

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to
the Rates, Charges, Rules and Regulations of
Niagara Mohawk Power Corporation for Gas
Service

Case 08-G-0609

DIRECT TESTIMONY AND
EXHIBIT
OF
TARIQ N. NIAZI

Dated: October 27, 2008
Albany, New York

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TABLE OF CONTENTS

RATE OF RETURN ON EQUITY.....	3
A. <u>Proxy Group</u>	5
B. <u>Discounted Cash Flow Model</u>	9
C. <u>Capital Asset Pricing Model</u>	12
D. <u>Overall Recommendation</u>	16
E. <u>Analysis of Niagara Mohawk's Equity Return Proposal</u>	19

1 Q. Please state your name, title and business address.

2 A. Tariq N. Niazi, Acting Director Utility Intervention, New York State Consumer
3 Protection Board ("CPB"), Suite 2101, Five Empire State Plaza, Albany, New
4 York 12223.

5
6 Q. Mr. Niazi, please summarize your background and experience.

7 A. I passed my candidacy examination, completed all required course work and
8 passed all comprehensive examinations in the Doctoral Program in Managerial
9 Economics at Rensselaer Polytechnic Institute. I have a Master's Degree in
10 Economics from the State University of New York at Albany. I also received a
11 Master's Degree in Public Administration from Punjab University in Pakistan
12 and a Bachelor's Degree in Economics and Political Science at Forman
13 Christian College in Pakistan.

14 I have been employed by the CPB since March 1981, first as an
15 economic consultant and then as a rate analyst. Later, I was promoted to the
16 position of Principal Economist. I served as Chief Economist for the CPB from
17 October 1990 to September 2008 and worked on numerous issues in electric,
18 gas, telephone and water proceedings. I was appointed to my present position
19 in October 2008. As acting Director of Utility Intervention, I am responsible for
20 all aspects of advocacy regarding the regulation of utilities on behalf of New
21 York consumers.

1 I serve as the CPB's representative at the New York Independent
2 System Operator ("NYISO"). The CPB has been designated by the NYISO as
3 the statewide consumer advocate and is a formal voting member of the
4 NYISO's decision making committees. I also serve on the New York State
5 Energy Research and Development Authority's System Benefit Advisory
6 Group and the recently formed Public Service Commission's Evaluation
7 Advisory Group. Additionally, I have also served on the Natural Gas Reliability
8 Group as a customer representative.

9
10 Q. Have you previously testified before the New York State Public Service
11 Commission?

12 A. Yes. I have testified in numerous proceedings before the Public Service
13 Commission ("PSC" or "Commission")

14
15 Q. What is the purpose of your testimony?

16 A. I determine the fair rate of return that Niagara Mohawk Power Corporation
17 ("Niagara Mohawk" or the "Company") should be permitted to earn on its
18 equity capital. Additionally, my testimony will show that the Niagara
19 Mohawk's requested return on equity of 11.0% for its gas business is
20 overstated and that the Company's current cost of equity is 9.55%. My

1 testimony also refutes several assertions made by the Company in support
2 of its return estimate and identifies several errors in its presentation.

3

4 Q. Have you prepared an exhibit for your testimony?

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

6

7 **RATE OF RETURN ON EQUITY**

8

9 Q. What return on common equity is Niagara Mohawk requesting for its gas
10 operations?

11 A. Niagara Mohawk is requesting a return on common equity of 11.0%. Its
12 recommendation is based on averaging the results of multiple estimates from
13 three different methods: 1) an average of 10.8% using the discounted cash
14 flow method ("DCF") based on four different estimates ranging from 9.2% to
15 11.5%; 2) an average of 11.4% using the capital asset pricing model ("CAPM")
16 based on two estimates of 11.3% and 11.5%; and, 3) an average of 10.5%
17 using the Risk Premium method based on two estimates of 10.5%. In addition,
18 Niagara Mohawk is recommending a 0.3% premium for committing not to seek
19 further rate increases for three years. As I discuss in my testimony, the equity
20 returns based on the DCF and CAPM methods are overestimated and should
21 be rejected, while equity returns based on the Risk Premium method should be
22 discarded as the use of this method has been repeatedly rejected by the

1 Commission. Finally, a premium for an extended stay out, as I discuss later in
2 my testimony, should also be rejected at this time.

3

4 Q. What is your recommended rate of return or capitalization rate for Niagara
5 Mohawk?

6 A. I recommend a total equity return of 9.55% for Niagara Mohawk. My equity
7 cost estimate is based on application of the DCF and CAPM methods to a
8 proxy group of electric and combination electric and gas companies with
9 investment grade debt ratings by Moody's and Standard & Poor's ("S&P").
10 This rating criterion is different from the "A/A" rated proxy group for
11 combination electric and gas companies reflected in the Recommended
12 Decision in the Generic Finance Case (91-M-0509). As explained below, this
13 change in the rating standard is appropriate and necessary to arrive at a proxy
14 group of sufficient size to obtain reliable results. In other respects, my
15 approach is consistent with the Recommended Decision in the Generic
16 Finance Case.

17 The DCF approach applied to the proxy group results in a median
18 equity cost estimate of 9.65%. The CAPM approach applied to the same proxy
19 group produces an equity cost of 10.05% for the traditional CAPM and 10.46%
20 for the zero-beta CAPM. The average of the two CAPM methods results in an
21 equity return of 10.26%. The CAPM analysis is based on an 11.7% market

1 return, a .78 proxy group beta, a risk free rate of 4.19% and a risk premium of
2 7.51%. Applying weightings of 2/3 to the median DCF result and 1/3 to the
3 average of the CAPM results, in accordance with the Recommended Decision
4 in the Generic Finance case and the Commission's decision in several recent
5 cases,¹ I arrive at an equity return estimate of 9.85%. After applying a credit
6 quality adjustment of 30 basis points, my recommended equity return for
7 Niagara Mohawk's gas operations is 9.55%

8
9 A. Proxy Group

10
11 Q. How did you select the proxy group companies for your analysis?

12 A. As recommended in the Generic Finance Case and following Commission
13 practice, I developed a proxy group of combination electric and gas
14 companies, since Niagara Mohawk is a combined electric and gas company. I
15 used the following criteria in selecting the combined gas and electric proxy
16 group: 1) each company must be listed by Value Line as an electric or
17 combination electric and gas distribution companies; 2) each company must
18 have investment grade debt rated by Moody's and Standard & Poor's; 3) over
19 70% of each company's total revenues must be derived from regulated utility

¹ See, most recently, Case 05-E-1222, New York State Electric & Gas Corporation, Order Adopting Recommended Decision with Modifications, August 23, 2006, Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation, Order Adopting Recommended Decision with Modifications, March 7, 2003, p. 72 and Case 07-E-0523, Consolidated Edison Company of New York, Inc., Order Establishing Rates for Electric Service, March 25, 2008.

1 operations; and 4) the company should not be involved in merger/acquisition
2 activity.

3 Based on the stated criteria, I started the selection of the proxy group by
4 looking at all 58 electric and combination electric and gas companies listed by
5 Value Line. I used the latest issues of the Value Line Investment Survey
6 dated, August 8, 2008, August 29, 2008, and September 26, 2008 listing
7 electric and combination electric and gas distribution companies in the
8 Western, Eastern and Central states respectively. In step two, I discarded any
9 company that was rated below investment grade by either Moody's or
10 Standard & Poor's. As a result of this screen, 8 companies rated below
11 investment grade were excluded, leaving 50 companies in the proxy group.
12 Next, I reviewed the level of regulated operations of the 50 companies with an
13 investment grade debt rating in the proxy group, excluding companies with less
14 than 70% of total annual revenues derived from regulated utility operations.
15 As a result of these criteria, an additional 15 companies were excluded from
16 proxy group, leaving 35 companies. I further excluded 5 companies from the
17 proxy group; Energy East Corporation as it is in the process of being acquired
18 by Iberdrola SA, Entergy Corporation as it is in the process of a major
19 reorganization, El Paso Electric as it is not paying any dividends, ITC Holding
20 Corp. as it is a transmission only electric company and UIL Holding Corp. as its
21 debt is rated only by Moody's and not Standard & Poor's. After excluding

1 companies that did not meet the criteria for inclusion in the proxy group listed
2 above, the proxy group I have used for my analysis is comprised of 30
3 companies as shown in Exhibit__ (TNN), Schedule 1.
4

5 Q. Why did you not follow the criteria established in the Generic Finance Case for
6 the selection of the proxy group for combined electric and gas companies?

7 A. It has become virtually impossible to follow the criteria for selecting proxy
8 groups established in the Generic Finance Case because there is not a large
9 enough sample on which to establish a reliable estimate. Since the Return on
10 Equity Consensus Document ² (dated June 2, 1993) and the Recommended
11 Decision in the Generic Finance Case (dated July 19, 1994) were issued,
12 significant changes have occurred in the electric industry in terms of debt
13 ratings and the level of regulated utility operations. When the Return on Equity
14 Consensus Document was issued, there were 33 electric and combination
15 electric and gas companies that were rated "A/A" by Moody's and Standard &
16 Poor's. That number has now dwindled to 6 companies, 2 of which have
17 regulated revenues less than 70% of total revenues. In other words, only 4
18 companies would make the proxy group based on "A/A" rating as established
19 in the Generic Finance Case. That is not a large enough sample on which to

² Prepared by Signatory Members of the Electric and Gas Industry Group that included the Department of Public Service and all New York utilities including the Consolidated Edison Company of New York, Inc.

1 establish a reliable estimate of the cost of equity. In a recent Consolidated
2 Edison Company of New York, Inc. proceeding (Case 07-E-0523), the Judges
3 made the following observation:

4 With respect to the use of proxy group results, it has become
5 increasingly difficult to find representative firms, in sufficient
6 numbers, for the electric combination and the natural gas utility
7 companies that operate in New York.

8 * * *

9
10
11 As long as the Generic Finance Case approach can be
12 sustained, we do not recommend that the Commission revert to
13 the approach that it previously used that relied predominantly on
14 the market data available for the company it was addressing in a
15 particular rate proceeding (Recommend Decision, p. 135)
16

17 Q. Did the Generic Finance Case establish a level of regulated operations for
18 inclusion in the combined gas and electric proxy group?

19 A. No. The only criteria established in the Generic Finance Case for the
20 combined electric and electric company proxy group was that all companies
21 included must have senior debt rated in the "A" category by Moody's and
22 Standard & Poor's.³ Presumably, most electric utilities at that time had
23 exclusively regulated operations; hence, the level of revenues derived from
24 regulated operations was not an issue. However, the Generic Finance Case
25 did address the issue of regulated versus unregulated operations in regards to

³ Id., at 6.

1 the establishment of the gas proxy group composed of “pure play” gas
2 distribution companies. It required that over 96% of each company’s total
3 revenues must be derived from gas utility operations.⁴

4 The proxy group of 30 companies I used for my analysis has an
5 average of 88.73% of its revenues coming from regulated operations.
6 Regulated operations for the companies in the proxy group range from a low of
7 76.2% to a high of 100%.

8
9 B. Discounted Cash Flow Model

10
11 Q. How did you arrive at your DCF equity return estimate for Niagara Mohawk?

12 A. I applied a two-stage DCF growth model to the proxy group. This is the same
13 model that was developed in the Generic Finance Proceeding and was
14 adopted by the ALJs in their Recommended Decision. It has been consistently
15 relied upon by the Commission for over a decade, including the recently
16 concluded Consolidated Edison Company of New York, Inc. proceeding (Case
17 07-E-0523)⁵. As shown in Exhibit__ (TNN), Schedule 1, page 3 of 3, this
18 resulted in a median equity return of 9.65% for Niagara Mohawk.

19

⁴ Id.

⁵ Case 07-E-0523 – Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Electric Service Order issued, March 25, 2008.

1 Q. Could you please briefly describe the DCF method that you applied?

2 A. Yes. The DCF method is a market based approach that determines the return
3 on equity from the investor's perspective. The familiar DCF formula is:

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$$P_0 = \frac{D_1}{k-g}$$

This fundamental equation states that a rational investor equates the current market price (P_0) of a stock to the expected future returns from that stock. Future returns from the stock are the expected stream of dividends discounted at the market-required return (k), net of the effect of growth (g).

D_1 is the first year dividend.

Since the capitalization rate is not directly observable, the basic idea of the DCF approach is to derive the cost of equity from the observed share price and an estimate of investor expected future dividends. This is based on the intuitive concept that dividends plus capital appreciation reflect the investor's total expected return.

The DCF formula can be rewritten by solving the above equation for the cost of equity (k).

$$k = D_1/P_0 + g$$

In terms of the rewritten DCF formula, the cost of equity (k) is equal to the sum

1 of the expected dividend yield (D_1/P_0) and the expected growth rate of future
2 dividends (g).

3

4 Q. What is the first component of the DCF formulation [$k = D_1/P_0 + g$]?

5 A. The first component of the DCF formulation is the expected dividend yield
6 (D_1/P_0). It is the quotient of the expected future dividends and the current
7 stock price. A stock's dividend yield, in comparison with the dividend yield of
8 other stocks, indicates whether it is an income or a growth asset. For
9 example, bonds generally have high yields and low growth, and are hence
10 considered income assets. Conversely, common stocks of growing firms have
11 low yields and high growth, and are generally considered growth assets.

12

13 Q. What is the growth term (g) in the standard DCF formula?

14 A. The growth term in the DCF formula represents the growth in the value of the
15 firm's common stock as reflected through dividend and stock price increases.
16 The DCF approach assumes that the firm is operating in a "steady state." If
17 the steady state holds, the growth rates in earnings per share, dividends per
18 share and book value per share are the same, and are a product of the
19 retention ratio and the expected return on equity.

20

In reality, it is not possible to achieve a "true" steady state. Thus, book

1 value per share, dividends per share and earnings per share generally grow at
2 different rates that may all differ from the growth rate indicated by the retention
3 ratio and expected return on equity.

4
5 Q. How did you estimate the two-stage proxy group DCF equity returns for
6 Niagara Mohawk?

7 A. I estimated the two-stage proxy group DCF equity return, relying on the model
8 used in the Generic Finance Proceeding by the Electric and Gas Industry
9 Group. The six-month average prices for the companies in the proxy group
10 are the average of the monthly high and low closing price of each stock. I
11 used the period April 1, 2008 to September 30, 2008. The other data, including
12 dividends per share, earnings per share, book value per share and the shares
13 of common stock, are all taken from the August 8, 2008, August 29, 2008, and
14 September 26 2008, issues of the Value Line Investment Survey. As shown in
15 Exhibit__ (TNN), Schedule 1, page 3 of 3, the median equity return based on
16 this method is 9.65%.

17
18 C. Capital Asset Pricing Model

19 Q. What were the results of your application of the CAPM methodology to
20 estimate Niagara Mohawk's equity return?

21 A. I used both the traditional and the zero-beta approaches to compute the

1 CAPM equity returns for Niagara Mohawk. The traditional CAPM produced an
2 equity return of 10.05% and the zero-beta CAPM approach an equity return of
3 10.46%. The average of the two CAPM approaches resulted in an equity
4 return of 10.26%. Exhibit__ (TNN), Schedule 2 provides a detailed explanation
5 of the calculations used to determine the equity return under the CAPM.
6

7 Q. Have you used the same CAPM methodology that was adopted in the Generic
8 Finance Case?

9 A. Yes. The only difference is that I used the Merrill Lynch based expected return
10 rather than the historic data from Ibbotson Associates used in the Generic
11 Finance Case. Once again, the Commission adopted this change from the
12 Generic Finance methodology over a decade ago and has consistently relied
13 upon it. In Case 05-E-1222, the Commission said the following:

14
15 As for the CAPM, NYSEG's reliance on the historic Ibbotson
16 data and a DCF of the S&P 500 to estimate the market return is
17 rejected. The historic Ibbotson data is inconsistent with more
18 recent forward-looking Ibbotson estimates and the S&P 500
19 DCF relies upon the single growth DCF model which the
20 Commission has not employed for over a decade.
21

22 (Order Adopting Recommended Decision with Modifications,
23 Issued and Effective August 23, 2006, at 96.)
24

25
26 Q. Please briefly describe the CAPM approach for estimating equity returns.

27 A. The CAPM formally describes the trade-off between risk and required return

1 for securities. The equation below illustrates that the rate of return required by
2 investors (R_c) consists of a risk-free return (R_f), plus a premium compensating
3 investors for bearing the risk commensurate with the stock's market risk (Beta)
4 and the market price of risk ($R_m - R_f$). The risk premium varies from stock to
5 stock. The traditional CAPM formula is stated as:

$$R_c = R_f + \text{Beta} (R_m - R_f)$$

7 A basic premise underlying the CAPM is that there is less risk
8 associated with an investment in a relatively stable stock than in the stock of a
9 small speculative venture. As a result, investors in a speculative venture stock
10 will require higher returns than investors in a stable stock, because they are
11 assuming additional risk. The CAPM quantifies the additional return investors
12 require for accepting this higher risk.

13
14 Q. Please describe Exhibit__ (TNN), Schedule 2.

15 A. Exhibit__ (TNN), Schedule 2 consists of two pages. Page 1 shows the
16 traditional CAPM formula used to derive the required return for the proxy
17 group, while page 2 shows the zero-beta CAPM application. The required
18 return is the sum of the risk-free rate and the market-risk premium adjusted
19 using the proxy group average beta.

20
21 Q. How did you determine the risk free rate, market return and beta used in this

1 analysis?

2 A. To determine the risk-free rate, I used the most recent six-month average
3 ending September 30, 2008, of 30-Year and 10-year Treasury Bond Yields as
4 reported by the Federal Reserve Board. (Federal Reserve Statistical Release,
5 Historical Data) That average is 4.19%.

6 The beta of 0.78, used to adjust the market risk-premium, was derived
7 from the proxy group as the average of the individual company betas as
8 reported by Value Line. These are the same 30 electric and combination
9 electric and gas proxy group companies used for the DCF analysis.

10 The market return of 11.7% I used is based on the October 5, 2008
11 issue of Merrill Lynch Quantitative Profiles - Monthly Insights for Equity
12 Management. The 11.7% estimate is the implied return for a portfolio of 1,164
13 firms.

14 The risk premium was derived by subtracting the risk-free rate of 4.19%
15 from the market return of 11.7%, resulting in a risk premium of 7.51%.

16 Incorporating all variables in the respective formulas, indicates a
17 required return of 10.05% for the traditional CAPM approach and 10.46% for
18 the zero-beta CAPM approach, as shown in Exhibit __ (TNN), Schedule 2, page
19 1 and 2 respectively. The average of the two CAPM approaches results in an
20 equity estimate of 10.26% $((10.05\% + 10.46\%)/2)$.

21

1 D. Overall Recommendation

2 Q. What is your estimate of equity cost for Niagara Mohawk before any
3 adjustments?

4 A. I estimated the cost of equity by applying the 2/3 DCF – 1/3 CAPM weighting
5 consistently used by the Commission and also recommended by the Judges in
6 the Generic Finance case. My median DCF estimate is 9.65% and my
7 average CAPM estimate is 10.26%. With the DCF estimate given 2/3 weight
8 and the CAPM estimate given 1/3 weight, the resulting return before any
9 adjustment, is 9.85%.

10

11 Q. Did you make any adjustments to the estimated equity return for Niagara
12 Mohawk?

13 A. Yes. I adjusted the estimated return of 9.85% for credit quality. Niagara
14 Mohawk is rated A- by Standard & Poor's and A3 by Moody's. The median
15 bond ratings of the proxy groups I have used are Baa2 by Moody's and BBB
16 by Standard & Poor's, both in the middle of the "B" rating category. To
17 account for the differences in the bond ratings of the proxy group and Niagara
18 Mohawk, I looked at the difference in A-rated and Baa/BBB-rated long term
19 utility bond yields. Over the most recent six-month period from April 2008 to
20 September 2008, A-rated utility bond yields averaged 6.20%, while Baa/BBB-
21 rated utility bond yields over the same period averaged 6.50%.

1 The 30 basis point spread between A-rated and Baa/BBB-rated bond
2 yields reflects the difference in the cost of debt. As discussed in the Generic
3 Finance Case this spread should be increased to reflect the fact that the
4 change in the cost of equity is greater than the change in the cost of debt.⁶ In
5 order to make that adjustment, I calculated the ratio of the proxy group equity
6 cost (9.65%) to its cost of debt (6.50%) that resulted in a ratio of 1.515%. I
7 then multiplied the 1.515% ratio with the 30 basis point bond yield spread to
8 arrive at a 45 basis points equity adjustment. I took 30 basis points or two-
9 thirds of the 45 basis points equity adjustment as the basis of my credit quality
10 adjustment. I did not use the entire equity adjustment recognizing that Niagara
11 Mohawk is rated on the low end of the "A" rated category by both Moody's and
12 Standard & Poor's. Subtracting 30 basis points from my earlier estimate of
13 9.85% results in an equity return estimate for Niagara Mohawk of 9.55% after
14 applying the credit quality adjustment.

15
16 Q. Are you adjusting your equity cost estimate for issuance cost?

17 A. No. To the best of my knowledge the Company is not planning to issue any
18 new shares of common stock during the rate year. Company Exhibit (AED-1),
19 Schedule 3, Sheet 1 of 1 that provides the sources and use of funds indicates
20 \$500 million of long-term debt but no new equity issuance during the rate year.

⁶ Return on Equity Consensus Document, June 2, 1993, p. 13.

1 The Commission in Cases 02-E-0198 and 02-G-0199 said the following:

2 We agree with the Judge's recommendation to exclude a
3 separate adjustment for selling and issuance costs, because our
4 policy has been to allow recovery of such expenses when they
5 are incurred and there has been no assertion by the Company
6 in this case of an external equity issuance. (Order issued March
7 7, 2003, p. 71))

8
9 Since a common stock issuance is not planned for the rate year, I would
10 recommend that the Commission not allow any adjustment for issuance
11 related expenses.

12
13 Q. Have you made an adjustment to your equity return recommendation for a
14 multi-year rate plan?

15 A. No, not at this time. I recommend that the Commission establish an equity
16 return for one year. The CPB is not willing to suggest a longer-term return rate
17 based on Niagara Mohawk's filed plan, which it does not support as presented,
18 and cannot speculate about the duration of any plan that may ultimately result
19 from this proceeding. Should a comprehensive and balanced multi-year rate
20 plan be addressed in negotiations, the CPB would be willing to discuss the
21 appropriateness of an adjustment to its calculated equity return for a multi-year
22 stay out.

23

24 Q. Have you estimated the revenue impact of your 9.55% equity return

1 recommendation as compared to the Company's 11.0% equity allowance
2 request?

3 A. Yes. Based on the Company's response to Multiple Intervenor's Interrogatory
4 No. 5, an increase/decrease of 100 basis points in equity return has a revenue
5 requirement impact of approximately \$9.4 million. Since the difference
6 between my equity return estimate of 9.55% and Niagara Mohawk's request of
7 11.0% is 145 basis points, Niagara Mohawk's gas customers would save
8 approximately \$13.6 million if my recommendation is adopted.

9

10 E. Analysis of Niagara Mohawk's Equity Return Proposal

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

13 A. Company Witness Dr. Roger Morin recommends an equity return of 11.0%
14 based on the use of three different methods. The three methods he uses are
15 DCF, CAPM, and Risk Premium. As shown in Exhibits RAM-5, RAM-6, RAM-
16 7 and RAM-8, Dr. Morin estimated four separate DCF equity returns using
17 different combinations of proxy groups and growth rates. Dr. Morin's DCF
18 calculations resulted in equity returns ranging from 9.0 % to 12.7%. He then
19 added 20 to 30 basis points for flotation costs to his DCF estimates resulting in
20 equity return estimates ranging from 9.2% to 12.9%. Second, he used the
21 CAPM approach that produced equity returns of 11.0% and 11.2% for the

1 traditional and zero-beta CAPM, respectively. Dr. Morin then added 30 basis
2 points for flotation costs, bringing his CAPM estimates to 11.3% and 11.5% for
3 the traditional and zero-beta CAPM respectively. Third, Dr. Morin used two
4 Risk Premium analyses, both resulting in estimates of 10.2% equity return.
5 Adding 30 basis for flotation cost increases the Risk Premium estimates to
6 10.5%.

7
8 Q. Do you agree with the Company's approach in estimating its equity return?

9 A. No. Dr. Morin's estimates should not be relied upon. His DCF analysis is not
10 consistent with the Recommended Decision in the Generic Finance Case, as
11 well as the numerous PSC decisions based on that methodology, and results
12 in estimates that are overstated. His CAPM estimates are also overstated as
13 they are based on the use of unrealistic market returns and an inflated risk free
14 rate. Moreover, Dr. Morin's selection of proxy groups is arbitrary, flawed and
15 inconsistent with the intent of the Generic Finance Case. Finally, the use of the
16 Risk Premium method was rejected by the ALJs in the Generic Finance Case
17 and has been repeatedly rejected by the Commission.

18
19 Q. Please briefly describe how Dr. Morin selected his proxy groups.

20 A. Dr. Morin utilizes two different proxy groups, the first comprised of investment
21 grade, dividend paying companies designated as natural gas distribution

1 utilities by Value Line and the second comprised of investment grade, dividend
2 paying companies designated as combination electric and gas utilities by AUS
3 Utility Reports and covered by Value Line. The natural gas distribution based
4 proxy group (Company Exhibit RAM-5 and RAM-6) includes nine companies
5 all with a market value in excess of \$500 million and at least 50% of revenues
6 derived from regulated gas operations. The AUS Utility Report based proxy
7 group of combination electric and gas utilities (Company Exhibit RAM-7 and
8 RAM-8) is comprised of 24 companies all with at least 50% of revenues
9 derived from regulated operations. As described in his testimony, Dr. Morin
10 used the following criteria to establish his proxy groups: 1) Utilities must be
11 investment grade; 2) Utilities must pay dividends; 3) Utilities must have at least
12 50% of revenues derived from regulated operations; 4) Utilities should be
13 covered by Value Line.

14
15 Q. Please comment on Dr. Morin's selection of proxy groups.

16 A. Dr. Morin's first proxy group comprised of only natural gas distribution utilities
17 should not be relied upon as Niagara Mohawk is a combination electric and
18 gas utility with significant electric operations. In the Generic Finance Case, it
19 was agreed that a proxy group of combination electric and gas companies will
20 be used for combined electric and gas utilities. The Generic Finance Case
21 required a proxy group comprised of only natural gas distribution companies

1 for pure gas only utilities.

2 With regards to the second proxy group comprised of combination
3 electric and gas companies, Dr. Morin does not explain why he starts his proxy
4 group selection with the companies listed in the AUS Utility Reports.
5 Moreover, he does not offer an explanation as to the criteria used by AUS
6 Utility Reports for inclusion in their list. The selection of companies included in
7 Dr. Morin's second proxy group is completely arbitrary. It includes some
8 combination electric and gas utilities while excluding others without any proper
9 basis. If Dr. Morin had applied his own criteria to all the electric and
10 combination electric and gas utilities for which Value Line provides data, he
11 would have included an additional 17 electric and combination electric and gas
12 utilities to his second proxy group.

13

14 Q. Are you suggesting that Dr. Morin should have included all the 17 companies
15 he left out of his second proxy group comprised of combination electric and
16 gas companies?

17 A. Yes. Based on his own criteria, he should have included all 17 companies in
18 his proxy group. All these companies that were left out of his proxy groups
19 meet his own criteria for inclusion in the proxy group; they all have investment
20 grade rating, they all pay dividends, they all have Value Line coverage and
21 they all have more than 50% revenues from regulated operations.

1

2 Q. Going back to Dr. Morin's second proxy group comprised of combination gas
3 and electric companies; did you find other problems with this selection?

4 A. Yes. There are several other serious problems with the selection of his
5 second proxy group. First, Dr. Morin has included 5 companies that are rated
6 below investment grade directly violating his own criteria for inclusion in the
7 proxy group. CMS Energy Corporation, PNM Resources, Puget Energy
8 Incorporated, Sierra Pacific Resources and UniSource Energy are rated below
9 investment grade by either Moody's or Standard & Poor's or both. Second,
10 Energy East Corporation that is included in Dr. Morin's proxy group is being
11 acquired by Iberdola SA and should be excluded. Third, Entergy Corporation
12 that Dr. Morin includes in his proxy group is in the process of a major
13 reorganization and should also be excluded from the proxy group. Value Line
14 did not report any forecasted statistics for Entergy Corporation in its latest
15 quarterly update of September 26, 2008.

16 Additionally, Dr. Morin and I have used different criteria regarding the
17 level of revenues derived from regulated operations for inclusion in the proxy
18 group. I have used at least 70% of revenues from regulated operations as a
19 basis of inclusion in the proxy group, while Dr. Morin has used only 50%.

20

21

1 Q. What is your conclusion regarding Dr. Morin's proxy group selection?

2 A. As shown above, the selection of Dr. Morin's proxy groups is arbitrary. Instead
3 of establishing a selection criteria and then applying it across the electric and
4 gas utility industry, he started with a predetermined list of companies used by
5 AUS Utility Reports that excluded numerous companies that should have been
6 included based on his own criteria of being investment grade, having Value
7 Line coverage and meeting a threshold for revenues from regulated
8 operations. In contrast, the process established in the Generic Finance Case
9 and used by the CPB is based on the logic of starting with all electric and
10 combination electric and gas utilities that are covered by Value Line and than
11 applying an agreed upon criteria to all those companies to arrive at a
12 reasonable proxy group. There seems to be no rational basis for excluding
13 certain utilities from Dr. Morin's proxy group. For instance FPL Group, Inc. with
14 relatively similar rating as Niagara Mohawk ("A2" by Moody's and "A" by S&P
15 for FPL Group, Inc. versus "A3" by Moody's and "A-" by S&P for Niagara
16 Mohawk) was excluded from both of Dr. Morin's proxy group. Similarly,
17 Southern Company, Wisconsin Energy Corporation, Duke Energy Corporation
18 and Vectren Corporation that were A-rated by either Moody's or Standard &
19 Poor's and met Dr. Morin's other criteria were all excluded from his proxy
20 groups. The only possible explanation for excluding these companies is that
21 they were not included in the initial list provided by AUS Utility Reports. This

1 begs the question as to the criteria used by AUS Utility Reports for inclusion in
2 their list. Since the formation of Dr. Morin's proxy groups are completely
3 arbitrary and lacking in logical basis, the application of DCF and CAPM
4 methods to these proxy groups leads to unreliable results.

5
6 Q. Please briefly describe Dr. Morin's DCF analysis.

7 A. Dr. Morin uses a single-stage model to perform four separate DCF analyses.
8 He uses two different proxy groups and two different estimates of growth rates
9 to perform these analyses. His first proxy group, based on companies
10 designated as natural gas distribution companies by Value Line (natural gas
11 proxy group), is composed of 9 utilities, while his second proxy group based on
12 companies in the AUS Utility Reports (AUS proxy group) is composed of 24
13 companies. For both proxy groups, Dr. Morin estimates the DCF equity return
14 alternatively using Value Line estimates of earnings per share growth and
15 Zack's long-term earnings growth estimates. For the natural gas proxy group,
16 he estimates returns of 9.2% and 11.2% for the Value Line and Zack based
17 growth rates respectively. For the AUS proxy group, Dr. Morin estimates DCF
18 equity returns of 11.6% and 12.9% for the Value Line and Zack based growth
19 rates, respectively. He further adjusts the AUS proxy group equity returns by
20 dropping Northeast Utilities and Public Service Enterprise from the Value Line
21 and Zack based growth rates respectively to arrive at equity returns of 11.2

1 and 11.5%. The average of his four different DCF equity cost estimates is
2 11.4%.

3
4 Q. Please comment on the Company's DCF analysis.

5 A. Dr. Morin's DCF analysis in this proceeding is similar to the analysis he
6 presented in the Case 07-E-0523 - Consolidated Edison Company of New
7 York Inc. As in that proceeding, he relies in this case on analysts' long-term
8 forecasts of earnings growth instead of expected dividend growth.
9 Alternatively applying Value Line and Zack's earnings growth forecasts to the
10 natural gas and AUS based proxy groups, Dr. Morin arrives at four different
11 DCF equity cost estimates. The Judge in rejecting Dr. Morin's approach in
12 Case 07-E-05223 said the following:

13 We do not find any need in this case to adopt any alternatives or
14 variants for the components [of] the DCF and the CAPM
15 methods. We believe that the Commission should adhere to the
16 calculation of these methods as specified in the Generic
17 Finance Case. (Case 07-E-0523, Recommended Decision,
18 p.134-135.)
19

20 The Commission in upholding the Recommended Decision said the
21 following:

22 We find no merit in Con Edison's claim that the DCF method
23 and the Generic Finance Case approach are flawed and should
24 not be used without an upward adjustment applied to the
25 indicated equity return allowance.
26

* * *

We are satisfied that the DCF method remains a valid and proper method in these circumstances and we are not inclined to modify it for the reasons presented by Con Edison. (Case 07-E-0523, Order Establishing Rates for Electric Service, p.123.)

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9 Q. Is Dr. Morin's DCF analysis consistent with that adopted in the Recommended
10 Decision in the Generic Finance Case?

11 A. No. Dr. Morin's DCF analysis makes a major departure from the methodology
12 specified in the Generic Finance Proceeding. Dr. Morin rejects the use of the
13 two-stage DCF model as recommended in the Generic Finance Case and
14 consistently relied upon by the Commission and instead uses a single-stage,
15 DCF model. He discusses at length why he uses analysts' forecasts of growth
16 contained in Zack's Investment Research, Inc. and Value Line while rejecting
17 other measures of growth like sustainable growth. The question of whether to
18 use a single-stage or two-stage DCF model along with numerous other issues,
19 many of which have been raised by Dr. Morin, were discussed in great detail
20 in the Generic Finance Proceeding and a consensus methodology was agreed
21 upon. After considering other methods, Dr. Stewart Myers of MIT concluded
22 the following:

23 Dr. Myers concluded that if dividend growth is expected to vary
24 in the future, rather than remain constant, then the simplifying
25 assumption that underlies the constant growth DCF model does
26 not work. Hence, the single stage DCF model overestimates the

1 cost of equity if immediate and near term growth is temporarily
2 high, and underestimates the cost of equity if immediate and
3 near term growth is temporarily low.

4 * * *

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6
7 The Myers Report concluded that for companies that have not
8 settled into steady state, there is no general rule for choosing
9 the most accurate growth rate forecasting method. He did note,
10 however, that the use of a two-stage DCF, or even a long form
11 variable growth dividend discounting model could do a better job
12 of capturing this type of situation than a single-stage model.
13 Therefore, errors in estimated investors' forecasts of future
14 growth are inevitable, and will occur even if all the DCF
15 method's assumptions are satisfied.

16
17 (Return on Equity Consensus Document, issued June 2, 1993,
18 Appendix A at 3, 4.)
19

20 Overall, all of Dr. Morin's DCF estimates are overstated and should be
21 rejected.

22
23 Q. Please comment further on Dr. Morin's DCF approach.

24 A. I have previously discussed in detail the problems with the formation of the
25 proxy groups used by Dr. Morin to estimate its cost equity. His first proxy
26 group comprised of natural gas distribution companies should not be relied
27 upon as Niagara Mohawk is a combination gas and electric company and as
28 decided in the Generic Finance Case a natural gas distribution proxy group
29 should be used only for pure natural gas distribution companies. His second
30 AUS Utility Reports based proxy group has numerous problems including five

1 utilities that are rated below investment grade violating his own selection
2 criteria. In applying the DCF method, Dr. Morin enhances the problem by
3 arbitrarily dropping companies from the proxy group. He starts his DCF
4 analysis on the AUS Utility Reports based proxy group with 24 companies.
5 While estimating the DCF return using the Value Line earnings growth Dr.
6 Morin drops Northeast Utilities from the proxy group results because its growth
7 rate is unsustainable. While using Zack's forecast of growth, he drops Public
8 Service Enterprise Group instead of Northeast Utilities from the proxy group
9 because of unsustainable growth projections along with three more
10 companies, CH Energy Group, Empire District Electric and MGE Energy East
11 because of the unavailability of growth projections.

12 Dr. Morin's four DCF estimates are based on proxy groups of different
13 sizes and composed of different companies. In some cases, he drops
14 companies based on unsustainable growth rates only to include them in
15 another proxy group. In setting up his proxy groups, he used the availability of
16 Value Line data as one of the criteria for inclusion. However, in his analysis
17 using the Zack's based growth rates; he drops companies that have Value
18 Line data. In sum, it appears that Dr. Morin's analysis is result driven rather
19 than based on a logical criteria applied uniformly throughout the analysis.

20
21 Q. Please comment on Dr. Morin's flotation cost allowance.

1 A. Dr. Morin has added 20 and 30 basis points flotation cost adjustment to his
2 four DCF equity cost estimates and 30 basis points to his two CAPM and two
3 Risk Premium equity cost estimates. There are two problems with this
4 approach. First, there is no reason why Dr. Morin computes two different
5 amounts for issuance costs, i.e., 20 and 30 basis points added to the DCF
6 estimates and 30 basis points added to the CAPM estimates. Second,
7 issuance costs should be permitted when they are incurred based on the
8 amount of issuance and not on an on-going basis. As mentioned earlier in my
9 testimony, the Commission's policy is to disallow adjustments for issuance
10 related costs when no issuance is planned by the Company. Since no
11 issuance is planned by the Company, I recommend that the Commission not
12 allow a flotation cost adjustment proposed by Dr. Morin.

13 Q. Please briefly describe Dr. Morin's CAPM analysis.

14 A. Dr. Morin estimates two sets of equity returns based on the traditional and
15 zero-beta CAPM approaches. For risk premium, he uses 7.4% as an average
16 of an Ibbotson Associates based calculation and a DCF analysis applied to the
17 aggregate equity market using Value Line data. For the risk free rate, Dr.
18 Morin uses the U.S. Treasury 30-year bond yield of 4.5% for February 2008.
19 Finally, for beta he uses .88, the average of the two proxy groups that he has
20 utilized for his DCF analysis. Based on these inputs, Dr. Morin computes a
21

1 traditional CAPM of 11.0% and an empirical or Zero-Beta CAPM of 11.3%. He
2 adds 30 basis points for flotation to these estimates to arrive at final estimates
3 of 11.3% and 11.5% for the traditional and zero-beta CAPM with an average
4 CAPM estimate of 11.4%.

5
6 Q. Do you agree with Dr. Morin's CAPM analysis?

7 A. No. Dr. Morin's risk premium of 7.4% is the average of a 7.1% Ibbotson
8 Associates and a 7.7% DCF derived risk premium. His first risk premium of
9 7.1% is taken from the Ibbotson Associates study, Stocks, Bonds, Bills and
10 Inflation, 2007 Yearbook, and is based on the spread between common stock
11 returns and the income component of returns on long-term government bonds.
12 Since risk premium is the difference between market return and the risk free
13 rate, Dr. Morin's assumed market return is 11.6% based on the risk free rate of
14 4.5% he used in his CAPM analysis. Although I do not agree with the use of
15 Ibbotson Associates study, the Company's assumed estimate of market return
16 to derive the risk premium is not very different from the 11.7% market return
17 reported by Merrill Lynch in its October 5, 2008 issue of Quantitative Profiles –
18 Monthly Insight for Equity Management.

19 I recommend that even though the risk premium derived from the
20 Ibbotson Associates study is relatively close to the market risk premium based
21 on the Merrill Lynch market return in this instance, that it not be relied upon.

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The Commission in Case 95-G-1034, Central Hudson Gas & Electric Corporation, said the following:

...the Judge's market return calculation based on Merrill Lynch estimate is a reasonable method of deriving a risk premium; and it avoids the problems of stale data in the Ibbotson estimate, or the circularity of the implied risk premium approach in relying on other commissions' return allowances (Opinion No. 96-28, October 3, 1996, p. 14)

Second, Dr. Morin estimates a risk premium of 7.7% based on a DCF analysis applied to the aggregate equity market using Value Line aggregate stock market index and growth forecasts. The assumed market return underlying Dr. Morin's 7.7% risk premium derivation is unrealistic. Given a risk premium of 7.7% and a risk free rate of 4.5%, the underlying market return assumed by Dr. Morin is 12.2%. As stated above, the market return reported by Merrill Lynch for 1,164 firms as reported in its October 5, 2008, issue of Quantitative Profiles – Monthly Insight for Equity Management is 11.7%. Merrill Lynch's estimate of implied market return for the S&P 500 is also 11.7%. In other words, Dr. Morin's estimate of market return of 12.2% is 50 basis points higher than the estimate of 11.7% provided by Merrill Lynch. The inputs to the CAPM formula are clearly excessive resulting in equity returns that are also excessive and unrealistic.

1 Q. Are there other flaws in Dr. Morin's CAPM analysis?

2 A. Yes. Dr. Morin has not used the approach recommended in the Generic
3 Finance Case and relied upon by the Commission for computing the risk free
4 rate. The Generic Finance Case recommended an average of 10-year and
5 30-year Treasury bond yields over a six-month period as the basis for
6 computing the risk-free rate. Dr. Morin used only the 30-year Treasury bond
7 yield over a single month (February 2008) as the basis of his risk free rate.
8 Although the risk free rate of 4.5% used by Dr. Morin is almost same as my
9 six-month estimate of 30-year bond yield (4.51%), ignoring the 10-year bond
10 yield of 3.88% instead of averaging the two estimates, as recommended in the
11 Generic Finance Case, leads to an inflated estimate of the risk free rate. The
12 average of the 10-year and 30-year Treasury bond yields over the most recent
13 six-month period as I discuss earlier in my testimony is 4.19%. Dr. Morin's
14 estimate relying solely on the 30-year bond yield is 31 basis points higher. I
15 recommend that the Commission reject his sole reliance on the 30-year bond
16 yield.

17
18 Q. Please comment on the Risk Premium approach used by Dr. Morin.

19 A. The Commission has repeatedly rejected the use of the Risk Premium
20 approach as used by Dr. Morin. In Cases 94-G-0885 and 93-G-0765, the
21 Commission referenced the Recommended Decision and rejected the risk

1 premium approach:

2 ... the Judge rejected two additional methods: the company's
3 risk premium approach (whose results he deemed too volatile),
4 and comparable earnings (presented by staff because it was
5 included in the generic finance case consensus proposal).

6
7 Opinion No. 95-16, National Fuel Gas Distribution Corporation,
8 issued September 15, 1995, page 44.

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11 More recently, in Case 05-E-1222, the Recommended Decision that

12 was adopted by the Commission said the following:

13 To begin, we find that, to the extent that the Company had
14 departed from the generally accepted approach produced by the
15 Generic Finance Case, it has not advanced the consideration of
16 such matters in this proceeding. We recommend that very little
17 weight, if any, be given to NYSEG's risk premium analyses and
18 comparable earnings analysis that clearly depart from the
19 Generic Financing Case approach. We also recommend that the
20 Commission continue to use the DCF and CAPM methods as its
21 principal means to determine the allowed equity returns for the
22 utility companies it regulates.

23
24 (Recommended Decision at 62, 63.)

25

26 Q. Does this conclude your testimony?

27 A. Yes.