

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  
JEFF D. MAKHOLM, PH.D**

February 12, 2010

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. Are you the same Jeff D. Makhholm, Ph.D, who presented direct testimony in this  
2 proceeding?

3 A. Yes.

4 Q. What is the purpose of your rebuttal testimony?

5 A. The purpose of this testimony on behalf of New York State Electric & Gas  
6 Corporation (“NYSEG”) and Rochester Gas and Electric Corporation (“RG&E”)  
7 is to respond to the direct testimony and exhibits of New York State Department  
8 of Public Service Staff (“Staff”) Finance Panel witnesses Kwaku Duah and  
9 Patrick J. Barry on the fair rate of return on common equity (“ROE”) for  
10 NYSEG’s and RG&E’s utility operations.

11 While my direct testimony specifically sets forth my ROE  
12 recommendations for the Companies, in this rebuttal testimony, I respond  
13 specifically to the ROE issues discussed in Staff’s testimony. In particular, I  
14 identify a number of Staff’s calculation errors, conceptual problems, and other  
15 mistaken assumptions and inconsistencies. Staff’s analysis cannot reasonably be  
16 held to reflect the expectations of investors, which we are supposed to be gauging  
17 in this proceeding to determine *their* expectations of the cost of equity capital for  
18 the proxy group and, in turn, for the Companies. Nor can the problems with  
19 Staff’s approach be said to be guided by the Generic Finance Recommended  
20 Decision (“Generic Finance RD”). Unless these problems are fixed, the ROE and  
21 weighted average cost of capital recommendations proposed by Staff will remain  
22 insufficient—*i.e.*, below what the evidence from the capital markets shows it to  
23 be.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. What conclusions do you draw?

2 A. I conclude the following:

- 3 • The Generic Finance RD proposed dividend per share (“DPS”) growth  
4 rates for the Electric/Gas group at a time when dividend payout policies  
5 were stable. However, circumstances have changed (dividend payout  
6 ratios have been in decline), and as a consequence, the DPS growth rates  
7 used for the first five years of Staff’s “long-form” Discounted Cash Flow  
8 (“DCF”) model are unsustainably low, due primarily to its exclusion of  
9 growth in retained earnings for those years. I propose a way to correct for  
10 these unsustainably low DPS growth rates, while retaining the basic  
11 elements of Staff’s two-stage DCF model, simply by adding an additional  
12 input for growth in retained earnings. *The effect on Staff’s recommended*  
13 *DCF ROE of this change is 23 basis points.*
- 14 • Rather than using the traditional mean to determine the DCF cost of  
15 equity, Staff calculates its DCF cost of equity using medians. The Generic  
16 Finance RD does not dictate the use of medians rather than means (that is,  
17 the simple average) for the calculation of the DCF recommended ROE.<sup>1</sup> I  
18 have also surveyed the 2009 orders of every state commission that was  
19 included in Regulatory Research Associates (“RRA”) survey of regulatory  
20 decisions and found that no other state commission uses the median. I  
21 conclude that the use of medians produces artificially low returns and I

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<sup>1</sup> New York Public Service Commission, *Recommended Decision, Proceeding on Motion of the Commission to Consider Financial Regulatory Policies for New York State Utilities*, Case 91-M-0509 (issued July 19, 1994).

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 recommend a return to the overwhelmingly prevalent practice of using the  
2 simple average. Given the accepted use of a tightly-defined proxy group  
3 of utilities specifically to avoid the problem of non-comparable outliers,  
4 there is no theoretical or conceptual reason to use the median. All of the  
5 companies in the proxy group are, by definition, comparable, and  
6 excluding some of those comparable companies is inappropriate. The use  
7 of the median in this particular case produces a substantial bias given the  
8 way that both the calculated ROEs and beta values are distributed for the  
9 proxy group. *The effect of this change on Staff's DCF ROE is 26 basis*  
10 *points. (The effect on the CAPM result is an additional five basis*  
11 *points.)*

12 • Staff uses what I consider a discriminatory and inappropriate rationale for  
13 failing to compensate for selling and issuance expenses. *The effect of this*  
14 *change on Staff's DCF ROE is 24 basis points.*

15 • Staff proposes a reduction in the cost of equity of 10 basis points due to  
16 decoupling. I show that such an adjustment has no evidentiary basis. I  
17 conclude that the rate design innovation of decoupling does not have any  
18 *material* effect on the business and financial risk for which equity  
19 investors require compensation, and furthermore, is inappropriate for  
20 combination electric and gas utilities.

21 • Staff's practice of using 10-year to 30-year U.S. Treasury bonds for the  
22 Capital Asset Pricing Model ("CAPM") risk-free rate is unnecessary given  
23 that a 20-year Treasury bond is available. While the consensus in the

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 financial literature is that a longer term is a more appropriate indicator of  
 2 investor expectations, at the very least a 20-year bond should be used  
 3 instead of using an average of 10-year and 30-year bonds, which yields a  
 4 result that is 10 basis points lower. I provide those yields in my testimony.

5 *The effect of this change on Staff's CAPM ROE is 10 basis points.*

6 I deal with these issues in turn. **Table 1** shows the cumulative effect of  
 7 these issues on Staff's recommended return on equity in comparison to Staff's  
 8 revised proxy group cost of equity estimate.<sup>2</sup>

9 **Table 1. Amendments to Staff's Proxy Group ROE Analysis**

<b>DCF</b>			
	Staff's Indicated DCF Cost of Equity	9.83%	
	DPS growth rate adjustment		0.23%
	Mean vs. Median		0.26%
	Selling and issuance expenses		0.24%
	<b>Adjusted Proxy Group DCF</b>	<b>10.55%</b>	
<b>CAPM</b>			
	Staff's Indicated CAPM Cost of Equity	9.79%	
	Beta mean vs. median		0.05%
	Risk-Free Rate		0.10%
	<b>Adjusted Proxy Group CAPM</b>	<b>9.94%</b>	
<b>ROE</b>			
	Staff's Total Proxy Group Cost of Equity	9.82%	
	<b>Adjusted Total Proxy Group ROE</b>	<b>10.35%</b>	
	With Staff Credit Quality Adjustment		
	<b>NYSEG</b>	<b>10.37%</b>	
	<b>RG&amp;E</b>	<b>10.53%</b>	

10 To the extent that Staff's general approach to ROE is adopted in this  
 11 proceeding, at the very least, each of the amendments discussed above in **Table 1**

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<sup>2</sup> In response to the Companies' data request (NYSEG-RGE-145 (DPS)), Staff's indicated proxy group cost of equity was revised to 9.82 percent. This revision increases Staff's DCF cost of equity estimate for the proxy group from 9.63 percent to 9.83 percent, while its CAPM estimate remains unchanged.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 and in this Rebuttal Testimony should be adopted. The proposed adjustments to  
2 Staff's DCF methodology are summarized in **Exhibit \_\_ (JDMR-1)**, and the  
3 proposed adjustments to Staff's CAPM calculations are summarized in **Exhibit**  
4 **\_\_ (JDMR-5)**. As discussed in Part G below, in the absence of these changes,  
5 Staff's proposals will result in unreasonably low ROEs for the Companies that  
6 will only perpetuate the opinions of RRA, credit rating agencies and investors  
7 regarding the quality of regulatory support in New York.

8 **A. DPS GROWTH RATE MEASUREMENT ERROR**

9 Q. Could you please explain Staff's revision to its DCF estimate?

10 A. Yes. **Exhibit \_\_ (JDMR-2)** provides Staff's response to NYSEG-RGE-145  
11 wherein Staff revised its cost of equity results to reflect its correction of the  
12 timing of dividends. Staff concluded it was more reasonable to grow dividends at  
13 the short-term growth rate for three years, rather than four. This revision corrects  
14 Staff's formula to align with its data.

15 **B. AN UNSUSTAINABLY LOW DPS GROWTH RATE**

16 Q. Staff says in its testimony (pp. 123-124), in response to your criticism of the use  
17 of DPS growth rates, that "[t]he model is functioning as it was intended and it  
18 should not be discarded." Do you agree?

19 A. No. I was a part of the Generic Financing proceedings in the 1990s, and I would  
20 say that the model is not working as intended in certain specific respects. For  
21 example, time and circumstances have changed since 1994, and the situation  
22 utilities face now would have made the use of adjusted DPS growth rates as part

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 of the Generic Finance proceeding untenable, due to declining dividend payout  
2 ratios.<sup>3</sup>

3 Q. What do you mean?

4 A. In 1993-1994 when the issue of a generic formula was being discussed among the  
5 participants in Case 91-M-0509, the dividend payout ratios for utilities in general  
6 (particularly electric utilities) were stable—meaning that the projected payout  
7 ratios were very close to the then-current ratios. For example, the July 1994  
8 *Value Line* for the electricity utility industry showed a current 1994 retention ratio  
9 of 20 percent and projected ratio for 1997-1999 of 22 percent.<sup>4</sup> With such relative  
10 consistency between current and projected retention ratios, the DPS growth rates  
11 at the time were very close to the sustainable growth rates.

12 But such is not the case today. The December 2009 *Value Line* projects  
13 that the 2009 retention ratio of 36 percent will increase to 44 percent by 2012-  
14 2014.<sup>5</sup> Based upon the new round of heavy capital expenditures that the utility  
15 industry is facing (which is discussed in more detail in Susan Abbott’s and John  
16 Reed’s and other Company witnesses’ testimonies), these increasing retention  
17 ratios—i.e. declining dividend payout ratios, make sense. This increase in  
18 retention ratios shows up in the significant difference between Staff’s average  
19 *Value Line* DPS growth rate for its proxy group of 3.61 percent and its *Value*

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<sup>3</sup> As I explained in some detail in my direct testimony (pp. 40-45), using DPS growth rates is fraught with difficulties in periods when dividend payout ratios are declining, as is the case at present—which is why other independent sources of growth estimates focus on earnings growth rather than dividend growth. Nevertheless, Staff appears to be committed to its approach and therefore I focus on rebutting Staff’s methods in this rebuttal testimony.

<sup>4</sup> *Value Line*, July 15, 1994, p. 701.

<sup>5</sup> *Value Line*, December 25, 2009, p. 687.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1        *Line*-derived “sustainable” growth of 5.05 percent. I do not think that Staff would  
2        dispute that the difference between these two average growth rates is  
3        significantly—if not largely—driven by short-term dividend payout policies for  
4        the companies in the proxy group. As I discuss in more detail below, merely  
5        because Staff considers retention in its 5.05 percent growth rate in its G2  
6        calculations does not countervail the impact of Staff’s use of the incorrect 3.61  
7        percent growth rate in G1.

8                It is unreasonable to think that the Electric/Gas utility group discussing  
9        these issues in 1993-1994 would have found acceptable the use of DPS growth  
10       rates, if those growth rates (and the resulting DCF calculations) were materially  
11       affected downward by their own declining payout policies, as is the case today.

12               This is to say, the appearance of DPS growth in a prominent place in the  
13       Generic Finance RD for the Electric/Gas group was a function of an equilibrium  
14       in short-term dividend payouts that is not the case today. Thus, it is not correct  
15       for Staff to say that the model is functioning as it was intended. Rather, the model  
16       is functioning today in a way that the utilities in New York find objectionable  
17       relating to circumstances that have changed since the early 1990s.

18    Q.        Why is it that declining projected dividend payout ratios create an unsustainably  
19       low growth rate for G1 if projected DPS growth is used?

20    A.        When companies have declining dividend payout policies, it does not mean that  
21       growth is declining. Rather, it means that a greater share of earnings growth is  
22       reflected in growth in retained earnings rather than through dividends. Staff’s use  
23       of DPS for G1 ignores the impact of this shift toward growth in retained earnings

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 during times of declining dividend payout ratios for the years in the first stage of  
2 its two-stage DCF model.

3 Q. Staff maintains that the use of the sustainable growth for G2 countervails the  
4 effect of short-term dividend payout policies for G1 in the DCF calculation. Do  
5 you agree?

6 A. No.

7 Q. Why doesn't Staff's G2 calculation fix the problems you have identified with G1?

8 A. Staff is entirely correct that its "DCF model is driven by the expected earnings"  
9 (p. 122). While Staff's G2 takes growth in retained earnings into consideration,  
10 Staff excludes growth from retained earnings in G1. However, Staff's claim that  
11 "[t]he short-term dividend rate actually has very little effect on the DCF return on  
12 equity" (p. 120) is incorrect and is of little consolation. Staff's model, by using  
13 short-term DPS growth for the first five years, injects the effect of those declining  
14 payouts (without accounting for any growth in retained earnings during that  
15 period) into its calculated result through G1, regardless of how G2 is calculated.  
16 In short, G1 reflects unsustainably low growth, a problem that is not remedied by  
17 other parts of the Staff DCF formula. Simply put, Staff's G2 calculations cannot  
18 compensate for the use of an unsustainably low DPS growth for G1 in the current  
19 financial environment for the proxy group utilities.

20 Staff's G2 (at a mean of 5.05 percent) allows for the effect of projected  
21 dividend policies for the proxy group companies, as Staff correctly points out in  
22 the particular case of Hawaiian Electric. That is, the G2 genuinely reflects a  
23 sustainable growth rate driven by companies' earnings growth prospects. But the

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 G1, reflecting short-term DPS growth, is not a sustainable growth rate. Thus, the  
2 generic DCF long-form model averages a flawed growth rate of 3.61 percent (G1)  
3 with a sustainable average growth rate of 5.05 percent (G2). Since Staff’s G2  
4 growth rate is not artificially high, it cannot offset the cumulative effect of using  
5 five years of an unsustainably low G1. Thus, the mistaken exclusion of retained  
6 earnings from G1 artificially depresses the overall growth rate. Staff should fix  
7 its G1 calculation to eliminate this error. For the Generic Finance DCF model to  
8 fix the dividend payout problem in G1, something must be added to the analysis  
9 to countervail the problem of using short-term growth rates that are unsustainably  
10 low.

11 Q. Staff comments on the Hawaiian Electric example (pp. 121-123), and  
12 accompanying Exhibit \_\_ (FP-24), showing how retention policies and  
13 sustainable growth interact. Do you have any comments?

14 A. Yes. Staff demonstrates that if payout ratio levels are higher, then retention  
15 growth rates are lower, and vice versa. In principle, this is correct—but it is not  
16 relevant or responsive to the point I am identifying. The average G1 for the proxy  
17 group is unsustainably low. The “sustainable” growth used in year six and  
18 onward in Staff’s “long-form” DCF does not correct for the deficiency; it only  
19 limits the growth problem to the first five years.

20 Q. How do you propose to correct the problem?

21 A. I propose to leave all of the existing Generic Finance DCF architecture in place,  
22 but to add back the effect of using what, in 2009, reflected an unsustainably low

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 G1 for those first five years. Effectively, I propose to add the value of growth in  
2 retained earnings to counteract the declining dividend payout ratios.

3 Q. How do you propose to do that?

4 A. I propose to calculate the difference in growth associated with today's payout  
5 ratios and those that show up with the lower payout ratios (and hence higher  
6 growth rates) associated with the *Value Line* projections for 2012-2014, leaving  
7 everything else in Staff's sustainable growth calculation unchanged. I then add  
8 this growth increment to the DPS growth rates for the first five years. In this way,  
9 changing short-term dividend payout policies truly has no effect on the calculated  
10 cost of equity.

11 If aggregate payout ratios for the proxy group are not moving, then my  
12 proposed adjustment is zero. If the aggregate payout ratios are projected to  
13 increase, the adjustment is negative. The adjustment is only positive to the extent  
14 that the long-form DCF model, which has become customary to use in New York,  
15 uses a level of growth for DPS for the first five years that cannot be sustained.  
16 While I would rather that Staff drop the DPS growth rate entirely and stick to  
17 sustainable growth if it does not want to use analyst projections of earnings  
18 growth, if the currently model is to be retained, then this adjustment to reflect  
19 Staff's unsustainable DPS growth rates is a fair one. It reflects a phenomenon  
20 that the body of utility equity investors can readily see: broad movements in  
21 short-term dividend payout policies for the industry.

22 My calculations are contained in **Exhibit \_\_ (JDMR-3)**. The increment to  
23 the long-form DCF cost of equity is 23 basis points.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. Staff's example for Hawaiian Electric shows the inverse relationship between  
2 near-term DPS growth and sustainable growth as measured by B\*R. Is there  
3 anything wrong with Staff's example as a computational exercise?

4 A. There is nothing wrong with Staff's arithmetic—but in that arithmetic, Staff loses  
5 sight of what the DCF growth rate is trying to gauge. That is, the growth rate is  
6 supposed to reflect what is in the mind of investors that drives them to purchase  
7 common shares at the price we observe in the market.

8 *Value Line's* forecast financial ratios are driven by its estimates of  
9 companies' future profitability—the extent to which companies sell services in  
10 excess of what it costs to produce those services. Projected EPS reflects *Value*  
11 *Line's* best estimates of that profitability per share, from which the rest of its  
12 financial ratios derive. Sustainable growth—or  $B^*R + S^*V$ —is another, more  
13 indirect and disaggregated, way to reflect that profitability per share. But the  
14 near-term dividend payout policy, which drives short-term DPS growth, has  
15 nothing at all to do with either *Value Line's* profitability projections or the  
16 indirect sustainable growth measure as a reflection of investors' opinions, which is  
17 why I am proposing my alternative approach of adjusting the DPS, as discussed  
18 above.

19 In my opinion, *Value Line* EPS growth projections are the best reflection  
20 of what investors think. Sustainable growth is a reasonable, building-block,  
21 alternative—which is why I use it too. But short-term DPS growth, to the extent  
22 it is skewed to reflect anticipated changes in dividend payout policies, has nothing  
23 whatsoever to do with anticipated company profitability, with anticipated earnings

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 per share, or anticipated sustainable growth. It would be an irrational investor,  
2 acting contrary to the well-accepted tenets of efficient markets, to place any  
3 weight on anticipated payout ratio changes in his or her beliefs in the profitability  
4 and growth potential for a share of common stock.

5 Q. Do you have any specific comments on Staff Exhibit \_\_ (FP-24)?

6 A. Yes. In this exhibit, Staff attempts to demonstrate that G1 reflects earnings  
7 growth by showing that if earnings were to increase by 16 cents, its model would  
8 produce a result of 8.89 percent, rather than 8.32 percent. The difficulty with this  
9 hypothetical is that it is *just* a hypothetical—earnings growth has not occurred in  
10 the way assumed in that hypothetical.

11 Staff's example with Hawaiian Electric reflects an over-engineering of the  
12 mechanics of the DCF model without a connection to what has the ability to shape  
13 investor behavior or reflect investor opinions. Investors have expectations that go  
14 beyond three years (Staff's G1). While Staff's sustainable growth (G2) has a  
15 chance of reflecting these visions, Staff's DPS-based G1 has no chance of doing  
16 so—investors will look right past it knowing that short-term DPS growth figures  
17 merely reflect the mood of the Board room to change payout ratios—not the  
18 company's real growth prospects.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 C. MEAN VERSUS MEDIAN

2 Q. Do you agree with Staff's use of a median of the proxy group's DCF results in  
3 calculating the utility peer group's cost of common equity?

4 A. No. I disagree with Staff's use of the median in its two-stage DCF analysis,  
5 rather than the arithmetic mean (a simple average). I also disagree with Staff's  
6 use of the median in its calculation of beta in the CAPM analysis.

7 Q. Why do you object to Staff's use of a median?

8 A. It is highly unusual, not based upon the Generic Financing RD, and it artificially  
9 suppresses Staff's calculated DCF result downward by a material amount (26  
10 basis points). Additionally, the use of medians in the CAPM model creates a  
11 downward bias of five basis points.

12 Q. Is the use by Staff of the median for the individual calculated ROEs for the proxy  
13 group normal practice among Staff's peers in other states?

14 A. No. While there are some consumer advocate witnesses that have proposed the  
15 use of medians from time-to-time, I have surveyed the 2009 orders of every state  
16 commission that was included in RRA's survey of regulatory decisions and find  
17 that New York is the only commission that uses the median. **Exhibit \_\_ (JDMR-**  
18 **4)** lists those cases, the states, and the dates. Moreover, based on the cases in  
19 which I have appeared, I know of no other commission staff peers to the Staff that  
20 use the median of the calculated ROEs for a proxy group rather than the mean.

21 Q. What is the problem with the median?

22 A. In a nutshell, it introduces an unjustifiable bias downward, given the  
23 characteristics of the peer group we are working with.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. How so?

2 A. The distribution of calculated (or awarded) returns for a proxy group of  
3 companies is limited on the low side—but not so limited on the high side—by the  
4 consistent dividend yield that defines inclusion in the proxy group. This means  
5 that measured over time, the distribution of ROEs is not a normal “bell” curve but  
6 is skewed to the right. In this situation, the median will by definition give a lower  
7 number than the mean.

8 Q. Can you explain what you mean with a simple example?

9 A. Yes. Suppose that the “true” cost of equity in the market is a hypothetical 12  
10 percent. Suppose also that the empirical reality is that the distribution of ROEs is  
11 such that three quarters of the time, for whatever reason, a firm will realize returns  
12 on equity half a percent less than allowed, and one quarter of the time, it will  
13 realize “abnormally” high returns of 1.5 percent above what is allowed. (That is,  
14 the distribution is skewed to the right.) The probability-weighted average (the  
15 mean) of the outcomes (*i.e.*,  $11.5\% * 0.75 + 13.5\% * 0.25$ ) is 12 percent, which is  
16 consistent with our assumed true cost of equity capital. However, if the median  
17 measure of 11.5 percent is used, then the utility’s expected return will be  $(11.0\% * 0.75 + 13.0\% * 0.25)$  or 11.5 percent, which is insufficient given the  
18 expectations of the investors.  
19

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. Staff says that it uses the median, rather than the mean, when reporting the group  
2 DCF results so as to “diminish” the “effect of any outliers.” (p. 83). Is this  
3 appropriate?

4 A. No. Medians are commonly used in statistics when outliers in the group (which,  
5 in this case, is a population, not a sample)<sup>6</sup> would otherwise bias the results  
6 unreasonably. However, this is not the case when employing a proxy group DCF  
7 approach where all utilities are by definition comparable to the subject company.

8 Q. When is the use of the median proper?

9 A. One common use of medians is in reporting typical or “average” incomes of  
10 people in a particular region. For example, if Bill Gates’ income was included in  
11 the mean income of people in the Seattle area, the result would overestimate the  
12 typical person’s income because Bill Gates’ income is so much higher than that of  
13 everyone else in the area. Using the median would place much less weight on Bill  
14 Gates’ income, and therefore would provide a more representative measure of  
15 income levels for a typical person. Proxy groups, in contrast, are specifically  
16 constructed to be representative of the company that is being investigated. If a  
17 company were not representative, then it would not be included in the proxy  
18 group in the first place. Therefore, there is no reason to prefer the median to the  
19 mean when conducting a proxy group analysis.

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<sup>6</sup> It is the population of all the companies that are comparable to the company given the screening process used by Staff.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. How does the underlying distribution of ROEs affect whether or not the median is  
2 a reasonable metric to use?

3 A. If a distribution is symmetric (*i.e.*, observations equidistant from the expected  
4 outcome have the same frequency), then the mean and median will be the same.<sup>7</sup>  
5 The more asymmetric the underlying distribution, the bigger the difference will be  
6 between the two measures. I have performed an analysis to show that the  
7 historical distribution of allowed ROE decisions has indeed been asymmetrical;  
8 specifically, it has been skewed to the right, with high values more likely than low  
9 ones.

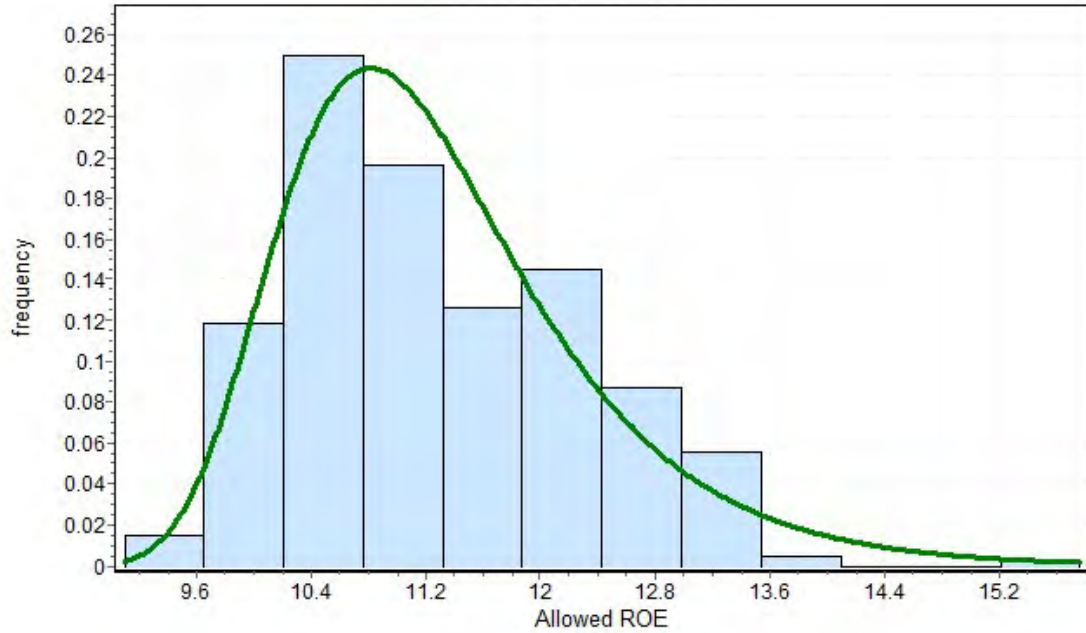
10 As **Figure 1** shows, ROEs allowed for Staff’s 33 company proxy group  
11 over the last 20 years have been distributed with precisely the kind of rightward  
12 skew that make the median an improper measure of expected value according to  
13 the example I provide above. This is further confirmed in **Figure 2**, which shows  
14 the distribution of “long-form ROEs” calculated in the Staff DCF model.  
15 Because all the companies in this set are by definition the Companies’ peers, each  
16 quantitative result should bear on the expected return that is the target of the ROE  
17 testimony. Diminishing the effects of so-called outliers, as the Staff suggests,  
18 distorts the true underlying distribution, and the expectations of investors.

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<sup>7</sup> Defusco, Richard A., *et al.*, *Quantitative Methods for Investment Analysis*, United Books Press, Baltimore (2001), p. 140.

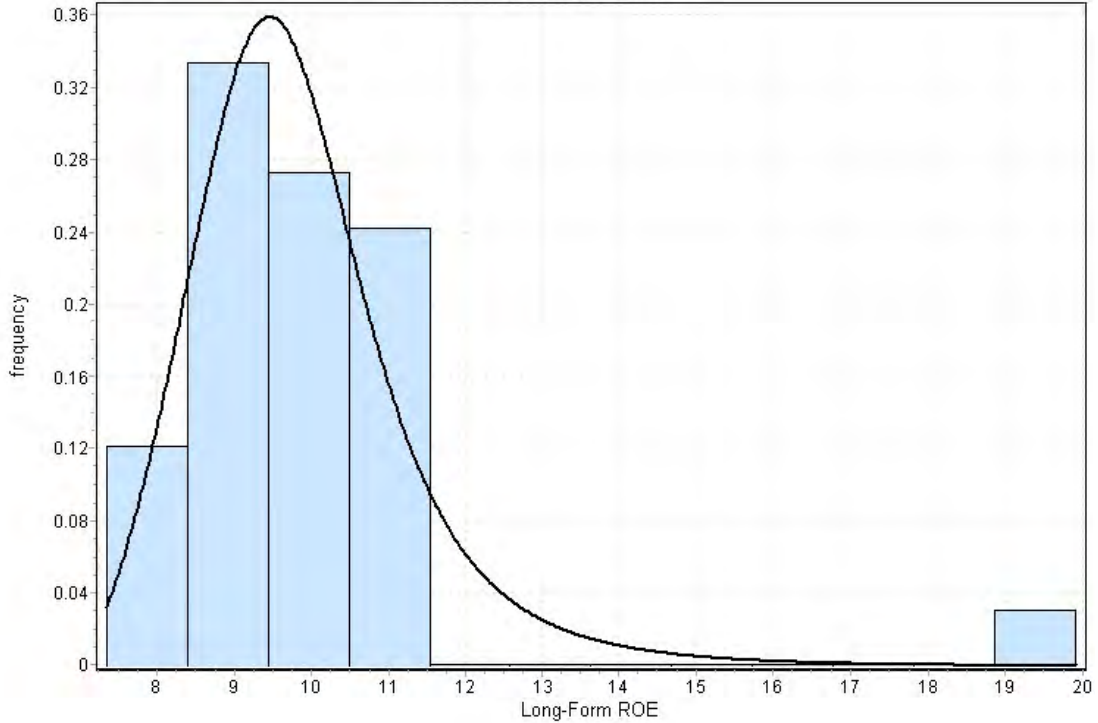
## REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D

1 **Figure 1. Distribution of Historically Allowed ROEs for the 33 Peers (1990-2009)**



2

3 **Figure 2. Distribution of Calculated Long-Form ROEs in Staff's Peer Group**



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**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1           Therefore, while it may be the case that we would be indifferent between  
2           using the mean or the median if the true distribution of ROEs were symmetrical,  
3           given actual outcomes, the median introduces a downward bias on the ROE  
4           calculation.

5   Q.   **Figure 2** shows one firm’s results far to the right. Would it be correct for Staff to  
6           use the median to avoid the effect of that lone observation?

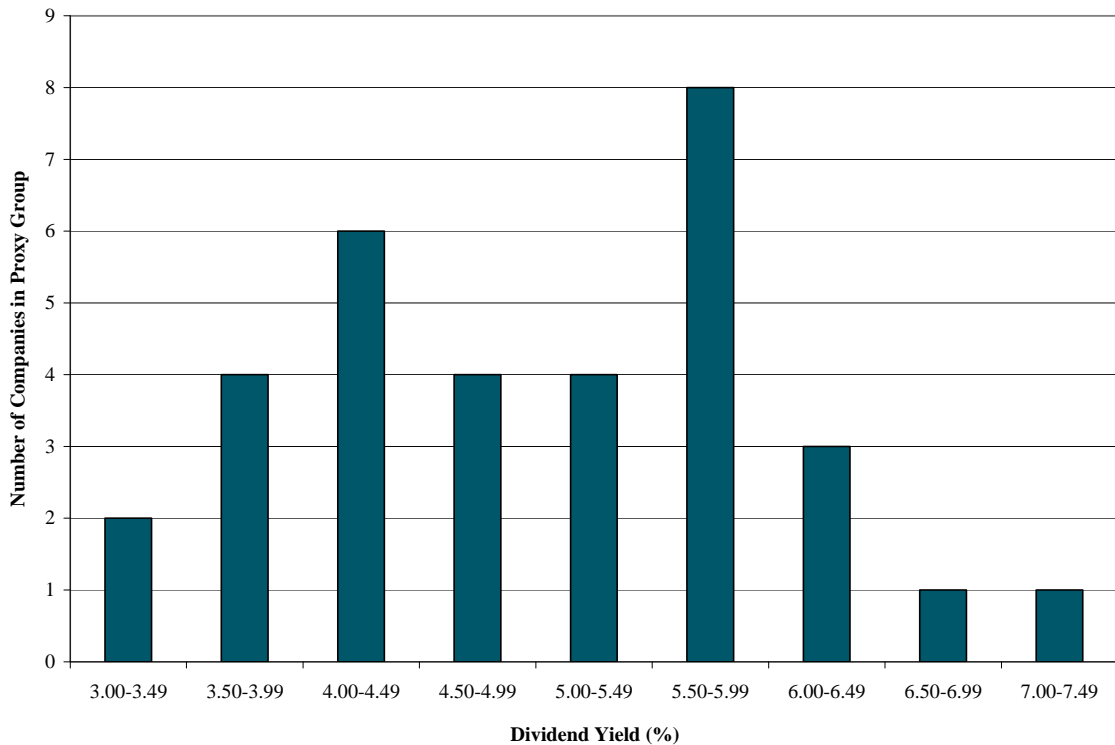
7   A.   No. That would be intentional data mining—which to those who deal with  
8           statistics signifies using the results of the calculations to justify a different form of  
9           analysis based on a desire for a particular result.

10 Q.   Please explain why the distribution of allowed ROEs can be expected to have that  
11           kind of right-hand tail to the distribution of returns.

12 A.   The fact that all of the companies pay a common dividend, and therefore have a  
13           dividend yield, puts a boundary on how low the allowed ROE can be set, as  
14           shown in **Figure 3**.

## REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D

Figure 3. Distribution of Dividend Yields in the Proxy Group



Using data in Staff's Exhibit \_\_ (FP-12) the current average dividend yield (2009 DPS/Price) is 4.99 percent (the median, minimum, and maximum current dividend yield are 5.16 percent, 3.02 percent, and 7.01 percent, respectively).

Expectations with respect to the growth rate, however, vary more widely with a right-hand skew. Using data from Staff's Exhibit \_\_ (FP-12), the average growth rate is 5.05 percent, the median growth rate is 4.51 percent, and the minimum and maximum are 1.68 percent and 17.20 percent, respectively. **Exhibit \_\_ (JDMR-3)** presents these calculations. Again, it is important to note that when performing a comparable group analysis, it would be inappropriate to favor certain results in order to create a desired outcome. Given this rightward skew, the use of medians

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 rather than means is inappropriate—because it artificially gives less weight to the  
2 observations in the right tail.

3 Q. Does the use of median also bias the beta result in Staff’s CAPM model?

4 A. Yes. The use of the median beta value of 0.70 instead of the mean 0.71 reduces  
5 the result of the CAPM model by five basis points.

6 **D. SELLING AND ISSUANCE COSTS**

7 Q. Does Staff object to the recovery of selling and issuance costs incurred in the  
8 past?

9 A. Yes. Staff argues (pp. 114-116) that my recommendation to allow recovery of  
10 issuance costs is “unsupported,” asserting that I have not identified any “equity  
11 issuances by NYSEG or RG&E during the rate year.” Staff’s argument, however,  
12 fails because I have seen no evidence that the accumulated issuance costs for  
13 NYSEG and RG&E have indeed been recovered in rates and therefore those past  
14 selling and issuance costs should be included when setting rates for the rate year.  
15 Such expenses have not been fully collected by the Companies in rates and  
16 therefore should be included here.

17 Staff describes a policy to deal with prospective selling and issuance  
18 expenses. What Staff ignores are past selling and issuance expenses that have  
19 never been expensed or collected in rates. Traditional selling and issuance  
20 adjustments in the rate of return include no provision for amortization of those  
21 costs. If those past expenses had been collected, there would be no dispute now.  
22 But, when the traditional adjustment is simply dropped based on a new policy to  
23 deal with future expenses, the past expenses remain uncollected.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1           Because of issuance costs, the net proceeds of common equity issuance  
2           will always be less than the total purchase price of the securities issued. Unless  
3           an adjustment is made to reflect this phenomenon in the fair rate of return—an  
4           adjustment consistent with the issuance cost adjustment already made for debt and  
5           preferred stock—the resulting fair rate of return calculations will be too low.

6 Q.    Please explain how Staff ignores issuance expenses that have never been  
7           expensed or collected in rates.

8 A.    Traditional practice in many states, New York included, was to include a return  
9           element for selling and issuance expenses, just like a return component is  
10          included for such expenses with debt. The only difference between the traditional  
11          treatment for debt and equity is that the debt selling and issuance expense  
12          principal would be amortized to be collected over the term of the debt issue.  
13          Since equity has no “term,” as such, there was no amortization of the principal—  
14          only a return component to reflect a holding charge. By pointing ahead to a  
15          prospective Commission policy regarding future equity issuances, Staff ignores  
16          the Companies’ accumulated retrospective selling and issuance expenses. It is as  
17          simple as that. I discussed this issue at length in my direct testimony (pp. 45-49),  
18          specifically with respect to this Commission’s policy.

19 Q.    Do you have any other comments on the importance of selling and issuance costs?

20 A.    Yes. It remains true that the companies in the proxy group have expenses  
21          associated with the issuance of their common stock, and unless recognition is  
22          made of the difference between what investors pay (as share prices) and what  
23          those utilities receive (as net proceeds from sale transactions), then a DCF

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 calculation will not accurately reflect the cost of capital for that proxy group as  
2 part of their reasonable cost of service. A DCF calculation for the proxy group  
3 that is correct in every other respect, but which does not reflect the cost of issuing  
4 securities, will understate the cost of capital for those companies—by precisely  
5 the selling and issuance expenses for those companies. The Commission’s task in  
6 this proceeding, as required by state and federal law, is to authorize a return on  
7 equity to be commensurate with the returns of comparable companies in the proxy  
8 group. Thus, a selling and issuance cost adjustment must be made in order to  
9 reflect that proxy group’s true capital cost—a cost attributable to NYSEG and  
10 RG&E as well. Correcting for the mistaken exclusion of past selling and issuance  
11 costs would increase Staff’s DCF result by 24 basis points.

12 **E. THE PROPER RISK-FREE RATE**

13 Q. Why would it be preferable to use a 20-year bond, rather than the average of a 10-  
14 year and 30-year bond, in the CAPM calculation?

15 A. To avoid giving weight to low short-term interest rates in the current markets.  
16 The Generic Finance RD refers merely to “long-term treasury bonds” when it  
17 discusses the CAPM (*e.g.*, p. 50). In this credit environment, when short-term  
18 government bond rates hover in the neighborhood of zero, it would be advisable  
19 to consider whether the traditional Staff interpretation of the generic formula,  
20 using an average of 10-year and 30-year bonds, is still wise. I think it is not wise,  
21 as the 10-year bonds are unduly colored by the collapse in short-term rates—rates  
22 that have nothing to do with the cost of equity.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Perhaps the best way to see how 10-year government bond rates are  
2 skewed downward is to examine how Staff’s recent practice compares to simply  
3 using a 20-year bond. In this credit market, where short-term government bond  
4 yields continue to be extraordinarily low, I would first recommend using only the  
5 longest-term bond, *i.e.*, the 30-year Treasury bond. But as a secondary  
6 recommendation, I would avoid both the 10-year and 30-year bonds in favor of  
7 the 20-year bond, which is widely traded. Replacing the Staff’s 10-year Treasury  
8 bond with the 20-year bond would increase Staff’s CAPM ROE by 10 basis  
9 points. **Exhibit \_\_ (JDMR-5)** shows the impacts of using different risk-free  
10 rates.

11 **F. DECOUPLING ADJUSTMENT**

12 Q. What is the purpose of this section your testimony?

13 A. I respond to Staff’s recommendation of a 10 basis point disallowance related to a  
14 revenue decoupling mechanism (“RDM”). Staff states (p. 94) that an RDM is “a  
15 true-up mechanism that transfers the risks of sales variances from a utility to its  
16 ratepayers.” I published an article in the *Energy Law Journal* in 2008 on the  
17 subject of decoupling, which is attached as **Exhibit \_\_ (JDMR-6)**.<sup>8</sup> In that  
18 article, I conclude that decoupling is an essentially incremental change in the way  
19 that a utility designs its rates or bills its customers. Such an incremental change in  
20 rate design and billing does not affect the risk for which investors require  
21 compensation in the form of a return on equity. This understanding of investor

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<sup>8</sup> Makholm, Jeff D., “‘Decoupling’ for Energy Distributors: Changing 19<sup>th</sup> Century Tariff Structures to Address 21<sup>st</sup> Century Energy Markets,” *Energy Law Journal* Vol. 29, No.1 (2008), pp. 157-172.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 expectations is bolstered by recent credit rating agency publications. As shown in  
2 **Exhibit \_\_ (JDMR-7)**, Standard & Poor’s has said, for example, that it “does not  
3 expect decoupling to have [a] noticeable impact on the company’s financial  
4 condition.”<sup>9</sup> There is no justification for using minor changes in rate design or  
5 billing practices as a pretext for reducing a fair rate of return.

6 Q. Does Staff’s Exhibit \_\_ (FP-15) present fair points of comparison?

7 A. No. The majority of the companies in Staff’s Exhibit \_\_ (FP-15) operate  
8 predominantly as natural gas distribution companies, rather than as combination  
9 electric and gas utilities like the Companies. In fact, over half of the decisions  
10 involving electric utilities made *no adjustment* for the revenue decoupling  
11 mechanism, while most of the decisions involving gas utilities made an  
12 adjustment.

13 RG&E and NYSEG are predominantly electric utilities.<sup>10</sup> The  
14 implications of revenue decoupling are quite different for electric and gas utilities,  
15 and the allowed ROEs should reflect that fact. Gas LDCs typically are  
16 experiencing declining use per customer, but that is generally not the case for  
17 electric utilities.<sup>11</sup>

18 Moreover, Staff’s computation of the average and median RDM basis  
19 point adjustment for the companies on Exhibit \_\_ (FP-15) is misleading, as Staff

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<sup>9</sup> Standard and Poor’s, “Bulletin: Decoupling Order Does Not Affect NSTAR Ratings,” (July 21 2008).

<sup>10</sup> In terms of revenues, 61 percent and 75 percent of RG&E and NYSEG revenues are from electric utility operations, with the remainder from gas distribution. When purchased gas and fuel and purchased power are backed out of the Companies’ gas and electric revenues, the ratios are 73 percent and 79 percent, respectively.

<sup>11</sup> EIA Annual Energy Review 2008, Report No. DOE/EIA-0384 (2008), June 26, 2009.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 excludes those instances in which the various commissions adopted an RDM  
2 adjustment of zero basis points.

3 Q. Please provide your general opinion on the decoupling adjustment proposed by  
4 Staff.

5 A. Staff's proposal is inappropriate and unsubstantiated. It creates a nexus between  
6 cost of capital and rate design/billing practices that simply does not exist. A  
7 revenue decoupling mechanism is best viewed as a way to automate some tightly-  
8 defined parts of a process that would otherwise play out through traditional  
9 regulatory processes (*i.e.*, the Companies' rate cases). Consider, for example, the  
10 decline in sales that many utilities experienced in 2009. That decline in sales may  
11 be attributed to many factors, including the economic downturn, customers'  
12 response to high commodity prices (price elasticity), increased energy efficiency,  
13 and demand-side management. It is noteworthy that these industry circumstances  
14 affected all utilities, those with decoupling mechanisms and those without.  
15 Utilities without decoupling mechanisms have sought rate adjustments through  
16 rate cases, while those with decoupling mechanisms have received the automatic  
17 rate adjustments that those mechanisms provide in between rate cases. How the  
18 rate adjustment is achieved holds less relevance than the fact that it is achieved.  
19 Rate adjustments for utilities whose costs and revenues diverge significantly were  
20 part of the regulatory framework in the U.S. prior to decoupling and will continue  
21 to be now that decoupling is a more common practice. Decoupling has not  
22 replaced the need for a rate case.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1           Decoupling mechanisms cannot be implemented without a periodic cost  
2 review to assure that costs and revenues do not diverge too much over time.

3           Ultimately all utilities, “decoupled” or not—and to be sure, there can be many  
4 subtle shades of “decoupling,” given that the term is often defined loosely—will  
5 need to go through rate cases to reset tariffs to cost of service. The form of  
6 achieving the rate adjustment does not affect the firm’s cost of capital and does  
7 not affect the value of the firm.

8 Q.    Are there ways in which decoupling may destroy value for equity investors?

9 A.    Yes. What is good for debtholders is not necessarily good for equity  
10 shareholders. The financial literature characterizes the relative positions of  
11 bondholders and equity shareholders as follows. The bondholders are viewed as  
12 the owners of the firm, while having issued a call option to the equity  
13 shareholders.<sup>12</sup> The value of the call option held by equity shareholders is directly  
14 linked to volatility of the firm's cash flows. A reduction in the volatility of firm  
15 cash flows will reduce the value of shareholders' call option.

16 Q.    Has the Staff provided any evidence at all that equity investors in combination  
17 electric and gas utilities believe that some sort of revenue decoupling is in their  
18 interest?

19 A.    None whatsoever. In my opinion, the effect of imposing a “decoupling  
20 adjustment” to ROE for combination electric and gas utilities like NYSEG and  
21 RG&E, when there is no conceptual basis for the adjustment or empirical

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<sup>12</sup> See, e.g., Ross, Stephen, Randolph Westerfield and Jeffrey Jaffe, *Corporate Finance*, Times Mirror Higher Education Group, 4<sup>th</sup> edition, Chicago, 1996, pp. 592-593.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 evidence that it reflects investor expectations, will signal increased risk of a  
2 failure to earn a reasonable return. Such would be the signal given to investors of  
3 any reduction to the allowed ROE that has no solid conceptual grounding and no  
4 evidence to support it.

5 Q. Have credit rating agencies stated the relevance of decoupling to a utility’s credit  
6 worthiness?

7 A. In **Exhibit \_\_ (JDMR-8)**, I provide a Moody’s document as a recent example of a  
8 “rating methodology” that specifically applies to regulated electric and gas  
9 utilities. In these industry studies, the rating agencies typically make some effort  
10 to display their expertise on the key topics of concern in that industry. Thus, on p.  
11 9, Moody’s discusses “decoupling” for gas local distribution companies, which  
12 suffer because of declining use per customer (something that is not the case for  
13 the electric utility industry). Credit agencies are focused on the risks borne by  
14 debtholders.

15 Q. Have you performed a quantitative analysis of investor reactions to commission  
16 decoupling rulings?

17 A. Yes, I performed an event study to test whether equity investors view decoupling  
18 as a material event. An event study uses share prices changes to measure the  
19 economic effect of a given event or set of events on the value of a firm or set of  
20 firms. Event studies are well suited to measuring the economic effects of a  
21 specific change in regulation or regulatory environment.<sup>13</sup>

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<sup>13</sup> See, e.g., Schwert, G. William, “Using Financial Data to Measure Effects of Regulation,” *Journal of Law and Economics*, April 1981, 24(1), pp. 121-158.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Q. What “events” did you examine?

2 A. Six U.S. states have pursued decoupling for electric utilities. For those states, I  
3 defined an “event” to be the issuing of an order by the state regulatory  
4 commission on decoupling. In two states, New York and Massachusetts, the  
5 regulatory commission mandated decoupling in a single Order. In other states,  
6 decisions to decouple were typically made and communicated to the market  
7 together with rate case decisions. In those situations, it was not analytically  
8 tractable, at least within the time permitted by the procedural schedule in this  
9 docket, to dissect the market response and determine what share of the response is  
10 attributable to decoupling, as compared to other news regarding utility rates. I  
11 therefore focused on the decoupling announcements that were independent of rate  
12 case news.

13 Q. How did you evaluate the economic effects of the events?

14 A. I define share price excess returns as the returns over and above those predicted  
15 by a market model, which accounts for normal volatility in returns and the  
16 correlation (*i.e.*, beta) relative to the broader market and peer index. If the excess  
17 returns of affected firms are statistically significant, then I consider decoupling to  
18 be a material event. If there is no significant excess return, I interpret that to  
19 mean decoupling is not material to equity investors.

20 Q. Is it possible that even if investors perceive the news of decoupling as lowering  
21 their risks materially, there would be no impact on the value of the affected firm?

22 A. If investors anticipate a lower allowed ROE associated with decoupling, then the  
23 firm’s expected future cash flows will be expected to decline as a result of the

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 decoupling news. If investors perceive that both the discount rate and the cash  
2 flows decline in just the right way, then, in principle, the share value could remain  
3 unchanged.

4 Q. Is this plausible?

5 A. It is plausible, but unlikely.

6 Q. Why is it unlikely that investors would anticipate a lower allowed ROE (and  
7 hence lower cash flows) as a result of decoupling?

8 A. There are three reasons this is unlikely. The first is that decoupling is essentially  
9 an incremental change in the way that a utility designs its rates or bills its  
10 customers. Decoupling does not modify the regulatory compact under which  
11 utilities commit their capital to serve the public.

12 Secondly, investors are well aware that public utilities commissions across  
13 the country do *not* consistently mandate reductions in allowed ROE as a result of  
14 decoupling, so there is no basis to assume that decoupling news should somehow  
15 imply a lower allowed ROE. While some commissions have reduced the allowed  
16 ROE, others have not. Some commissions have reduced ROE for one  
17 jurisdictional utility, but not for others. Furthermore, the adjustments vary in  
18 magnitude. In more than one-third of the cases cited by Staff in Exhibit \_\_ (FP-  
19 15), the regulatory commission applied no decoupling adjustment to ROE, despite  
20 the parties' proposals to reduce ROE for decoupling.

21 I cite below quotations from commissions, including this one, who have  
22 elected not to implement an ROE adjustment in connection with decoupling of  
23 one form or another:

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 No RDM adjustment is proposed or is being made to the ROE  
2 since the risk reducing effects of the RDM are already reflected in  
3 the Company's credit ratings. (NY PSC CASE 08-E-0539,  
4 ORDER SETTING ELECTRIC RATES, April 24, 2009)

5 Staff witness VanderHeyden states that the proxy group data he  
6 analyzed already incorporates the reduction in risk for weather or  
7 conservation mitigation. For this reason, Staff recommends no  
8 reduction in the Company's return on equity to account for any  
9 lowered risk due to Rider 8. The Company concurs with Staff that  
10 a reduction on return on equity in this case is unwarranted. BGE  
11 witness DeFontes states that Rider 8 only allows BGE to recover  
12 approved revenues and the Company does not see the need for a  
13 downward adjustment on return on equity. Based on the reasons  
14 provided by Staff and the Company, the Commission declines to  
15 order a specific adjustment for Rider 8 effects. (Maryland PSC  
16 ORDER NO. 80460, December 21, 2005)

17 The diverse actions of commissions with regard to an ROE adjustment for  
18 decoupling confirm that it would be unreasonable to expect investors to  
19 incorporate an expectation that the allowed ROE will be reduced in any  
20 predictable fashion.

21 Finally, to expect both the future cash flows (as dictated by the allowed  
22 rate of return) and the discount rate to adjust to precisely the level where firm  
23 value is unaffected is also unlikely.

24 Q. Please describe the results of your event study.

25 A. I do not find any statistically-significant effect of decoupling orders on equity  
26 share prices for the affected utilities. This suggests that either:

- 27 • there is no effect; or
- 28 • the effect is so small that it is immaterial.

29 In either case, the empirical evidence does not support the use of a downward  
30 adjustment to the allowed return on equity.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 **G. THE CLAIMED UNIQUENESS OF NEW YORK**

2 Q. Does the investment community treat New York as a state with policies that  
3 effectively countervail the low allowed ROEs in New York?

4 A. No. Staff vigorously but erroneously argues (pp. 127-134) that New York is  
5 somehow more generous in other areas of the ratemaking process and that this  
6 somehow offsets the low ROEs produced by the Generic Finance Proceeding  
7 methodology. However, as discussed in my direct testimony in considerable  
8 detail (pp. 57 - 64), this argument is not credible. For the financial community,  
9 the cost of common equity is the single most visible rate case figure. Even if New  
10 York is more “generous” than some other states in other aspects of a rate case,  
11 which I have explained is not the case, that does not eliminate the problem  
12 associated with New York’s persistently low allowed ROEs relative to other  
13 states.

14 The simple fact is that the Commission’s allowed ROEs continue to be  
15 unreasonably low at least in part as a result of the conceptual flaws and other  
16 inconsistencies that I describe in my testimony. Adopting Staff’s recommended  
17 positions on the DCF growth rate (*i.e.*, using DPS growth rates, while excluding  
18 retained earnings), using suspect inputs such as the medians for the DCF proxy  
19 group result and CAPM beta, denying recovery of selling and issuance costs, and  
20 imposing an unnecessary downward adjustment for implementation of a revenue  
21 decoupling mechanism will only perpetuate the unreasonably low ROEs allowed  
22 by New York as compared to its peers in other states. Such unreasonably low  
23 ROEs, in turn, will continue to influence the opinions of RRA, credit rating

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 agencies and investors regarding the quality of regulatory support from the  
2 Commission.

3 Q. The Staff Finance Panel claims that a regulatory pass-through of commodity costs  
4 is unique to New York. (pp. 100 -101) Is this factually correct?

5 A. No. New York is not different in allowing its utilities the opportunity for timely  
6 recovery of fuel and/or purchased power costs through an adjustment clause.  
7 Such adjustment clauses are common practice across the U.S. That every  
8 company—save one—in Staff’s peer group has similar adjustment clauses should  
9 be evidence that Staff is incorrect in its beliefs regarding the uniqueness of the  
10 regulatory framework in New York. In its response to Request for Information  
11 NYSEG-RGE-53, Staff presents outdated credit rating analyst reports, from 2004  
12 to 2006, as evidence of the rarity of fuel adjustment mechanisms elsewhere.  
13 However, this information, some of which is over four years old, is misleading.  
14 In the last several years, Commissions in eight traditionally-regulated jurisdictions  
15 have approved 11 new fuel adjustment clauses.<sup>14</sup>

16 Moreover, rate freezes have ended in the “electric restructuring” states.  
17 For the 14 states that can to be considered to have restructured, all have some  
18 form of power cost pass-through mechanism that passes the cost of procuring  
19 power (*i.e.*, the market price) directly through to end use customers. (This is often  
20 referred to as Standard Offer Service or Default Service.)

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<sup>14</sup> See Before the Public Service Commission of Utah, Supplemental Direct Testimony of Karl A. McDermott, Docket No. 09-035-15, August 12, 2009, p. 37.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1           As summarized in **Table 2**, essentially all of the peer group companies  
2           have commodity pass-through mechanisms in place—the only exception being  
3           Great Plains, which doesn't have commodity pass-through in one of the states it  
4           serves, Missouri.

5           Nor is decoupling unusual, as shown in **Exhibit \_\_ (JDMR-9)**. As shown  
6           in **Table 2**, the risk-reduction benefits of decoupling, if any, would already be  
7           factored into the prices of the peer group's equity securities.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1

**Table 2. Commodity Pass Through and Decoupling for Staff Proxy Group**

Company	Commodity Pass-Through	Decoupling
ALLETE	√	√
Alliant Energy Corp.	√	√
Ameren Corp	√	
American Electric Power	√	√
Avista Corp	√	
Black Hills Corp	√	
Cleco Corp.	√	
Con Edison Inc	√	√
DPL Inc.	√	√
DTE Energy	√	
Duke Energy Corp	√	√
Edison International	√	√
Empire District Electric	√	
Entergy Corporation	√	
FirstEnergy	√	√
FPL Group, Inc.	√	
Great Plains Energy		
Hawaiian Electric	√	√
IDACORP, Inc.	√	√
MGE Energy Inc.	√	√
Northeast Utilities	√	√
NStar	√	√
PG&E Corp	√	√
Pinnacle West Capital	√	
Portland General Electric Company	√	√
Progress Energy	√	
Sempra Energy	√	√
Southern Co.	√	
TECO Energy Inc.	√	
Vectren Corp	√	
Westar Energy Inc.	√	
Wisconsin Energy	√	√
Xcel Energy	√	

2

3

4

Note: A “√” indicates that at least one of the company’s subsidiaries has the clause described above.

5

Q. Staff Finance Panel further argues that such a regulatory pass-through should

6

lower the allowed ROE. Please respond.

7

A. Staff displays a narrowness of perspective when it characterizes New York as a

8

uniquely supportive regulatory jurisdiction. In this case and in numerous other

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 cases, in my experience, it has sought to distinguish the risks faced by equity  
2 investors in New York utilities from the risks faced by equity investors in non-  
3 New York utilities.

4 Staff characterizes the regulatory framework in New York as investor  
5 friendly and unique. Staff cites factors such as commodity pass-through clauses  
6 and the use of a forward-looking test year as examples of regulatory mechanisms  
7 that lower risks for equity shareholders in New York and therefore merit lower  
8 ROEs. In **Exhibit \_\_ (JDMR-10)**, RRA published its quarterly State Regulatory  
9 Evaluations in which New York is characterized as “Average/3” —only seven  
10 states have a lower ranking. As I explain in my direct testimony, however, when  
11 the facts are considered in a transparent and unbiased manner, in a way that equity  
12 investors would do, it is evident that the regulatory framework in New York does  
13 not differ materially on those issues raised by Staff from those of other states. As  
14 shown above, timely pass-through of changes in commodity costs is a virtually  
15 universal regulatory practice. Furthermore, as shown in my direct testimony (p.  
16 59), only a half-dozen states rely on a backward-looking test year and therefore  
17 New York’s use of forward looking data for test year ratemaking purposes is not  
18 unusual. (*See* Makhholm Direct Figure 4). New York does not stand out as unique  
19 in its regulatory practices and a downward adjustment to ROE is not justifiable on  
20 account of the regulatory framework in these respects.

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

- 1 Q. Did Staff make a correction to its calculations regarding the comparison of New  
2 York returns on equity with other states?
- 3 A. Yes. Regarding my comparison, Staff stated in its pre-filed testimony (p. 134)  
4 that considering the “A-” median bond rating in New York and the “BBB”  
5 median rating in other states “in and of itself moves New York ... within 40 basis  
6 points of the median national return on equity allowance.” According to Staff,  
7 that 40 basis point difference and “the many benefits . . . extended to utilities  
8 under New York regulation (p.134)” rendered incorrect my conclusion about New  
9 York being out of step with the national average. In its answer to NYSEG-RGE-  
10 56 (attached as **Exhibit \_\_ (JDMR-11)**, Staff corrected that 40 basis point figure  
11 to be 51 basis points, reflecting its interpolation for credit quality differences  
12 between the average return in New York that I presented (9.63 percent) and the  
13 median national allowed return (10.5 percent). Moving from 40 to 51 basis points  
14 strains the comparability with other states that Staff implies. Even then, Staff’s  
15 new 51 basis point gap accounts only for the credit quality difference between the  
16 “A-” median New York utility and the “BBB” comparable group in other states,  
17 not for that of “BBB+/Baa2” or “BBB/Baa2” rated NYSEG and RG&E,  
18 respectively. This appears to be an alternative credit quality adjustment that Staff  
19 is utilizing for its testimony, but is not applying to NYSEG and RG&E in this  
20 case. Accounting for Staff’s credit quality adjustment for NYSEG and RG&E  
21 (two and 18 basis points, respectively), still leaves an unexplained basis  
22 differential of 105 ( $10.5 - 9.63 + .18$ ) basis points and 89 ( $10.50 - 9.63 + .02$ )  
23 basis points for the two Companies, rather than the 51 basis points justified by

**REBUTTAL TESTIMONY OF JEFF D. MAKHOLM, PH.D**

1 Staff. If Staff were to utilize a credit quality adjustment consistently, it would  
2 substantially increase the nominal 2 and 18 basis point adjustments that Staff  
3 recommends here to bring NYSEG and RG&E's allowed ROE's to be within 51  
4 basis points of the national average allowed ROE. That is to say, if 51 basis  
5 points reflects Staff's view of the positive benefits of being regulated in New  
6 York, then in the case of NYSEG and RG&E that still leave 54 (105 – 51) and 38  
7 (89 – 51) basis points respectively, unaccounted for. Both Staff and the  
8 Commission should be more sensitive to the types of empirical and conceptual  
9 issues that drive such a wedge between them and their regulatory peers. Such  
10 sensitivity includes considering the specific points that I have addressed in this  
11 rebuttal testimony.

12 Q. Does this conclude your rebuttal testimony?

13 A. Yes.