer deposits balance of \$8.332
17 million in order to determine Central Hudson's
18 capital structure (Exhibit__(RRP-2)) as of June
19 30, 2009. We determined CH Energy's non-regulated
20 subsidiaries were capitalized with approximately
21 70% equity, an amount we found reasonable. We
22 also found a 48.1% equity ratio for Central
23 Hudson, and therefore, the Company's capital
24 structure for the rate year ending June 30, 2011

1 appears reasonable, given our analysis.

2 Q. Please explain the rationale for considering the
3 capitalization of CH Energy's non-regulated
4 investments as well as Central Hudson's stand
5 alone capital structure?

6 A. Credit agencies determine a regulated utility
7 subsidiary's rating based in large part on the
8 consolidated credit profiles of the holding
9 company. This is standard practice across all
10 industries, not just utilities, because not only
11 does the holding company represent the primary
12 channel through which a subsidiary can access
13 capital markets to fund its projects, but it also
14 represents the shareholders who own the subsidiary
15 that may, or may not, have the right to
16 collateralize (or leverage) it like any other
17 asset against their other investments.

18 Since non-regulated business activities do not
19 have the same cost recovery mechanisms that
20 regulated utilities do, they are judged as riskier
21 investments by both creditors and borrowers.

22 Given these considerations, we have to ensure that
23 the non-regulated investments do not lower the
24 creditworthiness of the regulated utility and that

1 the regulated utility's capital structure is not
2 used to support the non-regulated investment.

3 Q. Why is a 48% common equity ratio reasonable for
4 Central Hudson?

5 A. Central Hudson was allowed a 47% equity ratio in
6 its most recent rate case. The rating agencies
7 have since rated the Company as A/A3, a sign of a
8 strong company. However, S&P cautions that
9 additional debt could cause them to change Central
10 Hudson's Outlook to "Negative" and possibly lead
11 to a downgrading of the Company. The parent
12 companies in the proxy group used in our equity
13 costing methodologies have long-term debt ratios
14 of approximately 45.3% (Exhibit__ (RRP-8)). Our
15 proposed capital structure provides an even
16 greater equity cushion than that of the proxy
17 group companies. In addition, 48% is the equity
18 ratio that the Commission has approved for
19 Consolidated Edison Company of New York, Inc. (Con
20 Edison) and Orange and Rockland Utilities, Inc.
21 (Orange and Rockland) in recent rate cases. Both
22 of these companies are viewed by the rating
23 agencies as having similar levels of risk.

24 Rate of Return

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

3 A. A fair overall rate of return allows a utility the
4 opportunity to provide safe and adequate service,
5 to recover its prudent costs for debt and
6 preferred stock, and to provide its common
7 stockholders the opportunity to earn a return that
8 is commensurate with the risk of the company. At
9 the same time, the governing principle of
10 ratemaking provides that customers should pay no
11 more than the cost of service incurred to provide
12 them service.

13 Q. How is a fair rate of return established?

14 A. Generally, a fair rate of return can be determined
15 by a cost analysis of the individual components
16 (long-term debt, short-term debt, preferred stock,
17 common equity, etc.) of a company's pro forma
18 capital structure. The overall cost of capital is
19 then determined by a weighted average of these
20 individual components. The long-term debt and
21 preferred stock components of the company's pro
22 forma capital structure are readily quantified
23 because they consist mainly of previously issued
24 capital that have specific cost rates.

1 Additionally, the cost of customer deposits and
2 other forms of customer-provided capital (e.g.,
3 gas supplier refunds) are prescribed by the
4 Commission.

5 The cost of common equity, however, is neither
6 contractual nor prescribed by the Commission; it
7 is based upon investors' expectations. Although
8 these expectations are not necessarily apparent
9 through any one measure, financial analysts often
10 employ methodologies such as the Discounted Cash
11 Flow methodology (DCF) and the Capital Asset
12 Pricing Model (CAPM) to estimate the return
13 required by equity investors.

14 Q. Please describe how your cost rate recommendations
15 differ from those of the Company's witnesses, Mr.
16 Renner and Dr. Morin.

17 A. Given that we and the Company recommend a 48%
18 common equity ratio, the main differences between
19 our recommendations are as follows: 1) our
20 methodology for forecasting interest rates
21 resulted in lower interest rates for three
22 projected rate year debt issuances, 2) our
23 customer deposits cost rate was lower than the
24 Company's due to updates, and 3) we are

1 recommending a 9.60% ROE, as opposed to the 10.0%
2 reflected in the Company's revenue requirement and
3 as opposed to the 11.25% proposed by Dr. Morin.

4 Cost of Long-term Debt

5 Q. What is the Panel's recommendation for the
6 Company's embedded cost of debt for the rate year
7 ending June 30, 2011?

8 A. Our forecast of the Company's embedded cost of
9 debt is 5.05%. The rate reflects Central Hudson's
10 outstanding debt during the rate year, and three
11 20-year medium-term note issuances forecast by Mr.
12 Renner for January and September 2010 and April
13 2011. Our embedded cost of debt differs from that
14 presented by Mr. Renner because we reflect the
15 actual results of an October 2009 issuance and our
16 estimated interest rates for the three debt
17 issuances planned during the rate year are lower
18 than Mr. Renner's estimates.

19 Q. Mr. Renner forecasted interest rates for new debt
20 in 2009, 2010, and 2011 at 6.80%, 7.20% and 7.4%,
21 respectively. How did he estimate these interest
22 rates?

23 A. In his response to Staff IR DPS-87 located in
24 Exhibit__ (RRP-18), Mr. Renner determined the new

1 debt issuance rates by employing estimates of 30-
2 year Treasuries for 2009, 2010 and 2011 from the
3 Blue Chip Economic Forecast, to which he added 273
4 basis points, reflecting the average spread of A-
5 rated utility debt interest rates over Treasuries
6 (the average of 10-year and 30-year Treasury
7 yields) for the six-month period ended June 2009.
8 The utility spreads were obtained from a Bank of
9 America listing.

- 10 Q. Please explain how the Panel estimated the
11 interest rates for the forecast debt issuances?
- 12 A. Our forecasted rate for new debt issuances in the
13 first rate year is 5.10%. Our estimate uses the
14 average 10 and 30-year Treasury rates for October
15 2009, which as seen at Exhibit__ (RRP-12) is 3.79%,
16 as a risk-free rate. We then added a 131.5
17 average basis point spread above Treasuries as
18 seen at Exhibit__ (RRP-15), which we derived using
19 three methodologies. The result was our
20 forecasted debt cost of 5.10% shown at
21 Exhibit__ (RRP-3). The first method we used to
22 estimate the utility spreads was based on data
23 obtained from Bondsonline.com at Exhibit__ (RRP-
24 17), a website sponsored by Reuters that tracks

1 both primary and secondary debt issuances, which
2 indicated a current benchmark spread of 72 basis
3 points above 10-year Treasuries and 97 basis
4 points above 30-year Treasuries for A/A3-rated
5 utility debt, which we averaged together for 84.5
6 basis points. Second, we used Mr. Renner's method
7 of calculating the spreads, updated for the third
8 quarter of 2009 in his response to Staff IR DPS-
9 No. 233 (see Exhibit__ (RRP-18)), which resulted in
10 152.5 basis points. Finally, we calculated an
11 average of 157.5 basis points as the spread for
12 New York utility issuances in the third quarter of
13 2009. These issuances were from Central Hudson,
14 Niagara Mohawk (two separate ones), and Rochester
15 Gas & Electric Corporation.

16 Q. Why is your methodology of forecasting future debt
17 costs superior to that of Company Witness Renner?

18 A. While Mr. Renner's methodology is one possible way
19 to calculate the spreads, his data had become
20 stale since it was first used. This is
21 particularly important given the extreme market
22 volatility that was present during the time he
23 measured the spreads (the first half of 2009). In
24 addition, there are other reasonable methods for

1 estimating such spreads. Reuters provides up-to-
2 date spreads for utility debt by credit rating.
3 In addition, our methodology acknowledges that the
4 specifics of New York regulation may lead to
5 different spreads than found throughout the
6 country.

7 Q. Should the Commission update your interest rate
8 forecasts for the rate year debt issuances?

9 A. Yes, it should. In order for the Commission to do
10 this, the Company should provide the Commission
11 with the most current Bank of America Utility
12 Spread listing prior to the Commission's decision.

13 Q. In the Company's last rate case, due to the
14 volatility and uncertainties in the market, the
15 Commission ordered Central Hudson to defer the
16 variation between actual interest costs for any
17 new issues and for any existing auction-rate
18 securities and the amounts allowed in rates. Does
19 the Panel have a recommendation relative to this
20 adjustment in this proceeding?

21 A. Yes. As reported by Reuters, current spreads for
22 utility long-term debt are trading in the range of
23 100 basis points above Treasuries; this is
24 significantly lower than the 285 to 450 basis

1 points spreads we observed in October and November
2 of 2008, which were high due to the uncertainty in
3 the markets. However, given that market
4 conditions continue to be somewhat uncertain, we
5 recommend that the Commission re-authorize the
6 true-up of all new debt issuances and existing
7 auction rate securities. Accordingly, Central
8 Hudson should defer the variance between actual
9 interest costs for any new issues and for any
10 existing auction-rate debt and the amounts set in
11 rates. The true-up will serve to insulate the
12 Company from added financial risk and may protect
13 ratepayers/customers in the event that conditions
14 change and actual borrowing costs are lower than
15 forecast. Further, given that the uncertainty in
16 the market is subsiding, we recommend that this
17 adjustment be evaluated for cessation in rates
18 established beyond the rate year ending June 2011.

19 Cost of Customer Deposits

20 Q. What cost rate did the Panel employ for customer
21 deposits?

22 A. We employed a customer deposits rate of 2.45% for
23 investor-owned utilities. This rate was approved
24 and prescribed by the Commission at its November

1 12, 2009 session in accordance with Case 99-M-
2 1345. The customer deposit rate will be effective
3 on January 1, 2010.

4 Cost of Preferred Stock

5 Q. What cost rate did the Panel employ for Central
6 Hudson's preferred stock?

7 A. We reviewed and accept the 5.05% cost rate
8 presented in Mr. Renner's testimony.

9 Q. Please summarize the Panel's capital structure
10 recommendations for Central Hudson.

11 A. We recommend that for ratemaking purposes, Central
12 Hudson's revenue requirement for its gas and
13 electric operations should be determined on the
14 basis of the following capitalization ratios:
15 49.02% for long-term debt, 2.13% for preferred
16 stock, 0.85% for customer deposits and 48.0% for
17 common equity. Our recommendation supports the
18 Company's credit ratings and its access to
19 reasonably priced capital; our recommendation will
20 maintain the Company's investment grade credit
21 ratings.

22 Cost of Common Equity

23 Q. What methodology did the Panel use to determine
24 its recommended 9.60% cost of common equity for

1 Central Hudson?

2 A. We basically employed the methodology adopted by

3 the Commission in the Company's June 2009 Rate

4 Order in Cases 08-E-0887 and 08-G-0888 with three

5 exceptions. First, we did not apply an RDM

6 adjustment because the June 2009 Rate Order

7 instituted an RDM, we now assume that investors

8 reflect the RDM in the market price of the

9 Company's common stock. Second, we propose a

10 modification to the calculation of the proxy for

11 the market return in our CAPM analyses. Finally,

12 we propose a modification to the application of

13 the credit quality adjustment. Our methodology

14 establishes the ROE based on the result of a proxy

15 group-based, two growth rate DCF model analysis

16 and the average of two proxy group-based CAPM

17 analyses: the traditional CAPM and the zero beta

18 CAPM. We selected the proxy group from a universe

19 of 54 gas and electric utilities tracked by Value

20 Line Investment Survey (Value Line). Consistent

21 with Commission precedent, we determined the proxy

22 group cost of equity by weighting the results of

23 our DCF analysis and the average of our two CAPM

24 analyses at 2/3 and 1/3, respectively. Then, in

1 order to determine the return on equity for
2 Central Hudson, we applied a credit quality
3 adjustment factor to reflect the fact that the
4 Company has a lower overall risk profile than that
5 of the proxy group, and therefore, its return on
6 equity should be adjusted downward.

7 Q. The Commission's precedent is generally derived on
8 the basis of the RD in Case 91-M-0509, Proceeding
9 on Motion of the Commission to Consider Financial
10 Regulatory Policies for New York State Utilities
11 (GFC), issued on July 19, 1994. On page 16 of Dr.
12 Morin's testimony he criticizes the Commission's
13 use of this methodology. Do you have any
14 comments?

15 A. Yes, we do. Our cost of equity methodology is
16 formulated on the basis of a model, which when
17 developed in 1991, was backcast over the previous
18 13 years to ensure that it would provide
19 reasonable, non-volatile results over a range of
20 economic conditions. The inputs to the DCF and
21 CAPM models were fully vetted by DPS Staff,
22 experts in the field and by the utility companies
23 that participated in the proceeding. Since that
24 time, improvements, in the form of modifications

1 and refinements, have been made to the methodology
2 to reflect changes in the utility industry, more
3 reliable data sources and changes in the markets.
4 These improvements confirm the Commission's
5 commitment to support the credit quality of New
6 York State (NYS) energy utilities.

7 Q. The GFC RD was not formally ordered by the
8 Commission; however, over the years in the
9 Commission's rate orders it has consistently
10 authorized ROEs and other cost of capital issues
11 based on Staff's recommendations, which were based
12 on the GFC RD. Can the Commission rely on the GFC
13 RD for guidance in setting ROEs?

14 A. Yes, the Commission is entitled to consider prior
15 decisions and Staff's analyses in setting rates.
16 Although the GFC RD was not adopted by the
17 Commission, the Commission uses its general
18 framework in setting utility rates.

19 Proxy Group Analysis

20 Q. You indicated that the first step in your
21 methodology was to establish a proxy group. Why
22 are you using a proxy group to estimate the cost
23 of equity?

24 A. Proxy group analysis is widely accepted as the

1 standard practice for estimating the cost of
2 common equity. The benefits from employing a
3 proxy group are directly related to the number of
4 companies in the group. The more companies in a
5 given proxy group, the less sensitive the overall
6 cost of equity estimate because the impact of
7 irregularities from any one company's data tends
8 to be mitigated.

9 Q. What selection criteria did the Panel apply to
10 select its proxy group companies?

11 A. We applied four selection criteria to the universe
12 of 54 electric and gas utility companies tracked
13 by Value Line. The four criteria were that each
14 company: 1) have investment grade, senior debt
15 credit ratings from S&P's of BBB- and higher
16 and/or from Moody's of Baa3 or higher; 2) derive
17 at least 70% of its revenues from regulated
18 (electric and/or gas) utility operations, as
19 determined by its 10K report for 2008 (70%
20 selection criterion); 3) currently pay dividends;
21 and 4) have no current/pending mergers or other
22 circumstance that could significantly impact its
23 financial statistics as reflected in current
24 reports.

- 1 Q. How many companies did the Panel include in its
2 proxy group on the basis of these selection
3 criteria?
- 4 A. We constructed a proxy group of 30 electric and
5 gas utilities, as listed in Exhibit__ (RRP-8). Our
6 proxy group of 30 companies is slightly larger
7 than Dr. Morin's two proxy groups that each
8 contains 21 companies. Overall, the credit
9 ratings data, reflective of both business and
10 financial risks, and the other proxy group
11 statistics indicate that our proxy group is more
12 risky than Central Hudson. After determining the
13 proxy group cost of equity, we made an adjustment
14 to account for the risk differential between the
15 proxy group average and Central Hudson. For each
16 company in the proxy group, Exhibit__ (RRP-8)
17 provides its percentage of regulated revenues, its
18 S&P and Moody's bond ratings, its S&P business and
19 financial risk profile weightings for the risk
20 profile ratings and its equity ratio as of June
21 2009. We note that many of the companies in our
22 proxy group are holding companies and so the bond
23 ratings are that of the holding/parent company.
- 24 Q. Explain the relationship between holding/parent

1 company credit ratings to their utility
2 subsidiaries.

3 A. The methods we use for estimating the cost of
4 equity are based upon the stock prices of,
5 dividends paid by, and financial ratios reported
6 by the relevant entity. In the case of a utility
7 subsidiary that is owned by a parent/holding
8 company, this activity generally occurs at the
9 parent/holding company level. Equity investors do
10 not purchase ownership of the individual utility
11 subsidiary; instead, they purchase ownership of
12 the entire holding company, which includes its
13 utility subsidiaries and its non-utility
14 operations. Equity investors will logically base
15 their return requirements on the risk level of the
16 entire company, rather than its strongest
17 individual components.

18 Q. How does this relationship impact the overall
19 credit rating of the proxy group?

20 A. The price investors are willing to pay for a share
21 of common stock is based on their expectations
22 concerning the future of the "entire company" and
23 its associated risks. While an individual utility
24 subsidiary may be judged by rating agencies to be

1 worthy of approximately an "A" rating, the higher
2 risks of its parent's non-utility operations may
3 make the risk level of the entire enterprise
4 closer to that of a "BBB" rating, several notches
5 lower.

6 Q. Has the Commission ever adopted a cost of equity
7 recommendation based on a proxy group with a 70%
8 selection criterion?

9 A. Yes, in addition to the Company's 2009 Rate Order,
10 the Commission has set a number of ROE allowances
11 based on a proxy group with a 70% selection
12 criterion. The rate proceedings include: Orange
13 and Rockland in Cases 06-E-1433 and 07-E-0949, Con
14 Edison in Cases 07-E-0523 and 07-S-1315 and
15 National Fuel Gas Distribution Corporation in Case
16 07-G-0141.

17 Q. Given that Central Hudson is rated A/A3 by S&P and
18 Moody's, why didn't the Panel restrict its
19 selection criteria to only A-rated companies?

20 A. The intent of our selection criteria was to
21 achieve two goals: 1) to develop a proxy group of
22 utility companies with risk profiles similar to
23 Central Hudson, and 2) to obtain a relatively
24 robust number of utility companies in the proxy

1 group. Rather than restrict our selection
2 criteria to only A-rated utility companies
3 (resulting in only 9 companies), we relaxed our
4 selection criteria to include a greater number of
5 companies in our proxy group. As the number of
6 companies in the proxy group increases the better
7 the smoothing of vagaries between the companies in
8 the analysis.

9 Q. Is the proxy group's financial profile equally
10 matched to that of Central Hudson?

11 A. No, it is not. There are a number of factors that
12 differ. First, the proxy group derives 92.4% of
13 its revenues from regulated investments as opposed
14 to Central Hudson that achieves 100% of its
15 revenues from regulated operations. Second, with
16 an average credit rating of BBB+/Baa1-Baa2, the
17 proxy group's credit rating is two notches lower
18 than that of Central Hudson at A/A3. Third, the
19 average beta for the proxy group is 0.70, CH
20 Energy Group's beta is 0.60 and we estimate
21 Central Hudson's beta at 0.53. And, finally, the
22 proxy group's average S&P score for its financial
23 risk profile is equivalent to "significant", the
24 category below Central Hudson's "intermediate"

1 score. Both Central Hudson and the proxy group
2 have an "excellent" business risk profile score.
3 Overall, on the basis of the credit ratings that
4 incorporate both business and financial risks, the
5 proxy group is more risky than Central Hudson.

6 Q. Earlier you stated that you adjusted the proxy
7 group cost of equity because the proxy group is
8 more risky than Central Hudson. Could you explain
9 the basis for the adjustment?

10 A. Generally, when discussing financial returns,
11 riskier ventures are accorded higher returns
12 because investors undertake a greater risk when
13 they provide debt or equity to such ventures.
14 Since the proxy group is more risky than Central
15 Hudson, our failure to adjust the proxy group's
16 cost of equity for the Company would effectively
17 compensate the Company's investors for the risks
18 faced by the unregulated operations of the proxy
19 group companies. An unadjusted ROE is neither
20 just nor reasonable and discriminates against
21 ratepayers/customers. In a perfect world, the
22 risks of a proxy group would perfectly match
23 Central Hudson's risk; such a result is currently
24 unattainable given the relatively small number of

1 utility companies with A-ratings. To account for
2 this difference in risks, we applied a credit
3 quality adjustment factor to our proxy group cost
4 of equity. The mechanics of this factor is
5 explained in our discussion of the adjustment.

6 Q. Do you have a recommendation concerning the use of
7 proxy groups in the cost of equity analyses?

8 A. Yes, we recommend that the Commission adopt our
9 proxy group because our selection criteria
10 resulted in proxy group companies that are
11 generally less risky than that in Dr. Morin's
12 proxy groups.

13 DCF Methodology

14 Q. Describe the basic theory underlying the DCF
15 methodology.

16 A. The DCF method is a market-based approach that is
17 generally used to quantify the fair rate of return
18 on equity. According to this approach, the total
19 return to an investor from a share of common stock
20 is the discount rate that equates the current
21 stock price with the future returns on that stock.
22 Future returns include dividends paid over a
23 certain time period in the future and the price
24 that a future investor would be willing to pay for

1 the share of stock at the end of that time period.
2 These future payments are usually adjusted to
3 reflect investors' growth expectations with
4 respect to dividends and the value of the stock.
5 The DCF, as it is traditionally used, assumes that
6 an investor will hold a share of stock in
7 perpetuity. Alternatively, if the share of stock
8 is not held in perpetuity, the model assumes that
9 the next investor will pay a price that reflects
10 the same growth rate.

11 Q. Describe the Panel's DCF model and its data
12 inputs.

13 A. We employed a two-growth rate DCF model to
14 determine the proxy group's average cost of
15 equity. The assumptions used to derive the proxy
16 group cost of equity are presented in
17 Exhibit__ (RRP-6). For each utility in the proxy
18 group, we used stock prices and financial data for
19 the three-month period ended September 2009. The
20 stock price data input is the monthly high and low
21 closing price, from Yahoo Finance at
22 <http://finance.yahoo.com>, over the three-month
23 period. Other financial data were obtained from
24 Value Line, third quarter-2009 data, and included

1 each utility's beta, actual and forecast earnings
2 per share, dividends per share, book value per
3 share, and actual and forecasted number of common
4 stock shares outstanding.

5 Q. Why did you use three-month average stock prices
6 in your DCF model?

7 A. Three months reflects an adequate period of time
8 to capture current events, and therefore, it is
9 not stale, and it is long enough to minimize
10 volatility by smoothing data over the three
11 months. It is preferable to the spot price
12 employed by the Company, because a spot price for
13 a given company changes daily dependent upon
14 factors related to investors' reactions to
15 economic, business and political activity.
16 Volatile stock prices result in volatile and
17 unreliable cost of equity estimates. We employed
18 three-month average stock prices in our DCF
19 analysis because: 1) the Commission employed a
20 three-month average price in its determination of
21 the DCF cost of equity in the Company's 2009 Rate
22 Order and 2) the use of three-month average data
23 is consistent with the other data inputs to our
24 cost of equity model (i.e., quarterly (three-

1 month) data inputs from Value Line, our three-
2 month average risk free rate and our proposed
3 three-month average market return estimate.

4 Q. For your model you calculated short-term dividend
5 growth rates based on Value Line data and you
6 calculated long run dividend growth rates based on
7 your calculation of retention growth rates. Why
8 did you use Value Line data for the short-term
9 growth rates?

10 A. For each company in our proxy group, the short-
11 term dividend growth rate was based on Value
12 Line's estimates of its dividend growth over the
13 next five years. We used Value Line as our
14 reference for this data because it stands alone in
15 its provision of dividend growth rate data and we
16 have determined that the data is reliable.
17 Therefore, we are confident that these data inputs
18 do not bias our DCF cost of equity results.
19 Moreover, dividend growth estimates do not require
20 as many assumptions as earnings growth forecasts
21 because data concerning a company's past and
22 expected dividend policies are readily available
23 to investors. Given that a company pays its
24 dividends out of its earnings and earnings that

1 are not paid out are reinvested in the company in
2 the form of common stock, short-term dividend
3 growth rates are easy to determine and are rarely
4 contentious.

5 Q. Why did you calculate retention growth rates for
6 the long run dividend growth component of your DCF
7 model?

8 A. We use retention growth estimates as a proxy for
9 sustainable growth in the DCF model; this use is
10 consistent with Commission precedent. Retention
11 growth is referred to as sustainable growth
12 because it is based on the logical premise that
13 dividends, earnings and book value growth are
14 dependent upon retention growth (i.e., earnings
15 that are not paid out as dividends) in the long-
16 run.

17 Q. There is a debate concerning whether retention
18 growth rates are circular; what are the concerns
19 relative to your DCF analysis?

20 A. The general issue of circularity centers on the
21 question of why, in our current analysis, is the
22 long-run median expected return on equity 10.75%,
23 when our recommended return on equity is 9.60%.
24 We have two reasons that invalidate the

1 circularity argument relative to our analysis: 1)
2 the fact that the expected return on equity is
3 calculated for parent/holding companies of the
4 regulated operating utilities and 2) the
5 correlation between the investors' expected return
6 on equity and investors' required return on
7 equity.

8 Q. Why is the fact that the median expected return on
9 equity factor is based on parent/holding company
10 data an important consideration?

11 A. The expected return on equity is one of two
12 factors employed in the retention growth rate
13 calculation; the second is each company's
14 retention ratio. Our review of financial data in
15 the Regulatory Research Associates (RRA) report
16 entitled "SNL Energy Financial Focus, Electric
17 Utility Quality Measures: Rankings and Trends
18 Calendar Years 2004-2008 and 12 Months ended June
19 30, 2009" (Exhibit__(RRP-17)) indicated that for
20 the last five years ended December 2008, the
21 parent/holding companies earned an average ROE of
22 11.6% compared to the operating companies' average
23 ROE of 10.2%. For the 12 months ended June 2009,
24 the parent/holding companies earned an average ROE

1 of 10.9% and the operating companies earned an
2 average ROE of 9.3%. Therefore, it is not
3 surprising that our proxy group's median
4 "expected" ROE at 9.94% is higher than our 9.60%
5 recommended ROE for Central Hudson; this
6 differential invalidates neither our data input
7 nor our result.

8 Q. What is the correlation between the investors'
9 expected return on equity and investors' required
10 return on equity?

11 A. We employed Value Line data to calculate the
12 median expected ROE of 9.94%. The expected return
13 on equity in our model helps quantify the "growth
14 rate" that investors expect because the actual
15 return on equity has a great influence on the
16 level of future cash flows. The expected ROE in
17 our model is different from the expected return on
18 equity that investors expect to receive on their
19 market price investments. The return investors
20 actually receive reflects future cash flows
21 consistent with the achieved return on equity.
22 Our retention growth rate calculation is
23 consistent with the return investors require.
24 Accordingly, the Commission should continue to

1 employ retention growth rates in its DCF cost of
2 equity determinations.

3 Q. What was the result of the Panel's DCF analysis?

4 A. Based on the inputs described above, the median
5 DCF cost of equity for the proxy group was 9.94%
6 (Exhibit__ (RRP-5)).

7 Capital Asset Pricing Models

8 Q. Panel, please describe the basic theory underlying
9 the CAPM?

10 A. The CAPM separates a stock's total risk into two
11 components, systematic risk and unsystematic risk.
12 Systematic risk is the risk caused by general
13 movements in the stock market. It reflects the
14 risk inherent to all stocks due to changes in the
15 market economy. This risk cannot be diversified
16 away through either a blended portfolio or through
17 involvement in various enterprises. On the other
18 hand, unsystematic risk is company-specific risk.
19 Portfolio managers can minimize or eliminate
20 unsystematic/company-specific risk through
21 diversification of the portfolio by investing in
22 various enterprises that do not face unilateral
23 risks (e.g., investments in utility and
24 entertainment companies). Investment portfolios

1 are generally diversified on the basis of
2 unsystematic risk. Beta measures the degree of
3 systematic risk of stock by reflecting the return
4 volatility of a particular stock in relation to
5 the market. The higher the expected risk of an
6 investment, the higher its risk contribution to
7 the overall risk of a portfolio, and therefore,
8 the higher the return required by an investor to
9 make an investment. The average beta value of all
10 stocks is equal to 1.0. If a particular stock has
11 a beta of 1.0, the variability in its return due
12 to macroeconomic factors will be equal to that of
13 the market as a whole. A stock with a beta of 0.5
14 is half as risky as the average stock.
15 Conversely, a stock with a beta of 2.0 is twice as
16 risky as the average common stock. Utilities
17 generally have betas less than 1.0, as they are
18 less risky than the market as a whole. The proxy
19 group's average beta is 0.70, as seen at
20 Exhibit__ (RRP-6).

21 Q. Panel, how did you conduct your CAPM analysis?

22 A. To conduct our analysis, we employed two proxy
23 group CAPM approaches: the traditional CAPM
24 approach and the zero beta (or empirical) CAPM

1 approach.

2 Traditional CAPM

3 Q. Please describe the traditional CAPM analysis.

4 A. The traditional CAPM determines the cost of equity
5 by adding one factor to the risk-free rate (R_f),
6 the beta multiplied times the risk premium. For
7 our risk-free rate we used the three-month average
8 of 10-year and 30-year Treasury bonds. Since we
9 conducted a proxy-group based analysis, the beta
10 (β) input was the average of each proxy group
11 company's Value Line (third quarter ending 2009)
12 beta. Next we determined the risk premium (R_p)
13 which is calculated by subtracting the risk-free
14 rate from the proxy for the market return. Our
15 proxy for the expected market return (R_m) was the
16 three-month average of the implied and required
17 return for the companies in the S&P 500 index, as
18 forecasted by Bank of America/Merrill Lynch in the
19 August, September and October 2009 editions of
20 Quantitative Profiles shown at Exhibit__ (RRP-17).
21 The S&P 500 is an index that tracks the
22 performance of the common stock of the 500 largest
23 corporations that trade over the New York Stock
24 Exchange. The traditional CAPM equation is:

1 $K_e = R_f + \beta (R_m - R_f)$.

2 Q. What value did you determine for the CAPM data
3 inputs?

4 A. Our data inputs are shown in Exhibit__ (RRP-5). We
5 employed a risk-free rate (R_f) of 3.92%, an average
6 proxy group beta (β) of 0.70, and an expected
7 market return (R_m) of 11.95. We used these same
8 inputs in calculating the zero beta CAPM.

9 Q. Why did you use a three-month average of 10-year
10 and 30-year Treasury bonds as your risk-free rate?

11 A. This risk free rate reflects investors' short-term
12 and long-term investment horizons and mitigates
13 volatility, thereby yielding more reliable cost of
14 equity determinations. The use of a six-month
15 average of 10-year and 30-year Treasury rates was
16 a convention developed under the context of the RD
17 in the GFC proceeding. At the time, the six-month
18 average of the Treasury rates was proven to limit
19 volatility in cost of equity determinations. In
20 the Company's 2009 Rate Order, the Commission, in
21 light of the uncertainty in the markets,
22 determined that a three-month average was a better
23 indicator of current information, for both the
24 risk-free rate and the average stock prices

1 employed in the DCF model.

2 Q. You also indicated that for the market return you
3 are using a three-month average of implied and
4 required returns for the S&P 500, as reported in
5 Quantitative Profiles. Is the three-month average
6 a modification to this data input?

7 A. Yes, it is. In recent months we have noticed a
8 significant level of volatility in the cost of
9 equity calculation due to monthly changes in the
10 Quantitative Profiles estimates. Our analysis,
11 shown at Exhibit__ (RRP-10), shows that a three-
12 month average can mitigate some of this
13 volatility. In addition, the change to a three-
14 month average of implied and required returns for
15 the market return is consistent with the three-
16 month average data format we employ for inputs to
17 the DCF (market price, earnings, dividends, etc.)
18 and for the other elements of the CAPM (the
19 average beta and the risk-free rate). Our current
20 CAPM analysis is unaffected by this change because
21 at this time the three-month average for the
22 market return and the one-month average for the
23 market return are equal. Given the practicality
24 of this modification, we recommend that the

1 Commission adopt the three-month average of
2 Quantitative Profiles data for the expected market
3 return data input to the CAPM.

4 Q. What was the result of your traditional CAPM
5 analysis?

6 A. The traditional CAPM analysis yielded a 9.55% cost
7 of equity.

8 Zero Beta CAPM

9 Q. Please describe the zero beta CAPM analysis?

10 A. The zero beta CAPM holds one quarter of the
11 assumed "risk premium" to be constant. The
12 rationale is that studies have shown that
13 traditional CAPM results underestimate the
14 required return for low-beta securities. For our
15 analysis, the zero beta CAPM determines the cost
16 of equity by adding two factors to the risk free
17 rate: 1) a factor of 75% times the average proxy
18 group Value Line beta times the risk premium
19 earned by stocks in the S&P 500, and 2) a factor
20 of 25% times the premium earned by stocks in the
21 S&P 500. The zero beta CAPM equation used in the
22 GFC methodology is:

23
$$K_e = R_f + .75*\beta*(R_m - R_f) + .25*(R_m - R_f)$$

24 Q. What was the result of the zero beta CAPM

1 analysis?

2 A. The zero beta CAPM analysis yielded a 10.15% cost
3 of equity.

4 Proxy Group Return on Equity

5 Q. Given the cost of equity results for the proxy
6 group based on the DCF model analysis, the
7 traditional CAPM analysis, and the zero beta CAPM
8 analysis, what is the Panel's cost of common
9 equity result for the proxy group?

10 A. Our proxy group-based DCF analysis yielded a DCF
11 cost of equity of 9.94%, a traditional CAPM cost
12 of equity of 9.55%, and a zero beta CAPM cost of
13 equity of 10.15%. The average of the two CAPM
14 analyses was 9.85%. Using our 2/3 DCF and 1/3
15 average CAPM weighting, the resultant cost of
16 common equity is 9.91%; that is $[(2/3 * 9.94%) +$
17 $(1/3 * 9.85\%)]$. We reduced the 9.91% proxy group
18 cost of equity by a credit quality adjustment of
19 30 basis points.

20 Q. How does the Panel justify the 2/3 DCF-1/3 CAPM
21 weighting?

22 A. Since 1991, the Commission has consistently used
23 the DCF as its primary methodology for determining
24 ROE by applying a 2/3 DCF and 1/3 CAPM weighting

1 in the determination of the cost of equity. The
2 weighting was first established in the RD for the
3 GFC and has been the Commission's preferred
4 weighting in litigated rate proceedings
5 thereafter. The Commission underscored its
6 preference for this weighting in its Rate Order
7 for Orange and Rockland Utility Company, Inc.
8 (Orange & Rockland), Cases 06-E-1433 and 06-E-
9 1547. On pages 14 and 15 of the Order, the
10 Commission stated: "We will continue to accord
11 two-thirds weight to the DCF result and one-third
12 to the CAPM result as we have in past decisions.
13 This result is consistent with the recommendation
14 of the co-facilitators in the Generic Financing
15 proceeding. We note some of the concerns raised
16 by Orange and Rockland regarding undue weight on
17 the DCF methodology. Many of these concerns are
18 addressed by the two-stage DCF method employed by
19 Staff. Moreover, the method offers the
20 significant benefit of reliance on readily
21 available, objective data to measure an indicator
22 of real importance to investors. Our decision to
23 retain the current weighting of the two approaches
24 is also based on concerns we have regarding the

1 application of the CAPM. It is our general
2 observation that, while the business risks of New
3 York's electric utilities have declined as
4 generation assets have been divested, the betas of
5 the holding companies owning electric utilities
6 have in fact increased. While this increase in
7 the volatility of holding Company stock prices
8 relative to the market could reflect increased
9 utility risk, it could just as easily be
10 attributable to the higher risks of holding
11 Company non-utility businesses. ...Given concerns
12 such as these, we are not now inclined to deviate
13 from our long-held view that the CAPM methodology
14 should not be entitled to more than one-third of
15 the weight in our ROE determination." The
16 Commission's preference for this weighting is
17 still reasonable and, therefore, we applied the
18 2/3 DCF and 1/3 CAPM weighting as the basis of our
19 return on equity recommendation for Central
20 Hudson.

21 Credit Quality Adjustment (CQA)

22 Q. Why did the Panel apply a CQA to its proxy group
23 cost of equity determination?

24 A. As we indicated earlier, the proxy group profile

1 indicates that it is more risky than Central
2 Hudson. Our rationale for the CQA is based on the
3 fact that the return requirements of common equity
4 investors are commensurate with the risk of their
5 investment. Therefore, the risk of the proxy
6 group indicates that theoretically, its common
7 equity investors would require a higher return
8 than Central Hudson's common equity investors.
9 Since the S&P and Moody's credit ratings reflect
10 the default, business and financial risks of the
11 rated entity, we employed the credit ratings as a
12 measure of the companies' risk and as the basis of
13 our CQA.

14 Q. Are credit ratings a reasonable measure of the
15 companies' risk?

16 A. Yes, they are. S&P and Moody's assign ratings to
17 issuers of debt based upon their determination of
18 the entity's default risk. The assignment of
19 credit ratings, however, incorporates an entity's
20 business and financial risk. Therefore, within a
21 given industry group, such as regulated electric
22 gas companies, an investor would expect a greater
23 return on investments made in the companies with
24 higher default and/or business and/or financial

1 risks. In our analysis the proxy group has a
2 higher average level of default risk than Central
3 Hudson. Specifically, the proxy group profile
4 reflects an average of 92.4% of revenues from
5 regulated operations, a 45.3% equity ratio, an S&P
6 credit rating of BBB+, a Moody's credit rating
7 between Baa1 and Baa2, an excellent business risk
8 score and a significant financial risk score.
9 Comparatively, Central Hudson acquires 100% of its
10 revenues from regulated operations; it has a 48%
11 equity ratio, an S&P credit rating of A, a Moody's
12 credit rating of A3, an excellent business risk
13 score and a intermediate financial risk score
14 (Exhibit__ (RRP-8)). Central Hudson's credit
15 ratings at A/A3 are two notches above that of the
16 proxy group, which indicates that the proxy group
17 has higher overall risks than Central Hudson.
18 Specifically, the higher risks to bondholders
19 evidenced by lower credit ratings also creates
20 additional risks to shareholders because in the
21 event of bankruptcy, they are last to be paid.
22 Therefore, the proxy group cost of equity should
23 be adjusted downward to reflect this risk
24 differential.

1 Q. Has the Commission employed the CQA in determining
2 authorized returns on equity for utility
3 companies?

4 A. Yes, the Commission has consistently applied a CQA
5 to adjust for risk differentials between the proxy
6 group and the utility company under consideration.
7 In our analysis, the majority of companies in our
8 proxy group are parent/holding companies instead
9 of regulated utility companies; therefore, the
10 proxy group's average risk profile is more risky
11 than Central Hudson. The Commission applied the
12 CQA in the Company's last rate case and for all
13 return on equity determinations made in its
14 recently litigated rate case proceedings.

15 Q. How did the Panel calculate this adjustment?

16 A. Our adjustment uses utility bond yield data from
17 the October 2009 edition of Mergent Bond Record
18 shown at Exhibit__ (RRP-17) to calculate the five-
19 year average yield on debt rated A, Aa and Baa to
20 be 5.85%, 6.08% and 6.57%, respectively, as shown
21 at Exhibit__ (RRP-4). From this data, we
22 determined the implied yields for Central Hudson
23 and the proxy group to be 6.17% and 6.46%,
24 respectively. We next calculated the ratio of the

1 proxy group's DCF cost of equity at 9.94% to its
2 implied yield of 6.46% for a ratio of 1.5374. The
3 ratio of the "DCF" cost of equity rather than the
4 overall proxy group cost of equity is a
5 modification to the CQA that we are proposing in
6 this proceeding. We used the DCF cost of equity
7 because it is a company-specific model as opposed
8 to the CAPM methodology, which is more of a
9 market-based methodology. To determine the
10 adjusted Central Hudson DCF cost of equity, we
11 calculated the product of the ratio and Central
12 Hudson's implied 6.17% bond yield (1.5374 x
13 6.17%); this resulted in a Central Hudson DCF cost
14 of equity of 9.49, and a CQA of 46 basis points,
15 as shown in Exhibit__ (RRP-7). With our 2/3 DCF
16 and 1/3 CAPM weighting, the applicable CQA is 30
17 basis points (2/3 * 46 basis points). The
18 resultant Central Hudson cost of equity was 9.61%,
19 which we rounded to 9.60%.

20 Reasonableness Check

21 Q. In his discussion concerning the relationship
22 between financial risk and the authorized ROE on
23 page 52 of his testimony, lines 14 to 19, Dr.
24 Morin states that the Commission's last ROE

1 authorization for Con Edison was among the lowest
2 allowed ROEs for a major electric utility in the
3 country. Do you have any concerns about this
4 claim?

5 A. Yes, we reviewed allowed ROEs granted to electric
6 and gas utilities during 2009 to-date, as reported
7 in the SNL database (Exhibit__(RRP-17)) and
8 observed that 22 electric decisions had authorized
9 ROEs in the range of 8.75% to 11.50% and 14 gas
10 decisions had authorized ROEs in the range of
11 9.26% to 10.75%. Since, the average authorized
12 ROEs were 10.51% for electric and 10.12% for gas,
13 obviously, Con Edison's 10% ROE was only slightly
14 lower than the average ROE. We note that the
15 Commission did not authorize the 8.75% ROE, which
16 was the lowest in the country. Our 9.60%
17 recommended ROE falls within these ranges.

18 Q. Should the Panels' return on equity recommendation
19 for Central Hudson be compared to the authorized
20 return on equity determinations awarded to utility
21 companies in other jurisdictions?

22 A. No, it is very difficult to draw any meaningful
23 conclusions from a straight comparison of the
24 allowed ROEs in other jurisdictions to our

1 recommendation because there are many facts and
2 circumstances that differentiate the allowed
3 returns. For example, it is expected that utility
4 companies that have higher default, business and
5 financial risks will have higher ROE
6 authorizations. Higher ROEs are also expected for
7 multi-year rate plans (that typically include a
8 stay-out premium). Moreover, the allowed returns
9 associated with settlement agreements have to be
10 viewed with caution since the return which a
11 utility obtains in a settlement may be premised on
12 monetary concessions by the utility in other
13 areas, which could cause the utility to earn less
14 than the indicated allowed return.

15 Q. Are there other factors that are important to
16 consider when comparing return on equity
17 authorizations between NYS and other states?

18 A. Yes, there are a number of important ratemaking
19 differences between NYS and other states. First,
20 unlike most states, the Commission sets utility
21 rates on the basis of a forecast of costs for the
22 future rate year. Many Commissions set rates
23 using historical information or limited forecasts
24 of the future. The use of forecasts to set rates

1 makes it more likely that the utility will
2 actually earn its allowed return than a situation
3 in which rates for a future period are based
4 primarily on historic costs. This is particularly
5 important for companies like Central Hudson that
6 plan capital programs and, as a result, are likely
7 to see growth in rate base over time.

8 Q. Have you estimated the impact on Central Hudson's
9 allowed return on equity, if a historical rate
10 base were used instead of a fully forecast rate
11 base?

12 A. Yes, the Company's rate base as of March 31, 2009
13 was \$767.865 M, as shown in the Company's Response
14 to Staff IR DPS-328-"Summary and Details" at
15 Exhibit__(RRP-18). Assuming the same level of
16 pre-tax revenues as determined for our fully-
17 forecast rate base, the Company's allowed return
18 on equity would be set at nearly 13.7% instead of
19 9.60%.

20 Q. What other factors differentiate the Commission
21 from other state regulatory bodies.

22 A. The Commission has implemented a number of other
23 ratemaking mechanisms which result in a reduction
24 of utility risks. For example, Central Hudson has

1 a weather normalization clause and a revenue
2 decoupling mechanism. These mechanisms reduce
3 potential earnings volatility, and therefore,
4 risk. In addition to these mechanisms, the
5 Commission has a long-standing policy which allows
6 utilities to defer expenses provided the expense
7 is not already in rates, financially significant
8 and the utility is not in an overearnings
9 position. In fact, in this proceeding, we are
10 recommending that the Company be allowed to true-
11 up differentials in its new debt interest rates.
12 The Commission has also established regulatory
13 mechanisms which enable utilities to collect all
14 reasonable fuel and purchased power expenses in a
15 timely manner, and to collect pension and OPEB
16 costs and site investigation and remediation
17 costs.

18 Updates to the Panel's Return on Equity Recommendation

19 Q. Your testimony indicates that your recommended
20 return of equity should be updated for the ALJs'
21 RD and for the Commission's Order. How should
22 this update occur?

23 A. The updated return on common equity should be
24 based on a rerun of our model with the latest

1 available data inputs as required by the model, to
2 which an updated credit quality adjustment should
3 be applied.

4 Discussion of the Company's Rate of Return Testimony

5 Q. What is the Company's return on equity proposal?

6 A. The Company's witness, Mr. Mosher, is proposing
7 that the Company's initial revenue requirement
8 model include a cost of equity of 10% (from the
9 Company's 2009 Rate Order). Mr. Mosher refers to
10 the 10% return on equity as the best indicator of
11 the Company's cost of equity at the time of its
12 July filing (Mosher testimony, page 4, lines 5
13 through 13). Further, he states that the Company
14 reserves the right to increase its request if
15 economic indicators, so dictate; however, in
16 contrast to our recommendation that our cost of
17 equity be updated in accordance with our
18 methodology, at the time of the RD and the
19 Commission's Order, regardless of the impact of
20 the update, Mr. Mosher proposes no set methodology
21 nor point in time to update his cost of equity.
22 In response to Staff's IR DPS 14, Exhibit__ (RRP-
23 18), he indicates that the Company would only
24 increase its request. The Company also sponsored

1 a rate of return witness, Dr. Roger Morin, who is
2 proposing a return on equity of 11.25%, the
3 midpoint of his 11% to 11.5%, cost of equity
4 range. Dr. Morin indicates that he will update
5 his ROE testimony if substantial changes occur
6 between the filing date of his testimony and the
7 date his oral testimony is presented (Morin
8 testimony, page 60, lines 1-9). Dr. Morin
9 provides further information concerning his
10 testimony in the Company's Response to Staff IR
11 DPS-13, Exhibit__ (RRP-18).

12 Q. Could the Panel briefly describe Dr. Morin's cost
13 of equity methodology?

14 A. Dr. Morin's methodology included a traditional
15 CAPM, an empirical CAPM, a Historical Risk Premium
16 analysis and a single growth DCF model analysis.
17 The DCF analysis was conducted on two proxy
18 groups, a group of investment grade dividend
19 paying, combination electric and gas companies
20 culled from AUS Utility Reports and tracked by
21 Value Line (the Value Line proxy group) and a group
22 of utilities that make up the S&P Electric Utility
23 Index (the S&P proxy group). The average results
24 from each of the three analyses were CAPM at 9.8%,

1 the Risk Premium at 11.5% and the DCF at 12.3% for
2 a range of 9.8% to 12.3% and an average of 11.1%.
3 Dr. Morin then stated that from these results he
4 concluded that Central Hudson's cost of equity was
5 in the range of 11.0% to 11.5%, from which he
6 recommended the midpoint, 11.25%. Dr. Morin's
7 methodology includes several pervasive flaws and
8 therefore, his costs of equity results are
9 unreliable.

10 Q. What flaws did the Panel identify in Dr. Morin's
11 methodology?

12 A. We identified four main flaws in Dr. Morin's
13 methodology. The first flaw is applicable to all
14 of Dr. Morin's results, which is his application
15 of a 30 basis points flotation cost adjustment to
16 each of his cost of equity results. Second, his
17 historical risk premium model is unacceptable
18 because of his use of stale data to estimate the
19 risk premium. Third, his CAPM data inputs for the
20 risk-free rate and the market risk premium are
21 unreliable. Fourth, he employed a single growth
22 rate DCF model and his data inputs including spot
23 prices and earnings growth forecasts to estimate
24 dividend growth were unreliable. Moreover, he

1 failed to adjust his proxy group cost of equity to
2 reflect the risk differential between the proxy
3 group and the Company. When considered
4 collectively, these analytical shortcomings
5 indicate that Dr. Morin's proposed cost of equity
6 for Central Hudson is unreliable. We, therefore,
7 recommend that the Commission either reject Dr.
8 Morin's cost of equity methodology, or if it is
9 considered, the appropriate modifications should
10 be made to his methodology.

11 Dr. Morin's Flotation Cost Adjustment

12 Q. Dr. Morin's cost of equity methodology adds a 30
13 basis points flotation cost adjustment to each of
14 his cost of equity results. Why is this premium
15 an error?

16 A. The Commission only provides for recovery of
17 flotation costs/issuance expenses when a public
18 common stock issuance is planned during the rate
19 year. Since CH Energy plans no common stock
20 issuance during the rate year, Dr. Morin's
21 flotation cost adjustment proposal will increase
22 the cost of equity to recover flotation costs for
23 public common stock issues that occurred in
24 previous years; this is retroactive ratemaking and

1 is not recognized by the Commission. Given these
2 facts, the Commission should reject Dr. Morin's
3 proposal for a flotation cost adjustment in this
4 proceeding.

5 Dr. Morin's Historical Risk Premium Analysis based on
6 Utility Bond Yields and Utility Bond Returns

7 Q. In the past, Dr. Morin's historical risk premium
8 analyses were based on historical market returns
9 derived on spreads over Treasury bond yields. In
10 this proceeding, he has presented a historical
11 risk premium analysis based on the spread of
12 utility cost of equity determinations, for
13 companies in the S&P Utility Index, over long term
14 utility bond yields and over long term utility
15 bond returns over the period from 1930 to 2007
16 (Exhibit__RAM-4). Does the Panel have any
17 comments concerning this methodology?

18 A. Yes, we do. Dr. Morin calculated a market risk
19 premium of 5%, which he added to: a) a 6% current
20 estimate for A-rated utility bond yields and b) a
21 0.30% flotation cost premium, which resulted in an
22 11.3% cost of equity. We continue to reject Dr.
23 Morin's use of historical risk premium models
24 because the market risk premium is based on stale

1 data that does not reflect current market
2 conditions. In this case, he used a horizon of
3 more than 75 years (1930 through 2007) to
4 determine the 5% so-called risk premium for
5 Central Hudson. Further, the S&P Utility Index of
6 the past is not representative of the current
7 regulated electric and gas industry. Moreover,
8 the current index is not limited to "regulated"
9 electric and gas companies. S&P in its article
10 entitled "Consider Sector Funds for Targeted
11 Diversification" (Exhibit__(RRP-17)) makes two
12 revealing statements that confirm our position
13 that this analysis should be rejected. First it
14 states, "In the past, the prices charged by water,
15 gas and electric utilities were set by government
16 agencies. These prices included a profit for the
17 utilities, which was passed along to investors in
18 the form of dividends. Deregulation has swept
19 across many utility industries, creating more risk
20 and perhaps the potential for higher returns as
21 well." It next states, "However, increasing
22 deregulation in the gas, electric and
23 telecommunications fields has added a bit more
24 volatility to these stocks." In that volatility

1 reflects risk, as volatility increases, the
2 utilities' risks increase and accordingly
3 investors' return on equity requirements increase.
4 In addition, a Reuters' article entitled "U.S.
5 Power Stocks Charge Ahead as Risks Mount"
6 (Exhibit__(RRP-17)), indicated that since the
7 Enron collapse in 2001-2002, the S&P Utility Index
8 shed more than half of its value. Dr. Morin
9 indiscriminately employed risk premiums for
10 companies in the S&P Utility Index to determine
11 the cost of equity for Central Hudson. He made no
12 attempt to determine the extent to which Central
13 Hudson was more or less risky, with respect to
14 credit quality, regulatory environment and
15 numerous other factors, than the electric
16 companies in the S&P Utility Index.

17 Q. Return on equity proposals based on historical
18 risk premium methods have been presented to the
19 Commission as part of many rate proceedings. What
20 is the Commission's position concerning these
21 analyses?

22 A. We refer to Case 95-G-1034, Central Hudson Gas &
23 Electric Corporation - Gas Rates, Opinion No. 96-
24 28 (issued October 3, 1996), where the Commission

1 stated, "...we have avoided reliance on the risk
2 premium approach because it reflects allowed
3 returns which are an inferior alternative to a
4 direct estimate of a Company's own cost of
5 equity." The Commission reaffirmed its position
6 in the Company's 2009 Rate Order. In this
7 proceeding, Dr. Morin based his analysis on the
8 earned returns on equity of companies in the S&P
9 Utility Index instead of allowed ROEs; the data,
10 however, is inappropriate because there are many
11 factors that can affect a company's earned return
12 and those factors and ROEs should not be the basis
13 of current ROE determinations.

14 Q. Given your criticisms of Dr. Morin's historical
15 risk premium method, what is your recommendation?

16 A. The shortcomings of the S&P Utility Index as a
17 basis to determine the risk premium for Central
18 Hudson invalidate Dr. Morin's analysis because its
19 use results in unreliable and overstated risk
20 premium and cost of equity estimates. Therefore,
21 we recommend that the Commission reject the
22 Company's historical risk premium analysis.

23 Dr. Morin's CAPM Discussion

24 Q. Please describe Dr. Morin's CAPM methodology.

1 A. Dr. Morin's approach yielded an 11.0% cost of
2 equity estimate and his ECAPM approach yielded an
3 11.6% cost of equity estimate. Both estimates
4 include a 30 basis points flotation cost
5 adjustment. Dr. Morin's use of only one month of
6 data for the risk-free rate and his use of an 82-
7 year historical market risk premium makes his CAPM
8 results unreliable.

9 Q. Why is Dr. Morin's data input for the risk-free
10 rate problematic?

11 A. Dr. Morin employs the most recent month's 30-year
12 Treasury bond yield for his risk-free rate; an
13 estimate from only one month does not adequately
14 reflect investors' investment horizon and is more
15 sensitive to changing market conditions. As we
16 explained earlier, we employed a blended three-
17 month average of 10-year and 30-year Treasury
18 rates. The Commission employed this method to
19 determine the risk-free rate for the CAPM analyses
20 in the Company's 2009 Rate Order.

21 Q. What beta did Dr. Morin adopt for his CAPM
22 analyses?

23 Q. Dr. Morin employed a beta of 0.74% for his CAPM
24 analyses; it is the average beta for his Value

1 Line-based and S&P-based proxy groups that had
2 average betas of 0.71% and 0.76%, respectively.

3 Q. Describe Dr. Morin's calculation of the market
4 risk premium for his CAPM analysis.

5 A. Dr. Morin used the Morning Star (formerly
6 Ibbotson) study entitled Stocks, Bonds, Bills, and
7 Inflation-2009 Yearbook to determine a historical
8 (ex post) market risk premium of 6.5%; it was
9 computed over the income component of the long-
10 term Treasury bonds for the period 1926-2008. Dr.
11 Morin determined that his 6.5% estimate was
12 reasonable based on a study of forward-looking
13 market risk premiums, performed by
14 "Harris/Marston". Dr. Morin's use of Morning
15 Star's historical market risk premium for his CAPM
16 analysis is inappropriate because it is calculated
17 on the basis of stale data obtained over an 82
18 year study period (1926-2008) and, therefore, may
19 yield unreliable cost of equity estimates. The
20 Commission has continuously rejected the use of
21 market return data that is derived from historical
22 study periods (e.g., the Morning Star study)
23 because it is stale and it does not reflect
24 current market conditions. Moreover, since recent

1 studies provide evidence that the market risk
2 premium may be declining, we prefer to maintain
3 our approach rather than employ a method that can
4 overstate or understate the Company's cost of
5 equity.

6 Q. In this proceeding, your data inputs result in a
7 market risk premium of 8.03% versus the Company's
8 proposed market risk premium of 6.5%. It appears
9 that your market risk premium is increasing and
10 the Company's is decreasing. How do you integrate
11 these observations with your recommendation to
12 continue to employ the forward-looking market risk
13 premium in CAPM analyses?

14 A. Current market conditions are unique due to the
15 uncertainty in the financial markets after the
16 collapse of Lehman Brothers and great disruptions
17 in the banking market and the market for
18 mortgages. Our methodology for estimating market
19 risk premiums on the basis of the Quantitative
20 Profiles forward-looking market return data and
21 the risk-free rate reflects these anomalies and,
22 therefore, should be retained. Moreover, our CAPM
23 analyses indicate a higher proxy group ROE than
24 that of Dr. Morin, which is consistent with the

1 current state of the markets (i.e., higher risks
2 result in higher returns) and show the advantage
3 of using a forward-looking market premium over the
4 historical market premium.

5 Q. Can the Panel provide references to the recent
6 studies that discuss the declining market risk
7 premiums?

8 A. We refer to an article entitled "The Shrinking
9 Equity Premium" by Jeremy Siegel, The Journal of
10 Portfolio Management, Fall 1999, which expressed
11 this viewpoint. In addition, E. Scott Mayfield
12 published a study on the topic in an article
13 entitled "Estimating the Market Risk Premium" in
14 the Journal of Financial Economics, March 2002.
15 His study concluded that the Ibbotson Study
16 seriously overstates the MRP for the period since
17 the Great Depression. The article also indicated
18 that a structural shift occurred in the market
19 after 1940 primarily relating to market
20 volatility, and that as a result, the historical
21 risk premium market beginning from 1940 is only
22 5.6%. The fact that there is intellectual
23 discussion concerning the reasonableness of
24 historical market risk premiums as proxies for the

1 future, indicates the need for a conservative
2 approach in reflecting historic risk premiums in
3 Central Hudson's cost of equity determination.

4 Q. Can the Panel provide cites to Commission orders
5 that discuss its position relative to estimating
6 market risk premiums in the CAPM and utilizing
7 risk premium methods specifically?

8 A. Yes, we note two Commission orders where such
9 citations are found. The first is in Case 95-G-
10 1034, Central Hudson Gas & Electric Corporation -
11 Gas Rates, Opinion No. 96-28 (issued October 3,
12 1996), where the Commission stated, "...the Judge's
13 market return calculation based on Merrill Lynch
14 data is a reasonable method of deriving a risk
15 premium; and it avoids the problems of stale data
16 in the Ibbotson estimate." A second Commission
17 citation is found in Case 05-E-1222, New York
18 State Electric & Gas Order (issued August 23,
19 2005), where the Commission states, "...NYSEG's
20 reliance on the historic Ibbotson data to estimate
21 the market return is rejected..." These statements
22 confirm the Commission's position concerning stale
23 data and its acceptance of Bank of America/Merrill
24 Lynch data.

1 Q. Given the shortcomings in Dr. Morin's selection of
2 data inputs for the risk-free rate and the market
3 risk premium for his CAPM analyses, what is your
4 overall observation?

5 A. We recommend that the Commission reject Dr.
6 Morin's risk premium methodology and results. If
7 the Commission considers his CAPM analyses, it
8 should: 1) modify the risk-free rate to reflect at
9 minimum, the most recent three-month average of
10 30-year Treasury yields and 2) employ a forward-
11 looking market risk premium.

12 Dr. Morin's Single Growth DCF Analysis

13 Q. You employed a two growth rate DCF model and Dr.
14 Morin employed a single growth rate DCF model to
15 determine the Company's cost of equity. Are the
16 models comparable?

17 A. Our two-growth DCF model is superior to the
18 single-stage DCF model employed by Dr. Morin
19 because the model explicitly employs estimates for
20 investors' short-run and long-run growth
21 expectations. While the bases of the models are
22 similar, it is widely acknowledged that when the
23 market is in a relatively steady state, the
24 single-stage growth DCF model is appropriate

1 because a stable environment suits the single-
2 stage DCF model's assumption of constant growth in
3 dividends. At this time, however, the economy is
4 not static; there is a lot of uncertainty in the
5 market. Therefore, the single-stage growth DCF
6 model should not be employed because it will
7 provide unreliable results.

8 Q. How many companies were in Dr. Morin's Value Line
9 and S&P proxy groups?

10 A. The Value Line proxy group had 21 companies after
11 eliminating Allete because its forecasted earnings
12 growth rate was negative. In contrast, we note
13 that our analysis showed positive dividend growth
14 for Allete. The S&P proxy group also contained 21
15 companies after eliminating six companies because
16 their regulated revenues totaled less than 50%.

17 Q. What is the Panel's assessment of Dr. Morin's
18 proxy groups?

19 A. Dr. Morin's selection criteria that proxy group
20 companies earn at least 50% of revenues from
21 regulated operations (50% selection criterion)
22 resulted in proxy groups that were more risky than
23 Central Hudson. As shown in Exhibit__ (RRP-14), a
24 review of the proxy groups' average credit ratings

1 and other financial statistics (e.g., average
2 beta, S&P financial risk profile score, etc.)
3 confirm our observation.

4 Q. What does the risk differential between Central
5 Hudson and the proxy groups imply?

6 A. Similar to our analysis, the differential
7 indicates that the proxy groups' cost of equity is
8 higher than that required by the Company.
9 Therefore, consistent with financial theory, the
10 proxy group-derived DCF cost of equity estimates
11 should be adjusted downward. Dr. Morin's failure
12 to adjust his estimates to account for the risk
13 differential between his proxy groups and Central
14 Hudson resulted in overstated and unreliable cost
15 of equity estimates.

16 Q. Describe Dr. Morin's DCF analysis.

17 A. Dr. Morin performed two DCF analyses on each proxy
18 group on the basis of two different forecasts of
19 for earnings growth: Value Line Investment
20 Analyzer (VLIA) earnings forecasts based on a
21 three-year horizon and Zack's Investment Research,
22 Inc. (Zack's) earnings forecasts based on a five-
23 year horizon. To determine the return on equity
24 for each company in his DCF analyses, he added the

1 company's VLIA-determined spot dividend yield to
2 the respective earnings growth forecast and then
3 divided that sum by 0.95 to reflect the flotation
4 cost adjustment. On average the flotation cost
5 premium was 30 basis points (0.30%). Dr. Morin
6 selected the median ROE from each analysis to
7 establish his proposed ROE range for Central
8 Hudson.

9 Q. Dr. Morin employs the VLIA spot dividend yield
10 data in his DCF analyses. Do spot dividend yields
11 present the same problem as spot prices?

12 A. Yes, they do. Spot dividend yields cause
13 significant volatility in the DCF results; as such
14 the results are unreliable. We discussed the
15 benefits of using average data over a three-month
16 horizon in our discussion of the stock price data
17 we employed in our model.

18 Q. What were the proxy group's DCF results?

19 A. For the proxy groups described above, the DCF
20 results ranged from 12.1% to 12.5%. The Value Line
21 proxy group-based DCF analyses based on the VLIA
22 and Zack's earnings forecasts resulted in median
23 DCF return on equity estimates of 12.4% (Exhibit
24 RAM_7) and 12.3% (Exhibit RAM_8), respectively.

1 The S&P proxy group-based DCF analyses based on
2 the VLIA and Zack's earnings forecasts resulted in
3 median DCF return on equity estimates of 12.1%
4 (Exhibit RAM_11) and 12.5% (Exhibit RAM_13),
5 respectively.

6 Q. Please discuss Dr. Morin's use of earnings
7 forecasts as proxies for dividend growth.

8 A. Dr. Morin's use of earnings growth estimates is a
9 significant shortcoming because these growth
10 forecasts are not sustainable, are forecasted over
11 three-to-five years, are overstated, and
12 therefore, are unreliable dividend growth
13 estimates for use in the DCF model. Moreover, Dr.
14 Morin did not demonstrate a link between the long-
15 term earnings growth rates and long-term dividend
16 growth rates, which is a condition of the DCF
17 model, nor he did show that his earnings growth
18 rates are sustainable, as required by the
19 Commission. By sustainable, we mean that in the
20 long-run, dividend and earnings growth rates must
21 be equal, because dividend payouts cannot be
22 greater than earnings over an extended period of
23 time.

24 Q. Has the Commission previously rejected earnings

1 growth rates as proxies for DCF dividend growth
2 rates in any rate proceedings?

3 A. Yes, it has. We refer to the Commission's October
4 18, 2007 Order in Orange & Rockland's electric
5 rate proceeding in Cases 06-E-1433 and 06-E-1547.
6 The Commission stated that, "The Company [Orange
7 and Rockland] has not demonstrated any link
8 between its earnings per share growth estimate and
9 the future dividend growth of the proxy group
10 based on the actual dividend pay-out policies of
11 the companies in that group. Moreover, there is
12 no evidence suggesting that Orange and Rockland's
13 earnings growth rate estimate is sustainable over
14 time."

15 Q. What impact does the use of earnings growth rates
16 have on Dr. Morin's DCF results?

17 A. The use of earnings growth rates results in
18 unreliable cost of equity results. To develop
19 reliable estimates, the Commission uses retention
20 growth estimates as a proxy for sustainable growth
21 in the DCF model because retention growth rates
22 are the product of a company's expected return on
23 equity and its retention ratio. Dr. Morin claims
24 that his use of analysts' short-term earnings

1 growth forecasts provides reliable estimates of
2 sustainable growth because they are abundantly
3 available to investors; an abundance of data does
4 not denote reliability and overstated earnings
5 growth rates can negatively impact customers'
6 bills.

7 Q. Given the above, what is the Panel's
8 recommendation concerning Dr. Morin's proxy group-
9 based DCF analyses?

10 A. Dr. Morin's DCF analyses contains several
11 shortcomings for which obtaining new data inputs
12 (e.g., the dividends, stock prices and dividend
13 growth estimates) would require a significant
14 amount of time for the combined total of 27
15 companies in the two proxy groups. In addition,
16 his results are flawed by his appendage of a
17 flotation cost premium to each result and by his
18 failure to adjust each result to reflect the risk
19 differential between Central Hudson and the proxy
20 group. Accordingly, the Commission should reject
21 Dr. Morin's DCF analyses.

22 Recommendations for a Multi-Year Rate Plan

23 Q. Mr. Renner's testimony provided average cost of
24 capital schedules for Central Hudson for the three

1 rate years ending June 30, 2011, 2012 and 2013.

2 What are your recommendations for a three-year
3 rate plan?

4 A. If a multi-year rate plan is determined for the
5 Company, we recommend that the Company be allowed
6 a stay-out premium of 0.12%, for an ROE of 9.72%
7 over the duration of the rate plan.

8 Q. Why are you recommending a stay-out premium?

9 A. The Commission has previously approved the
10 addition of a stay-out premium to the return on
11 equity to reflect the additional risk that a
12 company will incur by agreeing to fixed rates for
13 a predetermined period of time. This policy
14 should be maintained if a multi-year rate plan is
15 established in this proceeding.

16 Q. How should the stay-out premium be calculated?

17 A. Commission precedent is to calculate the average
18 monthly differential for two, three, four and five
19 year Treasury yields over the one-year Treasury
20 yield, over a period of five years. The stay-out
21 premium is equal to one half of the five-year
22 average monthly differential for the Treasury
23 maturity equivalent to the duration of the stay-
24 out period. Exhibit__RRP-11 shows our calculation

1 of stay-out premiums for 2, 3, 4 and 5 year
2 periods at 6, 12, 19 and 26 basis points,
3 respectively. The premiums were calculated for
4 the five-year period ended September 2009.

5 Q. Multi-year rate plans generally contain provisions
6 for an earnings-sharing mechanism. Do you have
7 any recommendations for an earnings-sharing
8 mechanism?

9 A. Yes. For the duration of the multi-year rate
10 plan, an earnings sharing threshold of 10.4%
11 should be maintained. In addition, at the end of
12 the three year rate plan, we propose a three-stage
13 sharing mechanism.

14 Q. What are the specifics of your recommended three-
15 stage earnings sharing mechanism?

16 A. For the first stage, we recommend that earnings
17 over 10.4% and up to 11.4% be shared equally
18 between ratepayers and the Company. For the
19 second stage, we recommend that customers receive
20 65% of earnings in excess of 11.4% and up to
21 12.4%. Finally, we recommend that customers
22 receive 90% of earnings in excess of 12.4%. This
23 earnings sharing mechanism is comparable to the
24 mechanisms that the Commission adopted for Orange

1 & Rockland for its three-year electric plan in
2 Case 07-E-0949 and for its three-year gas plan in
3 Case 08-G-1398. In those cases the Commission
4 determined that the allocation of benefits and of
5 risks were reasonable. Therefore, our recommended
6 earnings sharing mechanism is reasonable.

7 Summary of Rate of Return Recommendation

8 Q. Please summarize the Panel's rate of return
9 recommendations for Central Hudson.

10 A. On the basis of our analysis, subject to updates,
11 we recommend that Central Hudson's revenue
12 requirement be set on the basis of our recommended
13 capital structure, which includes a common equity
14 ratio of 48.0%. We recommend that the Company be
15 allowed to earn a return on common equity of
16 9.60%, an overall after-tax weighted cost of
17 capital of 7.21% and an overall pre-tax weighted
18 cost of capital of 10.31%.

19 Q. Does this conclude the Panel's testimony?

20 A. Yes, at this time.

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