PUBLIC REDACTED VERSION

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
Central Hudson Gas & Electric Corporation
for Electric Service

Case 17-E-___

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Proceeding on Motion of the Commission as to the
Rates, Charges, Rules and Regulations of
Central Hudson Gas & Electric Corporation
for Gas Service

Case 17-G-___

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DIRECT TESTIMONY OF THE FINANCE PANEL

July 28, 2017

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I. INTRODUCTION

Q. Please state the names of the members of the Finance Panel ("Panel").

A. Our names are Stacey A. Renner, Eileen M. Lomoriello and Agnieszka Pokora.

Q. Mr. Renner, please state your current employer and business address.

A. I am employed by Central Hudson Gas & Electric Corporation ("Central Hudson" or the "Company") and my business address is 284 South Avenue, Poughkeepsie, New York 12601.

Q. Mr. Renner, in what capacity are you employed by Central Hudson and what is your scope of responsibilities?

A. My position with Central Hudson is Treasurer. I am currently responsible for the Company's treasury and financial planning activities, including: 1) developing and implementing Central Hudson's financing plans; 2) managing cash and maintaining adequate liquidity; 3) understanding and managing Central Hudson's creditworthiness; 4) managing Central Hudson's banking and credit rating agency relationships; and 5) directing financial planning processes and providing corresponding analytical support to the organization.

Q. Mr. Renner, what is your educational background and professional experience?

A. I hold a Bachelor of Arts degree in Economics from Union College (Schenectady, New York) and a Master of Business Administration degree in Finance from Marist College (Poughkeepsie, New York). I have been employed by Central Hudson for a total of nineteen years. I joined Central Hudson in 1990 and worked as a rate analyst until 1996. In that role, my responsibilities included electric sales, customer and revenue forecasting, electric rates, and related analysis. From 1996 through 2003, I was employed by IBM, where I worked as a financial analyst and finance manager. In those roles, I provided financial support for various units of IBM Global Services, including business cases and discounted cash flow analysis, as well as many aspects of corporate and strategic planning. In 2003, I re-joined Central Hudson as Director - Investment Planning and Analysis. In 2005, I was appointed Assistant Treasurer, and then was promoted to Treasurer in 2006.

Q. Mr. Renner, have you previously testified before the New York State Public Service Commission ("PSC" or the "Commission")?

A. Yes. I testified directly in Central Hudson's last three rate cases: Cases 08-E-0887 and 08-G-0888; Cases 09-E-0588 and 09-G-0589; and Cases 14-E-0318 and 14-G-0319 and submitted rebuttal testimony in the Fortis, Inc. ("Fortis") - Central Hudson merger case, Case 12-M-0192. I also prepared and submitted Central Hudson's last four financing petitions: Case 06-M-0785, Case 09-M-0308; Case 12-M-0172; and Case 15-M-0251.

Q. Ms. Lomoriello, please state your current employer and business address.

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A. I am employed by Central Hudson and my business address is 284 South Avenue, Poughkeepsie, New York 12601.

Q. Ms. Lomoriello, in what capacity are you employed by Central Hudson and what is your scope of responsibilities?

A. I am employed by Central Hudson as Director - Strategic Planning. In that capacity, my responsibilities include: 1) coordinating the Company's strategic planning activities; 2) overseeing the maintenance and development of the Company's financial budgeting and planning system and tools; and 3) developing five-year financial forecast scenarios and sensitivity analyses to be used in developing the Company's strategic plan and business plan, and in supporting the Company's position in regulatory proceedings, rating agency reviews, and interaction with financial institutions.

Q. Ms. Lomoriello, what is your educational background and professional experience?

A. I am a 1996 graduate of the University of Pennsylvania with a Master of Government Administration Degree (Finance concentration), a 1992 graduate of Barnard College/Columbia University with a Bachelor of Arts Degree in Political Science and also have a Bachelor of Science Degree in Accounting at SUNY New Paltz substantially completed. Prior to joining Central Hudson, I held various positions in public accounting, public sector management and tax and incentives consulting. I joined Central Hudson as an Accountant in the Financial Reporting Group in 2006 and held various positions of increasing responsibility within the Accounting organization through 2010. From 2010 through 2015, I ran Central Hudson's Credit & Collections operation within the Customer Service group. In 2015, I moved into my current role as an Associate Director of Strategic Planning and was promoted to Director in 2016.

Q. Ms. Lomoriello, have you previously testified before the Commission?

A. No, I have not.

Q. Ms. Pokora, please state your current employer and business address.

A. I am employed by Central Hudson and my business address is 284 South Avenue, Poughkeepsie, New York 12601.

Q. Ms. Pokora, in what capacity are you employed by Central Hudson and what is your scope of responsibilities?

A. I am employed by Central Hudson as a Senior Financial Analyst. In my current position, my work is focused on long term planning and forecasting, preparation of forecasts providing a future outlook of the corporate financial position, business cases and support of operating teams on special projects that require financial expertise.

Q. Ms. Pokora, what is your educational background and professional experience?

A. I hold an Associate in Science degree in Business – Accounting from Westchester Community College, Bachelor of Business Administration degree in Public Accounting from Pace University and Master of Business Administration degree in Finance from New York Institute of Technology. I joined Central Hudson in 2005 as Junior Accountant. I was promoted to Assistant Accountant in 2006 and Associate Accountant in 2007. In 2008, I transferred from Accounting Group to Strategic Planning Group to my new role as Associate Financial Analyst and was promoted to Financial Analyst in 2011 and Senior Financial Analyst in 2015. My work experience in the Accounting Group centered on preparation of financial statements and research and implementation of new accounting rules.

Q. Ms. Pokora, have you previously testified before the Commission?

A. No, I have not.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of the Finance Panel's testimony in these proceedings?

A. Our testimony presents Central Hudson's overall cost of capital, including the cost of debt and the cost of equity, and also addresses the Company's financial integrity, cash requirements, financing program, and capital structure. Accompanying sponsored exhibits were prepared under our direction and supervision. Finally, this testimony relies on cost of equity recommendations developed by Concentric Energy Advisors, Inc. ("Concentric") and presented in the testimony and exhibits of Ann E. Bulkley.

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Q. Is the Panel sponsoring any exhibits in support of your testimony?

A. Yes. We have prepared the seven exhibits summarized below.

1) Exhibit __ (FP-1) - Three schedules supporting our discussion of financial integrity, including: public utility bond yields; Central Hudson bond ratings summary; and a press release from Fitch Ratings (“Fitch”).

2) Exhibit __ (FP-2) - COPYRIGHTED credit rating agencies’ reports that we reference in testimony.

3) Exhibit __ (FP-3) - Four schedules showing Central Hudson’s historical and forecasted cash requirements.

4) Exhibit __ (FP-4) - Two schedules showing Central Hudson’s projected financing program.

5) Exhibit __ (FP-5) - Five schedules supporting our discussion of capitalization, including: Central Hudson’s historical and forecasted capitalization and capitalization ratios; the authorized common equity ratios, allowed return on equity (“ROE”) and bond ratings for Central Hudson’s peer New York State utilities; and credit rating forecast scenarios.

6) Exhibit __ (FP-6) - Two schedules supporting the development of the cost of Central Hudson’s long-term debt.

7) Exhibit __ (FP-7) - A schedule summarizing Central Hudson’s average cost of capital and a supporting schedule showing

common equity balances and the calculation of average common equity.

Q. What are the key findings and recommendations presented in this testimony?

A. The primary focus of much of this testimony concerns the Company's financial integrity and resultant credit quality. While Central Hudson's current ratings on senior unsecured debt are "A2" (Moody's Investor's Service), "A-" (Standard & Poor's), and "A-" (Fitch), the Company's future capital expenditures represent a substantial increase over historic requirements and, as demonstrated in the testimony of Company Witness Bulkley, exceed the capital requirements for most of our peers. Combining these increased capital requirements with reductions in the Company's ability to generate internal funds during the rate period produces a situation where our external capital requirements will increase substantially over the rate period. This increase in external capital requirements comes at a time when the Company has not received positive news from the financial community. Specifically, Central Hudson: 1) has experienced two credit rating downgrades; 2) had its business risk profile increased by one credit rating agency; and 3) had concerns expressed about its credit metrics and current allowed rate of return.

The Commission has supported the Recommended Decision's finding in the Generic Finance Case, Case 91-M-0509, that an investment grade bond rating in the range of mid to upper "BBB" to low to mid "A" minimized the long-term cost of capital. Given the Company's current credit ratings, statements from the credit rating agencies, and potential declines in our financial indicia as the result of the increase in external requirements, there will be downward pressure on our credit ratings without supportive regulation that carefully considers the Company's pro forma credit metrics. The financial pressures that the Company will experience over the rate period are greater than any it has experienced in the recent past. As a result, the Company believes the best way the Commission can support the Company during this period is through an increase in the allowed equity ratio from the 48% permitted in the past to 50%. This testimony explains why such a request is reasonable and addresses some significant shortcomings in past analyses that Department of Public Service Staff ("Staff") have employed to demonstrate the reasonableness of permitting only a 48% equity ratio.

III. FINANCIAL INTEGRITY

Q. Please discuss Central Hudson's financial integrity objectives.

A. Central Hudson has a long-standing commitment to maintaining a sound, creditworthy financial structure. This commitment is not only ideological, but also practical as it balances two key responsibilities the Company has to its customers: the obligation to provide safe and reliable service to our customers at a reasonable price.

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Q. Please explain what the Panel means by the Company's obligation to provide safe and reliable service to customers in its franchise area.

A. The Company has a fundamental responsibility to serve customers in our franchise area. This responsibility continues uninterrupted through time and encompasses periods of varying economic environments as well as financial markets that range from supportive to restrictive. The Company must have access to sufficient cash and credit to assure that it can provide safe and reliable service to our customers at all times regardless of prevailing economic and market conditions.

Q. Do you have examples demonstrating why access to cash and credit are critical for public utilities like Central Hudson?

A Yes. Central Hudson purchases large quantities of electricity and natural gas on behalf of its customers every day of the year. The quantities can vary considerably based on customer usage and are particularly driven by weather-related (temperature) end-uses like air conditioning and heating. The price of electricity and natural gas can also vary considerably in response to a range of factors, including market supply and demand conditions. Central Hudson typically pays its suppliers in advance of the collection of receipts from its customers. Therefore, Central Hudson must maintain adequate access to cash or credit to meet its unpredictable and varying daily supply needs.

The Company also must have sufficient resources to address unexpected events that create financial strains such as restoration activities after major storms. When Central Hudson expects to experience a storm event that causes significant service interruptions, it begins mobilization to restore service to its customers as quickly and safely as possible. It is imperative that the Company has immediate and ready access to cash in order to fund these restoration activities. Any delay in restoration caused by limited or a total lack of access to financial resources is a wholly unacceptable situation that clearly highlights the need for Central Hudson to maintain access to cash and credit at all times. Moreover, the ability to finance such outlays is critical because the recovery of these expenditures is typically not resolved until the Company's next rate filing with collection from customers likely to commence several years after the major storm event.

Q. Has Central Hudson faced these situations in the recent past?

A Yes, Central Hudson has experienced large cash needs related to both examples described above. In the first quarter of 2014, colder-than-normal winter weather led to higher customer demand and extreme price spikes for both gas and electricity. Central Hudson relied heavily on its credit facilities to fund energy purchases during that extreme period. The Company has also experienced several major storm events in recent years that have required significant expenditures for service restoration.

Thus, as a permanent institution with a critical role in the local economy, the Company must be able to raise capital to meet its service obligations at all times and under all conditions. This includes ongoing financing requirements that are planned for based on capital budgets as well as financing requirements created by unexpected events that by definition cannot be planned for in advance. For these reasons, a strong balance sheet and strong credit ratings are continually important over the long term.

Q. Please discuss the Company's obligation to provide reasonably-priced service.

A. Given the capital-intensive nature of electric and gas utility operations, Central Hudson's cost of capital as measured by capital structure ratios and specific capital cost elements is a key component of the Company's overall cost structure. Studies done in the Generic Finance Case, Case 91-M-0509, which continues to guide New York's ratemaking policies today, indicated that an investment grade bond rating in the range of mid to upper "BBB" to low to mid "A" minimized the long-term cost of capital. At bond ratings above this range, an equity heavy structure failed to take appropriate advantage of the tax deductibility of interest on debt and, as a result, the weighted average pre-tax cost of capital began to rise. At bond ratings below this range, the risk of financial distress drove the cost of both debt and equity and consequently the pre-tax cost of capital upward rapidly. The Company continues to balance these two considerations by targeting an "A" rating, with the intention of minimizing long-term capital costs, providing some added assurance of being able to raise needed capital in all situations, and acting as a cushion against unforeseen events.

Exhibit __ (FP-1), Schedule A, shows public utility bond yields over the past ten years at different credit ratings. The graph illustrates the significant benefit in bond yields when a rating improves from "Baa" to "A." The further move from "A" to "Aa" offers less benefit in bond yield.

Q. What expectations does Central Hudson have for its financial integrity?

A. Central Hudson's objective over the long-term is to maintain "A" ratings on its senior unsecured debt.

Q. Has Central Hudson consistently maintained an "A" rating?

A. For the most part, yes. As shown in Exhibit __ (FP-1), Schedule B, Central Hudson's senior unsecured debt ratings have been predominantly "A" or equivalent for most of the past ten years. This achievement and its stability over the long-term have been key factors in maintaining a low cost of long-term debt through widely varying economic and financial market conditions.

Q. What evidence is there to support this statement?

A. We believe that market conditions during the Great Recession strongly support Central Hudson's approach. For example, Central Hudson required debt financing in late 2008. Amidst significant uncertainty about future conditions in the financial markets, Central Hudson issued $30 million of 5-year notes in November 2008. Those notes, then rated "A2" by Moody's Investors Service ("Moody's") and "A" by Standard & Poor's Ratings Services ("S&P"), priced at a coupon of 6.85%, representing a 450 basis point credit spread over 5-year treasury notes. Several days later, Sempra Energy, rated only two notches lower ("Baa1" by Moody's and "BBB+" by S&P), issued comparable 5-year senior notes at a credit spread of 670 basis points over 5-year treasuries.[1] The two notch ratings difference in the skittish markets resulted in Sempra paying an interest rate 220 basis points higher than Central Hudson. Over the 5-year life of $30 million of bonds, this 220-basis point interest rate differential represented $3.3 million of interest expense - an amount representing more than 10% of the proceeds from the issuance.

Q. Does the Commission have any expectations related to Central Hudson's financial integrity?

A. Yes, the Commission's Order Authorizing Acquisition Subject to Conditions, Issued and Effective June 26, 2013 in Case 12-M-0192 ("Acquisition Order"), adopted the Joint Proposal for Commission Approval of the Acquisition of CH Energy Group, Inc. by Fortis Inc. and Related

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[1] Central Hudson filed a term sheet with the SEC on November 13, 2008. Sempra Energy filed a term sheet with the SEC on November 17, 2008. Both term sheets are available at www.sec.gov.

Transactions ("Joint Proposal"). The Joint Proposal includes the following conditions specifically designed to protect and monitor the Company's credit quality:

- Presentations to any credit rating agency by Central Hudson, Fortis, or any Fortis affiliate that discuss the finances and credit of Central Hudson or CH Energy Group will be provided to the Department of Public Service Staff ("Staff") within ten business days.[2]
- Central Hudson and Fortis must maintain bond ratings from at least two major credit rating agencies.[3]
- Central Hudson will continue to maintain separate banking and cash management arrangements and separate debt instruments and neither Fortis nor Central Hudson will enter into credit agreements containing cross-default provisions that affect Central Hudson.[4]
- Central Hudson and Fortis will continue to support the objective of maintaining an "A" credit rating for Central Hudson[5].

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[2] Case 12-M-0192, Joint Proposal for Commission Approval of the Acquisition of CH Energy Group, Inc. by Fortis Inc. and Related Transactions, as adopted in the Order Authorizing Acquisition Subject to Conditions, Issued and Effective June 26, 2013, p. 5.

[3] Joint Proposal, p. 5.

[4] Joint Proposal, p. 6.

[5] Joint Proposal, p. 6.

- Central Hudson will maintain a minimum equity ratio ("MER") that is no more than 200 basis points below the equity ratio used to set delivery rates. In the event the MER is not met, no dividends are payable until the MER is restored.[6]
- In the event the Commission does not recognize Central Hudson's actual capitalization for the purpose of setting delivery rates, Central Hudson shall be free to dividend excess equity capital.[7]
- Central Hudson will continue to comply with the bond ratings-based dividend restrictions of the Restructuring Settlement Agreement approved in Case 96-E-0909 ("RSA").[8]
- Central Hudson will not lend to, guarantee, or financially support Fortis or any Fortis affiliate except as permitted by the RSA or the money pooling provisions of the Acquisition Order.[9]
- Central Hudson is authorized to use private financing as an alternative to public debt offerings.[10]

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6 Joint Proposal, p. 6.

7 Joint Proposal, p. 7.

8 Joint Proposal, p. 8.

9 Joint Proposal, p. 9.

10 Joint Proposal, p. 9.

In addition, the Acquisition Order included conditions related to a special class of preferred stock that are relevant to financial integrity:

- For the purpose of protecting the interests of New York, Central Hudson will establish (and issue a share of) a special class of preferred stock that establishes a voting right to prevent voluntary bankruptcy ("golden share").[11]
- In any rate proceeding in which the use of Central Hudson's capital structure is requested, Central Hudson will submit the most current written evaluations from at least two credit rating agencies as support for the treatment of Central Hudson as a separate company. Together, the golden share and the ratings reports "would provide sufficient proof that the use of Central Hudson's capital structure should be used for rate making purposes." (Joint Proposal, p.13).[12]

Q. Does the Company still meet all of the conditions identified in the Acquisition Order?

A. Yes, it does. While the Company continues to be in compliance with these requirements, there has been pressure on the Company's credit ratios and bond ratings in recent years, putting the objective to maintain "A" bond ratings at risk. In 2015 and 2016, Fitch and S&P, downgraded

[11] Joint Proposal, p. 11.

[12] Joint Proposal, p. 13.

Central Hudson's senior unsecured debt to the low end of the "A" range. The most recent bond rating reports for Central Hudson, provided as Exhibit __ (FP-2), Schedules A, B and C, confirm that Central Hudson's senior unsecured debt continues to be rated in the "A" category at "A2/A-/A-" (Moody's/S&P/Fitch).[13] These reports also indicate that Central Hudson was evaluated primarily as a separate company, without material adjustment to the ratings based on Fortis.

Q. Do you believe an "A" rating for Central Hudson's bonds remains an appropriate target?

A. Yes. Maintaining an "A" credit rating is an important factor in the Company's continuous access to reasonably priced capital and we continue to target the middle of the "A" range. This is particularly important in challenging economic times and financial markets. In such times, investors' aversion to risk increases in response to rising uncertainty. As we discussed earlier, we observed this first-hand in 2008, at the start of the Great Recession, when Central Hudson was able to issue debt at a significantly lower risk premium than lower-rated utilities. Since that time, the Company has refinanced maturing debt and financed growth in utility plant assets at very attractive interest rates that will benefit our customers for decades.

[13] Central Hudson's "issuer default rating" by Fitch is currently BBB+. The equivalents at S&P and Moody's are A- and A2, respectively.

Q. Do you have other evidence supporting the maintenance of an "A" rating?

A Yes, please refer again to the data presented in Exhibit __ (FP-1), Schedule A. The graph compares secondary trading yields for public utility bonds with Moody's ratings of "Aa," "A," and "Baa" over the last ten years. There is a consistent difference between yields at these three levels of bond ratings over the period shown in the graph and the substantial rise in yields during the Great Recession (2008 and 2009) is clearly depicted. The widening differential between "A-rated" bonds and "Baa-rated" bonds clearly shows that maintaining an "A" rating provides the most benefit during periods with challenging markets conditions. Additionally, when higher-rated debt is issued with maturities extending out several decades, customers benefit from a lower cost of capital over the long-term.

IV. <u>CASH REQUIREMENTS</u>

Q. Have you prepared exhibits showing Central Hudson's cash requirements?

A. Yes. Exhibit __ (FP-3) includes four schedules addressing cash requirements. Schedule A shows a forecast of cash requirements for the three twelve-month periods ending June 30, 2019, June 30, 2020, and June 30, 2021. Schedule B shows a forecast of cash requirements for calendar years 2017 through 2021. Schedule C shows a forecast of cash construction expenditures for calendar years 2017 through 2021 and for the three twelve-month periods ending June 30, 2019, June 30, 2020, and June 30, 2021. Schedule D shows historical cash requirements for the calendar years 2012 through 2016.

Q. Why are the Company's cash requirements relevant in these proceedings?

A. As Schedule D demonstrates, internally generated funds are the primary source of cash for capital expenditures. In 2012 and 2014, they were closely aligned. In 2013, the year of the acquisition by Fortis, external financing requirements increased substantially as the result of the Positive Benefit Adjustment required in the Acquisition Order producing a steep drop in earnings without any corresponding change in cash construction expenditures.[14] In 2015, and throughout the forecast period shown in Schedule B, cash requirements have increased from levels during the historical period primarily due to: 1) higher construction expenditures; 2) lower deferred income taxes;[15] and 3) higher site investigation and remediation expenditures.

Adjusting the forecast presented by Company Witness Haering to remove non-cash items, cash construction and removal expenditures are projected at $1,079.4 million over the period 2017 through 2021.

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[14] The Company recorded the equivalent of $40 million in regulatory liabilities that reduced operating income and common equity.

[15] The end of bonus depreciation in 2019 results in lower deferred taxes in the forecast period compared to the historical period.

Assuming the continuation of significant earnings retained to fund construction, Central Hudson's internal funds are projected to be $818.7 million over the same period, representing 76% of cash construction expenditures. This means that $260.7 million of construction and removal expenditures will have to be financed with external capital.

In 2017, Central Hudson will refund $33 million of its long-term debt. Each year in the forecast period includes mandatory refunding of maturing debt for a total of $174.2 million over five years.

Other notable cash requirements include pension and other post-employment benefit ("OPEB") plan contributions, estimated at $55.3 million over the period 2017 through 2021. Also, variations between cash outlays for site investigation and remediation costs ("SIR") and recovery of those outlays in customer rates are projected to affect cash requirements from year-to-year throughout the forecast period.

Q. What are the projected total cash requirements for the five-year forecast period?

A. Total cash requirements for the five-year forecast period are projected at $546.9 million, consisting of: 1) $260.7 million to finance the balance of capital expenditures not covered by internally generated funds; 2) $174.2 million to refinance maturing debt; and 3) $112.0 million for various other cash requirements.[16]

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[16] See Exhibit __ (FP-3), Schedule B.

V. FINANCING PROGRAM

Q. How does Central Hudson plan to meet its projected cash requirements?

A. Central Hudson's projected financing of cash requirements is shown on Schedules A and B of Exhibit __ (FP-4). Exhibit __ (FP-4), Schedule A shows the proposed financing program for the three twelve-month periods ending June 30, 2019, June 30, 2020, and June 30, 2021. Schedule B shows the proposed financing program for calendar years 2017 through 2021.

Q. Please discuss the Company's financing program in detail and its relevance to these proceedings.

A. Over the forecast period shown in Exhibit __ (FP-4), projected cash requirements are expected to be funded in an economical and efficient manner primarily through the issuance of senior unsecured long-term debt. The forecast assumes that the Company maintains its target capitalization by retaining a large portion of earnings to fund new construction expenditures. For the twelve-month period ended June 30, 2019, approximately $118 million of long-term debt is projected to be issued. In that twelve-month period, equity needs are met by retaining all earnings and supplementing that with $21 million of equity infusions provided by Fortis Inc.

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Q. How does Central Hudson utilize short-term debt in its financing activities?

A. Central Hudson employs modest use of short-term debt, reserving most of its $200 million credit capacity for potential spikes in energy prices or volumes and other unforeseen events. Short-term borrowings are typically used to fund seasonal or unexpected cash requirements and to provide interim financing of construction expenditures incurred between issuances of long-term debt. Consequently, projected financing shows no short-term debt balance at June 30 and approximately $20 million at December 31 of each year shown in the forecast in Exhibit __ (FP-4).

Q. What length of maturity is assumed for long-term debt to meet net cash requirements?

A. All long-term debt needed to meet net cash requirements during the forecast period is projected to be 20-year senior unsecured debt. The use of 20-year maturities in the projections represents an average of 10-year and 30-year maturities. Central Hudson typically issues notes with maturities ranging from 10 years to 3-30 years, depending on prevailing conditions in the market for taxable long-term corporate debt and Central Hudson's maturity schedule. Consideration is made for spacing future maturities in a manner that will avoid refinancing a large amount of debt at a particular point in time.

VI. RECENT CREDIT RATING CHANGES

Q. What challenges does Central Hudson face in maintaining its financial integrity and achieving its target for credit ratings?

A. Central Hudson is in the midst of a multi-year period of elevated capital expenditures that is coincident with a significant increase in site investigation and remediation expenses. Additionally, the allowed ROE embedded in delivery rates is low, both historically and compared to other regulatory jurisdictions.[17] While the impact of these factors has been mitigated by lower interest rates, higher deferred taxes due to bonus depreciation, and recently by a temporary delay in the need to make payments to the New York State Energy Research and Development Authority ("NYSERDA") for the Clean Energy Fund, the phase out of bonus depreciation in 2019 and the resumption of Clean Energy Fund payments to NYSERDA in the fourth quarter of 2017 will have a negative effect on the financial ratios considered by the credit rating agencies.[18] One clear measure of the added financial pressure on the Company is that from 2012 through 2016, total annual cash requirements averaged approximately $42 million annually. In contrast, that level increases by

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[17] Regulatory Research Associates, Regulatory Focus: Major Rate Case Decisions – January – March 2017, April 20, 2017, pp. 1, 5.

[18] The Protecting Americans from Tax Hikes Act of 2015 allows 50% bonus depreciation for qualified property placed in service between 1/1/15 and 12/31/17, 40% bonus depreciation for qualified property placed in service between 1/1/18 and 12/31/18, and 30% bonus depreciation for qualified property placed in service between 1/1/19 and 12/31/19.

160%, to $109 million per year, over the ensuing five years, 2017 to 2021.[19]

Q. Have these challenges affected the assessment of Central Hudson's financial integrity and bond ratings by the credit rating agencies?

A. Yes, in the past two years, Central Hudson has been downgraded by one notch by both Fitch and S&P. On July 2, 2015, Fitch announced a downgrade of Central Hudson's long-term Issuer Default Rating ("IDR") to "BBB+" from "A-." In addition, Central Hudson's unsecured and senior secured debt was downgraded to "A-" from "A" and its rating outlook was revised to stable from negative. Fitch's ratings review, shown in Exhibit __ (FP-1), Schedule C, stated:

> The ratings downgrade is driven by Fitch's expectation of continued deterioration of CHG&E's financial profile over the next several years, despite the beneficial impact of the recently approved multi-year rate plan. **Based on Fitch's forecast, projected credit metrics are not supportive of an 'A' utility credit profile.** **The downtrend is largely due to incremental debt financings required to fund persistently elevated capex through 2019 and to the deferral of projected manufactured gas plant clean-up costs.** The deferred costs result in a significant build-up of

[19] See Exhibit___(FP-3), Schedule B and Schedule D.

> regulatory assets and generate lag in cash recovery.[20] (emphasis added).

Fitch also expressed a concern about the Commission's ROE allowance particularly in light of potential increases in interest rates:

> In addition, the 9% ROE authorized by the NYPSC is significantly below what was granted, on average, to utilities nationwide in 2014, and the multi-year plan does not include a tracker that accounts for the possibility of a future rise in interest rates.[21]

Q. What are the implications of Fitch's statements for Central Hudson in the future?

A. As shown in Exhibit __ (FP-3), Schedule B, Central Hudson's projected cash flow from internal sources is insufficient to fund both its construction expenditures and its other cash requirements. Moreover, future capital investments are projected at levels more than three times the funding provided by depreciation. The Company's financing requirements are driven by the capital-intensive nature of the electric and natural gas utility businesses and by the long depreciable lives of utility plant in service and resultant lengthy time periods required to recover investments in plant.

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[20] Fitch Ratings, "Fitch Downgrades Central Hudson's IDR to 'BBB+'; Outlook Revised to Stable," July 2, 2015, p.1.

[21] Fitch Ratings, "Fitch Downgrades Central Hudson's IDR to 'BBB+'; Outlook Revised to Stable," July 2, 2015, p. 1.

Because the cost of today's infrastructure investments almost always exceeds average system costs, the ratio of future capital investment to cash flow from internal sources will perennially reflect a weakening in the Company's ability to finance such investments solely with internally generated funds and an increase in the need to raise capital externally.

While weak net cash flows are not atypical for distribution utilities, Central Hudson's situation is exacerbated by a peak in its construction program. As explained in Company Witness Haering's testimony, Central Hudson has several ongoing major initiatives and will begin several new programs that will further increase capital expenditures during the forecast period. Currently, distribution automation and network infrastructure programs related to the modernization of the electric grid are driving higher capital investments in our electric system. On the gas system, our leak prone pipe replacement program is driving additional investment. Additionally, Central Hudson has proposed further modernization programs that affect IT investment and significant facilities improvements.

These factors are determinants in Central Hudson's credit profile and, ultimately, its cost of future financings, and are indicative of a future where the Company faces greater financial pressures than in the recent past. Given Fitch's concerns, it is imperative that the Commission carefully consider the implications of its decisions in this proceeding on the Company's credit quality.

Q. What are the details related to S&P's downgrade of the Company?

A. On June 21, 2016, S&P downgraded Central Hudson's corporate credit rating and senior unsecured debt rating to "A-" from "A" and revised the ratings outlook to stable from negative. That downgrade, Exhibit __ (FP-2), Schedule D, was driven by S&P's view that in the future Central Hudson will no longer maintain the regulatory advantage over its peers that S&P had previously assigned it. The direct result of this decision is that S&P will now assess Central Hudson's credit quality on the basis of more stringent benchmarks for a company with "significant" financial risk. S&P had previously employed benchmarks applicable to a company with "intermediate" financial risk. Thus Central Hudson must maintain credit quality metrics in the future that are stronger than historic levels if it is to retain its current rating. S&P's rating report provided the following context:

[redacted]

[redacted].[22]

Q. What are the implications of S&P's action for Central Hudson?

A S&P is now requiring Central Hudson to maintain stronger financial parameters to keep a rating in the "A" category than it had in the past. As noted earlier, this comes at a time when the Company's external capital needs are significantly higher than they have been in the recent past. Thus, S&P's action, like Fitch's underscores the need for the Commission to carefully consider the implications of its decisions in this proceeding on the Company's credit quality.

Q. Please provide an overview of the quantitative analysis performed by the credit rating agencies when assessing a utility's credit quality.

A. Financial ratios are the key determinants used in the quantitative assessment by credit ratings agencies. Moody's assessment is based on four financial ratios comprising 40% of the agency's rating factors:[23] 1)

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[22] S&P Global Ratings, "Research Update: Central Hudson Gas & Electric Corp. Rating Lowered to 'A-' on Average Management of Regulatory Risk; Outlook Stable," June 21, 2016, pp. 2-3.

[23] The weighting on these four ratios increased from 30% to 40% in Moody's December 2013 update to its rating methodology. Prior to that, a liquidity assessment contributed an independent 10% in Moody's rating methodology. Liquidity is now included in the qualitative considerations in the ratings analysis.

cash flow interest coverage; 2) cash flow to total debt; 3) financial leverage; and 4) balance sheet leverage. S&P's rating methodology initially gives equal weight to a company's business risk profile and its financial risk profile, before applying potential modifiers. The financial risk profile is measured by two core credit ratios: 1) cash flow to total debt; and 2) debt to earnings before interest, taxes, depreciation, and amortization ("EBITDA"). S&P also considers five supplemental ratios (three payback ratios and two coverage ratios that consider a utility's ability to make payments of interest and principal on outstanding debt) as part of its quantitative analysis. Fitch's rating methodology includes three debt leverage and coverage ratios: 1) debt to EBITDA; 2) debt to funds from operations; and 3) funds from operations to interest and fixed charges. Published credit rating methodologies for all three of the agencies are included in Exhibit __ (FP-2), Schedules E, F, G and H.

Q. Is there a common theme in the quantitative analyses employed by the credit rating agencies when determining bond ratings?

A. Yes, the results obtained from the majority of quantitative measures employed to assess credit quality are driven by the level of debt leverage at the subject utility and the amount of debt leverage included in the ratemaking capital structure. The corollary to this is that the amount of common equity maintained by the subject utility and the amount of common equity in the ratemaking capital structure also drive the quantitative measures considered by the credit rating agencies.

Q. How does the Company's equity ratio affect the quantitative assessment of the Company's credit quality?

A. A company's equity ratio affects both operating income and debt leverage. Operating income improves due to the application of the ROE to the incremental equity and a concomitant reduction in interest expense on debt. In addition, the capitalization has less leverage which is another key component in assessing financial risk in credit analysis. The combination of higher operating income and lower levels of debt leads to improvement in interest coverage ratios, leverage ratios, and payback ratios. Every quantitative measure employed by Moody's, S&P, and Fitch is positively affected by an increase in the ratemaking equity ratio.

Q. Given this information, what actions does the Panel recommend to address Central Hudson's challenges and the factors cited by Fitch and S&P in their recent downgrades?

A. Central Hudson can strengthen its quantitative credit metrics by increasing the equity ratio used in the calculation of cost of capital from 48% to 50%, a level that is consistent with the amount of common equity reflected on the Company's books.

DIRECT TESTIMONY OF THE FINANCE PANEL

Q. Would the establishment of a higher ROE based on current market conditions affect the quantitative assessment of the Company's credit quality?

A. Yes, it would. Increases in the allowed ROE will increase a utility company's operating income, an important component of the financial ratios used in credit analysis. The allowed return in Central Hudson's last rate case was 9.0%. Under current market conditions and supported by the testimony of Ann E. Bulkley, we have adopted an ROE of 9.5% for our cost of capital estimates. The 50 basis point difference in return represents a 5.6% increase in operating income. In Moody's rating methodology, three of the four key financial ratios include cash from operations and are positively affected by increases to operating income. In S&P's rating methodology, both of its core ratios are positively affected by increases to operating income. In Fitch's ratings methodology, all three financial ratios are affected positively by increases in operating income. It is important, however, to note that if interest rates increase at an equal or faster pace than allowed ROEs, the increase in ROE will not offset the negative impact of the interest rate increases on the quantitative credit quality metrics.

Q. Please describe how the rating agencies assess the qualitative aspects of a company's creditworthiness.

A. Qualitative factors considered by the rating agencies typically review factors affecting business risk. This includes: country/geography; industry sector; market position; and regulatory considerations. While many elements of utility business risks are similar, specific state regulatory risks can cause different qualitative risks assessments by the credit rating agencies for utilities in different states. Each rating agency considers the transparency and predictability of the regulatory framework and relative credit supportiveness for the utility being rated. This is the single largest qualitative factor used by each of the three credit rating agencies to differentiate one utility from another and can have a significant impact on a company's credit rating.

Q. Have the credit rating agencies expressed any concerns regarding a change in Central Hudson's regulatory environment?

A. Yes, the 2016 downgrade by S&P is notable because it is the direct result of concerns related to regulatory risk.

Q. Have the rating agencies expressed any other recent concerns about New York State utility regulation?

A. Yes, the credit rating agencies are carefully tracking events within the Reforming the Energy Vision ("REV") Proceeding.[24] For instance, Moody's specifically stated in Central Hudson's credit report that, "[redacted]."[25] Central Hudson's credit rating reports also generally describe the New York regulatory environment as supportive, with the exception of relatively low allowed ROEs.

VII. <u>CAPITALIZATION</u>

Q. What exhibits has the Panel prepared showing Central Hudson's capitalization?

A. Exhibit __ (FP-5) includes of three schedules showing the Company's actual and projected capitalization and capitalization ratios. Schedule A shows Central Hudson's current capitalization and capitalization ratios using the June 30, 2017 balance sheet and compares them to December 31, 2016. Schedule B shows actual capitalization at December 31 of each year for the period 2012 through 2016. Schedule C shows projected

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[24] CASE 14-M-0101 – Proceeding on Motion of the Commission in Regard to Reforming the Energy Vision.

[25] See Exhibit___(FP-2), Schedule A, p.2.

capitalization at December 31 of each year for the forecast period 2017 through 2021.

Q. Please discuss Exhibit __ (FP-5) in further detail and explain its relevance to these proceedings.

A. Schedules A, B and C of Exhibit __ (FP–5) show historical and projected capitalization and capitalization ratios based on the Company's financing program. As we discussed earlier, Central Hudson's investment in utility plant significantly exceeds internal funds during the forecast period. For the five-year period ended December 31, 2016, Central Hudson's net utility plant assets increased 30%, from $1.194 billion to $1.547 billion. Financing for those investments was mitigated by favorable tax treatment that applied during that period.[26] Central Hudson's accumulated deferred income tax liability grew by 28% over the same period, from $266 million to $340 million. Long-term financing of utility plant assets still increased significantly, however. As Schedule B shows, total ratemaking capitalization grew by 19%, from $976 million to $1.165 billion for the five year period ended December 31, 2016. Growth in capital expenditures and net utility plant is projected to continue, and the corresponding total capitalization will reach $1.801 billion in 2021, as shown on Schedule C.

[26] Favorable tax treatment includes bonus depreciation and the reclassification, for tax purposes, of maintenance capital expenditures as tax deductible expense.

As a result, Central Hudson will require significant additional long-term financing over the forecast period.

Q. What equity ratio do you recommend in the projections of capitalization and the estimate of Central Hudson's cost of capital?

A. We recommend a capitalization for rate setting purposes that reflects 50% equity. This capitalization is included in the capitalization and cost of capital exhibits for future periods.

Q. What is the basis for the use of a 50% equity ratio in this case?

A. The basis for our recommendation of a 50% equity ratio reflects: 1) Central Hudson's stand-alone capitalization; 2) demonstration of sufficient ring fencing through the satisfaction of the credit quality requirements in the Acquisition Order; and 3) demonstration that Central Hudson's capitalization is reasonable and supports its bond rating objective.

Q. What is Central Hudson's current stand-alone capitalization?

A. Central Hudson's current capitalization is shown on Exhibit __ (FP-5), Schedule A. At June 30, 2017 (preliminary financial statements), Central Hudson's equity ratio (ratemaking) was estimated at 50.9%. As shown in Exhibit __ (FP-5), Schedule C, we expect a ratemaking equity ratio of 50.1% at year-end 2017. Central Hudson's stand-alone capitalization is supportive of the Company's recommendation of 50% equity.

Q. How does the Company's ring fencing support your recommendation?

A. In the Acquisition Order, the Commission accepted stand-alone treatment of Central Hudson's capitalization at the time and established a range of credit quality protections and dividend restrictions that enable Central Hudson to continue to demonstrate that such treatment is warranted. The Acquisition Order states specifically on page 16:

> With the golden share in place, Central Hudson would be permitted to demonstrate in future rate cases that its stand-alone capital structure should be used for setting rates. That demonstration would be made by submitting current written evaluations from at least two credit rating agencies supporting the evaluation of Central Hudson as a separate company, without material adjustments based on risks related to the capital structure and ratings of Fortis.

Earlier in this testimony, we affirmed the Company's compliance with all ring fencing requirements and dividend restrictions. Written evaluations from the credit rating agencies demonstrating that Central Hudson was evaluated as a separate company are provided in Exhibit __ (FP-2). Central Hudson's stand-alone capital structure should be used in setting delivery rates in this case.

Q. How does Central Hudson's recommended equity ratio of 50% compare to other similar companies?

A. We've considered how Central Hudson's recommended equity ratio compares to two groups of companies: 1) peer utility companies in New York; and 2) the companies in Company Witness Bulkley's recommended proxy group for determining ROE. Exhibit __ (FP-5), Schedule D, shows the most recently authorized equity ratios for setting delivery rates for Central Hudson's New York State peer utility companies. While bond ratings vary one or two notches based on the unique circumstances of each company, the Commission has consistently used 48% common equity as the basis for setting rates for these companies in recent years. Authorized equity ratios in New York are significantly lower than our other comparator group, however. As Company Witness Bulkley discusses in her testimony and showed on Exhibit __ (AEB-13), the mean equity ratio of the recommended proxy group companies is approximately 54%. This exceeds a comparably calculated and recommended equity ratio for Central Hudson of 50.0% for setting delivery rates.

Q. Is your recommended equity ratio supportive of Central Hudson's current credit ratings?

A. Central Hudson's long-term capitalization is comprised primarily of equity and long-term debt, with less than 1% of capitalization from customer deposits. While equity ratio is not specifically discussed as a measurement in the reports from the credit rating agencies (they look at debt leverage), we explained earlier why it is a key determinant of credit quality and an increase in the equity ratio can have a positive impact on the quantitative rating analysis.

Q. Can you provide a more specific example of the positive impact your recommendations have on the financial ratios used in credit analysis?

A. We use the Moody's methodology to show the impact of changes in assumptions on Central Hudson's financial ratios. The Moody's methodology has two advantages over S&P and Fitch. First, Moody's rating of Central Hudson's senior unsecured debt remains in the middle of the "A" range, Central Hudson's long-term objective, at "A2" with a stable outlook. Second, Moody's currently offers the most transparent ratings methodology, enabling us to understand how changes in assumptions affect the ratings more easily than the other credit rating agency methodologies.

Exhibit__(FP-5), Schedule E, Page 1 of 2, shows the summary table from Moody's July 12, 2016 credit report on Central Hudson and includes the detailed qualitative and quantitative factors the comprise the overall rating based on the trailing 12 months ended March 31, 2016. We used Central Hudson's calendar year 2019 financial forecast to estimate what changes in the financial ratios would do to the overall rating in two scenarios: 1) maintaining the 9% ROE and 48% equity ratio in current delivery rates; and 2) adopting the recommended ROE and equity ratio from our testimony and exhibits. Note that all qualitative factors on Page 1 of 2 are left unchanged from the current rating.

Q. What does your projection of 2019 financial ratios show?

A. In 2019, a financial forecast based on our current allowed ROE and equity ratio, 9% and 48%, respectively, would result in a one notch decrease in the indicated rating using the Moody's methodology. Alternatively, a financial forecast based on our recommended ROE and equity ratio, 9.5% and 50%, respectively, result in no ratings change. Based on this analysis, we conclude that the Finance Panel's recommendations are supportive of Central Hudson's current Moody's credit rating.

Q. Please summarize your conclusions about Central Hudson's proposed capitalization ratio.

A. The Finance Panel recommends an equity ratio of 50% that reflects the capitalization on its current balance sheet. Central Hudson is also in compliance with the ring-fencing provisions of the Acquisition Order and meets the criteria outlined therein for consideration of its standalone capitalization as the basis for setting delivery rates. Furthermore, that standalone capitalization is reasonable by comparison to peer utility companies and supportive of Central Hudson's objective of maintaining an "A" rating on its senior unsecured debt.

DIRECT TESTIMONY OF THE FINANCE PANEL

Q. In the past Staff has opposed utility requests to increase equity ratios above the 48% level allowed in recent cases. What are your views regarding Staff's position?

A. Staff's position in recent cases rests on an analysis that consists of comparing the incremental cost of the increased equity ratio, as measured on a pre-tax revenue requirement basis, to any savings that could potentially be realized from a lower interest rate on debt issued during the rate year. Staff's analysis, however, is a snapshot that considers only short-term impact and by definition is unlikely to show benefits from the use of a higher ratemaking equity ratio. Staff's analysis should consider a variety of longer term benefits derived from the use of a higher equity ratio.

Q. What approach does Staff employ when assessing a utility request to increase the ratemaking equity ratio?

A. Staff measures the impact of moving to a higher equity ratio by comparing the pre-tax cost of equity to the cost of debt.[27] Because the pre-tax cost of equity is virtually certain to be higher than the cost of debt Staff concludes that moving to a higher equity ratio is costlier to ratepayers. For example, in a recent case Staff noted the following:

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[27] *See e.g.*, Cases 15-E-0283 et. al., In the Matter of New York State Electric & Gas Corporation and Rochester Gas & Electric Corporation, Direct Testimony of Abdul Qadir and Kenneth Bullock, pp. 24-27.

The cost of common equity is much greater than the cost of debt. For instance, both Company Witness Bulkley's 10.06% and our 8.6% recommended ROEs are much higher than either NYSEG or RG&E‟s cost of debt as calculated by us of 4.57% and 5.72%, respectively. It is also higher than the current new issue rate for "Baa+/A-" long-term debt securities of approximately 4.75% as indicated by the July 2015 edition of the Mergent Bond Record, shown as Exhibit (CCP-7). The true cost differential between these two types of capital instruments and their impact on the costs borne by the Company's ratepayers is much greater, due to very different income tax treatments for each instrument. Because the 10.06% and 8.6% ROE figures represent the return to shareholders after income taxes have been paid, both the Company and Staff revenue requirements will also include an allowance for income taxes such that their effective cost of common equity, on a pre-tax basis is approximately 16.6% and 14.2%, respectively. With its common equity ratio of 50.0%, the Companies requested capital structure effectively seeks to support an additional two percent of the rate base with the most expensive form of capital.[28]

Q. Will this type of analysis ever produce a finding that a thicker ratemaking equity ratio is appropriate?

A. It is doubtful because the cost of equity will in most situations always exceed the cost of debt. Taken to the extreme, Staff's analysis implies that lower equity ratios are always less expensive for ratepayers than higher equity ratios and utilities should therefore be reducing the ratemaking equity ratio. The fact that regulators across the country are setting ratemaking equity ratios at levels above those in New York suggests that Staff's approach is not fully considering the benefits of a higher equity ratio.

Q. Describe some of the benefits that Staff's analysis does not consider.

A. Staff does not consider a variety of factors including: 1) the reduction in the cost of equity associated with decreased financial risk or alternatively the higher cost of equity associated with a lower equity ratio; 2) future interest rate savings associated with reduced financial risk; 3) the ability of a higher equity ratio and improved credit quality to enable a utility to withstand unexpected shocks that could cause a lower rated utility to be downgraded to non-investment grade ratings or rating perilously close to that category; 4) the benefits of being solidly within the "A" rating category,

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[28] Id. at pp. 26-27.

which clearly manifested themselves for Central Hudson during the Great Recession; and 5) the specific and timely benefits to Central Hudson in the near future given its substantial increase in external capital requirements. We believe a fair consideration of these benefits fully supports the Company's request for a 50% ratemaking equity ratio.

VIII. COST OF DEBT

Q. What exhibits have you prepared to further explain the cost of debt proposed in this case?

A. Exhibit __ (FP-6) contains two schedules that address the development of the cost of debt. Schedule A shows the Company's projected average long-term debt for the three twelve-month periods ending June 30, 2019, June 30, 2020, and June 30, 2021. Schedule B shows the forecast of interest rates for 2017 through 2021 used to calculate interest expense on projected debt issuances.

Q. Please discuss Exhibit __ (FP-6) in more detail.

A For each of the twelve-month periods presented in Schedule A, a complete portfolio of Central Hudson's long-term debt is shown. New long-term debt issued in each period matches the financing program shown in Exhibit __ (FP-4), Schedule A. For existing debt, the interest rate shown reflects the actual coupons on the debt. For new issuances, the interest rate reflects the projections in Schedule B. Central Hudson also has two series of variable rate debt: 1999 Series B and 2014 Series

E. The interest rates for those two series also reflect the projections in Schedule B. In practice, Central Hudson issues debt at par without discounts or premiums. Therefore, the amortizations shown primarily reflect the expenses associated with the issuance of debt and the continued amortization of expenses related to retired debt, where applicable, resulting in a total average cost of debt of 4.5% in the Rate Year.

Q. What treatment do you recommend to account for variations in interest rates from your projections?

A. Central Hudson has had longstanding deferral accounting treatment for the interest expense on its variable rate bonds. This has enabled the Company to realize the cost benefits for its customers of short-term interest rates with the protection from changes in those rates over time. We recommend that the deferral treatment adopted in Cases 14-E-0318 and 14-G-0319 continue for this debt, including the impact of refinancing such debt. Central Hudson keeps interest rate caps on both series of variable rate bonds, protecting against unexpected increases in rates for periods from one to three years. Additionally, both series of variable rate bonds are callable for optional refinancing should conditions warrant it.

Q. What about the interest rates on newly issued long-term debt?

A. Most of Central Hudson’s long-term debt is comprised of bonds with fixed interest rates. Projected debt costs reflect these rates for all existing debt.

For projected new issuances of long-term debt, there is a chance that actual interest rates will vary from those assumed – future interest rates are nearly impossible to predict. Because of the relatively small size of our debt issuances, Central Hudson is a price-taker as a debt issuer in the financial markets. Our goals are to manage volatility, minimize refinancing risk, and achieve a reasonable cost of long-term debt over long periods of time. We do this by issuing mostly fixed rate debt, managing our maturity schedule, issuing long-dated maturities when market interest rates are low and issuing shorter maturities when market interest rates are high. We can do this most effectively when there is no interest expense impact driven by differences in actual interest rates at the time of issuance compared to those assumed in delivery rates. Therefore, it is our recommendation that an interest rate true-up be adopted for debt issued during the term of the rate agreement, using deferral accounting treatment to record the expense impact of favorable or unfavorable variations in actual coupons on newly issued debt compared to those coupons shown in our exhibits (or those ultimately reflected in delivery rates as a result of this case).

IX. COST OF COMMON EQUITY

Q. What is the basis for adopting 9.5% as Central Hudson's cost of equity?

A. Based on the quantitative and qualitative analyses discussed throughout Witness Bulkley's Direct Testimony, and an equal weighting of the DCF and CAPM results, we conclude that an appropriate ROE is within the range of 9.47% and 10.14%. Our requested ROE of 9.5% is at the low end of the range of reasonableness and is a conservative estimate of the investor-required ROE.

Q. Did the Panel make any other considerations or adjustments in selecting a cost of equity of 9.5% as the allowed ROE for purposes of developing Central Hudson's delivery rates?

A. The Panel acknowledges the time sensitive nature of the inputs utilized in the approaches undertaken in Ms. Bulkley's analysis. We recommend that the calculation of the cost of common equity be updated at the time of the Recommended Decision prepared by the Administrative Law Judge and at the time of the Company's Brief on Exceptions.

Q. Should the currently assumed ROE of 9.5% be incorporated into a multi-year rate agreement?

A. No, in the event of a multi-year rate agreement, a premium should be added to the updated equity cost of capital to acknowledge the risk inherent in the multi-year commitment.

X. AVERAGE COST OF CAPITAL

Q. Please summarize Central Hudson's projected cost of capital.

A. For the twelve-month period ending June 30, 2019, we recommend that Central Hudson be allowed to earn an after-tax rate of return ("ROR") of 6.99% and a pre-tax ROR of 10.06% based on an equity ratio of 50.0%

and an ROE of 9.5%. The calculation of the after-tax and pre-tax ROR, and corresponding inputs are included within Exhibit __ (FP-7), Schedule A, Page 1 of 3. The 4.5% cost of long-term debt corresponds to Exhibit __ (FP-6), Schedule A, Page 1 of 3. The 2.2% cost rate assigned to customer deposits reflects a projection of the rate mandated by the Commission, as shown in Exhibit __ (FP-6), Schedule B. The Commission updates the rate annually to reflect prevailing market conditions. Average common equity is projected in Exhibit __ (FP-7), Schedule B. The estimated ROR is used by the Revenue Requirements Panel to determine the revenue requirement in this case. As an important determinant in setting delivery rates, any factors causing the projected ROR to change should be reflected in an update prior to the conclusion of the rate proceedings.

XI. <u>CONCLUSIONS</u>

Q. What are your conclusions regarding the cost of capital used to determine Central Hudson's revenue requirement?

A. The Panel recommends a capitalization that reflects an equity ratio of 50%, debt costs that reflect Central Hudson's financial projections and interest rates from Blue Chip Financial Forecast, and an ROE of 9.5%.

Q. Has the Panel confirmed the beneficial impact that its recommendations would have on Central Hudson's financial integrity?

A. Yes. We have presented support for the beneficial impact that our recommended capitalization and cost of capital will have on financial integrity, as represented by credit ratings on the Company's long-term debt. We believe those recommendations are reasonable, supportive of Central Hudson's responsibilities to its customers, and address the concerns expressed by the rating agencies in their assessment of the Company's credit rating.

Q. Does this conclude your direct testimony at this time?

A. Yes.