

BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

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Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service	Case 09-E-0715
Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Gas Service	Case 09-G-0716
Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Electric Service	Case 09-E-0717
Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Gas Service	Case 09-G-0718

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**REBUTTAL TESTIMONY OF
JOHN J. REED**

February 12, 2010

REBUTTAL TESTIMONY OF JOHN J. REED

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EXHIBIT __ (JJRR-1): Résumé of John J. Reed

EXHIBIT __ (JJRR-2): Testimony Listing of John J. Reed

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I. INTRODUCTION

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Q. Please state your name, business address, and current employment position.

A. My name is John J. Reed, and I am Chairman and Chief Executive Officer of Concentric Energy Advisors, Inc. and CE Capital Advisors, Inc. (together “Concentric”). My business address is 293 Boston Post Road West, Suite 500, Marlborough, MA 01752.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of Rochester Gas and Electric Corporation and New York State Electric & Gas Corporation (“RG&E”, “NYSEG”, or collectively, the “Companies”).

Q. Please describe your experience in the energy and utility industries.

A. I have more than 30 years of experience in the energy industry, and have worked as an executive in, and consultant to, the energy industry for the past 25 years. Over the past decade, I have directed the financial advisory services of Concentric, Navigant Consulting and Reed Consulting Group, and I have been involved in the purchase or sale of more than \$20 billion of energy assets. I have served as Vice Chairman and Co-CEO of the nation’s largest publicly traded consulting firm and as Chief Economist for the nation’s largest gas utility. My

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1 background is presented in more detail in Exhibit __ (JJRR-1) and Exhibit
2 __ (JJRR-2).

3 **Q. Have you previously provided expert testimony in regulatory or civil**
4 **proceedings?**

5 A. Yes, I have provided expert testimony on more than 150 occasions over the past
6 30 years before regulatory agencies and in courts across North America. My
7 testimony has covered virtually every aspect of the ratemaking process, including
8 regulatory policy, return on and of capital, prudence and rate design.

9 **Q. Please describe Concentric's activities in energy and utility engagements.**

10 A. Concentric provides financial and economic advisory services to a large number
11 of energy and utility clients across North America. Our financial advisory
12 activities include merger, acquisition and divestiture assignments, due diligence
13 and valuation assignments, project and corporate finance services, and transaction
14 support services. Our regulatory economic and market analysis services include
15 utility ratemaking and regulatory advisory services, energy market assessments,
16 market entry and exit analysis, and energy contract negotiations.

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1 **Q. What is the purpose of your testimony in this proceeding?**

2 A. The purpose of my testimony is to respond to the Department of Public Service
3 Staff's ("Staff") recommendation in the area of depreciation policy. Specifically,
4 in the sections that follow, I will discuss:

- 5 • Staff's recommendation, as outlined in the Staff Policy Panel testimony, that
6 the excess theoretical depreciation reserve be amortized through a reduction in
7 customer rates over a 10 year period. This policy represents a significant
8 change from traditional ratemaking methodology and, taken together with
9 Staff's depreciation expense recommendations, would have a strong negative
10 impact on the financial health of the Companies.
- 11 • Staff's recommendation is at odds with the "matching" principle
12 (intergeneration equity) and will cause future ratepayers to pay an unfairly
13 large portion of the costs of plant and equipment that serve those customers.
- 14 • The negative impact that Staff's proposed excess depreciation reserve
15 amortization policy may have on the Companies' ability to access capital
16 markets going forward on reasonable terms.
- 17 • The Companies' growing capital spending requirements, driven by regulatory
18 requirements, aging infrastructure replacement, and new technologies and
19 how internal cash flow generation is important to financing a portion of these
20 requirements.

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1 **Q. How is your rebuttal testimony organized?**

2 A. After presenting a brief summary of my conclusions, I review the regulatory
3 principles and policies that relate to depreciation expense and the level of the
4 depreciation reserve and how the financial community relies on these policies. I
5 then review the importance of cash flow to support capital expenditures within the
6 utility industry. That is followed by an overview of Staff's recommendations in
7 this case regarding depreciation expense and the amortization of the theoretical
8 depreciation reserve surplus, and how those recommendations compare to the
9 regulatory principles and investor expectations that I discuss earlier.

10 **II. SUMMARY OF KEY CONCLUSIONS**

11 **Q. What are your key conclusions?**

12 A. My key conclusions are as follows:

- 13 • A theoretical depreciation reserve variance is not unusual or an indication
14 that customers have historically been overcharged or undercharged.
- 15 • An accelerated amortization of the excess reserve as proposed by Staff
16 violates the matching/intergeneration equity principle and provides an
17 unjustified benefit to current customers while leaving higher costs for
18 future ratepayers. Eventually, the proposed near term lower rates must be
19 reversed to pay for the Companies' invested capital.

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- 1 • The accelerated amortization of the excess reserve removes approximately
2 \$40 million per year in cash flow from the Companies, a large sum for
3 companies this size that could reduce their credit ratings and make the
4 Companies less attractive to investors. This cash flow reduction would be
5 especially difficult considering the Companies’ current financial condition
6 and that fact that they are entering a period of high and accelerating capital
7 expenditures.
- 8 • While Staff discusses reasons why it would be appropriate to improve the
9 credit ratings of NYSEG and RG&E, which are currently the lowest rated
10 companies among New York State energy utilities, Staff’s depreciation
11 proposal goes in the opposite direction, potentially leading to further
12 reductions in bond ratings.
- 13 • Staff’s proposed depreciation and amortization adjustments produce a
14 reduction in cash flow equivalent to reducing the after-tax ROE from the
15 9.80% level proposed by Staff to approximately 7.05% for RG&E and
16 from 9.60% to 7.23% for NYSEG. No rate case that I am aware of
17 anywhere in the U.S. in recent years has authorized ROE levels for electric
18 and/or gas utilities in this range, but that is the effective impact of Staff’s
19 depreciation and amortization proposals from a cash flow perspective.
- 20 • Staff’s stated goal in recommending this depreciation reserve amortization
21 is “rate moderation”, i.e., finding a method to grant no rate increase to the

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1 Companies. This is a clear example of results-oriented ratemaking using
2 novel depreciation and accounting approaches without any apparent
3 concern for the effect of this treatment on the Companies' cash flow,
4 capital needs, or financial position.

5 **III. REGULATORY PRINCIPLES AND POLICIES APPLICABLE TO**
6 **DEPRECIATION RESERVES**

7 **Q. What is a theoretical depreciation reserve variance and how is it created?**

8 A. The theoretical depreciation reserve variance is the difference between the actual
9 depreciation reserve (also known as the actual accumulated provision for
10 depreciation) that has been recorded on the books of the company from the in-
11 service date of its equipment (the "book" reserve) until the present and the
12 "theoretical" depreciation reserve that would have been recorded if the
13 depreciation reserve were recalculated using the depreciation rates in the most
14 recent depreciation study. For example, an "excess" theoretical depreciation
15 reserve is created if the depreciation rates in the most recent depreciation study
16 are lower than those utilized in the past. Conversely, a "deficit" in the theoretical
17 depreciation reserve is created if the depreciation rates in the most recent
18 depreciation study are higher than those utilized in the past.

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1 Company Witness Earl Robinson discusses the theoretical depreciation reserve
2 variance in more detail in his rebuttal testimony.

3 **Q. Is a theoretical depreciation reserve variance unusual?**

4 A. No. Unless a new depreciation study determines that all depreciation rates are
5 exactly the same as those used to compute customer rates in the past, a
6 depreciation reserve variance is created.

7 **Q. Does the existence of a theoretical depreciation reserve variance suggest that**
8 **customers have been overcharged or undercharged in the past?**

9 A. No. The theoretical reserve is merely a snapshot of the reserve based on one point
10 in time. An excess reserve means that customers were previously charged higher
11 depreciation rates for use of an asset than the current depreciation rates would
12 require, but this is not unusual or exceptional. Projected equipment lives change
13 regularly as companies' experience with depreciable equipment, technology
14 factors, maintenance procedures, and other issues provide the ability to use
15 equipment for longer or shorter periods of time. A new depreciation study should
16 capture at least a part of that change, causing depreciation rates to change in the
17 new study over what was used in the past, thus creating a theoretical depreciation
18 variance, either excess or deficit. Customers in the past paid a "fair" depreciation
19 rate based on the depreciation rates accepted at that time, and customers in the

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1 future will pay a fair depreciation rate based on the revised depreciation rates
2 because the equipment now has a different life expectancy.

3 A good example of this occurs when a power plant undergoes a life extension
4 process. The capital expenditures required for the life extension and the net plant
5 balance existing prior to the life extension are depreciated over the new, longer
6 remaining life. That certainly doesn't mean that past ratepayers paid too much, or
7 are entitled to some kind of refund. It simply means that on a going-forward
8 basis, the depreciation rate should be adjusted.

9 **Q. Is the existence of a theoretical depreciation reserve surplus a “bad” thing**
10 **from the perspective of customers or the utility?**

11 A. No. The existence of a theoretical reserve surplus means that the current net book
12 value of the utility's assets (on which a utility earns its rate of return) is below its
13 theoretical economic value, and that the utility's return in the future will be lower.
14 It also means that the utility now expects that it will be able to have more future
15 use of an asset than it originally expected. Certainly, neither of these facts is a
16 “bad” thing from the customer's perspective. The existence of a theoretical
17 reserve surplus can also act as a “shock absorber” for unforeseen future plant
18 retirements, such as from a major ice storm or economic obsolescence. If these
19 events occur, the theoretical reserve surplus will be less in future depreciation
20 studies, and may mitigate the need for future rate increases.

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1 **Q. How is the theoretical depreciation reserve variance traditionally treated for**
2 **rate making purposes?**

3 A. There are two issues: how the variance is treated for rate base purposes and how
4 the variance, either surplus or deficiency, is returned to or recovered from
5 customers. As it relates to rate base, the books and records of the company, and
6 thus the company's rate base, reflect the actual depreciation reserve booked since
7 the in-service date of the company's equipment. If an "excess" theoretical
8 depreciation reserve exists, the company's actual depreciation reserve booked to
9 date is higher than it would be under the new depreciation rates. Therefore,
10 because the actual depreciation reserve is subtracted from gross plant in
11 determining rate base for plant and equipment, the rate base utilized for rate
12 making purposes is lower than it would have been if the theoretical depreciation
13 reserve were utilized in the rate base calculation. This provides an ongoing
14 benefit to current customers due to a lower revenue requirement on rate base.

15 The method of amortization of the variance depends on the depreciation
16 methodology utilized and allowed for rate purposes. For companies that utilize
17 Whole Life depreciation, there is no explicit adjustment for actual book
18 depreciation (Whole Life depreciation is based on gross equipment values, not net
19 values) and thus any reserve variance is not explicitly charged to or recovered
20 from customers in the depreciation calculation. The assumption is that an
21 ongoing cycle of excess and deficit reserve positions will allow the reserve to

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1 move toward zero at the end of the equipment life period. Other companies use
2 Average Remaining Life ("ARL") depreciation. ARL depreciation explicitly
3 includes the actual book depreciation reserve in the calculation of depreciation
4 rates, so that future depreciation rates are adjusted within the ARL methodology
5 to appropriately "recover" any variance over the remaining life of the assets.

6 **Q. Generally, are utility customers better off if depreciation expense is kept as**
7 **low as possible and any theoretical reserve surplus is amortized promptly**
8 **against revenue requirements?**

9 A. No. One of the most important facts to remember about depreciation expense,
10 theoretical reserves and utility ratemaking is how the return *of* capital and the
11 return *on* capital interact. There is one immutable fact in the ratemaking process:
12 the life-cycle present value of what customers pay is neither increased, nor
13 decreased, by the depreciation policies of the regulator. The only exception to
14 this is if the depreciation policies are so out of step with the industry norms that
15 the utility's cost of capital is affected.

16 A regulator may focus on keeping depreciation expense low, believing that this
17 will reduce rates. Over the life of the assets, however, it doesn't. Lower
18 depreciation expense is exactly offset by higher net plant, causing customers to
19 pay higher return and taxes on that net plant, such that on a present value basis,
20 the total cost paid by ratepayers remains the same over the life of any asset.

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1 Depreciation policies affect the timing (or shape) of cost recovery, but not the
2 magnitude of cost recovery. Simply put, it is a matter of paying now, or paying
3 more (in nominal value terms) later.

4 Thus, since the customer base as a whole is financially indifferent to paying now
5 or paying later, it is important to consider other issues that may exist with regard
6 to depreciation policies. These include the “matching” principle and the need to
7 preserve the financial condition of the utility so that it can attract capital on
8 reasonable terms.

9 **Q. How does the “matching” principle or intergenerational equity issue relate to**
10 **a theoretical depreciation reserve variance?**

11 A. Matching or intergeneration equity stands for the principle that customers who
12 “use” an asset should pay for that asset at the time they use it. If, for example,
13 depreciation rates are set lower than appropriate levels on an asset, current
14 customers would pay less than their fair share of that asset’s cost. Consequently,
15 future customers would have to unfairly pay for a larger share of the cost of that
16 equipment through higher depreciation charges. This violates the matching or
17 intergenerational equity issue.

18 As it relates to the depreciation reserve variance issue, if the variance were a
19 result of customers being overcharged or undercharged for the past use of the
20 asset, the matching principle would suggest that the overcharge or undercharge be

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1 corrected quickly (a short amortization period) in order to fairly compensate or
2 charge existing customers. However, as I noted earlier, the existence of the
3 current theoretical depreciation reserve variance is not due to a past overcharge or
4 an undercharge. It is the result of a change in the remaining useful life of
5 equipment due to factors that have occurred since the last depreciation study.
6 Having a longer remaining life for an asset is a benefit to future customers, not a
7 detriment to past customers. Past customers paid rates based on the depreciation
8 expense level that the regulator determined to be just and reasonable at that time,
9 and had a lower level of return built into rates as a result of that depreciation
10 being paid. Current and future customers are rightfully asked to pay rates which
11 include return on and of the remaining capital, as well as the higher operating
12 costs which typically accompany assets at the end of their useful lives.

13 **Q. Do ratemaking practices embrace the matching principle?**

14 A. Yes. The matching principle is a commonly invoked ratemaking practice and has
15 been recognized by the Commission in past rate proceedings. This is an example
16 from a Central Hudson rate case:

17 “Further, intergenerational equity suggests that a return of the
18 mirror CWIP credit should be done sooner rather than later. These
19 funds were collected in the mid-80's, and the longer the funds are

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1 retained, the more likely it is that the ratepayers who originally
2 "loaned" these funds would not benefit from their return."¹

3 New York is not alone in recognizing the matching principle. For example, the
4 Kentucky Public Service Commission applied the matching principle in a
5 ratemaking order for The Union Light, Heat and Power Company ("ULH&P"):

6 "The Commission also finds that ULH&P's proposed accounting
7 deferrals are not appropriate based on the matching principle.
8 ULH&P has failed to explain how deferring the costs for
9 transmission service actually received in 2005 results in a proper
10 match of those costs with the 2005 transmission service that gave
11 rise to those costs."²

12 **Q. The other issue that you cited was the need to preserve the financial**
13 **condition of the utility. Please explain.**

14 A. As Dr. Makhholm explains in his direct testimony in this case, the ratemaking
15 process is built on what is often referred to as the "regulatory compact." This
16 compact recognizes that in order for investors and firms to commit the capital
17 necessary to provide public utility services, the utility must be permitted to charge
18 "just and reasonable" rates, which include a return on the invested capital and the
19 return of the invested capital (through depreciation and amortization, usually).

¹ Case 92-E-1055 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Central Hudson Gas & Electric Corporation for Electric Service, Opinion and Order Determining Revenue Requirement and Rate Design, at 20 (issued Feb. 11, 1994).

² *In the Matter of: Application of the Union Light, Heat and Power Company for Approval of Modifications to Accounting Practices to Establish Regulatory Assets and Liabilities Related to Certain MISO-related Costs and Revenues Not Already Included in Existing Base Rates*; Case No. 2005-00096, Opinion, July 28, 2005.

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1 While neither the return on or of capital is guaranteed, a utility must be provided
2 with a reasonable opportunity to accomplish both. Regulators recognize that
3 since the provision of utility services requires significant amounts of capital, and
4 since ratepayers will be asked to pay rates which include the market's required
5 cost of capital, regulation should help ensure that a utility is able to attract capital
6 on reasonable terms. This requires that the financial condition of the utility be
7 preserved through ratemaking that balances the interests of customers and
8 investors.

9 The financial community carefully monitors the financial condition of utilities,
10 and the ratemaking process to which they are subject. Metrics which investors
11 focus on include future earnings, cash flow, dividends, capital requirements, and
12 leverage.

13 **IV. REGULATORY POLICIES AND THE FINANCIAL MARKETS**

14 **Q. How does the regulatory environment in which a utility operates affect its**
15 **access to and cost of capital?**

16 **A.** The regulatory environment is one of the most, if not the single-most, important
17 factors in the financial community's assessment of a utility's risk. Commission
18 decisions or policy changes can profoundly affect the financial performance of a
19 utility. Rating agencies begin their assessment of the creditworthiness of a utility

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1 by analyzing the regulatory environment in which the utility operates to determine
2 if the regulatory environment is supportive of credit quality. As Companies'
3 Witness Susan Abbott notes, Moody's has stated that it now bases half of a
4 utility's rating on the quality of its regulatory environment. Investors, rating
5 agencies and companies who monitor regulatory bodies will label commissions as
6 "supportive," "not supportive" or something in between as they review the
7 activities of a regulatory commission over time and over a series of rate cases. A
8 commission that is considered by the investment community to be "supportive"
9 will be perceived to have less regulatory risk than other commissions. This will
10 tend to make the raising of capital by companies within that regulatory
11 jurisdiction easier and less costly.

12 **Q. How is regulatory risk currently viewed by the investment community?**

13 A. The regulatory environment and expected outcomes from rate cases are major
14 drivers considered by investment analysts. Deviations from expectations, or even
15 heightened risk of such deviations, can affect investment and ratings outlooks.

16 In a March, 2009 report, Credit Suisse Equity Research stated:

17 "We often hear (and have been known to share) the worry about
18 how to get excited about the Regulated Utilities since in a tough
19 economy/environment, the regulators will inevitably look to share

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1 the broad economic pain facing customers by leaning on Regulated
2 Utility returns, etc. We think that this is a well placed fear...”³

3 Oppenheimer Equity Research mirrors that theme:

4 “...negative regulatory developments in key states such as Florida
5 could offset the more constructive orders that have dominated the
6 group in recent quarters. Unfortunately, it would not take much to
7 spook investors away from the sector if the political rhetoric that
8 has come to dominate Florida were to spread to other states.”⁴

9 Turning to the rating agencies, Fitch stated the following in a December 2008
10 report:

11 “The regulatory compact is especially important in view of the
12 sector’s need for capital to support its projected, large post-2008,
13 mostly non-discretionary capital spending programs. Recent
14 changes in the political landscape articulated above enhance the
15 prospects of higher environmental spending, including carbon
16 controls.”⁵

17 Fitch goes further to state:

18 “In Fitch’s view, the business climate for the electric utility sector
19 is negative in both 2009 and the longer term. A deepening global
20 recession, ongoing financial crisis and a meaningful increase in the
21 cost of capital compound an already difficult operating
22 environment characterized by large projected capital expenditures
23 and commodity cost volatility.”⁶

24 It is fair to say, I believe, that the investment community is concerned about the
25 regulatory environment as capital expenditures remain high, sales are flat or down

³ Credit Suisse Equity Research, “Electric Utilities (Regulated Utilities/Independent & Integrated Power)”, March 10, 2009, Page 8.

⁴ Oppenheimer Equity Research, “2010 Utility Outlook”, December 8, 2009, Page 3.

⁵ Fitch Ratings, *U. S. Power and Gas 2009 Outlook*: December 28, 2008.

⁶ Fitch Ratings, *U. S. Power and Gas 2009 Outlook*: December 28, 2008.

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1 leading to the need for more frequent rate relief, and recessionary pressures on
2 customers encourage commissions to act in politically expedient ways.

3 **Q. How does the capital expenditure environment for utilities affect the need for**
4 **a supportive regulatory environment?**

5 A. Cash flow adequacy is the key behind a company’s ability to service its financial
6 obligations over time, and regulatory support is necessary to allow companies to
7 achieve the necessary cash flow. In a recent equity research report, Credit Suisse
8 comments on its preference for companies with access to the capital markets,
9 access that is strongly driven by internal cash flow generation:

10 “We also think that commissions need to appreciate the future
11 reinvestment obligations facing utilities as we confront a
12 combination of likely federal policies – renewable portfolio
13 standards and global warming policy – that will be heavily
14 dependent on access to the capital markets.”⁷

15 Susan Abbott notes that Moody’s and S&P’s ratings methodologies make it clear
16 that cash flow is the most important financial metric, simply because credit
17 ratings are intended to measure the ability of a company to pay its financial
18 obligations on time, and in amounts expected.

19 The cash flow of a regulated utility is in large part determined by a rate case and
20 the regulatory policy behind that case. The revenue that a regulated utility can

⁷ Credit Suisse Equity Research, “Electric Utilities (Regulated Utilities/Independent & Integrated Power)”, March 10, 2009, Page 8.

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1 collect from customers and the resulting cash flow to the company is the sum of
2 innumerable decisions that are part of a rate case: allowed cost recovery and
3 disallowances, allowed rate base levels, exclusions and allowed returns on rate
4 base, return of capital through depreciation and amortization, allowed return on
5 and recovery of regulatory assets, etc. The end result of the case must provide
6 sufficient cash flow from customers for a company to service its obligations,
7 including providing a timely return *of* capital and an adequate return *on* capital
8 invested, while providing fair rates to ratepayers. Rate cases that, in the end, fail
9 to provide adequate revenues force companies to either rely on financial markets
10 to fund shortfalls, or curtail investment and potentially other services in order to
11 manage their cash outflows to their cash inflows.

12 The issue of cash flow adequacy is increased in times of heightened capital
13 expenditures. If the return of capital is outpaced by capital spending, companies
14 are required to access the capital markets on a more frequent basis in order to
15 cover the costs of those expenditures. As noted earlier in my testimony, this
16 increased capital market activity increases perceived investor risk, reflecting the
17 risk that future regulatory decisions will be insufficient to protect investor
18 interests. Regulatory decisions that, on balance, provide sufficient revenues to
19 cover current costs and provide reasonable cash flow for investment help
20 companies raise capital on more attractive terms.

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1 **Q. Are there other issues that the financial community focuses on when it**
2 **evaluates the regulatory environment?**

3 A. Yes. There is one other important factor, which is the consistency and
4 predictability of regulatory policy. Ratemaking should be guided by certain
5 principles of public utility regulation, which should be equally applied in strong
6 economic conditions and weak ones, when capital markets are robust or not, and
7 when energy prices are rising or falling. It is important to recognize that investors
8 focus on risk, and require that they be adequately compensated for taking on risk.
9 Uncertainty of any kind, but especially in regulatory policies, creates additional
10 risk, which increases the costs of capital. Regulation that is results-oriented or
11 opportunistic rather than principled and consistent will drive investors to require
12 higher returns and risk premiums.

13 To that point, in a recent report, Barclays Capital (“Barclays”) ranked 49
14 regulatory jurisdictions (including FERC) according to five categories, which
15 stratify those jurisdictions from the lowest to highest cost of capital. Among the
16 factors considered in assigning jurisdictions to the various categories are the level
17 of authorized returns; the tendency for “more consistent, timely, and transparent
18 regulation over time; and a “Subjective Investor Friendliness Rating,” which
19 reflects the extent to which decisions are based on the testimony presented during
20 the proceeding. Barclays’ “Tier 1” is the “Lowest Cost of Capital” states and

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1 Barclays' considers Tier 5" to be the "Highest Cost of Capital" states. Barclays'
2 ranks New York as a "Tier 5" state, representing the "Highest Cost of Capital."⁸

3 Similarly, as noted by Susan Abbott, Regulatory Research Associates ("RRA")
4 rates regulatory jurisdictions from the perspective of investors, and assigns ratings
5 of Above Average, Average, or Below Average. RRA further distinguishes
6 jurisdictions within those respective categories by applying ratings of 1, 2 or 3,
7 with a rating of "1" being the strongest. In describing its ranking system, RRA
8 notes that:

9 "[t]he evaluations are assigned from an investor perspective and
10 indicate the relative regulatory risk associated with securities
11 issued by the jurisdiction's utilities. The evaluation reflects our
12 assessment of the probable level and quality of earnings to be
13 realized by the state's utilities as a result of regulatory, legislative,
14 and court actions."⁹

15 New York (together with nine other jurisdictions) currently is rated Average/3 by
16 RRA; only seven other jurisdictions received a lower rating. As Susan Abbott
17 points out, RRA reduced New York's ranking from Average/2 to Average/3 in
18 August 2007 after the Commission awarded a 9.10 percent ROE to Orange &
19 Rockland.¹⁰

⁸ Barclays Capital, *Utilities; Capital Management*, July 16, 2009.

⁹ Regulatory Research Associates, *Commission Profiles*, accessed February 7, 2010.

¹⁰ Direct Testimony of Susan D. Abbott, at 20.

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1 **Q. Has the Staff commented upon the need to maintain the financial health and**
2 **attractiveness to investors of regulated utilities in New York State?**

3 A. Yes. The Staff Policy Panel makes a number of statements about the importance
4 of the financial health of regulated companies in the state. Staff states that “[I]t is
5 very important for companies to maintain investment grade credit ratings.”¹¹

6 Staff also states that “It would be preferable if the Companies were able to
7 achieve ratings at a level of at least BBB+/Baa1.”

8 The Panel then suggests the following: “For now, it is reasonable to undertake
9 measures that will strengthen each company’s financial metrics to make a
10 BBB+/Baa1 rating more likely from S&P and Moody’s.”¹²

11 **Q. Beyond the heightened risks in the financial markets that Staff discusses, are**
12 **there other reasons that Staff cites for preferring stronger bond ratings,**
13 **possibly even “A/A” level ratings for utilities in the State?**

14 A. Yes. Staff cites the large construction programs that face the Companies, even
15 after reductions in capital expenditures proposed by Staff:

16 “... there is still a great deal of construction spending proposed for
17 NYSEG and RG&E that could present a degree of operational
18 difficulties and execution risk. First, it could put pressure on the
19 Companies’ leverage if the projects are financed solely by debt. It
20 could also subject the companies to construction overruns and

¹¹ Staff Policy Panel, page 29.

¹² Staff Policy Panel, Page 30.

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1 interest rate risk. These pressures could cause financial stress for
2 the companies.”¹³

3 Staff then goes on to further cite the risks of the construction program:

4 “The risks presented by their significant construction program
5 leave NYSEG and RG&E somewhat more vulnerable to reductions
6 in their credit quality. Moreover, unforeseen circumstances could
7 exacerbate any financial or operational difficulties and result in a
8 greater potential for a credit rating downgrade.”¹⁴

9 **V. THE CURRENT ELECTRIC UTILITY CAPITAL EXPENDITURE**

10 **ENVIRONMENT**

11 **Q. What is the electric and gas utility industry trend in terms of capital
12 expenditures?**

13 A. According to information gathered by the Edison Electric Institute (EEI), capital
14 expenditures for the industry have more than doubled in the past few years. As
15 shown in the chart below, capital expenditures for the 69 electric and combination
16 utilities tracked by EEI increased from \$41.4 billion in 2004 to an estimated
17 figure of \$84.2 billion in 2009.¹⁵

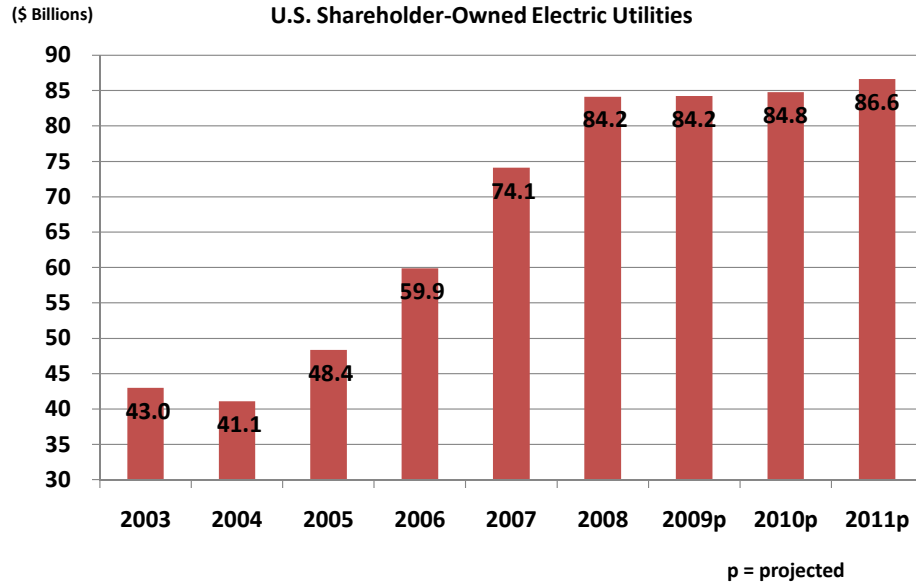
¹³ Staff Policy Panel, page 31.

¹⁴ Staff Policy Panel, page 32.

¹⁵ Financial Statistics and Trends, Electric Shareholder Owned Electric Utilities, Mark Agnew, Edison Electric Institute (information from EEI 2008 Financial Review Plus 2009 Developments).

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Industry Capital Expenditures



Source: SNL Financial, company reports and EEI Finance Dept.

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As noted in the chart, EEI expects capital expenditures to remain high compared to the recent past. Others expect them to grow at a rate exceeding inflation.

Scotia Capital, in a summary of the Edison Electric Institute Financial Conference in late 2009, noted:

“Fitch, along with Moody’s and S&P, remains concerned with political and regulatory lag to rising power prices and capital expenditures costs that will exceed CPI inflation, leading to higher and more frequent rate requests.”¹⁶

¹⁶ Scotia Capital Equity Research, “44th Annual Edison Electric Institute Conference”, November 23, 2009, Page 3.

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1 **Q. What are the reasons for this level of capital expenditures?**

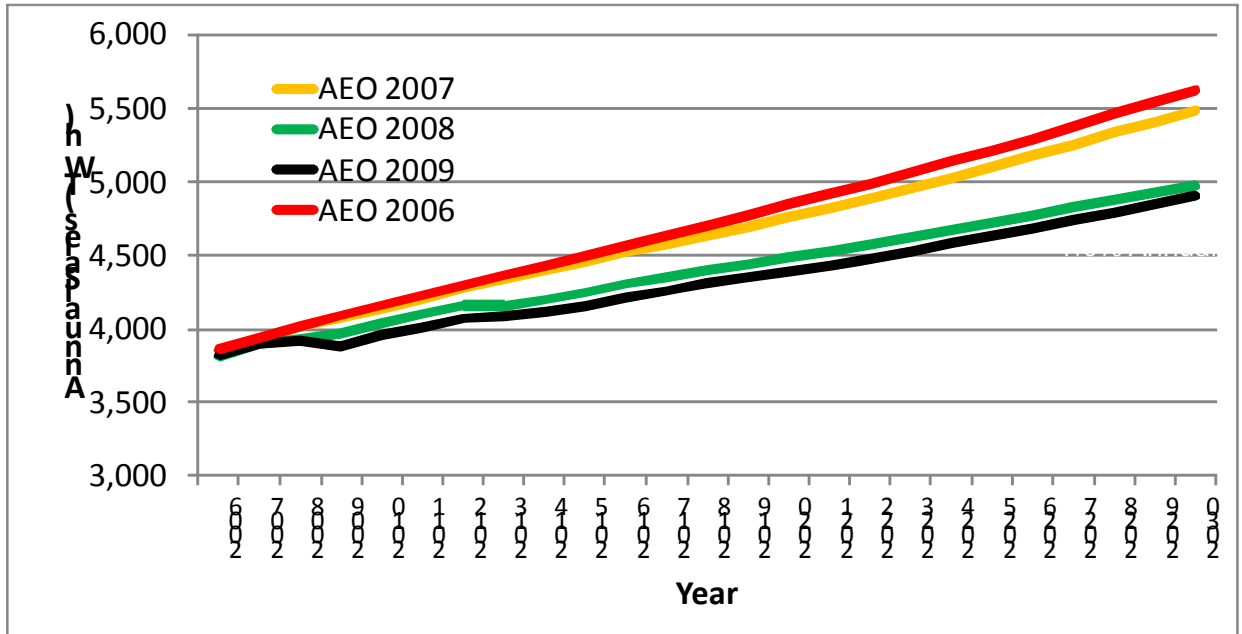
2 A. Much of the growth comes in the transmission and distribution segment of the
3 industry, as generation construction has been relatively stable over the period,
4 according to EEI.¹⁷ Increased electricity sales over the 2004 to 2009 period, as
5 shown in the chart below from the EEI,¹⁸ have caused a need for additional
6 transmission and distribution facilities to service the new load.

¹⁷ Financial Statistics and Trends, Electric Shareholder Owned Electric Utilities, Mark Agnew, Edison Electric Institute (information from EEI 2008 Financial Review Plus 2009 Developments).

¹⁸ Financial Statistics and Trends, Electric Shareholder Owned Electric Utilities, Mark Agnew, Edison Electric Institute (information from EEI 2008 Financial Review Plus 2009 Developments).

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**Long-Term Projections of Growth in Electric Sales
(Reduced but Still Upward Sloping)**



1 Source: U.S. Department of Energy; Energy Information Administration (EIA) Annual Energy Outlook (AEO) 2006-2009

2 Additionally, aging infrastructure is becoming a more serious problem in the
3 industry, particularly in the older regions of the U.S, such as the Northeast and
4 Midwest. The Governor's State Energy Plan recognizes this problem for New
5 York State as well.¹⁹

¹⁹ New York State Energy Plan, Energy Infrastructure Issue brief, December, 2009.

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1 Finally, new technologies, such as automated meters, are being developed to help
2 improve efficiency and better manage the electricity grid. Installation of these
3 new technologies, however, is expensive.

4 **Q. How do increased levels of capital expenditures affect access to capital?**

5 A. Heightened capital requirements increase business risk for companies (and affect
6 investors' required returns) in several ways. First, investors are always concerned
7 about a utility's ability to recover the cost of new investments through rates, both
8 in terms of regulatory lag and the risk of a disallowance. In addition, investors
9 are concerned about the rate impacts of major capital expenditures. Finally,
10 investors realize that there is greater risk when a utility has to rely on the financial
11 markets on a frequent basis, because it increases the chances of having to raise
12 capital under adverse market conditions.

13 **Q. Has the investment community expressed a view on the impact of capital
14 expenditure programs?**

15 A. Yes. Deutsche Bank Equity Research recently noted:

16 "When you start to enumerate the potential sources of new costs
17 for customers this becomes quite a laundry list including, but
18 probably not limited to carbon pricing, new emissions standards
19 for traditional pollutants, coal ash upgrades, cooling towers, new
20 nuclear, carbon capture and storage, renewable generation and
21 related transmission lines as well as backup generation, energy
22 efficiency programs, Smart Grid, upgrading infrastructure to
23 accommodate, and then build out a charging infrastructure for
24 electric vehicles, etc. While some of these items may end up being

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1 socialized outside of the electricity bill, the general theme is one of
2 significant cost increases and a commensurate risk of regulatory
3 pushback at the state level as reality sets in over time.”²⁰

4 From a ratings agency perspective, Fitch stated in its U.S. Utilities, Power and
5 Gas Outlook 2010: -

6 “The combination of high capital expenditures and relatively weak
7 electricity demand will continue to pressure credit quality and
8 require base rate increases in 2010 and beyond.”²¹

9
10 Susan Abbott notes that utilities are entering a significant construction cycle from
11 a level of financial weakness:

12 “...in that time [the last 33 years], I have seen ratings in the
13 electric utility industry migrate from an average of “AA” to
14 “BBB.” The impetus for that migration has been largely attributable
15 to the financial stress construction programs have put on utilities.
16 The industry is embarking on the first major round of construction
17 activity since the 1980’s, and it is starting from a position of
18 weakness...”²²

19 It is clear that the financial community has significant concerns about the
20 expected high capital expenditures that will continue in the electric utility sector
21 and the ability of the industry to finance those expenditures.

²⁰ Deutsche Bank Equity Research, “Bracing for Change: Utilities face up to challenging times” ,
December 1, 2009, Page 13.

²¹ Fitch Ratings, U.S. Utilities, Power and Gas 2010 Outlook, December 4, 2009, Page 12.

²² Rebuttal Testimony of Companies Witness Susan Abbott.

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VI. STAFF'S DEPRECIATION PROPOSAL

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Q. Please describe Staff's depreciation proposal and how it affects the Companies' cash flow.

A. The Staff has proposed substantial adjustments to both Companies' revenue requirements through reductions in depreciation expense and the amortization of the theoretical depreciation reserve surplus. The following table summarizes these adjustments (in millions):

		<u>Depreciation Expense</u>	<u>Reserve Surplus Amortization</u> ²³	<u>Total</u>
RG&E	Gas	\$6.4 ²⁴	\$0.0	\$6.4
	Electric	\$15.3 ²⁵	\$9.6	\$24.9
	Total	\$21.7	\$9.6	\$31.3
NYSEG	Gas	\$6.5 ²⁶	\$0.0	\$6.5
	Electric	\$1.7 ²⁷	\$30.4	\$32.1
	Total	\$8.2	\$30.4	\$38.6
TOTAL		\$29.9	\$40.0	\$69.9

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The proposed treatment of the theoretical reserve surplus is to amortize nearly all of the estimated surplus over a ten year period. As I noted earlier in my

²³ Staff Policy Panel, Pages 93-94.
²⁴ Exhibit __ (SRRP-5), Schedule A.
²⁵ Exhibit __ (SRRP-4), Schedule A.
²⁶ Exhibit __ (SRRP-3), Schedule A.
²⁷ Exhibit __ (SRRP-2), Schedule A.

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1 testimony, this short term amortization violates the matching principle and harms
2 the Companies' financial health.

3 **Q. Staff's proposal would substantially reduce the revenue requirements of each**
4 **Company. Can you put Staff's proposal in perspective and explain how the**
5 **financial community would view these modifications if they are adopted by**
6 **the Commission?**

7 A. There are two ways to look at this. In terms of cash flow, the financial
8 community, on both the debt and equity sides of the market, focuses heavily on
9 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA),
10 which is a broad measure of cash flow. EBITDA can be calculated on a proforma
11 basis from the elements of the revenue requirements calculations produced in
12 Staff's Schedules, and I calculated the level of EBITDA implied by Staff's
13 various recommendations. In the case of NYSEG, the pro-forma calculated
14 EBITDA is approximately \$273.4 million. For RG&E, the pro-forma calculated
15 EBITDA is approximately \$185.8 million.²⁸

16 The adjustments to depreciation and the reserve amortization are a significant
17 proportion of pro-forma EBITDA, at 14.1% for NYSEG and approximately
18 16.8% for RG&E, and would have a material negative impact on each Company's
19 cash flow.

²⁸ Concentric pro-forma calculations.

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1 Another way to look at this is to calculate what reduction in ROE would result in
2 the same level of cash flow decrease as Staff's depreciation and amortization
3 proposals. To do this I solve for the ROE that would produce the same \$273.4
4 million pro-forma EBITDA amount in the case of NYSEG or \$185.8 in the case
5 of RG&E. For NYSEG, a reduction in the after-tax ROE of approximately 237
6 basis points, from the 9.60% proposed by Staff to 7.23%, produces a reduction in
7 EBITDA that is equivalent to Staff's depreciation and amortization proposals. In
8 the case of RG&E, Staff's proposed depreciation and amortization proposals
9 would produce a reduction in cash flow that is the equivalent of reducing the
10 after-tax ROE by 275 basis points from the 9.80% proposed by Staff to
11 approximately 7.05%. No rate case that I am aware of anywhere in the U.S in
12 recent years has authorized ROE levels for electric and/or gas utilities in the range
13 7.00-7.25%. Staff is recommending reductions in cash flow to the Companies
14 through its depreciation and amortization proposals that would have the same
15 impact as reductions in their allowed ROEs to these extremely low levels.

16 From the perspective of the financial community, the cash flow impacts of Staff's
17 depreciation and amortization proposals are very large, and should be very
18 carefully evaluated by the Commission. Even though the reported net income of
19 each Company would not be affected directly by Staff's proposals on depreciation
20 and amortization, the financial position of the Companies would clearly be
21 eroded.

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1 **Q. Is Staff’s recommendation for amortizing the depreciation reserve excess**
2 **consistent with its recommendation to “strengthen” the companies**
3 **financially?**

4 A. No. It appears that Staff is driving more toward “rate moderation” than toward
5 strengthening the Companies’ financial positions. In response to a question as to
6 whether Staff is proposing to utilize RG&E Electric’s excess depreciation reserve
7 as a “rate moderator,” Staff responds:

8 “Yes. We recommend RG&E be directed to amortize its excess
9 depreciation reserve by \$9.6 million *to achieve no increase in its*
10 *delivery revenue requirement.*”²⁹ (emphasis added)

11 In a similar question as to whether NYSEG Electric’s excess depreciation reserve
12 should be used as a “rate moderator,” Staff responds in a similar fashion:

13 “Yes. We are proposing to amortize NYSEG’s excess reserve over
14 10 years. This proposal reduces NYSEG Electric’s rate year
15 depreciation expense by approximately \$30 million. However, it
16 may be appropriate for the Commission to adjust Staff’s proposal
17 based on the size of the rate increase ultimately approved by the
18 Commission.”³⁰

19 **Q. Is Staff’s position with regard to rate moderation appropriate?**

20 A. No, it is not. The Commission must, of course, consider the overall impact of a
21 rate case on customers and also on the regulated companies. The Commission

²⁹ Staff Policy Panel, page 94.

³⁰ Staff Policy Panel, page 93.

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1 must also consider the issues related to each element within the case, such as the
2 amortization of the excess depreciation reserve. However, Staff’s stated view
3 appears to be that “rate moderation,” i.e., finding a basis to grant no rate
4 increases, is the primary objective in this case. That is inappropriate and wholly
5 inconsistent with established ratemaking principles. This is a clear example of
6 results-oriented ratemaking, without any apparent concern for the effect of this
7 treatment on the Companies’ cash flow, capital needs, or financial position.

8 **VII. POTENTIAL FINANCIAL MARKET IMPACT AND RESPONSE**

9 **Q. Are there recent examples in terms of the impact of reduced cash flow from**
10 **similar depreciation proposals at other companies on bond ratings and**
11 **equity investor perceptions?**

12 **A.** Yes. On January 12, 2010, the Florida Public Service Commission announced its
13 decision on a rate case request for Florida Power and Light Company (FP&L).
14 FP&L had requested a rate increase of approximately \$1.3 billion, but was
15 granted only \$75.5 million in rate relief.³¹

16 A large portion of the reduction related to the issue of the theoretical depreciation
17 reserve excess, which totaled \$1.21 billion. The Florida Commission voted to use
18 \$314 million of the excess to offset capital recovery schedules. The remaining

³¹ Florida PSC News Release, “Florida Public Service Commission Reduces Florida Power & Light Company’s Revenue Request”, January 14, 2010.

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1 \$894.4 million would be returned to ratepayers over four years. This amounted to
 2 a reduction to rates of \$223.6 million per year. The reduction due to the
 3 amortization of the excess is approximately 9.6% of annual EBITDA for FP&L.
 4 (based on 2008 annual figures from FP&L 10-K).

2007/2008 EBITDA (\$MM's)							
	NYSEG		RG&E		FP&L		
	2008	2007	2008	2007	2008	2007	
Operating Income	\$60.4	\$234.1	\$42.0	\$158.3	\$1,529.0	\$1,563.0	
Depr. And Amort.	\$107.4	\$104.6	\$66.6	\$74.4	\$796.0	\$773.0	
PBA Adjustment	<u>\$164.7</u>	<u>\$0.0</u>	<u>\$110.2</u>	<u>\$0.0</u>	<u>\$0.0</u>	<u>\$0.0</u>	
EBITDA	\$332.5	\$338.7	\$218.8	\$232.7	\$2,325.0	\$2,336.0	
Proposed Reserve Amort.	\$30.4		\$9.6		\$223.6		
Reserve Amortization/EBITDA	9.1%		4.4%		9.6%		
Figures are from published financial statements of the companies.							

5
 6 Comparing just the reserve amortization amounts for NYSEG and RG&E versus
 7 the corresponding figures for FP&L using 2008 published financials, the proposed
 8 amortization of the theoretical excess depreciation reserve for FP&L as a percent
 9 of free cash flow is close to the corresponding percentage for NYSEG.

10 The outcome of the rate case decisions for FP&L produced strong negative
 11 responses from rating agencies and market participants. Staff’s proposals for

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1 NYSEG and RG&E are likely to have the same impact on the Companies as the
2 Florida Commission’s decision has had on FP&L.

3 Standard and Poor’s issued a research update citing:

4 “On January 14, 2010, Standard & Poor’s Ratings Services placed
5 the ‘A’ corporate credit ratings and all of the ratings on FPL Group
6 Inc. and subsidiaries on CreditWatch with negative implications
7 based on this week’s decision by the Florida Public Service
8 Commission (FPSC) to drastically cut a requested base rate
9 increase and discontinue a credit-enhancing rate mechanism for
10 generating plant additions for FPL subsidiary Florida Power &
11 Light Company. The lower than expected revenues combined with
12 continued economic sluggishness in the state are likely to impede
13 the ability of the company to achieve credit metrics that support
14 current ratings.”³²

15 On January 19, 2010, Moody’s Investors Service placed the ratings of FPL Group
16 and its subsidiaries, including FP&L, on review for possible downgrade. FP&L
17 bonds are currently rated A1 by Moody’s.³³

18 The stock price of FPL Group dropped from a high of \$56.25/share in mid-
19 December to \$46.46/share at the close of business on February 9, 2010, a 17%
20 decline.

21 Oppenheimer Equity Research stated the following after the decision:

22 “While we expect credit rating downgrades, we acknowledge that
23 FP&L’s decision to suspend the capital spending could, in a
24 perverse way, save the ratings at a cost of further infrastructure
25 developments in Florida. Nevertheless, given the poor PSC

³² S&P Research Update, FPL Group, January 14, 2010.

³³ Moody’s Rating Action, FPL Group, January 19, 2010.

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1 decision, we believe that the utility credit is likely to be
2 downgraded.”³⁴

3 Morgan Stanley Equity Research said it more succinctly:

4 “Don’t buy the stock” (commenting on both the regulatory
5 problems of FP&L and concerns about NextEra, FPL Group’s non-
6 utility energy business, as well).³⁵

7 These stock price reactions and negative investor comments on FPL Group, the
8 parent company, occurred despite the fact that it received a 10% authorized return
9 on equity on a nearly 60% book equity ratio for FP&L and the non-utility portion
10 of FPL is quite large (NextEra and FP&L each had approximately \$840 million in
11 net income for 2009).

12 **VIII. CONCLUSIONS**

13 **Q. Please summarize your conclusions regarding Staff’s proposed depreciation**
14 **and excess reserve amortization adjustments.**

15 A. Staff is proposing to reduce the annual depreciation expense for the Companies,
16 and to amortize nearly all of the balance of the theoretical depreciation reserve
17 excess, a total of \$429 million for the Companies, over a 10 year period on a
18 straight line basis. This will result in a reduction of customer rates, and thus cash
19 flow to the Companies, of \$40.0 million in the test year for the reserve

³⁴ Oppenheimer Equity Research, Company Update FPL Group, January 14, 2010, page 1.

³⁵ Morgan Stanley Equity Research, FPL Group, Inc., January 14, 2010, Page 1.

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amortization and an additional \$29.9 million for the proposed depreciation changes.

Staff’s position is inconsistent with traditional regulatory policy on this issue, and with Staff’s own conclusions regarding the need to strengthen the Companies’ financial position:

- Staff’s proposal to amortize these excess depreciation reserve to customers on an accelerated basis implies that the variance is a result of “overcollection” of depreciation expense from customers in the past. Therefore, Staff implies that an accelerated return of this excess over a 10 year period is warranted. However, the excess is created not because of past depreciation over-collections, but because of changes to depreciation rates captured by Staff’s changes in the Companies’ latest depreciation study as well as in the previous NYSEG Electric depreciation study. These changes rightfully “belong” to current and future users of the assets.
- Theoretical depreciation reserve variances are expected with each new depreciation study and they may be positive or negative depending on the changes in depreciation rates. Staff’s position produces a short-term rate reduction for customers in exchange for a larger future rate increase. While some regulators may find current circumstances to be

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1 an appealing opportunity to engage in innovative rate engineering, I
2 urge this Commission to resist resorting to myopic measures which are
3 not in the best long-term interests of customers or the utilities.

4 Furthermore, Staff's recommendation on this issue is likely to have a long term
5 negative impact on the Companies and their customers, as follows:

- 6 • Total cash flow to the Companies is reduced by \$40.0 million annually
7 by Staff's proposed reserve amortization (or \$69.9 million including
8 depreciation adjustments) at a time when the Staff agrees that the
9 Companies should be put on a stronger, not weaker, financial footing.
- 10 • This reduction in cash flow means that there will be less cash available
11 to the Companies to support their operations and capital expenditures,
12 putting more stress on the Companies' weak financial condition.
- 13 • This reduction in cash flow may cause the ratings agencies to reduce
14 their bond ratings of NYSEG and RG&E to levels even further below
15 that of other New York State utilities, which would make raising
16 capital that much more difficult and expensive.
- 17 • Implementation of Staff's recommendations on this issue, as well as
18 on issues such as the lengthening of depreciation lives and the
19 reduction in proposed net salvage collections, are likely to suggest to
20 the investment community that the regulatory climate in New York

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1 State continues to be less supportive of utilities' financial integrity
2 than most other jurisdictions. Investment capital is likely to flow more
3 easily to other jurisdictions with more supportive policy.

4 **Q. Does this conclude your rebuttal testimony?**

5 A. Yes.