

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

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|--|---|-------------------------|
| Bangor Hydro-Electric Company |) | Docket No. ER04-157-000 |
| |) | |
| Central Maine Power Company |) | |
| |) | |
| NSTAR Electric & Gas Corporation, on behalf of its affiliates: |) | |
| Boston Edison Company |) | |
| Commonwealth Electric Company |) | |
| Cambridge Electric Light Company |) | |
| Canal Electric Company |) | |
| |) | |
| New England Power Company |) | |
| |) | |
| Northeast Utilities Service Company, on behalf of its operating company affiliates: |) | |
| The Connecticut Light and Power Company |) | |
| Western Massachusetts Electric Company |) | |
| Public Service Company of New Hampshire |) | |
| Holyoke Power and Electric Company |) | |
| Holyoke Water Power Company |) | |
| |) | |
| The United Illuminating Company |) | |
| |) | |
| Vermont Electric Power Company |) | |
| |) | |
| Central Vermont Public Service Corporation |) | |
| |) | |
| Green Mountain Power Corporation |) | |

AFFIDAVIT OF RICHARD S. KIVELA

1. My name is Richard S. Kivela. I am employed by the Maine Public Utilities Commission (“Maine PUC”) as a Utility Analyst.

2. I have been employed by the Maine PUC since January 1995, and have both testified as an expert witness and acted as a hearing examiner on cost of capital issues on numerous occasions. I earned an MBA in Finance from the University of Rochester’s Simon School of Management in 1986. I was employed in the Regulatory and Corporate

Finance Departments at Rochester Telephone Corporation, the Treasury Department at Chase Manhattan Bank in Rochester New, York and in the Commercial Credit Department at Key Bank of Maine prior to joining the Commission Staff.

3. I have been asked by the New England Conference of Public Utilities Commissioners (“NECPUC”), of which the Maine PUC Commissioners are members, to perform an assessment of the 12.8% baseline return on equity (“ROE”) proposed by the New England Transmission Owners in their November 4, 2003 Joint ROE Filing of New England Transmission Owners Under the RTO New England Open Access Transmission Tariff submitted to the Federal Energy Regulatory Commission (“RTO-NE ROE Filing”).

4. I have reviewed the RTO-NE ROE Filing, including the supporting testimony and exhibits submitted by William E. Avera and Nicholas P. Winsler. My opinions will focus primarily on Dr. Avera’s ROE analysis.

5. I have identified several factual as well as methodological problems with Dr. Avera’s analysis that lead me to conclude that his 12.8% baseline ROE recommendation is excessive. I discuss these problems below.

PROXY GROUP

6. It is my understanding that FERC generally establishes regulated returns that do not have publicly-traded stock by applying a discounted cash flow (“DCF”) analysis to a group of proxy companies. In order to produce an ROE estimate that accurately reflects the level of return necessary to attract equity capital to a transmission company using such an approach, however, it is necessary to select proxy companies that have risk profiles similar to an electric transmission company.

7. To estimate the required ROE for the Transmission Owners, Dr. Avera applied a DCF analysis to four separate proxy groups: (i) a proxy group of twelve transmission-owning companies located in the Northeast (“Northeast TO Proxy Group”); (ii) proxy groups including Moody’s and Standard & Poor’s Electric Utilities groups, respectively, provided the companies satisfied minimum business ranking profiles; and (iii) a proxy group of natural gas transmission companies. Dr. Avera also derived an ROE estimate for the S&P 500.

8. Because Dr. Avera focuses primarily on the Northeast TO Proxy Group and his specific ROE recommendation is the midpoint of his adjusted range of returns for this group, my observations are addressed primarily to the Northeast TO Proxy Group. I would note, however, that most of the problems I have identified with respect to Dr. Avera’s analysis would also be applicable to the often overlapping companies in his Moody’s and S&P proxy groups.

9. Dr. Avera’s Northeast TO Proxy Group consists of the transmission-owning members of RTO-NE, New York Independent System Operator (“NYISO”), and PJM Interconnection, L.L.C. (“PJM”) that have publicly-traded stock. Dr. Avera excluded otherwise qualified companies that did not pay common dividends or that were not covered by Value Line and/or IBES.

10. Based on these criteria, Dr. Avera’s Northeast TO Proxy Group includes the following entities: Consolidated Edison, Constellation Energy, Energy East, Exelon Corp., FirstEnergy Corp., Northeast Utilities, NSTAR, Pepco Holdings, PPL Corp., PS Enterprise Group, UGI Corp., and UIL Holdings. These companies are generally holding

companies – parent corporations of the transmission-owning subsidiaries that have placed or will place their assets into RTO-NE, NYISO or PJM.

11. I have prepared the following table which provides notes concerning the relevant business segment information for each of the Northeast TO Proxy Group companies:

| Company | Business Profile |
|----------------------------|---|
| Consolidated Edison | 95% of 2000 - 2002 revenues were from regulated utility operations. Modest generation holdings. |
| Constellation Energy Group | 54% of 2002 revenues were from regulated utility (Baltimore Gas & Electric). Significant merchant generation holdings (46% of 2002 revenues). |
| Energy East Corporation | 92% of 2000 - 2002 revenues were regulated utility, natural gas LDC in NY, CT, ME and MA, electric in NY, ME and MA. Generation largely divested, with Ginna Nuclear under contract for sale to Constellation. Per <i>Value Line</i> , focus is on divesting unregulated operations. |
| Exelon Corporation | Heavy investment in Nuclear generation. Per <i>Value Line</i> , nuclear generating capacity will exceed 16,000 MW in 2004. |
| FirstEnergy Corporation | 75% of 2002 revenues were from regulated utilities (GPU, Toledo Ed, Ohio Ed and Cleveland Illuminating). Owns nuclear generation. Under scrutiny for August "Blackout." |
| Northeast Utilities | 78% of 2002 revenues were from regulated utilities (CP&L, PSNH, WMECO, Yankee Gas). Owns merchant generation in Select Energy subsidiary. |
| NSTAR | 98% of 2000 - 2002 revenues were from regulated utility operations (electric and natural gas in MA). Generation has been divested. |
| Pepco Holdings | 59% of 2002 revenues were from regulated utilities (Delmarva, Atlantic City Electric, Potomac Electric). Approximately 15% of property & plant invested in generation assets at FYE 2002. |
| PPL Corporation | Heavy investment in generation in US and abroad. 68% of 2002 revenues were from regulated utilities in PA. Per <i>Value Line</i> , most of PPL's "earnings uncertainty lies with its international distribution." |
| PSEG | Heavy investment in generation in US and abroad. Was 42% of balance sheet at FYE 2002. Per <i>Value Line</i> , generating capacity currently exceeds 14,000 MW. 76% of 2001-2002 revenues were from regulated NJ gas and electric utility. Also constructs generation projects US and abroad. "Major" energy trading operations per <i>Value Line</i> . |
| UGI Corporation | <i>Value Line</i> classifies UGI as Natural Gas LDC utility. 286k Natural Gas customers, 61k electric customers at FYE 2002. Only 23% of 2000-2002 revenues come from these utility customers. Remaining 77% comes from competitive retail distribution of propane to 1.3 million customers |
| UIL Holdings | 80% of 2000 - 2002 revenues were regulated electric utility in CT. Modest merchant generation investment in CT. Unregulated operations currently unprofitable per <i>Value Line</i> . |

12. As this table shows, many of the companies in the Northeast TO Proxy Group are involved in diversified lines of business beyond electric transmission, such as electric generation and/or international operations. Exelon, FirstEnergy and Constellation, for instance, all have significant generation businesses, including investments in nuclear generation. PPL and PS Enterprise Group have significant international operations. UGI Corp. is not even classified by *Value Line* as an electric utility, and, in fact, derives the majority of its revenues from distribution of propane.

13. Financial community investment analyses, which are a proxy for investors' views, typically cite the generation-related and other non-transmission businesses of the Northeast TO Proxy Group companies as investment risk factors, not regulated transmission operations. For example, many of the Northeast TO Proxy Group companies have significant investment in electric generation, and investment advisers tend to view the generation portion of the electric utility business as having been and continuing to be more risky than the transmission business. Among the risk factors for Exelon cited in a December 15, 2003 report by Fitch, for instance, are the possibility of an extended nuclear outage and inability to renew a power supply contract with its affiliate Commonwealth Edison. Generation-related risks are also prominent for Constellation, FirstEnergy (nuclear plant risk) and PPL Corp. Similarly, Value Line cites PPL's international distribution utilities as the source of "most of the company's earnings uncertainty." In contrast, investment analysts often cite the regulated operations of the Northeast TO proxy companies as ameliorating risk by providing a steady stream of revenue.

14. Further, it is reasonable to assume, given the steadiness of regulated revenues, that the high growth estimates for the proxy companies, if they can be considered logical at all, tend to be driven by the upside potential of unregulated operations or other factors, not growth in the regulated operations.

15. The fact that the investment community generally views the overall risk of the Northeast TO Proxy Group companies as being greater than that of their regulated T&D subsidiaries means that the DCF results for these companies will not directly reflect the ROE required to attract equity investment in a regulated transmission company.

ILLOGICAL RESULTS

16. Dr. Avera excludes the two lowest results from his Northeast TO Proxy Group DCF analysis, stating that the results (6.0% for Exelon and 6.2% for UGI Corp.) were lower than the contemporaneous average yield on triple-B public utility bonds, which he calculated as 6.7%. This proposed adjustment increases the midpoint of the range from 11.9% to 12.8%, and the median of the range from 9.8% to 10.2%.

17. While I do not disagree that, conceptually, it may be appropriate to exclude DCF results that are illogically low, it is not clear how Dr. Avera performed the calculations underlying the dividend yields for Exelon or UGI, or how he calculated the “contemporaneous” bond yield of 6.7%. As I note below in this respect, Dr. Avera’s dividend yield information for Exelon appears to be erroneous. Accordingly, It would be important to develop more information on this adjustment before excluding low-side outliers from Dr. Avera’s analysis.

18. While excluding DCF results that are allegedly illogically low, Dr. Avera does not propose to exclude any of his high-side results. In my opinion, however, several of Dr. Avera's DCF results should be excluded as illogically high.

19. Dr. Avera uses the yield on a triple-B bond as the benchmark for whether a DCF result is illogically low. I believe an appropriate benchmark for gauging whether a result is implausibly high is Dr. Avera's 14.24% DCF result for the S&P 500. The S&P 500, by definition, includes a diverse sample of publicly-traded companies from virtually every segment of the economy, including many segments of the economy that are viewed as more risky than electric transmission. In my opinion, it is not logical to conclude – given the observations of investment analysts regarding the relative risk of regulated transmission – that investors would require an equity return in excess of the S&P 500 to invest in a regulated transmission company.

20. At least two, and possibly three of the companies in Dr. Avera's proxy group have DCF results that exceed the 14.24% result for the S&P 500. Dr. Avera's exhibits show results for PPL (17.7%) and PS Enterprise Group (15.5%) that are higher than the S&P 500 results. Further, depending on the actual results for Exelon, the high-side figure for that company might also exceed the S&P 500 DCF result. It would be appropriate, in my view, to exclude these results from the DCF analysis as implausible.

21. Excluding PPL from the proxy group is supported by other indicia that its high-side result is not plausible. For instance, in a recent Q&A posted on PPL's website, PPL's CEO and CFO indicated that they expected to see 3% to 5% growth in earnings per share for the long term. As of December 2003, *Value Line* projects PPL's earnings per share growth will be 3% to 7%. These figures are much lower than the allegedly

“sustainable” 13.3% *br +sv* dividend growth figure that Dr. Avera calculates from *Value Line* data. It is illogical to think that PPL could sustain a 13.3% dividend growth rate when its own senior management forecasts a 3% to 5% earnings growth over the long-term.

22. If Dr. Avera’s “illogically” low results and the results I have identified as illogically high are all eliminated, Dr. Avera’s range would be 8.0% to 13.2%, with a midpoint of 10.6% and a median of 9.5%.

PROBLEMS WITH DR. AVERA’S DATA FOR EXELON

23. Dr. Avera’s Exhibit NETOs-3 shows a dividend yield of zero for Exelon. This would indicate that Dr. Avera believes that Exelon did not pay a dividend during the relevant period. My research shows, however, that Exelon *did* pay an annualized common dividend of \$2.00 per share during the relevant period. Thus, depending on the mechanics of the dividend yield calculation, Exelon’s dividend yield could have ranged between 3.4% and 4.3%. When this range of yields is added to its IBES growth rate forecast, it would eliminate Dr. Avera’s argument that the Exelon low-side results (which would rise to 9.5% based on my estimate) are illogical. By the same token, adding that same 3.4% to 4.3% dividend yield range to the 13.6% *br + sv* growth estimate catapults Exelon’s high-side result to the top of the range (18.2% based on my estimate) and raises questions about the logic of retaining this figure in the range of reasonableness.

24. I would also observe that, even if Dr. Avera was correct that Exelon was not paying a dividend, according to Dr. Avera’s own methodology, it should have been excluded entirely from his DCF analysis, just as Dr. Avera excluded other otherwise-qualified companies that had no dividend.

MIDPOINT VERSUS THE MEDIAN

25. I am informed that FERC has indicated in several decisions that the median is a better measure of central tendency than the midpoint in a skewed distribution of DCF results.

26. In making his ROE recommendation, Dr. Avera uses the midpoint of his adjusted range of results for the Northeast TO Proxy Group.

27. In my view, Dr. Avera's use of the midpoint – which is calculated by taking the average of the highest and lowest results in the DCF range – does not provide an accurate measure of the central tendency of his range, given that his range is skewed upwards, particularly by PPL, which, at 17.7%, is a significant high-side outlier in his range.

28. The median of Dr. Avera's adjusted DCF results for the Northeast TO Proxy Group is 10.2%

EFFECT OF NEW TAX LAW ON DIVIDEND YIELD

29. According to December 2003 data from C.A. Turner Utility Reports, there was an appreciable drop in dividend yields for electric companies beginning in June 2003. For the twelve months of 2003, the yields for electric companies were as follows:

| <u>1/03</u> | <u>2/03</u> | <u>3/03</u> | <u>4/03</u> | <u>5/03</u> | <u>6/03</u> | <u>7/03</u> | <u>8/03</u> | <u>9/03</u> | <u>10/03</u> | <u>11/03</u> | <u>12/03</u> |
|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|--------------|--------------|
| 5.4% | 5.4% | 5.8% | 5.5% | 5.2% | 4.6% | 4.5% | 4.8% | 4.8% | 4.6% | 4.6% | 4.4% |

30. C.A. Turner reported similar drops in yields for its “Combined Electric & Gas Distribution Companies” group and its “Natural Gas Distribution Transmission & Integrated Companies” group.

31. The likely explanation for this drop in dividend yields was the Jobs and Growth Tax Relief Reconciliation Act of 2003 which was signed into law near the end of May 2003. This new law reduced capital gains taxes on dividend payments to individuals by domestic corporations and qualified foreign corporations.

32. The drop in yields is likely attributable to the increased attractiveness, from an investment standpoint, of dividend-paying stocks under the new law, which would tend to drive up a dividend-paying company's stock price and, assuming no change in the dividend, decrease the dividend yield.

33. Dr. Avera's dividend yields reflect data for March to August 2003, and, thus, three of the months used by Dr. Avera do not reflect the tax law changes. In my opinion, any estimate of the required ROE for the Transmission Owners should utilize data reflecting the change in the tax treatment of dividends.