

BEFORE THE  
STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

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In the Matter of  
Central Hudson Gas & Electric Corporation  
Cases 08-E-0087 and 08-G-0088  
November 2008

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Prepared Testimony of:

Staff Rate of Return Panel

Paul Del Vecchio  
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Principal Utility Financial  
Analyst

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State of New York  
Department of Public Service  
Three Empire State Plaza  
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1 Q. Please state your names, employer and business  
2 addresses.

3 A. Paul Del Vecchio and Audrey Capers. 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. Mr. Del Vecchio, what is your position at the  
10 Department?

11 A. I am employed as a Senior Utility Financial  
12 Analyst and have been with the Department since  
13 May 2008. My responsibilities include updating  
14 the performance metrics graphs for each office in  
15 the Department on a quarterly basis and  
16 periodically updating credit ratings and regulated  
17 revenues of utilities in spreadsheet documents.  
18 My specific responsibilities for this case include  
19 performing the Panel's proxy group analysis, as  
20 well as the assessment of Dr. Morin's proxy  
21 groups.

22 Q. Please summarize your educational background and  
23 professional experience.

24 A. I am a graduate of Union College with a Bachelor

1 of Arts in Managerial Economics and a Masters  
2 degree in Business Administration, with a  
3 concentration in Finance from the Graduate College  
4 of Union University. I also hold Series 7, Series  
5 66 and New York State life and health insurance  
6 licenses.

7 Q. Have you previously testified before the Public  
8 Service Commission?

9 A. No, I have not.

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

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

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

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

1 Madison. I began my career with the Department in  
2 1984 in the OAF. I am a member of the Consortium  
3 for Graduate Study in Management.

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

7 A. Yes, I have testified before the Commission in  
8 numerous rate case proceedings on the fair rate of  
9 return for combination gas and electric, natural  
10 gas, steam, telephone and water companies, as well  
11 as in generic proceedings concerning policy and  
12 financing. I have also testified before the  
13 Connecticut Department of Public Utility Control.  
14 Exhibit\_\_ (RRP-1) provides a listing of some of  
15 the proceedings in which I have participated.

16 Q. Please identify the Panel's exhibits that support  
17 your testimony.

18 A. We have prepared 20 exhibits, Exhibit\_\_ (RRP-1)  
19 through Exhibit\_\_(RRP-20). The exhibits relate to  
20 our testimony and are described in further detail  
21 as they are discussed in our testimony.

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

24 A. We will provide an analysis recommending a fair

1 rate of return to be used in the determination of  
2 the revenue requirement for Central Hudson Gas &  
3 Electric Corporation (Central Hudson or the  
4 Company). Our analysis will recommend the  
5 appropriate capital structure for Central Hudson  
6 including the applicable cost rates for long-term  
7 debt, customer deposits, preferred stock and  
8 common stock equity, for the rate year ending June  
9 30, 2010.

10 Summary of Recommendations

11 Q. Please summarize your recommendations for Central  
12 Hudson.

13 A. We recommend that Central Hudson be allowed to  
14 earn an overall rate of return of 7.34% for the  
15 rate year ending June 30, 2010. This rate of  
16 return is commensurate with a common equity ratio  
17 of 45.0% and an allowed return on common equity  
18 rounded up to 9.45%, which reflects a 9.83% cost  
19 of equity minus a credit quality adjustment factor  
20 of 30 basis points and a revenue decoupling  
21 mechanism (RDM) adjustment factor of 10 basis  
22 points. The overall pre-tax rate of return is  
23 10.21%, which is shown at Exhibit\_\_ (RRP-2,  
24 Schedule 1). The cost of long-term debt and the

1 cost of common equity should be updated at the  
2 time of the Recommended Decision (RD) prepared by  
3 the Administrative Law Judge (ALJ) and at the time  
4 of the Commission's Order. The Company's cost of  
5 equity analyses and proposed return on equity for  
6 Central Hudson should be rejected because of  
7 shortcomings that yield excessive cost of equity  
8 results.

9 Capital Structure

10 Q. Please describe Central Hudson's organizational  
11 structure.

12 A. Central Hudson is a wholly-owned transmission and  
13 distribution (T&D) subsidiary of Central Hudson  
14 Energy Group (CHEG). CHEG is a very conservative  
15 Company in that all of its common stock is traded  
16 on the parent level and long term debt is only  
17 issued for Central Hudson. Central Hudson issues  
18 its own debt. Currently, all the long term debt  
19 and preferred stock reflected in CHEG's  
20 consolidated capital structure is attributable to  
21 Central Hudson.

22 Q. What capital structure did the Company recommend  
23 for Central Hudson in this proceeding?

24 A. Company witness, Mr. Renner, is recommending a

1 capital structure with a common equity ratio of  
2 48% for Central Hudson. This is 3 percentage  
3 points higher than the 45% equity ratio used in  
4 its last rate proceeding, which resulted in a  
5 three-year settlement agreement.

6 Q. How does the Company plan to achieve this 48%  
7 equity ratio?

8 A. Mr. Renner's testimony indicates that it will  
9 achieve the 48% common equity ratio by eliminating  
10 its dividend payments to CHEG and by the provision  
11 of a \$25 million equity infusion from CHEG.

12 Q. Is the Panel recommending a 48% equity ratio for  
13 ratemaking purposes for Central Hudson in this  
14 proceeding?

15 A. No. We think that the 45% equity ratio more  
16 adequately reflects CHEG's capitalization policy  
17 for Central Hudson, as indicated when we remove  
18 the unregulated capital at 100% common equity from  
19 its consolidated capital structure.

20 Q. Is an equity infusion from CHEG to Central Hudson  
21 required if Central Hudson's rates are set on a  
22 45% equity ratio?

23 A. No. While an equity infusion will not be  
24 required, a slightly higher long term debt ratio

1 will be required in order to meet the Company's  
2 capital requirements for the rate year. This  
3 results in an embedded cost of debt of 5.65%,  
4 slightly higher than the 5.59% forecast by the  
5 Company.

6 Q. How did the Panel develop Central Hudson's capital  
7 structure for the rate year ending June 2010?

8 A. First, we determined Central Hudson's actual  
9 ratemaking capital structure as of 2007. To do  
10 this, we started with CHEG's consolidated capital  
11 structure (debt, preferred stock and common equity  
12 balances) as of December 2007 and removed all the  
13 unregulated capital from its common equity  
14 balance. We then added the Company's customer  
15 deposits balance of \$7.99 million, as of December  
16 2007, in order to determine Central Hudson's  
17 capitalization ratios. The resultant  
18 capitalization ratios are 51.79% long term debt,  
19 2.7% preferred stock, 1.02% customer deposits and  
20 44.49% common equity.

21 In order to develop the rate year  
22 capitalization ratios we maintained the Company's  
23 projected rate year preferred stock and customer  
24 deposits balances constant at \$21.027 million and

1           \$8.114 million, respectively. The preferred stock  
2           balance is constant because during the rate year,  
3           the Company has no plans for new issuances, nor  
4           does it have plans to redeem any of its  
5           outstanding preferred stock. The balance for  
6           customer deposits was updated by the Company in  
7           its response to Staff interrogatory DPS-601  
8           (Exhibit\_\_ (RRP-3). We augmented the January 2009  
9           issuance by \$26.040 million to reflect our  
10          recommendation of a 45% common equity ratio,  
11          instead of the 48% common equity ratio assumed by  
12          the Company. Next, we rounded the common equity  
13          ratio up to 45% from 44.5%. Our recommended  
14          capital amounts and corresponding capitalization  
15          ratios for the rate year are: \$468.99 million, or  
16          51.8%, for long term debt; \$21.027 million, or  
17          2.3%, for preferred stock; \$8.114 million, or  
18          0.9%, for customer deposits; and, \$407.56 million,  
19          or 45.0%, for common equity. We show the  
20          development of the capital structure in Exhibit\_\_  
21          (RRP-2), Schedule 2).

22 Q. Is there Commission precedent for developing the  
23       capital structure in this manner?

24 A. Yes. Commission precedent regarding the

1 calculation of a capital structure in a litigated  
2 rate case has clearly been to start with the  
3 parent Company's capital structure and then adjust  
4 it assuming reasonable levels of debt and equity  
5 for non-utility operations. This is the  
6 methodology which was most recently employed by  
7 the Commission for electric rates in Case 06-E-  
8 1433 for Orange & Rockland Utilities, Inc., issued  
9 October 18, 2007, and for New York State Electric  
10 and Gas Corporation in Case 05-E-1222, issued  
11 August 23, 2006. For Central Hudson, we removed  
12 the unregulated capital solely from common equity  
13 consistent with CHEG's conservative policy.

14 Q. Is a capital structure with a 45.0% common equity  
15 ratio reasonable for Central Hudson?

16 A. Yes. A 45.0% equity ratio is reasonable because  
17 Central Hudson is a regulated transmission and  
18 distribution Company with very little business and  
19 financial risk. In recent years it has faced  
20 slightly more business risk because of differences  
21 between its sales forecast and actual sales. A  
22 major reason for the differential was the fact  
23 that Central Hudson's customers employed  
24 conservation measures in light of environmental

1 and economic conditions. Since a weather  
2 normalization clause (WNC) for gas operations and  
3 a revenue decoupling mechanism (RDM) for gas and  
4 electric operations is being adopted in this  
5 proceeding, that risk will be eliminated.

6 Q. Did you review the rating agency guidelines for  
7 the expected equity ratios?

8 A. Yes. We reviewed the rating agencies' guidelines  
9 for capital structures supportive of Central  
10 Hudson's current credit ratings which are an A by  
11 Standard & Poor's (S&P) and an A2 by Moody's  
12 Investors Service (Moody's).

13 Q. What are S&P's guidelines for A-rated utility  
14 companies?

15 A. In S&P's November 30, 2007 report entitled "New  
16 Business Profile Scores Assigned for U.S. Utility  
17 and Power Companies: Financial Guidelines  
18 revised", S&P indicates that A-rated companies  
19 with excellent business profile ratings, like  
20 Central Hudson, can maintain an A-rating with debt  
21 to total capital ratios as high as 60%, which is  
22 equivalent to a 40% equity ratio. More recently,  
23 in its report entitled "2007 Utility Comparative  
24 Ratio Analysis, Long-Term Debt-U.S.," S&P provides

1 data for utilities with A-rated debt, that  
2 indicates that in 2007, the average debt ratio of  
3 95% of the 51 utility companies with an "A-rating"  
4 was in the range of 58.2% to 45.0%, which  
5 corresponds to average equity ratios in the range  
6 of 41.8% to 55.0%. Comparable data for the three  
7 years ending 2007 showed that 95% of the 51  
8 utility companies had debt ratios in the range of  
9 59.2% to 46.4%, which corresponds to average  
10 equity ratios in the range of 40.8% to 53.6%. Our  
11 recommended common equity ratio for Central Hudson  
12 falls within these ranges and is reasonable.

13 Q. What are Moody's capital structure guidelines?

14 A. A table of Moody's capital structure guidelines is  
15 provided at the end of its September 22, 2008,  
16 credit opinion for Central Hudson. It shows that  
17 for Central Hudson, a Company with an A-rating and  
18 low business risk, reasonable debt to book  
19 capitalization ratio would be in the range of 50%  
20 to 75%, which is comparable to an equity ratio in  
21 the range of 50% to 25%. Our recommended common  
22 equity ratio of 45.0% falls within this range and  
23 is reasonable.

24 Q. Panel, the Company indicates that its common

1 equity ratio should be equal to that of other  
2 combination gas and electric utilities in New  
3 York. Do you agree with that supposition?

4 A. No, we do not. Central Hudson's credit rating at  
5 A(S&P)/A2 (Moody's) is stronger than the other S&P  
6 and Moody's-rated electric utility companies in  
7 New York because it has lower financial and  
8 business risks. The S&P and Moody's ratings of  
9 the major New York utility companies are shown in  
10 Exhibit\_\_(RRP-4). Examples of the additional  
11 risks inherent to some of the other utility  
12 companies are as follows: NYSEG/RG&E has more  
13 business risk than Central Hudson because the two  
14 companies have a fixed price option program that  
15 accounts for 20% of commodity/sales and  
16 Consolidated Edison Company of New York (CECONY)  
17 has higher reliability requirements than Central  
18 Hudson especially given the nature of its  
19 underground network, its higher demand and recent  
20 safety issues. Finally, both Niagara Mohawk (a  
21 subsidiary of National Grid) and NYSEG/RG&E  
22 (subsidiaries of Energy East) are owned by  
23 international companies. Moreover, as the result  
24 of the WNC and RDM rate mechanisms that Staff is

1 recommending for adoption by the Commission in  
2 this proceeding, Central Hudson's business risks  
3 will be further reduced. We note that Moody's and  
4 S&P both have indicated that CHEG's increasing  
5 investments in riskier business ventures may  
6 negatively impact the Company's credit rating. At  
7 the current time, CHEG has unregulated investments  
8 in ethanol, wind and biomass generation. Higher  
9 costs related to CHEG's unregulated investments  
10 should not be borne by ratepayers. Therefore, an  
11 equity ratio of 45% reflects Central Hudson's  
12 actual capitalization after removing CHEG's  
13 unregulated capital from its consolidated capital  
14 structure and is reasonable. Central Hudson's  
15 common equity ratio should be set at 45%.

16 Q. Please summarize the Panel's capital structure  
17 recommendations for Central Hudson.

18 A. We recommend that for ratemaking purposes, Central  
19 Hudson's revenue requirement for its gas and  
20 electric operations should be determined on the  
21 basis of the following capitalization ratios:  
22 51.8% for long term debt, 2.3% for preferred  
23 stock, 0.9% for customer deposits and 45.0% for  
24 common equity shown in Exhibit\_\_ (RRP-1), Schedule

1           1). Our recommendation is consistent with that of  
2           other New York utilities and is within the  
3           guidelines for an A-rated utility with Central  
4           Hudson's business and financial ratings.

5    Q.    Did the Panel consider the possible consequences  
6           that Central Hudson could face as the result of  
7           maintaining a 45% common equity ratio?

8    A.    Yes, we gave this consideration. However, in our  
9           opinion the 45% equity ratio will not negatively  
10          impact the Company's credit ratings or hinder its  
11          access to reasonably priced capital.  
12          Specifically, upon the implementation of an RDM  
13          for both its electric and gas operations and a WNC  
14          for its gas operations, Central Hudson's financial  
15          strength will be enhanced because its risks will  
16          be reduced and its cash flow will be more certain.  
17          Moreover, in its report dated October 14, 2008  
18          entitled "The U.S. Utility and Power Sector  
19          Appears to be Well Prepared to Manage Refinancing"  
20          S&P reported that in the current market, electric  
21          and gas utility companies are well positioned to  
22          endure the potential hardship that can impact  
23          other industries because of their solid cash flows  
24          and limited refinancing needs in the short run.

1 It also reported that most, if not all utility  
2 companies should be able to refinance pending  
3 maturities despite the currently unsettled  
4 markets. Finally, in its September 22, 2008  
5 credit opinion for Central Hudson, Moody's  
6 indicated that it would favorably view regulatory  
7 approval of a revenue decoupling mechanism because  
8 such an approach typically helps mitigate the  
9 negative financial consequence of lost revenues  
10 associated with conservation and other efficiency  
11 programs, as well as price elasticity. Given the  
12 above, we expect no decline in Central Hudson's  
13 credit strength upon adoption of our  
14 capitalization recommendation.

15 Rate of Return

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

18 A. A fair overall rate of return allows a utility the  
19 opportunity to provide safe and adequate service,  
20 to recover its prudent costs for debt and  
21 preferred stock, and to provide its common  
22 stockholders the opportunity to earn a return that  
23 is commensurate with the risk of the firm. At the  
24 same time, the governing principle of ratemaking

1 provides that customers should pay no more than  
2 the cost of service incurred to provide them  
3 service. An allowed equity return that would  
4 allow the regulated portion of Central Hudson's  
5 common stock to sell at book value provides these  
6 opportunities.

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

8 A. Generally, a fair rate of return can be determined  
9 by a cost analysis of the individual components  
10 (long-term debt, short-term debt, preferred stock,  
11 common equity, etc.) of a Company's pro forma  
12 capital structure. The overall cost of capital is  
13 then determined by a weighted average of these  
14 individual components. The long-term debt and  
15 preferred stock components of the Company's pro  
16 forma capital structure are readily quantified  
17 because they consist mainly of previously issued  
18 vehicles that have specific cost rates.  
19 Additionally, the cost of customer deposits and  
20 other forms of customer-provided capital (e.g.,  
21 gas supplier refunds) are prescribed by the  
22 Commission.

23 The cost of common equity, however, is  
24 neither contractual nor prescribed by the

1 Commission; it is based upon investors'  
2 expectations. Although these expectations are not  
3 necessarily apparent through any one measure,  
4 financial analysts often employ methodologies such  
5 as the Discounted Cash Flow methodology (DCF) and  
6 the Capital Asset Pricing Model (CAPM) to estimate  
7 the return required by equity investors.

8 Cost of Long-term Debt

9 A. The 5.65% long-term debt cost rate reflects  
10 Central Hudson's outstanding debt during the rate  
11 year, as well as two 20-year medium term notes  
12 issuances forecast by Mr. Renner for November 2008  
13 and another for January 2009 with interest rates  
14 of 6.20% and 6.70%, respectively. We augmented  
15 the January 2009 issuance by \$26.04 million to  
16 reflect our recommendation of a 45% common equity  
17 ratio versus the 48% common equity ratio assumed  
18 by the Company. The calculation of the 5.65% long  
19 term debt rate is shown in Exhibit\_\_(RRP-5),  
20 Schedule 1. Given the current market conditions  
21 we adopted the cost rates provided by the Company;  
22 however, we are aware that Central Hudson's  
23 current outstanding long term debt is trading  
24 between 5.8% to 6.7% as shown in Exhibit\_\_(RRP-5),

1           Schedule 2. As reported by Reuters, current  
2           spreads for utility long term debt is trading in  
3           the range of 285 to 450 basis points above  
4           Treasuries, or 7.3% to 8.9%. The spreads are  
5           abnormally high due to the financial turmoil in  
6           the markets. This fact is confirmed by the  
7           Company's update to Staff interrogatory DPS-602  
8           submitted as Exhibit\_\_ (RRP-3), which provides cost  
9           of debt information for debt it issued in  
10          November. The cost of long term debt, however,  
11          must be updated at the time of the ALJ's RD and  
12          the Commission's Order. We propose that the  
13          update be based on the most recent 3-months  
14          average of utility bond yields for debt rated  
15          "A2", as per the Mergent Bond Record. Further,  
16          due to uncertain conditions, the cost of this new  
17          debt should be trued up at the end of the rate  
18          year.

19    Q.    Given the uncertainties in market conditions, Mr.  
20          Renner has requested that deferral authorization  
21          be granted for the future recovery (or refunding)  
22          for the differential between debt costs reflected  
23          in rates and that actually incurred, including  
24          carrying charges. What is the Panel's position

1 with relation to this proposal?

2 A. Mr. Renner's proposal is consistent with the  
3 Commission's recent actions regarding Consolidated  
4 Edison Company of New York's and Orange and  
5 Rockland, Inc.'s variable auction rate debt. We  
6 recommend that Central Hudson be permitted to  
7 defer for future recovery the actual interest  
8 costs for any new issues and for any existing  
9 auction-rate debt. However, such deferral should  
10 be consistent with the Order under which the debt  
11 is authorized.

12 Cost of Customer Deposits

13 Q. What cost rate did the Panel employ for customer  
14 deposits?

15 A. We employed a customer deposits rate of 4.85% for  
16 investor-owned utilities. This rate was approved  
17 and prescribed by the Commission at its November  
18 12, 2008 session in accordance with the  
19 Commission's Case 99-M-1345. The customer deposit  
20 rate will be effective on January 1, 2009.

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

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

1 Cost of Common Equity

2 Q. You have indicated that the Panel is recommending  
3 a 9.45% cost of equity for Central Hudson, what is  
4 the Company's proposal?

5 A. The Company is proposing a cost of equity of  
6 10.25%. It is the lower end of the cost of equity  
7 range that Dr. Morin proposed for the Company.

8 Q. What methodology did the Panel use to determine  
9 its recommended 9.45% cost of common equity for  
10 Central Hudson?

11 A. We employed a methodology that establishes the  
12 return on equity (ROE) based on the results of a  
13 proxy group-based DCF model analysis and the  
14 average result of two proxy group-based capital  
15 asset pricing model (CAPM) analyses: the  
16 traditional CAPM and the zero beta CAPM. We  
17 selected the proxy group, which we will discuss  
18 further, from the universe of gas and electric  
19 utilities tracked by Value Line, to which we then  
20 apply our selection criteria. Consistent with  
21 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. Finally,

1 in order to determine the return on equity for  
2 Central Hudson, we made two adjustments to the  
3 proxy group cost of equity, a credit quality  
4 adjustment and an RDM adjustment.

5 Proxy Group

6 Q. You indicated that the first step in your  
7 methodology was to establish a proxy group. Why  
8 are you using a proxy group to estimate the cost  
9 of equity?

10 A. We use a proxy group because using a number of  
11 cost of equity estimates tends to mitigate the  
12 impact of any irregularities in any one Company's  
13 data.

14 Q. What selection criteria did the Panel apply to  
15 select its proxy group?

16 A. We began with a universe of 59 electric and gas  
17 utility companies that are tracked by Value Line.  
18 All companies selected for the proxy group: 1)  
19 have investment grade, senior debt credit ratings  
20 from S&P's of BBB- and higher and/or from Moody's  
21 of Baa3 or higher; 2) derive at least 70% of  
22 revenues from regulated (electric and/or  
23 gas) utility operations, as determined by each  
24 utility Company's 10K report for 2007; 3)

1 currently pay dividends; and 4) have no  
2 current/pending mergers or other circumstance that  
3 could significantly impact its financial  
4 statistics as reflected in current reports.

5 Q. How many companies did the Panel include in its  
6 proxy group on the basis of these selection  
7 criteria?

8 A. On the basis of our selection criteria, we  
9 constructed a proxy group of 30 electric and gas  
10 utilities, as listed in Exhibit\_\_ (RRP-6). The  
11 data in the Exhibit includes each Company's  
12 percentage of utility revenues, S&P and Moody's  
13 bond ratings, S&P business and financial risk  
14 profile ratings, associated scores and equity  
15 ratios. We note that many of the companies in  
16 our proxy group are holding companies and so, the  
17 bond ratings are that of the holding/parent  
18 Company.

19 Q. Explain the relationship between holding/parent  
20 Company credit ratings to their utility  
21 subsidiaries.

22 A. The methods we use for estimating the cost of  
23 equity are based upon the stock prices of,  
24 dividends paid by, and financial ratios reported

1           by the relevant entity. In the case of a utility  
2           subsidiary that is owned by a parent/holding  
3           Company, this activity generally occurs at the  
4           parent/holding Company level. As such, equity  
5           investors do not purchase ownership of the  
6           individual utility subsidiary; instead, they  
7           purchase ownership of the entire holding Company,  
8           which includes its utility subsidiaries and its  
9           non-utility operations. Equity investors will  
10          logically base their return requirements on the  
11          risk level of the entire Company, rather than its  
12          strongest individual components.

13   Q.   How does this relationship impact the overall  
14          credit rating of the proxy group?

15   A.   The price investors are willing to pay for a share  
16          of common stock is based on their expectations  
17          concerning the future of the entire Company and  
18          its associated risks. While an individual utility  
19          subsidiary may be judged by rating agencies to be  
20          worthy of approximately an "A" rating, the higher  
21          risks of its parent's non-utility operations may  
22          make the risk level of the entire enterprise  
23          closer to that of a "BBB" rating, several notches  
24          lower.

1 Q. If Central Hudson is rated A/A2 by S&P and  
2 Moody's, why didn't the Panel restrict its  
3 selection criteria to only A-rated companies?

4 A. The intent of our selection criteria was to  
5 achieve two goals: 1) to develop a proxy group of  
6 utility companies with risk profiles similar to  
7 Central Hudson, and 2) to obtain a relatively  
8 robust number of utility companies in the proxy  
9 group. Had we restricted our selection criteria  
10 to only A-rated utility companies, our proxy group  
11 would number ten companies. For this analysis, we  
12 chose to expand our criteria in order to allow  
13 more smoothing of vagaries between the companies.

14 Q. Is the Panel's proxy group a perfect match for  
15 Central Hudson in relation to the level of  
16 business and financial risks that investors face?

17 A. No, it is not. The proxy group derives nearly 88%  
18 of its revenues from regulated investments as  
19 opposed to Central Hudson that achieved 100% of  
20 its revenues from its regulated operations. Also,  
21 with an average credit rating of BBB+/Baa1, the  
22 proxy group's credit rating is two notches lower  
23 than that of Central Hudson at A/A2. Further, the  
24 average beta for the proxy group is 0.80 and CH

1 Energy Group's beta is 0.90. We will explain the  
2 meaning of the beta under our CAPM discussion.  
3 Finally, the proxy group average of S&P financial  
4 and business risk are aggressive and excellent,  
5 respectively, in comparison to Central Hudson's,  
6 which has an intermediate financial risk profile  
7 and an excellent business risk profile. Overall,  
8 on the basis of the credit ratings that  
9 incorporate both business and financial risks, we  
10 consider the profile of the proxy group to be more  
11 risky than that of Central Hudson.

12 Q. Does the fact that the profile of the proxy group  
13 is more risky than Central Hudson have an impact  
14 on the Panel's cost of equity results?

15 A. Yes, it does. Generally, when discussing  
16 financial returns, higher risks are accorded  
17 higher returns. As the Company's witness Dr.  
18 Morin pointed out on pages 8 through 13 of his  
19 testimony, Central Hudson's cost of equity should  
20 compensate investors for the specific business and  
21 financial risks of the Company's regulated  
22 operations. By contrast, Central Hudson's cost of  
23 equity should not compensate investors for the  
24 risks faced by CHEG's unregulated operations. In

1 a perfect world, the risks of a proxy group would  
2 perfectly match Central Hudson's risk, rather than  
3 CHEG's risks. This desirable result is currently  
4 unattainable given the relatively small number of  
5 utility companies with A-ratings. To address for  
6 this difference in risks, we adjusted our proxy  
7 group cost of equity determination by applying a  
8 credit quality adjustment factor. The mechanics  
9 of this factor is best explained in our discussion  
10 of our methodology.

11 Q. Are the profiles of the proxy groups used by Dr.  
12 Morin riskier than that of Central Hudson?

13 A. Yes they are. Dr. Morin's proxy groups have  
14 average bond ratings that range between BBB and  
15 BBB+, an average business profile rating of  
16 excellent and a financial risk profile of  
17 aggressive. Nearly 50% of his companies derive  
18 less than 70% of their revenue from regulated  
19 utility operations, with some getting most of  
20 their revenue from non-utility operations.

21 Q. Did Dr. Morin adjust his analyses to reflect the  
22 risk differential between his proxy groups and  
23 Central Hudson?

24 A. No, he did not.

1 DCF Methodology

2 Q. Describe the basic theory underlying the DCF  
3 methodology.

4 A. The DCF method is a market-based approach that is  
5 generally used to quantify the fair rate of return  
6 on equity. According to this approach, the total  
7 return to an investor from a share of common stock  
8 is the discount rate that equates the current  
9 stock price with the future returns on that stock.  
10 Future returns include dividends paid over a  
11 certain time period in the future and the price  
12 that a future investor would be willing to pay for  
13 the share of stock at the end of that time period.  
14 These future payments are usually adjusted to  
15 reflect investors' growth expectations with  
16 respect to dividends and the value of the stock.  
17 The DCF, as it is traditionally used, assumes that  
18 an investor will hold a share of stock in  
19 perpetuity. Alternatively, if the share of stock  
20 is not held in perpetuity, the model assumes that  
21 the next investor will pay a price that reflects  
22 the same growth rate.

23 Q. Describe your data inputs to the DCF model.

24 A. We show the assumptions used to derive the generic

1 proxy group ROE on Exhibit\_\_ (RRP-7), pages 1 and  
2 2. For each utility in the proxy group, we used  
3 the most current data for the 6-month period ended  
4 September 2008. The data included stock prices  
5 and financial data required to forecast growth  
6 rates for the utility shares of stock. The  
7 financial data included each Company's beta,  
8 actual and forecast earnings per share, dividends  
9 per share, book value per share, and actual and  
10 forecasted number of common stock shares  
11 outstanding. We obtained the stock price data  
12 from the Yahoo Finance web site  
13 (<http://finance.yahoo.com>). Using the common  
14 stock price data, we calculated the six-month  
15 average price of each utility's average monthly  
16 high and low closing price, over the six-month  
17 period ending September 30, 2008. We used Value  
18 Line data based on data reported through the third  
19 quarter of 2008 from Value Line Investment Survey  
20 (Standard Edition) for the Electric Utility  
21 Industry (East, Central and West).

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

23 A. Based on the inputs described above, the median  
24 DCF cost of equity for the proxy group was 9.66%

1 Exhibit\_\_ (RRP-7), page 3.

2 Capital Asset Pricing Models

3 Q. Panel, please describe the basic theory underlying  
4 the CAPM?

5 A. The CAPM separates a stock's total risk into two  
6 components, systematic risk and unsystematic risk.  
7 Systematic risk is the risk caused by general  
8 movements in the stock market. It reflects the  
9 risk inherent to all stocks due to changes in the  
10 market economy. This risk cannot be diversified  
11 away through either a blended portfolio or through  
12 involvement in various enterprises. On the other  
13 hand, unsystematic risk is Company-specific risk.  
14 Portfolio managers can minimize or eliminate  
15 unsystematic/Company-specific risk through  
16 diversification of the portfolio by investment in  
17 various enterprises that do not face unilateral  
18 risk. Investment portfolios are generally  
19 diversified on the basis of unsystematic risk.  
20 Beta measures the degree of systematic risk of  
21 stock by reflecting the return volatility of a  
22 particular stock in relation to the market. The  
23 higher the expected risk of an investment, the  
24 higher its risk contribution to the overall risk

1 of a portfolio, and therefore, the higher the  
2 return required by an investor to make an  
3 investment. The average beta value of all stocks  
4 is equal to 1.0. If a particular stock has a beta  
5 of 1.0, the variability in its return due to  
6 macroeconomic factors will be equal to that of the  
7 market as a whole. A stock with a beta of 0.5 is  
8 half as risky as the average stock. Conversely, a  
9 stock with a beta of 2.0 is twice as risky as the  
10 average common stock. Utilities generally have  
11 betas less than 1.0, as they are less risky than  
12 the market as a whole. The proxy group's average  
13 beta is 0.80.

14 Q. How did the Panel conduct this CAPM analysis?

15 A. Our methodology employs two CAPM approaches: the  
16 traditional CAPM approach and the zero beta (or  
17 empirical) CAPM approach.

18 Traditional CAPM

19 Q. Please describe the traditional CAPM analysis.

20 A. For our analysis, the traditional CAPM determines  
21 the cost of equity by adding one factor to the  
22 risk free rate: that is, the proxy group's average  
23 Value Line beta times the risk premium earned by  
24 stocks in the S&P 500. We determined the risk

1 free rate/current yield on long term treasury  
2 bonds by taking the average of 10-year and 30-year  
3 treasury bonds over the last 6 months. We  
4 calculated the risk premium by subtracting the  
5 risk free rate from the expected market return for  
6 the S&P 500,  $R_m$  as forecast by Merrill Lynch. The  
7 traditional CAPM equation is:

$$8 \quad K_e = R_f + \beta (R_m - R_f).$$

9 Q. Describe the inputs that the Panel used in its  
10 traditional CAPM analysis.

11 A. The traditional CAPM requires inputs for the  
12 estimate of a risk free rate ( $R_f$ ), the market  
13 return ( $R_m$ ) and the proxy group's average beta ( $\beta$ ).  
14 We used a risk free rate ( $R_f$ ) of 4.19%, the average  
15 of the monthly average yield of 10-year treasury  
16 bonds and 30-year treasury bonds over the six  
17 months ending September 2008. For the market  
18 return, we used the expected market return ( $R_m$ ) of  
19 11.4% that was forecasted by Merrill Lynch as the  
20 required return for the S&P 500, in its October  
21 2008 edition of Quantitative Profiles shown at  
22 Exhibit\_\_ (RRP-8). The S&P 500 is an index that  
23 tracks the performance of the common stock of the  
24 500 largest corporations that trade over the New

1 York Stock Exchange. Finally, we used Value Line  
2 data published as of the third quarter ending 2008  
3 for each utility to calculate an average beta of  
4 0.80 for the proxy group, as shown at  
5 Exhibit\_\_ (RRP-7), page 1. We used these same  
6 inputs in calculating the zero beta CAPM.

7 Q. What was the result of your traditional CAPM  
8 analysis?

9 A. The traditional CAPM analysis yielded a 9.98% cost  
10 of equity.

11 Zero Beta CAPM

12 Q. Please describe the zero beta CAPM analysis?

13 A. The zero beta CAPM holds one quarter of the  
14 assumed "risk premium" to be constant. The  
15 rationale is that investors cannot actually borrow  
16 at the risk-free rate. For our analysis, the zero  
17 beta CAPM determines the cost of equity by adding  
18 two factors to the risk free rate: 1) a factor of  
19 75% times the average proxy group Value Line beta  
20 times the risk premium earned by stocks in the S&P  
21 500, and 2) a factor of 25% times the premium  
22 earned by stocks in the S&P 500. The zero beta  
23 CAPM equation used in the GFC methodology is:

24 
$$K_e = R_f + .75 * \beta * (R_m - R_f) + .25 * (R_m - R_f)$$

1 Q. What was the result of the zero beta CAPM  
2 analysis?

3 A. The zero beta CAPM analysis yielded a 10.34% cost  
4 of 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. For the proxy group, our analysis yielded a DCF  
11 cost of equity of 9.66%, a traditional CAPM cost  
12 of equity of 9.98%, and a zero beta CAPM cost of  
13 equity of 10.34%. The average of the two CAPM  
14 analyses was 10.16%. Using our 2/3 DCF and 1/3  
15 average CAPM weighting, the resultant cost of  
16 common equity is 9.83%; that is  $[(2/3 * 9.66%) +$   
17  $(1/3 * 10.16\%)]$ .

18 Credit Quality Adjustment

19 Q. Earlier, in describing your cost of equity  
20 methodology, you indicated that the Panel made two  
21 adjustments to the proxy group results, a credit  
22 quality adjustment and an RDM adjustment. Please  
23 explain the credit quality adjustment.

24 A. Since Central Hudson's credit ratings are two

1 notches above that of the proxy group, we employed  
2 the difference in yield spreads as the basis for  
3 making this adjustment. The rationale for this  
4 adjustment is based upon the concept that the  
5 return requirements of common equity investors are  
6 commensurate with the risk of their investment.  
7 Our proxy group selection process resulted in a  
8 group of utility companies whose risks were  
9 similar to those of Central Hudson. Even so,  
10 there are real quantifiable differences between  
11 the risk profiles of Central Hudson and that of  
12 the proxy group. Central Hudson's lower business  
13 and financial risks relative to the proxy group  
14 should be reflected as a reduction to the cost of  
15 equity determination.

16 Q. How did the Panel calculate this adjustment?

17 A. Our adjustment, for which the details are provided  
18 in Exhibit\_\_ (RRP-9), uses utility bond yield data  
19 from the October 2008, Mergent Bond Record shown  
20 at Exhibit\_\_ (RRP-10), Schedule 1 to calculate the  
21 5-year average yield on debt rated A, Aa and Baa  
22 to be 5.88%, 6.06% and 6.35%, respectively, shown  
23 at Exhibit\_\_ (RRP-10), Schedule 2. From this data,  
24 we determined the implied yield for Central Hudson

1           rated (A/A2) at 6.06% and based on the 29 basis  
2           points spread between A and Baa2, we interpolated  
3           the data to estimate an implied yield of 6.25% for  
4           the proxy group with its average bond rating of  
5           BBB+(S&P)/Baa1(Moody's). We next calculated the  
6           ratio of the proxy group's cost of equity at 9.83%  
7           to its implied yield of 6.25% for a ratio of  
8           1.5754, which we multiplied by Central Hudson's  
9           implied 6.06% bond yield (1.5754 x 6.06%) which  
10          resulted in a cost of equity determination of  
11          9.53% for Central Hudson. The 9.53% cost of  
12          equity implies a credit quality adjustment of 30  
13          basis points to the proxy group's 9.83% cost of  
14          equity. This approach is consistently employed by  
15          the Commission.

16   Revenue Decoupling Mechanism

17   Q.    What is an RDM?

18   A.    An RDM is a true-up mechanism that shifts the risk  
19          of actual sales being lower than projected sales  
20          from the Company to ratepayers. The shifting of  
21          sales risk reduces a Company's business risk  
22          because the risk of lower revenues due to a  
23          reduction in sales is transferred from the Company  
24          to its customers.

1 Q. Please explain why the Panel is recommending that  
2 Central Hudson's cost of equity determination be  
3 adjusted to reflect an RDM adjustment.

4 A. Investors expect that the implementation of an RDM  
5 will decrease Central Hudson's business risk  
6 relative to sales. When customers' sales diverge  
7 from forecasts as the result of conservation  
8 efforts and environmental concerns efforts,  
9 Central Hudson will be made whole and the  
10 customers ultimately bear the risks. Since this  
11 risk is transferred to customers, they should not  
12 also pay for it in the cost of equity.  
13 Accordingly, Central Hudson's cost of equity  
14 should be adjusted to reflect its lower business  
15 risk due to the RDM.

16 Q. Did the Panel determine the number companies in  
17 its proxy group that have RDMs?

18 A. Yes. We determined that only four of the  
19 companies in our proxy group have RDMs.  
20 Therefore, given that only a few of the companies  
21 in our proxy group have RDMs, we based our  
22 recommendation on the Commission's 10 basis points  
23 RDM adjustment in its December 2007 Order for the  
24 National Fuel Gas Corporation in Case 07-G-0141,

1 where the proxy group of 13 companies had only one  
2 Company with an RDM.

3 Q. Does the Panel have a basis to support the 10  
4 basis point RDM adjustment?

5 A. Yes, we do. We think that an RDM adjustment of 10  
6 basis points is supported by statements made by  
7 the rating agencies. The credit agencies have  
8 indicated that the RDM would be looked upon as  
9 favorable. Specifically, in its September 22,  
10 2008 review of Central Hudson, Moody's indicates  
11 that the Company's cash flow is uncertain due to  
12 the fact that the Company does not have an RDM.  
13 It also stated that the financial performance of  
14 Central Hudson currently reflects that of a  
15 utility with a Baa credit rating, two notches  
16 lower than its current A2 credit rating. At a  
17 minimum, the adoption of an RDM would account for  
18 a relative increase in credit rating of one notch.  
19 We earlier presented an analysis that showed that  
20 a one notch change in credit rating is equivalent  
21 to a change in bond yield of 10 basis points. If  
22 we adjusted the 10 basis points by a factor of  
23 1.572 to reflect the comparable change in common  
24 equity, as per our credit quality adjustment in

1 Exhibit\_\_ (RRP-9), the resulting RDM adjustment  
2 would be 16 basis points. We, however, recommend  
3 the more conservative 10 basis points RDM  
4 adjustment.

5 Q. What impact would an RDM have on Central Hudson's  
6 earned ROE?

7 A. Based on our recommended rate of return, we  
8 estimate that for every \$1 million decrease in net  
9 income, the Company's overall rate of return will  
10 decrease by 67 basis points and its return on  
11 equity will decrease by 150 basis points; this is  
12 equivalent to \$1,232,550 for gas rates and  
13 \$4,522,050 for electric rates.

14 Q. Did Central Hudson impute a RDM adjustment?

15 A. Yes. On pages 51 to 52 of his testimony, Dr.  
16 Morin states that his costs of equity  
17 determinations are net of an RDM adjustment; he  
18 made no explicit calculation.

19 Recommended Return on Equity

20 Q. What is the Panel's recommended cost of equity for  
21 Central Hudson?

22 A. Our cost of equity determination for Central  
23 Hudson is 9.45%; it is composed of a proxy group  
24 cost of equity of 9.85% minus a 30 basis points

1 credit quality adjustment and a 10 basis points  
2 RDM adjustment. We recommend that the Commission  
3 allow Central Hudson to earn a return on equity of  
4 9.45%.

5 Reasonableness Check

6 Q. Did the Panel check the reasonableness of its  
7 allowed return on equity recommendation for  
8 Central Hudson?

9 A. Yes. We compared our allowed return on equity  
10 recommendation to the recommended allowed return  
11 on equity determinations for electric rates for  
12 Consolidated Edison Company of New York (CECONY)  
13 in Case 07-E-0523, for electric rates for Orange  
14 and Rockland Utilities, Inc. (O&R) in Case 07-E-  
15 0949, for gas rates for National Fuel Gas  
16 Corporation (NFG) in Case 07-G-0141 and for  
17 electric and gas rates in Central Hudson's last  
18 rate proceeding, Cases 05-E-0935 and 05-G-0936.  
19 In order to conduct a comparison, we determined  
20 the risk free rate at the time the Commission's  
21 order was issued for each Company. Then we  
22 subtracted that risk free rate from the current  
23 risk free rate of 4.19% that we employed in our  
24 cost of equity analysis in this proceeding. Next

1 we applied one-half the difference to the allowed  
2 return on equity authorization for the respective  
3 Company. The chart in Exhibit\_\_ (RRP-11) shows  
4 that upon update the allowed returns on equity for  
5 CECONY, O&R, NFG and Central Hudson would be  
6 9.09%, 9.44%, 8.78% and 9.43%, respectively.  
7 These results indicate that our recommended  
8 allowed return on equity determination for Central  
9 Hudson is not only reasonable, but is generous.  
10 It also shows that the credit rating reports that  
11 criticize the Commission for authorizing lower  
12 allowed returns than in the past have only  
13 compared number to number and did not adjust the  
14 return to account for different economic  
15 conditions.

16 A. Given these allowed returns, in our opinion a  
17 return on equity of 9.45% is reasonable.

18 Financial Integrity

19 Q. Did the Panel conduct a financial integrity  
20 examination?

21 A. Yes, we did. On the basis of our recommendations,  
22 Central Hudson's resultant pretax interest  
23 coverage ratio is approximately 3.49 times. S&P's  
24 August 28, 2008 research report "CreditStats:

1 Electric Utilities—U.S.” at Exhibit\_\_ (RRP-18)  
2 indicates that for the years 2005 through 2007,  
3 “A-rated” electric utilities had pre-tax interest  
4 coverage ratios in the range of 1.3x to 6.9x. The  
5 average and the median pre-tax interest coverage  
6 ratio for the “A-rated” electric utilities were  
7 3.78x and 3.70x, respectively. This data  
8 indicates that our recommendation maintains  
9 Central Hudson’s financial integrity.

10 Q. Panel, please evaluate the cash flow metrics of  
11 Central Hudson relative to its credit rating?  
12 Should investors be concerned about a possible  
13 shortfall in cash flow, and if so, should this be  
14 a reason to increase the allowed ROE?

15 A. No. The Commission has consistently allowed New  
16 York utilities the ability to reflect in its rates  
17 prudently incurred construction costs. To the  
18 extent that the Commission has not failed to carry  
19 through on its authorizations, investors in New  
20 York utilities should be confident of such  
21 authorizations.

22 Discussion of Witness Morin's Testimony

23 Q. Please briefly describe Witness Morin’s testimony?

24 A. Dr. Morin executed eight analyses to estimate a

1 cost of equity determination for Central Hudson:  
2 four DCF analyses and four risk premium analyses.  
3 He developed two proxy groups which he used as the  
4 basis of his DCF analyses. His risk premium  
5 analyses included two CAPM models, a traditional  
6 CAPM and an Empirical CAPM (ECAPM), and non-CAPM  
7 risk premium approaches; one employed 81 years  
8 (1926-2007) of historical risk premium data that  
9 is published by Ibbotson Associates and the second  
10 employed ten years (1998-2008) of historical  
11 allowed returns from other commissions to estimate  
12 the risk premium. He established a cost of equity  
13 range of 11.4% to 10.2%. The Company is  
14 requesting a return on equity of 10.25%.

15 Q. Does the Panel have any comments concerning Dr.  
16 Morin's testimony?

17 A. Yes. First, we have concerns related to Dr.  
18 Morin's suggestion at page 24 his testimony that  
19 the results from alternate cost of equity  
20 methodologies should be accorded at least as much  
21 weight as the DCF model. Second, we are troubled  
22 by Dr. Morin's proxy group selection criteria and  
23 resultant proxy groups. Third, Dr. Morin used  
24 questionable data for his DCF and CAPM analyses.

1 Fourth, he employed two risk premium analyses,  
2 analyses that the Commission has consistently  
3 rejected because the results are unreliable.  
4 Fifth, he added flotation costs to his cost of  
5 equity results. When combined, these analytical  
6 shortcomings resulted in an overstated, proposed  
7 cost of equity for Central Hudson. We, therefore,  
8 recommend that the Commission reject Dr. Morin's  
9 cost of equity analyses, his corresponding cost of  
10 equity results, and the Company's 10.25%  
11 recommended cost of equity.

12 Weighting of Cost of Equity Methods

13 Q. Can you summarize the basis for Dr. Morin's  
14 argument in weighting the DCF model equally among  
15 other methodologies?  
16 A. Dr. Morin discusses the structural changes of the  
17 energy utility industry at page 24, lines 11-22,  
18 mentioning deregulation, the changes in accounting  
19 rules and customer attitudes, alternative energy  
20 sources, unstable fuel prices and mergers-  
21 acquisitions, as specific examples. He also  
22 mentions that this industry transformation took  
23 place after the DCF methodology was developed, and  
24 that since then, these changes have influenced

1 stock prices in ways that deviate from the overall  
2 assumptions of the DCF model, particularly that of  
3 "constant growth" and "constant relative  
4 valuation." The latter refers to comparing a  
5 company's common equity share price to the market  
6 values of similar assets through the use of price  
7 multiples, such as "price-to-earnings (P/E)" and  
8 "market-to-book" or "MBR" ratios for which the DCF  
9 model, according to Dr. Morin, at page 25, lines  
10 4-15, unrealistically assumes constancy. Based on  
11 these ideas, Dr. Morin recommends that alternate  
12 methodologies for estimating the cost of common  
13 equity should be accorded as much weight as the  
14 DCF method.

15 Q. What is the Panel's concern related to Dr. Morin's  
16 proposal that all cost of equity methods be  
17 equally weighted for determining a utility's cost  
18 of equity?

19 A. Based on his testimony, Dr. Morin's position is  
20 that the Commission should equally weight all cost  
21 of equity methodologies, regardless of the  
22 validity of the analysis and its results. Such a  
23 position, especially in consideration of analyses  
24 with serious shortcomings, is unreasonable. Given

1           that the Commission has made many allowed return  
2           on equity decisions based on its 2/3 DCF and 1/3  
3           CAPM weighting of cost of equity since the changes  
4           mentioned by Dr. Morin, we think that this ratio  
5           should be maintained. The Commission's  
6           established weighting results in consistency  
7           between all allowed return on equity decisions  
8           made by the Commission and investors expecting  
9           that weighting.

10   Q.    What is the Commission's precedent for the  
11           weighting to which you refer?

12   A.    Since 1991, the Commission has consistently used  
13           the DCF as its primary methodology for determining  
14           ROE by applying a 2/3 DCF and 1/3 CAPM weighting  
15           in the determination of the cost of equity. The  
16           weighting has most recently been affirmed in 2008  
17           by the Commission's Order in Case 07-E-0523 for  
18           Consolidated Edison's electric rates and in 2007  
19           by the Commission's Order in Case 07-G-0141  
20           involving National Fuel Gas Company rates. In the  
21           latter case, the Commission stated that: "We also  
22           agree with Staff, CPB and Multiple Interveners  
23           that the Company (NFG) has not provided any  
24           compelling reasons to provide equal weight to the

1 DCF and the CAPM methods. Accordingly, we will  
2 continue to use the two-thirds DCF Method and one-  
3 third CAPM method weighting in this case.”

4 Q. Can the Panel refer to any other statements by the  
5 Commission that set the precedent for the  
6 weighting of cost of equity methods?

7 A. In Cases 06-E-1433 and 06-E-1547, an O&R rate  
8 proceeding on pages 14 and 15 of the Commission’s  
9 Order, the Commission stated: “We will continue to  
10 accord two-thirds weight to the DCF result and  
11 one-third to the CAPM result as we have in past  
12 decisions. This result is consistent with the  
13 recommendation of the co-facilitators in the  
14 Generic Financing proceeding. We note some of the  
15 concerns raised by Orange and Rockland regarding  
16 undue weight on the DCF methodology. Many of  
17 these concerns are addressed by the two-stage DCF  
18 method employed by Staff. Moreover, the method  
19 offers the significant benefit of reliance on  
20 readily available, objective data to measure an  
21 indicator of real importance to investors. Our  
22 decision to retain the current weighting of the  
23 two approaches is also based on concerns we have  
24 regarding the application of the CAPM. It is our

1           general observation that, while the business risks  
2           of New York's electric utilities have declined as  
3           generation assets have been divested, the betas of  
4           the holding companies owning electric utilities  
5           have in fact increased. While this increase in  
6           the volatility of holding Company stock prices  
7           relative to the market could reflect increased  
8           utility risk, it could just as easily be  
9           attributable to the higher risks of holding  
10          Company non-utility businesses. ...Given concerns  
11          such as these, we are not now inclined to deviate  
12          from our long-held view that the CAPM methodology  
13          should not be entitled to more than one-third of  
14          the weight in our ROE determination." Given this  
15          recent Commission precedent, we believe the  
16          appropriate weighting for the ROE methods should  
17          not be equal.

18   Dr. Morin's Market-to Book Ratio Illustration

19   Q.    You mentioned Dr. Morin presented a misleading  
20          analysis concerning market-to-book ratios (MBR);  
21          what is a MBR?

22   A.    It is the market price of a Company's common  
23          equity, divided by its book value which can be  
24          calculated on a per share basis or in totality.

1 Investors determine the market value of a  
2 Company's equity on the basis of projected  
3 earnings growth and the present value of all its  
4 future prospects. A Company's book value of  
5 equity is its tangible assets recorded at  
6 historical cost, less accumulated depreciation.  
7 When a Company's market value is divided by its  
8 book value, the resulting quotient is the MBR.

9 Q. How do you think Dr. Morin misrepresented  
10 shortcomings of the DCF?

11 A. On pages 18 to 21 of his testimony, Dr. Morin  
12 states that when a utility's MBR is greater than  
13 one, the DCF model understates investors' required  
14 return on equity and, vice-versa, when a  
15 utility's MBR is less than one, the DCF model  
16 overstates investors' required return on equity.  
17 We find Dr. Morin's contention to be incorrect and  
18 think that his use of the terms "investors'  
19 required return" and "investors' expected return"  
20 in his testimony to be indistinct. This poses a  
21 problem because rate setting is based on  
22 investors' required return, as opposed to  
23 investors' expected return. The DCF model cannot  
24 understate investors' required return because it

1 is in fact used by the Commission to determine  
2 required return. Further, Dr. Morin  
3 misrepresented shortcomings of the DCF model on  
4 page 20 of his testimony in scenario #3 where MBR  
5 is greater than one. He calculates "Market  
6 Return" through multiplying share price by the DCF  
7 cost rate and refers to it as understated  
8 "required return", when it is in fact "expected  
9 return".

10 Q. How do the concepts of investors' expected and  
11 required return relate to Dr. Morin's assertion  
12 about the shortcomings in the DCF relative to the  
13 MBR when it is greater or less than unity?

14 A. A MBR above 1.0 indicates that investors expect  
15 the utility's earned "return on equity" to be  
16 higher than its allowed "cost of equity" or  
17 required return on equity. When the MBR is less  
18 than one, investors' expectations are that the  
19 utility's earned "return on equity" will be lower  
20 than its allowed "cost of equity". However,  
21 investors' expectations are not relevant in  
22 setting rates because ratepayers should only pay  
23 the cost of the required return on equity.

24 Q. Explain why rate setting in New York is based on

1 investors' required returns and not investors'  
2 expected return?

3 A. If rates were based on "expected return," then  
4 allowed returns would be adjusted upward for  
5 companies whose MBR exceeds 1.0 resulting in an  
6 upward spiral for a Company's ROE: a company has  
7 an MBR greater than one, its commission then  
8 authorizes a relatively higher return on equity,  
9 shareholders then pay even more for that company's  
10 common stock, the company's MBR increases to a  
11 higher level, which would lead to an even higher  
12 allowed return on equity in the company's next  
13 rate proceeding. The converse is also true.

14 Q. How closely does the required return used for  
15 ratemaking in New York reflect investors' expected  
16 return?

17 A. A fundamental tenet of ratemaking in New York is  
18 that the return on equity is applied to the book  
19 value of common equity, and if the Company  
20 expected to earn this return on equity, MBR is at  
21 unity and its market price will equal its book  
22 value, all other things constant.

23 Q. Given this understanding, does the Panel consider  
24 the relationship between MBR and investors'

1 expected rate of return as a shortcoming in the  
2 DCF for regulatory purposes?

3 A. No, we do not. MBRs are irrelevant for rate  
4 setting purposes. Regulators allow a utility to  
5 earn equity earnings equal to the "cost of equity"  
6 times the equity book value, so that  
7 shareholders/investors are ensured to earn a fair  
8 rate of return. Since rates are not set to allow  
9 investors to earn what they expect, Dr. Morin's  
10 alleged DCF shortcoming relative to the MBR and  
11 investors' expectations is not a shortcoming for  
12 rate setting purposes.

13 Q. Would the Panel like to add any other comments on  
14 this topic?

15 A. Yes. Investors are well aware of the ratemaking  
16 methodologies employed by the Commission and other  
17 commissions throughout the United States. With  
18 respect to utility common stock in New York, we  
19 think that investors' knowledge of how the New  
20 York Commission sets its allowed returns on common  
21 equity supports an efficient market. These  
22 methodologies whether in a litigated rate case, or  
23 as the result of a multi-year joint proposal, have  
24 been followed by the investment community for

1 years. The fact that MBR ratios have exceeded one  
2 for almost two decades is an indication that  
3 expected earned returns on equity have exceeded  
4 the companies' cost of capital. Investors are  
5 willing to pay more than book value because they  
6 believe that earned returns will be higher than  
7 allowed returns. Dr. Morin explains this on page  
8 359 of his book entitled New Regulatory Finance.  
9 Central Hudson's return has been set without any  
10 consideration for MBR ratios.

11 Q. Do you believe utilities will always support the  
12 use of MBR as a basis for making adjustments in  
13 the ratemaking process?

14 A. We find it difficult to believe that utilities  
15 would make these same arguments which would  
16 support a lower return on equity if their MBR was  
17 below 1.0 due to the downward spiraling impact  
18 previously discussed. We note that CHEG's current  
19 MBR is 1.15x.

20 Proxy Groups

21 Q. What criteria did Dr. Morin employ to select the  
22 proxy groups for his analysis?

23 A. Dr. Morin's proxy groups criteria was that: 1) the  
24 utilities be included in S&P's listing of electric

1 and gas utility companies; 2) the utilities be  
2 listed in Moody's Investor Index (the Index)  
3 listing of utility companies; 3) that the  
4 utilities have investment grade credit ratings by  
5 S&P and by Moody's; 4) that each Company/parent  
6 Company generate at least 50% of its revenues from  
7 regulated operations; and 5) the companies should  
8 not be involved in merger/acquisition activity.

9 Q. How many proxy groups did Dr. Morin employ in his  
10 analyses?

11 A. Dr. Morin constructed four proxy groups for which  
12 initial selections were based upon an S&P and a  
13 Moody's Utility Index universe to which he applied  
14 growth estimates from the Value Line Investment  
15 Analyzer (VLIA) software or Zack's Investment  
16 Research Inc. (Zacks). The four proxy groups  
17 were: 1) the S&P/VLIA proxy group - Company  
18 selections from an S&P database analyzed with VLIA  
19 growth rate estimates, 2) the S&P/Zacks proxy  
20 group - Company selections from an S&P database  
21 analyzed with Zacks growth rate estimates; 3) the  
22 Moody's/VLIA proxy group - Company selections from  
23 the Moody's Utility Index (the Index) analyzed  
24 with VLIA growth rate estimates, and 4) the

1           Moody's/Zacks proxy group - Company selections  
2           from the Index analyzed with Zacks growth rate  
3           estimates.

4    Q.    What is the Panel's assessment of Dr. Morin's  
5           proxy groups?

6    A.    Dr. Morin's selection criteria that his proxy  
7           group companies earn at least 50% of revenues from  
8           regulated operations is problematic. The  
9           resultant proxy groups had average bond ratings in  
10          the range of BBB+/Baa2 which is more risky than  
11          Central Hudson's A/A2 bond rating. These are  
12          risks that do not adequately represent the risks  
13          of Central Hudson. Dr. Morin used data for these  
14          proxy groups in his DCF and CAPM analyses that  
15          resulted in overstated results in those analyses.  
16          While there is nothing wrong with using a 50%  
17          selection criterion, the problem is that Dr. Morin  
18          made no adjustments to his costs of equity results  
19          to account for the risk differences that exist  
20          between the proxy group and Central Hudson.  
21          Second, the Moody's Index, from which Dr. Morin  
22          selected his proxy group companies, has not been  
23          updated since 2002 and may contain companies that  
24          are inappropriate for determining Central Hudson's

1 cost of equity. Finally, since Energy East  
2 Corporation was involved in a merger/acquisition  
3 with Iberdrola S.A. at the time of Dr. Morin's  
4 analysis, it should be eliminated from his proxy  
5 groups because the common stock price of a company  
6 involved in merger/acquisition activities is  
7 generally unreliable due to investors'  
8 speculations.

9 Q. Please continue.

10 A. In addition to Northeastern Utilities and PPL  
11 Corp. that Dr. Morin identified as having outlier  
12 estimates, we identified two additional outlier  
13 companies, Public Service Enterprise Group, with a  
14 14.3% Zack's earnings growth rate and a 17.8%  
15 return on equity estimate, and DPL Inc. with an  
16 11.0% VLIA earnings growth rate and a 15.6% return  
17 on equity estimate, at Morin Exhibits RAM-6 and  
18 RAM-8. When Dr. Morin identified and used the  
19 median rather than the average results in order to  
20 mitigate the impact of the outliers In order to  
21 mitigate the impact of the outliers, Dr. Morin  
22 chose to use median rather than average cost of  
23 equity results. These outlier estimates yield  
24 unrealistic "sustainable" growth estimates and

1           these companies should be deleted from their  
2           respective proxy groups. Exhibit\_\_(RRP-12) shows  
3           our modifications to Dr. Morin's proxy groups.

4    Q.    If the 70% regulated revenues criterion is used to  
5           select proxy group companies from Dr. Morin's data  
6           bases and Energy East Corp. is eliminated because  
7           of its merger/acquisition activity, how would the  
8           composition of companies in Dr. Morin's four proxy  
9           groups change?

10   A.    The 70% criterion results in the elimination of  
11           PPL Corp., Exelon Corp., PEPCO Holdings Inc. and  
12           CH Energy Group from the proxy groups. The  
13           resultant S&P-based proxy groups would each  
14           contain six companies. The resultant Moody's/VLIA  
15           and Moody's/Zacks proxy groups would have ten and  
16           eleven companies, respectively. The results are  
17           shown in Exhibit\_\_(RRP-12). The small number of  
18           companies in these proxy groups would fail to  
19           mitigate the impact of irregularities from any one  
20           company's data, thereby resulting in cost of  
21           equity estimates that are too sensitive to the  
22           inputs and too volatile to accept with confidence.

23   Q.    Has the Commission ever adopted a cost of equity  
24           recommendation based on a proxy group selected on

1 the basis of a selection criterion that the  
2 companies in the group earn at least 70% of  
3 revenues from regulated operations?

4 A. Yes, the Commission has set return on equity  
5 allowances based on cost of equity methods that  
6 employed proxy groups selected on the basis of the  
7 70% criterion in several recent rate proceedings.  
8 The rate proceedings include: Orange & Rockland  
9 Utilities, Inc. in Cases 06-E-1433 and 07-E-0949,  
10 Consolidated Edison Company of New York (CECONY)  
11 in Cases 07-E-0523, 07-S-1315 and for National  
12 Fuel Gas Distribution Corporation in Case 07-G-  
13 0141. Even so, when there is a risk differential  
14 between the proxy group and the company for which  
15 the cost of equity is being determined, there is a  
16 need to adjust the cost of equity result.

17 Q. Given the above, what is the Panel's  
18 recommendation concerning the Company's proxy  
19 groups.

20 A. We recommend that the Commission reject Dr.  
21 Morin's proxy group analyses and the DCF and CAPM  
22 cost of equity results for which the proxy groups  
23 were employed.

24 DCF Discussion

1 Q. Please describe Dr. Morin's DCF methodology.

2 A. Dr. Morin used 3-year VLIA and 5-year Zacks  
3 single-stage earnings growth rates as forecast by  
4 analysts in the DCF model for his two proxy  
5 groups. His DCF approach resulted in cost of  
6 equity estimates ranging from 10.90% to 11.40%,  
7 inclusive of a 20 to 30 basis points flotation  
8 cost adjustment. In addition to the problems with  
9 his proxy group companies discussed earlier, we  
10 think that his use of earnings growth estimates is  
11 a significant flaw.

12 Q. Do you see any other problem with Dr. Morin's  
13 approach to estimating the growth rate?

14 A. A major problem is Dr. Morin's use of analysts'  
15 earnings growth forecasts. These growth forecasts  
16 are not sustainable because they are generally  
17 overstated and are generally three to five year  
18 forecasts. Moreover, Dr. Morin did not  
19 demonstrate a link between the long-term earnings  
20 growth rates and long-term dividend growth rates,  
21 which is a condition of the DCF model. In  
22 addition, he did not show that his earnings growth  
23 rates are sustainable. That is, in the long run,  
24 dividend and earnings growth rates must be equal,

1           because dividend payouts cannot be greater than  
2           earnings over an extended period of time.

3   Q.    Has the Commission deemed earnings growth rates  
4           unacceptable in any rate proceedings?

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

16   Q.    How should this shortcoming in Dr. Morin's  
17          analyses be addressed?

18   A.    These shortcomings compound the unreliability of  
19          Dr. Morin's DCF results which should be rejected  
20          by the Commission.

21   Q.    In the Panel's opinion, is Dr. Morin's DCF  
22          approach reasonable?

23   A.    In our opinion, no. Commission precedent has been  
24          to use retention growth estimates, which are the

1 product of a Company's expected return on equity  
2 and its retention ratio, as a proxy for  
3 sustainable growth in the DCF model. Dr. Morin  
4 states that his use of analysts' short-term  
5 earnings growth forecasts is reliable estimates of  
6 sustainable growth because they are abundantly  
7 available to investors. This argument is  
8 illogical because it is well known that the  
9 analysts' short term growth forecasts tend to be  
10 overstated and unreliable for use in the DCF  
11 model. This tendency can be examined within Dr.  
12 Morin's analyses. For each of his four DCF  
13 analyses, he made attempts after estimating the  
14 DCF cost of equity to mitigate the impact of  
15 earnings estimates and DCF cost of equity  
16 estimates that were significantly higher than that  
17 of other companies in the proxy group. Further, a  
18 comparison of the VLIA versus the Zacks earnings  
19 growth estimates for any given Company in Dr.  
20 Morin's proxy groups shows a significant variance  
21 in the estimates. We think that the use of  
22 analysts' earnings forecasts for long-run growth  
23 in the DCF model results in unreliable cost of  
24 equity determinations.

1 Q. How does the Panel view Dr. Morin's argument  
2 concerning the reliance on the DCF by other  
3 commissions?

4 A. Dr. Morin contends that other commissions have  
5 recognized the need to avoid exclusive reliance on  
6 the DCF in setting return on equity allowances.  
7 Dr. Morin, however, provided no support for this  
8 contention.

9 Q. Please continue.

10 A. Beginning on page 22 of his testimony, he stated  
11 that in a recent case involving Pacific Bell  
12 Telephone Company, the California Commission (CAC)  
13 declined to place any reliance on the DCF method,  
14 finding that it was "too dependent on one  
15 forecasted input." In response to our request  
16 that he substantiate this claim, Staff  
17 interrogatory DPS-227 submitted as Exhibit\_\_ (RRP-  
18 3), Dr. Morin stated that he could only "presume"  
19 the forecasted input referred to by the CAC. We  
20 also asked him to substantiate his claim that  
21 regulatory commissions in Indiana, Iowa, Hawaii  
22 and Pennsylvania "acknowledged the need" to adjust  
23 the DCF result when the MBR ratios exceeded one.  
24 His response to Staff interrogatory DPS-228

1 (Exhibit\_\_ (RRP-3) was that "Dr. Morin is not  
2 aware of whether these commissions adjust the DCF  
3 result when the M/B ratio is greater than one".  
4 Dr. Morin's responses to these questions indicate  
5 that he merely pulled statements from these  
6 commissions' decisions to support his position on  
7 their level of reliance on the DCF. He, however,  
8 is unable to substantiate his claims and his  
9 statements should be disregarded.

10 Q. Does the fact that another regulatory commission  
11 chooses to adjust a DCF result because an MBR is  
12 greater than one indicate that their decision is  
13 correct?

14 A. No, it does not. Determining the appropriate cost  
15 of equity for a utility is very complex and it  
16 requires that a commission be able to integrate  
17 the many theoretical, quantitative and qualitative  
18 factors in making its decision. There could be  
19 any number of reasons why a commission chooses to  
20 make a given decision. For example, it is  
21 possible, that a witness provided a presentation  
22 with numerous shortcomings or that the  
23 presentation did not clearly define the concepts  
24 of required investor returns versus expected

1 investor returns, or the presentation was not  
2 thoroughly vetted by the parties involved in the  
3 proceeding. Another example could be drawn from  
4 circumstances that occurred when the electric  
5 utility industry was deregulated; some states  
6 mandated deregulation and others encouraged  
7 deregulation. In some states, deregulation was  
8 considered a success, for others it was considered  
9 a disaster; and some states even discussed re-  
10 regulation. Given the differences in regulatory  
11 environments and the complexity of factors  
12 addressed in decision making, the New York  
13 Commission cannot blindly choose to follow a  
14 statement/decision of another commission relative  
15 to that commission's cost of equity  
16 determinations.

17 CAPM Discussion

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

19 A. Dr. Morin performed both a traditional CAPM and an  
20 empirical CAPM (ECAPM) analysis. While we  
21 performed the same analyses, we disagree with the  
22 source of Dr. Morin's data inputs for the market's  
23 risk premium, the risk free rate and the market  
24 beta, all of which resulted in overstated CAPM

1 results. Consequently, we recommend that the  
2 Commission reject Dr. Morin's traditional and  
3 empirical CAPM analyses because his data inputs  
4 were unreliable and yielded overstated cost of  
5 equity determinations.

6 Q. What is the Panel's concern relative to Dr.  
7 Morin's estimated risk free rate?

8 A. Dr. Morin's risk-free rate is calculated using  
9 only the 30-year Treasury bond yield. We think  
10 that our approach, which blends the 10-year and  
11 30-year treasury rates, provides a more accurate  
12 representation of the average investor's  
13 investment horizon. The use of only 30-year  
14 Treasury bond yields results in inflated CAPM and  
15 ECAPM results.

16 Q. What beta did Dr. Morin adopt for his CAPM  
17 analyses?

18 A. Consistent with his discussion on pages 32 to 33  
19 of his testimony, Dr. Morin calculated and  
20 employed an average beta of 0.82. It is the  
21 average of the 0.83 beta for his 12-Company  
22 S&P/VLIA proxy group and the 0.81 beta for his 16-  
23 Company Moody's/VLIA proxy group.

24 Q. What are Dr. Morin's CAPM results?

- 1 A. Dr. Morin calculated an 11.0% traditional CAPM  
2 cost of equity result ( $4.6\% R_f + 0.82\beta (7.4\% R_p) +$   
3  $30$  basis points flotation cost adjustment). His  
4 ECAPM produced an 11.6% cost of equity result  
5 ( $4.6\% R_f + 0.25(7.4\% R_p) + .75*0.82(7.4\% R_p) + 30$   
6 basis points flotation cost adjustment).
- 7 Q. Describe Dr. Morin's calculation of the market  
8 risk premium for his CAPM analysis.
- 9 A. Dr. Morin used a market risk premium of 7.4%.  
10 This risk premium was the result of averaging two  
11 estimates for the market risk premium, a 7.10%  
12 historical and a 7.80% forward-looking risk  
13 premium. He estimated a 7.1% historical market  
14 risk premium (ex post) based on the income  
15 component of the long term Treasury bonds, rather  
16 than the 6.5% risk premium based on the total  
17 return of the Treasury bonds. He estimated a 7.8%  
18 forward-looking risk premium (ex ante) which he  
19 determined by estimating the market return on the  
20 basis of a DCF analysis on the S&P 500 Index. He  
21 added the yield of the S&P 500 to a Value Line  
22 dividend growth rate estimate to estimate the  
23 market return. We find Dr. Morin's use of  
24 Ibbotson's market risk premium to be unacceptable.

1 Q. What is the Panel's position regarding Dr. Morin's  
2 use of the Ibbotson market risk premium?

3 A. We find Dr. Morin's use of the Ibbotson market  
4 risk premium to be unacceptable. The historical  
5 market risk premium was estimated using data  
6 published by Ibbotson Associates in its Valuation  
7 Edition-2007 Yearbook entitled Stocks, Bonds,  
8 Bills, and Inflation. The estimate is calculated  
9 using historical market premiums from 1926 through  
10 2007. The Commission has continuously deemed as  
11 stale, the Ibbotson market risk premium data  
12 because it does not reflect current market  
13 conditions. Moreover, recent studies have  
14 provided evidence that the market risk premium is  
15 declining.

16 Q. What is the Panel's position regarding Dr. Morin's  
17 ex-ante risk premium?

18 A. Dr. Morin used dividend growth rates in the DCF  
19 approach he employed to estimate the forward  
20 looking market return for the CAPM risk premium  
21 calculation. We question Dr. Morin's  
22 inconsistency in the application of the DCF  
23 method. In his risk premium analysis he employed  
24 Value Line dividend growth rates; however, he

1           relied upon earnings-based growth rates for his  
2           DCF analyses. In both applications, he failed to  
3           show how the selected growth rate was sustainable,  
4           a requirement for the DCF methodology.

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

8    A.    Yes we can. We refer to an article entitled "The  
9           Shrinking Equity Premium" by Jeremy Siegel, The  
10           Journal of Portfolio Management, Fall 1999,  
11           expressed this viewpoint. 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%.

23                    The fact that there is intellectual  
24           discussion concerning the reasonableness of

1 historical market risk premiums as proxies for the  
2 future, indicates the need for a conservative  
3 approach in reflecting historic risk premiums in  
4 Central Hudson's cost of equity determination.  
5 Accordingly, for the reasons discussed above, Dr.  
6 Morin's use of the historical risk premium should  
7 be rejected.

8 Q. Does the Panel have any other reason to reject the  
9 use of the Ibbotson data as an estimate of the  
10 market risk premium?

11 A. Yes. We refer to a discussion about Mr. Roger  
12 Ibbotson's market risk premium data in a Fortune  
13 Magazine article entitled "9% Forever" and dated  
14 December 26, 2005. The article reports that Mr.  
15 Ibbotson, the author of the study that heralded  
16 the use of extended historic time periods to  
17 estimate market returns, considered some of the  
18 criticisms of his long run market return data and  
19 had reduced his forecast of stock returns from 10%  
20 a year to 9.27%. Surprisingly, page 3 provides a  
21 reflection made by Mr. Ibbotson: "Ibbotson agrees  
22 that Fama has a point, and that he can no longer  
23 bank on the historical equity premium to predict  
24 future returns."

1 Q. Describe Dr. Morin's calculation of the  
2 prospective implied market risk premium for his  
3 CAPM analysis.

4 A. Using the May 2008 dividend yield for the S&P 500  
5 (1.78%) and its average projected long-term  
6 dividend growth rate of 10.21%, Dr. Morin  
7 calculated an 11.99% expected market return. He  
8 adjusted this market return to reflect an expected  
9 dividend yield and quarterly dividend payments,  
10 which increased the market return to 12.37%. He  
11 calculated the implied market risk premium of 7.8%  
12 (7.77% rounded up) by subtracting the 4.6% risk  
13 free rate from the market return.

14 Q. Can the Panel provide cites to Commission Orders  
15 that discuss its position relative to estimating  
16 market risk premiums in the CAPM and utilizing  
17 risk premium methods specifically?

18 A. Yes, we note two Commission orders where such  
19 citations are found. The first is in Case 95-G-  
20 1034, Central Hudson Gas & Electric Corporation -  
21 Gas Rates, Opinion No. 96-28 (issued October 3,  
22 1996), the Commission stated, "...the Judge's market  
23 return calculation based on Merrill Lynch data is  
24 a reasonable method of deriving a risk premium;

1 and it avoids the problems of stale data in the  
2 Ibbotson estimate, or the circularity of the  
3 implied risk premium approach in relying on other  
4 Commission's return on equity allowances." In  
5 this Opinion, the Commission also stated "...we have  
6 avoided reliance on the risk premium approach  
7 because it reflects allowed returns which are an  
8 inferior alternative to a direct estimate of a  
9 Company's own cost of equity." A third  
10 Commission citation is found in Case 05-E-1222,  
11 New York State Electric & Gas, Order, (issued  
12 August 23, 2005), where the Commission states  
13 "...NYSEG's reliance on the historic Ibbotson data  
14 to estimate the market return is rejected..."  
15 These Commission statements reject the use of the  
16 Ibbotson data and implied risk premiums and  
17 reaffirm the Commission's position that the market  
18 risk premium based on Merrill Lynch data is a  
19 reasonable method of deriving a risk premium. The  
20 Commission considers the results of non-CAPM risk  
21 premium analyses, such as the historical risk  
22 premium and allowed risk premium methods presented  
23 by Dr. Morin, as unreliable due to their  
24 shortcomings. Accordingly, Dr. Morin's risk

1 premium methodologies and their corresponding cost  
2 of equity determinations should be rejected by the  
3 Commission.

4 Q. Please summarize the Panel's concerns regarding  
5 the Company's CAPM analyses.

6 A. The Company's CAPM results are inflated because  
7 Dr. Morin's inputs did not adequately reflect  
8 investors' expectations. For his risk free rate  
9 he employed only 30-year Treasury bond rates  
10 instead of moderating the rate with 20-year  
11 Treasury bond rates. He also overstated his  
12 estimated risk premium by employing the average of  
13 an 81-year historical risk premium and a forward  
14 risk premium as opposed to our use of the more  
15 reliable Merrill Lynch estimate of the market  
16 return. Given, the shortcomings of his data  
17 inputs, the Commission should reject the Company's  
18 CAPM analyses and results.

19 Risk Premium Analyses

20 Q. Please describe Dr. Morin's risk premium analyses.

21 A. Dr. Morin performed two risk premium analyses to  
22 determine Central Hudson's cost of equity: a  
23 historical risk premium analysis and an allowed  
24 risk premium analysis. We will first discuss his

1 historical risk premium analysis.

2 Q. Continue.

3 A. As a proxy for the risk premium applicable to  
4 Central Hudson, Dr. Morin estimated the historical  
5 risk premium for the electric utility industry  
6 with an annual time series analysis applied to the  
7 industry as a whole, using Moody's Utility Index  
8 as a proxy. This is shown at the Company's  
9 Exhibit (RAM-3) The risk premium was estimated  
10 for each year from 1932 to 2007 by computing the  
11 actual realized return on equity capital for  
12 Moody's index (using the actual stock prices and  
13 dividends) and then subtracting that year's long-  
14 term government bond return. Dr. Morin determined  
15 that the average risk premium over the period from  
16 1932 to 2006 was 5.7% over the historical long-  
17 term Treasury bond returns and 5.8% over long-term  
18 Treasury bond yields; he used the 5.7% estimate.  
19 Based on this data, Dr. Morin calculated a 10.6%  
20 cost of equity estimate for Central Hudson ( $4.6\% R_f$   
21  $+ 5.7\% R_p + 30$  basis points flotation cost  
22 adjustment)

23 Q. What is the Panel's concern about this historical  
24 risk premium analysis?

1 A. The data for the companies in the Moody's Utility  
2 Index have not been updated since 2002. In  
3 addition, Dr. Morin calculated the average risk  
4 premium over a very long historical period from  
5 1932 through 2006 which he considered a reasonable  
6 proxy of the risk premium expected by Central  
7 Hudson's investors in the prospective period  
8 beginning July 2009 through June 2010. Dr. Morin  
9 defends the use of this approach by referring to  
10 various publications that he says recommend the  
11 risk premium approach for estimating the cost of  
12 capital. In addition, he argues for his use of  
13 historical data on the basis that the risk premium  
14 is constant over time. We discussed the issues  
15 concerning a constant risk premium in our  
16 evaluation of Dr. Morin's CAPM analyses, and we  
17 previously discussed the fact that the Commission  
18 has continuously rejected risk premium analyses  
19 due to their unreliable results.

20 Q. Does the Panel have any other concerns regarding  
21 Dr. Morin's use of historical equity risk premium?

22 A. Yes. Dr. Morin is indirectly taking risk premiums  
23 of a group of companies and applying the results  
24 to Central Hudson, regardless of any differences

1 in credit quality, regulatory environment or  
2 numerous other factors. Dr. Morin makes no  
3 attempt to determine the extent to which Central  
4 Hudson is more or less risky than the average  
5 electric utility contained in the Moody's electric  
6 utility common stock index for the period 1932 to  
7 2006. He also provides no evidence about whether  
8 the risks of the bonds used to calculate the yield  
9 for Moody's composite index have remained at the  
10 same level relative to the risks of the electric  
11 utility stocks comprising the Moody's electric  
12 utility common stock index, from 1932 to 2006  
13 study period. Finally, Dr. Morin has not provided  
14 any evidence indicating that the risks of utility  
15 bonds have remained at the same level relative to  
16 Treasury securities over this same period. Based  
17 on the above reasons, we recommend that the  
18 Commission reject Dr. Morin's risk premium  
19 methods.

20 Q. Describe Dr. Morin's allowed risk premium  
21 analysis.

22 A. For the allowed risk premium analysis, Dr. Morin  
23 estimates Central Hudson's cost of equity by  
24 determining an implied risk premium that was based

1 on return on equity authorized by regulatory  
2 commissions for electric utilities over the period  
3 1998 to 2007 relative to the contemporaneous level  
4 of the long-term Treasury bond yield. Dr. Morin  
5 states that he considers this approach to be  
6 reasonable because allowed risk premiums are  
7 presumably based on the results of market-based  
8 methodologies (DCF, Risk Premium, CAPM, etc.) that  
9 are presented to regulators in rate hearings and  
10 on the actions of objective unbiased investors in  
11 a competitive marketplace. He calculated a 5.6%  
12 average return on equity spread over long-term  
13 Treasury yields. Again, combining his 4.60%  
14 estimate of the risk free rate with the 5.6%  
15 implied risk premium, he estimated Central  
16 Hudson's cost of equity at 10.2%.

17 Q. What are the Panels' concerns relative to the  
18 allowed return risk premium analysis?

19 A. We think that Dr. Morin's methodology is circular  
20 because he employed the allowed returns on equity  
21 awarded by other states as a proxy for the implied  
22 risk premium. This circularity results in  
23 unreliable cost of equity determinations. In  
24 addition, the allowed risk premium method does not

1 account for risk differences between Central  
2 Hudson and the utilities in other jurisdictions.  
3 It does not take into account different regulatory  
4 approaches including use of fully forecast versus  
5 historical test years, settlements, and other  
6 true-up mechanisms, etc. The allowed risk premium  
7 approach also assumes a constant premium over  
8 time, a concern we discussed above, We recommend  
9 that the Commission reject Dr. Morin's historical  
10 and allowed risk premium analyses and their  
11 consequent cost of equity determinations.

12 Flotation Cost Adjustment

13 Q. What is the Panel's opinion of Dr. Morin's  
14 flotation cost adjustment of 30 basis points to  
15 his ROE determinations to compensate Central  
16 Hudson for common equity issuance costs?

17 A. We think that his adjustment should be rejected by  
18 the Commission because it is inappropriate. The  
19 Commission provides for recovery of flotation  
20 costs related to issuance expenses. Issuance  
21 expenses are explicitly recognized when a public  
22 common stock issuance is planned during the rate  
23 year.

24 Q. Does CHEG plan a public common stock issuance

1 during the rate year?

2 A. It does not. If CHEG planned a common stock  
3 issuance during the rate year, the Commission  
4 would provide an allowance for issuance costs.  
5 Dr. Morin proposal in this case is to increase the  
6 cost of equity to recover flotation costs for past  
7 public common stock issues. This is retroactive  
8 ratemaking, which is not recognized by our  
9 Commission. Therefore, Dr. Morin's proposal for a  
10 flotation cost adjustment should be rejected.

11 Updates to Recommendations

12 Q. Your testimony indicates that the cost of long  
13 term debt and the cost of equity should be updated  
14 at the time of the ALJ's RD and again at the time  
15 of the Commission's Order. How should these  
16 updates occur?

17 A. The cost of long term debt should be updated to  
18 reflect the most recent yield on 20-year medium  
19 term notes for the two debt issuances planned for  
20 the rate year shown. The updates should be based  
21 on the most recent 3-month, average of utility  
22 bond yields for debt rated "A2" by Moody's, as per  
23 data obtained from the Mergent Bond Record. The  
24 return on common equity determination should be

1 made by updating all data inputs employed in the  
2 cost of equity method, to which should be applied  
3 our proposed credit quality adjustment and the RDM  
4 adjustment.

5 New York Allowed Return on Equity (ROE) Allowances

6 Q. Does Dr. Morin discuss the regulatory environment  
7 in New York?

8 A. Yes, he discusses New York's regulatory  
9 environment on page 59-62 of his testimony. Dr  
10 Morin states that the Company's regulatory risk  
11 profile has recently increased and he uses a  
12 report by S&P and another report by Moody's to  
13 support this claim. Excerpts from these reports  
14 are presented on page 60 of Dr. Morin's testimony  
15 and they both refer to the Commission's March 2007  
16 decision in the Con Edison electric rate case.

17 Dr. Morin then notes that the Commission  
18 provided Central Hudson an "unreasonably low ROE  
19 in CHG&E's last rate order" and that the allowed  
20 return for Con Edison was the lowest allowed  
21 return for a domestic electric utility.

22 Q. What significance does Dr. Morin see in this  
23 information?

24 A. Dr. Morin notes that low allowed returns will

1           increase a company's reliance on debt financing.  
2           He sees a "spiraling cycle that further increases  
3           risks to both equity and debt investors" and notes  
4           that the costs of these events are borne by  
5           ratepayers. He then refers to a Con Edison bond  
6           downgrade and says the net result of low allowed  
7           returns and bond downgrades is that "ratepayers  
8           will have to pay hundreds of millions of dollars  
9           more on the much needed debt and equity capital to  
10          be raised by this company over the next decades."  
11          Finally, Dr. Morin presents an example that  
12          purports to quantify the impact of a 25 basis  
13          point increase in debt costs on \$100 million and  
14          \$1.0 billion of 20 year debt.

15    Q.    How does Dr. Morin apply these concerns to the  
16          current proceeding?

17    A.    Dr. Morin states that a low return on equity  
18          allowance for Central Hudson will increase the  
19          Company's reliance on debt to finance its capital  
20          needs. This results in greater debt leverage. He  
21          further notes that to the extent the Company tries  
22          to offset any increase in the debt ratio by  
23          issuing common stock, this will produce lower  
24          operating income and less income available to fund

1 dividend growth. Overall he believes these events  
2 will not only increase the cost of debt and equity  
3 financing to the Company but also the possibility  
4 that Central Hudson "will not have access to the  
5 capital markets for its outside financing needs,  
6 or if so, at prohibitive costs."

7 Q. What is your general opinion of Dr. Morin's  
8 arguments about the regulatory environment in New  
9 York?

10 A. The testimony in this proceeding and other public  
11 statements by the Company paint a very negative  
12 picture of New York regulation. We are concerned  
13 that these opinions, when presented and viewed in  
14 a vacuum, may do unnecessary damage to investors'  
15 perceptions of the regulatory climate in New York,  
16 and as a result make it more difficult and costly  
17 for New York utilities to raise capital.

18 Q. Why do you say that the damage Central Hudson may  
19 be inflicting is unnecessary?

20 A. While we will address the specifics of each of Dr.  
21 Morin's points later in this testimony, it is  
22 noteworthy that while he is more than willing to  
23 compare New York's allowed returns to those in  
24 other jurisdictions, he makes no attempt to make

1 other comparisons that are in our view just as  
2 important. The most critical omission Dr. Morin  
3 makes is the absence of any real world perspective  
4 regarding the Company's credit quality relative to  
5 the rest of the industry. Central Hudson's  
6 testimony in this proceeding does not mention the  
7 fact that on the basis of bond ratings, New York's  
8 electric utilities are very well situated relative  
9 to the industry as a whole. The Company strongly  
10 implies that the regulatory environment in New  
11 York is dismal but completely neglects to mention  
12 that based upon Standard & Poor's November 4, 2008  
13 "Issuer Ranking: US Regulated Utilities, Strongest  
14 to Weakest", at Exhibit\_\_ (RRP-19), only 6 of the  
15 185 utility entities assigned ratings by S&P had  
16 higher ratings than Central Hudson. Similarly,  
17 the Company has failed to address the fact that  
18 the same report also indicates that 1) New York's  
19 lowest rated electric utilities (New York State  
20 Electric and Gas and Rochester Gas and Electric)  
21 have BBB+ investment grade bond ratings that are  
22 still higher than 103 of the entities rated by  
23 S&P, 2) New York's two other A rated utilities  
24 (KeySpan Long Island and KeySpan New York) are

1 situated in exactly the same position as Central  
2 Hudson relative to the industry, and 3) New York's  
3 three remaining utilities (Con Edison, Orange and  
4 Rockland and Niagara Mohawk) have A- ratings and  
5 are in a better position than 135 of the electric  
6 utility entities rated by S&P. Central Hudson's  
7 myopic focus on allowed returns on equity clearly  
8 does not consider all the relevant factors that go  
9 into the rating agencies' credit quality  
10 determinations and as such raises questions about  
11 the objectivity of its analysis.

12 Q. Regarding the specific statements of Dr. Morin, do  
13 you agree that New York has recently allowed some  
14 of the lowest returns on equity in the United  
15 States?

16 A. Yes, we do. However, allowed returns on equity  
17 must be considered in light of New York's overall  
18 regulatory approach. Exhibit\_\_ (RRP-13), Schedule  
19 1, is a print-out of Regulatory Research  
20 Associates (RRA)/SNL Financial LC (SNL) data, and  
21 shows allowed returns for utility rate cases  
22 pending and decided in 2008 to-date. New York  
23 allowed returns on equity are at the low end of  
24 the results. At the same time, we also considered

1 Treasury rates over the last 30 years, and found  
2 that they have ranged from a high of 14.9% to a  
3 recent low on November 20, 2008 of 3.56%, the  
4 lowest levels since the Federal Reserve began  
5 keeping records in 1962. The return on equity  
6 models used by the Commission track interest  
7 rates, and so, consistent with the trend of  
8 interest rates, the Commission's allowed return on  
9 equity authorizations are low by historical  
10 standards.

11 Q. Does the Panel have any data that shows how the  
12 Commission's allowed returns track interest rates?

13 A. Yes, we do. We compared the relative change in  
14 Commission authorized returns to that of the 30  
15 year Treasury bond for CECONY, O&R, Central Hudson  
16 and NFG, from 1990 to-date, shown at  
17 Exhibit\_\_ (RRP-13), Schedule 2, and found few  
18 instances where the change in the Commission's  
19 authorized return did not move in the same  
20 direction of the change in Treasury bonds.  
21 However, in comparing the change in the allowed  
22 return on equity from Order-date to Order-date  
23 relative to the change in the weekly 30-Year  
24 Treasury bond rate for the same dates, we observed

1 some noticeable differences for each company.

2 Q. Please describe those differences.

3 A. From 1993 to 1996, Central Hudson's allowed return  
4 on equity declined by 60 basis points relative to  
5 a 57 basis points increase in the Treasury bond  
6 rate. Over the extended period from 1995 to 2006,  
7 CECONY's allowed return on equity declined by only  
8 130 basis points relative to the 255 basis points  
9 drop in the Treasury bond rate. For the period  
10 from 1992 to 1994, NFG's allowed return on equity  
11 declined by 70 basis points in comparison to the  
12 Treasury bond rate that was relatively flat.  
13 Finally, from 2003 to 2006, we observed a 70 basis  
14 points decrease in O&R's allowed return on equity  
15 relative to a decrease of about 10 basis points in  
16 the Treasury bond rate. The observations confirm  
17 our point that the Commission's allowed return on  
18 equity authorizations generally track interest  
19 rates.

20 Q. What conclusions can be drawn from a comparison  
21 of allowed ROEs?

22 A. 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. While our ROE recommendation of  
2 9.45% is below the median allowance of 10.43% for  
3 2008, a straight comparison of allowed returns  
4 with no further analysis is unreasonable.

5 Q. Why is it unreasonable to merely compare allowed  
6 returns on equity for United States utilities?

7 A. There are many facts and circumstances that  
8 differentiate the allowed returns. For example,  
9 the average bond rating of the non-New York  
10 companies receiving return allowances in 2008 is  
11 BBB. This implies a higher cost of equity for the  
12 group than for Central Hudson. It is also  
13 important to recognize that four of the 2008 rate  
14 decisions were for multi-year rate plans. Because  
15 the risk of locking in a return for more than one  
16 year is greater than the risk of a one year return  
17 allowance, the allowed return for a multi-year  
18 plan will typically include a stay-out premium.  
19 This also suggests a higher average return for the  
20 group than Central Hudson. Finally, seven of the  
21 2008 decisions were the result of settlements  
22 among various parties. Allowed returns associated  
23 with settlements have to be viewed with caution  
24 since the return which a utility obtains in a

1 settlement may be premised on monetary concessions  
2 by the utility in other areas, which would in fact  
3 cause the utility to earn less than the indicated  
4 allowed return.

5 Q. Are there other factors that are important to  
6 consider when comparing allowed returns on equity  
7 between New York and other states?

8 A. Yes, there are a number of important ratemaking  
9 differences between New York and other states.  
10 First, unlike most states, the Commission sets  
11 utility rates on the basis of a forecast of costs  
12 for the future rate year. Many Commissions set  
13 rates using historical information or limited  
14 forecasts of the future. Based upon information  
15 reported by RRA/SNL, 20 of the 25 cases decided in  
16 2008 are based on a ratemaking approach that does  
17 not employ a fully forecast rate year. The use of  
18 forecasts to set rates makes it more likely that  
19 the utility will actually earn its allowed return  
20 than a situation in which rates for a future  
21 period are based primarily on historic costs.  
22 This is particularly important for companies like  
23 Central Hudson that are embarked on capital  
24 programs and as a result are likely to see growth

1 in rate base over time. Staff witness Henry, in  
2 the ongoing Con Edison electric rate case,  
3 calculated that Con Edison's earnings would be  
4 reduced by about 70 basis points if this approach  
5 were not employed. Thus, this is a significant  
6 factor when comparing allowed returns.

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

10 A. Yes, all things being equal, the Company's allowed  
11 return on equity would have to be set at 11.9%, a  
12 2.45% increase from our recommended return on  
13 equity of 9.45%, if the Company were to be allowed  
14 to earn the same level of pre-tax revenues, as  
15 determined on our fully-forecast rate base. The  
16 same pre-tax revenues applied to the historic rate  
17 base would imply a 12.03% pre-tax rate of return  
18 and an 11.90% return on equity, instead of the  
19 10.21% pre-tax rate of return and 9.45% return on  
20 equity which are based on the fully-forecast rate  
21 base.

22 Q. Describe your analysis.

23 A. Given that many jurisdictions determine the  
24 revenue requirement on the basis of historic test

1           years, we calculated the pre-tax revenues of  
2           \$85,489,000 for Central Hudson by multiplying our  
3           pre-tax rate of return of 10.21% (ROE of 9.45%) by  
4           its fully-forecast rate base of \$837,649,000 (for  
5           the RYE 6/2010). We then divided these pre-tax  
6           revenues by the Company's historic rate base of  
7           \$710,698,000 (as of 3/31/2010) and determined that  
8           the pre-tax rate of return would have to be set at  
9           12.03%, equivalent to an ROE of 11.9%, in order to  
10          provide the same level of revenues. This is shown  
11          at Exhibit\_\_ (RRP-14). Our analysis explains why  
12          investors in utilities that operate in  
13          jurisdictions that use historical test years would  
14          require a higher ROE, all else equal.

15    Q.    What other factors differentiate the Commission  
16          from other state regulatory bodies.

17    A.    The Commission has implemented a number of other  
18          ratemaking mechanisms which result in a reduction  
19          of utility risks. For example, in this rate  
20          proceeding, Staff supports a weather normalization  
21          clause (WNC) and a revenue decoupling mechanism  
22          (RDM). These mechanisms, which are not  
23          consistently employed by other state regulators,  
24          should reduce potential earnings volatility and

1           therefore risk. In addition to the WNC and RDM,  
2           the Commission has a long-standing policy which  
3           allows utilities to defer expenses provided the  
4           expense is not already in rates, financially  
5           significant and the utility is not in an  
6           overearnings position. The Commission has also  
7           established regulatory mechanisms which enable  
8           utilities to collect all reasonable fuel and  
9           purchased power expenses in a timely manner, and  
10          pension and OPEB costs and site investigation and  
11          remediation costs.

12    Q.    Do you have any other evidence that raises doubts  
13          about the validity of a comparison of New York  
14          allowed returns on common equity to those allowed  
15          in other states?

16    A.    Yes, a 2007 rate decision for Avista in the state  
17          of Washington amply demonstrates some of the  
18          problems with this type of comparison. Based upon  
19          information obtained from RRA/SNL, Avista was  
20          provided an allowed return of 10.2% based upon an  
21          equity ratio of 46%. This return is only slightly  
22          below the average of all the returns allowed so  
23          far in 2008 and as such is quite a bit higher than  
24          recent New York allowed returns. A review of

1 background information from the rate case  
2 indicates that 1) the company is vertically  
3 integrated and as such has generation risks, 2)  
4 capital spending is significant (200% of  
5 depreciation), 3) rates are set based upon a  
6 historic test period, 4) Avista is at risk for the  
7 first \$4 million of fuel expenses, and 5) there is  
8 50/50 sharing for fuel expenses between \$4 million  
9 and \$10 million.

10 Together all of these items indicate that  
11 Avista faces far greater uncertainty than Central  
12 Hudson. In fact, the August 8, 2008 edition of  
13 Value Line states that "The utility hasn't been  
14 earning its allowed ROE for a long time."

15 Q. Dr. Morin states at page 61 that the cause of a  
16 downgrade for Con Edison was "the unreasonably low  
17 ROE allowed in CHG&E's last rate order, the lowest  
18 ROE for a major electric utility in the country."  
19 Is this an accurate statement?

20 A. No, initially, we think that Dr. Morin has  
21 referenced CHG&E when he meant to reference Con  
22 Edison. The reference to the lowest allowed  
23 return and the fact that the Central Hudson rate  
24 case was not mentioned as a cause for Con Edison's

1           downgrade form the basis for this opinion.

2    Q.    Please discuss Dr. Morin's opinion at page 61 that  
3           New York's low authorized ROEs ultimately result  
4           in higher interest costs to customers and that for  
5           Con Edison this equates to having ratepayers  
6           paying "hundreds of millions of dollars more on  
7           the much needed debt and equity capital to be  
8           raised by this company over the next decades."

9    A.    Dr. Morin provided an example to illustrate this  
10           potential hardship to customers/ratepayers. His  
11           assumption appears to be that a low allowed return  
12           on equity will result in a one notch downgrade in  
13           a utility's credit rating and that this would  
14           result in higher debt costs to the utility. He  
15           assumed that the cost of a one notch downgrade  
16           would be an additional 25 basis points. He then  
17           states that for \$100 million of 20 year debt, a 25  
18           basis point increase in the interest rate will  
19           increase interest costs by \$5 million. The higher  
20           debt costs would also increase the risk to common  
21           equity investors and therefore the cost of equity  
22           which would further exacerbate the situation. He  
23           provides no specific evidence supporting his  
24           statement regarding hundreds of millions of added

1 costs to ratepayers.

2 Q. Do you think that Dr. Morin's analysis is  
3 reasonable?

4 A. No, his example is based upon an unrealistic  
5 spread assumption and it fails to consider all  
6 customer costs.

7 Q. Why is his spread assumption unrealistic?

8 A. Dr. Morin assumed that the cost of a one notch  
9 debt rating downgrade was 25 basis points. This  
10 assumption is significantly larger than what  
11 historical data shows. Specifically,  
12 Exhibit\_\_ (RRP-10), Schedule 2 shows that over the  
13 last five years the average change in debt costs  
14 relative to a one notch change in debt rating is  
15 approximately 10 basis points. Therefore, Dr.  
16 Morin's estimate of the impact of a one notch  
17 ratings downgrade more than doubles the impact  
18 actually observed in the market.

19 Q. Do you have other concerns related to Dr. Morin's  
20 use of the 25 basis point?

21 A. Yes, the majority of Central Hudson's outstanding  
22 debt bears interest at a fixed rate. As such,  
23 this debt is not affected by an increase in  
24 Central Hudson's borrowing costs. While future

1 debt issues and variable rate issues would be  
2 impacted by higher borrowing costs, their  
3 immediate impact is limited. For the rate year,  
4 we estimate that a 25 basis point increase in the  
5 cost of new debt would increase the revenue  
6 requirement by \$170,482 per year, an amount that  
7 represents 0.72% of the Company's total electric  
8 and gas revenue requirement, as shown at  
9 Exhibit\_\_ (RRP-15), Schedule 2.

10 Q. Explain why Dr. Morin's analysis does not consider  
11 all customer costs in his analysis.

12 A. Dr. Morin estimates the cost to ratepayers of a  
13 one notch downgrade due to the Commission allowing  
14 a return on equity that is too low. He does not  
15 estimate the added cost to ratepayers of setting a  
16 return which in his view is not too low. This is  
17 particularly important because while it takes a  
18 dollar of revenue requirement to pay for a dollar  
19 of debt interest, because interest is tax  
20 deductible, it takes about \$1.67 of revenue  
21 requirement to produce a dollar of equity return  
22 because federal and state income taxes are an  
23 incurred expense prior to realizing \$1 dollar of  
24 net income. Moreover, while increases in the cost

1 of debt due to bond rating downgrades only impact  
2 new issues and outstanding variable rate issues,  
3 any increase in the cost of equity applies to all  
4 outstanding common equity. Dr. Morin made no  
5 attempt to reflect this fact. Thus, a 25 basis  
6 point increase in the cost of equity for Central  
7 Hudson would, when income taxes are considered,  
8 result in a \$1,534,342 increase in the revenue  
9 requirement, as shown at Exhibit\_\_ (RRP-15),  
10 Schedule 3. This 6.46% increase in revenue  
11 requirement far exceeds the 0.72% interest rate  
12 savings associated with a one notch improvement in  
13 bond rating.

14 Q. Do you have anything to add on this subject?

15 A. Yes, questions concerning the appropriate capital  
16 structure and bond ratings have come up at various  
17 times over the years. The Commission and the  
18 State's energy utilities considered this topic at  
19 length in the Generic Finance Proceeding in 1993  
20 in Case 91-M-0509, Proceeding on Motion of the  
21 Commission to Consider Financial Regulatory  
22 Policies for New York State Utilities. In that  
23 proceeding many of the parties, including Staff  
24 and Central Hudson reached agreement that an "A"

1 bond rating category target, under most  
2 circumstances, should continue to provide  
3 utilities with an adequate measure of financial  
4 strength." In reaching that agreement, Staff and  
5 certain other parties concluded that from a cost  
6 perspective a bond rating in the "BBB" category  
7 was less expensive, while the energy utilities  
8 determined that the pre-tax return for the "BBB"  
9 rated company is indistinguishable from that of an  
10 "A" rated company." These determinations were the  
11 result of a major analysis considering a wide  
12 variety of economic conditions. The evidence that  
13 Dr. Morin presents does nothing to refute these  
14 basic conclusions.

15 Q. Do you have anything else to add about the  
16 relevance of the Generic Finance Proceeding?

17 A. Yes, while Central Hudson has raised doubts about  
18 the quality of New York regulation, it is  
19 informative to recognize that all of New York's  
20 major energy companies are rated in the BBB+ to A  
21 range and as such are much better situated than  
22 the industry as shown in Exhibit\_\_ (RRP-16). This  
23 is not only consistent with the findings of the  
24 parties 14 years ago, it is fully indicative that

1 the Commission has supported the credit quality of  
2 New York's energy utilities.

3 Q. Does the data provide any insights about New  
4 York's regulation relative to the industry?

5 A. Yes it does. Exhibit\_\_(RRP-16), Schedule 3 shows  
6 that the average bond rating of the utility  
7 industry is "BBB+" versus the average "A-" bond  
8 rating of New York, which is exceeded by only  
9 Alabama, with an "A" bond rating. Further, only  
10 six other states have an average "A-" bond rating.

11 When we review the statistics in Exhibit\_\_(RRP-  
12 16), Schedule 2, it shows that S&P considers the  
13 regulatory environment of many of the lower rated  
14 states to be more supportive than New York, which  
15 is classified as a regulatory jurisdiction that is  
16 "Less Supportive". This confirms the complexity  
17 of bond rating process. As the rating agencies  
18 often state, they employ many factors, both  
19 quantitative and qualitative, in order to  
20 determine a utility company's bond rating.

21 Q. Dr. Morin states that because Central Hudson's  
22 risks have recently increased, it is appropriate  
23 to set rates based upon a higher allowed return on  
24 equity. Do you agree?

1 A. No, based upon the evidence presented in this  
2 section of our testimony, we see no basis for  
3 concluding that Central Hudson's business risk  
4 profile has risen relative to historical levels as  
5 a result of the Commission's regulation.

6 Q. Is there any other evidence supporting you on this  
7 point?

8 A. Yes, the assessment of the Commission by RRA/SNL  
9 has consistently rated the quality of New York  
10 regulation as average. We consider the rating  
11 service of RRA to be unbiased because it gains no  
12 potential economic benefit by rating the stocks or  
13 bonds of the utilities.

14 Q. Do you have any other information pertaining to  
15 Central Hudson's risks relative to its peers?

16 A. Yes, we refer you to our price volatility charts  
17 shown in Exhibit\_\_ (RRP-17). This chart summarizes  
18 changes in the stock price of and that of various  
19 other entities since September 16, 2008. The  
20 September date was chose because it is only one  
21 day before the major Lehman Brother announcement  
22 signaled the beginning of volatile market  
23 conditions. This chart shows that: 1) CHEG's  
24 common stock price has been maintained despite

1           these times of economic uncertainty; 2) its stock  
2           price volatility is relatively low in comparison  
3           to its peers; 3) investors have shown a preference  
4           for CHEG common stock relative to most other  
5           utility companies in the industry; and 4) its  
6           investors are much better off than most others.

7    Q.    What do these stock price performances indicate  
8           about CHEG?

9    A.    Investors consider utility stock, and more  
10           specifically CHEG's common stock to be relatively  
11           safe. The graphs at Exhibit (RRP-17) show the  
12           relative stock price performance of CHEG, the Dow  
13           Jones Utility average, the Dow Jones Industrial  
14           average, the Vanguard index, the S&P 400 Mid-caps,  
15           and the S&P 600 Small-caps. The graphs show the  
16           relative stock price performance since September  
17           16, 2008 and over the last 3 months, 1 year, 3  
18           years and 5 years. Obviously, utility investors  
19           have not chosen to disinvest from New York. CHEG  
20           is viewed as an attractive stock during this  
21           period of unsettled market conditions. As such,  
22           lower authorized ROEs did not negatively impact  
23           investors' choices due to the fact that investors  
24           consider not only the authorized return, but New

1 York's entire package of rate setting mechanisms,  
2 which as we noted earlier tend to reduce risks.

3 Summary of Rate of Return Recommendation

4 Q. Please summarize the Panel's rate of return  
5 recommendations for Central Hudson.

6 A. On the basis of our analysis, subject to updates,  
7 we recommend that Central Hudson's revenue  
8 requirement be set on the basis of our recommended  
9 capital structure, which includes a common equity  
10 ratio of 45.0%. We recommend that the Company be  
11 allowed to earn a return on common equity of  
12 9.45%, an overall after-tax weighted cost of  
13 capital of 7.34%, and an overall pre-tax weighted  
14 cost of capital of 10.21%.

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

16 A. Yes, at this time.