

Northern States Power Company  
Electric Utility – State of North Dakota  
Case No. PU-12-813

**State of New York Public Service Commission Orders  
Demonstrating Use of Sustainable Growth Models**

Overview

During cross examination by Mr. Norrell, Ms. Bulkley was asked to provide NYPSC orders placing an emphasis on sustainable growth models, to support her pre-filed testimony at page 50 concerning Mr. King and a recent proceeding in New York. Reference was made to New York using a sustainable growth (two-growth) model. A generic finance proceeding from the 1990s and more recent material was requested.

Documents Provided

Attached are three relevant excerpts pertaining to 3 cases. Only a small portion of the full documents are applicable to the use of a two-growth model and are not produced in their entirety due to volume. A description of each excerpt and information for locating the full documents are provided in the following.

- 1) The NYPSC conducted a proceeding to Consider Financial Regulatory Policies for New York State Utilities (CASE 91-M-0509) commonly known as the “Generic Financing Proceeding” initiated by Commission Order issued August 21, 1991. On July 19, 1994, the ALJs Deixler and Ansaldo issued their recommended decision that a 2-stage DCF model be included in the cost of equity calculation.

*Excerpts from LexisNexis search included. Note: The Docket proceeding is recognized by the NYPSC web site but documents are not available that far back. A copy of the approximately 60 page order can be provided at request.*

- 2) The NYPSC’s January 24, 2011 Order Establishing Rates for Electric Service in Case 10-E-0050 (for Niagara Mohawk Power Corporation Electric) identifies the two-stage growth analysis “....is the customary and ordinary practice ...”

and finds no reason to depart from this approach. *(Document link below; Topic addressed in pages 71-77 with conclusion discussed at page 76/77.)*

<http://documents.dps.ny.gov/public/MatterManagement/CaseMaster.aspx?MatterCaseNo=10-E-0050&submit=Search+by+Case+Number>

- 3) The NYPSC's June 17, 2011 Order Establishing Rates for Electric Service in Case 10-E-0362 upheld staff's recommendation regarding use of two-stage DCF method.

*(Document link below; continued use of Two-growth as part of standard approach confirmed at pages 64.)*

<http://documents.dps.ny.gov/public/Common/ViewDoc.aspx?DocRefId={41BF8CB8-0553-4E28-BACF-582977C88AD3}>



35 of 47 DOCUMENTS

Proceeding on Motion of the Commission to Consider Financial Regulatory Policies for  
New York State Utilities

CASE 91-M-0509

New York Public Service Commission

*1994 N.Y. PUC LEXIS 141*

July 19, 1994, Issued

**DISPOSITION:** [\*1] NOTICE OF SCHEDULE FOR FILING EXCEPTIONS

**OPINION:** Attached is the recommended decision of Janet Hand Deixler and Richard Ansaldo, Co-Facilitators in this proceeding, together with a copy of the Commission's rules governing the procedures to be followed. Briefs on exceptions will be due September 2, 1994 and briefs opposing exceptions will be due October 3, 1994.

JANET HAND DEIXLER and RICHARD ANSALDO, Co-Facilitators. n1

n1 Ms. Deixler was an Administrative Law Judge for most of the period during which this case was pending. Mr. Ansaldo, Chief of the Utility Finance Section of the Office of Accounting and Finance, presided together with Ms. Deixler because of the subject matter of the case.

PROCEDURAL HISTORY

Origin and Purpose of the Proceeding

This proceeding, which has become commonly known as the Generic Financing Proceeding, was initiated by Commission order (the Instituting Order) issued August 21, 1991. n2 In that Order, the Commission reviewed the history and development of its existing policies on financial [\*2] matters. Among the factors cited by the Commission as warranting a new investigation into financial policies affecting ratemaking were:

- . Assertions by intervenor groups that support of utility credit ratings no longer benefits ratepayers because utilities have ceased raising large amounts of capital for construction;
- . Questions about the relevance of policies developed for electric companies to gas, telephone, and water companies;
- . Questions about the relationship to the Commission's ratemaking policies of a utility's non-utility subsidiaries and its capitalization policy for subsidiaries;
- . The need to examine the proper regulatory responses to bond rating reductions that result from the

. . . designed to provide returns such that the utility has a reasonable opportunity and desire to achieve at least an A rating. Utilities striving to achieve or retain a higher rating should not be discouraged by any kind of regulatory penalty or disincentive for reaching a rating in the AA range, but neither should such a utility be given additional revenues through the regulatory process for such action. n2

n2 Telecom Proposal, May 18, 1993, pp. 44-45.

#### Electric/Gas Group

The proposal by the Electric/Gas group (the Electric/Gas proposal) n3 represents a less radical, but still substantial, departure from current Commission practice. It retains reliance on each individual utility's own capital structure and (with the exception of common equity) its own cost rates.

n3 References to the Electric/Gas proposal include the Water Group proposal.

[\*15]

#### 1. Generic Cost of Equity

The Electric/Gas proposal determines the generic cost of equity by averaging the results of three cost of equity calculations applied to a proxy group of companies. The three methods, which receive equal weight, are a DCF calculation, a CAPM calculation and a comparable earnings computation:

1. DCF Method: The proponents have adopted a two-stage DCF calculation. The first stage growth rate is the dividend stream implied by a comparison of the first-year dividends forecast by Value Line with the dividend projected by Value Line for three to five years into the future. The second stage growth rate is also derived from Value Line projections, picking up from the end of the three-to-five year period in the first stage and going out infinitely. The second stage growth rate includes an SV adjustment for external growth. This DCF calculation, which will be done semi-annually, does not contain an ex-dividend adjustment.

2. CAPM Method: The CAPM method recommended in the Electric/Gas proposal computes an average of four results produced by applying two different CAPM approaches (traditional and zero-beta) to two different proxy groups. These [\*16] four results together provide one input to the generic cost of equity calculation.

3. Comparable Earnings Method: The comparable group utilized in this portion of the proposal excludes gas and electric utilities, foreign companies not listed on a United States stock market, and financial services or banking institutions. It includes others with betas in a range of plus or minus 0.10 around the average five-year historical beta (rounded to the nearest 0.05) for the utility proxy groups used for the DCF and CAPM calculations.

The cost of equity would be calculated using these methods twice a year (to be effective each January 1 and July 1), and would be applied, after updating from the effective date of the calculation to the actual date it is applied, to each

1994 N.Y. PUC LEXIS 141, \*16

company whose new rates become effective in the ensuing period. The proponents (except for Consolidated Edison) propose that, since the proxy group companies, on average, have senior debt securities rated "A", the calculated proxy group results would be adjusted for rating variations from an "A" rating. A debt downgrading due primarily to unregulated operations would be ignored when making this adjustment.

The Electric/Gas [\*17] proposal also includes a proposed method to adjust for multi-year agreements. Essentially, this proposal includes no traditional "stayout" adjustment, but would adjust the return on equity upward by a proportion of the increase in the cost of equity in any year where such increase occurs. The proportion depends upon whether the multi-year agreement contemplates a rate freeze or rates that change in each year of the agreement. For example, a rate freeze plan would include a stayout adjustment of 0.2% for two years, or 0.5% for five years. A multi-year rate plan that allowed for revenue requirement updates would include no stayout adjustment, but would allow for a partial upward update of the return. Updates to the return would be allowed if the indicated return increased, but only up to the amount that would have been provided by a stayout adjustment plus 50% of any excess above that stayout adjustment.

## 2. Financial Integrity Proposal

The Electric/Gas Group developed a formal proposal, submitted on May 4, 1993, concerning financial integrity matters, and all of the parties, including those who oppose the rate of return proposal, joined in its support. The financial integrity document [\*18] was signed by the utilities, staff, CPB, PULPNY, Multiple Intervenors, and IPPNY. Essentially, the parties concluded that an "A" bond rating (applied to the primary type of debt security issued by the utility) remains an appropriate target. The conclusion was reached despite the finding that a "BBB" range rating was marginally less costly to ratepayers, because of the parties' concern that a target-range of "BBB" left the utilities and their ratepayers too exposed to the potential for a slip from investment grade with its associated costs.

The proposal included two noteworthy principles:

- . Utilities with bond ratings above the "A" target should demonstrate periodically that those higher bond ratings are not inconsistent with the public interest.
- . Utilities with bond ratings below "A" must take steps on their own to improve their financial position by increasing their equity ratios Or by other means (such as cost control), giving due regard to short-term rate impacts. (A suggested gauge for acceptable short-term rate impacts was a level of rate increases at or below the general rate of inflation.)

## Proposed Alternatives

### 1. Multiple Intervenors

Multiple Intervenors' [\*19] comments and proposals were limited to the Electric/Gas proposal. It would prefer to continue to determine rate of return in individual company rate proceedings. However, Multiple Intervenors would not object to a consolidated annual rate of return proceeding in which all returns were determined. It contends that many of the advantages of the procedures set forth by the proponents (i.e., resource savings and consistency) would be realized with a consolidated rate of return proceeding. If such a procedure were to be adopted, Multiple Intervenors would have it conducted as follows:

- . There should be an annual rate of return determination for all utilities, along the lines of a procedure followed in California.
- . No pre-determined rate of return formula should be adopted, but the Commission should be guided by its own preferred conventions.

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

At a session of the Public Service  
Commission held in the City of  
Albany on January 20, 2011

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman  
Patricia L. Acampora  
Maureen F. Harris  
Robert E. Curry, Jr.  
James L. Larocca

CASE 10-E-0050 - Proceeding on Motion of the Commission as to  
the Rates, Charges, Rules and Regulations of  
Niagara Mohawk Power Corporation for Electric  
Service.

CASE 08-E-0827 - Comprehensive Management Audit of Niagara  
Mohawk Power Corporation d/b/a National Grid's  
Electric Business.

ORDER ESTABLISHING RATES FOR ELECTRIC SERVICE  
(Issued and Effective January 24, 2011)

CASE 10-E-0050

integrated operations and combined finances, we have authorized a 48% equity position for ratemaking purposes and we have not exceeded this level for any such company. Were we to go beyond this level for Niagara Mohawk, we would add to ratepayer costs about \$10 million without obtaining any greater strength or confidence in the Company's financial metrics. Without an incremental advantage accompanying a movement from a 48% to a 50% equity position, we are not inclined to add to ratepayers' costs. Consequently, we do not find a sufficient basis here to exceed for Niagara Mohawk the 48% equity positions we have previously established for similarly rated companies such as Consolidated Edison and Central Hudson. To this extent, the Staff and MI exceptions are granted and the Judges' recommendation is modified.

Rate of Return on Equity

The Judges recommend a 9.3% equity return for Niagara Mohawk. Their recommendation is 155 basis points less than that proposed by the Company's financial expert and 30-60 basis points more than the amounts proposed by Staff, CPB and MI.

Niagara Mohawk insists that the allowed return should be commensurate with the returns that comparable enterprises receive for incurring corresponding risks.<sup>29</sup> For its evidence of commensurate returns for comparable enterprises with corresponding risks, the Company turns to state regulatory

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<sup>29</sup> Niagara Mohawk asserts that the ROE recommended by the Judges would not satisfy the constitutional requirement of *Hope Natural Gas v. Federal Power Commission*, 320 U.S. 591 (1944). This argument is misplaced. *Hope*, as reaffirmed in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), makes clear that only the end result, not any particular formula or component of the rate-making process, is relevant to any question of regulatory taking. The end result of this order reflects a balancing of ratepayer and investor interests. See also, *Abrams v. Public Service Commission*, 67 NY 2d 205 (1986).

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actions throughout the nation and points to allowed returns exceeding those in New York for electric and gas companies that are, broadly speaking, similar to the companies we regulate.

Niagara Mohawk's analysis shows, during calendar year 2010, the allowed equity returns in New York were between 75 and 107 basis points lower than those in other states. Niagara Mohawk does not believe that its business and financial risks are the least risky of all the electric and gas utilities in the nation.

Turning from the allowed equity returns in other states to the equity returns we have allowed other electric and gas utility companies in New York, Niagara Mohawk claims that the Judges' 9.3% recommendation is not comparable to the equity returns recently provided to NYSEG and RG&E (9.6% and 9.55% excluding stayout premiums, but after incentive adders, respectively) or the equity return provided to Consolidated Edison in March 2010 (which Niagara Mohawk believes suggests a 9.85% return for it after adjusting out a stay-out premium that does not pertain here). If Niagara Mohawk's allowed return is set at 9.3%, the Company believes its ability to attract capital and maintain its current credit rating are in jeopardy.

On exceptions, Staff asserts that the Judges 9.3% recommendation is not supported by the well-established approach the Commission has consistently used to set utility companies' allowed equity returns. Staff asserts that setting Niagara Mohawk's allowed return is not as simple a matter as suggested by the Judges efforts that sought to adjust the recent results had for Consolidated Edison. Adhering to the established methodology produces either the 9.0% return that the parties (other than the Company) supported on the record or a 8.7% allowed equity return if we were to update the methodology of record with the most recent financial data that became available

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after the close of the record. Staff insists that we should adhere to the established method and we should continue to recognize that the equity return allowance can change over time, as has occurred since the time Consolidated Edison's allowed return was set using the joint proposal for the multi-year rate plan that reached us for action in September 2010. In support of the lower indicated equity return for Niagara Mohawk, Staff points to the drop in Treasury interest rates in 2010 that explains much of the difference between the results for Consolidated Edison and those for Niagara Mohawk.

Like Staff, Multiple Intervenors excepts to the Judges' departure from the conventional methods that are used to calculate the allowed equity return. Inasmuch as the Judges' 9.3% equity recommendation is not tied to any specific elements of the established methodologies, MI believes their approach requires greater clarity than was provided in the recommended decision. Also, to the extent the Judges may have "copied and tweaked" the allowed equity return recently had for Consolidated Edison, RG&E and NYSEG, Multiple Intervenors states that Niagara Mohawk's allowed equity return should not be based on decisions made for other utility companies.

According to MI, Niagara Mohawk's circumstances differ from the other utility companies' in many important ways. Also, it does not believe that cases involving joint proposals and multi-year rate plans are comparable to those that are litigated and provide results for only one year. Further, MI points out that the timing of this case does not coincide with the timing of the other rate proceedings and significant financial data changed in the intervening months.

CPB asserts that two errors are manifest in the Judges' recommendation. The first relates to the timing differences between the rate cases involving multi-year rate

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plans and those processed as traditional rate cases. The second pertains to prevailing market uncertainty and fluctuations that have a significant impact on the methodologies used to calculate the allowed equity return.

According to CPB, the Judges should have focused on the changes in stock prices, interest rates, dividend yields and growth rates at the time of their recommended decision. Had they done so, they would have properly applied the established methods for calculating the allowed equity return. By focusing on the Commission results from September 2010, they did not capture the market indicators for November 2010. Instead, they perpetuated the use of market data from July 2010 and they did not take into account credit quality differences among the various utility companies. Given the substantial timing differences in the various utility companies' rate cases, CPB asserts that the Judges' recommendation is not useful.

We, like the Judges assigned to this case, recognize the value of the consistent application of our conventional approach in setting the allowed return on equity for the utilities under our jurisdiction. The same approach was used to render all of our rate of return determinations in 2010 and it is detailed in Staff's testimony. In this case, to Niagara Mohawk's advantage, we are not updating the Staff methodology with the post-record financial data. Also, as explained below, we reject Staff's proposed adjustment to the allowed equity return related to the adoption of a revenue decoupling mechanism in this case. Thus, we are adopting a 9.1% allowed equity return for a single-year case, or 9.3% with an additional stay-out year.

In addition to addressing the Judges' overall recommendation for Niagara Mohawk, the Company has raised five technical points on which it differs with Staff and CPB. These

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issues pertain to the specific methods used to calculate the allowed equity return.

1. DCF Long-Term Growth Factors

The Discounted Cash Flow (DCF) analysis used by Staff and CPB to estimate the cost of equity capital employs a two-stage growth factor. The first stage relies on a forecast of dividend growth and the second employs an analysis of sustainable growth. This approach has long been used and it has become a standard feature of the DCF methodology we employ. Niagara Mohawk proposes instead that we use a single growth rate derived from a consensus of financial analysts' forecasts of earnings growth. Specifically, the Company proposes that we use the 5.3% mid-point between Value Line's 4.8% long-term forecast of earnings growth and Zack's 5.7% growth forecast.<sup>30</sup>

According to the Company, 5.3% growth is sustainable and consistent with 5.5% nominal growth expected in the Gross Domestic Product and the GDP growth projections provided by the Congressional Budget Office and the Office of Management and Budget. Niagara Mohawk does not believe that growth in the GDP will exceed growth in the electric utility industry by 50 to 100 basis points and, for this reason, considers the Staff and CPB growth estimates to be too low. It also believes that the Staff and CPB growth estimates are too low because the first stage of their analysis, the Value Line forecasts of dividend growth, does not account for declining utility payout ratios. The Company states that investors are expecting growth from all earnings that are not paid out, however, the analyses provided by Staff and CPB do not include this source of growth.

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<sup>30</sup> In contrast, Staff's and CPB's two-stage DCF methods produce median growth rates of 3.38% (for the first stage) and 4.46% (for the second stage).

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In response, Staff states that a constant growth model assumes identical growth rates in earnings and dividends. However, when the two deviate, a two-growth model is needed to accurately reflect investors' expectations. Staff denies that it has understated the cost of equity and ignored a decline of dividend payout ratios in the electric utility industry. It states that when dividend payouts are decreasing and short-run dividend growth is declining, Staff's long-run sustainable growth factor is higher than it would otherwise be if dividend growth had not declined. Thus, declining dividend payouts are not ignored. Further, Staff states that this matter was raised previously in a Consolidated Edison rate proceeding and the Company's position was rejected there.

Staff also responds to the Company's assertion that its 3.38% short-term growth rate and its 4.46% long-term sustainable growth rate are too low. According to Staff, the Company's 5.5% GDP nominal growth lacks support and Staff disagrees that the GDP has any link to expected dividend growth rates. Staff insists that its 4.46% sustainable growth rate is consistent with the nominal GDP growth rate forecast when Staff filed its testimony and it remains consistent with more recent long-term forecasts.

We have considered Niagara Mohawk's request to depart from the two-stage growth factor analysis that is the customary and ordinary practice in our rate proceedings and the Company's request for a higher, long-run growth factor. We find no reason to depart from a two-stage growth model which provides us flexibility to consider both near-term growth factors and the sustainable, long-term growth when there are differences in the two.

Concerning the Company's claim that the Staff and CPB long-term, sustainable growth rates are too low, we find that

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the 4.5% growth rate they employed is closer to the Blue Chip GDP estimate running to 2022 than is the 5.5% growth estimate provided by the Company's witness. We are satisfied that the approach that has been used by Staff and CPB here, and has been consistently used in numerous previous rate proceedings, is entirely acceptable and no good basis exists for eliminating its use or to shift to a one-stage growth model of the kind suggested by Niagara Mohawk.

2. DCF Proxy Group Results - Mean vs. Median

Niagara Mohawk requests that we rule on whether the mean or median of the proxy group DCF results should be used to determine the DCF-derived cost of equity. The Company does not believe that this matter has been previously addressed by the Commission. According to it, the mean, rather than the median, should be used. The Company states that when there is a difference between the two it indicates that the distribution of observations in the sample is skewed. In such circumstances, according to the Company, the median incorrectly treats a number of observations as outliers when, in fact, they are representative of the sample as a whole. Thus, it supports the use of the mean.

Staff states that the mean only provides accurate results when data are clustered in a normal distribution. Since its proxy group results did not fall into a normal distribution, Staff argues the median is better suited. Further, Staff states that the median has been consistently used in all recent rate proceedings.

The difference between the Company and Staff involves the consideration to be given to the sample outliers when observations and data are not normally distributed. Niagara Mohawk suggests that the outliers not be automatically excluded and instead receive consideration unless they are specifically

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

At a session of the Public Service  
Commission held in the City of  
Albany on June 16, 2011

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman  
Patricia L. Acampora  
Maureen F. Harris  
James L. Larocca

CASE 10-E-0362 - Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of Orange  
and Rockland Utilities, Inc. for Electric  
Service.

ORDER ESTABLISHING RATES FOR ELECTRIC SERVICE  
(Issued and Effective June 17, 2011)

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STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

At a session of the Public Service  
Commission held in the City of  
Albany on June 16, 2011

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman  
Patricia L. Acampora  
Maureen F. Harris  
James L. Larocca

CASE 10-E-0362 - Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of Orange  
and Rockland Utilities, Inc. for Electric  
Service.

ORDER ESTABLISHING RATES FOR ELECTRIC SERVICE

(Issued and Effective June 17, 2011)

BY THE COMMISSION:

I. INTRODUCTION

On July 30, 2010, Orange and Rockland Utilities, Inc. (O&R or the Company) filed rates that would increase the Company's electric delivery revenues by \$61.7 million, effective July 1, 2011.<sup>1</sup> The increase would be offset by the expiration of temporary surcharges -- the Energy Cost Adjustment and the interim Revenue Decoupling Mechanism (RDM) adjustment -- leaving a net bill impact of \$47.8 million, which represents a 22% increase in electric delivery rates and an overall increase in electric bills of 7.3%.

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<sup>1</sup> Notice of the Company's filing was published in the New York State Register on February 2, 2011 (SAPA No. 10-E-0362SA1). The comments that were filed pursuant to this Notice are summarized herein.

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The rates proposed by the Company are based on a rate year beginning July 1, 2011, and ending June 30, 2012 (Rate Year). O&R is currently operating under a three-year rate plan, which expires on June 30, 2011 (current Rate Plan).<sup>2</sup>

After considering the parties' positions on exceptions, we determine that the Company's electric delivery base rate revenues should increase by \$26.587 million, which represents an increase of approximately 12.1% for electric delivery base rates. The revenue requirement increase, reflected in Appendix A, however, is mitigated, as discussed above, by the elimination of the surcharges, which reduces the overall bill impact of the base delivery rate increase. The elimination of these surcharges produces a net revenue impact of \$12.477 million, which represents a bill increase of about 5.7% for electric delivery, and 1.9% for total electric bills.<sup>3</sup>

A. Background

The parties in this case are the Company, Department of Public Service Staff (Staff), and intervenors: the Utility Intervention Unit (UIU) of the New York State Department of State's Division of Consumer Protection, formerly the New York State Consumer Protection Board; the Town of Ramapo (Town or

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<sup>2</sup> Case 07-E-0949, Orange and Rockland Utilities, Inc. - Electric Rates, Order Establishing Electric Rate Plan for Orange and Rockland Utilities, Inc. (issued July 23, 2008) (2008 O&R Rate Order).

<sup>3</sup> Bill impact tables are attached as Appendix B.

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1. Cost of Equity

In recent rate cases, we have repeatedly affirmed certain key elements of the methodology we use in determining the appropriate cost of equity to be included in rates. These include (1) the application of Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) analyses to a representative proxy group of utility companies; (2) utilization of a two-stage DCF computation with inputs derived from *Value Line*; (3) basing the CAPM result on an average of the outcome from standard and zero-beta models with a risk-free rate based on Treasury bonds, market risk premium provided by Merrill Lynch's *Quantitative Profiles*, and betas taken from *Value Line*; and (4) a 2/3 - 1/3 weighting of the DCF and CAPM results, respectively. We agree with the RD that no convincing demonstration has been made in this case that something about this particular utility or these particular economic times is sufficiently unique to require us to modify any of these basic aspects of our model. There are, however, a number of issues concerning the application of the methodology, which we address below.<sup>34</sup>

a. Proxy Group and Credit Quality Adjustment

Staff proposed an adjustment to its calculated ROE to reflect the difference between the average "Baa" credit rating of its proxy group and O&R's higher "A" rating. It derived the adjustment by applying the percentage difference in the five-year average spreads between "A" and "Baa" rated utility bonds with balances over \$100 million and maturities around 30 years to the median proxy group ROE. The result was a 2.7% discount

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<sup>34</sup> We note that the RD included several additional concerns the judges had about the methodology we use for calculating the ROE allowed in rates. We agree with Staff that this discussion was purely *dictum* and need not be addressed in resolving the litigated issues in this case.