Q. Please state your name and business address.
A. My name is Scott Sanders. I am employed by Consolidated Edison Company of New York, Inc. (“Con Edison”, “CECONY”, or the “Company”) as Vice President and Treasurer. My business address is 4 Irving Place, New York, New York.

Q. Briefly describe your educational background.
A. I hold a B.S. in Nuclear and Chemical Engineering from the University of California, Berkeley, and an MBA from the University of Chicago.

Q. Please summarize your professional background.
A. I joined Con Edison in January 2010. I previously co-founded New Infrastructure Advisors in 2009, a boutique financial advisory firm. Prior to New Infrastructure Advisors, I was employed at Bank of America where I was a Managing Director in the Power and Utilities group covering U.S. utilities. I previously covered U.S. utilities during my tenure at Citigroup and New Harbor Incorporated. My work with utilities also included work as a consultant to U.S. utilities at Deloitte Consulting. I began my career
with the California Public Utilities Commission,
working as a staff engineer on electric, gas, water
and telecommunications rate matters and then as an
advisor to Commissioner Patricia Eckert on electric
and gas matters. During my twelve years in the
financial services industry, as a senior investment
banking professional, I regularly valued, or directed
the valuation of utilities and utility assets
employing discounted cash flow valuations that applied
capital asset pricing model-derived market costs of
equity.

Q. Have you previously sponsored testimony before the New
York State Public Service Commission ("Commission")?
A. No.
Q. What is the purpose of your testimony?
A. My testimony discusses (1) the current financial
market environment, (2) CECONY’s historic and
projected capital structure and cost of capital, (3)
CECONY’s financial challenges and the need to maintain
access to financial markets at reasonable cost, and
Q. Please describe the current state of the financial markets.

A. The markets have improved from their lows of late 2008 and early 2009. However, the pervasive indifference to risk that characterized investor behavior leading up to the crisis has not returned, nor is it likely to in the near future. The financial markets are still challenged by crises, both domestic and international, and the flight to quality, which has driven U.S. Treasury debt rates to historically low levels and kept them there, is symptomatic of the skittishness of investors. Events in Europe and elsewhere have caused investors in money market funds, including CECONY, which invest in a broad spectrum of instruments, to question the safety of even the short-term instruments of highly-rated international banks and to consider switching to ones
that invest only in U.S. government securities or to invest in Federal Deposit Insurance Corporation-insured bank accounts. Never has the interdependence of global financial markets and their susceptibility to rumors and panic been so well demonstrated.

In response to the recent financial crisis, financial markets regulators are in the process of imposing stricter capital guidelines for financial institutions, requiring significantly more capital, particularly for the largest banks. We do not yet know what impact these requirements may have on capital availability and cost for companies that must access the bank and bond markets, and as noted by Company witness Lapson, it is likely that the importance of having strong credit ratings in order to access capital on reasonable terms as needed will continue.

Q. Can you discuss how the recent financial crisis has impacted the Company’s ability to access the bank credit market?

A. Prior to the crisis, utilities such as CECONY were
able to arrange a five-year revolving credit facility with minimal upfront fees (i.e., amortized at a basis point or so a year) and annual facility fees in single digit basis points (a basis point equals one-hundredth of one percent of the stated amount, in this case the borrowing capacity for which the lenders have committed).

As discussed below, revolvers today have facility fees, borrowing costs and upfront fees priced at multiples of what they were and the cost for having a lower credit rating has also increased. In addition, CECONY arranged bilateral credit agreements to provide liquidity for its variable-rate tax-exempt debt portfolio. Since the financial crisis the availability of such agreements has diminished and costs have increased.

Q. Why are bank revolving-credit facilities important to the Company’s financing plan?
A. There are four purposes for bank credit facilities in funding a utility company like CECONY. First, the facilities directly or indirectly provide the
liquidity that allows the Company to raise long-term financing when desirable, not when it has to. The facilities thereby save customers money because they eliminate the need to pre-fund spending and allow the Company to fund at times of its choosing. Second, the facilities allow the Company to issue letters of credit as collateral for its operations including managing the portfolio of energy commodity purchases made on behalf of customers in the wholesale and financial markets. Third, the facilities are the source of liquidity that assures purchasers of our commercial paper that they will be repaid. This “back up” function permits the Company to access a lower-cost source of funds for the day-to-day operation of the business. Finally, the facilities assure the rating agencies that the Company can meet its obligations even if it loses access to the capital markets for a period of time (and thus factors into the credit ratings for the Company).
CAPITALIZATION AND COST OF CAPITAL

Q. What capital structure do you recommend should be used in this proceeding?

A. I recommend the use of the stand-alone capitalization of CECONY in this proceeding.

Q. Please describe the stand-alone capitalization.

A. The stand-alone capitalization refers to the actual capital structure of CECONY, that is to say, the actual investment of capital required to provide services to CECONY’s customers.

Q. Does the initial actual capital structure plus projected financings represent the expected actual investment of capital in the Company during the rate year (i.e., January 1, 2014 – December 31, 2014) (“Rate Year”)?

A. Yes, it does.

Q. Has the Company prepared a rate of return required exhibit?

A. Yes. The document entitled “CONSOLIDATED EDISON COMPANY OF NEW YORK, INC. -- RATE OF RETURN REQUIRED
Q. Please describe any projected changes in CECONY’s long-term debt and how such changes have been incorporated into the rate of return required for the thirteen-month average ending December 31, 2014.

A. We expect to issue the following debentures:

- Change in the forecasted balance of long-term debt during the linking period between July 1, 2012 through December 31, 2013 as follows: new debt to be issued during the period of $900 million of Debentures, Series A 2013, 4.15% to be issued June 2013, due June 2043 and $420 million of Debentures, Series B 2013, 4.15% to be issued December 2013, due December 2043.

- Changes in the forecasted balance of long-term debt during the Rate Year are as follows: new debt to be issued during the period of $530 million of Debentures, Series A, 4.70% to be issued April 2014, due April 2044; and $600
million of Debentures, Series B, 4.70% to be issued June 2014, due June 2044.

Q. Please describe how you developed the cost of long-term debt.

A. Exhibit __ (AP-12, Schedules 5 and 6), present the detailed calculation of the cost of the long-term debt at June 30, 2012 and for the thirteen-month average ending December 31, 2014, respectively. These schedules detail each issue of long-term debt outstanding and calculate an effective annual cost for each issue, taking into consideration the original net proceeds to the Company and annual interest costs. The sum of the effective annual cost for all issues is divided by the gross amount of debt outstanding to derive the weighted average cost of long-term debt.

Q. Did you provide the interest rate forecasts used as a basis for the cost of debt in this Exhibit?

A. Yes.

Q. What method have you used to develop interest rate forecasts?
A. We have used forecasts of Treasury rates from the publication Blue Chip Financial Forecasts, plus a spread to Treasuries based on indicative quotes from financial institutions. The Blue Chip Financial Forecasts consist of the consensus forecast of more than fifty economists. This approach provides more accurate results than simply using the most current Treasury rates.

At the update stage of this proceeding, I will revise Exhibit __ (AP-12, Schedule 6) to reflect the most recent data available as well as any new or refinanced debt that the Company may have issued by that time.

Q. Do you have a recommendation for the treatment of forecasted interest rates?

A. Yes. I recommend the continuation of the true-up of interest costs for debt, that was authorized by the Commission in the Company’s last electric base rate case (Case 09-E-0428).

Q. What would be included in the true-up?

A. The true-up would include the difference between the rates actually prevailing during the Rate Year and the
interest costs set for the debt in this case. The
true-up would also be applied to credit support costs
such as letters of credit or insurance. In addition,
eexisting long-term debt has associated unamortized
issuance costs (representing underwriting fees and
other costs from the time of issuance) which should
also be included in the true-up. Furthermore, if
CECONY decides that refinancing any debt will likely
reduce total costs or because of government, legal or
regulatory requirements to do so, the actual cost of
the replacement debt issues (including issuance costs
and any credit support) and the new interest rate
would be trued-up as well.

Q. Please describe the method used to project the
Company’s equity balance through December 31, 2014.

A. The average consolidated equity of CECONY at December
31, 2014, excluding all non-utility subsidiaries and
Other Comprehensive Income was projected from June 30,
2012 using the following steps:
1. The forecast earnings for June 30, 2012 to December 31, 2014 were added to the June 30, 2012 equity balance; and

2. The forecast dividends to Consolidated Edison, Inc. (“CEI”) for June 30, 2012 to December 31, 2014 (i.e., $354.5 million for 2012, $714.8 million for 2013, and $720.7 million for 2014) were subtracted from the equity balance at June 30, 2012.

Q. What stand-alone capital structure for CECONY results from the calculations that you described?

A. Exhibit __ (AP-12, Schedule 2), shows the forecasted capital structure for the thirteen months ending December 31, 2014 of 48.68% long-term debt, 1.43% of customer deposits, and 49.89% common stock equity.

Q. Does Exhibit __ (AP-12) also show the forecasted capital structure, based on a thirteen-point average, for the twelve months ending December 31, 2015 and December 31, 2016?

A. Yes. Schedules 3 and 4 of this exhibit show the capital structure for those periods. These schedules
show that over those two years the debt ratios would increase to 48.97% and 48.84% of the Company’s capital structure, respectively, as new debt is issued. These schedules also show that the customer deposit ratio would decrease modestly and the equity ratio would be reduced to 49.62% and 49.76% for the twelve-month periods ending December 2015 and 2016, respectively.

Q. Are you requesting that the capital structure, upon which the revenue requirements are calculated in the contemporaneous rate filings, use an equity ratio of 49.89%?

A. Yes, for purposes of calculating the revenue requirements in the contemporaneous rate filings, the Company is proposing to use a 49.89% common stock equity component. Company witness Hevert provides further justification for the 49.89% equity ratio in his direct testimony Appendix B, titled “Market Based Capital Structure and the Financial Leverage Adjustment”.

Q. Please explain why the proposed common stock equity ratio is reasonable.
As discussed in the direct testimony of Company witness Hevert in the contemporaneous rate filings, the proposed capital structure and proposed equity ratio are reasonable based on his proxy group comparative analysis. The analysis demonstrates that the Company’s proposed equity ratio is below the mean equity ratio of the proxy group companies of 52.66%.

Q. What are you proposing for the Company’s return on equity?

A. We propose a 10.35% return on equity based on Company witness Hevert’s testimony.

Q. How does the Company’s overall “pretax” cost of capital requested in this case with a 49.89% equity ratio and 10.35% return on equity compare to the “pretax” cost of capital reflected in the current electric rate plan?

A. The pretax cost of capital requested by the Company in this case is very close. The pretax cost would be 11.09% versus the 11.00% contained in the joint proposal that was adopted as part of the current electric rate plan.
Q. How is it possible that the “pretax” cost of financing could remain so close to the cost in the current electric rate plan?

A. There are three primary reasons; first, the Company redeemed all of its previously outstanding preferred stock during the first part of 2012 and refinanced the preferred stock with lower cost 30-year debt; second, due to lower interest rates, the cost of our tax-exempt variable rate debt has decreased; and third, the Company has avoided the need to issue new debt contemplated as part of the current rate plan resulting in a lower embedded cost of debt.

Q. So your proposal to use a 49.89% equity ratio in conjunction with these other changes would have minimal impact on revenues?

A. Yes.

Q. How have the components of the Company’s capital structure changed?

A. On May 1, 2012, the Company redeemed all of its outstanding shares of preferred stock. The preferred
stock had accounted for approximately 2% of the Company’s capital structure prior to its redemption.

Q. Using this forecasted capital structure and cost of long-term debt and the return on equity, what overall rate of return results?

A. The overall rate of return is 7.69% as shown on Exhibit ___ (AP-12, Schedule 2).

**CAPITAL NEEDS AND INVESTOR CONCERNS**

Q. What is the nature of your testimony on the capital needs and investor concerns facing CECONY?

A. My testimony concerns the financial challenges and the need to maintain access to financial markets at reasonable cost. In addition to my testimony, Company witness Lapson provides testimony regarding the importance of the outcome of the contemporaneous rate proceedings to the credit-worthiness and investment standing of CECONY.

Q. Please describe the financial challenges facing the Company during the Rate Year and beyond.

A. The Company faces the following four inter-related
financial challenges: (A) the capital intensive nature of its business, (B) its unusually weak cash flows, (C) the restrictions that regulation places on its ability to respond to unfavorable developments in its environment, and (D) its dependence on the market to fund its capital needs.

Q. Please discuss (A) the capital intensive nature of the Company’s business.

A. The Company’s business requires significant capital investment every year, its assets are long-lived and the underlying technology, facilities and customer base are mature.

Capital intensity is high for electric utilities. According to an IHS CERA presentation titled “Post Fukushima: If not nuclear, what energy mix?” (June 2011), the electric utility industry is second only to railroads in capital intensity. As shown on Exhibit __ (SS-1), the Company’s capital intensity can be demonstrated by the fact that its ratio of net fixed assets per dollar of revenues is $1.94 versus $0.70 for the average S&P 500 company and $0.20 for the
median company. Capital intensity creates extra risk for investors because capital intensive businesses have to recover much larger fixed costs (interest and depreciation) before achieving a return.

CECONY’s assets also have extraordinarily long lives. Long-lived assets in the context of rate regulation create two financial challenges for the Company that are also risks for potential investors in the Company’s debt and shares. First, their investment horizons for capital recovery must be much longer. For debt investors, utility debt has much longer average maturities than other companies. Equity investors must wait for long-term repayment on their investment. Second, there is a regulatory risk in long-lived assets because U.S. rate regulation limits returns to a fraction of historic tangible book cost rather than replacement or current market value. The Company’s depreciation recoveries, which reflect historic tangible net book values, are small relative to its current capital costs, returning only 43% of its capital expenditures in the form of depreciation in
2011.

Due to the long depreciation lives established in rates, this dynamic is likely to continue for many years. As shown on Exhibit __ (SS-2, Schedule 1), by way of comparison, the average S&P 500 company recovered 167% of its capital expenditures through depreciation and amortization. This would have placed CECONY in the bottom 8% of companies in the S&P 500 that had meaningful recovery rates. CEI (which had a 41% capital expenditure recovery rate) had the seventh-lowest recovery rate among the 33 utilities in the S&P 500 as shown on Exhibit __ (SS-2, Schedule 2). The average recovery rate for the utility companies in S&P 500 utilities was 51%.

The Company’s large installed base of mature equipment requires an unrelenting investment in replacement assets. In other industries, a much larger portion of investment can be dedicated to new business (generating offsetting revenues) or new technology (lowering costs).

Mature assets raise operating costs and increase
operating risks, particularly in an environment which requires the highest level of reliability and imposes regulatory penalties for failing to achieve it with no corresponding opportunities to earn rewards for superior performance. The technology of the business is also mature, affording little opportunity to significantly reduce invested capital in the business through technological innovation. The need for continuous investment to maintain and improve the system with slight opportunities for demand growth and limited depreciation cash flow means that the Company must seek rate increases and raise new capital frequently to maintain its operations. Replacement capital needs alone substantially exceed the cash generated through depreciation recoveries for the Company.

Q. Will the proposal to accelerate recovery of the deficiency in the depreciation reserve, set forth in the testimonies of Company witnesses Hutcheson and Muccilo, help to alleviate this situation?

Q. Yes. While this proposal, if implemented, will not
remedy completely the Company’s unusually weak cash flows, it certainly is a step in the right direction.

Q. Please describe (B) how the Company’s unusually weak cash flows present a financial challenge.

A. The Company will continue to be challenged by its unusually weak cash flows and lack of positive free cash flow. In her direct testimony, Company witness Lapson presents an analysis of the sources and implications of CECONY’s weak cash flow metrics. As Company witness Lapson correctly concludes, weak cash flows, all else equal, will mean that CECONY will be more dependent on external funding.

Q. Please describe (C) how restrictions on the Company’s business imposed by the Commission present a financial challenge.

A. The Company is subject to several regulatory restrictions that limit its ability to react to unfavorable circumstances. It must provide service as requested, even if doing so entails significant investment upon unfavorable terms. It cannot refuse to provide service to new or unprofitable customers.
It also is limited in its ability to reach beyond its franchise area to serve attractive new customers. The Company’s assets are immovable; unlike those of most companies they cannot be used in a different location or business, their usefulness and profitability are tied to providing utility service in New York. Unlike other companies, CECONY has no meaningful ability to retain the advantages of its efforts to improve its efficiency and thus lower its costs of doing business for the benefit of its equity investors, as the Commission’s rate orders remove a fixed percentage upfront through an imputed productivity adjustment. Moreover, any additional efficiencies achieved by management are fully allocated to customers each time rates are reset as they invariably will given the capital recovery and cash flow parameters of historic cost-of-service rate making.

Q. Please describe (D) how the fact that the Company must continually raise capital increases risk for existing and prospective investors.
A. As mentioned earlier in my testimony, the Company must approach the markets for additional new debt capital on a frequent and recurring basis. CECONY is forecasted to raise $1,320 million in 2013 and $1,130 million in 2014. CECONY will need the backing of prospective cash flows and regulatory support to continue to market this debt. Each time CECONY markets its securities, investors will assess the risks they would bear upon investing in the Company due to the challenges identified above. Their assessment of these risks is, and will be, priced in the market each time that the Company seeks new capital in the years ahead. To the extent that analysis of risk leads the market to reduce stock prices or raise interest rates, the existing investors are disadvantaged and other potential investors are made more wary. Through this cycle of investors assessing and pricing risks that the Company faces, customers are negatively impacted through increases in the cost of financing the Company.

Q. What is the implication of the above mentioned large
capital needs?

A. To raise this capital at a reasonable cost, CECONY and CEI must remain attractive investments to both debt and equity investors. To remain attractive to these investors, CECONY must receive fair and reasonable treatment from its regulators.

Q. How much debt does the Company have outstanding and what type?

A. As of June 30, 2012 CECONY had $10,144 million of long-term debt (including long-term debt due within one year), of which $9,058 million were unsecured taxable debentures and $1,086 million was tax-exempt debt. CECONY had letters of credit outstanding in an amount of $465 million. Of this amount, $228 million consisted of letters of credit backing CECONY tax-exempt debt. Letters of credit represent an additional capital need which must be met, requiring CECONY to meet the test of credit quality and to compete for scarce funds in an increasingly regulated bank market.

Q. Who owns the Company’s debt?
1 A. Investment managers, insurance companies, pension
2 plans, hedge funds, banks, trust companies and
3 individuals.
4 Q. How do bond investors evaluate CECONY?
5 A. For most investors, the credit ratings assigned by the
6 SEC-recognized credit rating agencies are the
7 threshold basis for evaluating individual corporate
8 credits such as CECONY.
9 Q. What are the current ratings on CECONY debt?
10 A. As noted by Company witness Lapson, the long-term,
11 senior unsecured debt ratings are A3, A-, and A- by
12 Moody’s, Standard and Poor’s ("S&P"), and Fitch,
13 respectively. The short-term debt is rated P-2, A-2,
14 and F2, respectively. All ratings are stable.
15 Q. Are bond ratings the correct indicator of the risks to
16 shareholders?
17 A. No. Shareholders, unlike bondholders, only have a
18 residual claim to the resources and income of the
19 Company, and thus face risks even in well-rated
20 companies. If returns are inadequate, the bondholder
21 may suffer a loss from a credit downgrade. The
stockholder will suffer the loss directly. Efforts by the Commission to limit the upside potential of the shareholder through the elimination of incentives and other opportunities, combined with true-ups and implementation of enhanced penalties exacerbate the effect of lowered targeted returns.

Q. Why do companies such as CECONY need a particularly strong financial condition?

A. Capital intensive companies with a duty to serve have to borrow in spite of the state of the market and need continuous access to capital. When they are forced to pay high rates, these rates will stay with the companies and their customers for as long as 30 years. On the short end of the maturity spectrum, access to commercial paper and bank borrowing markets is key to allowing CECONY to pay for energy that must be delivered no matter the price. Only prime borrowers can maintain that status in all markets, a status that has become more tenuous for CECONY due to its current A-2/P-2 (Standard and Poor’s/ Moody’s) rating for commercial paper. At the height of the financial
The crisis of 2008-2009, A-2/P-2 borrowers, if they had access, paid rates significantly higher than those paid by A-1/P-1 borrowers.

The seizing up of the commercial paper market was relieved only by the Federal government’s extraordinary decision to provide an effective backstop for the highest rated (A-1/P-1) commercial paper issuers, a solution that may not always be available, and may not extend to lower quality issuers such as CECONY.

If CECONY lost access to the commercial paper market, borrowing costs would increase as the Company relied more upon long-term debt, which is more expensive. In addition, the Company would more often issue debt on less attractive terms because it lacked the flexibility to postpone issuance. The recent past has demonstrated how important maintaining a strong credit rating and investor confidence can be.

Q. Are there new factors which may serve to reinforce the need for and potentially limited supply of liquidity?

A. Yes. In the U.S., the Dodd-Frank legislation may
increase collateral needs for companies which hedge commodity exposure, such as utilities. Globally, the Basel III regulations require more capital for banks and may lower capital available for lending and increase costs.

Revolving credit facilities are an alternate source of short-term borrowing. While such facilities have begun to be offered for five-year periods again, they are now a significantly more expensive source of funds, particularly for companies with lower credit ratings. For example, the Company entered into a new revolving credit facility in October 2011 with borrowing costs at more than four times the pricing in the Company’s previous, 2006 revolving credit agreement. Similarly, the penalty for having a lower credit rating (i.e., the pricing premium between a borrower rated A- and BBB-) increased more than four times as compared to our previous revolving credit facility.

Q. Have you reflected these increased fees in your costs?
A. Yes, I have forecasted that financing-related fees would increase by approximately $3.4 million from the
historical level. The increase is primarily related to these increased revolving credit facility costs and letter of credit fees associated with tax-exempt, variable rate demand notes. This amount was provided to Company witness Kane who reflected this amount in Corporate and Fiscal expenses.

Q. Please explain why maintaining its current debt ratings is important for CECONY.

A. First, the Company has a significant continuing construction program which must be met in large part by debt financing. More important, the risk remains that access to credit markets will be restricted for lower quality credits.

In addition, a part of CECONY’s financing program is made up of short-term borrowing through its commercial paper program. Such borrowing is highly sensitive to credit quality and credit market conditions.

Q. Who owns the Company?

A. CECONY has one shareholder, CEI. As of June 30, 2012, CEI, in turn, is owned by 57,749 registered
shareholders. Registered shareholders are the individuals or businesses whose names are listed on the shareholder register of CEI.

Q. What are the characteristics of the registered shareholders?

A. As of June 30, 2012, institutional investors owned approximately 43% of CEI’s shares, while individuals owned 57%. Institutional investors often own shares for the benefit of others. These investors purchase CEI shares for the benefit of their investors who, in turn, may be pension funds and individual investors. Since pension funds exist for the benefit of the individual participants in their plans, it makes sense to think of the ultimate beneficiaries of share ownership in CEI and derivatively in CECONY of being millions of individuals who may own shares directly, invest in U.S. stock mutual funds, or receive or expect benefits from pension plans or life insurance policies.

Q. What do these people who own the Company provide to it?
A. They provide the capital that the Company needs above
and beyond what debt investors are willing to provide.
Their capital allows the Company to use the goods,
wages, services and borrowings that bring safe,
reliable energy utility service to the Company’s
customers. Without these share investors, the
Company’s customers would have to pay currently for
all of the costs of the services they receive.
Instead, customers can delay payment by promising to
pay these investors a greater amount in the future.
Therefore, instead of paying for a new substation as
it is constructed, for example, customers can plan to
pay for that asset over the subsequent decades during
the time they benefit from its operation.

Q. What do these share investors expect in return for the
benefit customers receive from their capital
investment?

A. They expect compensation either in the form of a
periodic dividend payment or as an increase in the
value of the business, or both.
Q. How do share investors in regulated utilities set their expectations for compensation?

A. The return expectations of share investors in rate-regulated energy utilities are grounded in the bargain termed “the regulatory compact.” The regulatory compact’s essence is that share investors forgo the monopoly earnings they would otherwise enjoy in return for the institutionalization of their monopoly in an exclusive franchise, and a fair and equitable return on the capital they have invested.

Q. What standards exist to help share investors and regulators determine whether a rate-regulated utility offers a fair and equitable return?

A. The general standards for a fair and equitable return for investors in utility shares are well-established in the U.S. The underlying requirement for fair treatment for share investors has been recognized for years. As discussed in the testimony of Company witness Hevert, it dates back to the Bluefield and Hope cases. The Supreme Court in those cases
established that in determining the fairness or reasonableness of a utility’s allowed ROE, one needed to look at the consistency of a utility’s allowed ROE with the returns on equity investments in other businesses having similar or comparable risks.

The key point is that in neither of these cases is there a specific limitation to looking only to the financial health of utilities when looking at enterprises with “similar or comparable risks.” And, as has been pointed out many times in prior New York rate proceedings, comparisons to other utilities introduces an incurable circularity to the assessment of an appropriate level of returns.

Q. How would a potential share investor evaluate the return limitations on New York utilities as to their magnitude, timing and probability?

A. There are four significant factors in an equity investor’s assessment of New York utility regulation: (1) headline rate of return on equity, (2) the likelihood of earning that return, (3) the symmetry of
potential earned equity returns, and (4) the restrictions the regulator places on the scope of the business. To make this assessment, a potential share investor will start with the basic parameters of the rate orders from the state.

Q. How do the Commission’s rate orders influence investors’ evaluation of the first identified return consideration?

A. The first factor, the level of returns on equity, is important for an equity investor because it provides the most visible indication in the rate order of the regulator’s willingness to balance the needs of investors and customers.

Q. How have the Commission’s authorized returns compared to those in other jurisdictions?

A. As we have stated in previous rate cases, the rates of allowed return granted in New York are well below those in other states. I have provided a comparison of allowed returns in New York versus other states (based on data from Regulatory Research Associates (“RRA”)) to demonstrate the consistency of this
practice (Exhibit__(SS-3)).

In past cases, Staff has argued that each of the rate cases in the RRA database is unique, and therefore no meaningful conclusion can be drawn. While I would agree that each is unique, it is equally obvious that the differences in the authorizations cannot always be such that New York companies should consistently and deservedly be permitted a chance to earn the lowest returns in the country.

Q. Can investors readily measure the degree to which a regulatory regime fairly rewards share investors?

A. In New York, yes. The Commission has a clear and long-standing policy of setting returns relative to the historic tangible book value of the investors’ shares. Information about returns on share book values for publicly-traded U.S. companies is readily available to investors from public sources as a basis for comparison.

Q. How does CECONY compare to this universe of alternative investments?

A. It does not fare well in the comparison. When looking
at 2011, CECONY had a return on book equity that would have placed it in the bottom 30% of S&P companies with meaningful data. The return for the average S&P company was 16.1%.

Q. Have you prepared an exhibit to show this?
A. Yes, please refer to my Exhibit __ (SS-4).

Q. Are companies typically valued by investors at their book value?
A. No, they are valued by investors based on their prospects. Exhibit __ (SS-5) shows the five-year average market to book ratios for those S&P companies with positive book equity. CEI’s market to book is in the bottom 20% of this universe for this important measure of investor perception of prospects, even after a massive financial crisis which most severely affected the financial sector and other industries.

Valuation methods such as the DCF can be reasonable (if imperfect) methods for determining expected returns for investors when they apply market-derived data to the firm’s market value of
equity. The method and the application are then internally consistent and reward the equity-holder for what his or her stock investment is currently worth. In contrast, the current practice of applying market-derived returns to a much lower book value not only strips out the accumulation of improvements to the business and its assets, but it is not consistent with standard, corporate finance practice. The application of the CAPM methodology suffers from similar flaws. Market-derived returns must be applied to market equity values. There is no theoretical basis to do otherwise.

Q. Are you proposing an alternative method to correct for this inconsistency?

A. Not at this time. As we have done in previous rate cases, we are pointing out a flaw in the methodology applied by Commission staff and adopted in previous Commission orders -- application of a market-derived return to book value-based equity. To support our view, Company
witness Hevert presents a methodology that, while much more conservative than applying a market-derived return to a market value of equity, represents movement in the right direction. In his direct testimony Appendix B, titled “Market Based Capital Structure and the Financial Leverage Adjustment”, Company witness Hevert proposes an adjustment to the allowed ROE to account for the differences between financial leverage embedded in market-derived returns and returns based on book value. Since financial leverage measured at book value generally exceeds financial leverage measured at market value, an upward adjustment to the ROE to capture the higher financial risk implied by higher financial leverage is appropriate.

In this proceeding, to remedy the flaw inherent in the application of a market-derived return to book value-based equity, the Commission should establish the Company’s approved ROE at the level recommended by Company witness Hevert.
Q. Does Company witness Hevert present the theoretical basis for his proposed ROE adjustment?

A. Yes. Please see Company witness Hevert’s direct testimony Appendix B.

Q. How would an investor assess the second factor: the likelihood of a utility actually earning the headline equity return?

A. The investor would analyze the adjustments made to actual costs that are allowed to be recovered, imputed productivity that may or may not be achieved, and any arbitrary revenue adjustments. To the extent that such adjustments to real costs are made, the headline rate of return is unlikely to be achieved.

Q. How would an investor assess the third factor: the symmetry of potential returns?

A. There is ample opportunity through penalty-only performance mechanisms, an absence of any meaningful positive incentives and one-way true-ups of costs—burdens which have increasingly been imposed in New York rate decisions—to realize significantly worse
returns than the headline authorized return. All of these aspects of New York rate orders create asymmetry in expected returns, which a rational potential share investor would judge as reducing his or her expected return. As pointed out in detail by Company witness Lapson, little evidence exists that these burdens are common in other jurisdictions in the country, where the peers that are the basis for the Commission’s DCF and CAPM results operate.

Q. Have the shortcomings in the treatment of Con Edison been reflected in equity analyst’s views of the Company?

A. Yes. As of December 31, 2011, Con Edison ranked as 490th of the 500 companies in the S&P 500 in terms of analyst buy/sell rankings Exhibit__ (SS-6).
CONCLUSION

Q. Please summarize your testimony on the financial challenges for the Company.

A. Company witness Hevert has presented the Company’s calculation of a required equity return for CECONY. My testimony concerns the financial challenges and the need to maintain access to financial markets at reasonable cost. Company witness Lapson has also presented testimony on the challenges CECONY faces from the perspective of the rating agencies and fixed-income investors. Both equity and debt investors perceive that the New York regulatory environment is a difficult one in which to operate. Such a perception, if it continues, will make financing needed expenditures more expensive in normal times and less certain in times of financial crises.

To avoid such an outcome, and to re-establish debt and equity investors’ trust in the fairness of New York regulation, a fair and equitable rate of
return, competitive with those available elsewhere in the market, and a reasonable chance to actually earn that return, are needed. And to achieve such, the Commission should grant the rate of return recommended by Company witness Hevert and the capital structure as recommended in this testimony.

DIRECTORS’ AND OFFICERS’ INSURANCE

Q. What is D&O insurance?
A. Consistent with New York State law, D&O insurance covers the Company and its directors and officers for claims and litigation brought against them for good faith decisions they make in their respective corporate capacities.

Q. Why does Con Edison need D&O insurance?
A. The Company purchases D&O insurance as part of its effort to recruit and retain qualified officers and directors to serve in those roles. Officers and directors understand the litigation exposure that attends to the responsibilities of boards and managements of companies, particularly large, public utility companies such as CECONY.
Q. Is D&O insurance an ordinary business expense for U.S. public companies?

A. Yes. D&O insurance is virtually universal among U.S. public companies. The administrative law judges in their Recommended Decision in a recent CECONY electric base rate case (Case 08-E-0539)(p. 172) found that more than 99% of all types of companies buy this insurance, a finding which the Commission did not disturb in its final rate order in that proceeding.

Q. Please describe the coverage under the Company’s D&O insurance.

A. The Company purchases $300 million of total D&O insurance, which is comprised of $250 million of standard ABC coverage, discussed below, supplemented by $50 million of stand-alone Side A coverage. This level of coverage has been in place since 2005. The standard policy coverage contains three coverage components. Coverage A of the standard policy protects and defends individual officers and directors for claims against them in the event of the Company failing to deliver on its commitment to provide
indemnification. In such cases a $0 deductible applies. Coverage B of the standard policy reimburses Con Edison for all amounts incurred to indemnify our directors and officers as required or permitted by applicable common or statutory law, or under our charter or by-laws, in which case a $5 million deductible applies. Coverage C of the standard policy covers Con Edison for securities claims against it. A $5 million deductible also applies to Coverage C.

Q. What claims are excluded from D&O coverage?
A. D&O policies typically exclude claims arising out of deliberate, fraudulent, criminal or malicious acts, claims in which the director or officer has gained a personal profit to which the director or officer was not legally entitled, and claims involving any profit from illegal insider trading. The policies typically do not cover dishonest, inappropriate, or willful criminal acts committed by directors and officers. These policies do cover the typical daily good faith business decisions, made by officers and directors related to management and operation of the business.
Q. Do these exclusions apply to Con Edison’s D&O insurance?

A. Yes, they do.

Q. Have you prepared or caused to be prepared an exhibit entitled “Consolidated Edison Company of New York, Inc. - Cost for Levels of D&O Insurance” which shows the cost of the Company’s insurance?

A. Yes. I have prepared Exhibit__(SS-7).

Q. Please describe this exhibit.

A. The exhibit shows the specific cost for each level of coverage. For example, the exhibit shows that the cost of the first $135 million of coverage above the applicable deductible is the sum of the first five layers of coverage or $2,814,742.

Q. How do companies determine the appropriate amount of D&O insurance coverage?

A. The appropriate amount of D&O insurance coverage for any particular company is a function of many factors including the riskiness of its operations, the location of its operations, the volatility of its cash flows and share price, whether it is a public or
private company, if it is public then the size of its market capitalization, its industry sector, and the D&O loss trends in that industry. An individual company’s evaluation of these factors to determine a prudent level of coverage cannot be reduced to an algebraic comparison of that company’s coverage to the average amount of coverage maintained by companies in a particular industry or a of particular market capitalization.

Q. What steps has Con Edison taken to determine the appropriate amount of D&O insurance coverage for it?

A. In making decisions as to amounts of coverage, the Company has sought the advice of professionals in this field. In 2005, our D&O insurance program was reviewed by outside counsel with expertise in insurance (Dickstein-Shapiro) and, based on that recommendation, Con Edison increased its overall coverage from $250 million to $300 million, which is where coverage remains today. In addition, we reconfirm annually with our insurance broker, Willis, that our D&O insurance costs and policies are in line...
Q. What else does Con Edison do to test the reasonableness of the financial limits of its D&O coverage?

A. Con Edison compares its level of coverage with other large utilities on a periodic basis. The Company gathers confidential coverage data from utilities with current market capitalizations greater than $10 billion by contacting the utilities directly.

Q. To what extent does the Company’s own survey support its level of coverage?

A. The Company’s most recent survey of large utilities was conducted in 2012 and has the benefit of capturing two of the several factors identified as more important in assessing the appropriate amount of coverage for a company. These two factors are industry and size. Although these factors are important to the determination of the appropriate amount of coverage, they are not dispositive. Therefore, we set our coverage limits in consultation with the professional expertise of insurance brokers.
and outside counsel specializing in the field. We use our survey to test, not establish, the amount of coverage.

Q. What were the results of the Company’s most recent survey?

A. In our 2012 survey, Exhibit__(SS-8), we found that six of the fifteen utility companies purchased total D&O limits of $300 million or more. The average coverage amount in our latest survey for the fifteen utilities with current market capitalization of over $10 billion is $271 million. The median limit in our 2012 survey of the fifteen utilities with a market capitalization above $10 billion is $250 million. The standard deviation of the data in the survey is approximately $80 million, defining a range of coverage for the survey results of from approximately $190 million to $350 million.

Q. Please summarize the result of the steps taken to assess the Company’s amount of D&O insurance coverage.

A. Our experts recommended and reconfirmed the amount of D&O insurance for the Company. Our survey shows us
that our coverage limits are very close to the average amount for large utilities. Our survey also shows that of the utilities in our size range, six of fifteen have $300 million or more in coverage. We think it reasonable that the largest distribution utility in the U.S., serving the largest, most urban and one of the most litigious cities in the U.S., should have insurance coverage no lower than the midpoint of other large utilities.

Q. What steps does the Company take to control the cost of this insurance?

A. Prior to each annual renewal the Company’s Insurance Department and Senior Management review with our broker: (a) the current D&O market conditions; (b) a list of insurance carriers who are currently on the program and those not on the program who may offer a competitive choice; (c) the financial stability and claims-paying reputation of each of these insurance carriers; (d) our goals for the renewal; (e) other possible program structures; (f) coverage specifics and (g) the marketing process itself. Our goal is
appropriate coverage terms and conditions at a fair
and equitable market premium from stable and secure
insurers. We work closely with carriers to secure the
most competitive pricing for each level of insurance.
Q. Should the Company be allowed to recover in rates the
cost of $300 million in D&O insurance coverage?
A. Yes. As the Commission determined in the Central
Hudson Gas & Electric Corporation rate cases (Cases
08-E-0887 and 08-G-0888), D&O insurance is a necessary
and reasonable business expense, the cost of which
should be recovered in rates. Rate recovery is
allowed so long as the coverage and premium amounts
are reasonable. As discussed above, the Company has
demonstrated the reasonableness of both its D&O
insurance coverage and premium amounts.
Q. Does that complete your testimony?
A. Yes, it does.