### **Appendix E**

### Exhibit No. NYT-18

#### UNITED STATES OF AMERICA BEFORE THE FEDERAL ENERGY REGULATORY COMMISSION

New York Transco, LLC	)	
	)	
Central Hudson Gas & Electric Corp.	)	
Consolidated Edison Company of	)	
New York, Inc.	)	Docket No. ER15000
Niagara Mohawk Power Corporation d/b/a	)	
National Grid	)	
New York State Electric & Gas Corp.	)	
Orange & Rockland Utilities, Inc.	)	
Rochester Gas and Electric Corp.	)	

#### PREPARED DIRECT TESTIMONY OF ELLEN LAPSON ON BEHALF OF THE NEW YORK TRANSCO, LLC

**December 4, 2014** 

#### DIRECT TESTIMONY OF ELLEN LAPSON

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#### Exhibits

- No. NYT-19: Lapson Experience
- No. NYT-20: Credit Effect of Cash Return on CWIP
- No. NYT-21: Comparing Financial Strength: NY Transco vs. Peer Companies
- No. NYT-22: Credit Rating Scales and Financial Rating Parameters
- No. NYT-23: Nexus of NY Transco Investment Risks and Related Mitigants and Incentives

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Orange & Rockland Utilities, Inc.	)	
Rochester Gas & Electric Corp.	)	
	)	

#### PREPARED DIRECT TESTIMONY OF ELLEN LAPSON ON BEHALF OF THE NEW YORK TRANSCO, LLC

#### 1 I. INTRODUCTION AND EXPERIENCE

A. My name is Ellen Lapson and my business address is 370 Riverside Drive, New York,
NY 10025.

PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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**O**.

#### Q. IN WHAT CAPACITY ARE YOU EMPLOYED?

- A. I am the founder and principal of Lapson Advisory, a division of Trade Resources
  Analytics LLC, of which I am a member. Lapson Advisory provides independent
  consulting services relating to the valuation and financial strength of utilities and
  infrastructure companies. Through Lapson Advisory, I advise clients on how to access
  capital and debt markets on favorable terms, and I conduct executive seminars on credit
  analysis, corporate finance, and financial analysis in utility and infrastructure finance.

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#### I-A Professional Qualifications

#### 13 Q. WHAT ARE YOUR QUALIFICATIONS?

- A. I received a BA degree from Barnard College in 1969 and earned a Masters degree in
  Business Administration with a concentration in Accounting from New York
  University's Stern School of Business in 1975.
- 17 Since 1969, I have worked in the financial services industry with special focus on 18 the financial analysis of utility debt and equity securities. Prior to founding Lapson 19 Advisory, from 1994 through December, 2011, I was a Managing Director and before 20 that a Senior Director of the utilities, power and gas analytical team at Fitch Ratings 21 ("Fitch"), one of the three prominent credit rating agencies in the U.S. market. For 22 seventeen years at Fitch, I evaluated or supervised other analysts evaluating the credit
  - 1

of hundreds of electric, gas and water utilities, primarily in the U.S. From 2004 through
 2011, I also supervised and wrote the credit rating criteria applied in the electric, gas,
 and water sector. An important part of my responsibility was to initiate and maintain
 ongoing contact with U.S. fixed-income investors, portfolio managers, and debt and
 equity securities analysts.

6 Prior to that, for 20 years from 1974 to 1994 I was an officer of either Chemical 7 Bank or Chemical Securities (both now succeeded by J.P. Morgan, Inc.). For 15 of 8 those years, I arranged funding and advised companies in the utility sector and related 9 sectors such as power generation and fuels, and for five years, I was a division 10 controller and managed internal treasury, accounting, and financial control functions for 11 the bank.

Before becoming a banker to utilities and related infrastructure projects, I started my career in the investment community as an equity analyst for six years at Argus Research Corporation, specializing in the gas, telephone, and electric utility sectors. In summary, I have 40 years of professional experience performing securities evaluation, financial structuring, and advisory work within the utilities sector.

### 17 Q. DO YOU HOLD ANY PROFESSIONAL LICENSE OR BELONG TO ANY 18 PROFESSIONAL ORGANIZATIONS?

A. Since 1978 I have been recognized as a Chartered Financial Analyst ("CFA") charter
holder and a member of the CFA Institute. Also, since 1996, I have been a member of
the Wall Street Utilities Group, an organization of professional equity and debt analysts
who focus on utility sector securities.

#### 1 I-B. Prior Testimony

### 2 Q. HAVE YOU EVER PREVIOUSLY APPEARED BEFORE THIS COMMISSION 3 OR ANY OTHER REGULATORY COMMISSION?

4 A. Yes. I testified before this Commission on behalf of the New England Transmission 5 Owners ("NETOs") in Docket No. EL11-66 (Martha Coakley, et al. v. Bangor Hydro-6 *electric et al.*, 147 FERC ¶ 61,234 at P 144 (2014) ("Opinion No. 531")). I am a witness 7 in the following pending cases: Docket No. EL14-90 (Seminole Electric Cooperative and Florida Municipal Power Agency v. Duke Energy FL, Inc.) on behalf of Duke Energy 8 9 FL; Docket No. EL14-86 (Attorney General of Massachusetts, et al. v. Bangor Hydro-10 electric et al.), again on behalf of the NETOs; and Docket No. EL13-48 (Delaware 11 Division of the Public Advocate, et al. v. Baltimore Gas and Electric Company and 12 PEPCO Holdings et al.) on behalf of respondents Baltimore Gas and Electric and PEPCO Holdings' subsidiaries. 13

I am or have been a witness before state regulatory commissions, including most
recently the District of Columbia Public Service Commission, Arkansas Public Service
Commission, New York Public Service Commission, Illinois Commerce Commission,
and Maryland Public Service Commission. A summary of matters in which I have
provided expert testimony is included in Exhibit No. NYT-19.

19 **II.** 

#### **PURPOSE OF TESTIMONY**

#### 20 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am appearing on behalf of the New York Transco, LLC ("NY Transco", "the
Company", or "Applicant"), an entity formed by affiliates of the New York investorowned transmission owners ("NYTOs"), consisting of: Consolidated Edison Company

1	of New York, Inc. ("Con Edison"), Niagara Mohawk Power Corporation d/b/a National
2	Grid ("National Grid"), New York State Electric & Gas Corporation ("NYSEG"),
3	Orange & Rockland Utilities, Inc. ("O&R"), and Rochester Gas & Electric Corporation
4	("RG&E"), and Central Hudson Gas & Electric Corporation ("Central Hudson"). My
5	testimony relates to NY Transco's application under Section 205 of the Federal Power
6	Act ("FPA") to establish a transmission formula rate and base ROE for transmission
7	facilities that will be developed and owned by the Applicant and its filing under
8	Sections 205 and 219 of the FPA to establish various transmission incentives for NY
9	Transco and its projects. My testimony will address or explain the following topics:
10	(1) NY Transco's need to raise external capital in order to fund its commitment to
11	acquire and construct approximately \$1.7 billion (in nominal dollars) for its initial
12	transmission projects that will enhance the New York State electric transmission grid,
13	and to build subsequent projects as requirements are identified in the regional
14	transmission planning process;
15	(2) The need for incentive mechanisms and risk mitigants to offset the risks that would
16	otherwise hinder NY Transco's ability to attract bank credit and issue bonds and
17	would place NY Transco in an unfavorable position in the financial markets relative to
18	its peers;
19	(3) The specific incentives that the Company requires to enhance NY Transco's
20	likelihood to achieve investment-grade credit ratings and support the Company's
21	ability to fund its significant initial construction commitments;

1	(4) Why the incentive measures requested in its application, including both risk-
2	reducing incentives and ROE enhancing incentives, are appropriate and essential to
3	mitigate the individual and combined risks that investors and rating agencies consider
4	when evaluating corporate credit and will consider when evaluating NY Transco;
5	(5) Why a strong balance sheet and overall investment return are necessary to
6	counterbalance the risks of NY Transco's new, stand-alone transmission venture with
7	its heavy capital investment budget; and
8	(6) Why anomalous capital market conditions that currently prevail in the U.S.
9	financial markets would distort the results of the FERC DCF model used to calculate
10	the base Return on Equity (ROE) and require special consideration by the Commission
11	when setting the base ROE in this proceeding, as recognized by the Commission in
12	setting the ROE in Opinion No. 531.

#### 13 Q. WHAT IS THE BASIS FOR YOUR TESTIMONY?

14 My testimony is based on my experience over the course of four decades in the capital A. 15 markets as an investment analyst specializing in utilities securities. In preparing my 16 testimony, I relied on my own expert knowledge of current and past market conditions and of alternative areas of investment with which NY Transco will compete in the 17 18 capital market for investors' dollars. Also my many years of interacting with 19 institutional investors and securities analysts to discuss the evaluation of debt securities 20 and capital market conditions in the utility sector informs my views of the capital 21 market environment that NY Transco will confront. Finally, my experience as an officer of Fitch Ratings and my study of the criteria and procedures of other major 22

rating agencies gives me a detailed knowledge of the credit rating standards applicable
 to the electric transmission utilities and the practices of credit and fixed income analysts
 in their evaluations of credit risk.

#### 4

#### **III. SUMMARY AND CONCLUSIONS**

### 5 Q. CAN YOU PLEASE SUMMARIZE YOUR TESTIMONY AND YOUR 6 CONCLUSIONS?

7 NY Transco is being formed to acquire and carry out the construction of multiple A. 8 electric transmission projects designed to address long-standing congestion constraints 9 and improve reliability, and permit the transmission of electric energy between the 10 major electricity supplies available in northern New York and the transmission-11 constrained load centers in southern New York State. As explained in the direct testimony of Witness Nachmias, the projects also meet numerous other objectives set 12 13 forth in New York State's Energy Highway Blueprint ("Energy Blueprint"). Three of 14 the projects have been deemed to be of high priority to address reliability in case of the 15 potential retirement of the Indian Point Energy Center ("IPEC") but are also relevant to 16 support reliability and reduce energy costs if IPEC remains in service. These three 17 projects have been designated by the New York Public Service Commission as necessary transmission projects to fulfill these State public policy initiatives. Two other 18 19 projects with later start and completion dates are still going through the state project 20 selection and approval process. Upon the completion of each project, NY Transco will 21 turn over control of the facilities to the New York Independent System Operator, Inc. ("NYISO") and provide service pursuant to the terms and conditions of the NYISO 22 23 transmission tariff.

1 The Commission's regulatory innovations since 2006 have stimulated capital 2 market investment in electric transmission development and construction by providing up-front regulatory certainty, cash flow stability, and improved access to investment 3 4 capital. It is important that NY Transco receive similar incentives in order to attract 5 investment capital to fulfill the Company's mission to build crucial new transmission 6 facilities in New York State. Capital market investors are not compelled to invest in 7 electric transmission or to fund this new company; investors are free to choose alternate 8 investments both within and outside of the utility sector that provide similar returns 9 with lower risks or higher returns with similar risks.

10 As a new transmission-only company without a financial history, established 11 credit ratings, and debt repayment history, NY Transco faces greater funding and financial risks than more established utilities. Moreover, NY Transco will take on the 12 13 commitment to carry out and fund multiple construction projects simultaneously over the first four years of its existence with little ability to time its access to capital markets. 14 NY Transco will issue debt in the capital markets without financial guarantees from its 15 16 owners. In its initial years, the Company will go several times to the long-term debt 17 market for funding, where it will compete to raise funds against more seasoned utilities 18 with established asset bases and existing, steady and continuing sources of revenues 19 and cash flow. In the early years in which NY Transco will acquire and make long 20 lead-time investments in projects, its revenues and cash flows will be considerably 21 weaker than those of more established utilities, absent special tariff mechanisms to 22 improve the Company's financial credit measures.

1 Therefore, NY Transco is requesting that FERC grant its application for 2 regulatory mechanisms to reduce these risks and to improve NY Transco's cash flow measures. Specifically, the risk-reducing incentives requested for NY Transco and the 3 4 projects included in its application are: (1) Inclusion of 100% of Construction Work in 5 Progress ("CWIP") in rates for two of its projects, Edic to Pleasant Valley and Oakdale 6 Fraser; (2) Recovery of pre-commercial expenses that are not capitalized and 7 recoverable through CWIP in the form of a regulatory asset to be recovered over five years along with the right to earn its authorized cost of capital on the unrecovered 8 9 balance; (3) The opportunity to recover 100% of prudently-incurred abandonment costs 10 in the event a project is terminated for reasons outside of NY Transco's control; and (4) Use of a hypothetical capital structure of 60% equity and 40% debt during the 11 12 construction and funding of its projects (with use of the actual capital structure for the entire company commencing after five years.) 13

14 The ROE enhancements requested by the Applicant are an incentive ROE adder of 50 basis points ("BP") for NY Transco being part of the New York State RTO 15 16 (NYISO) and turning control of its projects over to the NYISO. In addition, NY Transco is requesting an incentive of 50 BP for forming a separate transmission 17 18 company that will focus exclusively on developing and owning electric transmission; 19 and a risk incentive of 50 BP to compensate for the risks associated with developing a 20 portfolio of complex transmission projects, which risks exceed those that are 21 encountered by more established companies in the electric utility sector and that will be 22 incurred to build projects that reduce historic congestion and allow generation resources 23 to serve constrained markets.

1 In this testimony I will explain how each of the requested incentives will reduce 2 risks and uncertainties that are major concerns of lenders and fixed income investors and enhance the credit-worthiness of NY Transco, especially in its important early 3 4 years. The requested incentives are likely to contribute to investment grade credit 5 ratings that will enable the Company to issue long-term debt and obtain committed 6 credit facilities for construction funding on reasonable terms. Sound financial condition 7 is essential to the successful construction and completion of the New York transmission projects, and to that end, the combination of incentives will reduce regulatory 8 9 uncertainty, ensure a more stable and predictable cash flow, and compensate for risks 10 borne by NY Transco as a stand-alone entity. ROE incentive compensation is 11 important because it will position NY Transco to compete in the debt capital markets 12 for funding its project portfolio on an even footing with other electric transmission businesses subject to FERC rate-setting authority. I will address the need for the risk 13 14 incentive adder and the appropriate amount of that adder in section V-F of this 15 testimony.

In Section IX, I will support the testimony of Dr. Avera and Mr. McKenzie, which explains that current capital market circumstances are distorted in the same way that capital markets were distorted at the time the Commission issued Opinion No. 531. The Commission should follow a similar approach by adopting the base ROE recommended by Dr. Avera and Mr. McKenzie.

#### **IV. BENEFITS OF FORMING NY TRANSCO**

### 2 Q. WHAT ARE THE BENEFITS OF FORMING A STAND-ALONE, 3 TRANSMISSION-ONLY COMPANY?

4 A. Formation of NY Transco as a company centralizes and focuses the efforts of investor-5 owned utilities on developing and constructing five major projects that address state 6 public policy initiatives designed to add significant new electric infrastructure in a way 7 that overcomes long-standing constraints in the New York State power market. The projects selected for the NY Transco portfolio are projects that have a common state-8 9 wide purpose and involve complex permitting and construction challenges across the 10 various transmission systems of each of the NYTOs. A Transco is the most efficient way of dealing with these challenges. In forming the NY Transco joint venture, the 11 12 members have had to resolve investment and cost allocation issues among the separate members that would otherwise be barriers to progress if the companies worked 13 14 individually. Furthermore, this Commission has recognized as a matter of policy that a 15 company concentrating solely on developing and managing electric transmission is particularly likely to make investments in needed transmission infrastructure. 16

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#### V. REQUESTED INCENTIVES AND NEXUS TEST

### 18 Q. WHAT TYPES OF INCENTIVES HAS NY TRANSCO REQUESTED IN ITS 19 APPLICATION?

A. The application requests several types of risk-mitigating incentives as well as ROE
 adders to supplement the base ROE. These incentives are in consideration of the risks
 of NY Transco's business and projects. The risk-mitigating incentives and ROE adders

1		requested in this application are similar to those the Commission has granted to peer
2		transmission companies in recent proceedings.
3		V-A. Risk-Reducing Incentives Requested
4	Q.	HOW DO THE RISK-MITIGATING INCENTIVES THAT NY TRANSCO IS
5		REQUESTING IN THIS PROCEEDING RELATE TO THE RISKS THAT YOU
6		ADDRESS IN SECTION VII OF YOUR DIRECT TESTIMONY?
7	A.	NY Transco's application requests the following risk-mitigating incentives:
8		(1) Authorization to collect its cost of capital on 100% of CWIP on two of its
9		projects, Edic to Pleasant Valley and Oakdale to Fraser;
10		(2) Recovery of pre-construction and pre-operation expenses that are not
11		capitalized and recoverable in CWIP as a regulatory asset and the
12		amortization of the regulatory asset along with a return on the unrecovered
13		balance of the regulatory asset account;
14		(3) The authorization to recover all prudently incurred abandonment costs if
15		project termination results from factors outside of NY Transco's control;
16		and
17		(4) Use of a hypothetical capital structure of 60% equity and 40% long-term
18		debt for the Company's first five years.
19		Each of these risk-reducing incentives will mitigate specific risks related to the
20		large capital investments that NY Transco must make, its weak cash flow in the period
21		of its heaviest capital spending, and its dependence on external sources of funding, as I
22		will explain in Section VI of this testimony. NY Transco's credit ratings and investor

1	confidence in the Company's securities will be greater with the help of the requested
2	mitigants. Section V-G of this testimony sets forth the relationship between the
3	requested incentives and specific areas of financial risk.

HOW DOES CASH RECOVERY OF 100% OF CWIP AFFECT NY TRANSCO'S

4 V-B. Cash Return on CWIP

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#### **OPERATING CASH FLOW?**

7 If NY Transco is authorized to recover the cost of capital on 100% of CWIP in its A. 8 revenues with regard to the Edic to Pleasant Valley project and the Oakdale to Fraser 9 project, the two projects that have expected completion dates of 2019, the Company 10 will enhance its operating cash flow prior to the completion and initiation of 11 commercial operations of those two projects. The effect upon operating cash flow in the critical three years 2016-2018 of 100% cash return on CWIP in comparison with either 12 50% cash return on CWIP or no cash return is shown in Exhibit No. NYT-20. 13 14 Specifically, the exhibit compares NY Transco's estimated operating cash flow with a 15 cash return for the two projects expected to be completed in 2019 with 100% of CWIP, 16 50% of CWIP, or no cash return on CWIP. The effect of the cash return on CWIP is 17 dramatic because the revenue for cash return on 100% of CWIP on the two projects represents a very significant portion of NY Transco's projected base case revenue and 18 19 cash flow in 2016-2019. In the crucial three years 2016-2018, cash return on 100% of 20 CWIP is forecasted to comprise on average 50-55% of NY Transco's operating 21 revenues and over 60% of cash flow from operations. If the Commission authorized 22 only 50% cash return on CWIP for these two projects, the Company's operating revenues for the initial three years of the Company's existence would be reduced by 23

approximately 27% and cash flow from operations would on average be approximately
 30% lower than the cash flow with 100% cash return on CWIP, as shown in Exhibit No.
 NYT-20.

### 4 Q. WILL CASH RECOVERY OF 100% OF CWIP LESSEN NY TRANSCO'S 5 INVESTMENT RISK?

Yes. It will avoid the multi-year lag in receiving revenues that would otherwise occur 6 A. 7 between the inception of two of the Company's projects and the start of revenues at 8 their in-service dates in 2019 or later and improves cash flow-based financial ratios 9 used by financial analysts to gauge the Company's financial status and credit-10 worthiness. Having more cash flow from operations during years of very high capital 11 expenditures reduces a company's exposure to the risks of capital market financing. 12 Furthermore, cash recovery of a return on CWIP has been cited by credit rating 13 agencies as part of their rationale for applying a more favorable credit rating to utilities 14 in jurisdictions with that practice. In Standard and Poor's ("S&P") revised Key Credit 15 Factors criteria for rating regulated electric and gas utilities, S&P says that the 16 regulatory jurisdiction provides a "Strong Regulatory Advantage" if its policies and procedures indicate: "...support of cash flows during construction of large projects, and 17 18 pre-approval of capital investment programs and large projects lowers the risk of subsequent disallowances of capital costs."<sup>1</sup> 19

20 Consequently, the cost of debt capital to the Company would be reduced as a 21 result of improved investor sentiment and the favorable effect on NY Transco's credit 22 ratings.

<sup>&</sup>lt;sup>1</sup> Standard & Poor's Corporation, Key Credit Factors for the Regulated Utilities Industry, Nov. 19, 2013, paragraph 28, Table 1.

### Q. DOES CASH RECOVERY OF 100% OF CWIP ELIMINATE ALL FINANCIAL RISK FOR NY TRANSCO?

A. No, even with the cash flow benefit of incremental revenues that this incentive would
 provide during this critical early period, NY Transco will still have a significant cash
 flow deficiency in its initial four years relative to the cash outflows for capital
 expenditures.

7 V-C. Pre-Formation Expenses

#### 8 Q. HOW WOULD RECOVERY OF NON-PLANT EXPENSES OF NY TRANSCO 9 PRIOR TO FORMATION AND HAVING RATES IN PLACE REDUCE NY 10 TRANSCO'S INVESTMENT RISK?

11 A. From its inception, NY Transco will incur expenditures that do not qualify as a 12 component of electric plant and therefore cannot be added to CWIP under the FERC 13 Uniform System of Accounts. The costs of its formation along with the costs of this 14 filing and proceeding are just a few examples. Under generally accepted accounting 15 principles, such costs would be treated as expenses of the period and charged off 16 against earnings in the period incurred. As a result, NY Transco's Statement of Profit 17 and Loss would show losses relating to these expenditures, and these costs would never be recoverable. 18

An entity not subject to cost-of-service rate regulation would be able to charge any prices that the market would bear after its facilities enter commercial operation, and its future excess profits may compensate for these formation expenses and losses incurred prior to operation. In contrast, however, because NY Transco's prices will be determined by cost-of-service regulation, it would never have any opportunity to

recover any excess profits to compensate for the pre-operating expenses that were charged off as period expenses. The accumulated losses resulting from these expenses would reduce the balance of common equity and would require greater equity contributions by NY Transco's members. The remedy for that inequity is the accounting treatment proposed herein: to accrue such expenses as a regulatory asset and amortize the regulatory asset, along with earning the cost of capital on the unrecovered balance of the account, over a five-year period.

8 The result of accruing these expenses to a regulatory asset account will be to spare 9 NY Transco's income statement and its equity account from losses as a result of these 10 early year expenses. The result of receiving revenues to compensate for the 11 amortization of the regulatory asset over five years will be to provide some minor 12 amount of cash during NY Transco's early years. The effect of this mechanism should 13 be to support better credit ratings for NY Transco in its initial five years and to enhance 14 the Company's image in the financial markets.

### 15Q.DOESRECOVERYOFTHESEEXPENSESELIMINATEALLTHE16ASSOCIATED FINANCIAL RISK FOR NY TRANSCO?

A. No, it does not. Despite the benefits of this mechanism, NY Transco will still have
weak operating cash flows during the years 2015-2017 and will still require several
rounds of external debt financing during the period.

#### V-D. Recovery of Abandonment Costs

### 2 Q. HOW DOES THE OPPORTUNITY TO RECOVER COSTS OF PLANT 3 ABANDONMENT LOWER NY TRANSCO'S INVESTMENT RISK?

4 A. For electric transmission projects in general, siting and permitting is a very risky 5 process, and some projects are unable to surmount the related external obstacles. NY 6 Transco will bear the risk of cancellation of the project through no fault of its own. If 7 not permitted to recover 100% of the costs of abandoned plant, the Company may only recover 50%. Since NY Transco will have at its outset no assets or businesses other 8 9 than development projects, absorbing a loss of that magnitude in such event would be 10 devastating for the Company and for investors in NY Transco's debt securities and 11 equity.

12 The Commission's practice of providing the opportunity to recover costs of 13 abandonment for electric transmission projects over the past decade has been an 14 effective way to offset the catastrophic risk investors would otherwise perceive, thus 15 enabling many FERC-jurisdiction electric transmission projects to raise equity and debt 16 capital upon reasonable terms.

### 17 Q. DOES THE RECOVERY OF THE COSTS OF ABANDONED PROJECTS 18 ELIMINATE ALL PROJECT DEVELOPMENT RISK?

A. No, by no means. The abandonment provision will help to reduce the risk of project termination if the project is terminated due to causes outside of NY Transco's control.
However, it doesn't eliminate all project cancellation risk perceived by investors, because actual recovery will not have been awarded by this Commission. Recovery will be based upon facts specific to any project cancelation or termination.

Furthermore, the opportunity to recover costs of abandoned projects does not eliminate all project development risks facing NY Transco. Delays and cost over-runs will adversely affect NY Transco's earned ROE through the proposed cap on the incentive ROE adder. Abandonment of a project coupled with the potential risk of a finding that project cost over-runs were the result of imprudence poses another type of risk. These risks are not in any way reduced or mitigated by project abandonment provisions.

7 V-E. Capital Structure

#### 8 Q. YOU LISTED THE USE OF A HYPOTHETICAL CAPITAL STRUCTURE 9 AMONG THE REQUESTED RISK MITIGATING INCENTIVES THAT NY 10 TRANSCO SEEKS. CAN YOU PLEASE EXPLAIN THAT?

11 A. NY Transco's borrowing is likely to take place by means of long-term bond issuance to 12 fund the up-front acquisition payments, followed by drawings under bank facilities. 13 When there is a sufficiently large loan balance outstanding under the bank facility to 14 justify another long-term bond issuance, the Company will again issue bonds to permit 15 the repayment of outstanding bank loans, and so forth. The NYTOs will invest equity in 16 NY Transco incrementally at certain intervals. At any point in time during this process, 17 the actual debt and equity ratios may vary from the intended debt and equity capital proportions (especially since short-term debt is excluded from FERC formula rates). 18 19 For this reason, NY Transco seeks approval to use a hypothetical capital structure for its 20 first five years (2016-2020), giving the Company a sufficient amount of time to finance, 21 complete, and place in service the initial five projects. This is a mechanism that the 22 Commission has frequently granted in order to create more stable and predictable cash flows for electric transmission projects during their construction phase. For the 23

1 Commission to do otherwise would make NY Transco's rates and cash flows more 2 erratic or uncertain and would place it at a disadvantage relative to other electric 3 transmission companies in the capital market.

## 4 Q. WHAT HYPOTHETICAL CAPITAL STRUCTURE WOULD PROVIDE THE 5 MOST SOLID FINANCIAL FOUNDATION FOR NY TRANSCO PROJECTS 6 DURING THE YEARS OF CONSTRUCTION?

7 A. The NY Transco has requested a hypothetical capital structure of 60% equity and 40% 8 debt for the company's first five years. This requested mitigant corresponds with the 9 period of NY Transco's heavy capital expenditures for its five initial projects of 10 approximately \$1.7 billion from 2016–2020. A 60% equity ratio during this period of 11 greatest risk would enhance the likelihood that the Company would achieve its targeted 12 investment-grade credit ratings at the outset, materially aiding the Company to finance 13 its up-front capital expenditure commitments at favorable cost of capital and under the 14 most flexible terms.

15 The 60% equity and 40% debt capital structure reduces NY Transco's need to 16 borrow from investors by \$168 million from 2016-2018, a 20% reduction in 17 outstanding debt relative to the higher amount of debt employed at 50% debt to capital. 18 In the 60% equity case, operating cash flow would also be approximately \$20 to 30 19 million higher per annum in 2017-2019. The lower debt level and higher operating cash 20 flow will combine to enhance the key credit ratios used by S&P and Moody's and is 21 widely used by fixed income investors. The requested capital structure of 60% equity to 22 40% debt will reduce the Company's debt by 20% and will enhance operating cash 23 flow measures during the crucial years 2016-2019. That is likely to improve NY

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Transco's image in the financial market and will help the company to attract investment capital in competition with other electric utilities.

#### **3 V-F. Additional ROE Incentives**

### 4 Q. DO THE PROJECTS UNDERTAKEN BY NY TRANSCO QUALIFY FOR ROE 5 INCENTIVE ADDERS?

6 Yes, they do. The Commission set forth in its Policy Statement Promoting Transmission 7 Investment Through Pricing Reform, (Nov. 15, 2012) in Docket No. RM11-26-000 8 ("Policy Statement") three examples of rationales for incentive ROE. NY Transco's 9 projects conform to two out of three of these examples, namely: (1) the projects would 10 relieve chronic or severe grid congestion that has had demonstrated cost impacts to 11 customers; and (2) the projects would unlock location constrained generation resources that previously had limited or no access to the wholesale electricity markets. NY 12 13 Transco's projects are intended to ensure reliability and reduce the cost of delivered 14 power by reducing transmission congestion in the region. NY Transco Witnesses 15 Messrs. Haering and Allen have provided in their testimony a more detailed account of the projects and their conformity to the criteria of the Policy Statement.<sup>2</sup> 16

### 17 Q. PLEASE DESCRIBE THE REQUESTED ROE INCENTIVES AND WHY THEY 18 ARE NEEDED.

- 19 A. NY Transco's application requests three ROE incentives:
- 20 (1) An incentive for membership in and surrender of control of their assets
  21 to an ISO or RTO, which is typically 50 BP. Such an incentive is

<sup>&</sup>lt;sup>2</sup> Exhibit No. NYT-4: Prepared Direct Testimony of Witnesses Paul E. Haering and Richard Allen.

consistent with the Commission's policy to incentivize utilities to place their transmission activities under the control of an ISO.

(2) A 50 BP incentive for the formation of a transmission-only company 3 4 that will focus exclusively on developing and operating needed 5 transmission assets. The Commission has found that focused transmission-only entities have a much greater interest and success in 6 overcoming the obstacles posed by difficult electric transmission 7 8 projects. Aside from the project-specific risks discussed in section (3) 9 immediately below, NY Transco will be a new company without a track 10 record, competing in the capital markets for funding against larger and 11 more established entities with long acceptance by the investment 12 community. Providing an incentive adder for the formation of a 13 specialized transmission entity would help to balance these risks and is consistent with this Commission's policy objective to foster new 14 investment by transmission-only entities in transmission infrastructure. 15

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16 (3) A risk-based ROE incentive of 50 BP. This requested incentive would 17 compensate for the added risks faced in the construction and 18 development of electric transmission projects. Among those are risks of 19 project delays, unexpected changes in project plans and budgets due to 20 permitting requirements and land acquisition, and regulatory risks 21 associated with the evolving regulation of electricity wholesale market 22 design and transmission policy. Furthermore, the requested adder is 23 consistent with the benefits to electricity customers and to the public of

new transmission construction to relieve chronic or severe transmission congestion, to unlock transmission-constrained generation resources that previously had limited access to wholesale electric markets.

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4 NY Transco is committed to capital expenditures of at least \$1.7 billion (in 5 nominal dollars) for the acquisition and completion of five initial projects over its first 6 four years of existence, a period during which its internal cash flow will likely be 7 weak relative to that of the utilities with which the Company must compete for 8 financing. Thus, NY Transco faces funding risks and exposure to cyclical capital 9 markets, to an extent far greater than more established utility companies with large 10 bases of ongoing commercial operations and more modest capital budgets relative to 11 the size of the enterprise. The requested adders will help to attract investment capital, 12 offsetting the added risk faced by a start-up company with a major need for external 13 capital funding.

#### 14 V-G. Relevance of Requested Incentives to NY Transco Investment Risks

## Q. WILL THE REQUESTED INCENTIVES MAKE A DIFFERENCE TO NY TRANSCO'S SUCCESS IN ATTRACTING DEBT CAPITAL TO FUND ITS PROJECTS?

Yes. Exhibit No. NYT-21 shows the range of NY Transco's projected financial ratios as modeled in two cases. In the first case, Scenario A in the exhibit, presents a more leveraged capital structure of 50% debt, the requested base ROE of 10.6% and no incentive ROE adders. In the second case, Scenario B, includes the requested ROE of 10.6%, the 150 BP aggregate requested ROE adders, and the requested capital structure of 60% equity and 40% debt-to-capital. Both cases were modeled with 100% cash recovery of CWIP; the results of each would have been weaker if either case had been modeled with only 50% cash return on CWIP. These two cases produce a range of results that are then compared with the recent financial ratios of a set of three established transmission and distribution ("T&D") electric utilities, all rated within the range of BBB+/Baa1 to A by S&P and Moody's.<sup>3</sup>

6 NY Transco's average ratios during the years 2016-2018 of debt to EBITDA and 7 various measures of cash flow to debt in Scenario A are significantly weaker than the 8 ratios of the peer T&D utilities. On the other hand, the average three-year credit ratios 9 for NY Transco in Scenario B compare favorably with the credit ratios for the peer 10 T&D utilities. As a start-up entity with high capital expenditure and project completion 11 risk, NY Transco needs more favorable financial ratios than its more established peer 12 utilities in order to offset its perceived risks.

13 Exhibit No. NYT-21 demonstrates that the incentives sought in the application 14 can make a significant quantitative difference to the financial measures that are 15 important to credit rating agencies and bond investors, bringing NY Transco's financial 16 standing on a par with that of the peer utilities against which it must compete in the 17 capital markets. In addition to the quantitative effects, authorizing all of the incentives 18 sought by NY Transco will also provide a qualitative expression of regulatory support 19 that will be meaningful to credit rating agencies and to the investment community, 20 supporting the Company's ability to attract investment. Furthermore, the ROE 21 incentives are justified based upon FERC's policies and priorities for stimulating

<sup>&</sup>lt;sup>3</sup> A table comparing the long-term rating scales of three major credit rating agencies is presented in Exhibit No. NYT-22.

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investment in critical transmission infrastructure and compensating investors for the incremental risks associated with transmission investment.

### 3 Q. CAN YOU SUMMARIZE YOUR DISCUSSION ON THE VARIOUS INCENTIVE 4 MECHANISMS?

5 A. The individual requested incentives, including risk-reducing incentive mechanisms and the RTO and ROE incentive adders, will mitigate risks or compensate for risks that are 6 7 meaningful to potential bond investors and prospective lenders under credit facilities. 8 Taken together, the incentives requested in this filing are essential to enable NY 9 Transco to accomplish the construction of its portfolio of projects and to compete in the 10 bank market and long-term debt capital market with long-established utilities for 11 financing. Providing these requested incentives would be a significant signal from FERC to electric transmission companies and equity and debt investors that the 12 13 Commission continues to stand behind its policy to incent needed transmission 14 development in the United States. The connection of the individual incentives requested 15 to the specific risks that each incentive will mitigate is summarized in Exhibit No. 16 NYT-23, "NY Transco: Investment Risks and Related Mitigants and Incentives".

#### 17 VI. NY TRANSCO'S INVESTMENT AND FINANCING PLAN

#### 18 VI-A. Capital Spending Plan

#### 19

#### Q. PLEASE DESCRIBE NY TRANSCO'S CAPITAL EXPENDITURE PLAN.

A. The Company's initial investment plan includes five projects requiring an estimated
\$1.7 billion of investment over the five years 2016-2019. These projects and their
forecasted budgets are explained in detail by NY Transco Witnesses Haering and Allen
in Exhibit No. NYT-4. Beyond the projects already identified, NY Transco is likely to

develop additional projects to serve the infrastructure and reliability needs of New York
 State, although such incremental projects have not been finalized and are not the
 subject of this filing.

### 4 Q. WHAT ARE THE ESTIMATED IN-SERVICE DATES OF THE NY TRANSCO 5 PROJECTS?

A. Table 1 below indicates that NY Transco expects to complete its first five projects by
2019. The first three projects listed in Table 1 are the Transmission Owner
Transmission Solutions ("TOTS") projects, which have expected completion dates late
in 2016. The final two projects have expected completion in 2019 and comprise about
74% of the total capital budget.

#### 11 Table 1: NY Transco's Initial Projects and In-Service Dates

<u>Project</u>	Expected Completion	Estimated Budget \$ millions
Marcy South Series Comp; Fraser		
to Coopers Corners	2016	\$66
Ramapo - Rock Tavern	2016	121
Staten Island Unbottling	2016	262
Edic - Pleasant Valley	2019	1,022
Oakdale – Fraser	2019	<u>246</u>
Total		\$1,717

#### 12 Q. HOW DOES THE COMPANY'S PLANNED CAPITAL SPENDING COMPARE

#### 13 WITH ITS ANTICIPATED SOURCES OF CASH?

In early 2016, with none of its five initial projects in commercial operation, NY Transco will make payments to acquire all five projects from the NYTOs. Three projects should commence commercial operations late in 2016, if not subject to delay. Heavy capital

1 expenditure commitments will continue for two projects that will not be in service until 2 2019. Thus, NY Transco's revenues in its first three to four years of existence (approximately 2016-2018 and at least the first half of 2019) will largely be comprised 3 4 of the cost of capital that the Company is requesting to earn on its accumulated balance 5 of CWIP and the requested amortization of certain pre-commercial expenses that are not 6 capitalized in CWIP. In 2017-2018, with its three earliest completed projects in 7 commercial operations, cash outflows for capital expenditures on other projects will still exceed NY Transco's internal operating cash flow. 8

9 The ratio of internal cash flow from operations ("CFO") to capital expenditures is 10 an important credit indicator tracked by bond investors, fixed income asset managers, 11 and credit rating agencies. Annual internal cash flow that is at least equal to the yearly 12 capital expenditures is deemed to be a sign of very strong credit quality, while 13 committed capital expenditures that are far in excess of internal cash flow from 14 operating activities are viewed as a source of liquidity risk and weak credit.

15 Figure 1 below, "Capital Expenditures Exceed Internal Cash Sources", illustrates 16 that internal cash flow will provide only a fraction of aggregate capital expenditures in 17 the three years 2016-2018. Two scenarios are represented in this figure. In one case, 18 identified as "Low", NY Transco does not have the benefit of the various incentives to improve cash flow or capital structure requested in the application. In the low case, 19 20 CFO for the three years 2016-2018 averages only 13% of aggregate capital 21 expenditures for the same period. This means that capital expenditures during the 22 company's initial three years are six times greater than operating cash flow, and the net 23 cash deficiency (operating cash flow less capital expenditures) is approximately \$1.5

1	billion over the same period. As shown in the figure, NY Transco's ratio of CFO to
2	capital expenditures is weak in the three years 2016–2018. In the alternate case shown
3	in the figure, designated as "High," NY Transco benefits from the following cash flow-
4	enhancing incentives being requested from the Commission:
5	• Hypothetical capital structure of 60% equity and 40% debt for its first five years
6	and thereafter the actual capital structure, which is expected to be consistent
7	with the hypothetical capital structure;
8	• ROE incentives of 50 BP for joining an RTO, 50 BP for Transco formation, and
9	50 BP for risk mitigation;
10	• and 100% CWIP in rate base.
11	In this case, operating cash flow ("FFO") over the three years represents 19% of capital
12	expenditures (i.e., capital expenditures are five times greater than FFO), and the net
13	cash deficiency over the same period is somewhat lower at \$1.4 billion. While there is
14	still a substantial cash flow deficiency in the initial three years 2016-2018, the
15	deficiency is reduced by the incentives and the cash flow credit measures that are of
16	significance to credit rating agencies and creditors are enhanced.



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In summary, the requested ratemaking incentives will enhance NY Transco's financial condition and key cash flow measures during a period of initial heavy capital expenditures when NY Transco must rely heavily on borrowing and must attract external investors to meet its heavy capital expenditure commitments.

7 VI – B. Financing Plan

#### 8 Q. HOW WILL THE COMPANY FUND ITS PROJECTS?

9 A. I anticipate that NY Transco will depend on external funding sources until 10 approximately 2019, when all of the initial five projects are expected to be completed 11 and fully funded in the capital market, absent delays. Heavy capital expenditures and

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external financing needs may extend to later years if additional transmission projects are later adopted or if projects encounter unanticipated delays.

The Company is organized as a limited liability company controlled by its 3 4 members, and it does not plan to issue stock to the public. During its initial years, the 5 major sources of funding for NY Transco will be: (i) equity contributions by its 6 members, in proportion to their ownership shares; and (ii) external borrowing, both in 7 the form of loans pursuant to a bank credit agreement and longer term bond financing. NY Transco has not yet adopted a formal financing plan. Given the large payments that 8 9 Transco will have to make to acquire the five projects from the NY 10 sponsors/transmission owners at inception, it is anticipated that the Company will do an 11 initial bond offering to fund its ongoing construction budget in 2016. Then, following 12 the norm in the utility industry, it is likely that the Company will borrow under a bank 13 credit facility until the loan balance outstanding is large enough to warrant approaching 14 the bond market with an efficiently-sized offering of long-term debt (generally a minimum of \$250 million). Using the proceeds from the bond issuance to repay the 15 16 balance outstanding under bank lending commitments, the Company will then borrow 17 once again under the bank commitments until the amount of loans outstanding has built 18 up once more to the efficient bond offering size, and the cycle of borrowing under the 19 bank facility and funding out with longer-term bond issues would continue in this 20 manner during the period of heavy capital expenditures. Consequently, NY Transco will 21 need to enter the debt market several times to issue long-term bonds, perhaps at 22 intervals of every 12 months, from 2016 through 2019.

1 The approach explained above would require the Company to achieve and 2 maintain adequate credit quality to satisfy its lending group and bond market investors 3 while accessing funds during differing phases of the capital market and economic cycle, 4 including both "easier" and "tighter" credit periods.

5

#### VII. NY TRANSCO'S INVESTMENT RISKS

### 6 Q. WHAT ARE THE INVESTMENT RISKS THAT ARE INHERENT IN NY 7 TRANSCO'S BUSINESS PLAN?

- A. NY Transco faces numerous investment risks as a natural outgrowth of its status as a
  new entity without an existing base of earnings and cash flow, coupled with a
  substantial capital expenditure budget of \$1.7 billion to construct the five initial electric
  transmission projects. The major risks that investors and credit rating agencies will
  evaluate are as follows:
- Stand-alone entity without financial history;
- No pre-existing revenues or cash flow;
- Weak operating cash flow measures during its initial years;
- High capital expenditures relative to internal cash flow, requiring external financing
   and consequent funding risk;
- Complex project management for multiple projects (*i.e.*, completion risk);
- 19 Regulatory risk.

Q. CONSIDERING THE INDIVIDUAL RISK FACTORS THAT YOU HAVE JUST
 LISTED, WHAT DO YOU MEAN BY A "STAND-ALONE ENTITY WITHOUT
 FINANCIAL HISTORY"?

4 A. Although the NYTOs are established utilities, the company is a new entity lacking any 5 history of earnings. It has no established external investor base and no reputation in the 6 financial markets. Like other new electric transmission companies that started up in 7 recent years, it will issue non-recourse corporate debt without financial guarantees from 8 its members. In the financial markets, lenders have a strong preference for borrowers 9 with established historical financial data and a history of previously having repaid 10 borrowed money. Under favorable market conditions, companies with no established 11 history of earnings can raise capital based on modeled financial projections, but under 12 less flexible terms and conditions than more established credits. During stressful 13 markets conditions, companies without established financial history using modeled financial projections are likely to lose access to bank and capital market funding. 14

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#### Q. WHAT IS THE SIGNIFICANCE OF THE COMPANY'S ABSENCE OF INITIAL

16

#### **REVENUES OR CASH FLOW?**

A. At its inception, NY Transco will have no earning assets other than projects under construction, the three earliest of which are scheduled to enter commercial operation in 2016. Two projects, which together represent 74% of the projected initial capital investment plan, will begin service in 2019. Prior to their commercial operation, the only revenues or cash flow the Company will have at the start of 2016 will derive from a cash return on CWIP on two of its projects as well as the recovery of the amortization of start-up expenses, as the Company has requested in this proceeding. If the Company

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is authorized to earn a cash return on 100% of CWIP, this will enhance revenue in the early years, but the resulting operating cash flow will still be considerably smaller than the cash outflows for capital expenditures in the years 2016-2018.

### 4 Q. IS THAT WHY YOU SAY THAT NY TRANSCO WILL HAVE WEAK 5 OPERATING CASH FLOW?

6 Yes. NY Transco's internal cash flow will be derived from tariff revenues, and, during 7 the early years when more assets are under construction than in commercial operation, the revenues available to the Company will largely consist of the cash return on 100% 8 9 of CWIP (if authorized in this proceeding) and revenues to compensate for the five-year 10 amortization of pre-operational expenses (if authorized in this proceeding). However, as 11 I illustrated in Figure 1 above, even with added revenues from those favorable 12 regulatory mechanisms, the resulting net internal cash flow will be meager in the initial 13 years, and for the four years 2016-2019 will aggregate less than 30% of the Company's 14 heavy capital expenditures. During those initial years, the Company must rely on raising debt capital from external sources and repeated capital infusions from its 15 16 members to offset its persistent cash deficiency.

## 17 Q. ARE THERE CIRCUMSTANCES UNDER WHICH NY TRANSCO'S 18 OPERATING CASH FLOW COULD BE EVEN WEAKER THAN YOU HAVE 19 ESTIMATED?

# A. Yes, it is possible that my outlook is too optimistic regarding the improvement in NY Transco's cash flow and internal funding capabilities starting in 2019 and beyond. For the purpose of this application, NY Transco is presenting only the first five of its projects, and capital expenditures are limited to 2016-2019. But in reality, NY Transco
will not be a static portfolio of five initial projects. As NY Transco undertakes
additional projects, it is likely that more capital projects will appear in NY Transco's
investment portfolio, causing capital expenditures in 2017-2020 to increase. The
consequence of a more extensive portfolio of transmission investments would be that
NY Transco's cash flow ratios would not improve in 2019 and would remain stressed
during an extended period of external borrowing and capital investment.

Also, transmission projects may be subject to unavoidable delays or set-backs as a consequence of siting disputes, changing requirements for environmental compliance, and related change orders. Consequently, a project may take longer to complete and may incur higher costs than initially planned. With multiple major construction projects under development, NY Transco could face additional funding needs beyond those in its base case.

### 13 Q. WHY DO YOU CLASSIFY NY TRANSCO'S NEED FOR EXTERNAL 14 FINANCING AS A SOURCE OF RISK?

15 A. The need to obtain external financing from repeated issues of long-term debt from 16 capital market investors exposes NY Transco to shifting capital market cycles. Over 17 the next five years, conditions in the bank credit market and debt capital market are 18 likely to shift one or two times. Significant Federal Reserve intervention in the debt 19 capital market over the past several years to reduce interest rates and promote economic 20 growth via the Quantitative Easing program has fostered "easy and open" capital 21 market conditions, thereby permitting companies with low investment grade and sub-22 investment grade ratings to fund in the capital markets with relative ease. However, 23 borrowers with high capital expenditure commitments and weak internal cash flow and credit ratings in the lower tier of the BBB/Baa category may become illiquid and financially distressed in future periods of stress in the capital market. NY Transco will be committed to make heavy capital expenditures and will have to issue long-term debt repeatedly to carry out its investment commitments, under both favorable and unfavorable capital market conditions, and it is unlikely to be able to rely on perpetually easy credit conditions.

# 7 Q. CAN YOU PROVIDE EXAMPLES OF WHAT YOU MEAN BY REDUCED 8 ACCESS TO THE CAPITAL MARKET DURING PERIODS OF MARKET 9 DISTRESS?

10 A. The Financial Crisis of 2007-2009 brought about a particularly severe disruption of the 11 U.S. long-term and short-term debt markets. U.S. financial markets became unstable 12 beginning in mid-2007 as the magnitude of mortgage defaults and the ripple effects of 13 those defaults on asset-backed securities, bond insurers, and the banking system 14 became known. The most severe market impact was felt in September to December 2008. Issuers with single-A or higher credit ratings (rated A or higher by S&P, or A2 or 15 16 higher by Moody's) still had access to debt funding during that financial crisis, but 17 access was constrained for companies in the BBB to BBB- and sub-investment grade 18 categories. Borrowers with low tier BBB ratings continued to be at a disadvantage 19 through most of 2009. During the crisis period, banks experienced stress upon their 20 own capital and therefore restricted access to new or expanded loan commitments or 21 extensions of maturing credit facilities, causing further liquidity stress on BBB rated 22 entities that had not foreseen the sudden loss of capital market access.

1		Uncertain or stressful financial market conditions can occur at any time, and they
2		are not rare. Other recent examples include:
3		(1) 1997-1999 – Brought on by a series of international currency crises and defaults
4		(1997 - South Korean and other Asian currencies; 1998 - Russian debt default and
5		ruble crisis; and 1999 - Brazilian currency crisis);
6		(2) Late 2000 – Commercial paper defaults of Southern California Edison and Pacific
7		Gas & Electric disturbed the debt market, especially affecting utility issuers;
8		(3) November 2001 - Enron default;
9		(4) July 2002 - Worldcom default.
10		The events I have listed disrupted overall U.S. corporate bond issuance and caused
11		temporary contractions of the corporate commercial paper market for some duration.
12		They caused investors to avoid lower-rated bonds or loans and to give preference to
13		higher-rated issuers.
14	Q.	YOU STATED THAT PROJECT MANAGEMENT AND COMPLETION WILL
15		BE VIEWED AS A SOURCE OF RISK FOR NY TRANSCO. PLEASE EXPLAIN
16		THAT RISK.
17	А.	Investors and credit rating agencies will be well aware that NY Transco must efficiently
18		manage its five construction projects. NY Transco's initial projects are essential to the
19		state's Energy Blueprint, and work will be going forward on multiple projects
20		simultaneously. The Company will not be able to space out its projects to minimize
21		project management risk. Consequently, the first three years will be a period of very
22		high construction risk. It is important to note that credit rating agencies' criteria are

- concerned with completion risk when companies have heavy commitments to multi year capital expenditure projects.
- The following explanation of the investment and credit risks related to utility capital expenditures and complex project management comes from Moody's Investors Service rating methodology for electric and gas network utilities in a section regarding execution and efficiency:
- o execution and efficiency.
- 7 The more complex the capital expenditure programme, the greater the 8 likelihood that it may take longer than envisaged and could cost more. 9 Also, the cost overruns associated with such outcomes may not be 10 recoverable from future revenues, depending on the regulatory framework... 11 12 b) Scale and Complexity of Capital Programme Moody's makes an assessment of a regulated network's capital 13 14 expenditure programme by considering (i) the size of this capex programme relative to the issuer's asset base (expressed in percentage of 15 its Regulatory Asset Value or total fixed assets), and (ii) the complexity of 16 this capex programme, i.e. the type of assets to be built and associated 17 technical issues (e.g. offshore transmission) as well as the relative 18 concentration of challenging projects within the issuer's total capex 19 20 programme... 21 Issuers will score "Aaa" through "B", depending on the size of their 22 capital programme measured in terms of annual total capital expenditure (including both maintenance and enhancement spend, gross of any 23 24 subsidies) as a percentage of total net fixed assets or regulated asset base. A network with one large and complex project accounting for the majority 25 of its capital programme will also score "B" regardless of the relative scale 26 thereof.<sup>2</sup> 27 28 In the case of NY Transco, projects under construction will comprise 100% of the 29 Company's plant assets and the entirety of the capital of the Company at the start of 30 2016, and a sizeable share of plant assets and capital on average for the years 2016 until
- 31 2019.

<sup>&</sup>lt;sup>4</sup> Moody's Investors Service, "Rating Methodology: Regulated Electric and Gas", August, 2009, pages 12-13.

### Q. HOW DOES NY TRANSCO'S RISK-SHARING PROPOSAL AFFECT ITS REQUESTED ADDITIONAL ROE INCENTIVE?

As Mr. Nachmias explains in his testimony, NY Transco's risk-sharing proposal will shield customers from some risk from the cost of construction relative to the budgeted cost. NY Transco proposes to cap the amount of investment qualifying for the incentive ROE adder. Under the proposal, costs above the project's estimated cost would earn only the base ROE, foregoing all of the incentive adders. Thus, customers would be protected from some completion and project management risk, and a part of that risk will be borne by NY Transco's equity and debt investors.

### 10 Q. YOU STATED THAT NY TRANSCO FACES REGULATORY RISK. CAN YOU 11 EXPLAIN THAT?

12 A. All of the Company's assets and business will consist of investments in electric 13 transmission assets, and all will be subject to the regulations and rules of this Economic regulation of utilities under the best circumstances can 14 Commission. produce stability and strength for an entity, but if the regulatory authority's rules and 15 16 procedures are not supportive of stable cash flows for the regulated company or are 17 unpredictable, it can instead be an area of considerable risk. All three leading U.S. 18 credit rating agencies identify regulatory risk as one of the principal determinants of the 19 ratings of rate-regulated utilities; consequently, unsupportive, arbitrary and 20 unpredictable regulatory decisions and policy result in lower credit ratings and impair 21 investor confidence. In prior decisions on electric transmission company tariffs such as those involving Transource Missouri, LLC, RITEline Illinois LLC and RITEline 22 23 Indiana LLC, DATC Midwest Holdings, LLI, and Desert Southwest Power LLC, this

1 Commission has implemented regulatory mechanisms that are designed to stabilize 2 cash flow and support the financial strength of the utility during construction projects. These mechanisms include: (1) cash return on 100% of CWIP prior to completion; (2) 3 4 capitalization of pre-construction and pre-operation expenses as a regulatory asset with 5 cash recovery of the amortization of the regulatory asset along with a return on the 6 unrecovered balance of the account; (3) use of a hypothetical capital structure prior to 7 project completion; (4) opportunity to recover abandonment costs; and (5) certain ROE 8 adders. These are the same incentives that NY Transco is requesting in this proceeding.

9 Because of these regulatory innovations and incentives, investors and rating 10 agencies now regard this Commission as providing support for investment in electric 11 transmission. If this Commission decides to reverse course in this proceeding or other 12 proceedings and does not provide the supportive incentives that it applied to other 13 similar electric transmission companies, the investment community would rightly 14 conclude that the Commission's actions are inconsistent with its prior decisions, and that regulatory risk and uncertainty have increased in this sector. 15

#### 16 VIII. IMPORTANCE OF SOUND CREDIT QUALITY

#### 17 **Q**. HOW DOES CREDIT QUALITY AFFECT INVESTORS' DECISIONS TO 18 **INVEST IN BONDS?**

19 A. The primary investors in bonds of utilities, including NY Transco, are financial 20 institutions such as mutual funds, pension funds, and insurance companies. Institutional 21 investors are bound either by regulations or by their internal investment guidelines as to 22 the credit quality of investments eligible for holding in their portfolio. Higher rated 23 bonds and loans are eligible investments under the regulations or internal investment

1 policies and guidelines of the greatest number of institutional investors. When bonds 2 carry low credit ratings in the lower ranks of investment grade (*i.e.*, rated BBB- and/or 3 Baa3) or in speculative grades, some investment accounts are forbidden to hold them, 4 and many other accounts have internal investment guidelines that restrict the percentage 5 of the portfolio that may comprise investments of lower credit ratings. In addition, 6 even when investment managers are not constrained by law or policy to investments of 7 specific credit ratings, they use ratings from credit rating agencies along with their own 8 evaluations of credit quality to shape their investment decisions. The higher the credit 9 rating, the broader the investor market for corporate debt instruments, which leads to 10 more favorable credit terms and lower interest rates.

## 11 Q. HOW WILL CREDIT QUALITY AFFECT NY TRANSCO'S ABILITY TO 12 OBTAIN FUNDS FROM BANK LOANS AND LONG-TERM DEBT?

13 A. Having strong credit attributes will be crucial for NY Transco to fund its committed transmission build-out. Market access to bank commitments and long-term debt capital 14 markets varies at different times in the capital market cycle. During normal periods in 15 16 the financial markets, rate-regulated utilities with investment grade corporate issuer 17 ratings (BBB- /Baa3 or higher) typically are able to obtain new credit commitments 18 from banks and can issue new debt instruments into the debt capital market without 19 difficulty. During an "easy" or "normal" phase in the capital market cycle, issuers with 20 minimal investment-grade ratings of BBB- or Baa3 must provide higher returns to 21 investors and banks in compensation for the higher risk, but these borrowers at the 22 lowest rank of the investment grade category can generally arrange new bank credit 23 facilities and issue new bonds in reasonable quantity.

In contrast, during "tighter" periods in the financial markets, access to the long-1 2 term debt market becomes constrained or disappears, not only for sub-investment grade 3 credits (those rated below BBB- and Baa3) but also for those in the lower rungs of the 4 investment grade category, that is, those with ratings of BBB- or Baa3 or in a more 5 severe market disruption, for issuers with credit ratings of BBB or Baa2. At such times, 6 it may be impossible for borrowers with ratings at or below BBB-/ Baa3 to negotiate 7 new credit facilities or to expand or extend existing facilities, resulting in liquidity 8 crises not only for sub-investment grade borrowers but also for those at the lower end 9 of the investment grade.

With its heavy commitment to capital expenditures requiring regular infusions of capital over the period 2016-2019, NY Transco cannot count on issuing bonds only at times when capital market conditions are most favorable to issuers. By necessity, the Company will have to finance itself repeatedly as it funds its construction commitments, under both good conditions as at present and under stressed market conditions that could occur. Thus, having sound credit ratings in the range of mid to high BBB is important for optimal financing at NY Transco.

## 17 Q. HOW WILL CREDIT QUALITY AFFECT NY TRANSCO'S ACCESS TO LOANS 18 FROM BANKS IN SUPPORT OF ITS CAPITAL EXPENDITURE PLAN?

A. As I have already explained, in order to undertake so many capital projects in its initial
 years, NY Transco will of necessity rely upon drawing under bank credit facilities to
 carry out its capital expenditures and fund operating cash deficits. Both the cost and
 availability of bank credit facilities are affected by the borrower's credit quality. Banks
 are required by their regulators to maintain capital against their loan assets and undrawn

1 commitments based on the riskiness of the borrower. Consequently, banks provide 2 larger amounts of credit more readily and on more favorable terms to borrowers of stronger credit quality. Banks charge progressively higher fees on undrawn credit and 3 4 higher interest spreads on notes or letters of credit outstanding for progressively lower 5 rated borrowers. As previously mentioned, at times of market stress, it is difficult if not 6 impossible for lower rated borrowers (equivalent to BBB- /Baa3 or lower) to obtain 7 new credit commitments from banks or to expand existing commitments, as demonstrated during the 2008-2009 credit crisis, when borrowers with ratings of 8 9 BBB/Baa2 found they had very limited availability to expand existing credit facilities 10 or extend maturing commitments.

### Q. WHAT IS THE RELATIONSHIP BETWEEN CREDIT RATINGS AND THE COST OF BOND FINANCING?

13 A. Investors expect to be paid more to hold investments of lower credit quality. Once again, the amount of disparity between higher and lower credit rating categories shows 14 a marked cyclical variation. During periods of uncertainty or financial market distress, 15 16 the pricing disparity between credit rating categories widens materially relative to more 17 normal periods. As set forth in Table 2 below, the interest rate differential between 18 utility bonds in the BBB Utility Bond Index and those in the BB Utility Index during 19 the years January 1, 2009, through Sept. 30, 2014, averaged 1.61% (161 BP) for bonds issued with a ten-year maturity and 1.43% (143 BP) for bonds issued with a 30-year 20 21 maturity.

Those numbers represent the average differential, but at times of financial market distress, the differential is far greater and is especially disadvantageous to

issuers rated BB+ or lower. Table 2 shows that the maximum difference in the index credit spreads of BBB utility credits versus credits in the lower-rated BB category during the same period January 1, 2009, through Sept. 30, 2014, was 3.84% on bonds issued with a maturity of ten years and 3.56% for 30-year maturities.

Table 2: Y	Vield Di	fferentials
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<b>Yield Differential: BBB Versus BB Utility Bond Index Rates</b> (Basis Points)			
Jan. 1, 2009 - Sept. 30, 2014	10 Year Maturity	30 Year Maturity	
Average	161	143	
Minimum	93	53	
Maximum	384	356	
Average Yield Differential	BBB Vs. BB Utility 240	Bond Index Rates	
2010 Average	223	191	
2011 Average	177	146	
2012 Average	207	170	
2013 Average 2014 Average (thru Sept.	169	137	
30) Source: Barclays Investment I 2014	164 Bank, as of Oct.20,	155	

Q. WHY DO YOU FOCUS ON THE YIELD DIFFERENTIAL BETWEEN BBB
7 AND BB RATED BONDS?

A. Given the high capital spending projected in the first four years of the Company's business plan and the relatively weak internal cash flow sources, the most likely range of initial corporate issuer ratings for NY Transco is in the broad range of BB+ to BBB+.
The decisions by this Commission regarding the various incentives requested in this application will be a decisive factor in whether the Company's initial bond ratings are

1 at the higher or lower end of that range. With the benefit of the full set of incentives 2 requested by NY Transco, including the 60% equity capital structure, 100% cash return on CWIP for two projects, and the requested base ROE and incentive ROE adders, NY 3 4 Transco would be a candidate for ratings of BBB to BBB+ (equivalent to Moody's 5 Baa2 to Baa1). On the other hand, with a less favorable capital structure of 50% equity, 6 a base ROE of 9% or below, no equity incentive adders, and 50% cash return on CWIP 7 for all five projects, NY Transco's credit ratings would be likely to be BB+ (Moody's 8 Ba1) in 2016–2017, which are the years when the Company must issue most of its debt. 9 Therefore, the comparison of the yields on BBB versus BB utility bonds is a relevant measure of the implications of the requested ratemaking incentives on the cost of new 10 11 debt issuance by NY Transco.

12

#### **Q.** WHAT IS THE COMPANY'S TARGET CREDIT RATING?

A. In order for NY Transco to have adequate access to bond market funding and to be able to raise capital on reasonable terms, it would be desirable to achieve issuer credit ratings of at least BBB (Standard & Poor's and Fitch) and Baa2 (Moody's), and preferably BBB+ and Baa1. In 2019-2020, when all of NY Transco's initial projects are in operation, a reasonable "target rating" for NY Transco's senior unsecured debt would be in the range of BBB+ to A-, placing NY Transco on par with the mainstream of ratings of rate-regulated utility bonds.

20

#### Q. IS NY TRANSCO LIKELY TO ACHIEVE THE TARGET RATINGS?

A. Without strong regulatory support from this Commission to reduce or offset investment risks, the initial ratings of NY Transco's senior unsecured bonds could be lower, for example, BBB-/Baa3 or BB+/Ba1. Those ratings would be near the bottom of the

1 group of rate-regulated utilities. While those ratings would enable NY Transco to fund 2 under favorable market conditions, issuance could be problematic if there are capital market disruptions or if NY Transco encounters any difficulties in executing its 3 4 construction plan.

5 If this proceeding results in supportive treatment on the incentive items requested in the application, NY Transco has a far better chance to achieve the desired senior 6 7 unsecured debt ratings of at least BBB/Baa2, and within several years could be rated These ratings would enable NY Transco to finance its construction 8 BBB+/Baa1. program with reasonably good success and would confer some flexibility to withstand 9 10 difficult market conditions or challenges in its construction program.

11 IX. **BASE ROE** 

#### DR. AVERA AND MR. MCKENZIE RECOMMEND THAT THE COMMISSION 12 Q. 13 SHOULD SET THE BASE ROE IN THIS PROCEEDING ABOVE THE MEDIAN 14

### OF THE ZONE OF REASONABLENESS, AND WITHIN THE UPPER HALF OF THE ZONE OF REASONABLENESS. DO YOU AGREE? 15

16 I strongly agree with the recommendation. In Opinion No. 531, the Commission found A. 17 that capital market conditions were anomalous and out of the ordinary, and the DCF 18 midpoint results did not result in an ROE that satisfied Hope and Bluefield. Therefore, 19 the Commission set the base ROE at the middle of the midpoint and top end of zone of 20 reasonableness. Currently the U.S. capital market reflects continuing disruptions and 21 abnormal conditions, including unusually low interest rates and various related market 22 anomalies. These continuing anomalous financial market circumstances are a 23 consequence of both massive purchases of debt securities by the U.S. Federal Reserve

Bank that continued through September 30, 2014, and global disturbances in international "hot spots." Concerns about the European and Asian economies also produce investor flight from risk. Flight from geo-political risk has contributed, along with ultra-low interest rates, to raise the prices and suppress the yields of utility bonds and equities and has prolonged the anomalous investment environment. The abnormal conditions that the Commission cited in its preliminary Opinion No. 531 published on June 19, 2014, certainly remain valid today.

8

#### Q. WHAT EVIDENCE SUPPORTS THIS?

9 A. Abnormally low interest rates are an important indicator of current capital market 10 conditions. The 10-year U.S. Treasury bond rate was 2.5% on September 30, 2014, 11 and averaged 2.2% in October 2014. Although that is slightly above the record low 10-12 year Treasury yields of less than 2% in May-June 2012, it certainly does not represent a 13 return to a normal pattern relative to any long-term review of U.S. interest rates. 14 Interest rates and bond yields remain very low in the context of historical interest rates, as illustrated in Figure 1 in Avera/McKenzie direct testimony, Exhibit No. NYT-24. 15 16 Bank deposit rates remain near zero.

The persistence of very low interest rates is influenced by two factors: first, the Federal Reserve System has for the past two years purchased and continues to hold massive amounts of U.S. Treasury securities and mortgage backed securities issued by U.S. agencies in a highly unusual operation of unprecedented size; and second, the Federal Reserve System has targeted the Federal Reserve discount rate, a short-term rate that affects banking institutions, at between 0 and 0.25% since early in the financial crisis of 2008-2009.

# Q. THE FEDERAL RESERVE HAS CEASED ITS MONTHLY BOND PURCHASES. DOES THIS IMPLY THAT CAPITAL MARKET CONDITIONS ARE NOW NORMAL?

A. No, it does not. U.S. financial markets continue to reflect the effects of the Federal
Reserve's massive bond purchase program, which was of unprecedented magnitude and
completely out of proportion with any historical experience. From October 2012 through
December 2013, the U.S. government purchased from the markets \$85 billion per month
of debt instruments as well as reinvestment of the interest earned in additional purchases,
and as a result it now holds over \$4 trillion in debt instruments.

10 In January 2014, the Federal Reserve began to "taper" or reduce the monthly bond 11 purchases in its third program of Quantitative Easing, or QE3, a program it had initiated 12 in October 2012. Despite tapering the rate of new purchases by the Federal Reserve, it 13 still made significant bond purchases in 2014. As shown in Table 3 below, in January 14 2014 the Federal Reserve purchased \$75 billion of securities; in February and March 2014, it purchased \$65 billion each month; in April 2014, it purchased \$55 billion, and 15 16 in May and June 2014, it purchased a "mere" \$45 billion each month. So in the first 17 half of 2014, the Federal Reserve bought an aggregate of \$350 billion of debt 18 instruments from the debt capital markets, bringing the aggregate amount of securities 19 purchased under the QE3 program to just over \$1.6 trillion. From July through 20 September 2014, the Federal Reserve purchased securities at the rate of \$25 billion per 21 month, bringing the open market purchases under QE3 for 2014 alone to \$425 billion as 22 of the end of September, which is by no means a trivial amount. On October 29, 2014, 23 he Federal Reserve Board of Governors announced that it would cease major new QE3

1	bond purchases at the end of October, but would continue reinvestment of the proceeds
2	in replacement purchases to replace the principal of maturities of U.S. Treasury
3	Securities and federal agency mortgage securities.
4	The New York Federal Reserve published this notice:
5	OPERATING POLICY
6	Statement Regarding Purchases of Treasury Securities and Agency Mortgage-
7	Backed Securities
8	October 29, 2014
9	NEW YORK—On October 29, 2014, the Federal Open Market Committee
10	(FOMC) directed the Open Market Trading Desk (the Desk) at the Federal
11	Reserve Bank of New York to conclude the current asset purchase program by the
12	end of October. The FOMC also directed the Desk to maintain the existing policy
13	of reinvesting principal payments from the Federal Reserve's holdings of agency
14	debt and agency MBS in agency MBS and of rolling over maturing Treasury
15	securities at auction. This policy, by keeping the Committee's holdings of longer-
16	term securities at sizable levels, should help maintain accommodative financial
17	conditions.
18	Thus, the effects of the Federal Reserve monetary easing continue to manifest
19	themselves in the capital market throughout 2014.

### **Table 3: Federal Reserve Purchases of Securities in QE3**

	US\$ Billions per month			
	US Treasury Notes	MBS	Total	
Sep-12	45	40	85	
Oct-12	45	40	85	
Nov-12	45	40	85	
Dec-12	45	40	85	
Jan-13	45	40	85	
Feb-13	45	40	85	
Mar-13	45	40	85	
Apr-13	45	40	85	
May-13	45	40	85	
Jun-13	45	40	85	
Jul-13	45	40	85	
Aug-13	45	40	85	
Sep-13	45	40	85	
Oct-13	45	40	85	
Dec-13	45	40	85	
Jan-14	45	30	75	
Feb-14	35	30	65	
Mar-14	35	30	65	
Apr-14	30	25	55	
May-14	25	20	45	
Jun-14	25	20	45	
Jul-14	15	10	25	
Aug-14	15	10	25	
Sep-14	15	10	25	

Purchases Due to Quantitative Easing 3 (starting in Sept. 2012)

MBS - Mortgage-backed securities issued by US Agencies Source: Federal Reserve Bank of New York press releases; Minutes of Board of Governors of the Federal Reserve System C

- 2 Market Committee (FOMC)
- 3

1

The direct securities holdings of the U.S. Federal Reserve System, financed by the U.S Treasury,<sup>5</sup> continued to rise during 2014, despite the "taper," as is evident in Figure 2 below. Due to the continued open-market purchases of billions of dollars of U.S.

<sup>5</sup> 

<sup>&</sup>lt;sup>5</sup> Securities Held Outright in Federal Reserve parlance, reported weekly in statistical releases FRB H.4.1, http://www.federalreserve.gov/releases/h41/current/

Treasuries and mortgage-backed securities each month, albeit at a slower rate than in
 2013, and the use of proceeds of interest and maturities to make more bond purchases,
 securities held as assets on the Federal Reserve balance sheet increased steadily in 2014
 to \$4.2 trillion today.

5 Between 2002 and the start of federal stimulus policies in 2009, securities held outright by the Federal Reserve System never amounted to as much as \$0.8 trillion and 6 7 were under \$0.5 trillion at year-end 2008. This is the "normal" level that is consistent 8 with the Federal Reserve's accustomed operations as a reserve bank to the banking 9 system. In contrast, the aggregate balance of securities held by the Federal Reserve 10 System of \$4.2 trillion is an unprecedented amount, which reflects the exercise of an 11 extraordinarily stimulative monetary policy, including three rounds of Quantitative Easing operations. These cumulative debt purchases by the Federal Reserve has held, 12 13 and continues to hold, interest rates at abnormally low levels.



Figure 2: Federal Reserve System Securities Held Outright

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To express the size of these securities holdings relative to U.S. Gross Domestic Product ("GDP"), at the end of 2008, securities held outright by the Federal Reserve amounted to 3.4% of GDP, and by September 30, 2014, were approximately 23.7% of GDP.<sup>6</sup>

Another form of monetary stimulus that the Federal Reserve continues to employ is to hold the Federal Reserve discount rate, the rate at which it lends to banks and some other financial institutions, to a target of between 0 and 0.25%. This has not changed at all since 2012, and the Federal Reserve monetary authorities have not announced any date for raising their short-term rate target. This has the effect of causing short-term

<sup>&</sup>lt;sup>6</sup> Federal Reserve FRB H.4.1 (balance as of the final reported week of 2008 and second quarter of 2014); U.S. Bureau of Economic Analysis GDP report for the fourth quarter of 2008 and second quarter of 2014.

interest rates to be close to zero, an effect that we have all witnessed in our own deposit
 accounts.

### 3 Q. WHAT HAS BEEN THE EFFECT OF THE FED'S STIMULUS PROGRAMS ON 4 THE MARKET PRICES AND YIELDS OF DEBT AND EQUITY SECURITIES?

A. As I mentioned previously, the low target range of 0 to 0.25% for the discount rate has
kept short-term interest rates very low. The Federal Reserve's massive purchases of U.S.
Treasury instruments and mortgage-backed securities have lowered longer-term bond
interest rates, driving up the prices of debt securities. The holdings of debt securities on
the Federal Reserve balance sheet, an increase of nearly \$3.6 trillion over the prerecession level, lowered the supply of debt available to the market, driving down interest
rates and elevating the prices of debt of all types.

The capital market remains vulnerable to internal and external stresses. To date in 2014, investors have reacted to global events (such as the February annexation of Crimea by Russia, continuing interference by Russia in Ukraine, unrest in Iraq and Syria, hostilities between Gaza and Israel, sagging economic conditions in Europe, and the collapse of oil prices), by making the "flight to safety" into both low-risk U.S. Treasury securities, which are held at very low interest rates, and into slightly higher-yielding dividend paying securities, such as utility stocks, which is a defensive or "risk off" trade.

19 The anomalous capital market influences both the inputs to the FERC DCF model 20 and its output. For example, FERC criteria for selecting a proxy group of companies call 21 for removing as unreasonably low any returns that are less than about 100 basis points 22 above the long-term utility bond yield as measured over six preceding months. Under the 23 currently distorted capital market conditions, that test for unreasonably low returns results

1 in a low-end hurdle rate that is so low that a number of companies appear in the proxy 2 group despite implied cost of equity ("ICOE") values that are unreasonably low (below 7%). When interest rates are abnormally low, as at present, this test fails to remove low-3 4 end DCF results that do not reflect investors' prospective requirements for the sustainable 5 cost of equity capital. The presence of low ICOE results, including some below 7%, in a 6 proxy group suppresses the bottom end of the range of results and the median of the 7 range. FERC remedied this downside bias produced by this anomaly in Opinion No. 531 by setting the NETOs' base ROE halfway between the mid-point of the zone of 8 9 reasonableness and the top of that zone.

10 **Q.** 

#### PLEASE SUMMARIZE YOUR RECOMMENDATION REGARDING BASE ROE.

11 A. In order to assure that the base ROE set in this proceeding will meet the requirement to 12 be sufficient to allow NY Transco to attract capital in the financial markets, this 13 Commission should make a similar adjustment to the one applied in setting the base ROE of the NETOs in Opinion No. 531, in which it set the base ROE within the upper 14 half of the zone of reasonableness. Due to continuing anomalies in the capital markets 15 16 resulting from aggressive and unprecedented operations by the U.S. Treasury and 17 Federal Reserve System, setting the base ROE merely at the median of the zone of 18 reasonableness would result in a base ROE below 9%, which would not position NY 19 Transco to produce solid operating cash flow or to attract new capital on reasonable 20 terms.

1

#### X. CONCLUSIONS AND FINAL REMARKS

2 Q. DO YOU HAVE ANY CONCLUDING REMARKS?

3 A. Yes. As I have pointed out, NY Transco is a newly-formed entity that does not have 4 any established indicators of financial strength. It has no business history, no credit 5 rating, no history of debt repayment and no historical or current earnings, and it cannot 6 count on any guarantees of its obligations from its members. Furthermore, it will have 7 to compete in the financial marketplace for debt capital against other FERC regulated 8 transmission utilities that have longer operating histories than NY Transco, a greater 9 percentage of their assets in commercial operation, and a lesser percentage of assets 10 under construction.

11 Against this backdrop, the order of the Commission in this proceeding will be the 12 most important information upon which the financial community will base its financial 13 evaluations of NY Transco. Lenders and rating agencies will scrutinize the decision in this proceeding. Rate mechanisms and incentives that provide greater certainty and 14 stability with respect to cash flows and reduce the need for external financing will be 15 16 viewed favorably. On the other hand, if the Commission's decision in this proceeding 17 withholds the risk-reducing mechanisms and supportive incentives that this 18 Commission applied previously to peer transmission entities in similar circumstances, 19 the financial market will draw unfavorable conclusions about NY Transco's future 20 financial strength and creditworthiness.

21 Setting an adequate base ROE is important to assure that NY Transco can 22 compete on par with other electric utilities in order to raise capital. I recommend that 23 the Commission adopt the Avera and McKenzie recommendation for a 10.6% base

ROE, since the same distortions and anomalous capital market conditions as those that the Commission took into consideration in its Opinion No. 531 persist now.

1

2

The ROE incentive proposal in NY Transco's application takes into consideration the use of risk-mitigating regulatory mechanisms to reduce risk to the extent possible. Nonetheless, even with the benefit of these risk-reducing incentives, ROE adders are required to compensate for financial risks that are not mitigated by the risk-reducing mechanisms and to recognize the congestion relieving and wholesale market benefits the projects will have in New York State.

9 The requested incentives, including risk-reducing regulatory mechanisms, a 10 hypothetical capital structure prior to the projects' commercial operation, and the ROE 11 adders, are necessary so that NY Transco can compete for capital against long-12 established utilities and against other transmission companies. The authorized base 13 ROE together with the ROE adders must produce sufficient cash flow, investment 14 returns, and credit ratios to attract debt capital at reasonable cost and reasonable terms, to attract bank credit providers at all stages in the banking market cycle, and to 15 16 compensate for the risks of a new electric transmission entity with heavy commitments 17 for capital investments at the outset of its existence.

Over the next several years, when NY Transco must fund its capital expenditure budget, we cannot predict that debt and credit markets will always remain as open and accommodating as they are during this period of low interest rate, relatively low inflation, and continuing Federal monetary stimulus. Strong financial ratios, a sound equity base, solid cash flow, and sound credit ratings are important to assure NY

Transco access to capital markets to fund its committed investments even during
 periods of stressed capital markets.

### **3 Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?**

4 A. Yes, it does.

### **STATE OF NEW YORK**

#### **COUNTY OF NEW YORK**

I, ELLEN LAPSON, being first duly sworn on oath depose and say as follows:

) ss

The foregoing "Prepared Direct Testimony of Ellen Lapson on Behalf of the New York Transco, LLC" was prepared by me and the other witnesses listed therein, or under the supervision of one or more of such witnesses, and the factual statements contained in such testimony are true and correct to the best of my knowledge, information and belief.

Further affiant saith not.

Ulu Lapon

Ellen Lapson

On this  $\underline{/ }^{\underline{*}}$  day of December, 2014, before me, the undersigned notary public, personally appeared Ellen Lapson and acknowledged to me that she signed the forgoing document voluntarily for its stated purposes. I identified Ellen Lapson to be the person whose name is signed on the forgoing document by means of the following satisfactory evidence of identity (check one):

\_ Identification based on my personal knowledge of his/her identity, or

Current government-issued identification bearing his/her photographic image and signature.

Notary Public My comm

My commission expires: Systember 20, 2016 (SEAL)

JIMMY MA Notary Public, State of New York No. 01MA6116017 Qualified in New York County commission Expires Sept. 20, 2016

## Exhibit No. NYT-19

### EXPERIENCE AND QUALIFICATIONS ELLEN LAPSON, CFA

### LAPSON ADVISORY

Financial Consulting, Expert Testimony, Financial Training 370 Riverside Dr., 9D New York, NY 10025 +1-212-866-1040 www.lapsonadvisory.com

### SUMMARY OF QUALIFICATIONS

Over 40 years of professional experience in commercial and investment banking, securities analysis, and credit ratings. Industry focus on utilities, power generation and alternative energy sources, natural gas and fuels, corporate and project finance. Conduct executive training in utility financial analysis and credit analysis. Consult and provide expert witness testimony in matters involving capital access for infrastructure, energy and utilities. MBA in accounting and finance; Chartered Financial Analyst (CFA).

### **EMPLOYMENT**

### Lapson Advisory

Principal Dec. 2011 - present

### **Fitch Ratings**

Utilities, Power & Gas Managing Director 1999-2011 Senior Director 1994-1999 Financial consulting services to utilities and developers of infrastructure projects. Financial strategy and credit advisory for power, energy, infrastructure companies, and utilities. Legislative and regulatory communications and expert witness testimony. Financial and credit training.

Chair of Fitch's global Corporate Finance Criteria Committee overseeing criteria for rating corporations, financial institutions, insurers, REITs, and project finance transactions (2010-2011).

Manager or primary analyst on credit ratings of over 200 utility, pipeline, power generation companies. Utility tariff monetization. Senior member of rating committees for utilities and energy and powerrelated projects.

Liaison with utility sector fixed income investors, focusing on 50 largest institutional investors holding utility and power bonds, buy-side and sell-side analysts, and utility bankers.

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JP Morgan Chase (formerly Chemical NY Corp.) Vice President 1975-94	Managed financial advisory transactions, structured debt private placements, syndicated credit facilities for utilities, mining and metals, project finance. Structured financing for utility regulatory assets (first of its kind "stranded cost" securitization transaction) for Puget
Asst. Vice President 1974-1975	Energy, 1992-94. Led financing for bankrupt utility as debtor-in- possession; prepared financing plans for distressed utilities; structured exit financing for reorganization of two utilities emerging from Chapter 11. Divisional Controller - 1981-1986
Argus Research Corp. Equity Security Analyst – Utilities 1969-1974	Equity analysis of U.S. electric and gas utilities, natural gas pipelines, and telecommunications companies. Modeling and projecting corporate financial statements. Research coverage and reports.

### **EDUCATION & LICENSING**

Stern School of Business, New York University, MBA, 1975
 Major concentration: Accounting
 Master's Thesis: Cash Flow vs. Accrual Accounting Data in Utility Equity Valuation
 Chartered Financial Analyst (CFA<sup>©</sup>) since 1978
 Barnard College, Columbia University, BA, 1969

### **PROFESSIONAL ASSOCIATIONS**

Institute of Chartered Financial Analysts, 1978 - present Wall Street Utility Group, 1996 - present

### ADVISORY COUNCILS AND BOARD SERVICE

National Academy of Sciences/ National Research Council, Resilient America Forum, July 2014. MIT Energy Institute, External Advisory Council, The Future of Solar Energy, 2012-2014.

Electric Power Research Institute, Advisory Council, 2004-2011; Chair, 2009 and 2010.

### EXPERT WITNESS TESTIMONY

<u>Jurisdiction</u>	Proceeding	<u>Topic</u>
U.S. Federal Energy Regulatory Commission	Docket EL 14-90-000 Seminole Electric Cooperative, Inc. and Florida Municipal Power Agency vs. Duke Energy FL on behalf of Duke Energy	Return on Equity; capital market environment

Exhibit No. NYT-19 Page 3 of 5

Jurisdiction	Proceeding	Τορίς
DC Public Service Commission	Formal Case No. 1119 Supplemental testimony on behalf of Joint Applicants Exelon Corp. and Pepco Holdings Inc.	Ring-fencing for utility merger; avoidance of financial harm
U.S. Federal Energy Regulatory Commission	Docket EL14-86-000 Attorney General of Massachusetts et. al. vs. Bangor Hydro- Electric Company, et. al on behalf of the New England Transmission Owners	Return on Equity; capital market environment
Arkansas Public Service Commission	Docket No. 13-028-U. Rehearing direct testimony on behalf of Entergy Arkansas. (2014)	Investor and rating agency reactions to ROE set by Order.
Illinois Commerce Commission	Docket No. 12-0560 Rock Island Clean Line LLC, on behalf of Commonwealth Edison Company, an intervenor (2013)	Access to capital for a merchant electric transmission line
U.S. Federal Energy Regulatory Commission	Docket EL13-48-000 Delaware Division of the Public Advocate, et. al. vs. Baltimore Gas and Electric Company and PEPCO Holdings et al., on behalf of (i)Baltimore Gas and Electric and (ii) PEPCO and subsidiaries (2013)	Return on Equity; capital market view of transmission investment
U.S. Federal Energy Regulatory Commission	Docket EL11-66-000 Martha Coakley et. al. vs. Bangor Hydro-Electric Company, et. al on behalf of a group of New England Transmission Owners (2012-13)	Return on Equity; capital market view of transmission investment
New York Public Service Commission	Cases 13-E-0030; 13-G-0031; and 13-S- 0032 on behalf of Consolidated Edison Company of New York. (2013)	Cash flow and financial strength; regulatory mechanisms
Public Service Commission of Maryland	Case. 9214 "In The Matter Of Whether New Generating Facilities Are Needed To Meet Long-Term Demand For Standard Offer Service", on behalf of Baltimore Gas and Electric Co., Potomac Electric Power Co., and Delmarva Power & Light (2012)	Effect of certain power contracts on the credit and financial strength of MD utility counterparties

The following are some cases in which Lapson testified as a representative of Fitch Ratings from 2001-2005. Fitch Ratings ceased this activity in 2006.

<u>Jurisdiction</u>	Proceeding	<u>Topic</u>
Michigan Public Service Commission	Capacity Needs Forum, open public session, April 21, 2005	Mechanisms for funding new power capacity in a competitive market

		Page 4 of 5
U.S. Federal Energy Regulatory Commission	RTO & ISO Performance Standards, private session with Comm. Brownell and Staff, Feb. 23, 2004	Performance measures of the financial viability of RTOs
U.S. Bankruptcy Court	Bankruptcy reorganization of Pacific Gas & Electric, report submitted by intervenor California Public Utilities Commission Staff, Dec. 2002	Likely credit ratings on emergence with an alternate plan of reorganization
New Jersey Board of Public Utilities	Board of Public Utilities, Rockland Electric Co. base electric rate case. Letter of credit opinion submitted by Orange & Rockland Electric. March 2001	Credit opinion on the effect of rate freeze and deferred recovery of purchased power costs

Exhibit No. NYT-19

### LECTURER AND EXECUTIVE EDUCATION

SNL Knowledge Center Professional Training	"Credit Analysis for the Power & Gas Sector", Oct. 2013; Feb. 2013; Sept. 2012; May 2012.
	"Analyst Training in the Power & Gas Sectors: Financial Statement Analysis", August 2014; June 2013.
EEI Transmission and Wholesale Markets School	"Financing and Access to Capital", August 2012
National Rural Utilities Cooperative Finance Corporation, In-House Training	"Credit Analysis for the Power Sector", Sept. 2012
Judicial Institute of Maryland (Private training seminar for MD judges)	"Utility Regulation and the Courts: Impact of Court Decisions on Financial Markets and Credit", Annapolis MD, June 2007
Edison Electric Institute	"New Analyst Training Institute: Fixed Income Analysis and Credit Ratings", June 2008 and June 2004

### PUBLICATIONS BOOK CHAPTERS

Electric & Natural Gas Business: Understanding It, 2003 and Beyond, Robert E. Willett ed., Financial Communications Company, Houston, TX, 2003. Chapter 1: "Standard Market Design: Credit of Some Sectors Will Be Affected by SMD", Ellen Lapson, pp. 3-14.

Energy Modeling and the Management of Uncertainty, Robert Jameson ed., Risk Publications, London, 1999. "Managing Risks Through Contract Technology: Know Your Counterparty", Ellen Lapson, pp 154-155.

The US Power Market: Restructuring and Risk Management, Robert Jameson ed., Risk Publications, London, 1997. "Managing Credit Risk in the Electricity Market", Ellen Lapson (pp 281-291).

Deregulation of the Electric Utility Industry – Proceedings of the AIMR Seminar; ed. AIMR (CFA Institute), Charlottesville, VA, 1997. Speaker 3: E. Lapson.

### ARTICLES

"First Person With Ellen Lapson: The Economy, Technology, and R&D", Interview with Ellen Lapson, EPRI Journal, Spring, 2009.

"Rising Unit Costs & Credit Quality: Warning Signals", Ellen Lapson. Public Utility Fortnightly, Feb. 2006.

"The Future of Fuel Diversity", Ellen Lapson and Richard Hunter, Public Utility Fortnightly, Oct. 2004.

### **Exhibit No. NYT-20**

### Effect of Cash Return on CWIP on NY Transco Revenues and Cash Flow

Exhibit No. NYT-20 page 1 of 1

	\$ Millions		
Cash Return on 100% of CWIP	2016	2017	2018
Est. Revenue due to return on CWIP	36	95	129
Est. Operating Cash Flow from return on CWIP	29	77	105
Est. Total Transco Operating Revenues	84	171	203
Est. Total Transco Cash Flow from Operations	52	126	151
CWIP % of Total Operating Revenues	42%	55%	63%
CWIP % Total Cash Flow from Operations	55%	61%	69%
With Cash Return on 50% of CWIP			
Est. Revenue from Return on CWIP	18	47	64
Est. Operating Cash Flow from return on CWIP	15	39	52
Revised Total Transco Cash Flow from Operations	38	87	99
Change in Cash Flow from Operations*	-26%	-30%	-33%
With no cash return on CWIP			
Est. Revenue from Return on CWIP	0	0	0
Est. Operating Cash Flow from return on CWIP	0	0	0
Revised Total Transco Cash Flow from Operations	23	49	47
Change in Cash Flow from Operations*	-55%	-61%	-69%

\* Change relative to Cash Return on 100% of CWIP

Note: Estimates in this exhibit represent the mid-point of multiple scenarios with various assumptions as to base ROE and incentive ROE adders.

### **Exhibit No. NYT-21**

### Comparing NY Transco Projected Credit Ratios to Established Peer Utilities

		NY Transco Model		Xcel Energy, Inc.		Consolidated Edison, Inc.		Northeast Utilities Corp.	
		Average Ratio	os, 2016-2018						
		Scenario A	Scenario B	FY 2013	LTM 6/30/14	FY 2013	LTM 6/30/14	FY 2013	LTM 6/30/14
	Corp LT Rating - S&P	not ye	t rated		A-		A-		A-
	Corp LT Rating - Moody's	not ye	t rated		A3		A3		Baa1
	Sr Unsec Debt S&P	not ye	t rated		none		none		BBB+
	Sr Unsec Debt Moody's	not ye	t rated		none		none		Baa1
	Key Credit Ratios:				-		-		-
с	FFO/Total Debt	15%	25%	21.6%	20.3%	20.5%	22.4%	18%	19%
	(FFO + Interest)/ Interest	5.7	9.0	5.5	5.5	5.4	6.0	5.9	6.0
d	Debt/ EBITDA	6.0	3.9	3.9	4.0	3.8	3.6	4.3	4.4
d	EBITDA/ Interest	5.8	9.0	5.3	5.5	5.7	6.1	6.3	5.9
e, f	(FFO - Dividends)/Debt	2%	2%	17.3%	16.0%	14.7%	16.6%	13%	14%
g	Debt/ Total Capital	50%	40%	55.5%	55.8%	50.4%	50.5%	49%	49%

Data Source: SNL Financial, Jan 19, 2014 for all but NY Transco. NY Transco scenarios, Lapson Advisory.

- Notes:
- LTM Latest twelve months ended; None: no rated securities of that category
- Scenario A NY Transco forecasts, 3 year averge 2016-2018, based on 10.6% base ROE, no Incentive Adders; and 50% equity-to-capital.
- Scenario B NY Transco forecasts, 3 year average 2016-2018, based on 10.6% ROE plus 150 bp Incentive Adders and 60% equity-to-capital.
- c FFO = Cash flow from operating activities excluding changes in working capital.
- d EBITDA = Earnings Before Interest, Income Tax, Depreciation and Amortization.
- e Numerator is FFO less Dividends Paid; Denominator is Total Debt.
- f S&P supplemental ratio; S&P calls the numerator "Free Operating Cash Flow" or FOCF.
- g A core financial ratio for Moody's, not used by S&P

### Exhibit No. NYT-22

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	Moody's	Standard & Poors	Fitch
	A22	0.0.0	000
	Add		AAA
de	Aal	AA+	AA+
Gra	Aa2	AA	AA
Ĕ	Aa3	AA-	AA-
ner	A1	A+	A+
str	A2	A	A
UVE	A3	A-	A-
_	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
	Ba1	BB+	BB+
	Ba2	BB	BB
rad	Ba3	BB-	BB-
Ō	B1	B+	B+
tive	B2	В	В
ula	B3	В-	В-
Dec	Caa1	CCC+	
S	Caa2	ccc	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC
	С	С	С
Default	С	D	C or D

#### Long-Term Rating Scales and Correspondences

Source: Lapson Advisory
## **Exhibit No. NYT-23**

	Risk-reducing Incentives				ROE Incentives*		
				Capital			
				Structure 60%			
				Equity, 40%			
		Recovery of		Debt;			
INVESTMENT	Abandon-	pre-		Hypothetical			
RISKS OF NY	ment	commercial	Cash return	prior to	RTO	Forming	
TRANSCO	provision	expenses	on CWIP	completion	incentive	Joint transco	RIsk Adder
Siting and							
permitting risks	٧						٧
Negative cash							
flows due to							
construction and							
pre-commercial							
costs		V	v	v			
Construction		•	•	•			
project							
management							
risks cost							
overruns				v			v
Cash flow				•			•
shortfalls							
regulatory lag							
unnredictable or							
lumpy cash flow		N	N				
Need to raise		•	<b>v</b>				
external canital							
funding risk				2			2/
				V			v
Now start up							
vonturo. No pro							
ovicting or							
ongoing revenues							
or business;				- 1			
Civing we control				V		v	
Giving up control							
direction					ν		
forming laint							
Transco						V	

## NY Transco: Investment Risks and Related Mitigants and Incentives

Source: Lapson Advisory