1 STATE OF NEW YORK
PUBLIC SERVICE COMMISSION
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4 Case 07-M-0906 - Joint Petition of Iberdrola, S.A.,
Energy East Corporation, RGS Energy Group, Inc., Green
5 Acquisition Capital, Inc., New York State Electric & Gas
Corporation and Rochester Gas and Electric Corporation
6 for Approval of the Acquisition of Energy East
Corporation by Iberdrola, S.A.
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9 Evidentiary Hearing
3 Empire State Plaza
10 Albany, New York

11 Wednesday, March 19, 2008
9:00 a.m.
12

13 PRESIDING:
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15 RAFAEL A. EPSTEIN,
Administrative Law Judge
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1 JUDGE EPSTEIN: I call case 07-M-0906,
2 matter of Iberdrola. Is there anyone who wishes to
3 enter an appearance who hasn't already done so?
4 (No response.)
5 Is there any preliminary business?
6 MR. VAN RYN: Yes, Your Honor. I have the
7 trade secret and highly sensitive trade secret exhibits.
8 The number we reserved for the trade secret was
9 Exhibit 20. The number reserved for the highly
10 sensitive trade secret was No. 21.
11 JUDGE EPSTEIN: Okay.
12 MR. VAN RYN: I am assuming that the parties
13 who signed Exhibit 2 to the confidentiality agreement
14 should receive this exhibit.
15 JUDGE EPSTEIN: That would be my
16 understanding. Do Petitioners agree to that?
17 MR. FITZGERALD: To the trade secret, yes.
18 Not to the HST designation.
19 JUDGE EPSTEIN: Yes, I haven't gotten there
20 yet.
21 MR. FITZGERALD: Thank you.
22 JUDGE EPSTEIN: Exhibit 21 merely
23 supplements 19 or 20, as the case may be, by providing
24 some additional pages, right? But 20 is not a

1 supplement, it's a self-standing document.
2 MR. VAN RYN: Both supplement. Exhibit 19
3 are the public information request responses.
4 Exhibit 20 are the confidential responses. And
5 Exhibit 21 is the highly sensitive trade secret
6 responses.
7 JUDGE EPSTEIN: 20 and 21 don't reprise the
8 public information that's in 19, they just have no
9 public information.
10 MR. VAN RYN: Yes.
11 And I'd like to note that the highly
12 sensitive trade secret information was distributed only
13 to the entitled parties, which are Staff, CPB, and the
14 Petitioners.
15 JUDGE EPSTEIN: If there are distinctions to
16 be drawn among various Petitioners regarding their
17 entitlement to the information, I will assume that's
18 entirely the Petitioners' responsibility regardless of
19 the fact that Staff provided the Petitioners
20 collectively with 21.
21 A couple of other non-related items while on
22 the subject of confidentiality. I would like the record
23 to indicate that, when we were in closed session
24 yesterday, the purpose of it was to cross the

1 Petitioners' policy panel, if that's not already evident
2 from the record, and they were crossed about matters
3 related to the possibility of take-over attempts against
4 Iberdrola.
5 And also that the PSC is meeting today in
6 New York City and some people have noticed that there is
7 an Iberdrola item on that agenda. What it is is a
8 decision on Staff's interlocutory appeal from a ruling
9 on discovery of confidential materials. I will let you
10 know what the outcome of that is as soon as the vote is
11 taken except that you may very well have that
12 information before I will, sitting here.
13 Now, with that, I think the next order of
14 business -- are we ready for cross-examination?
15 Petitioners, you want to call your witness?
16 MR. CANNON: We'd like to call
17 Dr. William H. Hieronymus to the stand.
18 JUDGE EPSTEIN: Dr. Hieronymus, would you
19 please stand.
20 WILLIAM HIERONYMUS, after first having been
21 duly sworn, was examined and testified as follows:
22 DIRECT EXAMINATION
23 BY MR. CANNON:
24 Q. Could you please state your full name and your

1 address?
2 A. William H. Hieronymus, CRA International, 200
3 Clarendon Street, Boston, Massachusetts.
4 Q. Do you have a document in front of you entitled
5 "Direct Testimony of William H. Hieronymus" that's dated
6 November 28, 2007, that consists of a cover page and 33
7 pages of text?
8 A. I do.
9 Q. Was this document prepared by you or under your
10 direction?
11 A. It was.
12 Q. Do you have edits or corrections to the document?
13 A. No.
14 Q. If I were to ask you the same questions today
15 would you respond in the same manner?
16 A. On the basis of the facts as they existed on
17 November 28th, yes. There have been minor changes in
18 facts since then.
19 Q. Can you give a brief overview what the changes in
20 facts would be?
21 A. Sure, the ones that are relevant to some of the
22 factual statements in this document both came to my
23 attention last week, the fact that they occurred last
24 week.

1 The first is the additional gleams in the eye of
2 maybe-generation planned by Iberdrola Renewables
3 summarized in the supplemental discovery response is
4 IBER-0008(S) or something like that. And so that added
5 another, to the best of my recollection, 360 megawatts
6 name plate of possible future generation in New York,
7 some of which is scheduled, if it's built, to be
8 attached to the NYSEG transmission system. So that
9 would have added another 36 megawatts summer capability
10 and three times that -- that's 108 megawatts -- winter
11 capability.
12 If I had taken into account these gleams in the
13 eye -- which, as I testified, I don't believe is
14 appropriate because it's non-existing generation and
15 hence there is no merger-related generation or
16 generation and transmission as a result of it.
17 The other event was the partial acceptance letter
18 whereby applicants conditionally agreed to divest RG&E's
19 fossil generation. That, of course, is deconcentrating
20 from both the horizontal and vertical standpoint because
21 it means less affiliated generation. Best of my
22 recollection, that's something like 145 megawatts both
23 summer and winter -- a little more in the winter --
24 capability if you don't take Russell into account, and

1 another 253 megawatts name plate if you do take Russell
2 into account. So you have had an increase in possible
3 generation arising from Iberdrola Renewables' pipeline
4 and a decrease in generation arising from the
5 undertaking about divestiture.
6 Q. Thank you. Do you adopt the direct testimony as
7 sworn testimony in this proceeding?
8 A. Yes.
9 MR. CANNON: I would like to copy
10 Dr. Hieronymus' direct testimony into the record as if
11 given orally.
12 JUDGE EPSTEIN: Yes.
13 (The following is the prefiled testimony of
14 William Hieronymus:)
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DIRECT TESTIMONY OF WILLIAM H. HIERONYMUS

I. INTRODUCTION

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

A. My name is William H. Hieronymus. I am Vice President of CRA International, Inc., an economic and management consulting firm with offices in various locations in the United States and internationally. My business address is 200 Clarendon St., T-33, Boston, MA 02116.

Q. Please summarize your background.

I am an economist by training and have spent more than 30 years analyzing and working to improve various aspects of the electricity industry. For the past 19 years, I have worked primarily on the restructuring of the electricity industry from a fully regulated to a more competitively oriented model, both in the United States and abroad. Much of my time has been spent on market power issues. I have developed and commented on market power-related regulatory rules and Regional Transmission Organization ("RTO") (or foreign equivalent) tariff provisions on market power mitigation and monitoring as well as on issues of market structure. I have testified before the Federal Energy Regulatory Commission ("FERC") and other regulatory bodies on market power on numerous occasions. This includes a number of mergers and acquisitions over the past dozen years, including more than 20 mergers among electric utilities and "convergence" mergers of electric utilities and natural gas pipelines as well as numerous major acquisitions. My resume is attached hereto as Exhibit WHH-1.

DIRECT TESTIMONY OF WILLIAM H. HIERONYMUS

1 Q. Have you previously testified in other proceedings before the New York State
2 Public Service Commission ("Commission")?
3 A. Yes. I have testified before the Commission on several occasions in connection
4 with mergers and market power issues.
5 Q. Have you testified in any other jurisdictions regarding the proposed merger
6 between Iberdrola, S.A. ("Iberdrola") and Energy East Corporation (" Energy
7 East") that is the subject of this proceeding ("Proposed Transaction")?
8 A. I filed testimony at FERC in connection with the Proposed Transaction.
9 Q. What is the purpose of your testimony in this proceeding?
10 A. Almost a decade ago, the Commission expressed certain concerns regarding the
11 affiliation between a transmission owner ("TO") and a generation owner in Case
12 No. 96-E-0900 – *In the Matter of Orange & Rockland Utilities, Inc.'s Plans for*
13 *Electric Rate Restructuring Pursuant to Opinion 96-12, et al., Statement of Policy*
14 *Regarding Vertical Market Power,* (July 17, 1998), (the "VMP Policy
15 Statement"). My testimony addresses the Commission's VMP Policy Statement
16 in the context of the Proposed Transaction.
17 Q. Are you sponsoring any exhibits?
18 A. Yes. I am sponsoring Exhibits WHH-1, WHH-2, WHH-3 and WHH-4. Exhibit
19 WHH-1 is my resume. Exhibit WHH-2 is a map setting forth New York
20 Independent System Operator ("NYISO") zones and transmission constraints.
21 Exhibit WHH -3 summarizes average hourly prices for each NYISO zone for the

period January 2005 through September 2007. Exhibit WHH-4 is a schedule for NYSEG and RG&E generation operations.

Q. Were the materials included in the Exhibits WHH-1 through WHH-4 prepared by you or under your supervision?

A. Yes, they were, although I note that Exhibit WHH-2 is a map published by the New York State Reliability Council, L.L.C. ("NYSRC"), and not an original work by me.

Q. Please describe the organization of the rest of your testimony.

A. Section II provides an Executive Summary. Section III describes the Proposed Transaction. Section IV of my testimony explains the origins of the VMP Policy Statement and discusses subsequent developments in the electric industry. Section V of my testimony discusses why the Proposed Transaction rebuts the VMP Policy Statement's rebuttable presumption. Section VI explains how the Proposed Transaction promotes New York's stated policies on the development of renewable energy.

II. EXECUTIVE SUMMARY

Q. Would you please provide a brief summary of your testimony?

A. I conclude that the relevance of the VMP Policy Statement has been superseded by almost ten years of significant change in the electric industry in New York, and that, in any event, the specific facts of the Proposed Transaction successfully rebut the VMP Policy Statement's rebuttable presumption that ownership of generation by a TO affiliate would unacceptably exacerbate the potential for

vertical market power. I further conclude that vertical market power could not be exercised in these circumstances because New York State Electric & Gas Corporation ("NYSEG") and Rochester Gas and Electric Corporation ("RG&E") do not have the opportunity to exercise market power, and because reasonable means exist to mitigate any market power. Finally, based on other evidence in the record, the Proposed Transaction promotes New York's stated policies on the development of renewable energy.

III. DESCRIPTION OF THE PROPOSED TRANSACTION

Q. Please briefly describe your understanding of the Proposed Transaction.

A. The Proposed Transaction is a stock transaction occurring at the holding company level. On June 25, 2007, Energy East, the ultimate parent of NYSEG and RG&E, Iberdrola and Iberdrola's wholly-owned subsidiary Green Acquisition Capital, Inc. ("Merger Sub") entered into an Agreement and Plan of Merger (the "Merger Agreement"), whereby the acquisition of Energy East by Iberdrola would be accomplished by the merger of Merger Sub with and into Energy East. Energy East will be the surviving corporation and a wholly-owned subsidiary of Iberdrola. NYSEG and RG&E will continue to be wholly-owned subsidiaries of Energy East and will become indirect wholly-owned subsidiaries of Iberdrola.

Q. Given the nature of the Proposed Transaction are there any horizontal market power concerns raised by the Proposed Transaction?

A. No. As set forth in detail in the Affidavit of William H. Hieronymus attached as Exhibit 19 to the Joint Petition (which was also submitted at FERC), the Proposed

Transaction does not raise horizontal market power concerns since it does not involve further consolidation of New York transmission and distribution facilities and has a *de minimis* effect on concentration in the New York generation market.

Q. Does the Proposed Transaction raise vertical market power concerns?

A. No. As I explain in Sections IV and V of this testimony, the Proposed Transaction does not raise vertical market power concerns.

IV. ORIGINS OF THE COMMISSION'S VMP POLICY STATEMENT AND SUBSEQUENT EVENTS

Q. What is the history of the VMP Policy Statement?

A. Almost a decade ago, the Commission expressed certain concerns regarding the affiliation between a TO and a generation owner in Case No. 96-E-0900 – *In the Matter of Orange & Rockland Utilities, Inc.'s Plans for Electric Rate Restructuring Pursuant to Opinion 96-12, et al., Statement of Policy Regarding Vertical Market Power* (July 17, 1998).

Q. What types of vertical market power concerns was the VMP Policy Statement intended to address?

A. The VMP Policy Statement identifies, by example, two types of vertical market power concerns that could potentially arise as a result of such affiliation. First, the VMP Policy Statement notes that a TO may have an incentive to impede the entry of new generation that would compete with its affiliated generation. To that end, Appendix I to the VMP Policy Statement explains that a TO may attempt to delay the interconnection process or impose unreasonable interconnection requirements on an unaffiliated generator. Second, the VMP Policy Statement

1 notes that a TO's affiliation with generation on the high-price side of a
2 constrained interface could give the TO an incentive to take steps to maintain or
3 exacerbate the constraint. In particular, the VMP Policy Statement suggests that a
4 TO could refuse to construct, or delay construction of, new transmission facilities
5 so as to maintain high prices on the high-price side of the constraint where its
6 affiliated generation is located. The VMP Policy Statement further suggests that a
7 TO may have an incentive to operate its transmission facilities in a manner that
8 increases the frequency of constrained conditions.
9 Q. Does the VMP Policy Statement create an absolute prohibition to a TO acquiring
10 or being affiliated with generation in New York State?
11 A. No. The Commission concluded in the VMP Policy Statement only that "a
12 rebuttable presumption will exist for purposes of [its] Section 70 review of the
13 transfer of generation assets, that ownership of generation by a [TO] affiliate
14 would unacceptably exacerbate the potential for vertical market power." The
15 Commission also concluded that this presumption could be overcome upon a
16 demonstration "that vertical market power could not be exercised because the
17 circumstances do not give the [TO] an opportunity to exercise market power, or
18 because reasonable means exist to mitigate market power."
19 Q. Were TOs required to divest generation in New York?
20 A. No. As Staff Witness Thomas D'Ambrosia testified in a prior proceeding, the
21 Commission never attempted to require utilities to divest generation. Case 03-E-
22 0765 – *Proceeding on Motion of the Commission as to the Rates, Charges, Rules*

and Regulations of Rochester Gas and Electric Corporation for Electric Service; Case 03-G-0766 – Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Gas Service, Tr. 2763 and 2974 (Feb. 19, 2004).

Q. To your knowledge, has the VMP Policy Statement been adopted by the Commission as a formal regulation?

A. No. It is my understanding that it is a policy statement of the Commission rather than a formal regulation.

Q. What were market conditions like at the time the Commission issued the VMP Policy Statement?

A. The VMP Policy Statement was drafted almost ten years ago, shortly after the Commission's orders establishing a framework for a competitive electric market. At that time, the Commission was addressing utility restructuring plans, several of the utilities were in the process of implementing plans to divest regulated generation, competitive electricity markets in New York had not yet formed, the NYISO was not yet operational, and there were no standardized interconnection requirements or standards of conduct for transmission providers in place. In the face of the then-existing high level of uncertainty regarding the future structure and effectiveness of the electric industry in New York, my understanding is that the Commission viewed a presumption in favor of divestiture as a way to diminish incentives to abuse market power.

1 Q. How do the market conditions today differ from those that existed when the VMP
2 Policy Statement was first issued?
3 A. In almost a decade since the VMP Policy Statement was issued, the New York
4 electric industry has changed dramatically. Many if not most of the market
5 related uncertainties and opportunities for TOs to exercise vertical market power
6 that formed the rationale for the VMP Policy Statement no longer exist, are
7 mitigated or, at a minimum, are far better understood today. Given the numerous
8 and significant economic and regulatory developments in the New York electric
9 market since 1998, the VMP Policy Statement is now substantially outdated.
10 Q. Is it necessary for the VMP Policy Statement to be revoked or modified for the
11 Proposed Transaction to proceed?
12 A. No. While I believe that the VMP Policy Statement is outdated and should not be
13 applied to the Proposed Transaction, as my testimony demonstrates, the rebuttable
14 presumption under the existing VMP Policy Statement is overcome by the
15 Proposed Transaction.
16
17 V. VMP POLICY STATEMENT'S REBUTTABLE PRESUMPTION
18 Q. Does the Proposed Transaction rebut the presumption in the VMP Policy
19 Statement that a TO's affiliation with generation "unacceptably exacerbates the
20 potential for vertical market power"?
21 A. Yes. The VMP Policy Statement's presumption that a TO's affiliation with
22 generation "unacceptably exacerbates the potential for vertical market power" is,

with respect to the Proposed Transaction, either inapplicable or is rebutted for the following reasons: 1) affiliates of Iberdrola currently own, and plan to construct, only *de minimis* amounts of generation in New York State; 2) all of this affiliated generation consists of intermittent wind power projects; 3) none of this affiliated wind generation would be located in the NYSEG or RG&E service territories; 4) all of this affiliated wind generation would be located on the low-price, unconstrained side of the Central-East transmission constraint; 5) RG&E and NYSEG would not otherwise be able to influence congestion; 6) the Proposed Transaction does not change the generation already owned by RG&E and NYSEG, and therefore, existing RG&E and NYSEG generation should be excluded from this analysis; 7) measures implemented by FERC relating to open access transmission, standardized interconnection procedures and standards of conduct eliminate any potential vertical market power concerns; 8) NYISO effectively controls all of the functions giving rise to the Commission's vertical market power concerns, including transmission system dispatch and generation redispatch, transmission planning and generation interconnection procedures; and 9) Iberdrola's wind generation promotes New York's stated policies in favor of renewable energy development.

Q. How much intermittent wind generation does Iberdrola currently own in New York State?

A. The amount of generation controlled by Iberdrola in New York State is very small and is available only on an intermittent basis. Therefore, the theoretical economic

incentive for NYSEG or RG&E to create, maintain or worsen transmission constraints to increase location-based marginal prices ("LBMPs") at the Iberdrola wind generators' locations, or to increase their capacity value, is, at most, *de minimis*. Even if NYSEG or RG&E had such an incentive (which they do not), numerous protections, processes and oversight mechanisms in place at NYISO and FERC substantially mitigate and, indeed, effectively eliminate their opportunity to exercise market power. Moreover, as Iberdrola cannot generally control when its wind facilities operate (except with respect to scheduling outages), such generation could not be used to affect transmission constraints.

Q. Can you be more specific about Iberdrola's current interest in operating generating facilities in New York?

A. Iberdrola's sole current interest in operating generating facilities in New York is an indirect 50% interest in the Maple Ridge wind farm in Lewis County, which has a nameplate rating of 321.8 MW. The remaining 50% interest in the Maple Ridge wind farm is held by Horizon Wind Energy, which is owned by Energías de Portugal, S.A. ("EDP"). Iberdrola, through its wholly-owned subsidiary IBERDROLA Portugal Electricidade e Gas, S.A., holds a 9.5% equity interest in EDP, but does not exercise voting rights associated with more than 5% of EDP's share capital. Iberdrola does not have any directors on EDP's board, and does not otherwise participate in EDP's management. Thus, it is appropriate to consider Iberdrola's ownership interest in operating generating facilities in New York as 160.9 MW, which is 50% of the nameplate rating of the Maple Ridge wind farm.

Its only pre-operational generation project in New York that has been substantially developed is the Jordanville wind farm in Herkimer County, which is scheduled to be completed in 2009 and will have a nameplate rating of 98 MW.

Q. Are Iberdrola's affiliates in the process of developing any additional generation projects?

A. Yes. Iberdrola's affiliates are in the process of developing the following generation projects that are in the NYISO interconnection queue: (i) the Hardscrabble wind farm in Herkimer County, rated at 80 MW, that is currently scheduled to come on line between 2008 and 2010; (ii) the Horse Creek wind farm in Jefferson County, rated at 126 MW, that is currently scheduled to come on line between 2008 and 2012; (iii) the Roaring Brook wind farm in Lewis County, rated at 80 MW, that is currently scheduled to come on line between 2009 and 2012; and (iv) the Dutch Gap wind farm in Jefferson County, rated at 250 MW, that is currently scheduled to come on line between 2010 and 2012. Taking into account all of these planned projects, Iberdrola's interest in generation in New York would only be approximately 795 MW of nameplate capacity.

Q. Is it likely that all of the planned Iberdrola generation will actually be constructed?

A. Not necessarily. It is not certain whether any of the projects other than Maple Ridge (which is the only Iberdrola project in New York that is operational) and Jordanville (which is scheduled to be completed in 2009) should even be taken

1 into account in evaluating the Proposed Transaction's potential vertical market
2 impact as the completion of these projects is speculative at this point. Whether or
3 not any of these projects will actually be constructed will be determined by a
4 number of factors, including market conditions, regulatory approvals, available
5 financing, *etc*. There are approximately 7,000 MW of wind projects in the
6 NYISO interconnection queue, many of which will never be constructed.
7 According to the NYISO interconnection queue documents, of the more than 250
8 interconnection requests since 1999, few projects have actually been placed in
9 service, and more than 100 projects have been withdrawn.
10 Q. What is the significance of Iberdrola's planned capacity being all wind-powered?
11 A. The fact that all of Iberdrola's planned capacity in New York State is wind-
12 powered has several implications when evaluating the potential for the exercise of
13 vertical market power resulting from the Proposed Transaction. First, the
14 nameplate ratings of Iberdrola's planned wind projects substantially overstate
15 their fossil-equivalent generation capability. Wind power is energy-limited and
16 typically has a maximum capacity factor (*i.e.*, average availability) of only about
17 30%. Therefore, the fossil-equivalent energy production capability of Iberdrola's
18 operating and substantially completed generation in New York (*i.e.*, the Maple
19 Ridge and Jordanville projects) is only about 77.7 MW, which is approximately
20 30% of the 259 MW of existing and substantially completed wind generation of
21 Iberdrola in New York State. Hence, the theoretical incentive of NYSEG and
22 RG&E to manipulate transmission to increase LBMPs at the Iberdrola wind

generators' locations would be far less than the already *de minimis* nameplate capacity of the Iberdrola generation suggests.

Q. Are Iberdrola's wind projects located in load pockets?

A. No. Iberdrola's wind projects are not located in load pockets, unlike the affiliated generation owned by certain other TOs in New York. For example, Consolidated Edison of New York and the New York Power Authority are TOs that also own or control generation within New York City, a load pocket with significant internal constraints.

Q. Do Iberdrola's wind projects have considerable capacity value?

A. No. As a result of the intermittent and unpredictable nature of wind power, Iberdrola's wind projects have little capacity value. Currently, the default capacity value of wind generation in NYISO is 10% of a project's rated capacity in summer and 30% in winter. This means that the maximum amount that Iberdrola could potentially sell into NYISO's unforced capacity ("UCAP") market, based on summer ratings, is only approximately 25.9 MW from Maple Ridge and Jordanville, and only approximately 79.5 MW from all of its existing and planned generation together. Thus, as with energy, there is very little (if not zero) economic incentive for NYSEG, RG&E and Iberdrola to affect transmission constraints in order to increase the value of capacity for this *de minimis* amount of generation. Under current capacity market rules, the economic incentive is zero. Since the supply of UCAP in the relevant geographic market is a function solely of the amount of installed capacity and its forced outage rates (*i.e.*, transmission

constraints neither define the market nor affect the quantity of supply), there is no vertical issue arising from the UCAP market.

Q. Are there other consequences resulting from the nature of Iberdrola's generation?

A. Another consequence of the unpredictable and intermittent nature of Iberdrola's generation is that electric energy from these wind projects cannot reasonably be sold in NYISO's day-ahead market, in which the substantial majority of New York electricity is bought and sold. If a wind generator were to sell into the day-ahead energy market, it would have to assume the risk of paying the unpredictable real-time price to cover the financially firm energy that it sold in the day-ahead market in the quite common event that it cannot produce the committed energy (*i.e.*, if the wind is not sufficient to run its turbines). Instead, wind projects must participate in NYISO's much smaller real-time market, meaning that Iberdrola's generation can have no impact on day-ahead prices. Therefore, a hypothetical strategy of creating, maintaining or enhancing transmission constraints tailored to the market in which Iberdrola's generation is sold (*e.g.*, sudden forced outages occurring after the day-ahead market closes) would have, at most, a minor impact on prices paid by New York consumers.

Q. What is the significance of zero fuel costs for wind powered generation?

A. As Iberdrola's projects are all wind-powered units, they have zero fuel costs. For this reason, it would be economically costly, and thus irrational and self-defeating, to withhold wind-powered energy from the real time market. Indeed, wind resources are typically bid into energy markets as a price taker to ensure that

1 they are dispatched when capable of producing energy. Hence, Iberdrola's
2 generation would be ill-suited for the exercise of market power – either directly
3 through affecting LBMPs by bidding strategy, or indirectly through impacting
4 transmission constraints.
5 Q. Is there a theoretical possibility that Iberdrola's ownership of generation could
6 increase the capability of creating transmission constraints?
7 A. No. While not addressed in the Commission's VMP Policy Statement, there is at
8 least a theoretical possibility that owning generation could increase the capability
9 of creating transmission constraints. Generation with a significant shift factor
10 against a constrainable transmission element could affect constraints. However,
11 the most common concern of this type is that a low cost resource on the inside of
12 a constrainable interface could cause the constraint to bind by not running when it
13 is in merit. This concern is not valid with respect to the Proposed Transaction as
14 both Iberdrola's existing and planned generation – as well as the existing RG&E
15 and NYSEG generation – is on the low-price side of the constraint, and does not
16 have a shift factor with the sign or magnitude to be of concern.
17 Q. Can NYSEG and RG&E create, maintain or worsen transmission constraints in
18 New York to benefit Iberdrola's generation located in a constrained area?
19 A. No. None of Iberdrola's existing or planned generation is located in a constrained
20 area. Moreover, NYSEG and RG&E cannot create, maintain or worsen relevant
21 transmission constraints in New York. As described by the NYISO Market
22 Monitor in its 2006 State of the Market Report, one of the most important

constraints in New York is the Central-East constraint. All of Iberdrola's existing and planned generation is located in Zone E in central New York. A map setting forth NYISO zones and transmission constraints is set forth in Exhibit WHH-2. These projects are on the low-price side of the Central-East constraint and remote from other constrained areas in Eastern and Southeastern New York. Iberdrola's lack of generation inside of these constrained areas means that it cannot benefit from higher LBMPs that a TO controlling key elements of constrained interfaces could hypothetically cause. This means that, after the Proposed Transaction occurs, NYSEG and RG&E will have no incentive to maintain or worsen these known constraints to benefit Iberdrola's existing or planned generation since such generation is not located on the high-price side of these constraints.

Q. Given the location of Iberdrola's generation, does Iberdrola's proposed affiliation with NYSEG and RG&E fit the VMP Policy Statement facts and circumstances?

A. No. In particular, the concern raised in the VMP Policy Statement was that affiliation with generation on the high-price, constrained side of a constraint could give a TO capable of affecting the constraint an incentive to increase its frequency or severity so as "to retain the constraint to keep the market price high on the high cost side of the constraint." Since Iberdrola's existing and planned generation is on the low-price, unconstrained side of the Central-East constraint, the Commission's concerns are not present with respect to the proposed affiliation between Iberdrola and Energy East's TOs in New York. Even if the Commission were to determine that its rebuttable presumption with respect to the ownership of

generation by a TO affiliate continues to apply generally, it is overcome by the specific facts here.

Q. Do NYSEG or RG&E transmission facilities have the potential to be constraining elements of the Central-East interface or any other constraints further east and southeast of Central-East?

A. Neither NYSEG nor RG&E owns or maintains the transmission facilities that have the potential to be constraining elements of the Central-East interface, or any facilities relevant to constraints further east and southeast of Central-East. RG&E's transmission is all in Zone B; indeed, it is RG&E's service territory that defines Zone B. NYSEG's transmission system is significantly larger and less compact, with small areas in Zone A, the southern parts of Zones C and E, all of Zone D and small pockets of Zones F and H. All of Iberdrola's existing and planned generation facilities are in the northern part of Zone E.

Q. In what manner is the location of NYSEG and RGE's transmission systems relevant to a vertical market power analysis?

A. As an initial matter, it is clear that NYSEG's transmission facilities in Zones F and H are not relevant to vertical concerns, since Iberdrola's generation is on the low-price side of any constraints in these zones. Moreover, even if NYSEG and RG&E had any real economic incentive to affect these existing constraints (which they do not), they also lack the ability to do so. Therefore, the relevant vertical market inquiry is whether RG&E's and NYSEG's transmission facilities in Zones A through E comprise all or parts of a transmission constraint that can be

manipulated to increase LBMPs in the northern part of Zone E, where Iberdrola's generation is located. In order for this to be a concern, it would be necessary (but not sufficient) for Zone E to be on the high-price side of such constraint relative to NYSEG's and RG&E's transmission facilities. If this is the case, it would have to be true that the LBMPs in Zone E are higher than in areas on the other side of such transmission facilities. Hourly LBMPs for each zone are available on the NYISO website. The available data include the LBMP itself, as well as those portions of the LBMP that are attributable to marginal losses and congestion. If there are no material amounts of congestion (and hence no material congestion costs) within the zones in which the relevant transmission assets are located (*i.e.*, the "West super-zone"), there can be no valid concern that, in the words of the VMP Policy Statement, the TO "has the incentive to retain the constraint to keep the market price high on the high cost side of the constraint."

Q. Have you prepared a summary of the average hourly prices that illustrates this point?

A. Yes. Attached as Exhibit WHH-3 is a table that summarizes average hourly prices for each NYISO zone for the period January 2005 through September 2007.

Q. Why is Exhibit WHH-3 relevant?

A. As shown in the column labeled "LBMP," there is a significant price gradient across the West super-zone. However, this gradient is almost entirely a result of marginal losses, not congestion. This conclusion can be confirmed by looking at

the column labeled "LBMP minus Losses." The gradient of loss-adjusted LBMPs is very small, indicating that congestion has little impact on prices within the West super-zone. This conclusion can be confirmed directly by looking at the "Congestion" column. Congestion is slightly negative in Zones A, B and D (indicating that low cost generation is sometimes bottled in) and equivalently slightly positive in Zones C and E. Congestion in Zone E, where Iberdrola's generation is located, averages only $0.30 per MWh, less than half of a percent of the average price. The congestion spread between the Zone A, with the largest negative congestion cost, and Zone E is only about $0.60/MWh, or about 1% of the average LBMPs.

Q. Is the amount of congestion within the West super-zone that Iberdrola's generation hypothetically could influence quite small?

A. Yes. The truly minor amount of congestion within the West super-zone can be observed by contrasting it with congestion in the eastern zones. Crossing the Central-East constraint from Zone E into Zone F increases congestion cost by an order of magnitude, from $0.30/MWh to $3.40/MWh. Congestion cost then increases gradually toward the southeastern part of New York, rising to over $5.00/MWh in Zones H and I. It then jumps to $11.50 in Zone J (New York City) and $21.30 in Zone K (Long Island). Thus, there are valid concerns about congestion across the Central-East constraint and perhaps southward in the East super-region. Clearly, there are valid congestion concerns about the in-City and Long Island load pockets. Conversely, there is little congestion in the West

1 super-region containing Iberdrola's generation that hypothetically might be
2 influenced by actions of RG&E and NYSEG.
3 Q. How else have you confirmed that RG&E and NYSEG are unable to create
4 congestion that would favorably affect Iberdrola's generation?
5 A. First, it is worth noting that the upstate region is a "generation pocket", *i.e.*, there
6 is insufficient transfer capability to export from a lower-priced region to a higher-
7 priced region. Zones A through E contain almost 15,000 MW of generation
8 (summer rating). The forecast summer peak for 2007 for these zones was only
9 about 10,000 MW. RG&E's and NYSEG's inability to create congestion
10 favorably affecting Iberdrola's generation can be further confirmed by reviewing
11 NYISO data on congestion associated with individual lines for which they are the
12 TO. RG&E and NYSEG own a small share of the lines that comprise the Total
13 East constraint and outages on these lines can reduce the transfer capability on the
14 interface. However, the effect of such an outage, or reduction in transfer
15 capability, is to cause prices in the west and east to separate more frequently than
16 if no such outages occur. Price separation between these two regions lowers,
17 rather than raises, prices on the low-side of the constraint where the Energy East
18 and Iberdrola generation is located.
19 Q. Please identify NYSEG and RG&E's generation operations.
20 A. NYSEG and RG&E's generation operations are set forth in my Exhibit WHH-4.
21 Q. Should this existing generation owned by NYSEG and RG&E be taken into
22 account as part of a reasonable vertical market power analysis?

A. No. The existing generation assets of NYSEG and RG&E are not relevant for purposes of evaluating any vertical market power concerns resulting from the Proposed Transaction as they are not being transferred as part of the merger.

Q. Why else should the existing generation assets of NYSEG and RG&E be irrelevant for purposes of evaluating any vertical market power concerns resulting from the Proposed Transaction?

A. NYSEG's and RG&E's approximately 351 MW of existing generation is rate regulated. Both NYSEG and RG&E flow the market revenues earned from these resources back to their customers through the non-bypassable charge ("NBC"). At NYSEG, the NBC is subject to an annual true-up, providing no opportunity for NYSEG to profit from changes in the market price. Through 2008, RG&E could theoretically benefit by roughly 20% of any change in the market revenues earned by its resources; however, this incentive would further be shared 50/50 with customers (*i.e.*, RG&E's share would only be 10%). As a result of these mechanisms, NYSEG and RG&E would have little or no opportunity to profit from market sales from their existing generation.

Q. How have the concerns about a TO's opportunity to exercise vertical market power raised by the Commission almost a decade ago in the VMP Policy Statement been mitigated by subsequent regulatory developments?

A. When issuing its VMP Policy Statement in 1998, the Commission dismissed arguments raised by certain utilities that the NYISO and FERC would have sufficient control over the New York TOs to prevent the exercise of vertical

1 market power. At that time, the Commission observed that the degree to which
2 the NYISO and FERC regulatory controls and enforcement mechanisms could be
3 exercised to address the issue of vertical market power was "subject to debate."
4 Indeed, as shown in *Central Hudson Gas & Electric Corp.*, 83 FERC ¶ 61,352
5 (1998), *order on reh'g*, 87 FERC ¶ 61,135 (1999), when the Commission issued
6 its VMP Policy Statement in 1998, NYISO had only recently been conditionally
7 established by FERC and was not yet fully operational (as shown in *Central*
8 *Hudson Gas & Electric Corp.*, 86 FERC ¶ 61,062 (1999), *order on reh'g*, 88
9 FERC ¶ 61,138 (1999)). In addition, FERC had not yet accepted NYISO's Open
10 Access Transmission Tariff ("OATT") or market rules. As my testimony
11 illustrates, the concerns raised by the Commission in its VMP Policy Statement
12 relating to these uncertainties of the New York electric industry have since been
13 fully mitigated by subsequent regulatory developments at FERC and the NYISO.
14 Q. What is the importance of the NYISO OATT and the Agreement between NYISO
15 and Transmission Owners ("NYISO/TO Agreement") to any vertical market
16 power analysis?
17 A. The NYISO did not officially commence operations under its OATT and Market
18 Administration and Control Area Services Tariff ("NYISO Services Tariff") until
19 November 18, 1999. Pursuant to its OATT, NYISO offers open access to its
20 transmission system to all market participants on a non-discriminatory basis. In
21 particular, NYISO regulates the following operations pursuant to its OATT: (i)
22 transmission dispatch; (ii) generation redispatch; (iii) curtailment; and (iv)

transmission line ratings (which might affect the amount of congestion). Additionally, all planning for new transmission required by the NYISO system is controlled by NYISO. In sum, while NYSEG and RG&E own their respective transmission assets, they have little of the operational discretion that they had over those assets when the VMP Policy Statement was issued. Indeed, Appendix I of the VMP Policy Statement suggests that satisfactory market power mitigation measures include "limitation on the degree of control over the constraining transmission interface held by the T&D utility." Under the current framework, it is difficult to conceive of any further limitation on NYSEG and RG&E given the high degree of NYISO control that has evolved since the VMP Policy Statement was written. Thus, even if NYSEG and RG&E had the incentive to reduce transmission availability in order to benefit an affiliated generator (which they do not), their ability to do so would be at most marginal because they have minimal control over their transmission assets.

Q. What was the NYISO OATT based upon?

A. The NYISO's OATT is based on FERC's pro forma OATT, was approved by FERC in *Central Hudson Gas & Electric Corp.*, 86 FERC ¶ 61,062 (1999), *order on reh'g*, 88 FERC ¶ 61,138 (1999) (conditionally accepting the NYISO OATT) and is regularly updated in compliance with FERC orders. FERC recently issued *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 118 FERC ¶ 61,119 (Feb. 16, 2007), in order to further reduce opportunities for the exercise of undue discrimination in its pro forma OATT,

make undue discrimination easier to detect, and further facilitate FERC enforcement. Accordingly, FERC's extensive oversight of NYISO's OATT and the activities thereunder offer an additional level of protection against the exercise of vertical market power.

Q. Can you identify and describe other limitations on operational control of lines and outage scheduling practices?

A. Yes. The NYISO/TO Agreement also contains provisions governing the operational control of lines and outage scheduling practices. Under Article 2.01 of the NYISO/TO Agreement, TOs have specified facilities over which NYISO has day-to-day operational control ("Transmission Facilities under ISO Operation Control" or "A1 List") and facilities that require TO notification to NYISO regarding actions related to these facilities ("Transmission Facilities Requiring ISO Notification" or "A2 List"). I understand that NYSEG and RG&E have placed all critical facilities, including those facilities that connect existing generation to the system, on these designated facilities lists. Article 2.02 of the NYISO/TO Agreement requires that "each Transmission Owner shall operate and maintain its facilities that are designated as Transmission Facilities Under ISO Control and Transmission Facilities Requiring ISO Notification in accordance with the terms of this Agreement and in accordance with all Reliability Rules and all other applicable operating instructions and ISO procedures."

Q. What other provisions of the NYISO/TO Agreement relating to scheduling maintenance or outages reduce TO operational control of transmission?

A. Article 2.08 of the NYISO/TO Agreement states: "Transmission Owners shall schedule maintenance of their facilities designated as Transmission Facilities Under ISO Operational Control and schedule any outages (other than forced transmission outages) of said transmission system facilities in accordance with outage schedules approved by the ISO. The Transmission Owners shall comply with maintenance coordinated by the ISO, pursuant to this Agreement, for Transmission Facilities Under ISO Operations Control. Each Transmission Owner shall be responsible for providing notification of maintenance schedules to the ISO for Facilities Requiring ISO Notification." The NYISO Outage Scheduling Manual also provides that NYISO will coordinate all requests for transmission outages based on their potential to impact system reliability. This evaluation considers outage impacts on system transfer capability which is directly related to market impacts and system congestion associated with transmission outages.

Q. What is the NYISO's Open Access Same-time Information System ("OASIS")?

A. NYISO maintains OASIS where it posts outage schedules, actual outage execution timelines, and the associated impacts of said outages on system transfer capability. To ensure that NYISO does not favor a particular market participant as a result of its maintenance schedule coordination practices and procedures, all criteria, procedures and implementation practices must be specific and available to market participants for audit.

Q. Are you aware of any FERC orders that relate to OATT reform?

A. As I testified previously, FERC issued Order No. 890 to implement OATT reform in *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, 118 FERC ¶ 61,119 (Feb. 16, 2007). Key provisions of the revised OATT are aimed at system planning practices. In addition to FERC's previous focus on ISO-directed reliability planning, the new OATT adds requirements for economic planning with a goal of identifying and implementing projects to reduce or eliminate system congestion. The changes to the OATT further require increased visibility and market participant input on TO local planning activities that take place within the ISO planning processes.

Q. Please briefly summarize the impact of NYISO's general oversight of the New York transmission system on vertical market power concerns relating to the proposed transaction.

A. NYISO's general oversight includes the above-referenced NYISO requirements, protocols, safeguards and practices that mitigate and, indeed, eliminate, any potential ability of NYSEG and RG&E to exercise vertical market power or discriminate in favor of affiliated generation interests.

Q. What is the impact of NYISO's standardized interconnection procedures?

A. In the VMP Policy Statement, the Commission expressed concern that ownership of generation "located in the same market as the T&D company" could give the TO an incentive to impede entry, "by either delaying or imposing unrealistic interconnection requirements and thereby raising prices in the region." However, since the initial inception of NYISO, all of its interconnection procedures and

1 agreements have become standardized to prevent any attempts at such
2 discriminatory treatment. In *Standardization of Generator Interconnection*
3 *Agreements and Procedures*, Order No. 2003, 104 FERC ¶ 61,103 (2003), *order*
4 *on reh'g*, Order No. 2002-A, 106 FERC ¶ 61,220 (2004), *order on reh'g*, Order
5 No. 2003-C, 109 FERC ¶ 61,287 (2004), *order on reh'g*, Order No. 2003-C, 111
6 FERC ¶ 61,401 (2005), and the series of related orders ("Order No. 2003"), FERC
7 required all RTOs, including NYISO, to adopt standard procedures and
8 agreements for interconnecting with large generators in order to achieve
9 additional transparency and to prevent transmission owners from favoring
10 affiliated generators in the interconnection process. Among other things, FERC's
11 Order No. 2003 (*see* Order No. 2003, 104 FERC ¶ 61,103 at P 35; *see also New*
12 *York Independent System Operator, Inc. and New York Transmission Owners*,
13 108 FERC ¶ 61,159 at P 6 (2004)), mandated that NYISO control the
14 interconnection application processes and procedures, and specified certain cost
15 allocation methods for interconnection costs. Additionally, pursuant to FERC's
16 Order No. 2003 (Order No. 2003, 104 FERC ¶ 61,103 at P 36; *New York*
17 *Independent System Operator, Inc. and New York Transmission Owners*, 108
18 FERC ¶ 61,159 at P 7 (2004)), NYISO conducts all reliability-related studies
19 during the interconnection process. FERC also accepted in *New York*
20 *Independent System Operator, Inc. and New York Transmission Owners*, 108
21 FERC ¶ 61,159 (2004), the NYISO's Standard Large Facility Interconnection
22 Procedures ("LFIP") and Large Facility Interconnection Agreement ("LFIA") as

Attachment X to the NYISO OATT. Pursuant to NYISO OATT, Attachment X, § 2.2 of the LFIP, NYISO "receives, processes and analyzes all Interconnection Requests ... with independence and impartiality." Accordingly, NYISO's LFIP and LFIA adopted pursuant to Order No. 2003 further ensure that TOs are not able to exercise vertical market power by favoring affiliated generators in the interconnection process. Regardless of whether a generator is affiliated or unaffiliated with a TO, the generator must participate in the same System Reliability Impact Study and Facilities Study, led by NYISO, as well enter into a final three-party Interconnection Agreement with NYISO based upon the same LFIA. The final Annual Transmission Reliability Assessment must comport with NYISO's requirements under Attachment S to the NYISO Services tariff. Thus, the LFIP and LFIA make it effectively impossible for a TO to favor its generation affiliates.

Q. How does the NYISO's market monitoring program impact vertical market power concerns?

A. Any abuse or exercise of vertical market power is further discouraged by NYISO's market monitoring function and FERC's remedies. NYISO employs a robust market monitoring program utilizing an in-house market monitoring unit as well as an Independent Market Advisor. NYISO's market power mitigation measures, which are codified in Attachment H of the NYISO Services Tariff, are designed to provide NYISO with the ability to mitigate market effects of any conduct that would substantially distort competitive market outcomes in NYISO-

administered markets. If NYISO determines that additional mitigation measures are necessary, it may file with FERC for approval to implement any such measures. Attachment H also provides NYISO with the ability to impose financial penalties for parties that engage in physical withholding. These penalties are designed to negate the impacts on market price that result from the exercise of market power.

Q. What authority does FERC have to enforce civil penalties?

A. In enacting the Energy Policy Act of 2005, Congress granted FERC significant additional authority to institute civil penalties. FERC has established an Office of Enforcement and is able to levy civil penalties of up to $1 million per violation for each day that the violation continues. Furthermore, pursuant to the Federal Power Act § 316A, 16 U.S.C. § 825o-1 (2001), FERC has the authority to refer matters to the Department of Justice for criminal prosecution. Accordingly, NYISO's market monitoring program and FERC's enforcement authority effectively eliminate the ability by Iberdrola and Energy East to distort competitive markets through an exercise of vertical market power.

Q. Does FERC have Standards of Conduct and, if so, why are they relevant?

A. In *Standards of Conduct for Transmission Providers*, Order No. 2004, FERC Stats. & Regs. ¶ 31,155 (2003), Order No. 2004-A, FERC Stats. & Regs. ¶ 31,161 (2004), Order No. 2004-B, FERC Stats. & Regs. ¶ 31,166 (2004), Order No. 2004-C, 109 FERC ¶ 61,325 (2004) and a series of related orders (together, "Order No. 2004"), FERC issued certain "Standards of Conduct for Transmission

1 Providers" ("Standards of Conduct") that govern the relationship between public
2 utility transmission providers (including the New York TOs) and their generation
3 affiliates. The Standards of Conduct offer additional protections against the
4 potential exercise of vertical market power by NYSEG and RG&E with respect to
5 Iberdrola's generation resources. In particular, pursuant to Order No. 2004, a
6 transmission provider's employees engaged in transmission system operations
7 must function independently from the employees of its generation affiliates.
8 Furthermore, a transmission provider must treat all of its transmission customers
9 (whether affiliated or unaffiliated) on a non-discriminatory basis, and must not
10 operate its transmission system to benefit preferentially its generation affiliates.
11 Q. What are some other protections against the potential exercise of vertical market
12 power by a New York TO?
13 A. NYISO's complete independence from Market Participants in New York offers
14 further protection against the potential exercise of vertical market power by any
15 TO. NYISO is a wholly-independent, non-profit corporation governed by a 10-
16 member Board of Directors. The NYISO Board represents a broad spectrum of
17 expertise, with Board members from the power industry, environmental
18 organizations, and the fields of finance, academia, technology, and
19 communications. The members of the NYISO Board, as well as all of its
20 employees, are completely independent and have no business, financial, operating
21 or other direct relationship to any Market Participant or other stakeholder. NYISO
22 is also managed by three standing committees comprised of individuals from five

major sectors of the marketplace: TOs, generation owners, other suppliers, end-used customers, and public power and environmental parties. Thus, there is no opportunity for any TO (or any group of affiliated TOs) to exert undue influence over the NYISO governance process.

VI. THE PROPOSED TRANSACTION PROMOTES NEW YORK'S POLICIES ON THE DEVELOPMENT OF RENEWABLE RESOURCES

Q. How does Iberdrola's expertise and focus on wind generation provide ratepayer benefits?

A. This has been addressed in the Direct Testimony of the Benefits and Public Interest Panel submitted in this proceeding on August 1, 2007 (the "Benefits Testimony"). As described there, Iberdrola's expertise in and commitment to renewable generation development in New York State, when combined with the other valuable benefits of the Proposed Transaction, will result in "substantial ratepayer benefits" that should be sufficient to more than offset the at most trivial amount of vertical market power that hypothetically could be exercised. Iberdrola's focus on wind power development promotes New York's stated policies with respect to the development of renewable resources in New York. The State's 2002 Energy Plan warned of the possible consequences of New York's heavy dependence on fossil fuel, noting that the State's fossil fuel sources (*i.e.*, gas, coal and oil) are largely imported from abroad or out-of-state, have significant long-term negative environmental impacts, and ultimately face depletion. At the request of Governor George Pataki, the Commission began to explore the development of a Renewable Portfolio Standard ("RPS") in 2003. On

September 24, 2004, in its *Case 03-E-0188 – Proceeding on Motion of the Commission Regarding a Retail Renewable Portfolio Standard* (issued and effective Sept. 24, 2004), the Commission voted to adopt an RPS, codifying the goal of increasing the proportion of renewable electricity used by New York consumers to at least 25% by 2013. The Commission noted the following primary benefits expected from implementing the RPS Program: (i) diversifying the generation resource mix to improve energy security and independence; (ii) attracting the economic benefits from renewable resource generators, manufacturers, and installers to the State; and (iii) improving New York's environment by reducing air emissions and other adverse environmental impacts of electricity generation.

Q. Are you aware of any recent gubernatorial statements of State policy highlighting the benefits associated with renewable generation resources?

A. Yes. On April 19, 2007, Governor Eliot Spitzer announced the "15 x 15" clean energy strategy to reduce the State's electricity consumption by 15% from forecasted levels by 2015. This strategy establishes the most aggressive energy conservation target in the nation. This decrease in demand will be achieved by (1) decoupling utilities' profits from the amount of energy being consumed; (2) strengthening efficiency standards in energy-intensive appliances; and (3) making the State government, by far the largest energy consumer in the State, more efficient. Governor Spitzer pointed out the State government's special role in the new strategy: "Likewise, if government buys wind power, we drive the

technology market for wind generators. By embracing ambitious energy efficiency standards and renewable energy goals throughout State government, we will catalyze the growth of the clean power industry." The "15 x 15" strategy also calls for the State to implement a new power plant siting law, which will fast-track only clean power plant proposals, *i.e.*, those with low or no emissions. Accordingly, Iberdrola's focus on the development of renewable generation in New York will help to satisfy New York's RPS goals, and will offer environmental benefits to New York ratepayers.

Q. Has the Commission also recently stated its support for renewable energy?

A. Yes. Chairwoman Patricia L. Acampora stated in a November 13, 2007 presentation to Lehman Brothers in Anaheim, California, that one of the Commission's top five priorities for the coming year is the "continuing implementation of the goals of the Renewable Portfolio Standard designed to increase to at least 25 percent by 2013 the electricity sold in New York State from renewable resources."

Q. Does this complete your testimony?

A. Yes, it does.

1 BY MR. CANNON:
2 Q. Dr. Hieronymus, do you also have in front of you
3 four exhibits that were attached to your testimony,
4 Exhibits WHH-1 through WHH-4?
5 A. I do.
6 Q. Are these your résumé, map of the NYISO zones and
7 transmission constraints, a summary of the average
8 hourly prices for NYISO zones, and a schedule for NYSEG
9 and RG&E operations?
10 A. That is correct.
11 Q. Were these documents prepared by you or under
12 your direction?
13 A. Yes, although, as I noted in my testimony,
14 Exhibit 2 was a map that originated through one of the
15 state agencies. It's prepared by me only in the sense
16 that I put an exhibit number on it.
17 Q. Understood.
18 MR. CANNON: Your Honor, I would like to
19 copy the exhibits in to the record. We can do them all
20 as one exhibit if that's more efficient.
21 JUDGE EPSTEIN: Four exhibits, 72, 73, 74,
22 75.
23 (Exhibits 72 through 75 marked for
24 identification, respectively.)

1 BY MR. CANNON:
2 Q. Dr. Hieronymus, do you have also in front of you
3 a document entitled rebuttal testimony of William H.
4 Hieronymus dated January 31, 2008, that consists of 29
5 pages including cover page?
6 A. Yes, I do.
7 Q. Was this document prepared by you or under your
8 direction?
9 A. It was.
10 Q. Do you have any edits or corrections to this
11 document?
12 A. No, I don't.
13 Q. If I were to ask you these same questions today
14 based on the facts as they were at the time you
15 submitted your testimony, would you give the same
16 responses?
17 A. I would.
18 Q. Do you adopt this document as your sworn
19 testimony in this proceeding?
20 A. I do.
21 MR. CANNON: Your Honor, we'd like to copy
22 Dr. Hieronymus' rebuttal testimony into the record as if
23 given orally.
24 JUDGE EPSTEIN: Yes.

1 (The following is the prefiled rebuttal
2 testimony of William Hieronymus:)
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WILLIAM H. HIERONYMUS

1 Q. Please state your name and business address.

2 A. My name is William H. Hieronymus. My business address is CRA International
3 Inc., 200 Clarendon Street, T-33, Boston, MA 02116.

4 Q. Are you the same William H. Hieronymus who filed Direct Testimony earlier in
5 this proceeding?

6 A. Yes, I am.

7 **Summary of Rebuttal Testimony**

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

9 A. I am responding to the testimony of Mr. Mark Younger, a witness for the
10 Independent Power Producers of New York ("IPPNY"), and the portions of the
11 Staff Policy Panel testimony submitted by the Staff of the New York Public
12 Service Commission (the "Commission") dealing with market power issues.

13 Q. Can you give us an overview of the issues you would like to discuss?

14 A. Yes. The general areas that I will address are the recommendations made by
15 IPPNY and Staff concerning the conditions that the Commission, if it approves
16 the merger between a subsidiary of Iberdrola, S.A. ("Iberdrola") and Energy East
17 Corporation ("Energy East") that is the subject of this proceeding (the "Merger"),
18 should place on the merging parties to resolve supposed vertical market power
19 concerns. In part, I am responding to comments that these witnesses make
20 concerning my Direct Testimony, particularly as it relates to (1) the lack of
21 relevance of Energy East's existing generation to the Merger, (2) the *de minimis*

1 nature of Iberdrola's affiliated generation in the New York Independent System
2 Operator ("NYISO") region, and (3) the substantial increase in regulatory
3 oversight of the electric industry in New York since 1998 when the Commission
4 issued its Vertical Market Power Policy Statement (the "Policy Statement"). I
5 also re-emphasize the points I made in my Direct Testimony regarding the
6 unpredictable and intermittent nature of wind, which makes wind-powered
7 generating facilities ill-suited to be used in the exercise of vertical market power.
8 I also respond to certain arguments made by these witnesses that are not directly
9 responsive to my Direct Testimony.

10 Q. Please begin first with Mr. Younger's testimony. What are his concerns and
11 recommendations?

12 A. Mr. Younger is concerned that Energy East's New York utility subsidiaries, New
13 York State Electric & Gas Corporation ("NYSEG") and Rochester Gas and
14 Electric Corporation ("RG&E"), own, and after the Merger would continue to
15 own, rate-based generation (at 3). Mr. Younger contends that this ownership
16 contravenes established Commission policy and shifts cost risks to ratepayers (at
17 3). He also is concerned that allowing NYSEG or RG&E to own or be affiliated
18 with generation in their service areas would create vertical market power issues,
19 in that these utilities would favor their affiliated generation and impede the
20 development of unaffiliated generation in the areas (at 18-20). He recommends
21 that approval of the Merger be conditioned on the prompt sale of NYSEG's and
22 RG&E's cost-of-service regulated facilities, and a permanent bar on NYSEG and

1 RG&E owning or being affiliated with any generation in their respective service
2 areas (*see, e.g.*, at 2).

3 Q. What are Staff's concerns and recommendations?

4 A. Staff also is concerned with the potential vertical market power of the post-
5 Merger company, though (as with Mr. Younger) not all of its concerns relate to
6 the Merger itself. Staff believes that the Policy Statement remains relevant in that
7 the Commission should insist on strict structural separation between generation
8 and transmission (*e.g.*, at 126). Staff insists that regulation simply cannot guard
9 against any conceivable exercise of vertical market power and disagrees with my
10 characterization of the Merger's effects as *de minimis* (at 133-35). Staff
11 recommends that the Commission condition its approval of the Merger on the sale
12 of all generation in New York owned by either Iberdrola or Energy East, no
13 matter where that generation is located (at 288).

14 **The Existing Generation Owned by NYSEG and RG&E Is Unrelated to the Merger**
15 **and Irrelevant to a Vertical Market Power Analysis of the Merger**

16 Q. You stated that Mr. Younger was particularly concerned about the post-Merger
17 company owning rate-based generating facilities. Is Energy East's continued
18 ownership of cost-of-service regulated generation related to the Merger?

19 A. Clearly, the ownership of such facilities is wholly unrelated to this transaction.
20 Iberdrola owns no cost-of-service regulated generating facilities, and has no
21 transmission in New York. Hence, this issue raised by Mr. Younger and Staff

1 concerns existing conditions that relate solely to Energy East and have nothing to
2 do with the Merger. There is therefore no principled basis for conditioning
3 Merger approval on the disposal of Energy East's existing generating facilities.

4 Q. Much of Mr. Younger's testimony concerns various reasons why it is bad policy
5 to allow regulated utilities to own or construct rate-based generating facilities. Is
6 there a reason why the ownership of such facilities in the NYSEG or RG&E
7 service areas raises vertical market power issues that are more serious than if such
8 facilities were supported solely by market revenues?

9 A. No, and Mr. Younger does not assert such a connection between cost-of-service
10 regulation and vertical market power issues. If anything, the fact that these are
11 cost-of-service regulated facilities should lessen any theoretical vertical market
12 power concerns. In my Direct Testimony, I concluded that Energy East's profit
13 share of this rate-based generation is 10 percent, with the remaining 90 percent
14 flowing through to customers. It is therefore the ratepayers, and not Energy East,
15 that primarily benefit from any value enhancement to these facilities, whether
16 arising from the exercise of vertical market power or any other cause. Since there
17 is little if any profit incentive for Energy East to enhance the value of these
18 facilities, the concern about hypothetical vertical market power should be less for
19 these cost-of-service facilities. My reading of the Commission's order in the
20 KeySpan-National Grid merger proceeding suggests that this also is the
21 Commission's view. While the Commission required divestiture of KeySpan's
22 Ravenswood facility in that order, no such requirement was placed on the

1 KeySpan facilities dedicated to serving Long Island Power Authority's ("LIPA")
2 load under what are essentially cost-of-service contractual terms.

3 Q. Mr. Younger notes that you did not analyze vertical market power concerns as
4 they relate to RG&E's Russell Station. He asserts that since the Russell Station is
5 due to be retired in 2008, any repowering "is essentially a new generation addition
6 and must be reviewed in that context" (at 18). Would treating a repowering of the
7 Russell Station as a new unit change your view that it is not Merger-related?

8 A. No. The key fact about the Russell Station is not whether it is old or new, but that
9 it exists independent of the Merger and is not becoming newly affiliated with a
10 transmission owner as a result of the Merger. It is my understanding that, prior to
11 the announcement of the Merger, RG&E had already planned to propose to
12 repower the Russell Station. If, as Mr. Younger is testifying, it has been RG&E's
13 intention to repower the unit as a rate-based unit, this fact is not changed by the
14 Merger and hence is irrelevant to a vertical market power analysis of the Merger.

15 Q. Setting aside the fact that repowering the Russell Station as a rate-base unit is not
16 related to the Merger, is there a valid concern that the repowering would occur in
17 contravention of Commission policy that, as Mr. Younger suggests, seems to
18 oppose the recovery of the cost of owned units through regulated rates?

19 A. No. While I am not an expert on all aspects of New York utility regulation, I am
20 aware that a utility regulated by the Commission is not allowed to recover the cost
21 of investments that are not prudently incurred. I also am aware that, as a general
22 manner, it is necessary to get Commission permission to build new facilities.

1 Whether the latter applies to repowered facilities or not, it clearly is the case that
2 the costs of repowering the Russell Station would have to be found to be prudent
3 if they are to be recovered by RG&E. If, as Mr. Younger and Staff assert, this
4 investment would be contrary to Commission policy, RG&E would have to be
5 very cautious about moving forward with the repowering in the expectation that it
6 would be permitted to recover its costs in rates. To be clear, I am not in any way
7 providing any opinion as to whether any amounts already spent by RG&E with
8 respect to repowering the Russell Station, or any amounts that RG&E will spend
9 in the future, are in fact prudent. Rather, I am explaining why I do not believe
10 that Mr. Younger has raised a valid concern that a repowering of the Russell
11 Station would violate any Commission policy that may oppose the recovery of the
12 cost of owned units through regulated rates

13 Q. Mr. Younger concludes that the benefits of Energy East's continued ownership of
14 generation do not overcome the rebuttable presumption in the 1998 Policy
15 Statement (at 22). He bases his conclusion on a discussion of the economics of
16 repowering the Russell Station (at 22-23). Is this part of his testimony relevant to
17 this proceeding?

18 A. No. Mr. Younger's conclusion that there is no ratepayer benefit to RG&E
19 retaining and repowering the Russell Station is irrelevant to the Merger. If,
20 hypothetically, Mr. Younger is correct that Energy East's own analysis
21 demonstrates that repowering the Russell Station would not be cost effective, this
22 would factor into a prudence analysis when RG&E attempts to include those costs

1 in its rate-base. This would make it less likely that RG&E East would in fact
2 proceed to repower the unit unless circumstances change.

3 Q, Mr. Younger also recommends the divestiture of the remaining rate-based hydro
4 and gas-fired units owned by NYSEG and RG&E (at 25). Do you see a reason to
5 require this divestiture?

6 A. No. First, these are also pre-existing NYSEG and RG&E units that will not
7 become affiliated with a transmission owner as a result of the Merger, and are
8 therefore unrelated to the Merger and any vertical market power analysis of the
9 Merger. Second, the amount of this generation is truly *de minimis*, less than 300
10 MW,[1] and is primarily run of river hydro and old gas turbines that rarely run.
11 The total output of these units in 2006 was only about 750,000 MWh, equivalent
12 to only a 100 MW base-load unit running at an 85 percent capacity factor. It
13 strains credulity to contend that the continued ownership of this amount of
14 generation by NYSEG and RG&E creates a vertical market power concern, even
15 if such generation were related to the Merger (which it is not).

16 Q. The Staff Panel is asked, "Why should the exiting (sic) RG&E and NYSEG
17 generation be included in the analysis of the proposed transaction?" (at 131).
18 Does the Panel answer this question?

19 A. No. The answer that follows merely identifies the facilities that are owned by
20 NYSEG and RG&E and recounts evidence that RG&E has appeared intent on

[1] In fact, this amount is closer to 200 MW when the Carthage Energy unit owned by NYSEG Energy Solutions is excluded.

1 repowering the Russell Station. None of this discussion is responsive to the
2 question. The only element of Staff's response that potentially bears on the
3 Merger is the statement that applicants might withhold output from Energy East's
4 105 MW of peakers, which Staff states, parenthetically, to be a horizontal market
5 power issue (at 132). Notably, Staff nowhere suggests that the Merger causes any
6 horizontal market power problem, nor could it. It would defy logic to assert that
7 combining Energy East's very small share of generation with Iberdrola's minute
8 share would cause a horizontal market power problem.

9 **IPPNY's Proposed Limitation on the Post-Merger Company's Development and**
10 **Acquisition of New Generation in the NYSEG and RG&E Service Areas Is**
11 **Unnecessary**

12 Q. Mr. Younger also suggests that the Commission should require a commitment
13 from the merging parties that they would not in the future develop or acquire
14 generation in the NYSEG and RG&E transmission service areas (at 25).
15 Assuming that the Commission indeed does want to limit the amount of vertical
16 integration of transmission owning utilities, why is this commitment necessary?

17 A. Mr. Younger does not say why he believes this commitment would be necessary
18 given that the Commission already has regulatory oversight of these activities. It
19 may be that, because the Commission might in the future be more favorably
20 inclined toward vertical integration, he seeks a commitment that would survive
21 beyond such a change in policy. For example, without this commitment, the
22 Commission might in the future approve a utility-owned unit as part of the

1 regulated reliability backstop process. Mr. Younger is silent on how, having
2 made such a commitment, NYSEG and RG&E would be able to meet the
3 requirement in Attachment Y of the NYISO tariff that they be prepared to offer
4 new regulated facilities in the event that the market does not support sufficient
5 capacity to meet reliability requirements.

6 Q. What do you mean when you say that the Commission already has regulatory
7 oversight over the future development or acquisition by the post-Merger company
8 of generation in the NYSEG and RG&E service territories?

9 A. Presuming that the Commission continues to want to limit vertical integration, it
10 has sufficient tools at its disposal to do so without requiring a commitment from
11 the merging parties in this proceeding that they will not in the future develop or
12 acquire generation in the NYSEG and RG&E transmission service areas. For
13 example, as described above, the Commission could prevent inclusion of a utility-
14 built generating unit in rate base by NYSEG and RG&E if it so desires. The
15 Commission also could presumably reject a Certificate of Public Convenience and
16 Necessity ("CPCN") application for any unit proposed by affiliates of NYSEG or
17 RG&E in the future, whether located in the NYSEG or RG&E areas or not.
18 While the CPCN process does not apply to qualifying cogeneration facilities and
19 solar, wind, resource recovery and small hydro facilities with a capacity up to 80
20 MW, it is unlikely that any project smaller than 80 MW would be economic to
21 develop, except for small peakers required to meet specific local needs and
22 perhaps dispersed generation. Wind projects are typically larger than 80 MW as

1 demonstrated by the wind farms that have been built or proposed in New York
2 (including Iberdrola's affiliated projects that are in operation or under
3 development). I note also that Section 70 of the New York Public Service Law,
4 governing transfers of assets of utility corporations, gives the Commission
5 authority over the acquisition of any generating asset of non-trivial value.

6 Thus, while the Commission may not currently have the authority to fully
7 prevent all new generation developed or acquired by these applicants or their
8 affiliates in the future, it already has the authority (pursuant to the CPCN and
9 Section 70 provisions of the New York Public Service Law) to limit such
10 ownership to trivial amounts. Moreover, it is my understanding that Iberdrola and
11 Energy East are committing in their Policy Panel Testimony that NYSEG and
12 RG&E will not develop any new generation unless the Commission authorizes
13 such development.

14 **The Commission Orders Cited By IPPNY and Staff Do Not Support their**
15 **Conclusion That the Merger Should Be Conditioned Upon Divestiture of**
16 **Generation To Address Vertical Market Power Concerns**

17 Q. Mr. Younger and Staff point to various Commission orders and policy
18 pronouncements in concluding that the Commission fully opposes vertical
19 integration by utilities (*see, e.g.,* Policy Panel at 116). Do you agree that the
20 Commission will automatically reject a utility's proposed affiliation with
21 generation?

1 A. No. If this were the case, I would not be testifying since it would be pointless to
2 argue that the affiliation of Iberdrola's wind facilities with Energy East is benign.
3 Rather, as Mr. Younger and Staff concede, the Policy Statement merely creates a
4 rebuttable presumption that the affiliation between generation and transmission
5 needs to be scrutinized. The Policy Statement expressly provides for the ability to
6 override this presumption, essentially on the grounds that any vertical market
7 power issue is *de minimis,* as I have concluded is the case here. In the Policy
8 Statement, the example of *de minimis* status is a very small transmission utility.
9 However, since it is the combination of generation and transmission that matters,
10 it likely should be the case that the combination of a substantial transmission
11 owner with *de minimis* generation should be permissible. The Policy Statement
12 also provides for the mitigation of any potential vertical market power.

13 Q. A more recent order that Mr. Younger cites for the proposition that the
14 Commission remains opposed to vertical integration is the December 24, 2007
15 order establishing a long-range electric resource plan, which he identifies as the
16 "ERP Order" (at 11). Does that order reaffirm the Commission's Policy
17 Statement?

18 A. No. If anything, the essence of the ERP Order justifies a softening of the
19 Commission's policy with respect to vertical integration. I note that the first
20 passage quoted by Mr. Younger has nothing to do with vertical market power
21 issues, but rather merely reaffirms the Commission's preference for using market
22 mechanisms in preference to regulated solutions. However, the primary

1 discussion in the ERP Order is an explanation as to why purely market solutions
2 may not meet the State's needs in terms of reliable service, economic generation,
3 risk diversification, environmental and other externalities, and so forth. The
4 second cited passage does indeed mention the risk of vertical market power.
5 However, a fair reading of that passage, which deals primarily with the need for
6 and implications of long-term contracts, is that the principal point being discussed
7 is the allocation of risks as between generators and customers (and not vertical
8 market power concerns). Indeed, the Commission concludes that long-term
9 contracts may be needed and even desirable in order to obtain the level and mix of
10 generation needed to meet the State's policy goals.

11 Q. If this order signals a willingness on the part of the Commission to contemplate
12 long-term contracts that transfer some cost and performance risk from generators
13 to customers, what, if anything, does that have to do with vertical market power?

14 A. It has long been recognized that horizontal and vertical market power issues can
15 arise from certain types of contracts just as readily as from generation ownership.
16 In analyses of mergers and of market power in other contexts, the policy of the
17 Federal Energy Regulatory Commission ("FERC") has long been to treat certain
18 contracts as transferring generation from the actual owner to its contractual
19 counter-party. The threshold issue is the length of the contract term. According
20 to FERC policy, short-term (*i.e.,* less than one year) contracts never transfer
21 control. For long-term contracts, it is the terms of the contract that dictate
22 whether control has passed from the owner to the contractual buyer. The two

1 dimensions of control are (1) who profits from higher prices, and (2) who has
2 dispatch control over the facility. Regarding the profit issue, any long-term fixed
3 price contract or other contract that is not tied directly to prices in the electricity
4 market (*e.g.*, a contract indexed wholly or partially to fuels costs) transfers the
5 benefit of the contract to the buyer. The other dimension of contracts relevant to
6 market power is the control over generation dispatch, since it is this ability to
7 withhold generation from the market that is the *sine qua non* of exercising market
8 power. However, as Staff rightly observed, it is the financial interest that
9 primarily matters to vertical market power analysis, not the control over
10 generation dispatch.

11 Q. Can you summarize your conclusions on this point and how they relate to the
12 Merger?

13 A. I am making two points with this discussion. First, NYSEG and RG&E have the
14 requisite degree of control over generation (*i.e.*, a profit interest) for considerably
15 more generation than they actually own. For example, the market power
16 incentives that NYSEG and RG&E have as a result of their long-term contracts
17 for power from Nine Mile Point and Ginna facilities are precisely the same as
18 they would be if the companies had retained ownership of those facilities. Indeed,
19 in my FERC market power analysis of the Merger, I attributed all of Energy
20 East's long-term contracts to the company as if it owned the assets lying behind
21 the contracts. Thus, any generation divestiture will not cure the vertical market
22 power concern that Mr. Younger and Staff have raised.

1 Moreover, as I will explain in detail later in my testimony, the addition of
2 Iberdrola's generation in New York (all of which is wind powered and therefore
3 unpredictable and intermittent in nature) to what already is controlled by Energy
4 East will have little impact on its market share. In my FERC analysis, I
5 concluded that Energy East's share of the NYISO market, inclusive of all of its
6 long-term contracts, is 2.9 percent and Iberdrola's is 0.2 percent. For the New
7 York West market, the shares are 5.7 and 0.4 percent, respectively. I concluded,
8 and FERC agreed, that the addition of Iberdrola's miniscule share to Energy
9 East's small share did not create any market power issue, either horizontal or
10 vertical. Later in my testimony, I will address other specific reasons why
11 Iberdrola's affiliated generation in New York does not raise any vertical market
12 power issues, including the significance of that generation being all wind-
13 powered, and therefore unpredictable and intermittent in nature.

14 My second point is that the Commission recognizes that long-term
15 contracts may be desirable or necessary, notwithstanding that such contracts, like
16 ownership, create potential vertical market power issues. In the ERP Order, the
17 distinction made between ownership and contracts was not about vertical market
18 power. It was about the allocation of cost and performance risk. In this regard, it
19 is notable for purposes of evaluating Mr. Younger's reliance on the ERP Order
20 that applicants are <u>not</u> seeking rate-base treatment for any Iberdrola-affiliated
21 generation. More generally, the ERP Order signals an acceptance that there are
22 tradeoffs between vertical market power concerns and other policy goals. It

1 further suggests that current policy requirements may not be achieved without a
2 modification of historic policies that sought to allocate all cost and performance
3 risks to generators and fully eliminate vertical market power risks.

4 Finally, I note that one of the concerns expressed in the ERP Order is that,
5 without long-term contracts, it could be difficult to achieve the State's renewables
6 objectives. The existing and planned generation in New York owned by
7 Iberdrola's affiliates is wholly renewable. It would not be advantageous in terms
8 of meeting the State's renewables objectives to prohibit the post-Merger company
9 from owning or contracting for renewable power as a condition of Merger
10 approval, particularly in light of Iberdrola's proven track record in developing
11 renewable resources. Yet, since ownership and a long-term contract for
12 renewable power are fully equivalent in terms of vertical and horizontal market
13 power concerns, that is effectively what Staff is proposing.

14 Q. A third Commission order that Mr. Younger and Staff point to in arguing that the
15 Commission's policy is resolutely against vertical integration involving
16 transmission operators is the KeySpan-National Grid merger order (*see, e.g.,*
17 Policy Panel at 121). In that case, the Commission required that KeySpan's
18 Ravenswood station in New York City be divested. Is there anything that
19 distinguishes that case from the Merger that is the subject of this proceeding?

20 A. Yes. First of all, the Ravenswood station is a very large part of the New York
21 City market, a load pocket with wholly inflexible capacity requirements. Along
22 with the other two largest generation owners in the City, the Ravenswood station

1 has always been subject to comprehensive mitigation measures. Conversely,
2 Iberdrola's affiliated wind generation is a small part of the NYISO Western
3 market which has excess supply and, significantly, is connected to other RTOs
4 that provide additional supply elasticity in the energy and capacity markets.
5 Recently, the Ravenswood station has been successful in maintaining prices in the
6 New York City capacity market above those that are consistent with the demand
7 curve, leading to an ongoing investigation into capacity market rules at FERC.
8 Maintaining higher prices in New York City by bidding capacity out of the
9 market requires a very large amount of capacity to be profitable. It requires still
10 more capacity in the statewide market.[2] Iberdrola's affiliated capacity is far too
11 limited to have any impact on the New York energy, capacity and ancillary
12 services markets and, as I describe later in my testimony, is in any event all wind-
13 powered, and therefore unpredictable and intermittent in nature (and,
14 correspondingly, accorded far less than its nameplate rating as a capacity
15 product). In addition, the Commission appears to have relied on Staff evidence
16 that the energy price that Ravenswood receives in New York City can be, and has
17 been, significantly affected by the operation of National Grid's New York
18 transmission system. I am aware of no similar evidence, or even assertions, in
19 this proceeding.

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2 The requirement that 80% of in-City load must be met from in-City resources narrows that market to only in-City capacity. Further, unlike the statewide market in which imports can be used to meet requirements, the 80% in-market capacity requirement is absolutely fixed, except for operation of the demand curve. Further, the steeper slope of the in-City demand curve in comparison to the statewide demand curve means that withholding of capacity in-City can be profitable for smaller amounts of generation.

1 In conclusion on this point, my reading of the KeySpan order is that the
2 requirement to divest the Ravenswood facility was, at least to some degree,
3 dependent on the specific facts concerning that facility and the in-City market.
4 This conclusion is reinforced by the fact that KeySpan was not required to divest
5 its Long Island (Zone K) generation, despite the fact that the Long Island
6 generation is both more megawatts than Ravenswood and a higher share of
7 generation in the market in which it is located.

8 **There Are Adequate Safeguards and Incentives In Place To Prevent the Exercise of**
9 **Vertical Market Power**

10 Q. Both Staff (at 117-19) and Mr. Younger (at 21-22) assert that the arguments you
11 made in your Direct Testimony concerning the sufficiency of NYISO, FERC and
12 Commission oversight are similar to those made by generation owners, and
13 rejected by the Commission when it issued the Policy Statement, in the mid-
14 1990s. How do you respond?

15 A. The purpose of my Direct Testimony on this subject was to demonstrate the
16 extent to which circumstances have changed since the Policy Statement was
17 issued nearly ten years ago. The general appeal to the sufficiency of regulation
18 that was made at that time, and that was addressed in the Policy Statement, is far
19 different than pointing to the track record of NYISO market oversight, the
20 developments in market rules, expansion in FERC oversight and increases in its
21 remedial authority, none of which was in evidence at that time. I agree with
22 Staff's and IPPNY's characterization of the Commission's viewpoint in 1998. It

1 is precisely my point that the facts have changed significantly since 1998, such
2 that the Commission should be comfortable with respect to the affiliation of
3 Iberdrola's extremely small amount of wind generation with Energy East.

4 Q. The Staff Panel disputes the conclusion you made in your Direct Testimony that
5 changed facts should cause the Commission to be more comfortable with the
6 vertical market power issues concerning the Merger (*see, e.g.,* at 133-35). Does
7 Staff raise substantive concerns?

8 A. Most of Staff's testimony is merely a recitation and interpretation of Commission
9 orders. This has little value concerning issues properly addressed by expert or
10 fact witnesses in this proceeding. In any case, the situation in New York in the
11 mid-1990s (of which I was a very close observer) was one in which each utility
12 owned not a few megawatts of generation, but enough to meet the substantial
13 majority of its load. Some or all were not eager to face competition or market
14 testing. It also was the case that New York had suffered through very substantial
15 cost overruns and even dead investments (*e.g.,* Shoreham) that created a strong
16 reason to separate the risks of generation ownership from regulated activities.
17 Once the State decided to restructure its electricity industry, New York also faced
18 a very difficult stranded cost calculation issue that was made more manageable if
19 assets were sold at arm's-length prices. Hence, there were many reasons for the
20 Commission to adopt a very strong policy of separating generation from
21 transmission and, still more so, from load service. Much of this motivation is no
22 longer relevant. Even the purely vertical concerns are far less, since the success

1 of retail access has eliminated or at least substantially reduced the monopsony
2 power that the utilities previously were potentially able to exercise in the
3 wholesale power market.

4 Q. What other comments does the Staff make in response to your conclusion that the
5 Merger does not raise any vertical market power issues?

6 A. Staff observes that a transmission operator has an incentive to favor any affiliated
7 generation located in the same market and to frustrate unaffiliated generation (*see,*
8 *e.g.,* at 140). Staff also provides some examples that demonstrate how the
9 planning and operation of transmission systems could affect market prices and the
10 economics of connected generators. However, several elements are missing from
11 Staff's discussion. First, NYSEG and RG&E already have affiliated generation in
12 New York, as well as long-term contracts that give them the same theoretical
13 incentive to exercise vertical market power. Despite the nearly ten years of
14 operation of the NYISO, Staff presents no instances where NYSEG or RG&E
15 have in fact behaved improperly in favoring their affiliated generation or
16 damaging competing or potentially competing generation for vertical market
17 power concerns. No intervenor in this proceeding has presented such evidence or
18 even raised any such allegation. Indeed, Staff concedes that there are substantial
19 amounts of new generation in the NYISO queue seeking to locate in the NYSEG
20 and RG&E transmission areas. If vertical market power arising from the
21 ownership of small amounts of generation were viewed by entrants as a real
22 problem, one would not expect to see this level of queue activity.

1 Second, Staff does not demonstrate, or even seek to demonstrate, that
2 Energy East's affiliation with Iberdrola will injure customers or competitors. The
3 primary section in the Staff Panel Testimony dealing with potential harms is the
4 section dealing with "deliverability" issues. The point Staff appears to be making
5 is that, under NYISO rules, deliverability matters to generation owners,
6 particularly with respect to qualifying for deliverable status in the capacity
7 market. Staff believes that, by being recalcitrant in making the transmission
8 investments necessary to make output deliverable, NYSEG and RG&E can keep
9 competing generators out of the market to the advantage of their own affiliated
10 generation. However, this is not likely. Ever since the collapse of the merchant
11 bubble in 2001-3, there have been strong incentives for a transmission owner to
12 increase rate base. The very large increase in transmission construction that is
13 occurring demonstrates that utilities find it profitable to build transmission since
14 such investments earn regulated rates of return that are regarded as profitable.
15 Owners of transmission and distribution assets also have another, less direct
16 incentive to increase (rather that decrease) the amount of new generation in the
17 energy and capacity markets serving their customers. In particular, regulators and
18 other policy makers respond to high and increasing rate levels in a number of
19 ways. One response to high costs for generation is to put downward pressure on
20 delivery tariffs by, for example, setting allowed rates of return lower. Given the
21 weakness of the incentive arising from affiliation of Iberdrola's generation with
22 RG&E and NYSEG, it takes little countervailing incentive to overwhelm any

1 incentive that such affiliation might have to increase power costs. Staff provides
2 no analysis of these competing incentives, no nexus between its concern about
3 affiliated generation and this transaction, and no evidence to support its claims.

4 Staff insists that regulation can never detect and prevent all possible
5 exercises of vertical market power (at 133-35). It is a tautology that undetectable
6 exercises of vertical market power cannot be detected, and hence cannot be
7 disciplined by market monitoring and regulation. Generally, it is both state and
8 federal policy in the U.S., and in most other market economies, that absent the
9 showing of particular harm, businesses will be allowed to pursue their perceived
10 self-interests, including decisions to combine and to engage in transactions in
11 upstream or downstream markets. If it is the policy of the Commission that no
12 vertical affiliation between transmission owners and generation is acceptable, so
13 be it. If that is not the case, then Staff has provided no basis for concluding that
14 the affiliation of Energy East with Iberdrola's miniscule generation raises any
15 market power issues.

16 **Iberdrola's Affiliated Wind Projects Will Not Have Any Adverse Impact on the**
17 **Development of Renewable Resources in the State**

18 Q Staff expresses a view that the affiliation of Iberdrola and Energy East would
19 actually reduce the amount of renewable generation in New York, because
20 potential suppliers of wind and other renewables would shy away from places
21 where there is a possible incentive for a transmission owner to exercise vertical
22 market power (at 142-44). Do you have a response?

1 A. Yes. I strongly disagree with this theory for a variety of reasons. Staff's concern
2 with respect to this generation is belied on so many bases that it is difficult to
3 recount them. First, Staff itself has pointed to a substantial queue of potential
4 renewable generation seeking to connect to the NYSEG and RG&E transmission
5 systems (at 124). If vertical affiliation between generation and transmission were
6 a significant concern for competing developers, this queue would not exist and/or
7 would quickly be dissipating (which is not occurring). Second, none of these
8 generators, nor any other potential provider of renewable energy in New York,
9 has raised any concerns with the issue that actually is involved in the Merger – the
10 new affiliation between Iberdrola's generation and NYSEG's and RG&E's
11 transmission. Even IPPNY, which seeks to condition Merger approval on Energy
12 East's divestiture of its existing, non-Merger related rate-based generation, does
13 not claim that Iberdrola's affiliated wind projects will eliminate renewable
14 competitors in New York, and does not ask that Iberdrola's affiliates be required
15 to divest those projects. Third, the size of the renewables generation queue is so
16 much larger than the likely ability of western New York to absorb wind
17 generation that even if, hypothetically, vertical concerns would discourage some
18 potential entrant generators, this would not diminish the actual feasible supply of
19 such generation. Fourth, there are excellent wind regimes in Western New York
20 in areas not served by NYSEG and RG&E – indeed, more than half of the wind
21 power in the NYISO queue is in areas not served by NYSEG and RG&E. Fifth,
22 many of the areas in which NYSEG and RG&E own transmission are also served

1 by other transmission owners, including the New York Power Authority, so that
2 competing generators wishing to locate in these areas would not necessarily have
3 to connect to NYSEG or RG&E transmission.

4 Q. Is there any significance to the fact that all of the generation in New York owned
5 by Iberdrola's affiliates is wind-powered?

6 A. Yes. As I described in my Direct Testimony, the fact that all of Iberdrola-
7 affiliated operational and planned capacity in New York is wind-powered has
8 several implications when evaluating the potential for the exercise of vertical
9 market power resulting from the Merger. The first is that wind is energy limited,
10 so that its energy and capacity value (hence, its "size" relative to vertical and
11 horizontal market power issues) is much less than its nameplate capacity. Second,
12 wind resources have unpredictable and rapidly variable output levels. Given the
13 unpredictable and intermittent nature of wind, electric energy from these projects
14 cannot reasonably be sold in NYISO's day-ahead market, in which the substantial
15 majority of New York electricity is bought and sold. If an Iberdrola-affiliated
16 project were to sell into the day-ahead energy market, it would have to assume the
17 risk of paying the unpredictable real-time price to cover the financially firm
18 energy that it sold in the day-ahead market in the quite common event that it
19 cannot produce the committed energy (*i.e.*, if the wind is not sufficient to run its
20 turbines). Instead, wind projects generally will participate in NYISO's much
21 smaller real-time market, meaning that Iberdrola's affiliated generation can have
22 no impact on day-ahead prices. Therefore, a hypothetical strategy of creating,

1 maintaining or enhancing transmission constraints tailored to the market in which
2 Iberdrola's generation is sold (*e.g.*, sudden forced outages occurring after the day-
3 ahead market closes) would have, at most, a minor impact on prices paid by New
4 York consumers.

5 In addition, these wind projects have zero fuel costs. For this reason, it
6 would be economically costly, and thus irrational and self-defeating, to withhold
7 wind-powered energy from the real-time market. Indeed, wind resources are
8 typically bid into energy markets as a price taker to ensure that they are
9 dispatched when capable of producing energy. Hence, Iberdrola's affiliated
10 generation would be ill-suited for the exercise of market power – either directly
11 through their affecting prices by their bidding strategy, or indirectly through
12 impacting transmission constraints. Significantly, the Policy Panel did not
13 address any of these points.

14 Q. The Policy Panel also asserts that Iberdrola's affiliation with Gamesa, a supplier
15 of wind turbines and other equipment could enable it to discourage competitors
16 from entering New York (at 142-43). Is this a reasonable concern?

17 A. No. Gamesa is only one of several suppliers to the wind industry. According to
18 information on its web site, its worldwide market share is about 16 percent. Since
19 it is a Spanish company, with half the Spanish market, it is unsurprising that it is
20 still less of a factor in the U.S. According to data compiled by the American
21 Wind Energy Association, it supplied only 484 MW of the 5,244 MW of wind
22 turbines installed in the U.S. in 2007.

1 **The Vertical Market Power Impact of the Merger is *De Minimis***

2 Q. Staff also disagrees with your characterization of the vertical market impact of
3 this transaction as *de minimis*, with your statement that none of Iberdrola's
4 affiliated generation is located in NYSEG or RG&E service areas, and with your
5 calculation of the amount of Iberdrola's affiliated generation (at 137-39).
6 Beginning with the *de minimis* issue, what is the basis for Staff's disputing your
7 conclusion?

8 A. I do not know, since Staff does not explain why it disputes my conclusion that the
9 impact of this transaction is *de minimis*. I based my conclusion in substantial part
10 on the fact that Iberdrola's affiliates controlled only 259 MW of wind powered
11 energy that either exists or is firmly planned to be completed. This equates to 26
12 MW of summer capacity and 78 MW of winter capacity. Staff concludes that I
13 should have counted an additional 15 MW of capacity which would add 1.5 MW
14 to summer capacity and 5 MW to winter capacity. This adjustment should not be
15 sufficient to cause Staff to dispute my conclusion that the impact of the Merger is
16 *de minimis*. Staff also focuses on all of the generation planned by Iberdrola's
17 affiliates, no matter how indefinite such plans are. Effectively, Staff treats
18 inclusion in the NYISO queue as equivalent to constructed capacity. As I noted
19 in my Direct Testimony, it is quite unlikely that all of this capacity will be built,
20 and it is not common practice to include merely planned facilities in analyzing
21 mergers. However, even if all of the capacity identified by Staff is conservatively
22 included, it amounts to only about 92 MW of summer capacity and 276 MW of

1 winter capacity and energy. Staff agrees with my conclusion that Western New
2 York is a single market and, indeed, seems to suggest that it should not be
3 considered in isolation from its links to PJM and Canada. My FERC testimony,
4 filed earlier in this docket, found that Iberdrola's affiliates' share of the Western
5 New York market was 0.4 percent. Including the additional 15 MW that Staff
6 would attribute to Iberdrola does not change this conclusion. Staff also focuses
7 on all of the planned generation interests of entities in which Iberdrola has an
8 interest, including non-controlling interests (at 137-39). As noted above, this
9 amounts to 276 MW of energy equivalent capacity and 92 MW of summer
10 capacity. In comparison, the Western New York capacity, including all planned
11 capacity as Staff has done for Iberdrola, is sufficiently large that Iberdrola's
12 existing and planned capacity is less than 1 percent of the market, and its summer
13 capacity less that half a percent of the market. These remain *de minimis* shares.

14 Q. What is the basis for Staff's conclusion that you have understated the amount of
15 Iberdrola-controlled generation (at 137-39)?

16 A. In my Direct Testimony, I included only capacity controlled by Iberdrola's
17 affiliates and excluded an equity interest equivalent to 15 MW accruing to it as a
18 result of Iberdrola's minimal investment in Electricidad de Portugal. I did so
19 because FERC focuses on control in determining the party to whom generation
20 should be attributed. Staff observes, that when considering whether affiliation
21 with Iberdrola gives Energy East an incentive to misuse its control of

1 transmission, the equity share is what matters. Even if this additional 15 MW of
2 Maple Ridge is attributed to Iberdrola, the impact is *de minimis*.

3 Staff also concludes that Iberdrola has planned facilities in the NYSEG
4 and RG&E transmission service area by reason of its indirect and non-controlling
5 ownership shares in Gamesa Energy and Horizon Wind (at 137-38). While I have
6 no reason to split hairs on this issue, my statement as made was correct. The
7 possibility that firms in which Iberdrola has a non-controlling interest may build
8 facilities in the NYSEG and RG&E transmission areas does not change it. Also,
9 as I discussed in my Direct Testimony, it is wrong to treat merely planned
10 facilities as if they were real capacity. Indeed, Staff notes that one of the two
11 facilities that Horizon Wind had planned for the region as of 2006 has since
12 disappeared from the NYISO queue.

13 **The Merger Does Not Raise Any Gas-Related Vertical Market Power Issues**

14 Q. Staff also briefly discusses Energy East's ownership of gas distribution as a
15 potential source of vertical market power (at 144). What is your response?

16 A. First of all, this issue is of little even theoretical consequence. NYSEG and
17 RG&E serve only about 150 MW of gas-fired third party generation, an amount
18 far too trivial to raise any market power concerns. Staff states that there are 314
19 MW of gas-fired generation in the NYISO queue in the NYSEG service area (at
20 144). There is no indication, however, as to whether these units plan to connect to
21 NYSEG's and RG&E's gas distribution networks, and no assurance that they will
22 be built at all. Second, this issue does not relate to the Merger, and even Staff

1 does not treat it as such. Indeed, in hypothesizing potential harm arising from gas
2 distribution ownership, Staff focuses on how Energy East could use its gas
3 distribution system to favor Carthage (at 144), a unit owned by Energy East, not
4 Iberdrola.

5 **Conclusion**

6 Q. Do you have any summary thoughts to add?

7 A. Nothing in Mr. Younger's nor the Policy Panel's testimony causes me to modify
8 the conclusions I reached in my Direct Testimony. Indeed, the only event of
9 significance that has occurred since I submitted my Direct Testimony is that
10 FERC has concluded that the Merger creates no cause for concern that it will
11 result in the exercise of either horizontal or vertical market power.

12 Q. Does this complete your rebuttal testimony?

13 A. Yes, it does.

1 MR. CANNON: I think we are ready for
2 cross-examination.
3 JUDGE EPSTEIN: Cross for this witness.
4 MR. VAN RYN: Yes, Your Honor.
5 CROSS EXAMINATION
6 BY MR. VAN RYN:
7 Q. Good morning.
8 A. Good morning, sir.
9 Q. Could you please turn to IR response IBER-357?
10 A. I don't have it with me.
11 Q. Could the Company provide that?
12 A. I have it.
13 MR. SCHWARTZ: Len, just one second so we
14 can pull it, one second.
15 MR. VAN RYN: Sure.
16 MR. CANNON: We have it.
17 BY MR. VAN RYN:
18 Q. Could you refer to question No. 3, and there you
19 state that you do not know how the output of the
20 Carthage facility is sold, correct?
21 A. That's what it says.
22 Q. You also named the owner of the facility as the
23 Energy Network; is that correct?
24 A. That is correct.

1 Q. Originally, when the Company filed its original
2 petition, the name of the owner was
3 NYSEG Energy Solutions. Could you please explain how it
4 was transferred or the discrepancy in the names?
5 A. No, I can't.
6 MR. VAN RYN: Can we make that a transcript
7 request?
8 BY MR. VAN RYN:
9 Q. You performed a detailed vertical and horizontal
10 market power analysis for the Petitioners; is that
11 correct?
12 A. I hesitate a bit. The analysis was not as
13 detailed as it might have been under FERC regulations
14 because of the di minimus nature of the overlap. With
15 that caveat I would agree.
16 Q. Why was it not necessary to know how the output
17 of the Carthage facility was sold in performing that
18 analysis?
19 A. Because I attributed it to the applicants, which
20 was the most adverse treatment of it available to me.
21 If it had been sold in such a way they could not benefit
22 from higher prices and it was sold on a long-term basis,
23 it could have been attributed to a counter-party.
24 Since I didn't do that, this was the most

adverse-to-applicants treatment I could make. It's, in that sense, conservative.

Q. I don't quite understand your comment about how, if it were sold under a long-term contract -- you mean under a long-term contract to someone else?

A. Yes.

Q. That would have changed your analysis?

A. It might have. It depends on the nature of the contract but, frequently, yes.

Q. So you did ascertain that such a contract did not exist?

A. No, I assumed it did not exist.

Q. Thank you.

MR. VAN RYN: Your Honor, I would like to make a transcript request for how the output of the facility is sold.

BY MR. VAN RYN:

Q. Can we agree that, if the Carthage facility sells into the NYISO day-ahead-of-real-time market, an increase in the price of those markets will increase the revenues it earns for its direct and indirect owners?

A. That is correct.

Q. Could you turn to IR response IBER-355.

A. I have it.

1 Q. There, you state that subsequent actions to
2 rates -- excuse me, strike that.
3 There, you state that, "Subsequent actions to
4 raise market prices will not aid RG&E in a prudence
5 review over the cost of a repowering of the Russell
6 facility."
7 Is that correct?
8 A. Just give me a moment.
9 Yes, I should note that this was in a particular
10 context, which is the presumption that there has been an
11 imprudence filing and their requirement to write down
12 the value of the plant for regulatory book purpose.
13 That's the customary way of doing things.
14 Q. You also state the opinion that, "Prudence would
15 be determined primarily based on the forecast of market
16 prices at the time the facility is built."
17 Is that correct?
18 A. In as far as forward prices are relevant to the
19 prudence determination at all, that has been the
20 customary way that it happens. That is correct.
21 Q. Assume that the forecast market prices show that
22 the cost forecast to repower the facility is prudent.
23 RG&E, therefore, proceeds with construction of the
24 facility but then the costs it incurs in building a

1 facility are much greater than forecast.
2 Do you believe that a regulator could review the
3 prudence of the cost over-runs?
4 A. The regulator can review the prudence of the cost
5 over-run or not. So regulators -- before an asset is
6 rate-based -- have the capability to determine -- and,
7 indeed, the requirement to determine--whether those
8 costs were prudently incurred. Sometimes it's done
9 without a great deal of investigation; sometimes with a
10 great deal of investigation. It's always within their
11 ability.
12 Q. Also assume that market prices have exceeded
13 those forecasts when this prudence review of over-runs
14 is conducted. Assume that, even though the cost of
15 building the facility exceeds the original forecasts,
16 those costs translate into a price for electricity from
17 the plant that is less than the higher market price that
18 also exceeds the forecast.
19 Under those circumstances, would the Company
20 argue that, even though it's been imprudent in incurring
21 excess costs to build the facility, there is no harm
22 because the costs of the facility are still less than
23 market prices?
24 A. You're asking me to speculate about what the

1 Company would argue. I don't know what the Company
2 would argue.
3 Q. Would you make such an argument?
4 A. No.
5 Q. Why not?
6 A. Because the predicate of your question --
7 although you didn't quite state it, my understanding of
8 the predicate of the question is: The over-run costs
9 were imprudently incurred, shouldn't have happened.
10 If that is the case, then those costs were
11 imprudent, irrespective of the economic value of the
12 plant.
13 Q. Could you return to -- could you turn to response
14 IBER-358?
15 A. I have it.
16 Q. And there you state that, "The overall cost of
17 the Rochester transmission project is estimated at
18 approximately $125 million."
19 Is that correct?
20 A. That's my understanding, yes.
21 Q. Subject to check, when the facility was
22 certified, the Commission in its order granting the
23 certificate set forth an estimate of about $75 million;
24 is that correct?

1 A. I don't know.
2 Q. Would you accept that subject to check by
3 reviewing the order?
4 A. Sure.
5 Q. And you also show in that IR response the cost of
6 repowering the Russell station is estimated at about
7 $420 million; is that correct?
8 A. Yes.
9 Q. Would you expect a similar cost over-run for that
10 project?
11 A. I have no opinion about that.
12 Q. Could you turn to page 16 of your rebuttal
13 testimony.
14 A. Yes.
15 Q. There, beginning at line 11, you state that,
16 "Ownership and a long-term contract for renewable power
17 are fully equivalent in terms of vertical and horizontal
18 market power concerns."
19 Is that correct?
20 A. Yes, that's what I am saying. I should have been
21 a little bit more cautious. It depends on the nature of
22 the contract.
23 Q. Would you agree that a utility that contracts at
24 a fixed price for the purchase of generation from an

1 unaffiliated generator would not have the same incentive
2 to raise market prices as a utility that owns an
3 affiliate that sells generation at market prices?
4 A. No, I wouldn't.
5 Q. Why not?
6 A. That's precisely the kind of contract that does
7 have the effective equivalent to ownership. If I have
8 the right to the power from a plant and I am paying five
9 cents a kilowatt hour for it and I control the operation
10 of that plant -- so it's a typical tolling contract -- I
11 am mixing -- I am paying say $100 a kilowatt year for
12 the plant plus variable O&M. I bring the fuel. So all
13 my terms are fixed, or conversely, I am just paying a
14 fixed price, I don't care which it is.
15 Any enhancement to the value of the output goes
16 to me, not the owner of the plant. Conversely, the
17 example of a case where it doesn't have the equivalents
18 to ownership is if I have a contract that says I get the
19 output from this plant and I pay you whatever the market
20 price is, then it does not give me an incentive to raise
21 prices.
22 But if I am getting it at a fixed price or
23 price-indexed-to-fuel or some such arrangement, then, as
24 the buyer, I am the one who gets the increased value

1 when prices are higher, not the owner.
2 So that's the key characteristic. I have the
3 equity-like interest in the enhanced value of the
4 outlook from the plant if I am the one who benefits with
5 respect to higher prices.
6 Q. Let's focus for a minute on the ownership of an
7 affiliated generator. Say there is a holding company
8 that owns a regulated utility and also owns a generator
9 that sells at market prices. If market prices rise,
10 would that holding company earn greater revenues as a
11 whole?
12 A. You haven't given me a fact to say other than,
13 yes, it would.
14 There maybe specific circumstances where it would
15 not be true, but based barely on what you said, it would
16 earn more from that unregulated affiliated generator and
17 nothing else would change. That may or may not be true
18 depending on the nature of the regulation of the
19 regulated utility. Based solely on the facts that
20 you've given me, there's an increase in profitability
21 from the unregulated affiliate and there may be no
22 off-setting decrease elsewhere.
23 Q. Now, the regulated utility buys at a fixed
24 contract price. It's not going to care what market

1 prices are because it's going to take that output and
2 merely distribute it to its ratepayers. Would you
3 comment on that scenario?
4 A. I am sorry, I don't know what you want me to
5 comment on.
6 Q. Would you agree that the utility would not care
7 what market prices were in that scenario?
8 A. So, forget about the affiliate for the moment,
9 we're just talking about the regulated utility.
10 The regulated utility buys at a fixed price. If
11 it buys at a fixed price and on-sells to its customer at
12 that same fixed price; is that your predicate?
13 Q. Not exactly the same fixed price.
14 Yes, well, flows through the fixed price from the
15 contract to ratepayers along with other rates.
16 A. Then, at a first order accounting sense of
17 things, it's indifferent as to what that price it. That
18 doesn't mean it really is, but that's the accounting of
19 it.
20 Q. Could you turn to page 23 of your rebuttal where
21 you discuss the size of the Renewables generation queue?
22 A. I have it.
23 Q. If the size of the generation queue is so large
24 that elimination of some potential entrants would not

1 diminish the overall supply that can be achieved, then,
2 if some potential entrants are, in fact, lost, there is
3 no harm to reaching the state's renewable goals; is that
4 correct?
5 A. That's not what I said.
6 Q. Could you clarify?
7 A. Sure. What I said was: It would not diminish
8 the actual feasible supply. Now, there may an effect on
9 whether that feasible supply is reached. My point here
10 is simply: There are limits on the amount of wind that
11 can be absorbed. The amount that can be absorbed is
12 almost certainly less than is in the current
13 interconnection queue. And so it is not -- it certainly
14 is not definite and may not be the case that eliminating
15 some entrant would reduce the actual amount produced.
16 But that's not what this statement says. This
17 statement says the amount that can be absorbed
18 determines what is a feasible supply, and that's a limit
19 well below the amount that's in the queue.
20 Q. Could you turn to response IBER-220?
21 A. I have it.
22 Q. There you state that vertical market power would
23 not have been an issue in State proceeding testimonies
24 that you have listed; is that correct?

1 A. You are referring to the original one, not the
2 supplemental, I presume?
3 Q. Yes.
4 A. Yes, in respect of the New York cases that have
5 been identified, best I can recollect, vertical market
6 power was not an issue in any of them.
7 Q. Just to make sure, you have never proposed
8 vertical market power mitigation measures in any state
9 proceeding that you can recall?
10 A. No, that's not the case. I don't believe I have
11 said that.
12 Q. Could you explain?
13 A. There have been vertical market power issues that
14 arose -- are they really vertical or are they
15 horizontal? That's an interesting question.
16 There have been transmission-related market power
17 issues that have arisen in some of the cases where I had
18 both federal and state testimony. And certainly in at
19 least two of them, there was transmission-related
20 mitigation that was proposed.
21 One of them was an AEP-CSW merger; one was an
22 acquisition by Oklahoma Gas & Electric of an imbedded
23 combined cycle unit. I hesitate about nomenclature
24 because my recollection is that, despite that these

1 fixes had to do with transmission and with the
2 applicants' use of transmission, the problem they were
3 solving was actually horizontal.
4 Q. Sometime, could you provide us with the case
5 numbers for those two proceedings?
6 A. Sure. You have them. It would be a matter of
7 identifying them.
8 Q. Thank you.
9 MR. VAN RYN: I have nothing further for
10 this witness.
11 JUDGE EPSTEIN: Okay. Other cross?
12 MR. JOHNSON: I have some.
13 MR. PRESTEMON: I have one question. Should
14 I do it first before I pass the microphone?
15 BY MR. PRESTEMON:
16 Q. Dr. Hieronymus, I believe at pages 10 and 11 of
17 your testimony, you described?
18 MR. CANNON: Rebuttal or direct?
19 MR. PRESTEMON: Sorry, rebuttal.
20 BY MR. PRESTEMON:
21 Q. You described the jurisdiction of the Public
22 Service Commission or the opportunities that the Public
23 Service Commission has to review vertical market power
24 issues in the context of applications for the

1 construction of generating units generally; is that
2 correct?
3 A. Yes.
4 Q. And I believe you state that, in the case of wind
5 units -- or, in fact, any alternative energy facility
6 proposed under 80 megawatts -- there is, at present, no
7 requirement that the developer obtain a certificate of
8 public convenience and necessity; is that correct?
9 A. That's my understanding, yes.
10 Q. If, as a condition of this merger, the Commission
11 were to impose a condition that would require Iberdrola
12 to obtain such a certificate for any wind power
13 development within the NYSEG and RG&E's service
14 territories, would you consider that a limitation not
15 imposed on similarly situated companies?
16 A. As you constructed the hypothetical, that would
17 be the case, yes.
18 Q. Thank you.
19 And then my obvious follow-up question is one for
20 which I don't have the right witness. Shows I can't
21 think ahead.
22 If I can make this an on-the-record request, I'd
23 like to know whether the imposition of that limitation
24 would constitute a limitation that would obviate your

1 renewable development commitment under Exhibit 50 in the
2 partial acceptance? You can answer it right now if you
3 want.
4 MR. SCHWARTZ: Dave, can you restate the
5 full question.
6 MR. PRESTEMON: My question is: If, as
7 Dr. Hieronymus says, requiring Iberdrola, as a condition
8 of this merger, to apply for a certificate of public
9 convenience and necessity for wind power projects
10 smaller than 80 megawatts would be a limitation
11 different from those imposed on other companies, would
12 Iberdrola consider that limitation that would obviate
13 its commitment under the partial acceptance to expend
14 $100 million on renewables?
15 MR. SCHWARTZ: One of the things we heard
16 yesterday was that -- we heard this in testimony from
17 Mr. Azagra -- was that Iberdrola was willing to live up
18 to all legal requirements that are generally applicable
19 in the state. So your hypothetical assumes that a
20 certificate of public convenience and necessity would
21 not otherwise be required. And the answer would be that
22 it would depend upon -- the answer would be that it
23 would depend upon what is being considered in that
24 process and, most importantly, whether your hypothetical

1 assumes that this certificate of public convenience and
2 necessity process would, in fact, be pursuant to a
3 change in regulatory policy in New York State that would
4 apply to all wind generators in the state. Because, if,
5 in fact, it would apply to all wind generators in the
6 state, it would not change our commitment.
7 MR. PRESTEMON: My question was: If it did
8 not apply to all wind generators, it applied only to
9 Iberdrola. If it was simply imposed as a condition of
10 this merger, then that would be a differential
11 obligation or differential limitation on Iberdrola.
12 MR. SCHWARTZ: One of the important pieces
13 of this puzzle is that Iberdrola at that point would
14 have to look at it and say, Are the new criteria that
15 are being imposed upon -- in this instance, it would be
16 Iberdrola Renewables -- in this process, is it
17 effectively imposing a limitation that would make the
18 bar to development so unreasonably high that it would
19 preclude Iberdrola Renewables from meeting that
20 commitment. If so, Iberdrola would not be able to
21 fulfill the 100 million minimum renewable development as
22 a result of that regulatory selective process. I think
23 the devil would be in the details of the regulatory
24 requirements on Iberdrola Renewables pursuant to that

1 certificate of public convenience and necessity
2 proceeding.
3 MR. PRESTEMON: Thank you. I guess we still
4 don't know how the story will turn out until we have a
5 final decision, but thanks.
6 BY MR. MAGER:
7 Q. Dr. Hieronymus, I just have a few quick questions
8 following up your additional direct testimony prior to
9 being cross-examined.
10 Do you recall discussing Iberdrola response
11 0008(S)?
12 A. I do.
13 Q. And that's been marked as Exhibit 57.
14 In that response, Iberdrola identified five
15 projects that, as a result of certain project
16 acquisitions and revised timing estimates, may become
17 operational within five years; do you recall that?
18 A. Yes.
19 Q. And I believe you described them as a "gleam in
20 Iberdrola's eye"; is that how you described it?
21 A. Yes.
22 Q. So that's your understanding of how Iberdrola's
23 pipeline works?
24 A. I listened to Mr. Azagra discussing this

1 yesterday, and he did not use those words and he
2 probably would even object to the words as being a bit
3 pejorative. Nevertheless, he did make it clear that
4 these are projects that have reached only a threshold
5 level of reality. There are still many, many steps to
6 go before they could become a real reality. "Gleam in
7 the eye" is not a phrase I made up for this purpose.
8 I've used it numerous times before to discuss projects
9 that are at a very low level of development.
10 Q. Do you know what steps each of these five
11 projects has passed on the list?
12 A. Not specifically, no. Obviously, since they're
13 so newly added to the list, my presumption would be
14 they've passed very few.
15 Q. But you do not know that for the fact?
16 A. I have not investigated these individually.
17 Q. I believe you said these were roughly 360
18 megawatts of power and you compared them with the
19 generating units that Iberdrola has offered to divest as
20 part of its Exhibit 50. Do you recall that decision?
21 A. Yes.
22 Q. I believe you kind of described them as kind of a
23 wash or a little impact because they went in opposite
24 directions; was that your testimony?

1 A. That was one of the things I said. I think I
2 said two things.
3 One is that the divestiture, conditional on the
4 merger being approved, is real. These additional gleams
5 in the eye may or may not be real.
6 Q. Now --
7 A. Excuse me. I wasn't finished.
8 The other thing I did say that they are
9 off-setting in the sense of going in opposite
10 directions.
11 Q. What I just wanted to make clear for the record,
12 though is that there are differences between the
13 divestiture of those plants and potential new plants --
14 and, in particular, what I am thinking of is, the plants
15 that would be divested, the ones that are owned by
16 Rochester Gas & Electric Corporation.
17 For those units, is it your understanding that
18 the revenues received from those units go back to
19 customers?
20 A. You are asking for more than I really know. I
21 know that there is such an arrangement. There are
22 aspects of it that only go through 2008, but beyond
23 that, I am not the right witness to ask about that.
24 Q. I just want to explore your knowledge a little

1 further though.
2 To your knowledge, all or a portion of the
3 revenues realized by the RG&E-owned generating units are
4 used for the benefit of RG&E's customers?
5 A. At present, yes.
6 Q. The wind development plants that Iberdrola may
7 develop -- Iberdrola Resources -- the revenues from
8 those plants would go to Iberdrola shareholders?
9 A. Iberdrola Renewables' shareholders, yes.
10 Q. Iberdrola is an 80 percent owner of that company?
11 A. That's my understanding, yes.
12 Q. Thank you.
13 MR. MAGER: Thank you. I have nothing
14 further.
15 BY MR. JOHNSON:
16 Q. Dr. Hieronymus, in your testimony, you noted that
17 there was a limitation, 3300-megawatt limitation for
18 development of wind projects in upstate New York; is
19 that correct?
20 A. I don't recall using a number.
21 Q. It was in the RPS order, which reviewed the
22 development of wind projects in upstate New York.
23 A. All I am saying is, I don't recall having said
24 that. I will accept that it is the order.

1 Q. Based on your testimony, is it true that it
2 doesn't matter how much wind Iberdrola adds upstate and
3 it doesn't matter where it is located with respect to
4 vertical market power?
5 A. I think the essence of my testimony is that, in
6 my opinion, the controls over the exercise of vertical
7 market power are so substantial that, under at least
8 most circumstances, any circumstance that I reasonably
9 can contemplate what you said would be true.
10 Now there is a lot more flesh that can be put on
11 the bones. For example, it is even more clearly true if
12 it is not attached to the Energy East Company's
13 transmission systems, albeit, I don't think that's a
14 singly important distinction.
15 There could be circumstances where Iberdrola, at
16 least in principal, could become so large in terms of
17 what it owned as to exercise market power irrespective
18 and independent of and unrelated to anything related to
19 this merger. Anything related to RG&E or NYSEG or their
20 transmission system. If you make it open-ended enough,
21 I could make Iberdrola awfully big and awfully important
22 in the New York power market.
23 I don't think that's plausible, but as a purely
24 hypothetical matter, if they were to build 60,000

1 megawatts of new generation and drive out everything
2 that had positive fuel costs, it would be an interesting
3 system.
4 Q. In preparing your testimony in this case, did you
5 review the Public Service Commission's September 17,
6 2000 order approving the merger of National Grid and
7 KeySpan?
8 A. I think you gave me the wrong date.
9 Q. 2007.
10 A. I read parts of it. I don't think I read the
11 whole order.
12 Q. Did you read the part concerning vertical market
13 power and the reasons why the Commission --
14 A. Yeah, I think I did. Not in the context of this
15 proceeding, but because I was working for KeySpan on
16 unrelated matters.
17 Q. Do you agree that the divestiture of KeySpan's
18 Ravenswood facility was required to address vertical
19 market power concerns?
20 A. That's my reading of the order. I note, however,
21 that the divestiture of the bulk of KeySpan's generation
22 was not required.
23 Q. Do you agree with the result?
24 A. You mean, do I agree with their having required

it?

Q. Do you think it was required?

A. Do I think that divestiture of Ravenswood was required to solve the vertical market power problem?

Q. That is correct.

A. No. I think it's utter nonsense. I say that with all respect to the Commission, but -- for it to be a vertical issue -- now, there may have been other reasons why the Commission wanted Ravenswood divested, but from a vertical standpoint, to say that a generation unit in Zone J has to be divested because it's becoming affiliated with some wholly-external transmission system, makes no sense to me.

Now, if you say, I don't want it to be affiliated with a gas distribution system. Or, I don't want it to be affiliated with all the other generation that KeySpan owned. Or, I just don't like KeySpan as an owner because of the way it bids that into the New York City capacity market.

I think there are lots of other reasons the Commission might have wanted it done. But I think, frankly, the notion that it was vertical is pretty thinly defended. The only thing in the order that made it a vertical issue at all was a reference to what I

1 believe was some Staff testimony that asserted that the
2 use of National Grid's transmission system could affect
3 prices in Zone J. And to the best of my recollection,
4 there was no analysis supporting that assertion
5 whatever.
6 MR. JOHNSON: That's all I have, Your Honor.
7 Thank you.
8 JUDGE EPSTEIN: Any other cross for
9 Dr. Hieronymus? Redirect?
10 MR. CANNON: Can we speak with the witness
11 for a few minutes.
12 (Brief discussion.)
13 MR. CANNON: We have just a couple
14 questions.
15 REDIRECT EXAMINATION
16 BY MR. CANNON:
17 Q. Dr. Hieronymus, in your response I believe it was
18 to Mr. Johnson's question about, hypothetically, if
19 Iberdrola were to construct a number of megawatts in
20 New York, would that raise any vertical market power
21 concerns regardless of what the size of that was. I
22 believe you referred to the fact that -- or the
23 hypothetical that some of this generation could be
24 interjected to the NYSEG RG&E service territories. I

1 believe you said, "It would not be singly significant."
2 Could you explain what you meant?
3 A. Sure.
4 My point simply was: There are obviously -- from
5 this docket, it's quite apparent -- some people think
6 that the fact of being connected to the RG&E or NYSEG
7 transmission systems is worrisome from a vertical market
8 power standpoint. I don't agree with that but it would
9 make it more transparently -- it would eliminate that
10 concern. Despite I think that concern is not valid, in
11 my opinion, this is not a particularly important fact
12 but it would be even more obvious that it wasn't a
13 vertical issue to everybody, including those people who
14 are concerned if they weren't so connected.
15 Q. Can you explain why you think the concern is not
16 valid?
17 A. As I testified at some length, I think the
18 controls over -- the control over the transmission
19 system is always relevant to vertical market power and
20 rests in the main with New York ISO, and to the extent
21 that they are not fully covered that way they are
22 back-stopped by a quite Draconian capability at FERC to
23 impose penalties and whatever additional penalties this
24 Commission might impose on the basis of misbehavior.

1 Q. In response to a question from Mr. Mager with
2 respect to who benefits from the sale of certain assets,
3 the shareholders or Iberdrola Renewables, could you
4 provide clarification on that?
5 A. I think the comparison I was asked to make was
6 between assets for which the value currently goes to
7 customers versus Iberdrola Renewable assets for which
8 the value goes to its shareholders. And I answered
9 correctly, but the inference, I think, that could be
10 drawn from that is incorrect.
11 What's left unsaid in that comparison is that,
12 first of all, as I understand the testimony yesterday,
13 and as I understand New York precedent generally, the
14 value of selling the assets itself will flow to
15 customers. So they are being compensated for the loss
16 in the future value at least as the market evaluates
17 that loss through getting the net proceeds of sale.
18 Secondly, with respect to the Iberdrola
19 Renewables assets, the benefit that flows to customers
20 and indeed from New York State generally from having the
21 renewables is there, but certain customers are entitled
22 to no further benefit from them because they're not
23 putting up the money. The money is not theirs. Unlike
24 the cases arguably with respect to the other assets

where it is a regulatory asset for the benefit of customers. These are no different than if it were Enron Wind--that's a bad example--West Wind building the new wind generation.

MR. CANNON: No further questions, Your Honor.

JUDGE EPSTEIN: Further cross.

RECROSS EXAMINATION

BY MR. MAGER:

Q. Dr. Hieronymus, you answered a series of questions on redirect concerning the simultaneous ownership of generation and transmission; do you recall those questions?

A. Yes.

Q. Let me pose a hypothetical.

Let's say a transmission and distribution utility develops, say, 1,000 megawatts of generation upstate. Can you think of any ways that that utility, if it wanted to, could exercise market power?

A. I need a whole lot more.

Q. I am asking you to use your imagination, Doctor. If a utility owns the wires and it owns substantial generation, in what ways could it possibly exercise vertical market power?

1 A. Now you are asking me a hypothetical which is
2 very general about the exercise of vertical market power
3 by a T&D utility.
4 Q. Yes. That's a hypothetical.
5 A. I think the Commission has, in its Vertical
6 Market Power Statement, properly identified the areas of
7 concern, which are the frustration of entry and imposing
8 costs on rivals and treating affiliates
9 discriminatorily.
10 Those are the hypothetical concerns. That's what
11 this Commission and FERC and the New York ISO spent the
12 last ten years creating regulatory devices to make sure
13 those things don't happen, not merely here but
14 elsewhere.
15 Q. Isn't one of the devices the New York Commission
16 has used is to divert the generation?
17 A. That's a device that they put in place back in
18 1998 under the circumstances that existed.
19 Q. And they used it last year in the last big merger
20 case, right?
21 A. I think I addressed that as best I could. They
22 required the divestiture of a unit for a variety of
23 reasons and they made reference to the vertical market
24 power statement in support of that. That's as far as I

1 can take it.
2 MR. MAGER: Thank you. Nothing further.
3 JUDGE EPSTEIN: Anything else?
4 MR. CANNON: No further questions.
5 JUDGE EPSTEIN: Thank you, Doctor. You are
6 excused.
7 Mr. Johnson?
8 MR. JOHNSON: I would like to call
9 Mr. Mark Younger.
10 MARK YOUNGER, after first having been duly
11 sworn, was examined and testified as follows:
12 DIRECT EXAMINATION
13 BY MR. JOHNSON:
14 Q. Can you please state your name and address for
15 the record?
16 A. Mark David Younger. 69 Werking Road, East
17 Greenbush, New York, 12061.
18 Q. Do you have before you a 25-page document with a
19 cover page entitled "Direct Testimony of Mark D.
20 Younger"?
21 A. I do.
22 Q. Was this testimony prepared by you or under your
23 supervision?
24 A. It was.

1 Q. Do you have any changes to it?
2 A. No.
3 Q. Are the answers given true and correct to the
4 best of your knowledge?
5 A. They are.
6 Q. If I asked you the questions posed in your
7 testimony, would your answers be the same as if given
8 under oath?
9 A. Yes.
10 MR. JOHNSON: I ask that the testimony of
11 Mr. Younger be copied into the record as if orally given
12 today.
13 JUDGE EPSTEIN: Yes.
14 (The following is the prefiled testimony of
15 Mark Younger:)
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DIRECT TESTIMONY OF MARK D. YOUNGER

1 **Q. Please state your name, address and current position.**

2 A. My name is Mark D. Younger. I am employed as Vice President of Slater Consulting.
3 My business address is 69 Werking Road, East Greenbush, New York 12061.

4 **Q. Please briefly describe your educational background.**

5 A. I received a Bachelor of Science degree in Engineering in 1981, a Master of Engineering
6 degree in Operations Research in 1983, and a Master of Business Administration degree
7 in 1983, all from Cornell University.

8 **Q. Please summarize your background.**

9 A. My entire professional career has been devoted to matters relating to electric generation
10 and the development of competitive electricity markets. For the past ten years, I have
11 been an active participant in the working groups refining the New York Independent
12 System Operator, Inc. ("NYISO") market structure and developing methods to improve
13 the market design, including all aspects of its energy, ancillary services and capacity
14 markets. My resume is attached hereto as Exh__(MDY-1).

15 **Q. Have you previously testified before the New York State Public Service Commission**
16 **("Commission")?**

17 A. Yes. I have testified in a number of proceedings at the Commission. Most recently, I
18 submitted testimony in the Commission's proceeding on the merger of National Grid
19 PLC ("National Grid") and KeySpan Corporation ("KeySpan"), addressing how the
20 terms proposed in the Joint Proposal that had been executed by a subset of parties in that
21 case would adversely impact the wholesale competitive electricity market in New York in
22 Case 06-M-0878.

DIRECT TESTIMONY OF MARK D. YOUNGER

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

2 A. My testimony demonstrates why the Commission should condition any order approving
3 the proposed acquisition (the "Transaction") of Energy East Corporation ("Energy East")
4 by Iberdrola, S.A. ("Iberdrola," together with Energy East, "Petitioners") upon: (i) the
5 filing with the Commission by Petitioners of their process to auction Rochester Gas &
6 Electric Corporation's ("RG&E") Russell Station site to an unaffiliated third party, in
7 accordance with the commitments RG&E made to do so in Case 03-T-1385,[1] which shall
8 include a detailed time line with milestones, including their commitment to complete the
9 sale of the Russell Station site within nine months of the Commission's ruling on the
10 Transaction; (ii) a commitment by Petitioners that they will divest all of their other
11 existing cost-based rate regulated electric generating facilities, and they will not construct
12 or otherwise acquire an ownership interest in any electric generation in New York that
13 will be subject to cost-based rate regulation, unless otherwise ordered by the
14 Commission; and (iii) a commitment by Petitioners that they will not construct or
15 otherwise acquire any ownership interests in other electric generating facilities located in
16 RG&E's and New York State Electric & Gas Corporation's ("NYSEG") respective
17 service territories.

18 My testimony demonstrates that Energy East's publicly announced proposal to repower
19 Russell Station with a 300 MW gas-fired electric generating facility directly contravenes
20 RG&E's commitment to the Commission to auction Russell Station to an unaffiliated
21 entity upon the completion of its Rochester Transmission Project ("RTP"). My testimony

[1] *See* Case 03-T-1385, *Application of Rochester Gas and Electric Corporation for a Certificate of Environmental Compatibility and Public Need for the Construction of the "Rochester Transmission Project," Approximately 38 Miles of 115 Kilovolt Transmission Lines in Multiple Municipalities of Monroe and Wayne Counties* (hereinafter "RTP Proceeding").

1 also demonstrates why RG&E's proposal to repower Russell Station and Petitioners'
2 ownership of other generation in RG&E's or NYSEG's service territories or any rate-
3 based generation in New York as a whole would improperly skew the wholesale markets,
4 and thus, violate the Commission's long-standing policies to separate the generation
5 function from the transmission and distribution ("T&D") function to ensure a fair and
6 efficient competitive wholesale electricity market in New York.

7 **COMMISSION POLICIES TO SEPARATE GENERATION FROM T&D**

8 **Q. Please describe the Commission's policies to separate generation from T&D.**

9 A. In its seminal opinion issued in 1996 to introduce competitive electric markets in New
10 York State, the Commission adopted its policy endorsing, *inter alia*, the creation of a
11 competitive wholesale generation market.[2] In Opinion 96-12, the Commission
12 determined that competitors would have a greater incentive to lower costs than utilities
13 under a cost of service regulatory regime which would inure to the benefit of New York's
14 consumers.[3] The Commission also recognized in its Opinion 96-12 that the most
15 efficient means of selecting new resources is via the competitive market. Indeed, as
16 expressly stated by the Commission, one of the primary benefits of competitive
17 electricity markets is that investment risks are shifted from captive utility ratepayers to
18 private investors. The Commission stated that divestiture would help create a larger
19 number of competing generating companies, which would result in a dynamic and

[2] Cases 94-E-0952 *et al.*, *In the Matter of Competitive Opportunities Regarding Electric Service*, Opinion and Order Regarding Competitive Opportunities for Electric Service, Opinion 96-12 (May 20, 1996) at 32 ("Opinion 96-12").

[3] Opinion 96-12 at 30.

1 aggressive market.[4] The Commission therefore strongly encouraged the T&D utilities to
2 divest their generation facilities.

3 **Q. Have the Commission's pro-competition policies been effective in providing benefits**
4 **to consumers?**

5 A. Yes. Competitive markets have produced significant benefits to consumers. In fact,
6 identifying New York's wholesale markets as "the most complete and efficient set of
7 electricity markets in the U.S.," Dr. David Patton, the NYISO's independent market
8 advisor, found in his State of the Markets Report issued earlier this year that "[t]he
9 NYISO markets continue to deliver substantial benefits to the States' consumers by
10 meeting its demands at the lowest cost."[5] Similarly, in its March 2, 2006 report on the
11 state of competitive electricity markets, the Department of Public Service ("DPS") Staff
12 concluded that "New York's wholesale markets are among the most advanced in the
13 nation and that wholesale competition has led to significant efficiencies."[6] DPS Staff
14 found that the inflation adjusted price of electricity for a typical residential customer in
15 New York dropped by an average of approximately 16% between 1996 and 2004.[7]

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[4] *Id.* at 65.

[5] 2006 State of the Markets Report, New York Electricity Markets (May 2007), presentation to the NYISO Management Committee Meeting, May 21, 2007, at 3.

[6] New York State Department of Public Service Staff Report on the State of Competitive Energy Markets: Progress to Date and Future Opportunities (March 2, 2006) at 2.

[7] *Id.*

1 **Q. How does shifting investment risks of new generation from captive utility ratepayers**
2 **to private investors benefit consumers?**
3 A. Merchant developers must rely on the market to earn sufficient revenues to cover their
4 costs and to earn potential revenues, forcing them to be more efficient than regulated
5 utilities when making investment decisions and conducting their operations. As DPS
6 Staff observed, competitive markets have benefited consumers by improving the
7 availability of the State's generating facilities, which has led to lower installed reserve
8 margins and lower energy prices.[8] In addition, when a utility recovers the costs of new
9 infrastructure through cost-of-service rate regulation, ratepayers can be required to pay
10 the costs of significant cost overruns that they would otherwise not bear if the
11 infrastructure were built by private developers. For example, the construction of the East
12 River Repowering Project ("ERRP") by Consolidated Edison Company of New York,
13 Inc. ("Con Edison") resulted in more than $350 million of cost overruns that ratepayers
14 are now obligated to pay.[9] If the project had been developed by a developer on a purely
15 merchant basis, consumers would not be required to pay more than the market value for
16 the facility, and the developer would have been forced to absorb the uneconomic cost
17 overruns. Another example of cost overruns is RG&E's own RTP. At the time the
18 Commission granted the certificate of environmental compatibility and public need to
19 RG&E to construct the RTP, RG&E projected the capital cost of the RTP to be

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[8] *Id.* at 16.

[9] *See* Case 05-S-1376, *Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc., for Steam Service*, Direct Testimony of Con Edison witness Victor Gonnella, Exhibit VG-2 (testifying that at the time Con Edison submitted its Article X application, Con Edison estimated the cost of the ERRP to be $406 million) and Order Determining Revenue Requirement and Rate Design (September 22, 2006) at 6 (capping cost recovery for ERRP at $788.3 million)

1 approximately $75.4 million.[10] In response to information request IBER-0211, RG&E
2 stated that the most current estimate of all costs of the RTP is approximately $125
3 million, a 60% increase from its initial estimate.

4 **Q. Were there other reasons why the Commission encouraged the T&D utilities to**
5 **divest their generation facilities?**

6 A. Yes. In Opinion 96-12, the Commission found that in a wholesale or retail competitive
7 model, generation and energy service functions should be separated from T&D to prevent
8 the exercise of vertical market power ("VMP"). The Commission determined that total
9 divestiture of generation was a clear way to allay concerns about VMP and avoid anti-
10 competitive behavior (such as cross-subsidies among affiliates in both competitive and
11 monopoly environments, and favored treatment of affiliates).[11]

12 **Q. Has the Commission defined VMP?**

13 A. Yes, in 1998, the Commission issued its VMP policy statement.[12] The Commission
14 stated: "Vertical market power occurs when an entity that has market power in one stage
15 of the production process leverages that power to gain advantage in a different stage of
16 the production process. A transmission and distribution company (T&D company) with
17 an affiliate owning generation may, in certain circumstances, be able to adversely
18 influence prices in that generator's market to the advantage of the combined operation."[13]

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[10] Case 03-T-1385, Rochester Gas and Electric Corporation, Order Granting Certificate of Environmental and Public Need (December 16, 2004), Appendix B at 13.

[11] *Id.* at 64-65.

[12] Case 96-E-0900 *et al., In the Matter of Orange & Rockland Utilities, Inc.'s Plans for Electric Rate Restructuring Pursuant to Opinion 96-12*, Appendix I, Statement of Policy Regarding Vertical Market Power (July 17, 1998) ("VMP Statement").

[13] *Id.* at App. I, p. 1.

1 **Q. Please describe the Commission's policies to address VMP.**

2 A. The first paragraph of the VMP Statement summarizes the Commission's findings:

> 3 In creating a competitive electric market, the Commission has viewed
> 4 divestiture as a key means of achieving an environment where the
> 5 incentives to abuse market power are minimized. Recognizing that
> 6 vigilant regulatory oversight cannot timely identify and remedy all abuses,
> 7 it is preferable to properly align incentives in the first place.[14]

8 Given the adverse impacts that would result from the exercise of VMP on both the
9 continued development of competitive markets, and concomitantly, consumers, the
10 Commission established later in the VMP Statement that the proponent of a proposal to
11 own both transmission and generation would face a very high hurdle in its Section 70
12 proceeding, namely, it must overcome the rebuttable presumption that such dual
13 ownership would unacceptably exacerbate the potential for VMP. The Commission
14 stated:

> 15 To guard against undesirable incentives, a rebuttal [sic] presumption will
> 16 exist for purposes of the Commission's Section 70 review of the transfer
> 17 of generation assets, that ownership of generation by a T&D company
> 18 affiliate would unacceptably exacerbate the potential for vertical market
> 19 power. To overcome the presumption the T&D company affiliate would
> 20 have to demonstrate that vertical market power could not be exercised
> 21 because the circumstances do not give the T&D company an opportunity
> 22 to exercise market power, or because reasonable means exist to mitigate
> 23 market power. Alternatively, the T&D company would need to
> 24 demonstrate that substantial ratepayer benefits, together with mitigation
> 25 measures, warrant overcoming the presumption.[15]

26 **Q. What forms of VMP did the Commission identify in its VMP Statement?**

27 A. The Commission identified the potential for VMP when: 1) company owned generation
28 was in the same market as the T&D company; and 2) company owned generation was on

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[14] *Id.*

[15] *Id.* at 1-2.

1 the high side of a transmission constraint. In the first instance, the concern was that the
2 T&D company could use its control of the T&D system to favor its own generation or
3 thwart its competition either by lowering competitors' revenues or raising their costs. In
4 the second instance, the concern is that the T&D company could use its control of the
5 transmission system to increase constraints and raise the value of its generating assets.

6 **Q. Did the Commission specify how to protect against VMP?**

7 A. Yes. The Commission found that structural separation of generation assets from T&D
8 assets was preferable to relying upon regulatory controls and enforcement mechanisms.
9 Separating ownership of generation from ownership of T&D avoids the potential for
10 abuse.[16]

11 **Q. Did the T&D companies divest their generating capacity as a result of their**
12 **restructuring cases?**

13 A. All of the T&D companies except RG&E divested virtually all their regulated non-
14 nuclear generating capacity as a result of the restructuring cases. Con Edison continued
15 to own a small subset of its generating capacity but this was necessary to allow it to
16 provide steam to its steam system. In other cases the T&D companies were allowed to
17 retain small amounts of generation that were either needed for reliability or were thought
18 to have too small a value to be worth divesting. For example, NYSEG retained a single
19 7.4 MW gas turbine and slightly more than 100 MW of hydro facilities.

20 **Q. Why wasn't RG&E required to divest its generation as a result of its restructuring**
21 **case?**

[16] *Id.* at 3.

A. A primary reason that RG&E was allowed to continue owning generation was due to the characteristics of its generating fleet. At the time of its restructuring, most of RG&E's capacity consisted of full ownership of the Ginna nuclear power plant, partial ownership of Nine Mile Point 2 and two relatively old coal fired power plants. Specifically, at the time of the restructuring it was expected that RG&E would either shut down or divest most of its facilities shortly. In its order approving RG&E's restructuring plan, the Commission stated:

> RG&E has stated that it will transition out of its wholly-owned fossil and hydro generation over the next several years. The company plans to retire or otherwise remove Ginna Station from rate base when its license expires in 2009, and prior to that Ginna Station and Nine Mile 2 are subject to a statewide resolution of nuclear plant ownership and ratemaking. In view of the relatively short remaining lives on much of the company's generation, the pending resolution of nuclear plant issues, and the incentive to divest plants, functional separation of RG&E's existing operations is accepted.[17]

Q. Why was much of RG&E's generation seen as having short remaining lives?

A. Apart from its ownership of nuclear assets, which were being addressed outside the restructuring agreements, RG&E's single biggest facility was its Russell Station generating facility, an older, coal-fired facility that has never been retrofitted with environmental controls to address NO_x and SO_2 emissions. For this reason, in discussing the Russell Station in support of the need for the RTP in the RTP Proceeding, the Commission found that "[t]he Russell Station must be either taken out of service and repowered by 2008 to comply with environmental (acid deposition reduction)

[17] Case 96-E-0898, Opinion and Order Adopting Terms of Settlement Subject to Conditions and Changes, Opinion No. 98-1. (January 14, 1998) at 40.

1 requirements, sold, or shut down."[18] In the RTP Order, the Commission then cited
2 RG&E's commitment to auction the Russell Station upon the RTP's completion.[19]
3 **Q. Since it issued its VMP Statement, has the Commission applied its VMP Statement**
4 **to require divestiture of utility generation?**
5 A. Yes. As recently as just four months ago, the Commission reaffirmed its position on
6 VMP issues. In its order addressing the National Grid/KeySpan proposed merger issued
7 on September 17, 2007, the Commission conditioned approval of the merger upon, *inter*
8 *alia*, National Grid's agreement to divest KeySpan's 2,450 MW Ravenswood generating
9 facilities.[20] In establishing this condition, the Commission noted, "[f]or more than 12
10 years, this Commission has taken numerous actions to develop competitive markets for
11 generation products in New York. The long-term goal is that customers should be able to
12 obtain generation products by paying prices resulting from a fully competitive generation
13 market in lieu of regulated prices (or rates) based on the costs of generation."[21] Finding
14 other alternatives insufficient to adequately address VMP concerns, the Commission
15 held: "We agree with IPPNY and others that a decision by us to rely solely on regulatory

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[18] *See* Case 03-T-1385, Order Granting Certificate of Environmental Compatibility and Public Need (December 16, 2004) (hereinafter "RTP Order") at 5.

[19] *Id.*

[20] Case 06-M-0878, *Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and Other Regulatory Approvals*, Order Authorizing Acquistion Subject to Conditions and Making Some Revenue Requirement Determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (September 17, 2007) (hereinafter "Grid/KS Merger Proceeding").

[21] Case 06-M-0878, Order Authorizing Acquisition Subject To Conditions And Making Some Revenue Requirement Determinations For Keyspan Energy Delivery New York And Keyspan Energy Delivery Long Island (hereinafter "National Grid/Keyspan Merger Decision") at 128.

solutions would signal and in fact would amount to a weakening of our resolve to ensure a competitive generation market and its attendant benefits."[22]

Q. Have there been other cases where the Commission has addressed its pro-competitive market policies and reaffirmed its position that the generation function should remain separate from the T&D function?

A. Yes. The Commission recently reaffirmed its policy that competitive markets are the most efficient means to procure needed resources and that generation should be separate from T&D in its order issued just three weeks ago, holding:

> We also reiterate our often repeated policy, as a number of parties requested, supporting competitive markets and market mechanisms, where feasible, as the most efficient means to serve the public interest. As we have said, competitive markets wholesale and retail, where feasible, help ensure the provision of safe and adequate service at just and reasonable rates.[23]

Q. Did the Commission address the construction of new facilities in its ERP Order?

A. Yes. Noting that consumers would continue to derive substantial benefits with limited exposure, the Commission recognized that long-term contracts may be a component to go forward with merchant projects to "temper the risk of entry for generators and render financing more available."[24] The Commission also expressly limited the role to be played by the utilities in this regard, holding:

> However, allowing Transmission Owners to construct regulated generation would shift 100 percent of investment and operating risks back to consumers, eliminating a large portion of the benefits we achieved for

[22] *Id.* at 134.

[23] Case 07-E-1507 *et al.*, Proceeding on Motion of the Commission to Establish a Long-Range Electric Resource Plan and Infrastructure Planning Process, *Order Initiating Electricity Reliability And Infrastructure Planning* (December 24, 2007) (hereinafter "ERP Order") at 4-5.

[24] *Id.* at 23.

> the public in our restructuring efforts. In addition, utility generation ownership raises serious concerns regarding vertical market power. While it would not be prudent to conclude that utility construction and operation of power plants would never be in the public interest, the Commission is not anxious to foist upon customers all of the risks we removed in creating competitive markets.[25]

DISPOSITION OF RG&E'S GENERATION ASSETS

Q. Did RG&E dispose of its nuclear assets as expected in its restructuring case?

A. Yes, RG&E sold its part ownership of Nine Mile Point 2 to Constellation Energy Group ("Constellation") in 2001. Constellation acquired the Ginna nuclear power plant from RG&E in 2004.

Q. Did RG&E dispose of its non-nuclear units as expected in its restructuring case?

A. Most of RG&E's non-nuclear capacity was comprised of its Beebee and Russell Station coal plants. RG&E's 80 MW Beebee plant was retired in 1999. Its 253 MW Russell Station is scheduled to be retired in the second quarter, 2008 upon the completion of the RTP. With the shutdown of Russell Station, RG&E will continue to own slightly less than 55 MW of hydro units, 38 MW of gas turbines and a 67 MW combined cycle unit.

Q. Why wasn't Russell Station disposed of earlier?

A. Russell Station was needed to support the transmission system in the Rochester area. RG&E pursued the RTP to "ensure adequate, reliable service to the Rochester area following the closing of the Russell generating station."[26]

Q. Did RG&E make any commitments regarding Russell Station as part of getting the RTP proposal approved?

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[25] *Id.*

[26] RTP Order at 3.

1 A. Yes. As cited by the Commission in the RTP Order, RG&E expressly committed in an
2 information request response to "follow an appropriate competitive auction process with
3 a goal of the sale of the Russell Station site to a non-affiliated entity."[27] This
4 commitment was then embodied in the Joint Proposal that was accepted by the
5 Commission in the RTP Order.[28] Their only condition was that the actual transfer of
6 ownership would have to occur after the RTP was completed. RG&E stated in response
7 to information request IBER-0210 that the RTP is currently scheduled to be completed in
8 the second quarter of 2008.

9 **Q. Given the pendency of the RTP's completion, has there been any indication that**
10 **RG&E is actively pursuing the auction of the Russell Station site as it committed to**
11 **the Commission that it would do in its RTP Proceeding?**

12 A. No. To the contrary, by all appearances, RG&E intends to attempt to repower Russell
13 Station itself notwithstanding its express commitments to the Commission.

14 **Q. Please describe RG&E's current plans regarding Russell Station.**

15 A. Despite its agreement to auction the site to a non-affiliated entity, RG&E has publicly
16 announced plans to repower the Russell Station. In a March 19, 2007 press release,
17 Energy East (parent company to RG&E) announced that it was planning to invest $500
18 million for repowering Russell Station using clean coal technologies. A May 2, 2007
19 Energy East press release announced that RG&E had informed the NYISO that it planned
20 to build a new 300 MW plant at the Russell Station site. At this point, the proposal was
21 for either a clean coal or a gas combined cycle facility. An Energy East June 25, 2007

[27] *Id.* at 5.

[28] RTP Order, Joint Proposal at 30.

1 press release announced that Iberdrola had reached an agreement to acquire Energy East.
2 One of the benefits touted for the merger in the press release was that "IBERDROLA will
3 also bring construction expertise to Energy East's plans to repower the Russell generating
4 station."

5 **Q. Has RG&E publicly proposed to go forward with its Russell Station repowering**
6 **project?**

7 A. Yes. RG&E proposed its Russell Station repowering project to the NYISO as a regulated
8 backstop solution to meet a reliability need identified in the NYISO's 2007 Reliability
9 Needs Assessment ("RNA").

10 **Q. Please describe the NYISO's planning process.**

11 A. Pursuant to the NYISO's Comprehensive Reliability Planning Process ("CRPP"), the
12 NYISO directs a transmission owner to develop a regulated backstop solution to meet a
13 reliability need identified in the RNA if no merchant development has come forth in time
14 to meet the need. If the NYISO orders a transmission owner to meet a reliability need,
15 the costs of the transmission owner's regulated backstop solution are recovered through
16 regulated, cost-based rates.

17 **Q. Did the NYISO choose RG&E's Russell Station repowering project to meet the**
18 **reliability need identified in the 2007 RNA?**

19 A. No. In its 2007 Comprehensive Reliability Plan, the NYISO did not choose RG&E's
20 Russell Station repowering project because other merchant and reliability backstop
21 solution projects were available to meet the reliability need.

1 **Q. Notwithstanding the fact that the Russell Station repowering regulated backstop**
2 **proposal was not triggered by the NYISO, has RG&E taken any steps to repower**
3 **Russell Station?**
4 A. Despite the NYISO's determination that the Russell Station repowering project is not
5 needed to meet the reliability need, RG&E is actively pursuing the interconnection of this
6 new facility to the transmission system. RG&E has filed an interconnection request with
7 the NYISO to interconnect a 300 MW natural gas fired combined cycle facility at the
8 Russell Station site. Before its interconnection request can be granted, a project must
9 complete a System Reliability Impact Study ("SRIS") to determine the impacts of the
10 new interconnection on the transmission system. The SRIS study scope for the Russell
11 Station repowering was approved by the NYISO's Operating Committee on November
12 30, 2007.
13 **Q. How does RG&E plan to recover its costs for the repowered Russell Station?**
14 A. RG&E indicated in response to information request IBER-0214 that "any costs associated
15 with the project are being treated as capital costs" and that RG&E intends to recover such
16 costs through regulated cost-based rates.
17 **Q. Is it appropriate for RG&E to recover costs from ratepayers associated with its**
18 **Russell Station repowering project?**
19 A. No. RG&E's intent to recover the costs from ratepayers is inconsistent with the
20 Commission's directives to avoid regulated generation in the ERP Order and its
21 commitments to the PSC to auction the site. RG&E has not received any authorization to
22 take any steps to repower Russell Station. It is inappropriate for ratepayers to bear any of
23 the costs RG&E has incurred and continues to incur with respect to the Russell Station

1 repowering project particularly where, as here, RG&E has committed to the Commission
2 to auction the Russell Station site to an unaffiliated third party, the NYISO has not
3 determined that the project should be triggered to meet a reliability need and the
4 Commission has not found that it would be in the public interest to proceed with this
5 alternative to address reliability needs.

6 **Q. How would a generating facility subject to cost-based rate recovery impact electric**
7 **customers and the competitive markets?**

8 A. Customers would be at risk for the potential that they will pay for an uneconomic project.
9 In response to DPS Staff Information Request # 74 (IBER-130S), attached as
10 Exh__(MDY-2), the company provided a redacted estimate of the overall costs and
11 market value for the first five years of its operation for the repowering of Russell Station
12 as a combined cycle facility. The results show that by RG&E's own estimation, its costs
13 would be higher than the market value of the facility, and thus, RG&E ratepayers would
14 be worse off than if RG&E did not repower the facility.

15 There is also a significant risk that RG&E's initial estimates significantly understate the
16 cost of the project and the uneconomic costs that are ultimately borne by ratepayers are
17 much worse than currently estimated by RG&E. The recent experience with both Con
18 Edison's ERRP and with the RTP show the potential for costs to ultimately be much
19 higher than the utility originally estimated. There was also numerous cost overruns on
20 generation facilities before restructuring. In addition, the competitive markets are
21 harmed by regulated generation because the addition of the uneconomic generation
22 artificially depresses the market clearing price from competitive levels. This artificially
23 reduces the prices to the merchant generators that rely upon market revenues to cover

1 their costs and return on costs. The potential for regulated subsidized entry also raises the
2 risk faced by existing and future merchant facilities, and this raises their costs to the
3 customers' ultimate harm.

4 **VERTICAL MARKET POWER CONCERNS**

5 **Q. What are the key VMP concerns in this proceeding?**

6 A. The key concern is that Petitioners would use their control of the RG&E and NYSEG
7 T&D systems to thwart competition. As I discussed previously, the Commission was so
8 concerned about this potential threat that it imposed the rebuttable presumption that
9 ownership of generation by a T&D company affiliate would unacceptably exacerbate the
10 potential for vertical market power. To overcome the presumption, the T&D company
11 affiliate would have to demonstrate that vertical market power could not be exercised
12 because the circumstances do not give the T&D company an opportunity to exercise
13 market power.

14 **Q. Have Petitioners attempted to rebut the presumption that their ownership of**
15 **generation would unacceptably exacerbate the potential for vertical market power?**

16 A. Yes. Dr. William Hieronymus filed testimony on behalf of Petitioners in an attempt to
17 demonstrate that the Transaction would not allow Petitioners to exercise vertical market
18 power. In sum, Dr. Hieronymus claims that the Commission's VMP Statement has been
19 superseded by changes in the electric industry in New York in the past 10 years and that
20 reasonable means exist to mitigate market power.[29] Many of the arguments that Dr.
21 Hieronymus made regarding the protections against VMP were also raised a decade ago
22 when the Commission was developing its VMP Statement. The Commission's

[29] Direct Testimony of William H. Hieronymus (November 28, 2007), Case 07-M-0906 at 8.

1 conclusion then that it is better to remove the incentive than to rely upon regulatory
2 protections continues to hold today.

3 **Q. Did Dr. Hieronymus rebut the VMP presumption with respect to Petitioners'**
4 **ownership of existing or future facilities in NYSEG's or RG&E's service territory,**
5 **including the Russell Station repowering project?**

6 A. No. Dr. Hieronymus analyzed potential vertical market power concerns solely with
7 respect to Iberdrola's ownership interests in wind energy projects located in Niagara
8 Mohawk Power Corporation's service territory.

9 **Q. Did Dr. Hieronymus address the Russell repowering project in his testimony?**

10 A. No. Dr. Hieronymus asserted that continued ownership of this facility was not relevant
11 for addressing VMP issues because it is not being transferred in the merger.[30] In doing
12 so, Dr. Hieronymus wholly ignores the fact that RG&E previously had committed to
13 auction this site upon the RTP's completion. Since the current Russell Station coal
14 facility will be retired with the completion of the RTP regardless of whether it is
15 ultimately repowered, the repowering of the site is essentially a new generation addition
16 and must be reviewed in that context. In addition, Dr. Hieronymus wholly fails to
17 address the concerns that this Commission has repeatedly identified that support the need
18 to structurally separate the generation and T&D functions.

19 **Q. Why should all existing and future generating projects owned by RG&E and**
20 **NYSEG be considered in determining whether there are VMP concerns?**

21 A. The continued ownership of the existing facilities provides an ongoing incentive to
22 exercise VMP to favor the existing facilities. Future regulated facilities provide an even

[30] *See* Hieronymus Testimony at 21.

1 greater incentive to exercise VMP as the company sees the potential to increase its rate
2 base.

3 **Q. Please explain how Petitioners could exercise VMP with respect to facilities located**
4 **in RG&E's and NYSEG's service territories.**

5 A. There are several ways in which Petitioners could favor their facilities in their service
6 territories and make competition more difficult. For example, they could make it easier
7 for their own facilities to interconnect to their transmission systems while making it
8 harder for their competitors to do so. The operation of the generating facilities require
9 ongoing interaction between the generators and the local T&D company to resolve issues
10 related to operation and delivery. If the T&D company also owns generation, there will
11 always be the potential that issues related to its own generators are resolved faster than
12 the same issue for merchant generators and/or that the T&D company finds cheaper ways
13 of resolving issues for the company's own generation than for its competitors. Since
14 each issue with each generator is unique, it will be virtually impossible to determine
15 whether the T&D company is treating all generation in a fair and equivalent manner.
16 There is also the potential that the company could schedule its transmission outages so
17 that it favors its own generation over its competition. While transmission owners must
18 schedule maintenance outages with the NYISO, the NYISO has no control over what
19 maintenance projects the transmission owners either propose or actually perform.
20 Petitioners could use transmission outages to financially harm their competitors while
21 benefiting their own facilities. Transmission outages can cause significant financial harm
22 to a merchant generator as evidenced by the current complaint filed at the Federal Energy
23 Regulatory Commission ("FERC") by R. E. Ginna Nuclear Power Plant, LLC ("Ginna")

against RG&E regarding Ginna's lost revenues associated with transmission outages during the RTP construction.[31] Finally, they could use the NYISO planning process to give their own proposed generation development favored treatment.

Q. Is Dr. Hieronymus correct that the Commission's VMP statement has been superseded by changes in the electric industry in New York in the past 10 years?

A. No. The Commission rejected the same argument offered by KeySpan/Grid's witnesses when it directed the divestiture of the Ravenswood plant. The need for the Commission's VMP policy statement still stands. The fundamental problem that the exercise of VMP will be difficult to detect and protect against remains, and it is better to remove the opportunity rather that to attempt to rely upon regulatory protections.

Q. Is Dr. Hieronymus correct that reasonable means exist to mitigate market power?

A. No. The Commission addressed this very issue when it approved the VMP Statement a decade ago. At that time it stated:

> While the utilities are correct that regulatory controls and enforcement mechanisms exist, the degree to which these mechanisms can be effective is subject to debate. For example, the ISO can recommend, and FERC or this Commission can direct, that a utility reinforce its transmission system. That utility, however, must go through the siting process for authorization, and its role as a possibly reluctant sponsor could introduce complexities and delays in the process. It is also difficult for regulators to detect an inappropriate failure to act when critical information resides with the T&D utility. . . .
>
> The task of uncovering vertical market power abuses would remain with the regulator. Such regulation is likely to be costly and create conflict. It is preferable to avoid the incentive for abuse unless there are demonstrable efficiency gains and adequate mitigation procedures. It is that demonstration which a purchasing utility could make in rebutting the presumption in a particular case.[32]

[31] *See* FERC Docket No. EL07-77-000.

[32] VMP Statement at 3.

1 These are the same arguments that that were raised by the petitioners in the National
2 Grid/KeySpan Merger case. In rebutting these arguments, DPS Staff stated:

> 3 This is simply a reiteration of the arguments that were raised by the
> 4 utilities, and rejected by the Commission, at the time of the Commission's
> 5 VMP Statement. The Commission did not say "if we had a better idea of
> 6 how NYISO operations would work," or "if only FERC penalties were
> 7 larger," then it would be satisfied with a behavioral rather than structural
> 8 solution. Rightfully, the Commission said that it was concerned that
> 9 "vigilant regulatory oversight cannot timely identify and remedy all
> 10 abuses"; that, even when regulators order a utility to reinforce its
> 11 transmission system, that "utility, however, must go through the siting
> 12 process for authorization, and its role as possibly reluctant sponsor could
> 13 introduce complexities and delays in the process"; and that "it is also
> 14 difficult for regulators to detect an inappropriate failure to act when
> 15 critical information resides with the T&D utility."[33]

16 In the National Grid/KeySpan Merger case, the Commission once again rejected the
17 argument that regulatory controls were sufficient and instead directed that the Keyspan
18 Ravenswood assets be divested.

19 **Q. Are the concerns described by the Commission in its VMP Statement still relevant**
20 **in this proceeding?**

21 A. Yes. While there are some regulatory controls to attempt to address the interconnection
22 process and operation of the transmission system, the problem remains that it is very
23 difficult to differentiate between actions that are part of normal and appropriate
24 operations and those that are part of a VMP strategy. As DPS Staff testified in the
25 National Grid/KeySpan Merger case, "there are innumerable ways a utility could
26 undermine any long run goals and processes to improve transmission flows without
27 producing 'smoking gun' type evidence that would allow us to find them financial [sic]

[33] *See* New York State Department of Public Service Merger Policy Panel Testimony, Case 06-M-0878 *et al.* at 138-139

1 liable.[34] The T&D utility holds all the information that would be necessary to attempt to
2 determine whether the utility's actions were an exercise of VMP. The developments over
3 the last ten years have not changed this fundamental problem. While there is the
4 potential to raise a dispute related to most, if not all, of the potential issues related to
5 VMP, the problem with these remedies is that it costs money for a market participant to
6 pursue the remedy. Those costs alone can be another barrier to competition.

7 **Q. In the VMP Statement, the Commission left open the possibility that a T&D**
8 **company could continue to own generation if it could demonstrate that substantial**
9 **ratepayer benefits, together with mitigation measures, warrant overcoming the**
10 **presumption that ownership of generation by a T&D company affiliate would**
11 **unacceptably exacerbate the potential for vertical market power. Has the company**
12 **demonstrated substantial ratepayer benefits?**

13 A. No. As addressed above, the company's own analysis of the Russell Station repowering
14 shows that it is expected to have costs that exceed its market value.

15 **Q. Is this surprising?**

16 A. No. Rochester is on the low price side of most of the transmission constraints in New
17 York. All of the new generation that has been built in the last decade has been in the
18 eastern and southeastern part of the State so that it can capture the higher value of the
19 market in those areas presented by higher load growth and transmission constraints. The
20 generation that is being added pursuant to New York's Renewable Portfolio Standard
21 ("RPS") program is an exception. In that case, the generation is being added where it can
22 best take advantage of the wind and water resources. In contrast the Independence

[34] *Id.* at 154.

1 Facility, a state of the art combined cycle facility also located on the low price side in
2 Oswego, only averaged a 20% capacity factor for 2006. Moreover, virtually all the
3 renewable energy that is being added in the State is in the west and north. Most of the
4 renewable generation will likely be bid into the NYISO's energy markets at very low or
5 $0 levels consistent with its zero cost "fuel." The repowered Russell Station must
6 compete with this generation for transmission capability to get to the load in the eastern
7 and southeastern parts of the state. The benefit of building more combined cycle
8 capability in Western New York in the face of the current and projected market forces is
9 far from obvious.

10 **Q. Do Petitioners have any particular capability or expertise that would enable them to**
11 **provide substantial ratepayer benefits by repowering the Russell Station compared**
12 **to what the market can provide?**

13 A. No. There are numerous companies that are capable of building and operating generation
14 resources. More than 6,000 MW of proposed generating projects are identified in the
15 NYISO's interconnection queue. Petitioners do not have any apparent capability that
16 would indicate that they could do it better or cheaper than these other companies.

17 **Q. Are there any reliability reasons that dictate that RG&E alone should be permitted**
18 **to repower the Russell facility?**

19 A. No. RG&E has invested over $125 million to construct the RTP to resolve all of the
20 issues to allow its system to operate reliably without Russell Station. To the extent issues
21 remain notwithstanding that significant investment or they are forecasted to recur in the
22 future, they can be adequately addressed through contracts with the new owner of the site
23 or by pursuing non-generation solutions to the reliability problem. For example, when it

1 divested its generating assets, NYSEG, RG&E's sister company, executed the Milliken
2 Operating Agreement to address voltage issues in the Ithaca area. Likewise, capacitor
3 banks have been installed in New York State to address voltage problems.

4 **Q. Accepting that Energy East has failed to cross the first threshold of demonstrating**
5 **substantial ratepayer benefits, are there sufficient regulatory controls and**
6 **enforcement mechanisms available to address the VMP concerns?**

7 A. No. The regulatory controls fail to address the underlying incentive. As addressed
8 above, the problem with attempting to rely upon regulatory controls is that forcing market
9 participants to assure a level playing field by using the regulatory protections raises the
10 competitors costs. It is also difficult to differentiate between actions that are attempts to
11 exercise VMP and costs that result from legitimate differences.

12 **Q. What action should the Commission take to protect against VMP in this case and to**
13 **ensure the development of the most efficient resources?**

14 A. As the Commission concluded a decade ago and reaffirmed just four months ago, rather
15 than attempting to rely on regulatory controls and enforcement mechanisms, structural
16 separation of generation and T&D is the best means to remove all opportunity for
17 exercises of VMP and to ensure that investment risks are borne by private investors and
18 not captive utility ratepayers. In furtherance of these policies, the Commission should, if
19 it approves the Transaction, direct Petitioners to:

20 1) file with the Commission its process to auction Russell Station which shall
21 include a detailed time line with milestones, including a commitment to complete the sale
22 of Russell Station within 9 months of the Commission's order;

1 2) commit to divest all of their other existing regulated electric generating facilities
2 and to not construct or otherwise acquire an ownership interest in any electric generation
3 in New York that will be subject to cost-based rate regulation, unless otherwise ordered
4 by the Commission; and
5 3) commit to not construct or otherwise acquire any ownership interests in other
6 electric generating facilities located in RG&E's and NYSEG's respective service
7 territories.
8 **Q. Does this conclude your testimony?**
9 A. Yes, at this time.

1 BY MR. JOHNSON:
2 Q. Do you have two exhibits to your testimony?
3 A. Yes.
4 Q. A one-page resume and a five-page interrogatory
5 response, IBER-013(S)?
6 A. 0130(S).
7 Q. Is the information contained therein true and
8 accurate, to the best of your knowledge?
9 A. The resume is. The other one is definitely a
10 data response. I don't know whether it's true and
11 accurate. It wasn't my response.
12 MR. JOHNSON: Your Honor, I ask that the
13 exhibits identified be marked for identification.
14 JUDGE EPSTEIN: 76 and 77.
15 (Exhibits 76 and 77 marked for
16 identification.)
17 MR. JOHNSON: He's available for cross but
18 there is no cross.
19 MR. GERGEN: Good morning, Your Honor. My
20 name is Michael Gergen from Latham & Watkins. I'd like
21 to present our next witness, Eugene T. Meehan.
22 EUGENE T. MEEHAN, after first having been
23 duly sworn, was examined and testified as follows:
24 DIRECT EXAMINATION

1 BY MR. GERGEN:
2 Q. Mr. Meehan, could you please state your name and
3 address for the record?
4 A. My name is Eugene T. Meehan. The address is 1255
5 23rd Street Northwest, Washington DC, 20037.
6 Q. Thank you.
7 Mr. Meehan, do you have before you a 40-page
8 document of questions and answers entitled "Rebuttal
9 Testimony of Eugene T. Meehan" dated January 31, 2008?
10 A. Yes.
11 Q. Was that document prepared by you?
12 A. Yes.
13 Q. Do you have any corrections or changes to your
14 rebuttal testimony?
15 A. I have one correction. On page 38, line 3, there
16 is a number 5.14 percent and that number should be 5.47
17 percent.
18 Q. Thank you.
19 If I were to ask you the questions set forth in
20 your rebuttal testimony, would your answers be the same
21 as set forth in the testimony as corrected?
22 A. They would.
23 Q. Do you adopt this as your sworn rebuttal
24 testimony in this proceeding?

EUGENE T. MEEHAN

I. QUALIFICATIONS, PURPOSE, AND CONCLUSIONS

Q. Please state your name and business address.

A. My name is Eugene T. Meehan. I am Senior Vice President at National Economic Research Associates ("NERA"). My business address is 1255 23 St. NW, Washington, DC 20037.

Q. Please summarize your professional qualifications.

A. I have over twenty-five years of experience consulting with electric and gas utilities. That work has involved examination and advice on many issues related to power markets, power contract design, fuel and purchased power procurement and hedging, competitive bidding and contract evaluation. For the past ten years, I have been extensively involved in advising clients on restructuring-related issues, including risk analysis, risk management, power plant and power contract valuation, and post-transition regulatory issues.

I have been involved in power procurement activities for a variety of utilities and regulatory agencies. I have advised utilities in developing and implementing evaluation processes for new generation, with the objective of achieving the best portfolio evaluation. I have helped regulators in Ireland and Canada design and implement portfolio evaluation processes.

I have performed many assignments that require financial and economic analysis. I have advised electric utilities on economic evaluations of generation and transmission expansion, testifying on the economics of particular investments, the

1 prudence of planning processes, and the prudence of particular investment decisions.
2 I have advised utilities and utility Boards of Directors with respect to merger
3 evaluations and assessment of merger candidates.

4 In the past few years, I have advised several utilities with respect to the
5 acquisition of power from third parties. These assignments have involved the review
6 of power contract offers made by competitive power marketers and owners of
7 generation assets. Additionally, I have testified several times with respect to the
8 prudence of utility planning and power procurement.

9 I have testified on utility regulatory matters before a variety of state commissions,
10 including numerous appearances before the State of New York Public Service
11 Commission (the "Commission"). I have also testified before the Federal Energy
12 Regulatory Commission, arbitration panels, and Federal District Courts. My
13 curriculum vitae is attached as Exhibit___(ETM-1).

14 Q. Will you briefly describe the nature of NERA's business?

15 A. NERA is a firm of over 500 professional economists located in offices throughout the
16 United States, Europe, Asia and Australia. NERA provides consulting advice in
17 litigation and regulatory settings, as well as strategic and planning advice to clients in
18 the energy, telecommunications, television and broadcasting, securities,
19 transportation, health and banking industries.

20 Q. What is the purpose of your testimony?

1 A. IBERDROLA, S.A. ("Iberdrola") has announced its offer to acquire Energy East
2 Corporation ("Energy East") (this transaction is referred to as the "Proposed
3 Transaction"). Energy East is the parent company of two public utility companies in
4 New York—New York State Electric & Gas Corporation ("NYSEG") and Rochester
5 Gas and Electric Corporation ("RG&E")—both of which are regulated by the
6 Commission with respect to their electric and gas utility operations.

7 The purpose of this rebuttal testimony is to respond to the prepared testimony
8 submitted by Commission Staff, and, in particular, the testimony of the Staff Policy
9 Panel,[1] and to explain that the Proposed Transaction provides net benefits to
10 ratepayers in New York.

11 Q. Does your testimony address Staff's responses to information requests related to the
12 Policy Panel's direct testimony addressing the issues discussed in your testimony?

13 A. Yes, but not specifically. I have received and reviewed several responses by Staff to
14 information requests related to the Staff Policy Panel Testimony, but I have not
15 specifically addressed any of these responses in my rebuttal testimony. Additional
16 analysis will be required to review and possibly specifically address many of Staff's
17 responses as there was insufficient time to complete my review in the time provided
18 to submit my testimony. I further note that in certain responses, Staff has indicated

[1] Prepared Testimony of Thomas A. D'Ambrosia, Patrick J. Barry, Maynard Bowman, Michael Salony, and Stephen A. Berger on behalf of the State of the New York Department of Public Service, Case 07-M-0906, (Jan. 2008) ("Staff Policy Panel Testimony").

1 that it intends to revise certain exhibits, and I will be prepared to modify my rebuttal
2 testimony at hearing to address any changes to Staff's exhibits.
3 Q. What conclusions have you drawn?
4 A. I conclude that:
5 ▪ The Proposed Transaction is a first-mover, geographic extension merger and
6 therefore the typical sources of merger savings—*e.g.*, reductions in officers,
7 staff and administrative expenses—are not present. This is not to say that the
8 merger will not bring real benefits to New York and New York customers; it
9 is only to say that these benefits are not quantifiable or immediate.
10 ▪ In New York, a number of non-synergy mergers have been found to be in the
11 public interest without the imposition of up-front rate concessions that are not
12 related to the net benefits provided by the merger. This transaction should be
13 held to a comparable standard.
14 ▪ A close analogue to the Proposed Transaction was the acquisition of United
15 Water Resources ("UWR") by Lyonnaise American Holding, Inc. ("LAH"),
16 which is now part of the Suez Environment division of the Suez Group
17 ("Suez"). This was a first-mover, non-synergy transaction in which a local
18 utility was acquired by a foreign holding company. Like this Proposed
19 Transaction, the UWR/LAH case did not involve synergies, and yet the
20 conditions imposed in that case were determined to be sufficient to protect
21 consumers without requiring up-front rate decreases or write-offs, or requiring

1 rate reductions that were not based on synergies achievable within the
2 regulated utility.
3 ▪ The financial, technical and managerial resources that Iberdrola and Energy
4 East bring together would provide benefits to utility customers in New York
5 over the longer term. These benefits would become apparent over time and
6 could be taken into account in future rate cases. The Proposed Transaction can
7 also be expected to enhance economic development in the State of New York,
8 and thereby benefit the entire State, not just utility customers.
9 ▪ The Staff Policy Panel alleges that there are various harms that might flow
10 from the merger. Dr. Makholm, Mr. Fetter, and the Joint Petitioners' Policy
11 Panel ("JPPP"), as well as other Iberdrola and Energy East witnesses, address
12 allegations of risk (harm) from the merger and explain that these concerns are
13 misplaced.
14 ▪ While the Staff Policy Panel ascribes $1.68 billion of merger benefits to
15 Iberdrola and others (Exhibit___(PP-20)), these purported benefits are
16 conjectural in nature and have nothing to do with the cost of service of Energy
17 East's operating utilities in New York. Benefits of this type are an
18 inappropriate basis for rate concessions. I explain the problems with the Staff
19 Policy Panel's analysis of merger savings, which include:

1 – None of the benefits identified by the Staff Policy Panel have anything
2 whatsoever to do with NYSEG/RG&E efficiency gains that result
3 from this merger. Ratepayers are entitled to share in the benefits that
4 result from more efficient utility operations in New York, but cannot
5 expect to "reach up" to share in benefits that are at the holding
6 company level.
7 – Most of the purported benefits are highly speculative in light of
8 regulatory and other uncertainties (e.g., the potential goodwill-related
9 tax benefits at the holding company level, which are not known and
10 measurable at this time).
11 – A portion of the purported benefits have nothing at all to do with the
12 merger (e.g., the attempt to capture the benefits, if any, of renewable
13 tax credits).
14 – The attempt to quantify benefits by reference to costs incurred by
15 Iberdrola's shareholders is logically flawed. These are costs that are
16 being incurred to make the Proposed Transaction happen. Even if one
17 were to subscribe to the view that any benefit to the acquiring entity
18 should be shared with ratepayers, it is only sensible to share net
19 benefits in excess of the costs of achieving the benefit. The Staff
20 Policy Panel's attempt to characterize costs incurred by Iberdrola's

1 shareholders to achieve the Proposed Transaction as a "benefit" makes
2 no sense,

3 ▪ The Staff Policy Panel's attempt to compare the Proposed Transaction to an
4 asset sale (*i.e.*, to the sale of the Ginna plant) is inapt. The basic ratemaking
5 principle is that ratepayers pay a utility for regulated services but do not own
6 the company. In other words, ratepayers may have "paid for" an asset that was
7 in rate base and may be entitled to a share in the benefits/costs of selling that
8 asset and taking it out of rate base. But a utility holding company's stock price
9 is never in rate base. Just as ratepayers would not share in a decline in the
10 value of the stock of a holding company, they would also not be entitled to
11 share in the benefits/costs of the sale of that stock by shareholders. In this
12 case, there is no change. Before and after the transaction, NYSEG and RG&E
13 were/are regulated operating utilities in New York State. No regulated assets
14 are sold and nothing is taken out of rate base.

15 ▪ Because this is a geographic extension merger that is not anticipated to result
16 in synergies, the write-off, reserve, rate decrease, and other ratemaking issues
17 that have been raised by Staff are not directly relevant to approval of this non-
18 synergy transaction.

1 ▪ While Staff suggested that the Commission's order ("NG/KS Merger Order")[2]
2 addressing the National Grid/KeySpan ("NG/KS") merger should be used as a
3 benchmark for the Proposed Transaction, the NG/KS merger is not directly
4 comparable to the Iberdrola/Energy East transaction. Prior to acquiring
5 KeySpan, National Grid had acquired the former New England Electric
6 System in early 2000, followed by the acquisition of Eastern Utilities
7 Associates in the same year. In early 2002, National Grid acquired Niagara
8 Mohawk—doubling the size of its U.S. operations. Thus, the NG/KS merger
9 was not a first-mover transaction, and care is needed in any comparison to that
10 merger.
11 ▪ While the NG/KS merger was not a first-mover transaction, I show how the
12 non-synergy rate concessions, *i.e*, what was referred to as rate mitigation, of
13 the NG/KS merger can be calculated and compared to the Proposed
14 Transaction in a much more accurate manner than the comparison set forth by
15 the Staff Policy Panel.

16 **II. SYNERGY AND NON-SYNERGY MERGERS**

17 Q. In New York, merger benefits have been classified as "synergy" or "non" synergy.
18 Please discuss.

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[2] Commission, *National Grid, PLC, Order Authorizing Acquisition Subject to Conditions and Making Some Revenue Requirement Determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island*, Joint Petition of National Grid PLC and KeySpan Corporation, Case 06-M-0878 (Sept. 17, 2007).

1 A. I have reviewed New York Commission orders, issued over the past 10 years,
2 approving merger transactions involving Commission-regulated utilities. I have found
3 that there is a clear line of demarcation between what I will call "synergy" mergers
4 and "non-synergy" mergers.
5 Synergy mergers provide quantifiable and immediate benefits resulting from
6 combined utility operations. All of these mergers have involved acquiring entities that
7 already had significant utility operations in the U.S.
8 Non-synergy mergers also provide benefits to ratepayers but those benefits are not
9 quantifiable or immediate. The Commission has approved a number of non-synergy
10 mergers, taking care to identify the non-quantifiable but real benefits of the merger
11 and to assure that no harm comes to consumers.
12 Q. How are synergy mergers analyzed?
13 A. For synergy mergers, a study is done that compares the utility's costs after a merger
14 with the costs that the utility would have experienced *but for* the merger. Then, costs
15 that are necessary to achieve those merger benefits are deducted to provide net
16 merger benefits. These net merger benefits are then shared between customers and the
17 utility in a rate plan. Absent a rate plan, the benefits of synergy mergers would flow
18 to customers in the normal rate case process. The purposes of rate plans are both to
19 provide for rate stability during the term of the rate plan and to provide a mechanism
20 that allows the utility to share in the benefits of its efficiency-enhancing actions
21 during the term of the rate plan.

1 The methodology for calculating merger-enabled savings must begin with a
2 reasonable benchmark against which to measure the utility's actual performance. To
3 determine what would have happened absent the merger, a factual-counterfactual
4 analysis is necessary. This analysis compares the outcomes under the scenario that
5 was or will be chosen, with the results that likely would have been produced if
6 another scenario had been chosen. When conducting such "what if" analyses, it is
7 very important that realistic assumptions be used. The problem of establishing an
8 appropriate counter-factual, which reflects what would have occurred but for the
9 merger, is one that regulatory agencies face frequently. These analyses focus on the
10 utility's costs because those are the costs that are used to set utility rates.
11 Q. Is the Proposed Transaction a synergy merger?
12 A. No, it is not. Typically, synergy mergers provide immediate and quantifiable
13 opportunities to reduce costs through combined operations, for example, by
14 consolidating administrative resources. The potential efficiencies that can result from
15 a synergy merger include economies of scale, scope, and learning that benefit
16 consumers. Economies of scale, scope, and learning are generally achieved by
17 spreading fixed costs over a larger volume of output or a broader complement of
18 services. The term "economies of scale" refers to reductions in the average cost of a
19 product in the long run, resulting from an expanded level of output. The term
20 "economies of scope" refers to economies that result from the expanded range of a
21 firm's operations—*i.e.*, cost savings that result from simultaneous production of

1 several different outputs in a single enterprise, as contrasted with their production in
2 isolation by separate firms. If economies of scope or scale are present, different
3 functions of a production process can be provided most efficiently by the same
4 organization. Finally, the term "economies of learning" can be thought of as the
5 cumulative economies of scale and scope that result from discovering, evaluating, and
6 gaining experience with best practices throughout the combined firm.

7 The Proposed Transaction is not a synergy merger because Iberdrola does not
8 currently own regulated utility assets in the U.S. For geographic extension (first
9 mover) mergers, it is particularly important to recognize the limited opportunities to
10 immediately realize synergies. While a geographic extension (first mover) merger can
11 provide efficiencies, those benefits are necessarily limited in nature and take time and
12 effort to realize. Therefore, Staff's efforts to identify synergistic benefits and capture
13 a share of these purported benefits for New York ratepayers are misplaced.

14 Non-synergy mergers, such as the Proposed Transaction, may still provide
15 economies of scale, scope or learning, but they either are not immediately realized or
16 quantifiable at the time of Commission review and approval. To the extent that such
17 benefits are realized, however, the Commission could flow such benefits to ratepayers
18 in normal rate cases in the future.

19 Q. Has the Commission previously approved non-synergy mergers?

20 A. Yes. As discussed above, I have reviewed merger cases before the Commission over
21 the past ten years. In this review, I identified a number of non-synergy mergers

1 approved by the Commission which provided benefits that were either not
2 quantifiable or not immediate, including transactions and mergers involving
3 United/Aquarion (C. 07-W-0176), United Water NY/United Water South County (C.
4 06-W-0131, C. 06-W-0244), Philadelphia Suburban (C. 02-W-1447), Long Island
5 Water/American Water Works/Thames (C. 01-W-1949), Aquarion/NY American (C.
6 01-W-1770), and UWR/LAH (C. 99-W-1542). Notably, I am not aware of any non-
7 synergy mergers that have included up-front rate reductions, though several of the
8 mergers resulted in rate stay-outs of 1-3 years. An analysis of these non-synergy
9 transactions therefore shows that modest benefits over time and the absence of harm
10 are sufficient for approval of "first-mover" mergers—*i.e.*, Commission approval is
11 not dependent on quantifiable synergistic benefits.
12 Q. Can you discuss in detail an example of a non-synergy merger previously approved
13 by the Commission?
14 A. Yes. One relevant precedent that I would like to highlight is the transfer of stock of
15 UWR to LAH, the U.S. investment arm of Suez, a French holding company.[3]
16 Q. How did the Commission evaluate this non-synergy merger?
17 A. The Commission took a balanced view of this transaction, recognizing that the
18 potential for long-term benefits on one hand combined with the Commission's ability

[3] Commission, *United Water Resources, Inc., Order Approving Stock Acquisition*, Joint Petition of United Water Resources, Inc., and Lyonnaise American Holdings, Inc., Case 99-W-1542 (July 27, 2000) (as modified by Errata Notice issued August 1, 2000).

1 to set rates, monitor affiliate transactions and ensure quality of service on the other
2 resulted in positive net benefits.

3 Many of the objections raised in the UWR/LAH merger are analogous to the
4 objections raised here by Staff: objectors claimed that a foreign parent would lack
5 local knowledge and sensitivity; that the transaction would jeopardize the financial
6 integrity of UWR; that affiliate transactions would result in the cross-subsidization of
7 foreign holdings; and that the prospect for traditional benefits was limited. Objectors
8 asserted that the merged entity would have the incentive for either "excessive" rates
9 or "draconian" efficiency measures at the expense of customers and employees. Some
10 opponents also claimed that a portion of the stock purchase price should be used to
11 offset rates.[4]

12 The Commission found the opponents' views "unpersuasive,"[5] noting that, even if
13 any of these concerns should eventually prove to be well-founded, UWR would still
14 be regulated under the Commission's jurisdiction. In addition to the one-year rate
15 freeze agreed to by UWR, the Commission pointed to the retention of local
16 management and the fact that UWR was not seeking recovery of any transaction costs
17 as important benefits.[6] The Commission said:

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[4] *Id.*, pp 7-9.

[5] *Id.*, p. 9.

[6] *Id.*, pp. 8-9.

1 The public interest standard under § 89-h is satisfied here because
2 SLDE—one of the world's largest water distribution and treatment
3 companies—can provide enormous technological and financial assets to
4 help the subsidiary meet precisely those unique local challenges cited by
5 the opponents.[7]

6 The Commission went on to state that:

7 United Water will remain a fully regulated commodity and service
8 provider, subject to our jurisdiction—and under local management,
9 according to the proponents' representations—in case there emerges some
10 reason for concern about the company's ability or willingness to maintain
11 safe and adequate service and conduct its affiliate transactions on an arms'
12 length basis.[8]

13 Rather than turn down the merger, the Commission recognized that, given the
14 extent of its authority over regulated utilities in New York, it could protect utility
15 customers from harm if some unanticipated threat to customers were to emerge in the
16 future.

17 This example serves to show that: (1) the Commission has previously approved
18 first-mover geographic extension mergers that lack quantifiable synergy savings; and
19 (2) the Commission has ample experience in regulating utilities with foreign parent

[7] *Id.*, p. 7.

1 companies and can exercise its regulatory tools to ensure that no harm comes to New
2 York ratepayers. The Commission should apply the same standards here.
3 Q. Some non-synergy cases involve water utilities. Why are water utilities relevant to
4 this proceeding?
5 A. While the Staff Policy Panel focused exclusively on electric utility mergers, the
6 Commission has experience with non-synergy mergers in the water utility industry
7 that is applicable to the Proposed Transaction. Large-scale foreign companies have
8 been active in purchasing U.S. utilities, including utilities in New York, reflecting a
9 worldwide trend towards consolidation in utility ownership, as well as significant
10 developments in various industries in the U.S.
11 The U.S. water industry faced important challenges in the late-1990s. The existing
12 plant and equipment of many water utilities needed to be upgraded in order to meet
13 new Federal regulations on clean water standards: the U.S. Environmental Protection
14 Agency estimated that the 20-year infrastructure needs related to Safe Water Drinking
15 Act ("SWDA") compliance totaled about $151 billion in 1999 dollars.[9] Aging water
16 transmission and distribution infrastructure and the need to meet customer demand
17 for water distribution service (with sprawl-type development resulting in longer
18 distribution lines and lower customer density) presented major challenges to the U.S.

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[8] *Id.*, p. 8.

[9] *Drinking Water Needs and Infrastructure: Hearing Before the Subcomm. on Environment and Hazardous Materials of the H. Comm. on Energy and Commerce*, 107th Cong. 140 (Mar. 28, 2001) (statement of Janice A. Beecher, Beecher Research Policy, Inc.).

1 water utility industry. The American Water Works Association (an industry group)
2 estimated that 20-year water needs totaled about $366 billion in 1999 dollars.[10]
3 In various orders (for example, addressing the UWR/LAH and Long Island
4 Water/American Water Works/Thames transactions), the Commission recognized that
5 large foreign water companies were well suited to use their expertise and knowledge
6 acquired from operating utilities internationally to generate additional value from
7 existing operations. Plainly, the electric utility industry today faces its own set of
8 challenges. In the electric and gas utilities industries, the Proposed Transaction is the
9 first geographic extension (first mover) merger that has come before the Commission.
10 Even though the Commission lacks precedent addressing geographic extension
11 mergers in the electric and gas industries, the Commission can rely on its experience
12 in the water utility industry—where acquisitions of water utilities by foreign water
13 utility companies have become commonplace.
14 I would note that I have also reviewed recent acquisitions of U.S. gas and electric
15 utilities by foreign companies. In 2001, for example, the large German utility, E.ON,
16 acquired Louisville Gas and Electric Co. ("LG&E") and Kentucky Utilities Co.
17 ("KU") through its acquisition of PowerGen PLC.[11] Although this was a non-synergy
18 merger and there were no quantifiable synergy savings associated with the merger,

[10] *Id.*, p. 141.

[11] Commonwealth of Kentucky Public Service Commission, Order in the Matter of Joint Application for Transfer of Louisville Gas and Electric Company and Kentucky Utilities Company in Accordance with E.ON AG's Planned Acquisition of *PowerGen* PLC., Case 2001-104 (Aug. 6, 2001).

1 the merger was found to be in the public interest due to the managerial and technical
2 expertise E.ON would bring to Kentucky.[12] It is also my understanding that ratepayer
3 benefits have been realized as E.ON has pursued cost reductions through the sharing
4 of information on "best practices" as part of coordination initiatives.[13] These
5 initiatives and examples of cross-company sharing are consistent with what one
6 would expect out of a geographic extension merger: there would initially be no
7 obvious synergy benefits but, with time, management would be able to identify cost
8 saving opportunities that could be passed down to ratepayers through normal rate
9 proceedings.

10 I would further note that one of the fundamental tenets of utility regulation is the
11 development and application of a consistent set of standards by which conduct and
12 transactions are to be evaluated. This approach affords predictability to those who
13 come before the Commission with matters that are similar in nature to those that have
14 gone before. I also find that the water company cases, and, in particular, the language
15 from the UWR case quoted above, are consistent with the traditional approach the
16 Commission has taken to mergers, especially where there are not readily identifiable
17 or quantifiable savings present (as in the "first mover" cases). The Commission has
18 recognized synergy savings where they exist and has not attempted to manufacture

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[12] *Id.*, p. 5-6.

[13] *See:* Louisville Gas and Electric Company and Kentucky Utilities Company Annual Report 2006, SEC Form 10-K, p. 83.

1 merger savings where synergies are not present. Thus, I believe that the proceedings
2 involving water companies are in line with this tradition of predictable and consistent
3 regulation of mergers and acquisitions.

4 III. BENEFITS OF THE PROPOSED TRANSACTION

5 Q. You previously stated that the Proposed Transaction is not a synergy merger. Does
6 the Proposed Transaction provide net benefits to utility customers in New York?
7 A. Yes, it does. As discussed herein, and as supported by other Iberdrola and Energy
8 East witnesses in this proceeding, there are net benefits and no harm to customers
9 from the Proposed Transaction.
10 Even where, as here, no quantifiable savings have been identified, future potential
11 savings may be realized over time. These potential benefits may accrue over time as
12 NYSEG and RG&E are able to consult with Iberdrola on management, share
13 information regarding "best practices" and gain from Iberdrola's experience as a
14 large, global leader involved in more diverse aspects of the energy industry on an
15 international scale. That this possibility might be achievable is suggested by Energy
16 East's current "best practices" ranking in the U.S.[14] As discussed above, the
17 Commission has previously recognized such benefits in approving non-synergy
18 mergers.

[14] Iberdrola, Investor Presentation, *IBERDROLA + Energy East, Expanding the Global Platform*, June 26, 2007, p. 31.

1 It is important to avoid over-stating the likely efficiency-enhancing benefits of
2 Iberdrola's acquisition of Energy East, given the productive efficiencies that Energy
3 East, NYSEG and RG&E have already achieved. Nevertheless, the financial,
4 technical and managerial resources that Iberdrola and Energy East will together be
5 able to bring to bear with respect to their U.S. utility operations will provide benefits
6 to utility customers in New York that would become apparent over time. This would
7 be especially true if Iberdrola acquires additional utility operations in the U.S., which
8 could provide greater opportunities for achieving economies.

9 Most concretely, Iberdrola's acquisition of Energy East could have a beneficial
10 impact on NYSEG's and RG&E's ability to issue debt at lower cost, which would
11 tend to reduce their cost of debt capital. As discussed by Mr. Fetter in his testimony
12 and by Mr. Azagra in the Rebuttal Testimony of the JPPP, Iberdrola's credit rating
13 remains higher than that of Energy East. It is my understanding that Iberdrola now
14 has an "A-" long-term corporate credit rating from Standard & Poor's, an "A" rating
15 from Fitch Ratings, and an "A3" rating from Moody's. Thus, it is my understanding
16 that Iberdrola's corporate credit rating continues to be within the broad "A rating"
17 category, which includes the "A+," "A," and "A-" ratings. I have also reviewed data
18 from the December 2007 Mergent *Bond Record* that shows (p. 12) that public utility
19 bonds within the broad "A" rating category had bond yields that were about 20-30
20 basis points lower than public utility bonds within the broad "Baa" rating category
21 (using Moody's rating categories, which is equivalent to the "BBB+," "BBB," and

1 "BBB-" ratings for Standard & Poor's and Fitch Ratings).[15] Thus, the fact that
2 Iberdrola's credit rating is higher than that of Energy East would, all other things
3 being equal, benefit NYSEG and RG&E and, over time, lead to cost savings that
4 benefit customers.

5 In addition, the Proposed Transaction provides benefits to the State of New York,
6 not just customers. The support that the Proposed Transaction has received reflects
7 these benefits. The New York State Department of Economic Development ("Empire
8 State Development") supports the merger because it provides the opportunity to
9 realize key economic development benefits for upstate New York.[16] Similarly,
10 Greater Rochester Enterprise, a regional economic development organization,
11 supports the transaction because of its beneficial positive economic impact.[17] The
12 International Brotherhood of Electrical Workers also supports the transaction because
13 of its job retention benefits.[18] These benefits reflect the broader interests of the State
14 as a whole in creating or retaining jobs.

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[15] During periods of turmoil in the capital markets, the spreads between the broad A and Baa rating categories can widen substantially. Thus, in 2002, a year of financial stress in utility bond markets, the spread between the broad A and Baa rating categories was about 65 basis points.

[16] Gunderson, D.C., Before the Commission, Comments on Behalf of Empire State Development, Case 07-M-0906 (Jan. 11, 2008).

[17] Mullen, D.M., Before the Commission, Direct Testimony on Behalf of Greater Rochester Enterprise, Case 07-M-0906 (Jan. 11, 2008).

[18] Casey, G., Before the Commission, Testimony on Behalf of System Council U-7 and Local 36 International Brotherhood of Electrical Workers, Case 07-M-0906 (Jan. 10, 2008).

1 The Rebuttal Testimony of the JPPP, and in particular, Mr. Azagra of Iberdrola,
2 addresses in greater detail these and other benefits to customers and the State of New
3 York from the Proposed Transaction.
4 Q. How did you evaluate whether there is harm to customers as a result of the Proposed
5 Transaction?
6 A. I first reviewed Staff's filing in this proceeding. Staff identified numerous examples
7 of risk and uncertainty. I evaluated these claims, reviewed the testimony of other
8 witnesses on behalf of Iberdrola and Energy East, considered whether any credible
9 harm (risks) that Staff had identified could be mitigated, and then drew my overall
10 conclusion.
11 There are several issues to consider when evaluating Staff's concerns, which are
12 overwhelmingly anecdotal in nature. First, there is the question of whether the
13 harm/risk issues have anything directly to do with this merger. A number of the issues
14 raised by Staff would have been concerns even if the Proposed Transaction had not
15 been proposed. Dr. Makholm, Dr. Hieronymus and Mr. Fetter consider allegations of
16 harm/risk raised by Staff.
17 Second, there is the question of whether the harm/risk can be mitigated. Critically,
18 given that the Commission's authority to regulate NYSEG and RG&E will continue
19 unchanged, the Commission can be confident that utility customers in New York will
20 not be harmed as a result of this merger. The Commission will retain all of the
21 authority that it has now and, as Dr. Makholm explains, the substitution of one

1 foreign parent corporation shareholder for Energy East's individual and institutional
2 shareholders will not affect the Commission's ability to exercise its authority.
3 Moreover, and as discussed in greater detail by Mr. Azagra in the Rebuttal
4 Testimony of the JPPP, Iberdrola has agreed to a number of potential conditions,
5 which provide additional ratepayer protections. These include the agreement that
6 NYSEG and RG&E customers will not: (1) pay rates that reflect the recovery of the
7 acquisition premium being paid by Iberdrola's shareholders for the stock of Energy
8 East; and (2) pay rates that include recovery of transaction costs related to this
9 proceeding, such as investment bank fees, legal fees, transfer or other taxes, among
10 others. These concessions mitigate the risk that NYSEG and RG&E customers will be
11 harmed by the Proposed Transaction.
12 After reviewing all the evidence, I conclude that the Proposed Transaction will
13 result in positive benefits to Energy East, NYSEG and RG&E over time, and will also
14 not result in harm to New York ratepayers. Thus, applying the standards that the
15 Commission has previously used in assessing non-synergy mergers, the Proposed
16 Transaction should be approved.

17 **IV. MERGER BENEFITS IDENTIFIED BY THE POLICY PANEL**

18 Q. There is a substantial difference of opinion between the Staff Policy Panel and
19 Iberdrola on net merger benefits. How would you go about analyzing these issues?

1 A. The Staff Policy Panel identifies $1.68 billion of benefits to Iberdrola/Energy East
2 and others. Exhibit___(PP-20). In addition, Staff provides a comparison that shows
3 total cumulative delivery revenue reductions (nominal dollars, over five years) for
4 Iberdrola/Energy East of $740.9 million. Exhibit___(PP-21). To respond to these
5 issues, I explain the economic principles that are important to a proper benefit-cost
6 analysis and then respond to the specific methodological and policy issues raised by
7 Staff's analysis. The Rebuttal Testimony of the Rate Adjustment Panel provides a
8 detailed analysis and response to Staff's calculation of the positive benefit
9 adjustments ("PBAs") and rate reductions.
10 Q. Does the Staff Policy Panel follow the standard procedures when calculating merger
11 benefits?
12 A. No. Staff's calculation of benefits to Iberdrola does not follow standard practice.
13 Rather than comparing the New York utility's costs after the merger with the utility's
14 costs but for the merger, Staff estimates "benefits" across all jurisdictions to Iberdrola
15 and others. Thus, Staff's focus is not on the benefits of the transaction to NYSEG and
16 RG&E.
17 This shift of focus from NYSEG and RG&E to Iberdrola and others is puzzling—
18 and misleading. As Dr. Makholm shows, 100 years of ratemaking practice in New
19 York points to the need to focus on the regulated utilities. Instead, Staff has offered
20 an analysis that does not focus on outcomes relevant to New York.

1 One of the purposes of utility regulation is to insulate utility customers from harm
2 through exposure to the utility's affiliates and parent company. Thus, ringfencing,
3 codes of conduct, and affiliate rules all aim to provide a clear line of demarcation
4 between the utility and its affiliates/holding company. The basic concept of symmetry
5 suggests that if regulators want to insulate utility ratepayers from harm from
6 affiliates, then they should also accept that utility ratepayers would not benefit when
7 utility affiliates are successful. To do otherwise would create a classic "heads-I-
8 win/tails-you-lose" situation.
9 Q. Has Staff performed an economically sound analysis of the benefits of the Proposed
10 Transaction?
11 A. No. The benefits that the Staff Policy Panel identifies on Exhibit___(PP-20) have a
12 number of problems, not the least of which is the fact that these benefits have nothing
13 to do with the realization of operating efficiencies achievable by the regulated utility
14 operations of NYSEG or RG&E as a result of the Proposed Transaction.
15 Q. Can you please address each of the purported benefits identified by the Staff Policy
16 Panel? Please first address the amortization of goodwill under Spanish law identified
17 by the Staff Policy Panel.
18 A. The Staff Policy Panel's proposed benefits to Iberdrola/Energy East and others
19 include tax benefits resulting from the amortization of financial goodwill under the
20 Spanish Corporate Income Tax law of $476 million. These benefits are not known
21 and measurable at this time; would shift benefits, if any, from the holding company to

1 New York ratepayers; and have nothing to do with the realization of economies of
2 scale, scope, and learning in New York. As an initial matter, the JPPP Rebuttal
3 Testimony explains the uncertainties surrounding the question of whether Iberdrola
4 will ever realize any of these tax benefits in Spain, such as the recent rulings by
5 Spanish tax authorities that questioned whether the acquisition of a holding company
6 (such as Energy East) qualifies for goodwill amortization.

7 Equally important, governments provide tax benefits in order to provide
8 incentives. Those incentives would be dampened if the tax benefits do not flow to the
9 intended party. For example, Congress sometimes provides investment tax credits to
10 encourage investment in plant and equipment by U.S. companies and may require that
11 these benefits flow to the intended recipient. In the Revenue Act of 1964, for
12 example, Congress barred state agencies from flowing through the benefits of utility
13 investment tax credits to ratepayers.[19] In this case, the principle is particularly clear:
14 the tax benefits, if any, are intended to go to Spanish companies to give them an
15 incentive to invest abroad. These benefits have nothing to do with the cost of service
16 of New York regulated electric and gas utilities and the Staff Policy Panel's attempt
17 to capture these tax benefits for New York ratepayers is clearly inappropriate.

18 Q. Can you also address the benefits associated with Production Tax Credits ("PTCs")
19 identified by the Staff Policy Panel?

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[19] Leonard Saul Goodman, *The Process of Ratemaking* (Vienna, VA: Public Utilities Reports, 1998), p. 726.

1 A. The Staff Policy Panel's proposed benefits also include tax benefits from PTCs of
2 $150 million. Again, the JPPP Rebuttal Testimony explains why these purported
3 benefits are speculative at best. Indeed, after Congress failed to renew incentives for
4 renewable energy production in the energy bill passed in December, there is currently
5 a high degree of uncertainty about the level of benefits that will be available in the
6 future, if any.[20]

7 Moreover, and as with the amortization of goodwill under Spanish law, PTC
8 benefits (if any) have nothing to do with Energy East's regulated utility operations,
9 and the Proposed Transaction also has nothing to do with whether or not Iberdrola
10 will be able to realize these tax benefits. There has been some confusion on whether
11 Iberdrola's acquisition was proposed, in part, to take better advantage of renewable-
12 related tax benefits. This question, however, is misguided—there are numerous ways
13 for Iberdrola to use its U.S. renewables-related tax benefits efficiently. For example,
14 Mr. Azagra points out in the JPPP Rebuttal Testimony that third-party equity
15 investors have already used available PTCs, and that PTCs are far from certain and
16 are completely unrelated to NYSEG and RG&E. As such, the PTC benefits fail the
17 "but-for-the-merger" analysis; in the absence of the Proposed Transaction, PTCs
18 would be used by third-party equity investors. With the Proposed Transaction,
19 nothing changes.

[20] Robin Goldwyn Blumenthal, ed., "Tax Credit in Jeopardy: Green Energy Blues," *Barron's*, Jan. 21, 2008, p. 17. This article quotes a spokesman for the House Ways and Means committee, who said that it

1 Moreover, and as with the amortization of goodwill, any attempt to divert PTC
2 benefits away from Iberdrola to New York ratepayers would be a bad policy for the
3 Commission to adopt. Attempts to shift tax benefits away from the intended recipient
4 would affect the incentives of the recipient. Simply put, if Congress decides to
5 continue to provide tax credits for renewables, that decision would provide an
6 incentive to build more renewables in the U.S. Requiring the sharing of renewable-
7 related tax benefits with someone else (*i.e.*, NYSEG and RG&E ratepayers in New
8 York) would reduce the incentive to build renewables, thereby subverting the public
9 policy efforts of Congress and state legislatures for the short-term benefit of
10 ratepayers within the utility's service area.
11 Q. Please address the benefits to employees, third parties and shareholders identified by
12 the Staff Policy Panel.
13 A. The Staff Policy Panel's proposed benefits also include payments to
14 executives/management and third parties of $78 million and $46 million, respectively.
15 The basic point to make here is that these are *costs* to Iberdrola, not *benefits*. In order
16 to enter the U.S. utility business and acquire a platform for future growth in the U.S.,
17 Iberdrola is bearing certain "transaction costs" to complete the Proposed Transaction.
18 These costs include certain payments to Energy East executives under existing
19 employment contracts, as well as to third parties (such as law firms and consultants).

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was "too early to handicap" the chances for legislation.

1 The Staff Policy Panel has proposed that 50 percent of these transaction costs should
2 flow to NYSEG and RG&E ratepayers in New York. However, doing so would force
3 Iberdrola to pay a second time for these costs. The simple point is that these are costs
4 and that only benefits in excess of costs are realizable benefits.

5 The Staff Policy Panel's proposed benefits also include $930 million that flow to
6 Energy East's shareholders in the form of an "acquisition premium" reflecting the
7 amount of the price paid to shareholders by Iberdrola above the share price at a point
8 in time. Again, these are costs to Iberdrola, and not benefits that can somehow be
9 assigned to NYSEG/RG&E ratepayers. Moreover, and as Mr. Azagra explains in the
10 JPPP Rebuttal Testimony, NYSEG and RG&E will not seek recovery of the
11 acquisition premium or transaction costs for the Proposed Transaction from
12 customers. Dr. Makholm also explains in his rebuttal testimony why a large
13 acquisition premium at the holding company level would not skew or distort the
14 incentives of the potential combined Iberdrola/Energy East entity relative to the status
15 quo. Nonetheless, Staff wants to capture (on behalf of ratepayers) alleged financial
16 benefits that will accrue to Energy East shareholders. There is no principle under
17 which this is justifiable. The Commission regulates the cost of the utilities within
18 New York. The costs and finances of holding companies that own utilities in New
19 York are outside of the purview of the Commission, and the Commission is only
20 concerned with holding companies to the extent that they affect the Commission-
21 jurisdictional utilities. Staff in the current case is distorting this concept and

1 transforming a principled and established concept into a form of "pay to play." The
2 Proposed Transaction should be approved if it meets the standard of providing
3 benefits to New York and, as described above, it does meet that standard. It is
4 inappropriate to demand rate and other concessions based on potential financial
5 benefits to investors for a transaction that meets the established standard for approval.
6 Q. Please discuss Staff's comparison of the Proposed Transaction with the Ginna
7 acquisition.
8 A. The Staff Policy Panel compares the Iberdrola/Energy East merger transaction with
9 the Ginna transaction, which was RG&E's most recent asset divestiture (*see:* Staff
10 Policy Panel Testimony, p. 237, lines 14 to p. 238, line 1). This comparison is
11 inappropriate.
12 The Ginna transaction involves a generating asset that was included in RG&E's
13 rate base. Beginning in the early 1970s, a return *of* and *on* the Ginna rate base was
14 included in RG&E's regulated electric utility revenue requirement and therefore was
15 included in the tariffed rates paid by RG&E's end-use customers.[21] When an asset
16 that has been included in rate base is sold and thus removed from rate base, the long-

[21] The undepreciated original cost book value was included in RG&E's test-year electric utility rate base. The return *on* that rate base was the test-year rate base times the allowed fair rate of return on invested capital. The return *of* that rate base was the test-year depreciation expense.

1 standing regulatory practice in the U.S. is to assign all or a portion[22] of the benefits of
2 that sale to ratepayers, who, after all, have paid for that asset in their regulated rates.[23]
3 Energy East's shares, in contrast, have never been in the regulated rate base in
4 New York. The value of Energy East's shares may depend on any number of factors,
5 and ratepayers of NYSEG and RG&E are not obligated to ensure that the shares of
6 Energy East maintain any particular market value. Thus, ratepayers are not entitled to
7 a share of changes in the market value of Energy East. Similarly, neither NYSEG's
8 nor RG&E's ratepayers should be entitled to capture any of the benefits of the sale of
9 Energy East's common shares to Iberdrola. Moreover, even if ratepayers of NYSEG
10 and RG&E were somehow entitled to receive the change in market value in the shares
11 of Energy East (which they are not), Staff inappropriately assumes that this benefit
12 would not have to be shared with ratepayers of Energy East's other operating
13 subsidiaries in Connecticut, Maine, Massachusetts and New Hampshire.
14 Q. Why is it appropriate that only merger benefits that result from utility operational
15 savings properly attributable to NYSEG and RG&E form the basis for the rate
16 concessions?
17 A. This is appropriate because attaching rate conditions to merger approval has a
18 principled foundation. Rate conditions are not a form of legalized extortion or a

[22] Utility shareholders frequently receive a share of the gain on the sale of a regulated utility asset. This provides utility management with a "carrot" to seek and find utility assets that are no longer needed to provide utility service and therefore can be sold.

1 ransom to be paid to customers. Rather, rate conditions serve two purposes. First,
2 they are a way of assuring that customers are not harmed by a merger. For example, if
3 customers were to pay an acquisition premium or if merger savings were less than
4 merger integration costs, rates could rise as a result of merger. Rate conditions protect
5 against this.

6 In synergy mergers, cost savings would exceed integration costs and rates would
7 fall. However, mergers come with transaction costs, including acquisition premiums,
8 integration costs, and legal and financial fees. The second purpose of rate conditions
9 is to serve as a means to enable a merger to proceed and for those costs to be
10 recouped by the acquirer, thereby providing an incentive for the utility to search for
11 and find opportunities to increase the utility's operating efficiency. In many synergy
12 mergers, rate plans provide for rate reductions that flow a portion of synergy benefits
13 on to customers, while providing an opportunity for a portion of those benefits to
14 flow to investors to cover merger costs and incentivize synergistic mergers. When the
15 plan expires, customers receive all synergy savings benefits in the form of lower cost
16 of service.

17 With non-synergy mergers, rate plans often have periods during which rates are
18 fixed to provide incentives for cost reduction and to place some of the risk of actually
19 achieving the reduction on the merged entities. Certainly, to the extent that the merger

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[23] See: David W. Wirick, *State Public Service Commission Disposition of the Gain on Sale of Utility Assets*, National Regulatory Research Institute, NRRI 94-17 (Aug. 1994).

1 lowers utility costs, the Commission can eventually lower rates to reflect the cost
2 reductions. As I explained before, in a synergy merger, the opposite is done. For a
3 period of time in a synergy merger, a portion of operating cost reductions is re-
4 directed to the investor and away from the customer to provide a means to recover
5 merger transaction costs and to share in the benefits of the utility's efficiency-
6 enhancing actions. Hence, rate plans and rate concessions are not designed just to
7 provide customer benefits in synergy mergers—those will come through lower cost of
8 service and the rate setting process—but to provide a means to enable acquirers to
9 share in merger synergy benefits. If an acquirer could not have an opportunity to
10 share in the operational benefits of a merger, it may not recover the merger
11 transaction costs and mergers that could be beneficial would not occur.

12 Here, Staff has the entire paradigm backwards. As rate plans for NYSEG and
13 RG&E are relatively short lived and there will be no immediate material synergy
14 savings resulting from the Proposed Transaction, customers are indeed getting near
15 100 percent of the operational benefits of the merger, which can be assessed in
16 normal periodic rate cases. A defined rate plan to share those benefits with investors
17 is not needed and is not being sought by Iberdrola.

18 Q. Does Staff's characterization of benefits have public policy implications beyond the
19 Proposed Transaction?

20 A. Yes. Staff's attempt to reach beyond traditional benefits raises the cost of the
21 transaction. By characterizing transaction costs as benefits and by claiming a share of

1 purported holding company-level tax incentives, Staff is sending a signal to potential
2 investors that one must "pay to play" in New York. This can be damaging because it
3 could make other utility investors interested in bringing their capital to New York less
4 likely to do so. Potential beneficial mergers may not be realized if investors see Staff
5 as charging a "toll" to invest in New York.

6 In addition, an unsubstantiated rejection of foreign ownership of a U.S. electric
7 utility could reduce future foreign interest in U.S. utility capital investment. The
8 Edison Electric Institute ("EEI") forecasts that electric companies in the U.S. will
9 need to spend, on average, $14 billion per year on distribution investment over the
10 next 10 years. EEI projects the total value of transmission investment over the 2007-
11 2010 time period to be $38.1 billion.[24] In addition to these investments in traditionally
12 regulated T&D facilities, over $400 billion of electric industry infrastructure
13 investment in generating plants will be required between 2006 and 2030.[25]
14 Investments will be needed not only to accommodate the growth in population and
15 the economy, but also to replace aging facilities, reduce emissions, and fund research
16 and development of innovative technologies.

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[24] Edison Electric Institute, http://www.eei.org/industry_issues/energy_infrastructure/distribution/index.htm and http://www.eei.org/industry_issues/energy_infrastructure/transmission/index.htm (Accessed Jan. 30, 2008).

[25] "[T]otal of 258 gigawatts of new [generating] capacity is expected between 2006 and 2030, representing a total investment of approximately $412 billion (2005 dollars)," *Annual Energy Outlook* 2007 at 41, Energy Information Administration, DOE/EIA-0383 (Feb. 2007).

1 Foreign direct investment can aid in this process. The ability to draw on the
2 financial resources of foreign capital is a valuable option, and it is important to
3 consider the mid to long-term implications that a rejection of the acquisition of
4 Energy East by Iberdrola would have. In short, if access to foreign capital for New
5 York utilities is reduced, it may be more difficult to ensure affordable and reliable
6 electricity supply in the future. New York utility customers would be worse off—in
7 terms of price and service quality—if New York utilities were handicapped in seeking
8 investment by only being able to attract capital from domestic companies. As I
9 mentioned previously, faced with a similar need for investment in water
10 infrastructure, the Commission recognized the benefits of affiliation of water utilities
11 in New York with large and sophisticated foreign holding companies.

12 V. COMPARISON OF NATIONAL GRID/KEYSPAN TO THE
13 PROPOSED TRANSACTION

14 Q. Please discuss the Policy Panel's PBA comparison.

15 A. Staff's Policy Panel identifies cumulative delivery revenue reductions totaling $740.9
16 million, which they depict as PBAs in Exhibit___(PP-21) and which they compare on
17 a percentage of delivery revenue basis to the NG/KS merger and the Energy
18 East/RGS merger.

19 Q. Is the comparison valid?

1 A. No. Exhibit___(PP-21) has a number of problems, both conceptual and
2 computational, including: (1) comparing the Proposed Transaction, which is a non-
3 synergy merger, to synergy mergers; (2) using incorrect delivery revenue reduction
4 levels; and (3) using an incorrect denominator by excluding the delivery revenues of
5 Niagara Mohawk and Long Island Power Authority ("LIPA"). I believe that the Staff
6 Policy Panel is attempting to use Exhibit___(PP-21) to cloak as legitimate and
7 reasonable PBAs or delivery rate reductions of $740 million by attempting to paint
8 this level of percentage reduction as comparable to that achieved in other mergers.
9 However, these other mergers are synergy mergers and, as discussed previously, the
10 Proposed Transaction is not a synergy merger. Further, the comparisons made by
11 Staff are in error even for what they are.
12 Q. Why would it be incorrect to compare the Proposed Transaction to NG/KS and
13 Energy East/RGS?
14 A. The Proposed Transaction is a geographic extension (first mover) merger with no
15 quantifiable or immediate merger savings. The transactions that Staff focuses on in
16 Exhibit___(PP-21), however, are synergy mergers.
17 The difference can be most readily seen by comparing the Energy East/RGS
18 transaction with the Proposed Transaction.
19 The Energy East/RGS transaction involved two operating utilities in New York,
20 NYSEG and RG&E, both of which operate electric and gas utilities. As a result,
21 there were obvious opportunities to combine operations. The same can be said for the

1 NG/KS transaction. National Grid already operated an electric utility in New York,
2 Niagara Mohawk, and had additional utility operations in New England. Thus,
3 National Grid was not a first-mover with respect to the NG/KS transaction—National
4 Grid had entered the U.S. utility market in 2000, with the acquisition of New England
5 Electric System ("NEES"), with utilities in Massachusetts, New Hampshire, and
6 Rhode Island.

7 Delivery rate reductions in a synergy merger are enabled by the savings that come
8 from synergy savings. To the extent that operating costs decrease, rates can and will
9 decrease. In a non-synergy merger there is no immediate decrease in costs. As a
10 result, there is no basis for delivery rate reductions. Further, the synergy mergers that
11 the Staff Policy Panel used in Exhibit___(PP-21) obscure the fact that a portion of net
12 synergy savings actually went to shareholders.

13 Q. Could Exhibit___(PP-21) be corrected to provide a more accurate comparison of
14 Staff's PBA recommendations for the Proposed Transaction to the other transactions?

15 A. Yes, it can be corrected for some of the gross errors, but the resulting values may well
16 still exaggerate the percentage rate reductions for the other transactions. I will
17 concentrate on the comparison to the NG/KS merger as there is a reasonably detailed
18 settlement and Commission Order that lays out the rate reductions. Further, Staff
19 through a data request has already cut in half the percentages applicable to the
20 EE/RGS merger. Also, the JPPP Rebuttal Testimony argues that even Staff's new
21 number is incorrect.

1 In Exhibit___(PP-21), the Staff Policy Panel assumes that rate mitigation relative
2 to the stand-alone rate plans of $602.8 million flow to NG/KS over the five years
3 following the transaction. However, this is not the level of benefits acknowledged by
4 the Commission in the NG/KS Merger Order. The actual, acknowledged nominal
5 level of benefits is $407.88 million to KEDNY and KEDLI over five years.[26] The
6 Commission pointed out that the difference between the $602.8 million and $407.8
7 million was not mitigation resulting from the merger, but was an amount by which
8 rates would have been mitigated even absent the merger. Adjusting for this is
9 necessary and would lower the ratio of reductions to delivery revenues to 6.97 percent
10 in the NG/KS merger.
11 Further, of the $407.8 million acknowledged by the Commission, $45.1 million is
12 due to net synergy savings (net of costs to achieve). Those savings are not available
13 in the Proposed Transaction. Removing these synergy savings lowers the 6.97
14 percent to 6.19 percent. Further adjustments are still required. The $45.1 million only
15 represents the customers' 50 percent share of net synergy benefits. Shareholders will
16 also retain a 50 percent ($45.1 million) share of the net synergy benefits allocable to
17 KEDNY and KEDLI. As explained above, investors are allowed to retain this
18 amount to help pay for transaction costs and to incentivize synergistic mergers. This
19 amount offsets rate reductions and therefore must be subtracted from the savings in

[26] NG/KS Merger Order, p. 118.

order to obtain a true comparison for a non-synergy merger. After this adjustment, the remaining unfunded concessions for KEDNY and KEDLI would be $317.6 million, or ~~5.14~~ 5.47 percent of delivery revenues.

This figure still needs further adjustment. Staff's analysis neglects the fact that both LIPA and Niagara Mohawk received a share of merger synergy benefits in the NG/KS merger and there is no reason to divide the non-synergy rate mitigation for KEDNY and KELDI by a delivery revenue value that excludes Niagara Mohawk and LIPA revenue. If the correct non-synergy rate mitigation of $317.6 million is divided by aggregate New York delivery revenues for KEDNY, KELDI, Niagara Mohawk and LIPA, the percentage of non-synergy rate reductions to delivery revenues would be 1.34 percent. Applied to the Proposed Transaction, this would yield non-synergy rate mitigation of $87 million. The 1.34 percent calculation provides a truer comparison to the NG/KS merger and if the Proposed Transaction was treated comparably to that transaction, the nominal non-synergy rate mitigation level over the five years following the merger would be no more than $87 million.[27] My calculations are shown in Exhibit___(ETM-2).

Q. Why do you qualify with the phrase "no more than" the values that you calculate to make a more appropriate comparison to the NG/KS merger?

[27] If LIPA revenues are excluded, the percentage would be 2.07% and, applied to the Proposed Transaction, this would yield non-synergy rate mitigation of $134.3 million.

1 A. I qualify using this phrase because I believe that the 1.34 percent and $87 million
2 values are overstated. The rate mitigation values in NG/KS are not clearly reductions
3 that result from the merger. For example the NG/KS Order (page 83) states, "DPS
4 Staff notes that the largest mitigation measure for KEDNY – the imputation of $106.2
5 million of additional revenues over the five years – addresses three key issues for
6 DPS Staff that were subject to a degree of litigation risk." On page 84, the Order
7 goes on to state that "DPS Staff also notes that the largest mitigation measure for
8 either company was KEDLI's agreement to impute $152.2 million of additional
9 revenues over five years. This imputation is intended to address the same three DPS
10 Staff concerns that were addressed by a similar adjustment for KEDNY." In other
11 words, $261.5 million of the total non-synergy rate mitigation amount of $317.6
12 million is not necessarily a merger-related reduction, but is rather the resolution of
13 issues that Staff acknowledges may have gone either way in a litigated rate case. It is
14 impossible to judge what portion of that $261.5 million should be used in a
15 comparative analysis, but the Staff Policy Panel blindly attributes all $261.5 million
16 to the merger and this is a clear overstatement.
17 Q. Are you suggesting that the Commission should require non-synergistic rate
18 concessions for the Proposed Transaction?
19 A. No. As discussed above, the Commission has previously approved non-synergy
20 mergers without requiring up-front rate reductions or write-offs/write-downs. There is
21 no reason why the Proposed Transaction should be treated differently. The

1 Commission must of course do what is necessary to assure that no harm comes to
2 New York ratepayers as a result of the Proposed Transaction, but that is no cause to
3 assume that the Proposed Transaction must provide some threshold minimum
4 concessions to proceed. I see no reason why there should be quantitative rate
5 reduction standards in the absence of quantifiable synergy benefits and to the extent
6 that there were synergies, a portion of those synergies should for a period of time be
7 shared with investors.
8 Q. Does this conclude your testimony?
9 A. Yes, it does.

1 MR. GERGEN: Mr. Meehan, I would like to
2 direct your attention to two exhibits attached to the
3 testimony, ETM-1 and ETM-2. The first being your
4 curriculum vitae. The second, "A Comparison of Rate
5 Mitigations Between National Grid KeySpan and Iberdrola
6 Energy East Transaction."
7 Were those exhibits prepared by you or under
8 direction and supervision?
9 A. Yes, they were.
10 MR. GERGEN: Your Honor, may we have the
11 described exhibits marked for identification?
12 JUDGE EPSTEIN: 78 and 79.
13 (Exhibits 78 and 79 marked for
14 identification.)
15 MR. GERGEN: Thank you. The witness is
16 available for cross-examination.
17 JUDGE EPSTEIN: Mr. Van Ryn.
18 CROSS EXAMINATION
19 BY MR. VAN RYN:
20 Q. Good morning.
21 A. Good morning.
22 Q. Could you please turn to pages 6 and 7 of your
23 rebuttal testimony?
24 A. Yes, I am there.

1 Q. The sentence that runs the bottom of one page to
2 the top of the other, you opine that characterizing
3 costs incurred by Iberdrola shareholders to achieve the
4 proposed transaction as a benefit makes no sense to you;
5 is that correct?
6 A. That is correct.
7 Q. Do you agree that the Petitioners have referenced
8 the retention of existing jobs at RG&E and NYSEG as a
9 benefit of the transaction?
10 A. I do agree with that.
11 Q. Do ratepayers pay the costs of retaining those
12 employees and the regulated rates they pay?
13 A. Ratepayers will only pay the costs that are
14 prudently necessary to provide service, and they will
15 bear the costs necessarily to prudently provide service.
16 So, to the extent those jobs are necessary to provide
17 service, ratepayers will pay for the labor provided to
18 provide the service.
19 Q. Why is it proper to reference the cost ratepayers
20 will bear as a benefit while a comparison to the cost
21 shareholders bear is not?
22 A. I don't think I would agree with the premise that
23 you are referencing a cost that ratepayers bear as a
24 benefit. As I said, ratepayers logically have to pay

1 the prudent cost of providing service. Those jobs, I
2 would assume, are being retained because they are
3 required to provide service.
4 This is not the type of adjacent utility synergy
5 merger that enables staff to be cut. It certainly is
6 not my understanding that jobs that would otherwise be
7 cut or are unnecessary are being retained as part of the
8 merger.
9 My understanding of why that's a benefit is from
10 the economic development perspective. It's pointed out
11 that this is not the type of merger that will result in
12 a reduction of employment in upstate New York.
13 Q. So things staying the same is a benefit, in your
14 view?
15 A. I don't think that's one of the things that I
16 cite as a benefit, but certainly, one of the attributes
17 of the merger is that it's not negatively impacting
18 employment in upstate New York.
19 Q. Could you turn to page 9 of your testimony.
20 A. I am there.
21 Q. And there, you categorize mergers into two types,
22 synergy mergers and non-synergy mergers; is that
23 correct?
24 A. That is correct.

1 Q. Can you point to any New York electric and gas
2 utility merger that occurred within the past ten years
3 that you would characterize as a non-synergy merger
4 other than this merger?
5 A. No. I believe that all those mergers were
6 between utilities that either operated in New York or
7 had utility operations in proximate states that were
8 more along the traditional synergy lines of
9 consolidating functions, reducing work force, and
10 achieving savings through those types of synergies.
11 Q. Could you turn to page 16.
12 A. Yes, I am there.
13 Q. There, you say, in evaluating what you described
14 as this non-synergy merger, "The Commission can rely on
15 experience in the water utility industry."
16 Is that correct? If you look at lines 11 and 12.
17 A. Yes, that's on lines 11 and 12 there, yes.
18 Q. On lines 7 and 8, you say, "The electric industry
19 today faces its own set of challenges."
20 Is that correct?
21 A. Yes, I do.
22 Q. Do you believe that the challenges the electric
23 industry faces are comparable to the challenges the
24 water companies you described in your testimony faced

1 when they were acquired?
2 A. I think they are comparable in nature. They may
3 not be similar in magnitude or degree, but the water
4 companies certainly faced the need for infrastructure
5 improvement and capital investment, and I think
6 utilities also face that need. Some 14 billion a year
7 nationally in distribution investment over the next ten
8 years.
9 Q. Can you discuss the ability of the water
10 companies to meet their capital needs as compared to the
11 ability of the electric utilities to meet their needs?
12 A. I think generally the water companies have been
13 able to meet their needs. Certainly, they face probably
14 a more difficult time than electric utilities in raising
15 capital, historically, at least.
16 Q. Could you turn to IBER-246?
17 A. Yes, I have that in front of me.
18 Q. There, you discuss a water company transaction
19 that took place in 2000 and you also state that the
20 water company at issue there had not been earning its
21 allowed return.
22 Have you compared the returns of NYSEG and RG&E
23 to the water company you discuss there?
24 A. Let me first correct your characterization. It's

1 close but not exact. What I do is, I agree with the
2 fact that the Commission, in its order in the rate case
3 and merger case consolidated stated that the utilities
4 in question had been having some difficulty in earning
5 its allowed rate of return.
6 I think the second part of your question relates
7 to NYSEG and RG&E. Could you just repeat that part? I
8 lost track of that part of the question.
9 Q. Have you compared the allowed returns at NYSEG
10 and RG&E to the water company return that was at issue
11 in the 2000 transaction?
12 A. I did not make the comparison. I didn't feel it
13 was necessary.
14 Q. Why not?
15 A. Well, I am relying on looking at the principles
16 in the case, the UWR-Lyonaise or Suez case. To look at
17 the fact that the Commission has recognized the same
18 type of merger we have here -- geographic extension
19 merger; one where benefits come from a stronger
20 financial parent; one where benefits come from the
21 ability to import international practices -- and
22 recognizing that, in connection with that case, there
23 was no mandated rate reduction or write-off or anything
24 other than an extension of a rate plan. And I didn't

1 think it was necessary in translating those principals
2 to do comparisons between the earned and allowed rate of
3 returns for the utilities in question.
4 Q. Could we return to page 16 of your testimony.
5 There, you address another transaction which I
6 would like to describe as the American Waterworks
7 transaction.
8 A. Yes.
9 Q. And that transaction was originally approved in
10 2002?
11 A. I will accept that subject to check. My memory
12 of the date on that transaction is not refreshed.
13 Q. The order I am referring to was issued November
14 27, 2002, in case 01-W-1949.
15 A. Yes, I am familiar with that order.
16 Q. And subject to check, at page 6 of that order, it
17 states that, "The affiliation of the regulated water
18 company with a foreign holding company will provide the
19 regulated company with better access to capital markets
20 on favorable terms."
21 Will you accept that subject to check?
22 A. Let me check it right now.
23 MR. GERGEN: Do you have a copy of that we
24 can look at?

1 MR. VAN RYN: I am afraid I only have one.
2 If you desire it, it's easily available from the
3 Commission website. We can have somebody go print it
4 for you.
5 MR. SCHWARTZ: If you give us extra time to
6 look at it after Gene Meehan is finished looking at it,
7 that would be satisfactory.
8 A. I think, Mr. Van Ryn, you were referring to
9 page 6 where the Commission states that,
10 "American Waterworks has an acceptable financial
11 standing and that it's reasonable to expect that
12 American Waterworks' affiliation with Thames will
13 provide Long Island Water better access to capital
14 markets on favorable terms."
15 That's in the order, yes.
16 Q. Now, the same regulated utility was the subject
17 of a subsequent order issued July 26th, 2007, in case
18 06-W-0490. Are you aware of that order?
19 A. I do not have that order with me. I would have
20 to see it. I am not sure if I reviewed the order or
21 not.
22 MR. GERGEN: Counsel, do you have copies of
23 the order?
24 MR. VAN RYN: I have one.

1 MR. GERGEN: Your Honor, I object to having
2 cross on materials that are unavailable to us and
3 unavailable to the witness. I think it's entirely
4 inappropriate.
5 JUDGE EPSTEIN: It's a problem unless you
6 are just going to ask him to accept something subject to
7 check and drop it. If you are really going to cross him
8 on it, it would be a good investment in time to get
9 copies.
10 MR. VAN RYN: I am going to ask one question
11 subject to check.
12 MR. GERGEN: I would at least ask that
13 counsel would share, even in asking the question.
14 Subject to check, share the copy with the witness, and
15 give us copies too.
16 MR. VAN RYN: Fine. If they would like
17 copies made, I'll take a break for five minutes.
18 MR. GERGEN: That would be acceptable.
19 JUDGE EPSTEIN: Let's do that.
20 (Brief recess.)
21 JUDGE EPSTEIN: Back on the record.
22 BY MR. VAN RYN:
23 Q. Mr. Meehan, do you have a copy of the order we
24 have been discussing in front of you?

1 A. Yes, I do.
2 Q. To oversimplify somewhat a very complex
3 transaction, let's just state that the ultimate parent
4 in this transaction is known as RWE and it's a German
5 holding company. And this order is primarily concerned
6 with American Water, which is one step up from the
7 regulated entity.
8 A. You are not expecting me to react to that, are
9 you?
10 Q. No. You can take that subject to check.
11 The information I am really interested in starts
12 at the sentence on the bottom of page 5 and runs over to
13 page 6, and it states that American Water at year end
14 2005 had an equity ratio of 28.9 percent with
15 $3.2 billion of goodwill representing 114 percent of the
16 common equity balance. Do you see those numbers?
17 A. Those numbers are on page 6.
18 Q. If you note on the first full paragraph on
19 page 6, it states that, "The RWE parent intends to
20 infuse equity into American Water prior to an IPO."
21 Is that correct?
22 A. I think in the first paragraph it talks about the
23 financial profile and how the RWE rating has bolstered
24 the American Water rating from BBB up to A as a result

1 of its affiliation with RWE, a large international
2 company.
3 It says, "While American Water's result in
4 overall financial profile has been consistent with, at
5 best, a BBB-rated company, its low-risk profile and its
6 relationship with RWE has resulted in a rating of A-/B
7 AA-1 by S&P and Moody's."
8 Were you referring to another paragraph?
9 Q. The first full paragraph.
10 A. I think that says that, if this transaction is
11 approved by the Commission, there will be at least a
12 45 percent common equity ratio for American Water and
13 American Water would be able to maintain its current
14 bond ratings.
15 Q. That is going to occur after the IPO is
16 conducted?
17 A. I am going to have to read through the whole
18 order to answer questions of that nature. I mean, the
19 implication in that specific language is that the equity
20 infusion should result in an IPO sales price with at
21 least a targeted 45 percent common equity.
22 MR. VAN RYN: Your Honor, I would like to
23 have marked as an exhibit the Moody's report on
24 American Water.

1 JUDGE EPSTEIN: 80.
2 (Exhibit 80 marked for identification.)
3 BY MR. VAN RYN:
4 Q. There are two elements of this report I would
5 like to point out to you.
6 The last sentence in the second paragraph states
7 that, "The IPO transaction is expected to take place
8 sometime in late 2007."
9 And the first sentence in paragraph 3 which
10 states that, "American Water's cash flow-derived credit
11 metrics are below what is commensurate with a BAA-1
12 rating."
13 MR. VAN RYN: To complete the picture, I
14 would like to present the next exhibit.
15 JUDGE EPSTEIN: 81.
16 (Exhibit 81 marked for identification.)
17 MR. VAN RYN: This is a filing of
18 American Waterworks with the Securities & Exchange
19 Commission.
20 MR. GERGEN: This is a partial document?
21 These are excerpts?
22 MR. VAN RYN: Yes.
23 MR. GERGEN: Do you know how long the
24 complete document is?

1 MR. VAN RYN: It's hundreds of pages.
2 Again, if the Company believes there's anything else in
3 the document they'd like to see on the record --
4 MR. GERGEN: Do you know if the material
5 referenced in these pages is referenced in other
6 portions of the SEC filing?
7 MR. VAN RYN: This is the table of contents,
8 so there might be other references in it.
9 MR. GERGEN: Perhaps we should put the
10 entire document in the record?
11 MR. VAN RYN: I'd happy to discuss that off
12 line how much you would like to see in there. I don't
13 think we have to do that now.
14 MR. GERGEN: Thank you.
15 BY MR. VAN RYN:
16 Q. If you look at page 25--if you look at the bottom
17 of page 23, if you look at the top--towards the middle
18 of the page, it describes goodwill impairment for the
19 years 2005, 2006, and 2007 ranging between $200 million
20 and over $500 million per year.
21 Can you find those figures?
22 A. Yes.
23 Q. If you look at the next page, the last sentence
24 of the first paragraph states that further impairments

1 could have a material effect -- and here I am going to
2 quote -- "...could make it more difficult for us to
3 secure financing at attractive terms."
4 Do you see that?
5 A. That statement is in there.
6 Q. Would you accept that this is an example of where
7 goodwill has harmed a utility's ability to secure
8 financing needed for its operations?
9 A. Not at all. I think you have to put this into
10 context. These are risk factors in a financing
11 offering. You throw the kitchen sink in to be
12 conservative. These are a listing of all risk factors.
13 I am sure we've all read a lot of the documents and you
14 have to disclose any potential risk factor. It
15 certainly doesn't mean it has had an impact or will have
16 an impact. It means that it's something that could
17 potentially happen.
18 When you look at this in the context of the order
19 that the Commission issued, as I was breezing through
20 that, it addresses that a goodwill impairment will be
21 recorded, but if the common equity goes below 45
22 percent, the public would be notified and RWE would make
23 capital infusion necessary to insure a common ratio of
24 at least 45 percent.

1 It looks like potential issues with goodwill and
2 maintaining bond ratings are certainly anticipated in
3 the order and the customer is protected.
4 Q. Would you turn to page 35 of your testimony.
5 A. Yes.
6 Q. And there, you state that, "Grid-KeySpan is a
7 non-synergy merger."
8 Is that correct?
9 A. I don't think that's true. I hope I don't state
10 that.
11 Q. No, you don't. I got it reversed, I am sorry.
12 You state that it's a synergy merger?
13 A. Yes.
14 Q. If you turn to page 38, you described $317
15 million of benefits in that merger as "unfunded
16 concessions."
17 Is that correct?
18 A. Can you give me a line reference? I know that as
19 a general --
20 Q. If you look at line 2, it uses the term "unfunded
21 concessions"?
22 A. Yes, that is correct.
23 Q. As you described it, that means benefits that
24 will not be achieved through synergy savings; is that

your intent?

A. Benefits that would not be achieved through synergy savings or cost savings. Benefits that are just an agreement to lower rates.

I think the Staff panels pointed out they are not real cost savings, they don't have a permanent impact on creating lower rates.

Q. Why were non-synergy benefits required for approval of this synergy merger?

A. I don't know that they were required. They were part of the settlement and they were part of the package that the Commission approved. But I do not -- I can't state that that would not have been approved without--if the case had been litigated or went all the way through a process. It may well have been approved without any of these non-synergy rate concessions.

Q. If you could turn to page 40.

A. Yes.

Q. You state, "The Commission is obligated to assure that no harm comes to New York ratepayers."

At lines 1 and 2.

A. Yes.

Q. So do you believe the Commission should approve this merger if the Petitioners can show it will not harm

1 ratepayers?
2 A. No, that's not--that's the intent of that
3 testimony here. I think the Commission should approve
4 this merger if it's in the public interest.
5 Q. And how would you define that?
6 A. I would define it as, if there are benefits to
7 the state, including ratepayers, and I think we have
8 that here.
9 We have a large international company coming in
10 with a better credit rating -- unlike Grid-KeySpan --
11 with a better credit rating, enhancing the ability of
12 the Company to attract capital and financing on lower
13 cost, which, in the long-term, will provide lower costs
14 to ratepayers. We have a large international company
15 coming in able to bring best practices in which will
16 lower costs. Those lower costs will eventually accrue
17 to the benefit of ratepayers, as well as the various
18 ways that some of the other intervenors have described
19 the economic development benefits that will occur.
20 So I think what we have here is a transaction in
21 the public interest because it provides benefits to
22 ratepayers in the long-term as well as to other aspects
23 of the state's economic development including the
24 renewables.

1 Q. I notice you didn't include any monetary benefits
2 on your list.
3 A. Sure, they are monetary. They're just not
4 immediate and quantifiable.
5 I think the financing and best practices are
6 going to become monetary benefits, and I think that's
7 what the public interest standard would require. I
8 don't see anything there that says there's an artificial
9 rate reduction that is part of that test.
10 Q. Even though those benefits you have not
11 quantified yet?
12 A. Right. I don't believe that they are
13 quantifiable at the current time, but I don't think that
14 makes them any less real.
15 I would point out that ratepayers will get those
16 benefits. When synergy benefits get quantified, they
17 don't get quantified for the purpose of getting them to
18 ratepayers. Ratepayers automatically get benefits.
19 Synergy benefits get quantified for the purpose of
20 giving a portion to shareholders.
21 Q. Turn back to page 37.
22 There, you discuss the difference between a
23 $603 million benefit in the KeySpan-Grid merger and a
24 figure you described as -- the Commission described as a

1 $408 million benefit of the merger. And the difference
2 between the two is that that difference would have been
3 realized even in the absence of the merger?
4 A. That was the Commission's view, yes.
5 Q. Are you aware of the Petitioners' rate adjustment
6 panel testimony?
7 A. Not in great detail.
8 Q. I would like to refer to Exhibit RAP-3 already on
9 the record in this proceeding.
10 Do the Petitioners have a copy for the witnesses?
11 A. I have that in front of me.
12 Q. And do you see at page 1 of RAP-3 a line labeled
13 "One-Time Charges"?
14 A. I do.
15 Q. And to be consistent with the analysis in the
16 KeySpan-Grid merger, that line should be divided into
17 amounts attributable to the merger and amounts that
18 would have been realized in the absence of a merger;
19 would you agree with that?
20 A. I don't know that I would agree with that because
21 I don't know what the purpose of this exhibit is or what
22 you are -- I don't know what exact comparison you want
23 to make.
24 MR. GERGEN: I think we also object because,

as I understand it, this material came from Staff. It did not come from Mr. Meehan. So without a foundation, I don't know that he can really answer any questions.

MR. VAN RYN: It's the Petitioners' exhibit.

A. I have no idea what the exhibit is.

MR. GERGEN: This material was derived from material provided by Staff. Yes, it was prepared by Petitioners but from material that came from Staff. Mr. Meehan is not a witness to this. He hasn't testified to this.

MR. VAN RYN: We will move on.

BY MR. VAN RYN:

Q. Referring back to the $603 million figure in your testimony.

That was the rate benefit realized by KeySpan's gas subsidiaries; is that correct?

A. Benefit of what? It's not a benefit of the merger, no.

Q. If you could turn to your exhibit ETM-2.

A. Yes.

Q. There, you use the $603 million figure in your exhibit; is that correct? Where it states that "All of the signatories claimed mitigations."

A. I use it as all the signatories claimed

1 mitigations, not as mitigations related to the merger.
2 Q. Let's step back a minute.
3 Could you explain what role you believe the
4 $603 million played in the approval of the KeySpan-Grid
5 merger by the Commission?
6 A. I really am not going to speculate how the
7 Commission weighed any specific number. I would think
8 the $603 million would have been heavily discounted by
9 the Commission as they dismissed almost $200 million as
10 not related to the merger, things that would have
11 happened anyway.
12 It would be hard for me to conceive that the
13 Commission would dismiss that $200 million and then
14 consider it in approving the merger. Doesn't make
15 logical sense.
16 Q. Are you aware that utilities and Staff enter into
17 settlements of rates and revenue requirement matters,
18 correct?
19 A. Sure.
20 Q. And would you believe that -- could the
21 $200 million figure we are talking about be viewed as a
22 revenue requirement-type settlement?
23 A. Possibly a settlement. There is certainly, in
24 what remains in the 407 million, the bulk of that, I

1 know, is settlement, things that were subject to
2 litigation risk.
3 The 200 million, to me, as I recall it, seemed to
4 be things the Commission was a little more certain were
5 going to be rate reductions that would have occurred,
6 not settlements.
7 Q. Until the Commission orders -- until the
8 Commission approves a revenue requirement, you don't
9 know what's actually going to be included in that
10 revenue requirement; is that correct?
11 A. That's a fair statement, yes.
12 Q. So a settlement of a revenue requirement always
13 involves some reduction of litigation risk; is that
14 correct?
15 A. It does. I am just expressing the Commission's
16 view here, that the difference between 600 and 400 was
17 things that would have happened anyway.
18 Q. Turning back to the $603 million number.
19 That does not include any monetary benefits
20 realized by delivery customers of National Grid in the
21 Niagara-Mohawk service territory; is that an accurate
22 characterization?
23 A. Yes, that's an accurate characterization.
24 Q. If you could look at item 5 on Exhibit ETM-2.

1 There, you list approximately $318 million in
2 totally unfunded mitigations; is that correct?
3 A. It is correct.
4 Q. And those dollars were recognized in the KeySpan
5 subsidiary delivery rates and not in the Niagara-Mohawk
6 delivery rates; is that correct?
7 A. The mitigations made were to the KeySpan delivery
8 New York gas delivery rates. The 317. Which, again, as
9 I noted in my testimony, includes a fair amount -- about
10 265 of it is amounts Staff identified as subject to
11 litigation risks. How much of that is pure concessions
12 and how much of that is settlement of litigation risk,
13 317 is certainly a maximum number there.
14 Q. Also in that calculation, you include
15 Niagara-Mohawk delivery revenues?
16 A. Sure.
17 Q. And if none of the benefits went to
18 Niagara-Mohawk, why would you include their revenues?
19 A. Let's put it in perspective what it is. Staff
20 offers three rationales for reducing rates.
21 One of those rationales -- and I don't agree with
22 any of the rationales -- one of the rationales is that
23 other transactions reduce rates by this amount. The two
24 examples that Staff uses are the KeySpan-Grid, which I

1 am addressing here, and then the NYSEG and RG&E.
2 We know in the NYSEG and RG&E, there was a
3 significant error where those were overstated. Even
4 with the correction of that error, we are down in the
5 low, low single digits for NYSEG-RG&E. Actually, NYSEG
6 and RG&E, every single rate reduction in the NYSEG RG&E
7 was a synergy reduction. There were no non-synergy
8 reductions.
9 In KeySpan-Grid, I certainly don't agree with the
10 logic that, just because you have a percentage of
11 delivery rates reduction in one case, that you should
12 have it in the other case. And even if that was the
13 standard, we have a lot of difference. There, we had a
14 lower-rated international company acquiring a utility.
15 Here, we have a higher-rated one acquiring a utility.
16 So there is some significant difference in the
17 transaction.
18 But, nonetheless, Staff wanted to compare and
19 say, "What was the comparison of the revenue reductions
20 made in one case to the other?" My point is: If you
21 are going to do that, you have to do it properly, and
22 doing it properly means removing concessions that are
23 based upon synergies or cost savings because those
24 aren't really concessions to customers. Customers

1 always get the synergy savings. The concession is when
2 you give a shareholder a portion of the synergy saving.
3 If you take and look at the claim that Staff made
4 of 10.3 percent of reduction, I think it is just wrong.
5 First, they started with 600, which included 200 million
6 that we just discussed of things the Commission said
7 weren't related to the merger.
8 Second, they included the synergy saving, so
9 you've got to take them out, if you want to get a
10 comparison, because we don't see from immediate and
11 quantifiable synergy saving here.
12 We arrive at 317, which, as I stated, includes
13 265 of settlement subject to litigation risk, so it's
14 high.
15 If we look at that as just a portion of gas
16 delivery revenues, it would be the 5.43 percent. I
17 think I said 5.47 in correcting my testimony, maybe 5.43
18 percent.
19 But the operations KeySpan has in New York are
20 not just limited to those. So they're getting those
21 rate concessions in conjunction with merging a variety
22 of activities. I think it's quite appropriate to look
23 at it over all the New York delivery revenues.
24 There are certainly synergy savings that are

1 going to go to Niagara Mohawk and there's some savings
2 that go to LIPA. Those customers are benefitting, but
3 if you look at the unfunded mitigation -- which I think
4 it is the appropriate comparison -- I think it's
5 appropriate to look at all the New York revenues of
6 KeySpan.
7 If we look at LIPA, that would give 1.34 percent.
8 If we look excluding LIPA, that would give 2 percent for
9 the unfunded synergy savings. If I was going to do a
10 comparison that's the comparison I would do here.
11 Again, as I stated, in NYSEG and RG&E, I've reviewed
12 that in detail and every single dollar was funded by
13 immediate synergy savings -- net synergy savings.
14 Q. When you prepared this calculation at item 5, did
15 you incorporate any monetary benefits that went to
16 Niagara Mohawk or LIPA as a result of the approval of
17 the Grid-KeySpan transaction?
18 A. No, my understanding was they were all
19 synergy-related savings.
20 Q. If you could turn to page 28?
21 A. Yes, I am there.
22 Q. At the top of that page, you say that Staff has
23 proposed 50 percent of certain transaction costs should
24 flow to NYSEG and RG&E ratepayers. If you look back at

1 page 27, it appears the transaction costs you are
2 referring to are payments to executive management and
3 third parties of approximately $78- and $46 million; is
4 that correct?
5 A. Yes.
6 Q. These costs total 142 million; is that correct?
7 A. 144 million. 124 million.
8 Q. Can you show where Staff directed that $71
9 million in costs go to ratepayers?
10 A. I think I can show that. Staff, I believe, uses
11 as a justification for its savings -- I think I was
12 referring there to Staff 237 where it said how Staff
13 evaluated the reasonableness of its proposed PBAs. It
14 says, "We perform three types of comparisons. First, we
15 looked at sharing and merger benefits. In most recent
16 cases" -- I am going to exclude the parentheticals --
17 "merger savings were shared 50/50."
18 The parentheticals refer to RG&E, Energy East,
19 and Grid-KeySpan. In this case, the overall benefits
20 exceed 1.6 billion. 50 percent of that amount would
21 yield approximately 800 million.
22 My testimony is paraphrasing there the fact that
23 Staff is generally using and saying 50 percent of
24 claimed 1.6 billion in savings, and I will say, I think

1 that number is grossly overstated and includes things
2 inappropriate to include and includes incorrect
3 calculations.
4 50 percent of those costs should flow to NYSEG
5 and RG&E ratepayers, but one component of that cost is
6 the transaction cost. So that's what the point I am
7 making there.
8 Q. The point you are making is not that the costs
9 themselves flow to ratepayers, but you are criticizing
10 the comparison?
11 A. To the extent that including these transaction
12 costs as a basis for the PBAs -- because the PBAs
13 themselves are really just arbitrary items selected to
14 reduce rates. They have no logical relation to the
15 merger. To the extent they are justified based on the
16 look of these transaction costs, in that category, you
17 essentially would be making the acquirer pay twice for
18 the transaction cost. They are not a benefit. They are
19 a cost.
20 Q. It's a comparison to the cost? Would you accept
21 that characterization?
22 A. It's a rationalization for the arbitrary rate
23 reduction.
24 MR. VAN RYN: I have nothing further.

1 JUDGE EPSTEIN: I understand there is other
2 cross for Mr. Meehan. I guess, at this point, if I
3 could just try to follow up on some of this at least to
4 clarify my own thinking.
5 As I began to read your testimony,
6 Mr. Meehan, I started out with the following perception.
7 I think it's your testimony that there are synergies
8 that can be quantified at the outset and others that
9 cannot, and we are dealing with the latter. You are
10 saying that the synergies are expected and real, just
11 not quantifiable.
12 A. I think that's right, Your Honor. I'm saying the
13 synergies are like we'd get in a water case with an
14 industry even less prone to the internationalization of
15 the industry. But that they're synergies from a
16 stronger financial parent, which we had in the water
17 case, we did not have in the National Grid-KeySpan. And
18 also from the implementation of some best practices that
19 provide savings that in the long-term will go to
20 companies -- they're not like Con Ed-O&R or Nice-Niagara
21 Mohawk or NYSEG and Rochester, where we're merging two
22 companies and going to get an immediate cost reduction.
23 JUDGE EPSTEIN: Let's assume there is a real
24 prospect of cost reductions and that the only thing that

1 remains to happen is that they have yet to become known.
2 When I started out reading your testimony, I
3 was thinking, Well, are we really dealing with an
4 allocation of risk between customers and shareholders?
5 Because somebody has to bear the risk of uncertainty as
6 to what the quantifiable synergies, ultimately, are
7 going to be. I think your testimony is consistent with
8 that. Would you agree with that?
9 A. Well, I would agree we don't know the exact
10 level. There is a level of uncertainty on what they are
11 going to be. I don't really think there's much
12 uncertainty, that given the nature of the acquirer and
13 the transaction, that there will be some savings. Nor
14 that, to the extent there are some savings, that they're
15 going to accrue to the customers in the longer term.
16 But I would agree that there is certainly uncertainty
17 over the exact level of the savings.
18 What I don't think is necessarily relevant is
19 whether the level of the savings is X or Y. As long as
20 it's positive, I think the merger would meet the public
21 interest standard.
22 JUDGE EPSTEIN: But if the Commission makes
23 a judgement that some rate conditions should be imposed
24 now in lieu of future benefits, I am wondering what

1 should guide that judgment.
2 Do you think a judgement that a rate
3 condition now in lieu of future synergies is
4 illegitimate simply because all future synergies are
5 going to accrue to ratepayers anyway? Is that what you
6 are saying?
7 A. I think you put it pretty well, as I would say
8 it. It's mainly because the in-lieu-of portion isn't a
9 workable portion. It's not in lieu of. It would have
10 to be in addition to, because those synergies are going
11 to go to ratepayers when they do occur. So if the
12 Commission were to insist on a synergy that is not a
13 cost savings but just a rate reduction at this time, it
14 would -- I don't think it would be appropriate because
15 it would be in addition to the cost saving and it would
16 be unfunded. I don't think you can create a benefit by
17 taking money from one party and putting it to another.
18 The benefit has to come from some type of savings.
19 JUDGE EPSTEIN: That gets to the problem I
20 am having. If I look at the bottom of page 31, we are
21 talking about rate conditions in non-synergy mergers.
22 And around line 18 and 19, I think they are talking
23 about -- in the testimony here, I think we are talking
24 about what you and I were just talking about, which is

1 the problem of who bears the risk related to the
2 uncertainties. And then over on page 32, around lines
3 14 and 15, you remark that ratepayers are going to get
4 100 percent of the benefits eventually.
5 And I guess the -- don't we still have a
6 problem that we don't know -- there's still uncertainty
7 as to what they are going to get 100 percent of. We
8 know they will get -- well, theoretically, under
9 conventional ratemaking, but there is an uncertainty as
10 to how much that's going to be, which, it seems to me,
11 leaves unanswered the question: Who's going to bear the
12 risk of that uncertainty? Getting back to page 31.
13 A. There's going to be uncertainty as to the
14 ultimate level of the rate reduction. I guess the first
15 way I look at it is: Is that uncertainty material to
16 the decision?
17 So, whether that's 200, 400, or 800 million, it's
18 still a positive benefit that ratepayers are getting
19 from the merger. Certainly, I would think that
20 regulation, as Mr. Makholm addresses, in New York is
21 pretty effective at encouraging the most efficient
22 operations. And over time, you would have to rely on
23 that.
24 But I don't think that uncertainty would change

1 the fact that there would be benefits to the merger. I
2 can understand your uneasiness that, with the
3 uncertainty, we don't know what the impact level of the
4 benefit is. What I am not sure of is whether that is
5 something that has to be known to make a decision in the
6 case.
7 JUDGE EPSTEIN: Okay. Thank you.
8 Mr. Mager?
9 BY MR. MAGER:
10 Q. Thank you. Mr. Meehan, let's just follow up on
11 the last few questions.
12 First, in talking about the synergies, they
13 don't -- would you agree with me that they don't go to
14 ratepayers or customers when they occur but rather when
15 rates are reset?
16 A. That's regulatory lag. It's just the normal
17 ratemaking process, the same way that excess cost
18 doesn't immediately get reflected. Synergies go through
19 the normal ratemaking process, which can have regulatory
20 lag.
21 Q. So the answer is yes though?
22 A. Sure.
23 Q. There was a lot of discussion about --
24 A. I am going to have to qualify that because there

1 is an issue. New York does have forward test years and
2 does have rate plans. If the synergies were recognized
3 in a forward rate case projection, they could go as soon
4 as they are incurred.
5 Q. And if there were no rate plans or there were
6 existing rate plans that were continued, then those
7 synergy savings would go to shareholders until rates are
8 reset?
9 A. Yes.
10 Q. Now, in talking about the public interest
11 standard, there was a lot of discussion about benefits,
12 and that's only one side of the equation, correct?
13 A. You want to look at the net benefits.
14 Q. Right. And to get to net benefits you have to
15 compare benefits to costs or harms, right?
16 A. I don't know what you mean by "harms," but if you
17 had costs, you would compare it to costs.
18 Q. What about risks? I understand that the Company
19 doesn't agree with a number of the risks that Staff
20 identified and let's not get into whether they are right
21 or wrong.
22 To the extent that there are potential risks
23 associated with the merger, wouldn't you agree that
24 public interest standard would require those risks to be

1 balanced with the potential benefits of the merger?
2 A. I think in meeting the public interest standard
3 you would want to look at both the benefits or the costs
4 and the risks. You can't always do that quantitatively
5 on either side. The risk side also can be quantified
6 and we won't get into the -- I think Mr. Mager more
7 addresses the issue of whether there truly are risks.
8 So I won't get into that.
9 Q. Following up on that, I agree that not all
10 benefits or risks can be quantifiable, and so, when the
11 Public Service Commission has to balance risk --
12 potential risks and potential benefits, to some extent,
13 it's a qualitative judgment as well as quantitative,
14 wouldn't you agree?
15 A. I think with some of the risks there could be a
16 qualitative judgment that was made.
17 Q. To the extent synergy savings are identified in
18 this case or imputed or something other than synergy
19 savings, such as positive benefit adjustments are
20 identified -- to the extent those are paid to customers
21 that would be viewed as a benefit of the transaction for
22 customers?
23 A. I just can't see it that way. You're just taking
24 money from the shareholder and giving it to the customer

without a cost reduction. You're not compensating the shareholder in that case for providing service. It's going to harm the investment environment in New York and it's going to harm the shareholders. This view of just arbitrarily decreeing a rate reduction as a benefit to customers, I don't think that's correct.

Q. Let's say synergy savings are identified but the Commission has a difficult time quantifying them, it could impute some amount?

A. To shareholders? That's typically what's done with synergy savings. When they are identified, it's for the purpose of reserving some for shareholders. For ratepayers, ratepayers get them subject to the regulatory lag.

Q. If the Commission found that in the absence of quantifiable synergy savings flowing to the customers that the risks of this merger outweighed the benefits, what do you think would be more appropriate for the Commission to do? Reject the merger outright? Or condition it upon some financial benefit flowing to customers that might tilt the balance in favor of the public interest?

A. I don't feel qualified to speculate on what the Commission should do in that case. As I said, I

1 reviewed Mr. Makholm's testimony. I think New York
2 regulation is effective enough that the transaction
3 doesn't provide risks. I think other states -- Kentucky
4 with EON -- has found the same thing. And I think the
5 water company mergers here show that the Commission
6 has -- I believe, in Lyonaise-United Water -- has
7 indicated its ability to effectively regulate a foreign
8 holding company.
9 In the hypothetical, and accepting the
10 hypothetical that the Commission found there were large
11 risks here, I'd have to say I just don't know whether it
12 would be more appropriate for the Commission to outright
13 reject the merger or to try and put its own on the
14 risks. I don't know how anyone would try to put a
15 number on those risks.
16 Q. Let's say that, rather than rejecting the merger
17 outright, the Commission indicated it would be willing
18 to approve the merger subject to certain conditions.
19 They could be financial or something else. At that
20 point, is it your understanding that Iberdrola could
21 decide to either accept or reject the conditions?
22 A. I believe that in mergers in other places, maybe
23 even in New York -- no, in New York, everything is run
24 by settlement. But I think there have been instances

1 where regulators said, We will approve this subject to
2 some conditions, and the merging parties can decide
3 whether conditions are acceptable, yes.
4 Q. So from Iberdrola's standpoint, wouldn't it be
5 preferable to at least have a choice whether to accept
6 certain conditions than have the merger rejected
7 outright?
8 A. From Iberdrola's standpoint, I think it probably
9 would be preferable.
10 Q. Now, I just have a few more questions. If you
11 could go to page 4 of your testimony.
12 A. Yes.
13 Q. And you discuss first mover, geographic
14 extension-type mergers. Do you see that? Starts on
15 line 5.
16 A. Yes, I do.
17 Q. And when you say that there may not be synergy
18 savings -- quantifiable synergy savings as a result of
19 this merger, did you personally perform any studies to
20 see whether there were, in fact, synergy savings that
21 could result from this merger?
22 A. No. I did not.
23 Q. Did you see any studies prepared by anyone else
24 on behalf of the Petitioners that examined whether

synergy savings were possible?

A. I did not. I mean, I am generally familiar with synergy studies. I have done quite a few of those, but they usually involve adjacent utilities. But I did not see here synergy savings. I guess I read the testimony that said the number of employees would be preserved, that operations wouldn't really change. From that, I think it's plausible that, in that context, you won't get synergy savings.

Q. So it was an assumption on your part?

A. Based upon a review of other testimonies, yes.

Q. Could there be synergy savings where the service territories are not adjacent and may, in fact, be quite a distance apart?

A. There could. I will point out that not quantifying synergy savings is very conservative. As I said, synergy savings aren't quantified to give to the customer. The customer gets -- synergy savings are quantified to reserve for the shareholder. So, yes, synergy savings occur here, they're going to go right to the customer.

Q. It's conservative in one sense, but the merger would certainly appear to be more in the public interest if there were a lot of synergy savings, wouldn't it?

A. I don't know there are degrees of public interest. My understanding is, if there are benefits, it's in the public interest.

Q. It would be an easier call to make if there were a billion dollars in synergy savings that were going to flow to customers as compared to zero? Wouldn't you think that would be an easier call for the Commission to make?

A. No, because I think it's fairly clear that there are long-term benefits to this transaction.

Q. Now, Iberdrola has assets in North America that are not regulated T&D utility, does it not?

A. It does.

Q. How familiar are you with those assets?

A. Very high-level. I just have the understanding that they have wind generation. I am not more familiar than that. I am sorry. North America -- I know they have gas plants in Mexico.

Q. And they have gas storage plants and --

A. Natural gas-fired generation, combined-cycle generation in Mexico.

Q. Now, could only another T&D utility provide the opportunity for synergy savings? Or is it possible that synergy savings could be identified if Iberdrola's other

operations -- withdrawn. Let me try to rephrase that better.

Is it possible that synergy savings can be identified among businesses that are not exactly the same?

A. Sure. I mean you have things like shareholder relations, some accounting services. Sometimes you get synergies in there even when you have utilities that weren't adjacent if it was feasible to combine those systems.

MR. MAGER: Thank you. That's all I have, Your Honor.

JUDGE EPSTEIN: Mr. Prestemon?

MR. PRESTEMON: Yes, very briefly, Your Honor.

BY MR. PRESTEMON:

Q. On the issue of the sharing of synergy savings, you indicated that in a merger involving a utility in which there is no extraordinary--or rate plan outstanding that would automatically transfer the benefits of synergy savings to the customer, those benefits would not accrue until the Commission, in fact, revised its rates for that company; is that correct?

Would accrue to the ratepayers, if I am not being

clear.

A. I think what I am saying is, in the absence of a rate plan, the synergy benefits are going to accrue to the ratepayer in their entirety -- in their entirety.

If there is a long-lasting rate plan, certainly, those synergy benefits accrue to the shareholder as opposed to the ratepayer if there wasn't some allowance made for the synergy benefits.

Q. At the time the merger is approved, if there is no provision in the order for changing the rates then in place, and the merger achieves significant synergy savings for the combined companies, isn't it true that those savings will inure entirely to the benefit of shareholders until rates are reset?

A. Until rates are reset, that would -- until rates were reset, that would happen. I mean, in the context of what we have here, the longest-lasting rate plan we have is through the end of 2008.

Q. But rates will -- the benefits will flow to the shareholders until rates are reset even if there is a rate plan unless the Commission brings that company back in affirmatively for a rate case. It's up to the Company to decide when to come in for revised rates; is that correct?

A. Well, that's a big "unless," but that's true.

Q. At the time of the merger, if the Commission decides that a portion of projected synergy savings that were going to accrue to the benefit of shareholders be shared with ratepayers, in fact, the Commission is shifting money from shareholders to ratepayers, not as you put it, setting aside money for shareholders. That money was going to shareholders initially; isn't that correct?

A. During the regulatory lag period. I stand by my testimony: The synergy savings go to ratepayers. Yes, we have instances where, before a company comes in for a rate case, they can potentially share in the savings just through natural forces. As you said, they can be called in for a rate case, and that is the normal way that regulation works is to give incentive during the regulatory lag period.

There is certainly -- I will not disagree that if you have a lag and you have a synergy savings, that savings doesn't go to the customers until rates are reset. That is correct.

Q. And in this case, you've mentioned that, although you don't see these as immediate synergy savings in the traditional sense, there certainly will be savings that

eventually will be quantifiable in this case; is that correct?

A. Yes.

Q. But there is going to be a lag?

A. There could be lag. We don't know if there's going to be a lag. There are forward test years. We don't know -- there is other factors, there's other costs that can go up. We don't actually -- synergy savings could be off-setting some of the other cost rises. So we really don't know for sure, but there certainly is the potential for a lag.

Q. If, in this case, the Commission decided to make an effort to quantify what it sees as the future benefits and to set some of those aside for ratepayers immediately, it would not be doing anything significantly different than what it does in what you call a synergy merger; is that correct?

A. I think it would be. I think the main purpose in a synergy merger is either to put those benefits to customers in the context of a rate plan. If it's not in the context of rate plan, put the benefits to shareholders.

I think we're talking about, really, a real detail here with this regulatory lag period. That when

1 benefits are in the future, the whole system of
2 regulation does have a possibility that a benefit --
3 just as there's a possibility that an extra cost will be
4 borne by shareholders, there's a possibility that a
5 savings will go to shareholders.
6 I think if the Commission was to quantify very
7 difficult-to-quantify benefits here, it would be doing
8 something different. And the question would be: When
9 would they go to shareholders? You'd have to have a
10 system of tracking the regulatory lag, which would seem
11 to be quite complex.
12 Q. But whether or not the job is more difficult or
13 not, in both cases where we are dealing with this lag,
14 there is a risk for all the parties as to what is
15 actually going to turn out to be the case in the future.
16 And the Commission, if it decides to do so, in setting
17 aside money for shareholders -- or for ratepayers
18 initially--is trying to reduce that risk for ratepayers
19 to some extent; is that correct?
20 A. You mean the risk of regulatory lag? I guess
21 there is a risk, if it's that. I am just not sure that
22 I buy into the premise that customers are harmed that
23 the second a cost savings occurs it doesn't get
24 reflected in rates.

1 If that's the premise, you'd also have the
2 premise that the second cost was incurred, it should get
3 reflected in rates. Instead of having the regulatory
4 system we have, you'd almost have a global adjustment
5 clause for all utility costs. Yes, you could solve
6 things that way, but that would come at the cost of
7 incentives for efficient operation.
8 Q. In a case where a transaction is premised on
9 benefits being achieved for ratepayers, then there is a
10 reason to try to minimize the risks that those benefits
11 are going to be realized. We're not talking about
12 resetting rates every time a dollar is saved. We are
13 talking about projections which are subject to changes
14 during a period of regulatory lag and a remedy in the
15 form of removing some of the risk by establishing rates
16 now in anticipation of the future benefit; isn't that
17 correct?
18 A. I don't see it that way. I mean, you issue a
19 bond and we get a lower rate on a bond that persists for
20 20 or 30 years. You bring in a best practice and you
21 lower costs going forward for many, many years. To say,
22 Well, ratepayers are at risk because they're not going
23 to get the savings for six months or a year due to
24 regulatory lag, I guess I just have a hard time seeing

that as a risk to ratepayers. I mean, if that's the risk we are talking about, it's a pretty small item, and it seems very difficult to solve. The water merger certainly didn't try and account for that.

MR. PRESTEMON: No further questions.

JUDGE EPSTEIN: Mr. Duthie.

MR. DUTHIE: Just a couple of questions.

BY MR. DUTHIE:

Q. Good afternoon, Mr. Meehan.

A. Good afternoon, Mr. Duthie.

Q. Is rate stability a consideration that the Commission should address in considering whether to approve a merger and what conditions to attach to it?

A. I would guess in some situations. I am not sure it would apply here if a merger could provide enhanced rate stability. The Commission may want to consider that.

Q. Do unfunded revenue reductions enhance rate stability or does it decrease rate stability?

A. I think they decrease rate stability.

MR. DUTHIE: I have no further questions, Your Honor.

JUDGE EPSTEIN: Other cross? Redirect.

MR. GERGEN: Could we have three minutes

with the witness?

JUDGE EPSTEIN: Sure.

MR. GERGEN: Thank you.

REDIRECT EXAMINATION

BY MR. GERGEN:

Q. Mr. Meehan, a number of parties expressed some concern about future potential synergies yet unquantifiable today, to the extent those synergies are realized in the future how they would flow to ratepayers. Do you have any further comments on that?

A. Yes, I think a lot of those questions went into: Could something be done today to give more certainty to them. I would note that the partial acceptance offer provides for $200 million of near-term rate reductions to customers.

Q. Also in your cross-examination, you mentioned a number of times that, very quickly each time, concerning the sort of general rule that in a merger synergies are typically estimated so that some portion of those synergies can actually be reserved for shareholders. Just so the record is crystal clear, can you walk through an explanation of that?

A. Sure. I have been involved in quite a few mergers and synergy estimates, and one of the first

1 aspects of analyzing the merger is to determine what
2 type of synergy cost savings can be achieved. And then,
3 how those can be used to offset some of the costs of the
4 merger.
5 What I mean by that is that when synergies are
6 quantified, part of a merger -- I am talking generally,
7 not just in the context of this specific merger in
8 New York -- part of the idea is to say, here are the
9 synergy benefits that can come from the merger.
10 They will usually start low and ramp up over
11 time. They increase over time. And I think the point
12 is then, how do you -- if customers normally, without
13 any rate plan or without anything else, they are all
14 going to go to customers. There's no way that they
15 would offset some of the costs of the merger.
16 Typically what gets done with the synergy savings
17 is it's identified, and then through some sort of rate
18 plan, either reserving some portion of the synergy
19 savings for customers, or figuring it into rate plan, or
20 reserve -- some portion is then reserved for
21 shareholders so shareholders can fund the cost of
22 the--one example would have been the NYSEG-RG&E merger.
23 NYSEG Electric had a rate plan and 50 percent of
24 the synergies were reserved for shareholders. The other

50 were based into the rate plan.

The other three entities -- the NYSEG Gas, RG&E Gas, and RG&E Electric -- didn't have a rate plan. So there was explicit arrangement that 50 percent of the merger synergy savings for the first five years would go to shareholders. Absent that type of agreement, all those savings would have went to customers.

So it's really a function of providing an incentive for an efficient merger, it's necessary to reserve some of the savings for the shareholders.

MR. GERGEN: Thank you. No further redirect.

JUDGE EPSTEIN: Recross.

MR. MAGER: Thank you.

RECROSS EXAMINATION

BY MR. MAGER:

Q. You mentioned a couple times that, absent allocation to shareholders, all synergy savings would go to customers; is that your testimony?

A. Yes.

Q. But that supposes that all the synergy savings would flow -- in this case, that would assume that all synergy savings would flow to customers of NYSEG and RG&E, correct?

A. Right, they are synergy savings to the utilities, yes.

Q. Is it possible that the synergy savings could flow to Iberdrola's other operations in North America or that they can flow to the parent level? Synergy savings don't always go in one direction, do they?

A. In this case, I don't think there has been any legitimately identified synergy savings that would go to Iberdrola.

Q. There is no savings going to customers either, right?

A. There is no savings going to customers and there's really no benefits going to Iberdrola either. So...

Q. Let me give you an example. You talk about best practices and somehow over time, we don't know how much time, Energy East and--I am sorry, NYSEG and RG&E--realized cost savings because they've learned a best practice from Iberdrola. That's one example you mentioned?

A. Yes.

Q. Couldn't it work the other way? Isn't it possible that Energy East actually has a best practice that Iberdrola does not have, and that as a result of

1 the merger Iberdrola adopts Energy East's best practice
2 and Iberdrola realized cost savings that will never be
3 seen by NYSEG and RG&E's customers?
4 A. Sure, it's going to be a sharing of knowledge and
5 a sharing of cost savings, and I should be clear, it's
6 the allocated cost savings, so certainly there could be
7 cost savings in the future that would flow. For
8 example, the National Grid-KeySpan cost savings to all
9 the utilities in New England, and all the utilities in
10 New York, I am not implying that they all go to the
11 New York utility.
12 MR. MAGER: Thank you.
13 JUDGE EPSTEIN: Anything further? Okay,
14 thank you, Mr. Meehan, you are excused.
15 JUDGE EPSTEIN: Petitioners, do you want to
16 call your next witness?
17 MR. GERGEN: Our next witness is -- may I
18 step out of the room for just a moment?
19 JUDGE EPSTEIN: I mentioned yesterday that
20 I'd noted the appearance of Mr. Martinez for NRDC
21 because he would like to have the testimony of Mr. Gupta
22 inserted into the record, there being no
23 cross-examination for Mr. Gupta. So I am going to do
24 that at this time. I am giving the reporter a copy of

that testimony.

(The following is the prefiled testimony of Ashok Gupta:)

1 **I. Identification and Qualifications**

2 **Q. Please state your name and business address.**

3 A. Ashok Gupta, 40 West 20th Street, New York, NY 10011.

4 **Q: On whose behalf are you testifying?**

5 A: I am testifying on behalf of the Natural Resources Defense Council ("NRDC").

6 **Q. Mr. Gupta, by whom are you employed and in what capacity?**

7 A. Since September 1991, I have been employed by the NRDC, a national not-
8 for-profit environmental advocacy organization with more than 650,000
9 members. I am currently a Senior Economist and the director of NRDC's
10 Air and Energy Program. My responsibilities include working on energy
11 policy in New York, the Northeast and nationally, as well as related issues
12 such as utility restructuring, energy efficiency, green buildings, petroleum
13 dependence and renewables.

14 **Q. Could you please summarize your educational background and professional**
15 **experience?**

16 A. I received my Bachelor's degree in Physics and Math from Georgetown
17 University and a Master's degree in Economics from American University.
18 Prior to joining NRDC, I was employed as a Senior Economist by the New
19 York City Department of Telecommunications and Energy from 1989 to

1991. I was also employed as an energy and telecommunications economist by the Public Utility Law Project of New York from 1984 to 1989.

Q. Do you serve on the boards of any energy-related organizations and do you serve on any energy advisory boards?

A. I currently serve on the Boards of Directors of the Alliance for Clean Energy New York; Coalition for Environmentally Responsible Economies; U.S. Green Building Council - New York; the Low Impact Hydropower Institute; and Clean Air-Cool Planet. I also serve on Mayor Bloomberg's Energy Task Force Advisory Committee and Sustainability Advisory Board; NYSERDA's System Benefits Charge Advisory Committee; and Lieutenant Governor's Renewable Energy Task Force.

Q. Have you previously testified before the New York State Public Service Commission (the "Commission")?

A. Yes. I have previously testified in various cases before the Commission, including Case 96-E-0987 (Con Edison electric rate/restructuring case), Case No. 96-E-0134 (Niagara Mohawk electric rate case), Case 95-E-0491 (Orange and Rockland electric rate case) and Case 04-E-0572 (Con Edison electric rate case).

II. Introduction

Q: What issues will you address in your testimony?

1 A: I will discuss a revenue decoupling mechanism (RDM), demand side
2 management (DSM) targets, and performance incentives for DSM programs for
3 a merged Iberdrola, S.A. / Energy East company or for Energy East Corporation
4 if the merger is not successful (hereafter "Iberdrola" or the "Company"), in
5 addition to the issues of renewable electricity and market power.

6 **III. Revenue Decoupling**

7 **Q: Does the organization on whose behalf you are testifying support revenue**
8 **decoupling?**

9 A: Very much so. Decoupling revenues from sales is critical to removing the
10 financial incentive created by traditional ratemaking for utilities to distribute
11 more electricity.

12 **Q: Has the Commission recognized the importance of decoupling?**

13 A: Yes. The Commission issued an Order on April 20, 2007, which requires
14 "utilities to develop and implement mechanisms that true-up forecast and actual
15 delivery service revenues and, as a result, significantly reduce or eliminate any
16 disincentives caused by the recovery of utility fixed delivery costs via
17 volumetric rates or marginal consumption blocks."[1]

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[1] New York State Public Service Commission (PSC) Case No. 03-E-0640, Proceeding on Motion of the Commission to Investigate Potential Electric Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation and PSC Case No. 06-G-0746, In the Matter of the Investigation of Potential Gas Delivery Rate

1 **Q: Do you recommend general principles for how a good revenue decoupling**
2 **mechanism should be designed?**
3 A: Yes. A good RDM should meet the following criteria:
4 - Decoupling must break the link between profits and sales.
5 - Set allowed revenue and true-up actual revenues to allowed revenues.
6 - Incentives for reliability (or anything else) and collection of deferred
7 revenue should not be tied to sales.
8 - Allowed revenues should be adjusted for desirable or unexpected and
9 unavoidable factors that increase or decrease costs.
10 - Growth in customers, jobs and businesses are all desirable factors that
11 might drive up costs.
12 - If these factors go down, costs should go down, as should
13 allowed revenues.
14 - Extreme storms and terrorist attacks are factors that might
15 unexpectedly and unavoidably drive up costs.
16 - Allowed revenues should be adjusted on a customer class basis if there
17 are significant factors unique to each class.
18 - Adjustments to revenue, actual revenues, and true-ups should be calculated in
19 a transparent way.

Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation, Order Requiring Proposals for Revenue Decoupling Mechanisms (issued April 20, 2007).

- Any factors used to adjust allowed or actual revenue should be outside of the utilities' control.
- Any adjustment formulas should be simple and readily replicable by any active party.
- Adjustments based on number of customers and customer class should be carefully reviewed to avoid incentives for gaming.
- Actual revenues can be weather normalized before being compared to allowed revenues as long as the weather normalization does not require overly complex calculations.

- Deferrals of rebates or surcharges should be avoided to the greatest extent possible.
  - Adjustments and true-ups should be done as often as practical without creating overly complex calculations.
  - Limits on true-ups to avoid rate volatility or rate increases during economic down-turns may be appropriate, but the need for such limits should be determined with consideration of the deferral costs they impose.
  - Frequent true-ups keep rates more in-line with average short-term costs.

Q: Has Iberdrola proposed a method of revenue decoupling?

A: No, it has not.

1 **Q: What would be a good revenue decoupling approach for the Company?**

2 A: The Company should adopt a RDM that adheres to the principles laid out
3 above. Generally, we recommend that a simple approach be developed
4 through a three-month stakeholder process and compliance filing process
5 after the Commission's decision in this case.

6 One adjustment to the allowed revenues that the Commission and
7 stakeholders should consider is some sort of economic development factor
8 such as job growth in the region. One concern regularly raised regarding
9 decoupling is that the utility collects the same revenue even during an
10 economic downturn or a period of economic development. To the extent
11 that the number of customers fluctuates with the economy, using a per
12 customer approach already adjusts for economic shifts. However, the
13 economy may also drive changes in patterns of use, and it is generally
14 considered desirable to have utilities encouraging economic development.
15 Scaling allowed revenues with job growth and loss would be one way to
16 address this concern, though the scaling factor would need to be carefully
17 thought through. Allowed revenues can also be adjusted for other factors
18 such as the Consumer Price Index to capture expected growth in costs,
19 though this is usually also coupled with a productivity factor to capture the
20 idea that utilities should get better at controlling costs over time. We are
21 open to considering such adjustments, but recommend the simplest

1 approach possible be used at the outset and then evaluated after a period of
2 time.

3 **IV. Demand Side Management Targets**

4 **Q: Should Iberdrola adopt a (DSM) target?**

5 **A:** Yes. New York State's energy efficiency goal, enumerated by Governor Spitzer
6 in April of this year, is to reduce electricity consumption through efficiency 15
7 percent below forecasted levels by 2015 (hereafter "15 by '15"). The Company
8 should procure all cost-effective energy efficiency and should be required to
9 achieve a 15 percent reduction in electricity consumption below forecasted
10 levels by 2015, in accordance with New York State's energy efficiency goal.
11 The Company should be required to do the same with respect to natural gas, as
12 well. The Company should be responsible for determining how the 15% will be
13 achieved among the various energy efficiency service providers and programs in
14 its service area.

15 **Q: What level of interim targets would keep the Company on track to achieve**
16 **the 15 by '15 goal?**

17 A: Iberdrola should set interim electricity and natural gas consumption reduction
18 targets of 3% for the year 2010 and 9% for the year 2013, in order to ensure that
19 it is implementing effective energy efficiency measures and is progressing
20 towards the 15% goals, at a minimum. Such interim targets reflect a 1%

decrease in consumption per year through 2010, a 2% decrease per year for 2011 through 2013 and a 3% decrease per year for 2014 and 2015.

Q: Should the Company's DSM targets regarding electricity be set in terms of energy or demand reductions?

A: The Company's DSM targets regarding electricity should reflect the fact that the Company will implement permanent energy efficiency programs to achieve such targets. Thus, these targets should be established in terms of energy savings (GWh), rather than avoided capacity.

Q: What should the Company's role be with respect to delivery of energy efficiency programs?

A: The Company should coordinate with government entities delivering energy efficiency in its service territory and should provide for the seamless, integrated delivery of gas and electric programs, but ultimately the Company should be the party responsible for ensuring that its service territory achieves the 15 by '15 goal. The Company enjoys certain inherent advantages with respect to its customer base, including, but not limited to, a local presence and customer relationships, the collection and maintenance of customer usage data, and the ability to facilitate customer access to attractive financing for efficiency improvements. The New York State Energy Research and Development Authority (NYSERDA) has other inherent advantages, such as the ability to more effectively implement statewide market transformation programs. The

Company's coordination should ensure that the respective strengths of the Company, NYSERDA and others are utilized to the maximum extent possible.

V. Performance Incentives for DSM Programs

Q: How should an appropriate performance incentive for Iberdrola be designed?

A: The award of incentives should be based largely on actual verified performance of achieving efficiency results and should be scaled, with higher incentives for higher achievement. The target award level should be based on aggressive but achievable goals, with the opportunity to earn greater incentives for exemplary performance beyond these base goals, which avoids the situation where utilities stop pursuing more cost-effective efficiency once they reach the base target.

The largest portion of incentives should be based on achieving actual benefits, ideally based on total resource net benefits from kWh or therm savings. For the Company, the goals should support achieving the 15 by '15 targets, as I discuss above. However, additional goals tied to other criteria should exist. These goals can be used as countervailing influences, to avoid the Company simply focusing on savings at the potential detriment of critically important considerations such as equity and comprehensiveness. Examples could include: targets for low income participation; geographic or demographic equity goals; comprehensive treatment goals.

1 Incentives can be annual or multi-year. Multi-year goals have the
2 advantage of allowing utilities more flexibility to modify designs over time to
3 make most efficient and effective use of resources. It also allows for goals
4 focused on things like market transformation that may take multiple years to
5 show results.

6 Finally, all incentive earnings should be subject to independent verification
7 of achievements, and not pre-specified based on simply completing certain
8 milestones.

9 A good example of an appropriate performance incentive structure for the
10 Company was included in the State of California Public Utility Commission's
11 September 25, 2007 Decision in Rulemaking 06-04-010.[2]

12 Building on this model, I propose that a threshold be set at 85 percent of
13 the base energy savings goal. At this threshold, the Company would start
14 earning an incentive of 9 percent of the net benefits. The incentive should be
15 stepped up to 12 percent if the Company's DSM performance level achieves 100
16 percent or more of the goals. This structure is important because if it is clear
17 prior to the end of the period that a utility will not reach the target, it should still
18 have an incentive for pursuing as much efficiency as possible.

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[2] State of California Public Utilities Commission, Rulemaking 06-04-010, Order Instituting Rulemaking to Examine the Commission's post-2005 Energy Efficiency Policies, Programs, Evaluation, Measurement and Verification, and Related Issues, Interim Opinion on Phase 1 Issues: Shareholder Risk/Reward Incentive Mechanism for Energy Efficiency Programs, Decision 07-09-043 (issued September 25, 2007).

The Company should also be penalized for poor performance on its savings goals. Penalties should be assessed if the Company's performance falls to or below 65 percent of the base goal, at which point penalties should be assessed per kWh or therm for each unit below the goal. Such a penalty would ensure that the Company will have a consistent incentive to improve performance.

VI. Renewable Electricity and Market Power

Q: Does the NRDC support the development of renewable energy in the state of New York?

A: Absolutely. Renewable energy can supply a significant share of the state's energy needs, creating significant public benefits including environmental improvement, increased fuel diversity and economic development. The development of renewable energy sources in New York state is a critical component of the efforts to reduce global warming emissions in-state and to achieve the goals of the state's Renewable Portfolio Standard. The NRDC is a strong proponent of renewable energy and actively advocates for the development of renewable energy sources across the state and nation.

1 **Q: Do you believe Iberdrola's permanent residence in the state of New York**
2 **through the purchase of Energy East will help New York achieve its stated**
3 **goals for renewable power in the state?**
4 A: Yes. Iberdrola is a known international leader in the development of wind
5 power. The company's interest in the state, in part, stems from the opportunities
6 available for the profitable development of renewable electricity. The
7 permanent residence of an international leader in wind development will add to
8 the competitiveness of renewable markets and lead to the development of
9 additional renewable capacity within state borders.
10 **Q: Do you believe Iberdrola's purchase of transmission and distribution**
11 **facilities in the state of New York will give the company undue market**
12 **power, which it may use to stifle the development of renewable power**
13 **within the state?**
14 A: Development of renewable power in the state of New York is primarily driven
15 through the demand established by the Renewable Portfolio Standard. As we
16 have seen elsewhere, other states have opted to increase the percent of load
17 served by renewable power in order to meet state climate policy goals and
18 reduce emissions from power generation. Iberdrola's ownership of a
19 Transmission and Distribution utility will not change the requirements or
20 deadlines in New York's Renewable Portfolio Standard. Additionally,
21 appropriate safeguards can be established to ensure that any behavior perceived

1 to be uncompetitive is restrained or eliminated, as has been the case with other
2 utility-owned generation.

3 **Q: With the energy efficiency targets, revenue decoupling and performance**
4 **incentives described, would you support the merger?**

5 A: Yes.

6 **Q: Does this complete your testimony?**

7 A: Yes.

1 JUDGE EPSTEIN: And associated with that
2 testimony are five exhibits.
3 MR. VAN RYN: Judge, my records show I only
4 got one.
5 JUDGE EPSTEIN: I'm sorry. There are two
6 exhibits. One is the exhibit that was prefiled together
7 with the testimony, and that will be No. 82. And the
8 other is the affidavit adopting his testimony in
9 absentia, and that will be 83, a number reserved for
10 that affidavit.
11 (Exhibits 82 and 82 marked for
12 identification.)
13 MR. GERGEN: We'd like to present our next
14 witness, Jeffrey Makholm.
15 JEFFREY MAKHOLM, after first having been
16 duly sworn, was examined and testified as follows:
17 DIRECT EXAMINATION
18 BY MR. GERGEN:
19 Q. Mr. Makholm, could you please state your full
20 name and address for the record?
21 A. Yes, Jeff, middle initial D, Makholm,
22 M-A-K-H-O-L-M. My address is 200 Clarendon Street,
23 Boston, Mass.
24 Q. Do you have before you a 72 page document of

1 questions and answers entitled, "Rebuttal Testimony of
2 Jeff D. Makholm" dated January 31, 2008?
3 A. Yes.
4 Q. Was that document prepared by you?
5 A. Yes.
6 Q. Do you have any corrections or changes to your
7 rebuttal testimony?
8 A. I have four. The first of those is on page 27,
9 line 18. Strike the words, "and RG&E," in the middle of
10 that sentence. The second is on page 46, line 12, at
11 the end of that line there are some page references,
12 78-79, 82-84. Those should be struck and replaced with
13 78-84. Next one is on page 52, line 11. There is a
14 typo. There is the word "rules" in that line. It
15 should read "ruled." And the last one is in a footnote
16 on page 58. Footnote 23, in that legal style book
17 reference there is a number 205. That should read 138.
18 That's all.
19 Q. If I were to ask you the questions set forth in
20 your rebuttal testimony, would your answers be the same
21 as set forth in the testimony as corrected?
22 A. Yes.
23 Q. Do you adopt this as your sworn rebuttal
24 testimony in this proceeding?

A. Yes.

MR. GERGEN: Your Honor, may we have the rebuttal testimony of Jeffrey D. Makholm copied into the record?

JUDGE EPSTEIN: Yes.

(The following is the prefiled rebuttal testimony of Jeffrey D. Makholm:)

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

I. Introduction

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

A. My name is Jeff D. Makholm. I am a Senior Vice President at National Economic Research Associates, Inc. ("NERA"). NERA is a firm of consulting economists with its principal offices in a number of major U.S. and European cities. My business address is 200 Clarendon Street, Boston, Massachusetts, 02116.

Q. Please describe NERA.

A. NERA was founded in 1961 by consulting economists working in conjunction with Professor Alfred E. Kahn of Cornell University (a future Chair of the New York Public Service Commission and still an active Special Consultant at NERA), making it the oldest firm of independent consulting economists. Consistent with NERA's tradition of providing independent economic advice, the firm has no interest, as such, in the Iberdrola/Energy East merger and no stake in its outcome.

Q. Please describe your academic background.

A. I have M.A. and Ph.D. degrees in economics from the University of Wisconsin, Madison, with a major field of Industrial Organization and a minor field of Econometrics/Public Economics. My 1986 Ph.D. dissertation is entitled "Sources of Total Factor Productivity in the Electric Utility Industry." I also have B.A. and M.A. degrees in economics from the University of Wisconsin, Milwaukee. Prior to my

1 latest full-time consulting activities, I was an Adjunct Professor in the Graduate
2 School of Business at Northeastern University in Boston, Massachusetts, teaching
3 courses in microeconomic theory and managerial economics.

4 Q. Please describe your work experience pertinent to this proceeding.

5 A. My work as a consulting economist principally involves the area of regulated
6 industries—both those that operate networks (such as oil and gas pipelines, electricity
7 transmission and gas distribution systems, telecommunications and water utility
8 systems) and those operating infrastructure business at specific sites, such as airports,
9 electricity generation plants, oil refineries and sewage treatment plants. In such
10 industrial settings, I have researched and provided evidence regarding regulated
11 pricing, the presence or absence of market power, competition, the fair rate of return,
12 regulatory rulemaking, incentive ratemaking, load forecasting, least-cost planning,
13 cost measurement, contract obligations and bankruptcy, among other issues. I have
14 prepared expert testimony and affidavits, and I have appeared as an expert witness, in
15 many state, federal and United States District Court proceedings, as well as in
16 regulatory and court proceedings abroad.

17 I have also directed studies on behalf of utility companies, governments and the
18 World Bank in many countries. In these countries, I have drafted regulations,
19 established tariffs, recommended financing options for major capital projects and
20 advised on industry restructurings. I have also assisted in the privatization of state-
21 owned utilities. As part of my international work I have conducted formal training

1 sessions for government, industry and regulatory personnel on the subjects of
2 privatization, pricing, finance and regulation of the gas industry. My current
3 curriculum vitae, which more fully details my educational and consulting experience
4 and my publications, is provided as Exhibit ___ (JDM-1).

5 Q. Are you familiar with the way in which New York and other states, as well as the
6 federal government, regulate the rates of utilities and other network industries such as
7 interstate pipelines and electricity transmission systems?

8 A. Yes. I have submitted hundreds of testimonies in dozens of state and federal
9 jurisdictions in the United States. These include a number of pieces of evidence for
10 NYSEG, RG&E and other Energy East companies in NY, CT and ME, both before
11 and after their mergers with Energy East. I have provided many testimonies on
12 capital structure and cost of capital in NY for a number of gas and electric utilities,
13 and I am familiar with the regulation of utilities by the Public Service Commission in
14 New York State ("Commission").

15 Q. Please describe your appearances before the Commission.

16 A. Over the past 20 years, I have appeared as a sworn expert witness, or presented a
17 sworn affidavit or testimony, 21 times before the Commission on a diverse range of
18 subjects for electricity, gas and water utilities. The cases in which I have appeared
19 are as follows:

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

- Prepared Rebuttal Testimony on behalf of National Fuel Gas Distribution Corp., Cases 28947 and 28954, September 14, 1987. Subject: Pass-through mechanisms for gas acquisition costs.

- Supplemental Prepared Direct Testimony on behalf of Empire State Pipeline, Case 88-T-132, October 17, 1988, in conjunction with testimony of Professor Alfred E. Kahn: Subject: Measured benefits of pipeline entry to gas transportation markets in New York State.

- Prepared Rebuttal Testimony on behalf of Empire State Pipeline, Case 88-T-132, September 6, 1989. Subject: Benefits of pipeline entry in New York State.

- Prepared Rebuttal Testimony on behalf of National Fuel Gas Distribution Corporation, Case 88-G062, October 27, 1989. Subject: Pass through of contract reformation costs of interstate gas pipelines pursuant to federal gas industry restructuring.

- Prepared Direct Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-1050, November 22, 1989. Subject: Cost of capital and capital structure.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-1050, April 27, 1990. Subject: Cost of capital and capital structure.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-126, May 18, 1990. Subject: Cost of capital and capital structure.

- Prepared Direct Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, November 15, 1990. Subject: Cost of capital, cost effect of weather adjustment clauses.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, April 10, 1991. Subject: Cost of capital and capital structure.

- Prepared Supplemental Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, July 29, 1991. Subject: Cost of capital.

- Prepared Direct Testimony on behalf of the New York State Electric and Gas Corporation, Case 91-E-0863, et al., August 28, 1991. Subject: Cost of capital.

- Prepared Rebuttal Testimony on behalf of New York State Electric and Gas Corporation, Case 91-E-0863, et al., February 3, 1992. Subject: Cost of capital.

- Testimony in Support of Multi-Year Agreement on behalf of New York State Electric and Gas Corporation, Case 92-E-1084, et al., April 15, 1993. Subject: Cost of capital.

- Rebuttal Testimony in Support of Multi-Year Agreement on behalf of New York State Electric and Gas Corporation, Case 92-E-1084, et al., May 3, 1993. Subject: Cost of capital.

- Rebuttal Testimony on behalf of Jamaica Water Supply Company, Case 92-W-0583, May 28, 1993. Subject: Cost of capital.

- Prepared Direct Testimony on behalf of the Brooklyn Union Gas Company, Case 93-G-0941, November 1, 1993. Subject: Cost of capital.

- Prepared Direct Testimony on behalf of New York State Electric & Gas Corporation. Case 01-E-0359. August 3, 2001. Subject: Electric price protection plan.

- Prepared Rebuttal Testimony on behalf of New York State Electric & Gas Corporation. Case 01-E-0359. September 12, 2001. Subject: Electric price protection plan.

- Direct Testimony on behalf of Rochester Gas and Electric Corporation. Case 02-E-0198, Case 02-G-0199. February 15, 2002. Subject: Cost of capital.

- Rebuttal Testimony on behalf of Rochester Gas and Electric Corporation. Case 02-E-0198, Case No. 02-G-0199. September 30, 2002. Subject: Cost of capital.

- Affidavit in support of Rochester Gas and Electric Corporation's Response to Staff's November 8, 2002 filing. Case 02-E-0198, 02-G-0199. November 14, 2002. Subject: Respond to staff's filing with respect to the rate-of-return and risk impacts of various regulatory mechanisms.

In addition, I participated in the Generic Finance Proceeding in New York in the early 1990s, as a consultant to the group comprising all of the regulated electricity and gas companies in the state. That work involved an investigation into the possibility of adopting a formula that would automatically update the cost of capital for regulated utilities in the state without necessitating formal case-by-case evidentiary hearings. While that lengthy proceeding took over a year and produced

1 many written reports and recommendations, and is still referred to by Staff from time-
2 to-time in its various rate case testimonies, it was never adopted formally by the
3 Commission.

4 Q. So would you say that you are familiar with the way in which the Commission
5 regulates the companies in its jurisdiction?

6 A. Yes. More specifically, in the case of independently owned and traded utilities,
7 operating companies of larger holding companies and new regulated entrants, I am
8 familiar with both the way in which this Commission administers its responsibilities
9 to look out for the interests of consumers of utility services in New York and the way
10 in which the Commission sets the fair rate of return, oversees utility capital structures
11 and generally regulates tariff levels to that end.

12 Q. Have you worked in the past with Energy East or the utility operating companies that
13 it now holds?

14 A. Yes. In addition to providing evidence for NYSEG on the cost of capital in New
15 York, I worked for Central Maine Power, prior to its merger with Energy East, with
16 respect to the productivity factor, based on my own empirical Total Factor
17 Productivity (TFP) measurements, in its multi-year price cap plan in Maine. I also
18 represented the Connecticut gas distribution utilities that are now a part of Energy
19 East—Southern Connecticut Gas Company and Connecticut Natural Gas. I
20 represented both companies as part of the Algonquin Customer Group in a number of

1 FERC cases involving interstate pipeline rates and charges. I also represented
2 Southern Connecticut Gas, both before the courts in Connecticut and the Department
3 of Public Utility Control regarding the recovery of its system enhancement costs.

4 Q. Does your experience with regulated utilities extend outside the U.S.?

5 A. Yes. I have directed projects involving the privatization and tariff regulation,
6 including assessments of the opportunity cost of capital, for major regulated utilities
7 and other network infrastructure businesses in many countries, including Poland, the
8 United Kingdom, the Netherlands, Ireland, Spain, Argentina, Chile, Bolivia, Mexico,
9 Canada, China, New Zealand, South Africa, Russia, and Australia, among others.

10 Q. Do you have any experience in bankruptcy proceedings, either for utilities or for
11 firms related to utilities (like utility holding companies, power plants or energy
12 marketing firms)?

13 A. Yes. I was a consultant to Public Service Company of New Hampshire in 1988 on
14 various ratemaking questions when that firm became the first U.S. utility since the
15 Great Depression to file for bankruptcy. I have since filed testimony in federal court
16 in three bankruptcy proceedings involving utilities, interstate pipeline contracts or
17 power sales contracts:

18 – Before the United States Bankruptcy Court for the District of Maine,
19 Testimony on behalf of the Massachusetts Municipal Wholesale Electric
20 Company in Eastern Maine Electric Cooperative, Inc., Adversary Proceeding
21 No. 89-1006, December 14, 1989.

1 – Before the United States Bankruptcy Court, Northern District of Texas, Fort
2 Worth Division, Report on behalf of Mirant Corporation, et al, Debtors. Case
3 No. 03-46590 (Jointly Administered). March 22, 2005. Subject: Pipeline
4 capacity valuation for a rejected pipeline capacity contract.

5 – Before the United States Bankruptcy Court, Northern District of Texas, Fort
6 Worth Division, Reply Report on behalf of Mirant Corporation, et al, Debtors.
7 Case No. 03-46590 (Jointly Administered). April 12, 2005. Subject: Pipeline
8 capacity valuation for a rejected pipeline capacity contract.

9 – Before the United States Bankruptcy Court, Southern District of New York,
10 Report on behalf of Solutia, Inc., Debtors. Case No. 03-17949 (PCB). March
11 23, 2007. Subject: Discount rate for damage projections for a rejected power
12 sales contract.

13 – Before the United States Bankruptcy Court, Southern District of New York,
14 Supplemental Report on behalf of Solutia, Inc., Debtors. Case No. 03-17949
15 (PCB). April 20, 2007. Subject: Discount rate for damage projections for a
16 rejected power sales contract.

17 In addition, I have consulted and/or provided testimony in state proceedings for
18 the solvent operating utilities of bankrupt holding companies or bankrupt sister
19 subsidiaries under holding company structures. In particular, these cases included
20 Portland General Electric Company (a subsidiary of the bankrupt Enron Corp) and
21 Public Service Company of Colorado, a sister subsidiary of the bankrupt power
22 trading company NRG under the holding company Xcel.

23 Q. Have you published papers relating to regulating the rates of public utilities?

24 A. Yes. My C.V. lists 17 published papers and one book pertaining to various elements
25 of state and federal regulation, both in the U.S. and abroad.

26 Q. What is the purpose of your testimony?

1 A. My evidence in this proceeding serves to rebut evidence given by the New York
2 Department of Public Service Staff Policy Panel ("Staff Policy Panel" or "Staff"). I
3 conclude that the panel wrongly characterizes the transaction, misstates the nature of
4 the proposed merger as it relates to the public interest in New York, misinterprets the
5 significance of the opinions of the independent ratings agencies, wrongly criticizes
6 the suitability of Iberdrola as a holding company vis-à-vis Energy East, and presents
7 subjective and inappropriate financial calculations and conditions. The Staff Policy
8 Panel's criticisms are inconsistent with the way New York, as well as other state
9 commissions, regulates its investor-owned utilities.

10 Staff's strongly negative view of the proposed merger has no foundation in the
11 "regulatory compact" that has evolved in the United States over many decades to
12 serve the twin goals of protecting the public interest while allowing investor-owned
13 utility companies to pursue their own legitimate business interests. Based on my
14 experience, I believe the Staff's approach is inconsistent with the position of its peers
15 in other state jurisdictions as well as that of Congress, the Federal Energy Regulatory
16 Commission (the FERC) and the Securities and Exchange Commission (the SEC).
17 Those other agencies realize that utility holding companies—whether based in the
18 United States or abroad—cannot erode the rights of utility ratepayers and can neither
19 evade nor lessen the effectiveness of the longstanding methods that federal and state
20 legislatures and the courts have given regulators to protect the public interest when
21 ratepayers are served by investor-owned utilities.

1 Q. Does your testimony address Staff's responses to information requests related to the
2 Staff Policy Panel's direct testimony addressing the issues discussed in your
3 testimony?
4 A. Yes. I have received and reviewed several responses by Staff to information requests
5 related to the Staff Policy Panel's direct testimony and have specifically addressed
6 some of the responses in my rebuttal testimony. However, additional analysis will be
7 required to review and possibly specifically address many of Staff's responses as
8 there was insufficient time to complete my review in the time provided to submit my
9 testimony. I further note that in certain responses, Staff has indicated that it intends
10 to revise certain exhibits and I reserve my right to revise my rebuttal testimony at
11 hearing if those Staff revisions bear on my testimony.
12 Q. Are you sponsoring any exhibits in addition to your C.V?
13 A. Yes. Exhibit __ (JDM-2) contains a copy of one interrogatory response referenced in
14 this testimony.
15 Q. How do you organize your testimony?

16 A. The Staff Policy Panel testimony runs to 317 pages with the various issues that I rebut
17 spread throughout. To narrow my rebuttal to those elements that I consider most
18 objectionable, I organize my response into the following seven topics, the contents of
19 which I briefly describe below:

20 1. Incentives Attached to "Goodwill". Staff wrongly claims that the merger will
21 create incentives for Iberdrola, as the new owner, to "cut corners" and seek
22 unreasonably high earnings from the regulated New York operating utilities in
23 order to make a return on the accounting "Goodwill" that it will book for this

transaction. In fact, the presence of Goodwill in connection with a utility acquisition is routine in such transactions, and no new incentives will accompany this transaction or its outcome.

2. Credit Quality/Ratings. Staff misstates the issues surrounding credit quality. The rating agency concerns relating to New York pertain, according to them, largely to the State's harsh treatment of its regulated companies, not to this proposed transaction. Further, to the extent that the ratings agencies refer to this transaction, their concerns pertain largely to the problems that would occur if the Commission attempted to extract excessive concessions from the regulated operating companies.

3. Vague Statements of "Risk". Staff's various uses of the term "risk" (e.g., generalized statements of concern regarding Iberdrola's unregulated subsidiaries and foreign utility operations) have nothing to do with ratepayers or with this transaction. The "risks" that can affect ratepayers (i.e., business risk, financial risk, etc.) are well defined terms of art in the financial and regulatory literature. Staff provides no basis—conceptual or empirical—for concluding that such risks will increase with this transaction.

4. Transparency/Cross Subsidies/Affiliate Issues. Staff implies that there are uncertainties regarding the internal workings of Iberdrola and its affiliates that create a potential problem for *ratepayers*. Such an implication is incorrect. The Commission will give up none of its reliable methods for dealing with affiliated interest issues in this transaction. If there are specific and substantive concerns from the Commission, merger conditions can make explicit the commitments that Iberdrola makes with respect to regulation in New York.

5. Upstream Tax/Benefit Issues. Staff's attempts to value this acquisition from Iberdrola's perspective are subjective and unrealistic, in addition to being irrelevant regarding the cost-based rates for New York consumers that the Commission oversees. The valuation of this merger in Iberdrola's eyes is a question that lies outside the appropriate frame of reference of the Commission.

6. Improper Calculations/Wrong Proceeding. All of Staff's calculations pertaining to "backed out" capital structure ratios are subjective and improper. Furthermore, Staff examines the subject of the cost of equity for the operating companies in a context inappropriate for the merger issues before it.

7. Basic Statutory Control. Staff ignores two fundamental points in its objection to this merger: (1) The Commission in New York will lose none of its ability to use its broad, legislatively-granted powers to protect the public interest in

New York through direct regulation of NYSEG and RG&E as a result of this transaction; and (2) the view of holding companies in the United States has evolved over time—from the 1935 Public Utility Holding Company Act to the 2005 Energy Policy Act. Holding companies subject to books and record requirements and protections against improper affiliate transactions are accepted by the Congress, the FERC and the SEC as a normal part of modern energy markets. Staff's proposal to go beyond these requirements and protections and essentially seek to regulate Iberdrola is out of step with these other regulators and Congress that recognize that it is neither wise nor necessary to promote both modern energy markets and the wider interests of the public.

8. The Golden Share. Staff recommends that a "golden share" condition be placed on approval of the transaction in order to prevent the possibility of a parent bankruptcy triggering the bankruptcy of its subsidiary. The voting rights of this golden share would be held by a party appointed by the Commission. This condition is not needed, as the Commission retains effective control over the regulation of the companies in its jurisdiction, including over affiliate transactions that could be associated with a parent bankruptcy. But in any case, it is contrary to the custom and practice of U.S. regulation for the Commission to appoint a party in the governance structure of an investor-owned utility.

Q. Please proceed.

A. I will address each of these points in order.

II. Incentives/Goodwill

Q. Please describe the purpose of this section of your testimony.

A. The Staff Policy Panel expresses significant concern with the price that Iberdrola proposes to pay Energy East above the regulated book value (i.e., the "rate base") in the regulated entities (see, for example, Staff Policy Panel testimony at pp. 179-193 which is entitled "Risky Nature of Goodwill"). Staff asserts that the resulting Goodwill that Iberdrola will book in its own accounts for this transaction will create

1 new incentives for it to raise rates above reasonable levels or degrade the level of
2 service to New York ratepayers in order to make a return on that Goodwill. In this
3 section of my testimony I discuss why Staff's concern with Goodwill at the Iberdrola
4 level is misplaced. Not only Iberdrola, but every private investor in U.S. utilities,
5 pays above the book value for shares of utility equity. The incentives to earn profits
6 by running utilities are no different for Iberdrola than they currently are for Energy
7 East or for any other traditional equity investor for any utility in the country.

8 In other words, having Iberdrola replace Energy East as the holding company will
9 have no effect whatsoever on the profit incentives inherent in the investor-ownership
10 of NYSEG or RG&E, however Iberdrola treats the premium paid over book value.
11 Staff's assertion that Iberdrola faces any new incentive to profit at ratepayers'
12 expense, or that its avenues for profitability are different than those that have
13 traditionally driven utilities in the U.S., is illogical and contrary to economics.

14 Q. Where does the Staff Policy Panel speak about how the Iberdrola Goodwill from this
15 transaction will supposedly create new incentives to profit at ratepayers' expense?

16 A. The Staff Policy Panel brings up the issue several times in its testimony. For
17 example:

18 On page 30, the Staff Policy Panel states:

19 [w]e believe that the long term excess capital arising out of the M&A
20 transaction (i.e., the premium paid), will create long term pressure on the
21 management of the combined entity to cut corners and seek to extract a

1 return from the utility assets which exceeds the realistic and reasonable
2 earnings potential of those properties. The result can be financial stress
3 and service problems over the long run.

4 On page 31, the Staff Policy Panel states:

5 Post transaction, Iberdrola would have Goodwill and intangible assets on
6 its books in an amount that is equal to 46% of its equity balance. This is a
7 significant hazard to ratepayers.

8 On page 86, the Staff Policy Panel states:

9 ...the amount of non-earning assets created by this merger places a great
10 deal of stress on utility operations to produce an adequate return to meet
11 the needs of all of Energy East's operations. Goodwill already on the
12 books of Energy East and Goodwill related to this transaction will make
13 up approximately 63% of the equity of Iberdrola's investment in Energy
14 East.

15 On page 192, the Staff Policy Panel states:

16 When Iberdrola acquired Energy East, second generation Goodwill was
17 created. Second generation Goodwill is Goodwill generated by the
18 acquisition of an entity that already has Goodwill on its books. If
19 Iberdrola is acquired at a premium, third generation Goodwill will be
20 created. ... This process is unsustainable in the long run.

21 Q. How do you respond to these kinds of Staff Policy Panel assertions that the merger
22 will create incentives for Iberdrola to "cut corners" and "seek to extract" an excessive
23 return as a result of its acquisition of Energy East?

24 A. The incentives facing Iberdrola are no different than those already facing all investor-
25 owners of U.S. utilities, whether they are individual shareholders or holding company
26 parents. Before specifically responding to Staff's claims as they relate to Goodwill,
27 which I discuss further below, it is helpful to recall the long-established balance

1 struck in U.S. utility regulation between ratepayer interests and the interests of private
2 owners of utilities.

3 Q. Please proceed.

4 A. In the normal state of affairs, utility owners have long been recognized as having an
5 interest in making the greatest return on the smallest investment in regulated public
6 services. Since the early 20th century, when private utility ownership was accepted as
7 the norm in the United States (as opposed to the practice of government ownership of
8 utilities in many other countries), those incentives have been embraced as the way to
9 harness private company initiative while maintaining high quality services to the
10 public. The public is protected from the possibility of owners charging excessive
11 prices or degrading the quality of service—whether the owners are individual
12 shareholders or a corporate parent. That is to say, balancing public interest with
13 investor ownership—*i.e.*, the "regulatory compact"—does not depend on whether the
14 owners are individuals or a holding company.

15 Q. What is this "regulatory compact?"

16 A. The literature on regulation of investor-owned public utilities refers consistently to
17 the concept of the "regulatory compact," defined by Professor Charles F. Phillips Jr.,
18 of Washington and Lee University—an authoritative writer in the field of public
19 utility regulation—as follows:

1 First, in return for a monopoly franchise, utilities [accept] an obligation to
2 serve all comers. Second, in return for agreeing to commit capital to the
3 business, utilities [are] assured a fair opportunity to earn a reasonable
4 return on that capital.[1]

5 Others have called this mutuality of commitments the "regulatory bargain,"
6 reflecting the older terminology of early 20th century economists studying the
7 economic and institutional foundation of American utility regulation. These
8 economists saw a number of new relationships form in the development of complex
9 "going concerns" during the industrial revolution. The economists called them
10 "bargains" to signify what Professor Martin Glaeser at the University of Wisconsin—
11 the author of the first authoritative regulatory economics text—described as "the
12 economic framework by means of which business is carried on."[2] The *cost bargain*
13 was how regulated enterprises acquired inputs in the market, and the *investment*
14 *bargain* was how regulators would induce owners of capital to contribute it for

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1 *See* C.J. Phillips, Pub. Utils. Reports, Inc., *The Regulation of Public Utilities, Theory and Practice* at 21 (1993) (referencing I.M. Stelzer, *The Utilities of the 1990s*, Wall St. J., Jan. 7, 1987, at 20).

2 M.G. Glaeser, *Outlines of Public Utility Economics* at 102, Macmillan (1927). Glaeser's influence on public utility economics in the United States, directly and through his many graduate students, has been profound. Indeed, Professor Phillips relies on Glaeser for, among other things, his basic definition for public utilities as distinct types of firms in the U.S. economy. *See* Phillips at 4. Glaeser himself, as an undergraduate at the University of Wisconsin in 1907, was one of 15 students in the world's first university class in regulatory economics, taught by the great institutional economist at Wisconsin, and drafter in 1907 of Wisconsin's regulatory statute, John R. Commons (later the President of the American Economic Association). Dr. Milo Maltbie, who almost simultaneously drafted New York's first regulatory commission statute, and an inaugural Commissioner of the New York Public Service Commission (appointed by Governor Charles Evans Hughes), credits Commons as having encouraged him to seek that appointment. According to Maltbie: "Professor Commons dropped into my office and asked if I were making any attempt to secure an appointment to the commission, ... [and] that I was qualified for just such a place and that the Governor would appoint at least one man who knew what it was all about." *See* Howard J. Read, *Defending the Public: Milo Maltbie and Utility Regulation in New York* at 25, Dorrance Publishing Co. (1998); J. R. Commons, *Myself* at 128, Macmillan, (1934). Maltbie eventually served as Chairman of the New York PSC from 1930 to 1949. I bring up this history merely to help to show that the charges by the Staff Policy Panel that a new and harmful incentive will accompany this transaction are not only incorrect but uninformed. The protections of customers that utility regulation provides in New York, as elsewhere in the U.S., rests on a longstanding and substantial economic and institutional foundation crafted and administered by farsighted experts.

1 certain public purposes. The *income bargain* or *rate bargain* covered the transactions
2 with utility customers.[3] These three relationships developed into the more modern
3 term *regulatory bargain* that has defined U.S. regulation since the 1944 *Hope Natural*
4 *Gas* decision.[4]

5 Q. What does the "regulatory compact," or alternatively "regulatory bargain," mean, in
6 practical terms, for how customers are served by investor-owned regulated
7 companies?

8 A. It means the compensation for the owners of utilities depends on the adequacy and
9 quality of service to the public. If the public is not well served, the regulator can
10 apply specific sanctions to the company or prevent it from earning a return
11 commensurate with other firms in the market.

12 My point is this: The broad statutory powers given to regulators like the
13 Commission in New York are fully capable of responding to poor services on the part
14 of the investor-owned companies that they regulate. Whether the owners are
15 individual shareholders or corporate parents has nothing to do with the Commission's
16 key role of ensuring that the public is provided with safe, adequate and reliable
17 service at the lowest reasonable cost.

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[3] Glaeser, *Outlines of Public Utility Economics* at 102-107; *see also* R.R. Breutigam, *A Regulatory Bargain for Diversified Enterprises*, International Journal of Industrial Organization, Vol. 11 at 1-20 (1993).

[4] *Fed. Power Comm'n. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

1 Q. Getting back to the specific issues of risk associated with allegedly excessive
2 Goodwill, do you believe Iberdrola can "cut corners" to the detriment of ratepayers as
3 Staff alleges it might if it acquires Energy East?

4 A. Iberdrola will have no more ability to cut corners on NYSEG and RG&E customer
5 service than these utilities had before and after they were acquired by Energy East. If
6 the bills are wrong, if outages increase, if wait time for service calls increase, etc., the
7 Commission can impose sanctions on the operating companies regardless of whom
8 the corporate parent is. Staff's claim that Iberdrola's level of Goodwill will, in Staff's
9 words, "create long term pressure on the management of the combined entity to cut
10 corners," raises an unjustified concern given the Commission's ample regulatory
11 authority over NYSEG and RG&E. The transaction will not "create" anything. The
12 pressure on utility management to reduce costs has always existed—which is
13 precisely why the Commission has the job of looking out for corner-cutting, listening
14 to ratepayers' complaints, and sanctioning utility companies if for any reason they
15 degrade what the Commission feels is adequate service. This transaction in no way
16 increases this pressure. Moreover, it is my understanding that Iberdrola has
17 committed to operate with local management.[5] Staff's allegations therefore seem
18 speculative and unsupported.

[5] See Section VIII, below, where I discuss how the Commission previously cited the importance of local management, among other things, in its approval of the acquisition of United Water Resources by the French holding company, Suez Lyonnaise des Eaux.

1 Q. Changing the focus from service quality to rate levels, the Staff Policy Panel says that
2 Iberdrola will "seek to extract a return from the utility assets which exceeds the
3 realistic and reasonable earnings potential of those properties" (*see* Staff Policy Panel
4 at p. 30). Can it?

5 A. No. Every owner of every investor-owned utility in the United States might be
6 expected to want to earn profits "which exceed the realistic and reasonable earnings"
7 of those utilities—but regulation prevents this from happening. These are
8 monopolies, after all, and if we let them charge prices as they wished, they would
9 raise prices and enjoy the fruits of their monopoly power. But it is incorrect to imply
10 that just because the owners of a utility in the United States have the *incentive* to raise
11 prices and extract extra profit, that they have the *ability* to do so. Ratepayers have no
12 more risk of being overcharged by NYSEG and RG&E as subsidiaries of Iberdrola
13 than they did when these companies were independently owned. Staff's suggestion to
14 the contrary has no merit.

15 Moreover, there is nothing in the record to support Staff's speculation that
16 Iberdrola will need to extract an extraordinary level of return to support its level of
17 Goodwill. In fact, Staff's suggestion is contradicted elsewhere in its own testimony.
18 In its discussion of "Benefits," the Staff Policy Panel (at p. 85) says that, based on its
19 calculations, the proposed transaction "could be accretive to earnings." This would
20 appear to alleviate Staff's concerns about whether Iberdrola can support the Goodwill
21 that will be placed on its books in connection with the planned transaction.

1 Q. But what about the level of Goodwill on Iberdrola's books? Staff estimates that $1.4
2 billion will be recorded as Goodwill in connection with the transaction, and
3 emphasizes (on page 181) that under recent changes in accounting standards that
4 Goodwill is no longer amortized, but stays on the balance sheet unless it is impaired.
5 Won't that be a hazard to ratepayers in New York?

6 A. The level of Goodwill estimated by Staff is not particularly unusual for a utility
7 transaction of this size and I do not conclude that it will be a hazard. First, utility
8 equities in the United States normally sell at a premium over book value—meaning
9 that the Goodwill issue is the normal state of affairs for all utility equity investments.
10 Second, the Goodwill at Iberdrola, and the accounting treatment of Goodwill on its
11 balance sheet, is irrelevant from the perspective of how the Commission will set rates
12 or ensure service quality for New York ratepayers.

13 Q. Please explain.

14 A. It is typical for utility equities to change hands—either for individual shares or for
15 whole companies—at prices in excess of book value. Except for the unexpected
16 inflationary periods of the 1970s and 1980s, or idiosyncratic examples of utility
17 distress (such as those trying to finish nuclear power plants after Three Mile Island),
18 utility equities in the United States have always sold at premiums above book value—
19 sometimes substantial premiums. These premiums reflect investor expectations that
20 companies will grow and that share prices will increase. Goodwill, whether booked
21 as part of a parent company transaction or inherent in the purchase of an individual

1 share of stock at a price above book value, is just the normal state of affairs in the
2 United States, and it places no pressure on rates at all. Nor does it constitute a
3 "significant hazard" to ratepayers, as the Staff Policy Panel states.

4 Q. You said that Goodwill places no pressure on rates. Why doesn't Goodwill enter the
5 ratemaking process?

6 A. Because rates come from the rate base, and not the current market value of traded
7 shares of utility equities. When the Commission sets the fair rate of return, it applies
8 the result to the rate base, not to the price at which shares happen to be selling in the
9 market. The Staff Policy Panel states, at page 189, that as the proportion of Goodwill
10 to hard assets grows, the "hard assets must work harder and harder to generate a
11 return…to keep Goodwill from being impaired."

12 Staff's assertion that assets are doing the "work" is illogical. It is the management
13 and employees that "work" to enable a company to be successful and to earn its
14 owners a return consistent with expectations in the market for capital. The Staff
15 Policy Panel implies, without basis, that somehow the assets themselves will be
16 stressed, or worn out, or broken, because of Iberdrola's level of Goodwill. But there
17 is no basis whatsoever to imply that Goodwill will promote stress on capital
18 equipment. When any purchaser of utility common stock equity (directly or
19 indirectly through another company) pays more than its book value, the purchaser
20 expects growth to allow it to earn a return greater than the product of the current fair
21 return granted by the commission multiplied by the current rate base. Iberdrola

1 should expect what any other buyer of utility equities would expect—to be able to
2 manage and run these companies in a way that gives it an adequate return for
3 committing its capital to the service of ratepayers in New York and the other states
4 served by operating companies of Energy East. Whether it does so will be the result
5 of its own skill, foresight and industry in managing these companies. But none of
6 that has anything to do with the quality of services to ratepayers in those jurisdictions
7 or the prices that the regulators will allow.

8 Q. Staff performs a calculation, on page 86, to show how Goodwill will cut by two thirds
9 the return that Iberdrola can expect on its investment in Energy East. Are those proper
10 calculations?

11 A. No, they are not proper, because they ignore the contribution of growth to the value
12 of utility equity.

13 Q. Please explain.

14 A. In its calculations, the Staff Policy Panel assumes a current ROE of 12 percent and a
15 level of Goodwill related to this transaction of approximately 63 percent. From these
16 assumptions, it states (at pages 86-87) that

17 ...it would mean Iberdrola would see an ROE of just over 4% on its
18 investment in Energy East [i.e., 12 x (1-0.63)]. Clearly other factors are in
19 play other than utility earnings as to why Iberdrola decided to purchase
20 Energy East.

1 These are not proper calculations. When the cost of equity for utility investments,
2 as measured by the market, is 12 percent, then simply because that result is applied to
3 the rate base, and not the higher market value, it does not mean that investors expect
4 something less than 12 percent. Investors expect company earnings to grow—to
5 expand levels of service and to do so with operations that become more productive
6 and efficient.

7 In other words, if a stock sells at 150 percent of book value in a market where the
8 cost of equity (reflected by the Commission-awarded rate of return) is 12 percent,
9 then the buyer of a share of stock in the market expects 12 percent—with part of the
10 return coming from the return on the rate base and the other part coming from
11 investors' expectations of earnings growth. The relationship between current yield
12 and prospective growth is a part of every utility rate proceeding. I have been in
13 numerous rate cases both inside and outside New York. No party to those cases
14 would give credence to a witness who divided the fair rate of return by the current
15 ratio of the market price to the book value to assert that the result is all that investors
16 could see as part of their operation of the utility (as Staff Policy Panel has done in its
17 calculations). This is precisely because those parties understand that growth is an
18 integral part of the equity return equation for investors. By excluding growth from its
19 calculations, Staff Policy Panel has drawn unsupportable conclusions on this issue.

20 Q. What do you conclude regarding the Goodwill issue?

1 A. Nothing about Goodwill will affect the regulatory compact or enter the service quality
2 or ratemaking equation for New York ratepayers. Goodwill resulting from the
3 proposed transaction will not be pushed down onto the books of NYSEG, RG&E or
4 Energy East, and thus will have no effect on rate base or customer rates. The concern
5 that the Staff Policy Panel displays with respect to Goodwill has no foundation in
6 anything that will affect New York ratepayers. Iberdrola was readily capable of
7 raising equity for this transaction—to acquire utilities with an exacting and highly
8 evolved regulatory compact—Goodwill notwithstanding.

9 **III. Credit Quality and Ratings**

10 Q. Please describe the purpose of this section of your testimony.

11 A. I comment on the Staff Policy Panel's discussion of credit quality and independent
12 credit ratings. Staff seems to believe that the proposed transaction will hurt the credit
13 ratings of NYSEG and RG&E and thereby raise their own cost of debt, and it quotes
14 various rating agency opinions in the process. There are two issues in particular that
15 deserve rebuttal in this respect. The first is the fact that Iberdrola maintains a better
16 credit rating, according to those ratings agencies, than the Energy East companies that
17 it proposes to acquire. The second is Staff's unwillingness to acknowledge the
18 significance of the criticism that the market seems to be leveling on the regulation of
19 utilities in New York.

1 Q. Where does the Staff Policy Panel discuss the issue of credit ratings and the cost of
2 borrowed funds to the operating utilities in New York?

3 A. The Staff Policy Panel makes numerous statements about ratings and credit quality. I
4 give some examples below, along with some preliminary reactions to what I consider
5 highly unsupportable or illogical assertions on the part of the Staff Policy Panel.

6 On page 150, the Staff Policy Panel states:

7 The leverage reflected in Iberdrola's pro forma capital structure puts
8 downward pressure on its credit quality. ... Moreover, when the effects of
9 the write down of Goodwill are considered, the capital structure ratios are
10 not fully consistent with investment grade bond ratings.

11 Please notice here how Staff is substituting its own judgment on credit ratings for
12 that of the independent ratings agencies. On page 158, the Staff Policy Panel states:

13 The credit rating advantage that Iberdrola currently enjoys over Energy
14 East apparently has no direct benefit to the utilities. S&P has NYSEG and
15 RG&E on negative outlook due to issues arising from the M&A
16 transaction. This casts doubt on Iberdrola's promise of greater financial
17 strength for NYSEG and RG&E.

18 Mr. Fetter, for Iberdrola, will point out how this is a misstatement of the ratings
19 agency opinions.

20 On page 168, the Staff Policy Panel states:

21 Q. How much of a downgrade is likely as a result of the transaction?
22 A. Since S&P has not stated otherwise, we believe the credit agency will
23 limit any downgrade of for (sic) NYSEG and RG&E to one rating notch.
24 We are not confident, however, that there will not be further downgrades
25 to both the New York utilities and Iberdrola.

1 Notice again that S&P has said nothing about such downgrades, but only the Staff
2 Policy Panel (because "S&P has not stated otherwise"). On page 170, the Staff
3 Policy Panel states:

> 4 The S&P credit reports for both NYSEG and RG&E highlight two reasons
> 5 for a downgrade: the potential Iberdrola acquisition and the recent
> 6 NYSEG rate case. That the NYSEG rate case appears in both credit
> 7 reports is telling. In theory, NYSEG's rate case should have no bearing on
> 8 the credit quality of RG&E. They are two separate entities whose rates, in
> 9 theory, should have no effect on the other. The fact that S&P appears to
> 10 consider the effects of the NYSEG ratemaking in an RG&E credit analysis
> 11 indicates that regardless of whether the acquisition is approved or not,
> 12 additional structural separations and other financial protections are needed
> 13 to shield the two subsidiaries from all of their affiliates (my emphasis).

14 Please note here that the Staff Policy Panel uses the phrase "in theory" twice to
15 attempt to separate the Commission's treatment of NYSEG and its effect on RG&E.
16 It should be obvious that in practice, harsh treatment of one operating subsidiary of a
17 holding company in a state like New York foretells a strong possibility of similarly
18 harsh treatment to its sister subsidiary. Staff takes its "theory" to "indicate" a need
19 for additional structural separations from all of Iberdrola's affiliates. The ratings
20 agency reports do not indicate this at all. What they indicate is that those subsidiaries
21 that can be affected by Commission action are in the same ratings boat—it has
22 nothing to do with potential unregulated affiliates that lie beyond the reach of the
23 Commission.

24 And on pages 171-4, the Staff Policy Panel first quotes Moody's, and then takes it
25 upon itself to "rebut" the Moody's analysis:

1 The Moody's reports state: "The negative outlooks for [Energy East] and
2 its subsidiaries reflect, in part, the financial and operating challenges
3 resulting from a surprisingly unfavorable decision NYSEG received in its
4 general rate case decided in August 2006. ... The negative outlooks also
5 recognize that while the transaction with Iberdrola is subject to numerous
6 state and some federal regulatory approvals, it is not uncommon for
7 approvals of this nature to be conditioned upon additional rate
8 concessions. ..."

9 We [the Staff Policy Panel] would be remiss; however, if we did not rebut
10 certain misunderstandings contained in the Moody's report. ... The
11 adjective "harsh" used by Moody's [to refer to conditions imposed by the
12 Commission] merely recognized the reality that rate concessions in excess
13 of real merger savings will have a negative impact on credit quality.

14 Q. What is your reaction generally to these statements about ratings and credit quality?

15 A. In all of these statements the Staff appears to be trying to substitute its own judgment
16 and opinion for that of the disinterested ratings agencies. What is clear to readers of
17 those ratings agency reports of the past couple of years is that the Commission's
18 "surprisingly unfavorable" treatment of NYSEG ~~and RG&E~~ has worried those
19 agencies. The Staff Policy Panel does not acknowledge the ratings agencies' direct
20 expression of concern about the impact of regulators' actions on the utility
21 subsidiaries, and instead tries to turn that concern into a criticism of the potential
22 effects of the merger.

23 Q. What do you see from an examination of the last two or three years of rating agency
24 opinions about the credit ratings stemming from the treatment of the regulated
25 utilities in New York?

1 A. A reading of all the recent ratings reports leads me to conclude that the ratings
2 agencies are not so much concerned about Iberdrola's proposed acquisition of Energy
3 East as they are about the Commission's regulation of NYSEG and RG&E.

4 Q. Did rating agencies downgrade Energy East and its subsidiaries upon the merger
5 announcement?

6 A. No. The announcement of Iberdrola's acquisition of Energy East did not adversely
7 affect the ratings of Energy East or its subsidiaries. Both S&P and Moody's
8 reaffirmed their ratings of these companies:

9 On June 26, 2007, Standard & Poor's Ratings Services affirmed its 'BBB+'
10 corporate credit rating on Energy East Corp. and its affiliates on the
11 announcement that Iberdrola S.A. will acquire the company for about $8.5 billion,
12 including the assumption of about $4 billion of debt. The outlook remains
13 negative.[6]
14

15 Effective June 27, 2007, Moody's affirmed the ratings and negative outlook of
16 EEC and its regulated utility subsidiaries [...]. The ratings affirmation was in
17 response to the announcement that Iberdrola of Spain agreed to acquire EEC[...].
18 The rating outlook remains negative for EEC and all of its subsidiaries.[7]
19

20 Q. How do rating agencies characterize the acquisition's effect on the credit quality of
21 Energy East?

[6] Standard & Poors, *Research: Energy East Corp.* at 1 (Nov. 16, 2007).

[7] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

1 A. Moody's opinion is that Iberdrola's actions to raise funds for the acquisition have
2 been consistent with its purpose of maintaining Energy East's credit quality
3 unaffected:

4 Although Iberdrola has announced it will acquire 100% of the outstanding equity
5 stock of EEC and its subsidiaries for cash, Iberdrola has recently undertaken
6 various capital raising initiatives, including issuance of common equity. Our
7 current ratings of A3 for Iberdrola's senior unsecured debt and Prime-2 for its
8 commercial paper take these capital raising initiatives into account. We view
9 these initiatives to be consistent with our view that it has been Iberdrola's
10 objective to complete the acquisition in a way that would not unduly compromise
11 credit quality. We note that some of the required approvals in order to close the
12 acquisition have been obtained, but others, including a key approval from the
13 New York Public Service Commission, are still pending.[8]

14 Q. What do you see from an examination of recent rating agency opinions about the
15 credit ratings stemming from the treatment of the regulated utilities in New York?

16 A. In view of the recent adverse decision in the NYSEG rate case, while assessing the
17 outlook for Energy East, Moody's recognized the adverse regulatory environment as
18 a reason to give these companies a negative outlook. The following excerpts from
19 Moody's and S&P point out that the adverse regulatory environment recently has and
20 will continue to have a negative impact on Energy East's ratings:

21 [P]otential regulatory outcomes that could hurt cash flow metrics would
22 precipitate lower ratings. Ratings stability at the current level is highly dependent
23 on a balanced capital approach at Energy East, consistent cash flow metrics, and
24 supportive regulatory outcomes.[9]
25

[8] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

[9] Standard & Poors, *Research: Energy East Corp.* at 2 (Nov. 16, 2007).

> The offsetting factors are a weaker regulatory environment for NYSEG and Energy East's consolidated financial profile that is likely to be pressured over the intermediate term. [...] Energy East's financial performance is likely to deteriorate in the intermediate term due to the NYPSC's adverse rate decision. NYSEG contributed about 57% of Energy East's earnings in 2006, so the rate decrease materially affects the company's overall financial health. The authorized 9.55% ROE is considerably lower than its previously allowed 12.5% ROE and the 11% NYSEG had requested. Therefore, the $36.2 million annual reduction of delivery rates beginning in 2007 will result in weaker credit measures than expected for the rating.[10]

> The negative outlooks for EEC and its subsidiaries reflect, in part, the financial and operating challenges resulting from a surprisingly unfavorable decision NYSEG received in its general rate case decided in August 2006. The decision in this case introduced the risk that there could be residual negative financial effects on EEC's other utility subsidiaries in the event that the parent required an increase in dividends from those companies to compensate for any potential reduction in the levels previously paid by NYSEG.[11] (my emphasis)

Q. What do you conclude about the outlook on Energy East and its subsidiaries from the perspective of the rating agencies?

A. In evaluating the merger, rating agencies are not very concerned about Iberdrola intrinsically. They are more concerned about unreasonable concessions that the Commission may require to authorize the merger:

> [R]egulatory decisions in the pending acquisition by Iberdrola that do not impose harsh rate concessions could also lend stability to EEC's rating outlook.[12]

---

[10] *Id.*

[11] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

[12] *Id.* at 7.

1 While the rating agencies mentioned that aggressive amounts of debt used in the
2 financial strategy for the merger could play a role in downgrading Energy East, they
3 also mentioned that this is unexpected since Iberdrola has shown a solid commitment
4 to its plan to maintain Energy East's credit quality intact. S&P and Moody's are
5 more concerned about the regulatory environment in the State of New York,
6 particularly given the adverse decision in the 2006 NYSEG rate case:

7 If EEC's receipt of dividends from its subsidiaries (especially NYSEG) is
8 compromised in any material way because of less support from state regulators, or
9 if Iberdrola *unexpectedly* uses aggressive amounts of debt in its acquisition
10 financing strategy, then that could cause us to consider a downgrade of EEC's
11 ratings. Also, if future regulatory decisions by the NYPSC are unsupportive, then
12 the potential for a downgrade of the ratings of RG&E, EEC, and its other utility
13 subsidiaries could increase (my emphasis).[13]
14

15 Q. Do you have some way of demonstrating further that "surprisingly unfavorable"
16 treatment mentioned by Moody's?

17 A. Yes. Figure 1, below, shows the return on equity, and overall rate of return, for every
18 final state rate case decision in the past two years. The results at the bottom are from
19 New York. It is obvious to the subscribers of regulatory newsletters (the source of
20 those data) and to the credit markets generally that New York has awarded returns
21 lower than those of any other state in the nation. Two recent decisions awarded 9.1

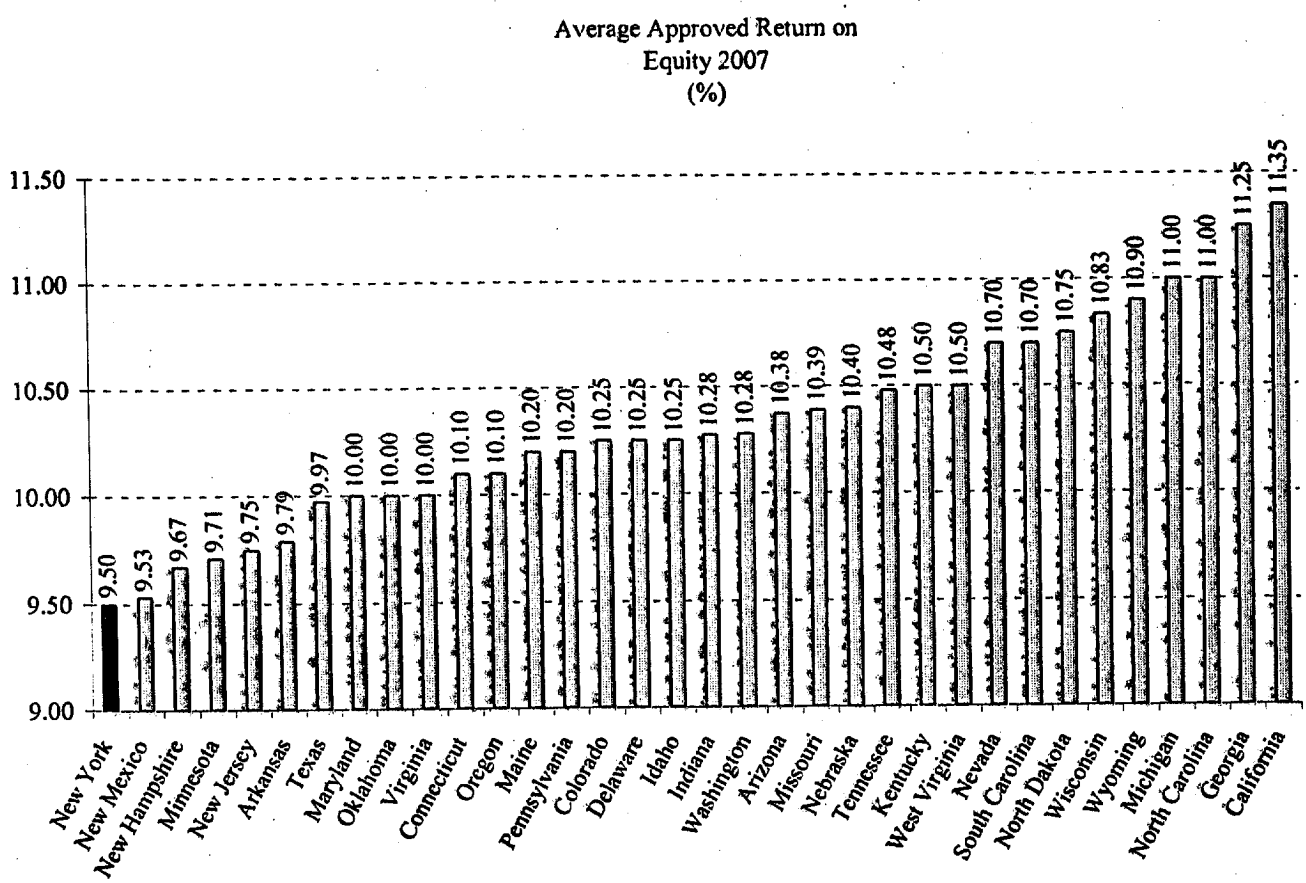
[13] Moody's Investor Service, *Credit Opinion: Energy East Corporation* at 7 (Dec. 26, 2007).

1 percent to both Orange and Rockland and National Fuel Gas Distribution

2 Corporation.[14]

3

4 **Figure 1**



Source: Regulatory Research Associates

5

[14] *See* Case 06-E-1433 *Orange & Rockland Utilities Inc.* (Oct. 18, 2007); Case 07-G-0141, *National Fuel Gas Distribution Corp.* (Dec. 21, 2007).

1 Q. Does New York's position in this respect have an effect on ratings and the costs of
2 borrowing for New York operating utilities?

3 A. I conclude that it does affect the cost of borrowing, based on my review of the ratings
4 agency reports and in the recorded cost of borrowing for New York operating
5 utilities. Indeed, the Staff Policy Panel shows at least part of that effect. On pages
6 176-78, the Staff Policy Panel states:

> 7 On November 29th, 2007, NYSEG went to the capital markets and issued
> 8 debt 225 basis points above 10-year treasures. This is significant [for in
> 9 the same period] three companies deemed comparable to NYSEG by the
> 10 company itself ... issued debt that was on average 192 basis points above
> 11 the 10-year treasury benchmark. Therefore, ... [t]he debt issued by
> 12 NYSEG was issued at 30 basis points above its self-described comparable
> 13 peers. ... This will cost ratepayers $600,000 ... annually. ...
> 14 We believe that an imputation of 30 basis points should be made to
> 15 NYSEG's rates to remove the effects of Iberdrola from the company's
> 16 cost of debt.

17 Staff here simply asserts that the problem is Iberdrola, with no acknowledgment
18 of the ratings agencies' discussion of the "surprisingly unfavorable" treatment of
19 NYSEG at the hands of the Commission, or other factors that may have contributed
20 to the higher pricing of the debt issued by NYSEG (an issue discussed further in
21 Petitioners' Policy Panel testimony).

22 It is more likely than not, in my opinion, that the continued negative outlook for
23 NYSEG's and RG&E's credit ratings originates in the Commission's "surprisingly
24 unfavorable" treatment of NYSEG rather than their proposed affiliation with a better
25 rated company. It appears that the rating agencies' concerns with respect to the

1 merger derive not from the merger itself, but rather from the possibility that the
2 Commission will impose unfavorable conditions as part of the merger approval
3 process. Staff's own testimony in this proceeding further justifies the rating agencies'
4 concerns.

5 Q. Does the Staff Policy Panel make other statements that seem to substitute its own
6 opinions for those of the ratings agencies?

7 A. Yes. The Staff Policy Panel states, on pages 206-207:

8 Because Iberdrola's credit quality is adversely affected by its increase in
9 debt leverage and ongoing ambitious investment program, NYSEG and
10 RG&E cannot obtain the strong A rating implied by their respective equity
11 ratios.

12 There is nothing supporting Staff's opinion, and I see three problems with it.
13 First, nothing from the rating agencies supports the charge that Iberdrola's "credit
14 quality is adversely affected." Second, nothing from the ratings agencies makes such
15 a tie between Iberdrola and the operating companies. Third, what rating the operating
16 companies can attain is far more clearly tied by the ratings agencies to their treatment
17 by the Commission in New York, which is where those operating companies' money
18 comes from to cover their interest charges. In short, the Staff Policy Panel's assertion
19 that Iberdrola is the cause of the operating companies' failure to achieve a strong "A"
20 rating is without foundation and has nothing to do with the ratings agencies.

21 Q. What do you conclude about the Staff Policy Panel's statements regarding credit
22 ratings and credit quality?

1 A. The Staff Policy Panel statements do not properly reflect the views of the rating
2 agencies as stated in those agencies' reports. The principal message from the ratings
3 agencies for NYSEG and RG&E is that the Commission has been, and is, unduly
4 harsh in its treatment of operating utilities in the state. Evidence from allowed returns
5 backs this up—New York is at the very bottom of U.S. state regulators in the returns
6 it allows in regulated rates.

7 Based on my analysis of the credit reports and recent actions taken in the NYSEG
8 rate case, I cannot agree with the Staff Policy Panel's discussion of the source or fair
9 consequences of the operating companies' credit ratings. It remains the case that
10 Iberdrola has better credit rating from the ratings agencies' perspective, than the
11 Energy East's utility operating companies in New York. I do not see the credit risk
12 issue with respect to this proposed transaction that Staff purports to exist.

13 **IV. Vague Statements on "Risk"**

14 Q. Please describe the purpose of this section of your testimony.

15 A. In a number of places in its testimony, the Staff Policy Panel warns how "risky" this
16 merger will be for ratepayers. I have already dealt with those issues of risk for
17 ratepayers that Staff alleges accompany Iberdrola's booked Goodwill from this
18 transaction. In this section, I deal with other unfocussed and unsupported allegations
19 of risk coming from the Staff Policy Panel.

20 Q. Please proceed.

1 A. The Staff Policy Panel catalogs a number of what it calls the "risks" of this
2 transaction.

3 On pages 26-27, the Staff Policy Panel makes a preliminary statement about risk that
4 epitomizes much of its subsequent use of the term:

> 5 A significant risk to customers is how remote the corporate parent will be
> 6 from the operating utilities and the language, foreign currency, and
> 7 accounting differences between the parent company and its utility
> 8 subsidiaries. ... Another substantial risk is posed by the multitude and
> 9 scope of the unregulated businesses in which Iberdrola is engaged and the
> 10 complexity of its capital structure.

11 Q. Are these risks for ratepayers?

12 A. To the extent that the term "risk" applies to the possibility that customers will be
13 overcharged (with respect to the legitimate cost of service) or will be underserved
14 (with respect to standards for safe, adequate and reliable service), the answer is no.
15 Staff says nothing about how the "risk" issues it discusses relate to ratepayers in any
16 particular way. Just as in my discussion of the Goodwill issue, there is nothing about
17 this transaction that prevents the Commission, or the Staff, from regulating NYSEG
18 and RG&E as it has always done. Whether the ultimate parent's headquarters is in
19 New Gloucester, Maine, or in Spain does not constitute a material risk given the
20 traditional care and methods that state regulatory agencies apply in regulating utility
21 operating companies.

22 Q. Does the Staff Policy Panel make any other broad statements about risk?

1 A. Yes. On page 32, the Staff Policy Panel states:

2 The transaction provides no benefits to the customers of NYSEG and
3 RG&E, while saddling the customers with the enormous financial risks we
4 described above.

5 On page 100-101, the Staff Policy Panel states:

6 Besides the obvious financial and business risks that we address
7 elsewhere, there are potential risks associated with this transaction because
8 the combination of companies will greatly expand the size, scope, and
9 geographic reach of the ultimate parent and affiliates of NYSEG and
10 RG&E.

11 Staff has identified neither a rational basis for the "enormous financial risk" it
12 asserts will be imposed on customers of NYSEG and RG&E as a result of this
13 proposed merger, nor any source of additional business risk for NYSEG and RG&E.
14 Iberdrola has a better credit rating than the operating companies and nothing on the
15 horizon seems to point to that changing. Whatever financial risk is faced by NYSEG,
16 RG&E and their respective customers is tied to the regulated capital structures of
17 NYSEG and RG&E—the customer rates based on these capital structures is where
18 the money to cover interest and principal payments will come from. The parent does
19 not affect financial risk, as such; the regulated capital structure does. If there is no
20 particular change in the capital structure accompanying this transaction, there will be
21 no accompanying change in financial risk. Staff's use of the phrase "enormous
22 financial risks" is misplaced and has nothing to do with this transaction in a practical
23 sense.

1 Regarding business risk, Staff is also misusing the term. The business risk for
2 investors in regulated enterprises stems from what the capital in question *does* and
3 how it is regulated, not who *owns it*. Electric and gas utilities, as local public service
4 monopolies, have always faced some degree of business risk—although those risks
5 are largely ameliorated by the operation of cost-of-service regulation. One element of
6 business risk not so ameliorated is *regulatory risk*. That risk, which is the risk that
7 the process of regulation under the control of a regulatory commission will prevent a
8 utility from recouping its legitimate costs, is necessarily a part of all regulated
9 enterprises.

10 There is nothing inherent in the transaction that will serve to raise business risks
11 for NYSEG and RG&E. The service territory, the weather, the national economy
12 affecting customer purchases, etc., will all remain the same. The owner of the equity
13 will change, but the source of equity is not a component of business risk. The
14 regulatory risk will also remain the same.

15 In short, there is nothing to support Staff's charge of "obvious business risks"
16 associated with this transaction, as that term is used and understood in the financial
17 literature. There are no particular changes in business risk for NYSEG and RG&E
18 associated with this transaction.

19 Q. Are there any other instances where the Staff Policy Panel engages in what you
20 consider the misuse of the term "risk" as it applies rates or ratepayers?

1 A. Yes, there are many. But a good proportion of those have to do with the "risk" that
2 something bad can happen to ratepayers because of the new corporate affiliations of
3 Iberdrola versus Energy East. It is that issue that I turn to next.

4 **V. Transparency and Affiliate Issues**

5 Q. Please describe the purpose of this section of your testimony.

6 A. The Staff Policy Panel states that it is unable to understand the detailed internal
7 workings of Iberdrola or its many affiliates, many of which are unregulated. Staff
8 implies that Iberdrola's larger and assuredly more complicated corporate structure
9 will create difficulties for Staff and also creates "risks" that ratepayers will subsidize
10 Iberdrola's unregulated affiliates. Having presented this supposed problem, Staff
11 states that the way to combat such potential affiliate abuse is to engage in a detailed
12 operational accounting of Iberdrola—that is, to regulate Iberdrola's books to prevent
13 New York ratepayers from cross-subsidizing unregulated Iberdrola operations. They
14 claim that their difficulties in "regulating Iberdrola" as I would put it, are a reason to
15 recommend the rejection of the merger.

16 None of this supposed problem asserted by the Staff—in essence, Staff's inability
17 to regulate Iberdrola's own books as opposed to NYSEG's or RG&E's—is a genuine
18 regulatory concern from the perspective of New York ratepayers. The defense
19 against illicit utility transactions lies with the careful attention to the operating
20 companies' books and records—not on the parent's. Proper separation of the

1 operating subsidiaries' books, proper codes of conduct regarding the relationship
2 between the parent and subsidiaries and, especially, the examination of affiliate
3 interest transactions are the time-tested ways to deal with affiliate issues in regulation
4 in the United States. There is nothing about the Iberdrola transaction that changes
5 this.

6 Q. How does the Staff Policy Panel raise the issue?

7 A. Staff notes its concerns with the size and asserted complexity of Iberdrola many times
8 in its testimony. I give only a few examples here.

9 On page 27, the Staff Policy Panel makes a statement about the supposedly new
10 incentives to loot the utilities, so to speak, that the transaction would create:

11 Another substantial risk is posed by the multitude and scope of the
12 unregulated businesses in which Iberdrola is engaged and the complexity
13 of its capital structure. The multitude of its unregulated operations <u>creates</u>
14 <u>incentives</u> to misallocate costs and the complexity of its corporate
15 structure would make it difficult to follow audit trails for its complex
16 transactions (my emphasis).

17 The phrase "<u>creates incentives</u> to misallocate costs" is a Staff theme that I've
18 already commented upon above in the section on Goodwill. The incentive of utility
19 owners to profit by charging monopoly prices for the least commitment of capital has
20 been around for more than a century. Nothing about the proposed transaction
21 changes these incentives and nothing about Iberdrola diminishes the Commission's
22 power to prevent owners of utility monopolies from acting successfully on these
23 longstanding incentives.

1 On pages 49-50, the Staff Policy Panel states that it needs to look to the parent for
2 the information it needs effectively to regulate the operating subsidiaries in New
3 York:

> 4 Operational detail [at the Iberdrola parent level] is very useful as a screen
> 5 to help detect potential cross-subsidization of non-regulated entities by
> 6 regulated utilities. This detail could be used to detect unusual patterns or
> 7 results concerning a competitive operation's expenses. If unusual results
> 8 or patterns are detected, it may signal potential cross-subsidization of
> 9 competitive businesses by regulated businesses.

10 What the Staff Policy Panel is saying here is that they want to compare the
11 operational detail of Iberdrola's various regulated and unregulated businesses to try to
12 detect cross subsidies.

13 I cannot emphasize strongly enough how misguided it is to think that dissecting
14 the "operational details" of Iberdrola's various businesses will lead to detecting cross
15 subsidies between those businesses and its New York utilities. It is the *affiliate*
16 *transaction* between operating utility and its affiliates that is the proper subject of
17 careful scrutiny, not the parent's "operational details".[15] Indeed, this Commission's
18 own recognition of this principle appears evident in the approval of another foreign
19 holding company transaction in New York (as I discuss further in Section VIII), the

[15] In section VIII, I refer specifically to the testimony of Isaac C. Hunt Jr. before Congress in 2002 where he recommended the repeal of the Public Utility Holding Company Act of 1935. Mr. Hunt's testimony before Congress quite appropriately focuses on affiliate transactions, and not the operating details of the parent.

1 takeover of United Water Resources by the French company, Suez Lyonnaise des
2 Eaux.[16]

3 In any event, how Iberdrola decides to devote resources, or allocate costs, profits,
4 tax deductions, etc., to its various subsidiaries is not the point. The point for the
5 Commission (as for any U.S. regulatory commission) is to prevent the business at the
6 parent level from raising the legitimate cost of service for the regulated operating
7 companies. Commissions have long dealt with such issues and have practical and
8 realistic ways to do so. For example, inputs that come from markets (electricity and
9 gas, capital, service trucks, etc.) reflect arms-length, competitive prices. For
10 management or central office activities of holding companies (which are not terribly
11 large in the greater picture), there are longstanding allocation formulae to reasonably,
12 transparently and fairly perform the allocations. For any particular inputs that are
13 purchased from affiliates, Staff and others can readily refer to market transactions to
14 assess the adequacy of cost. My point is that these issues are nothing new, and that
15 nothing about Iberdrola stepping in as the upstream owner of Energy East changes the
16 way in which this Commission will continue to work to protect ratepayers. One
17 doesn't protect ratepayers by becoming deeply involved in the parent's operations—
18 one protects ratepayers by standing at the barrier between the parent and the regulated

[16] Case 99-W-1542, *United Water Resources Inc., Order Approving Stock Acquisition* at 8 (July 27, 2000) (noting that United Water would "remain a fully regulated commodity and service provider, subject to our jurisdiction—and under local management, according to the proponents' representations—in case there emerges some reason for concern about the company's ability or willingness to maintain safe and adequate service and conduct its affiliate transactions on an arms' length basis.").

1 operating subsidiaries (as always) to make sure that money does not cross that
2 barrier—either way—without justification.

3 I note, however, that the Rebuttal Testimony of the Joint Petitioners' Policy Panel
4 provides a detailed description of Iberdrola's affirmative commitments to ensure that
5 there are no concerns related to transactions between NYSEG and RG&E and
6 Iberdrola's unregulated affiliates, or a lack of access to books and records of Iberdrola
7 or any Iberdrola affiliates that are related to NYSEG or RG&E.

8 Q. Does the Staff Policy Panel have anything else to say about the nature of Iberdrola's
9 upstream transactions being a risk to ratepayers?

10 A. The Staff Policy Panel brings up the subject many other times. For example, on
11 pages 107-8, it states:

12 The utilities reports will concern transactions recorded by the utilities.
13 These reports will not provide any information or details on the activities
14 of the service or holding companies or the other business interests of
15 Iberdrola. Without full knowledge of all of these entities, we cannot
16 reliably confirm that the costs of the utilities are fairly stated.

17 "Full knowledge" of the Iberdrola entities is not a prerequisite for the
18 Commission to have, as it has now, all of the tools at its disposal to protect the
19 electric and gas ratepayers in New York from cross-subsidizing either ratepayers
20 elsewhere or Iberdrola's unregulated operations.

21 The question of potential cross-subsidies between ratepayers of different utilities
22 is raised by the Staff Policy Panel on page 221, where it states:

1 Currently, the Energy East companies are located in the northeast United
2 States and are primarily engaged in regulated utility distribution business.
3 ... Cost shifting between these regulated businesses and service
4 companies generally should not result in any long-term advantage to
5 Energy East as cost increases to one regulated business will result in cost
6 reductions in another regulated business (my emphasis).

7 Staff seems to be saying that any internal subsidy from one operating company
8 within Energy East to any other is less of a problem because Energy East is
9 "primarily engaged" in utility distribution. This makes no sense at all. NYSEG
10 ratepayers will be justifiably aggrieved if they thought that they were paying for
11 RG&E's services. And the Commission in New York would be very upset if they
12 thought that New York utilities were paying for services at Central Maine Power or
13 vice versa (and the Maine Public Utilities Commission would be just as upset).

14 The idea, implied by the Staff Policy Panel, that there is less to worry about if
15 costs shift around Energy East's various operating companies (to be sure, not all of
16 which are regulated) does not accurately characterize how regulatory commissions in
17 any state deal with multi-state holding companies. I do not know of any federal or
18 state regulatory commission that has been relaxed about the nature of holding
19 company operations just because they are "primarily" engaged in the same line of
20 business. And if they were relaxed, they would not be doing their job of protecting
21 the interests of those operating companies' ratepayers based on those companies' own
22 legitimate costs.

23 Q. What do you conclude regarding the Staff Policy Panel's discussion of the affiliate
24 issues regarding this transaction?

1 A. As with its discussion of Goodwill, the Staff Policy Panel fails to recognize the
2 traditional types of safeguards that regulatory commissions in the U.S. use to protect
3 the rights of ratepayers from marauding at the holding company level. It is clear that
4 Iberdrola is a large and sophisticated international company engaged primarily in
5 energy utility operations. It is not acquiring Energy East to diversify into a business
6 about which it is unfamiliar.

7 That being said, there is nothing particularly unusual about this transaction from
8 the perspective of how U.S. regulatory commissions will deal with the rates and
9 service obligations of the various operating companies in their jurisdictions.
10 Iberdrola is larger and more distant, geographically and linguistically, than such
11 commissions are used to. But those things are not material in terms of the tools and
12 methods that regulators have to police affiliate transactions and regulate the rates or
13 service obligations of their local utilities. There are no new incentives that come into
14 play in this transaction.

15 These are electric and gas distributors, after all. The regulation of these utility
16 enterprises simply does not require that state regulators know everything that the
17 parent company does and where. The Staff Policy Panel's complaints about the
18 complexity and Spain-based nature of Iberdrola seems to me nothing more than a
19 straw man, so to speak—to knock down by saying that the impossibility of regulating
20 Iberdrola's internal operations leaves no choice but to object to the transaction.

1 **VI. Upstream Tax and Other Benefits for Iberdrola**

2 Q. Please describe the purpose of this section of your testimony.

3 A. The Staff Policy Panel devotes a substantial portion of its testimony to describing,
4 valuing, and trying to appropriate for New York ratepayers the supposed benefits that
5 this transaction will have for Iberdrola and its own shareholders. In this section of my
6 testimony, I will describe how Staff's arguments are speculative and fall outside the
7 scope of what the Commission must evaluate in its duty to protect the interests of
8 New York ratepayers.

9 Q. Please proceed.

10 A. The Staff Policy Panel in its testimony shifts the spotlight from "synergies" that can
11 lower rates to the consumers of the operating companies to "synergies" that can
12 somehow work to benefit the shareholders of Iberdrola. On pages ~~78-79, 82-84~~ 78-84, the
13 Staff Policy Panel states:

14 Q. What non-traditional synergistic tax benefits have you identified?
15 A. Staff has obtained information indicating that Iberdrola will reap
16 very significant tax benefits as a result of this M&A transaction. These
17 tax benefits come in the form of United States Production Tax Credits
18 (PTC) and Spanish tax credits. ...
19 PTCs are tax credits against U.S. federal income taxes. PTCs are not
20 refundable, so their use is dependent on earning a level of U.S. income tax
21 liability equal to or greater than the value of the credits. ...
22 If Iberdrola constructs all of the planned generation for 2007-2008 ... and
23 assuming such generation is eligible for PTCs, it could generate up to
24 $150 million in PTCs per year by 2008. ...

> While we concede some of the above analysis is based on assumptions, more certain information is not available because Iberdrola's (sic) has declined the opportunity to provide better information. ...
> Staff [thus] found that there are hundreds of millions of dollars of benefits related to the merger that are tangible and significant, but that are not presented as customer benefits.

Q. How do you respond to Staff's claim that PTCs are an unidentified tangible benefit to customers?

A. Staff's claim is wrong in both critical respects—PTCs are not a source of benefit to ratepayers, nor are Staff's calculations "tangible." These PTCs have nothing to do with NYSEG's or RG&E's customers and the assumed value to Iberdrola's shareholders that Staff has placed on them as a result of this transaction is completely speculative.

Q. Please explain.

A. PTCs may be real enough for some of those who generate electricity from renewable resources. But such power production facilities that are owned by Iberdrola's affiliates sell into a competitive wholesale power market—they are not traditionally regulated facilities, as such. Whether and what "benefits" these unregulated facilities can provide to Iberdrola as their owner, is not as a threshold matter an issue pertaining to the customers of NYSEG and RG&E.

Furthermore, the extent to which Iberdrola can use such tax credits has nothing to do with Energy East. If Iberdrola needs tax liabilities to enjoy the credits, it has any number of ways of obtaining them (either through the purchase of tax paying entities

1 or through some other method of assuming U.S. income tax liabilities). The Joint
2 Petitioners' Policy Panel explains further why from a practical perspective there are
3 no PTC-related "benefits" associated with this transaction.

4 It is important to remember the role of income taxes for NYSEG and RG&E—
5 whether they are independent operating utilities or parts of any sort of larger holding
6 company. The rates that the Commission approves contain a fair rate of return for
7 those who devote their equity capital to the service of the public. This is simply a
8 part of the *regulatory compact* that drives all investor-owned utility regulation in the
9 U.S. Because the return for equity holders constitutes owners' income, it creates a
10 federal income tax liability. Every regulator of every investor-owned utility in the
11 U.S. thus grosses up the permissible revenue to include those federal income taxes
12 into customer rates. It is precisely because of this that investor-owned public utilities
13 are such reliable sources of federal income tax revenues—the taxes are there because
14 the regulators set the income levels that generate the federal income tax proceeds.
15 None of this is left to the market in the way that taxes are paid (or not) by unregulated
16 corporations if they record profits (or don't).

17 The Staff Policy Panel, in its discussion of PTCs, confuses the question of federal
18 income taxes owed by regulated operating utilities and those owed by unregulated
19 affiliate corporations. None of what goes on at the level of the owners of the equity is
20 relevant from the perspective of what customers pay for the capital that is devoted to
21 serve them—as a matter of fact. That is not the way utility rates are set in this

1 country, and for good reason. If regulators tried to appropriate the upstream tax
2 benefits of utility owners, then it would have to try to regulate what kind of
3 shareholders were capable of owning utility equity—and that is not the business of
4 U.S. regulators. Anyone can own shares in utility common stock. While it is true
5 that regulators have long been concerned with whether utility stock is held by
6 individual investors or a holding company (as I describe in Section VIII, below),
7 taxes at the holding company level have not been the issue of concern.

8 Q. What do you conclude about this tax issue related to PTCs?

9 A. In its discussion of PTCs, Staff appears to want to appropriate the tax credits of
10 Iberdrola and its affiliates in order to lower the cost of service for ratepayers. This,
11 however, is inconsistent with the way operating utilities are regulated in the U.S.
12 Whether there is a holding company or not, the operating companies pay federal
13 income taxes on the income that represents the payment to owners for the use of their
14 capital to serve the public.

15 Staff seems to want to cloud the issue of whether this is a synergistic merger or
16 not. By raising the issue of PTCs under the heading on page 78 of "Other Synergistic
17 Benefits Exist," the Staff Policy Panel has confused whose synergies we are talking
18 about. By shifting the focus from "regulated operating synergies" to "parent tax
19 benefits," the Staff Policy Panel has shifted its spotlight to something that has nothing
20 to do with regulated rates for NYSEG and RG&E.

1 **VII. Improper Capital Structure and Cost of Capital Calculations**

2 A. Please describe the purpose of this section of your testimony.

3 Q. The Staff Policy Panel engages in two sorts of capital structure and cost of capital
4 calculations in its testimony. The first pertains to what I call a "re-engineering" of
5 hypothetical regulated capital structures for NYSEG and RG&E under Iberdrola
6 ownership. The second has to do with what looks like *pro forma* cost of capital for
7 the post-transaction regulated operations at NYSEG and RG&E. This section of my
8 testimony serves to show that both sets of calculations are improper. The first is
9 improper because Iberdrola's consolidated capital structure reflects a firm that
10 heretofore has had nothing to do with regulated U.S. utilities. The second is improper
11 because this is not a rate case, which I believe is inappropriate for this merger
12 transaction proceeding.

13 Q. Please explain.

14 A. The first issue deals with the Staff Policy Panel's hypothetical calculations pertaining
15 to a post-Iberdrola transaction capital structure for the regulated operations of
16 NYSEG and RG&E. In its testimony on pages 194-205 (headed: "Inadequacy of Pro
17 Forma Capital Structure for NYSEG and RG&E"), the Staff Policy Panel comes to
18 the conclusion that the post merger capital structure is untenable for the regulated
19 operations of NYSEG and RG&E. The Staff Policy Panel states on page 205:

1 Simply put, the pro forma consolidated capital structure of Iberdrola is too
2 leveraged given the business profiles of its operations. The burden of
3 supporting this aggressive capital structure would fall squarely onto the
4 shoulders of the ratepayers of NYSEG, RG&E and the rest of the Energy
5 East utilities. It is one of the many reasons why the Commission should
6 reject this transaction.

7 Q. Do you see a problem with Staff's assertions?

8 A. Yes, there is a threshold problem that renders all of the Staff Policy Panel's
9 calculations inappropriate and irrelevant. Under the pretense of using a
10 "consolidated" capital structure as if it were required to do so, Staff has taken
11 Iberdrola and backed into a regulated capital structure for NYSEG and RG&E using a
12 number of completely subjective and unsupportable adjustments (e.g., removing
13 Goodwill from the capital structure and removing $10 billion from Iberdrola's
14 consolidated equity and $3.3 billion from its consolidated long-term debt—see page
15 203). The problem is that starting any regulated capital structure calculation for
16 NYSEG and RG&E by working backward from an adjusted capital structure for
17 Iberdrola is nonsensical, even if the calculations were not already completely
18 subjective on the Staff Policy Panel's part.

19 Q. Doesn't the Staff Policy Panel say that it is customary policy for the Commission to
20 use a consolidated capital structure?

21 A. Yes, but even if the Commission in New York has used such an approach on
22 occasion, particularly when a regulated parent like National Fuel Gas Company, for

1 example, that raises debt for its various regulated subsidiaries, it does not appear to be
2 required in this case and most certainly is not advisable.

3 Q. Please explain why this policy is not inconsistent with Commission precedent.

4 A. The Staff Policy Panel makes this point on pages 194-195 when it cites the National
5 Fuel Gas Distribution Corporation case:

> 6 The Commission declared in Case 28947, Opinion No. 85-15 (issued
> 7 September 26, 1985), p. 47, "When the utility itself is a subsidiary, as is
> 8 National Gas Distribution Corporation, it is proper, at least in the first
> 9 instance, to assume that the parent corporation's cost of capital is also the
> 10 subsidiary's because it is the parent that raises capital."

11 When the Commission ~~rules~~ ruled in Case 28947, National Fuel Gas was a holding
12 company subject to broad regulation by the SEC under the PUHCA, because it owned
13 regulated gas distribution operations in Ohio, Pennsylvania and New York as well as
14 supply and transport operations subject to FERC regulation.[17] The holding company
15 raised the long-term debt for all of the state-regulated gas distribution utility
16 operations and federally-regulated gas supply and pipeline transport businesses. In
17 that case, the broader company was almost totally a regulated entity (either at the
18 FERC or in the three states), and the use of a consolidated capital structure has some
19 appeal because of the lack of alternatives.

[17] *See Moody's Public Utility Manual*, Vol. II at 2873 (1983).

1 Here, however, NYSEG and RG&E will continue to raise their own debt capital,
2 as always.[18] For that reason, and because they will remain independently regulated
3 operating companies in New York (unlike in the National Fuel Gas case in both
4 respects), it would appear neither necessary nor practical to look to the parent for
5 information on a regulated capital structure, There is an ample number of independent
6 operating utilities regulated by the commissions in the various states to judge the
7 reasonableness of NYSEG's and RG&E's ratemaking capital structure without
8 looking to the parent, with its various mix of businesses.

9 Q. Besides the question of the starting point—that is, Iberdrola's capital structure—are
10 there any other problems with the Staff Policy Panel's calculations in that section of
11 its testimony.

12 A. Yes. The Staff Policy Panel's calculations are subjective and reflect unsupported
13 assumptions, which are to be expected when trying to arrive at a reasonable regulated
14 capital structure for NYSEG and RG&E from the starting point of Iberdrola—which
15 is to say, there is no objective or accepted roadmap for such calculations as the Staff
16 Policy Panel attempts. For example, on page 199, Staff backs out $55.4 billion from
17 Iberdrola's capital structure at a 50/50 capital structure ratio based on S&P U.S.

[18] Iberdrola, in the testimony of the Joint Petitioners' Policy Panel, has stated that Iberdrola shall not borrow from money pools in which NYSEG and RG&E are participants and that NYSEG and RG&E will not loan funds to Iberdrola or any unregulated affiliate, either through a money pool or otherwise, unless otherwise authorized by the Commission. In any event, the Commission retains effective control on where and in what markets these operating companies obtain their debt capital.

1 ratings criteria. Iberdrola is not a U.S. utility, so there is no logic in such a
2 calculation.

3 On pages 202-4, the Staff Policy Panel further backs out Goodwill at a 75/25
4 equity/debt ratio with the only justification that it is "conservative." Again, there is
5 no foundation for Staff's calculations, other than Staff's own assumptions.[19] The
6 Staff Policy Panel reports the result of these two calculations, driven by Staff's own
7 assumptions, as follows:

8 The ratemaking capital structure after these two adjustments produces an
9 untenable capital structure (it implies a negative equity ratio). These two
10 adjustments show that, after the merger, Iberdrola's pro forma
11 capitalization would be over-leveraged. There is not enough equity to
12 adequately support an A3 rating for Iberdrola's current operating assets,
13 its Goodwill and the operating assets of Energy East. ... Simply put, the
14 ratemaking capital structure for NYSEG and RG&E that would be
15 developed through subsidiary adjustments to Iberdrola's capital structure
16 is unacceptable. ... The subsidiary adjustments expose the depth and
17 breadth of the risks attending Iberdrola's overall capitalization.

18 Staff, however, simply made the two "adjustments" without any objective or
19 accepted basis for doing so, and they therefore do not prove anything with regard to
20 capital structure. Moreover, they have nothing to do with the credit ratings (like the
21 A3 rating cited by Staff) issued by independent ratings agencies, which as Mr. Fetter
22 discusses, have done a forward-looking analysis of Iberdrola, including the proposed
23 transaction, and affirmed a "stable" outlook for Iberdrola.

[19] This is confirmed in Staff's response to IBER / EE IR No. DPS 84, attached hereto as Exhibit ___ (JDM-2).

1 Reverse engineering a regulated capital structure for NYSEG and RG&E, by
2 starting with Iberdrola's consolidated capital structure, makes no sense. The National
3 Fuel Gas case that the Staff Policy Panel cites argues against such a practice,
4 precisely because its status in 1985 is totally different than that facing NYSEG and
5 RG&E as a result of the merger. I cannot believe that the Commission would engage
6 in such a string of subjective and unsupported assumptions as the Staff Policy Panel
7 has suggested here to set regulated capital structures for the utilities in its jurisdiction.
8 Even if this were a rate case in which the capital structures of NYSEG and RG&E
9 were at issue—which it is not and should not be—there are other more reliable and
10 objective methods for setting regulated capital structures. First among these more
11 reliable methods is to use a proxy group of independent operating gas and electric
12 utilities that are in the same business and subject to the same types of business risk,
13 and hence ability to reasonably leverage their capital structures, as NYSEG and
14 RG&E.

15 Q. Does the Staff Policy Panel use a set of proxy companies in its ROE calculations?

16 A. I believe it does. But while Staff does appear to reference a proxy group in support of
17 what I conclude is a very low proposed ROE (particularly by the standards of other
18 commissions as Figure 1 shows) what I'm speaking of here is another point. My
19 point is that there is no basis in this proceeding for proposing a consolidated capital
20 structure, nor any basis for making artificial adjustments to the capital structure, for
21 the purpose of attempting to extract concessions associated with merger approval.

1 Q. What about the Staff Policy Panel's imputation of a cost of equity for these regulated
2 operations going forward?

3 A. The Staff Policy Panel states on p. 267 that "the appropriate return on equity for
4 NYSEG and RG&E given its risk factors is 9.0%."

5 Q. Do you think this is reasonable?

6 A. No. A glance back at Figure 1 will show that it is not reasonable—far below the
7 range of returns granted in other jurisdictions.

8 There is no question that if the cost of equity were to be fully litigated (which, as I
9 have discussed, would be inappropriate in this proceeding), evidence would be
10 brought to bear to show that the Staff Policy Panel's 9.0 percent recommended return
11 on equity is unreasonably low.

12 **VIII. Basic Statutory Issues Regarding Utility Regulation and Holding Companies**

13 Q. Please describe the purpose of this section of your testimony.

14 A. In this section I provide the background for my statement that the Staff Policy Panel
15 has ignored two critical points: (1) that the Commission loses none of its broad power
16 effectively to regulate the rates and services of NYSEG and RG&E, whoever the
17 holding company is (indeed, Iberdrola is making transparency/reporting commitments
18 in this case, and such similar commitments fully addressed concerns raised about
19 these issues in Maine); and (2) the view of holding companies in the U.S. has

1 changed in the past 70 years, led by Congress, the FERC and the SEC. Holding
2 companies are no longer the troublesome sources of vague risks for ratepayers that
3 they were before the modern era of utility regulation—as suggested in the Staff
4 Policy Panel's negative comments regarding Iberdrola's purported incentives.

5 Q. You have stated that the Commission has all the tools it needs to effectively regulate
6 holding companies. Has this always been the case in New York?

7 A. No. Early efforts at public utility regulation in New York, unlike today, were ill-
8 equipped to deal with the regulation of holding companies. The States of New York
9 and Wisconsin were the pioneers in creating regulatory agencies that dealt with the
10 deficiency.[20] The Staff Policy Panel takes such a number of shots at the presumed
11 problems of regulating a subsidiary of Iberdrola. Accordingly, I describe briefly
12 below how New York's regulation developed and why, in conjunction with actions
13 taken later by Congress, the Commission is already well suited to deal with and
14 Iberdrola subsidiary.

15 Q. Please proceed.

16 A. A fundamental turning point in state utility regulation came in 1905, when Charles
17 Evans Hughes (future Governor of New York and Chief Justice of the U.S. Supreme
18 Court) was chosen to lead a public inquiry into the gas industry in New York State.
19 At issue was the capital stock of the gas trust which, through a series of mergers, had

[20] *See* Phillips, *The Regulation of Public Utilities, Theory and Practice* Phillips 132-33.

1 inflated its valuation to several multiples of the original cost.[21] Hughes was able to
2 expose this merger-induced overvaluation and draft new laws creating a new
3 Commission of Gas and Electricity to regulate rates.[22] Hughes' report concluded:

> 4 The gross abuse of legal privilege in overcapitalization and in the
> 5 manipulation of securities ... shows clearly that ... for the protection of
> 6 the public there should be created a commission with inquisitorial
> 7 authority, competent to make summary investigations of complaints, to
> 8 supervise issues of securities and investment in the stocks or bonds of
> 9 other companies, to regulate rates and to secure adequate inspection, or
> 10 otherwise to enforce the provisions of the law.[23]

11 Hughes' efforts led to the establishment of strong commissions with power to set
12 "fair and reasonable" rates and that were expected to utilize "special knowledge,
13 flexibility, disinterestedness, and sound judgment in applying broad legislative
14 principles that are essential to the protection of the community, and of expanding
15 enterprise."[24]

16 Q. Did utility holding companies come under the scrutiny of Congress later on?

17 A. Yes. In the late 1920s, the Federal Trade Commission (FTC) conducted an
18 investigation of public utility holding companies and published a huge report (96
19 volumes) showing the considerable dominance of vertically-integrated holding

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[21] *Id.* at 136.

[22] 1905 Laws of New York, Chapter 737.

[23] M.J. Pusey, *Charles Evans Hughes*, Columbia University Press at ~~205~~ 138 (1951) (referencing C.E. Hughes (1905).

[24] Pusey at 202.

1 companies and their effectiveness at evading state regulation.[25] Congress in response
2 passed the Public Utility Holding Company Act (PUHCA) of 1935. PUHCA gave
3 the Securities and Exchange Commission (SEC) jurisdiction over public utility
4 securities. As part of its new jurisdiction, the SEC was given the power to simplify
5 the holding company structures of gas and electric utilities.

6 The SEC, under the "death sentence clause" that gave it authority to break up the
7 holding companies, was largely successful and the Supreme Court upheld its
8 constitutionality in several cases.[26] By 1950, utility reorganizations were virtually
9 complete, and the regulation of holding companies was passed to the SEC.[27]

10 Q. What has happened in utility holding company regulation since PUHCA?

11 A. During the energy market reforms of the 1980s, efforts to repeal PUHCA began in
12 earnest, supported by the SEC. The emerging importance of qualifying facilities
13 (QFs) and independent power producers (IPPs) in the wake of the Public Utility
14 Regulatory Policies Act of 1978 (PURPA) generated strong calls for the repeal of
15 PUHCA to allow utilities to participate in this type of generation.

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[25] Final Report of the Federal Trade Commission to the Senate of the U.S. pursuant to S. Res. 83, 70th Cong., 1 Sess. at 615 (1935).

[26] Charles Evans Hughes, the force behind New York's original 1907 statute, was Chief Justice of the Supreme Court during the period of most intense challenges to the constitutionality of PUHCA, and wrote several of the majority opinions upholding the statute. *See, e.g., Elec. Bond and Share Co. v. SEC*, 303 U.S. 419 (1938).

[27] Energy Information Administration (EIA), "Public Utility Holding Company Act of 1935: 1935-1992" at 12 (1993).

1 The Energy Policy Act of 1992 (EPAct 1992) included significant reforms to
2 PUHCA—but did not repeal it. PUHCA became an issue again in 2002, when a D.C.
3 Circuit Appeals Court decision prompted the SEC to reexamine its approval a merger
4 of American Electric Power (AEP) and Central and South West Power (CSW). In the
5 decision, Judge Tatel said that PUHCA may be "outdated in light of recent
6 technological advances. In view of the statute's plain language, however, only
7 Congress can make that decision."[28]

8 The SEC did reexamine its role in overseeing utility holding companies. One of
9 its Commissioners, Isaac C. Hunt, Jr., testified before Congress in 2002 specifically
10 to recommend that PUHCA be repealed and that the SEC end its holding company
11 oversight role. Specifically with respect to affiliate transactions and the possibility
12 for cross-subsidization, Mr. Hunt testified:

13 As we have testified in the past ... we continue to believe that, in order to
14 provide needed protection to utility consumers, the FERC and state
15 regulators should be given additional authority to monitor, police, and
16 regulate affiliate transactions.[29]

17 His emphasis on *affiliate transactions* is notable, for it stands in sharp contrast to
18 the Staff Policy Panel's preoccupation with the internal workings of Iberdrola.
19 Chairman Hunt also discussed how the repeal of PUHCA would eliminate barriers in
20 the flow of capital to the utility industry:

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[28] *Nat'l Rural Elec. Coop. v. SEC*, 276 F.3d 609, 618 (D.C. Cir. 2002).

[29] *The Effect of the Bankruptcy of Enron on the Functioning of Energy Markets: Hearing Before the Subcomm. on Energy and Air Quality of the H. Comm. on Energy and Commerce*, 107th Cong. 52 (2002) (statement of Isaac C. Hunt, Jr., Comm'r, U.S. Securities and Exchange Commission).

> ...repeal of [PUHCA] would eliminate regulatory restrictions that prohibit utility holding companies from owning utilities in different parts of the country and that prevent nonutility businesses from acquiring regulated utilities. In particular, repeal of the restrictions on geographic scope and other businesses would remove the impediments created by [PUHCA] to capital flowing into the industry form sources outside the existing utility industry.[30]

It is evident from this testimony that the historical problems in parent company ownership of utilities had long ceased to trouble the SEC—as long as regulators continued to have the ability effectively to monitor affiliate relationships. Congress apparently agreed in 2005, when it repealed PUHCA in conjunction with enactment of the Energy Policy Act of 2005 (EPAct 2005) and replaced it with the more limited Public Utility Holding Company Act of 2005 ("PUHCA 2005").

Q. Did the FERC, for its part, have any supportive words to say about the repeal of PUHCA?

A. Yes. FERC Chairman Pat Wood III said the following in 2003 in his testimony before Congress concerning PUHCA:

> PUHCA was enacted primarily to undo harms caused by certain holding company structures that no longer exist. In the almost 70 years since PUHCA was enacted, utility regulation has increased substantially under the Federal Power Act (including oversight of corporate restructurings such as electric utility mergers), federal securities laws and state laws, all of which ensure that customers are fully protected.[31]

Commissioner Brownell agreed, saying:

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[30] *Id.* at 55.

[31] *Electricity Proposals and Electric Transmission and Reliability Enhancement Act of 2003: Hearing on S. 475 Before the S. Comm. on Energy and Natural Resources*, 108th Cong. 130 (2003) (statement of Pat Wood III, Chairman, Federal Energy Regulatory Commission).

> I support the repeal of PUHCA. PUHCA was necessary to address abuses that existed a half-century ago. However, that statute has not only outlived its usefulness, it is actually thwarting needed development of our electricity resources by subjecting registered utility holding companies to heavy-handed regulation of ordinary business activities and to outdated requirements that they operate "integrated" and contiguous systems... The FERC is aware of the concerns of the cooperatives and of the problems with market power in general, and we are engaged in an overhaul of our efforts at market monitoring and market power protection.[32]

I conclude that it is reasonable to say that both the SEC and the FERC understand and rely on the fact that the broad substance of the "regulatory compact" in the U.S. provides for the protection of ratepayers, holding companies notwithstanding. Both of these agencies appear to realize that opinions on the treatment of holding companies have evolved since the 1930s. The source of the fears that originally caused Congress to cause holding companies to be dissolved, as FERC Chairman Wood stated, "no longer exist."

Q. Are we to take from this that holding companies are no longer a concern?

A. No, and indeed PUHCA 2005 provides for certain reasonable oversight relating to the books and accounts of holding company systems. What we should take from this is that while holding companies may remain a concern, the powers of regulatory commissions in the U.S. since the 1930s are sufficiently advanced to deal with the affiliate and securities issues that holding companies pose. A great deal of the modern architecture of utility ratemaking and constitutionality occurred in the later

[32] *Comprehensive National Energy Policy: Hearings Before the Subcomm. On Energy and Air Quality of the H. Comm. On Energy and Commerce*, 108th Cong. 60 (2003) (statement of Nora Mead Brownell, Comm'r, Federal Energy Regulatory Commission).

1930s and 1940s. With those regulatory advancements, and the recent liberalization of upstream energy markets (in power and natural gas), Congress, in my opinion, saw that the 1935 PUHCA law was no longer necessary. This Commission's focus, however, can and should remain on the New York regulated subsidiaries of Energy East, and protecting local ratepayers through appropriate regulation of the utilities' rates and services, including proper scrutiny of affiliate transactions.

As long as a vigilant regulator stands on the boundary between regulated utilities and their holding company parents, as the Commission does now, there is no reason to believe that holding companies would pose a threat to ratepayers. The Commission said as much itself in its approval of the takeover of United Water Resources by the French holding company, Suez Lyonnaise des Eaux, responding to opponents' claims that a distant holding company would be detrimental to quality of service:

> The threat of management insensitivity to customers' needs appears chimerical because there is no basis for the opponents' assumption of indifference on the part of the parent company. And, even if the assumption were valid, United Water will remain a fully regulated commodity and service provider, subject to our jurisdiction—and under local management, according to the proponents' representations—in case there emerges some reason for concern about the company's ability or willingness to maintain safe and adequate service and conduct its affiliate transactions on an arms' length basis.[33]

Thus, the Commission already knows that it is perfectly capable of continuing to act as the guardian of ratepayers, whether the holding company is located in New

[33] Case No. 99-W-1542, *United Water Resources Inc., Order Approving Stock Acquisition* at 8 (July 27, 2000).

1 York, France or Spain. As previously noted, Iberdrola is not seeking recovery of any
2 transaction costs associated with the merger, and no harm will come to ratepayers so
3 long as the Commission exercises its well-established regulatory tools in monitoring
4 affiliate transactions and quality of service. In these respects, the merger, in my
5 opinion, is in the public interest and should be approved.

6 **IX. The Golden Share Issue**

7 Q. Please describe the purpose of this section of your testimony?

8 A. Staff Policy Panel recommends the creation of a "golden share" as a condition of the
9 merger. In this section of my testimony I describe why I conclude that this is a
10 counterproductive proposal that will serve no beneficial purpose but can create costs
11 and unanticipated problems for Iberdrola, and possibly for ratepayers, down the road.

12 Q. Please proceed.

13 A. The Staff Policy Panel proposes a "golden share" condition on the Iberdrola
14 transaction that it defines on page 283 as:

15 ...a class of preferred stock having one share, subordinate to any existing
16 preferred stock, and [which would be issued] to a party to be determined
17 by the Commission who would protect the interests of New York and
18 would be independent of the parent company and its subsidiaries. The
19 "golden share" will have voting rights, which limit ...[the] right to
20 commence any voluntary bankruptcy, liquidation, receivership, or similar
21 proceedings without the consent of the holder of that share of stock.

1 Further, the Staff Policy Panel holds the golden share to be a very important
2 condition of this proposed transaction, saying on page 285:

> 3 We believe it is an important tool, perhaps the most important tool that the
> 4 Commission can use to isolate NYSEG and RG&E from the risks of
> 5 Iberdrola. Given those risks, ... a golden share that controls whether a
> 6 utility may voluntarily be placed into bankruptcy is essential. The
> 7 Commission might also consider an LPE [limited purpose entity holding
> 8 the golden share] as an instrument for ensuring compliance with dividend
> 9 and money pool restrictions. These vehicles could create greater structural
> 10 separation between Iberdrola and its subsidiaries.

11 Q. Do you agree?

12 A. No, I do not agree. The golden share proposal is a redundant and unnecessary
13 protection for the customers of NYSEG and RG&E. In Section VIII, above, I
14 discussed at length why the SEC and the FERC (as well as Congress) concluded that
15 the modern measures for dealing with affiliate transactions are sufficient to deal with
16 the protection of ratepayers.

17 Q. What is the harm in the golden share?

18 A. The golden share has actual and potential costs and consequences that we cannot
19 predict. As new layers of corporate governance, it will by necessity create direct
20 costs. Furthermore, its novelty both in New York and in U.S. utility regulation
21 generally creates uncertainties for Iberdrola (and possibly also for utility customers)
22 that have no corresponding benefit. The idea, put forward by the Staff Policy Panel,
23 that NYSEG or RG&E would voluntarily declare bankruptcy at the behest of
24 Iberdrola, so that Iberdrola could "siphon assets out of its financially healthy

1 subsidiary"[34] simply is nowhere near a realistic possibility. Such "siphoning" is
2 impossible as a realistic regulatory matter, as I discussed in Section VIII. But further,
3 my experience with utility bankruptcies (and other bankruptcies) leads me to
4 conclude that there is no basis whatsoever in believing (either within Iberdrola or
5 within the Commission) that declaring bankruptcy could erode the protections for
6 ratepayers or work to benefit the equity owners of the utility operating companies.

7 In a nutshell, the golden share proposal serves no purpose but to inject a new class
8 of preferred shareholder into the New York operating utilities' governance and
9 financial picture, potentially tying their hands (or Iberdrola's) for no legitimate
10 reason. Given that the Staff Policy Panel also suggests additional things—beyond the
11 bankruptcy issues—that a golden shareholder would do ("The Commission might
12 also consider an LPE as an instrument for ensuring compliance ..."), I conclude that
13 the LPE idea serves only to obstruct the merger to no useful end.

14 Q. Where did the idea come from in New York?

15 A. My understanding is that the golden share proposal, with an LPE to hold it, arose in
16 the negotiations for the National Grid/Keyspan merger. The concept is new generally
17 in regulating companies in the United States.

[34] This is a quote from a 1999 S&P document referred to by the Staff Policy Panel that I conclude is both dated and not aimed at this type of transaction in the U.S. under a strong regulatory environment like New York's. I will return to this S&P document further below.

1 Q. Is there other U.S. precedent for such a golden share controlled by a party appointed
2 by a regulatory commission?

3 A. Not to my knowledge. The Staff Policy Panel brings up the case of MidAmerican /
4 PacifiCorp, but that example is different than what Staff is proposing here.
5 Specifically, while the Staff Policy Panel refers to MidAmerican / PacifiCorp, in that
6 case, there was no involvement by the Public Utility Commission in Oregon in
7 selecting a party that would become a part of the governance of the utility
8 (PacifiCorp). Rather, the special purpose entity was set up to include standard
9 provisions for separating corporate entities, including provisions for separate books
10 and records, financial statements, and arm's lengths relationships with affiliates.[35]
11 This was a far less intrusive measure than Staff's proposal of setting up a "golden
12 share" to be controlled by a party appointed by the New York Commission.

13 Q. The Staff Policy Panel specifically brings up the question of a voluntary bankruptcy
14 at NYSEG or RG&E being ordered by Iberdrola. Would the interjection of LPEs
15 prevent Iberdrola from ordering such a thing?

16 A. I cannot conceive of any possible scenario that would cause Iberdrola to order its
17 otherwise healthy, going-concern, utility subsidiaries in New York to declare
18 bankruptcy. Not only is such a thing totally unprecedented as a historical/factual
19 matter, there is no possibility for Iberdrola to gain from a process before a federal
20 bankruptcy judge in a very expensive bankruptcy process.

[35] *See MidAmerican Energy Holdings Co.*, Order No. 06-082, 2006 Ore. PUC LEXIS 74 (2006).

1

2 The bankruptcy of substantial utilities in the United States like NYSEG or RG&E
3 is exceedingly rare. And when those events happen, the companies are driven to
4 bankruptcy by matters of great uniqueness and exigency. There have only been four
5 investor-owned utility bankruptcies since the Great Depression. I provide that list in
6 Table 1, below. The first two were caused by companies suffering with stranded,
7 non-operating nuclear power plants post Three Mile Island. The third was a gas
8 pipeline company operating subsidiary of a larger holding company hobbled by take-
9 or-pay contract that arose with the one-time gas industry restructuring. The fourth
10 arose in the context of the complicated California Energy Crisis of 2000-2001. We
11 have none of those circumstances here.

1 **Table 1**

Company	Bankruptcy Filing Date	Reason	Context
Public Service Company of New Hampshire	January 28, 1988	Unable to service its debt, in large part due to its investment in the Seabrook nuclear facility.	Invested approximately $2.9 billion in Seabrook. Under NH law, plant was not allowed in rate base until the plant was actually online. Provided electric service to 400,000+ homes and businesses.
El Paso Electric Company	January 8, 1992	The PUCT authorized $47 million of a requested $131.3 million rate increase. El Paso was unable to meet its debt obligations.	Incurred substantial debt related to the construction of the Palo Verde nuclear facility. Integrated utility, served about 270,000 customers.
Columbia Gas Systems, Inc.	July 31, 1991	The settlement Columbia negotiated required it to make two $15 million deposits into an escrow account, one immediately after the settlement.	Columbia was involved in a class action suit regarding its underpayment of gas contracts. A settlement was reached in 1991. These were "take or pay" contracts." These contracts, in conjunction with the deregulation of the wellhead price of gas, forced Columbia to incur gas commodity costs that it could not pass on in full.
Pacific Gas and Electric	April 6, 2001	Retail rates had been frozen. During the rise in wholesale cost of power, retail rates did not cover the cost of power purchases.	Victim of the 2000-2001 California Energy Crisis.

Source: Company Annual Reports and Commission Reports

2

3 In all of these cases, the question of ratemaking and the traditional public service
4 issues of service adequacy stayed with the relevant Commission throughout.

5 Q. Have there been cases of bankrupt parents controlling solvent and going-concern
6 operating utilities?

7 A. Yes. Portland General Electric (PGE) in Oregon remained a going utility concern
8 while its parent (Enron) suffered bankruptcy. I am personally familiar with the

1 operation of PGE through his period. Enron owned PGE from July 1, 1997 to April
2 3, 2006, and filed for Chapter 11 bankruptcy on December 2, 2001. I filed
3 testimonies before the Oregon Commission for PGE in 2001, 2004 and 2005, both
4 before and after that bankruptcy filing.

5 Q. You seem to be suggesting that there is a possibility that LPEs and golden shares
6 could create unanticipated problems for Iberdrola, and possibly for ratepayers, down
7 the road. What do you mean by that?

8 A. Golden shares are a novel and untested addition to the governance structure of U.S.
9 utilities. Whether the LPE can deal with issues other than bankruptcy, or whether it
10 would survive if Iberdrola decided to spin NYSEG or RG&E back into an
11 independent operating utility are questions that Staff does not address. Staff seems to
12 want the LPE to prevent a voluntary bankruptcy that has no practical payoff for
13 Iberdrola (i.e., one which is ordered by Iberdrola for the purpose of "siphoning" funds
14 from the operating companies). To the extent that NYSEG or RG&E truly require the
15 protection from creditors that voluntary bankruptcy customarily provides, the LPE
16 would either be redundant or could conceivably get in the way of what bankruptcy is
17 designed to accomplish for companies seeking protection from their creditors.

18 Q. What do you conclude regarding this issue?

19 A. Neither LPEs nor golden shares are traditional parts of U.S. utility regulation. They
20 seem only to have been adopted once (in New York) as part of a negotiated

1 settlement. The other case brought up by the Staff Policy Panel (in Oregon) did not
2 involve the Commission in the way proposed here. I know of no other instance of
3 this form of corporate governance for any utility in the U.S. This added layer of
4 governance is superfluous, since the "siphoning of subsidiary funds through voluntary
5 bankruptcy" is not a realistic concern.

6 In the near term, the perceived problem associated with the golden share for
7 National Grid (a lower credit rating of the prospective parent) does not accompany
8 this transaction with Iberdrola (which has a credit rating solidly higher than NYSEG
9 and RG&E). In the longer term, ongoing and effective regulation of affiliate
10 transactions provides a sufficient protection for ratepayers without adding what I
11 conclude is a superfluous layer of corporate governance.

12 Q. Do you have any final overall comments regarding the Staff Policy Panel's
13 testimony?

14 A. Yes. I have structured my testimony to target those aspects of the Staff Policy
15 Panel's testimony that I conclude are the most flagrantly subjective or unsupportable
16 regarding this merger. As such, my comments are quite targeted, and they include
17 some considerable detail about how regulation works to protect the public interest—
18 holding companies notwithstanding.

19 From a wider perspective, I can see no harm to ratepayers in New York from this
20 proposed transaction. The Staff Policy Panel's many allegations of risk and harm

1 associated with Iberdrola as a holding company are, in my opinion, not based on any
2 factual substance or valid theoretical concern. The Staff Policy Panel has substituted
3 its own view for the opinions of independent ratings agencies, it has offered
4 calculations that have no foundation, it has cast aspersions on Iberdrola's motives and
5 has repeatedly sought concessions from Iberdrola that have no connection with the
6 genuine cost of serving customers of NYSEG and RG&E. As a result, I do not
7 believe there is a sound basis for Staff's statements about the need for the
8 Commission to reject this merger. As has been the case in other jurisdiction (like
9 Maine), I recommend that with suitable commitments, such as those provided here by
10 Iberdrola, information provision and the scrutiny of affiliate transactions, that the
11 Commission permit this transaction to go forward.

12 Q. Does this conclude your testimony?

13 A. Yes.

BY MR. GERGEN:

Q. Mr. Makholm, could you refer to two exhibits that are attached to your testimony JDM-1 and JDM-2. JDM-1 is your curriculum vitae. JDM-2 is a DPS Staff interrogatory response to IBER/EEIR No. 84. Were these exhibits prepared by you or under your direction and supervision, or provided by another party in response to an information request interrogatory in this proceeding?

A. Yes.

MR. GERGEN: Your Honor, may we have the described exhibit marked for identification?

JUDGE EPSTEIN: Yes. The next one is 84 and the second exhibit is 85.

(Exhibits 84 and 85 marked for identification.)

MR. GERGEN: Mr. Makholm is available for cross-examination.

JUDGE EPSTEIN: Cross for Mr. Makholm.

CROSS EXAMINATION

BY MR. VAN RYN:

Q. Good afternoon.

A. Good afternoon, Mr. Van Ryn.

Q. Could you please turn to page 11 of your testimony? There you interpret rating agency concerns

regarding what is described as New York's harsh treatment of its regulated companies?

A. Yes.

Q. Over the past three years how many downgrades of New York utilities have been attributed to actions by the New York State Commission?

A. I don't know if there have been any downgrades as such.

Q. If you could turn to page 13 of your testimony. And there you state your belief that Staff's concerns regarding goodwill at Iberdrola and Energy East are overstated?

A. Can you use the line? I don't think I used the word "belief".

Q. I am describing it as your belief.

A. Do you have a line reference?

Q. If you look at lines 11 through 13, you state that Staff's concerns are illogical and contrary to economics?

A. Well, I say Staff's assertion that Iberdrola faces any new incentive to profit at ratepayers' expense or that if avenues for profitability are different than those that have traditionally driven utilities in the U.S. is illogical and contrary to economics; that's what

that sentence says.

Q. Line 4 you state that Staff's concern with goodwill at the Iberdrola level is misplaced?

A. Yes.

Q. What did you mean by "misplaced"?

A. I mean that goodwill has nothing whatsoever to do with the rates for regulated operating companies in this state or any other, and hence a fixation on goodwill. If your concern is ratepayers it's misplaced because it has nothing to do with regulated rates.

Q. Does credit quality have anything to do with regulated rates?

A. It does.

Q. Can goodwill affect credit quality?

A. Not in my opinion for regulated operating companies, no. Regulated operating companies raise their own money, they raise their own debt, they set their own rates to pay for the interest and capital charges on the debt, and in that loop, goodwill does not appear.

Q. So you are saying the credit quality of a parent cannot affect the credit quality of a regulated subsidiary?

A. That I have not said. We in this state have

1 experienced -- you in this state have experienced
2 recently with a parent coming in with a lesser credit
3 quality than the operating companies it has purchased,
4 and that caused some concerns, that's the Grid-KeySpan
5 case. This is a qualitatively different situation with
6 a parent. That the greater credit quality -- in this
7 case we have a different qualitative situation where the
8 acquirer has a better credit rating than the companies
9 it's proposing to acquire.
10 Q. As of today; is that correct?
11 A. As of the last rating -- I see in February
12 2008. As of today essentially.
13 Q. And if the acquirers--quality of the acquirers'
14 credit were impaired because of goodwill you believe
15 that would not affect the credit quality of the
16 subsidiary in the future?
17 A. I believe that's correct. I worked for utilities
18 that had good health and operating with bankrupt
19 parents, and I referenced one of those in my testimony.
20 Enron owned Portland General Electric Company, a client
21 of mine, has had no material effect on the rates or
22 quality of service or operations of Portland General
23 Electric Company despite the fact that the parent was
24 one of the most notorious bankrupt companies on the

1 planet.
2 Q. Was that due to ring fencing?
3 A. Ring fencing, I have seen the use of the word
4 ring fencing a lot in this case. Ring fencing from my
5 experience abroad is generally a foreign term. Ring
6 fencing is not a longtime term that's used in American
7 regulation.
8 If by "ring fencing" you mean that the Commission
9 in Portland uses the uniform system of accounts and
10 traditional accounting in rate making procedures in
11 order to set rates and service levels for Oregon
12 ratepayers, if that's what you mean by ring fencing,
13 meaning our decades old accounts and administrative
14 procedures, then yes, that is important to make sure
15 that ratepayers are not harmed by whatever goes on at
16 the parent level. It's nothing new, however.
17 Q. That's what you understand by the term, ring
18 fencing?
19 A. That's how I am defining the term ring fencing in
20 a case like Portland General Electric and Enron. It's
21 the cumulative effect of many decades of regulatory
22 accounting, administrative procedures and law that go
23 into the setting of rates for ratepayers in
24 jurisdictions in the United States. Outside the United

1 States that don't have decades of history of regulation,
2 they have other things they call ring fencing in lieu of
3 uniform systems of accounts or the Administrative
4 Procedures Act or other things. Using the word ring
5 fencing in the United States context, I think, is a bit
6 of loose usage.
7 MR. VAN RYN: Your Honor, I would like
8 marked as an exhibit a document from Standard and Poor's
9 on the treatment of intangible assets as goodwill.
10 JUDGE EPSTEIN: 86.
11 (Exhibit 86 marked for identification.)
12 Q. If you turn to page 5 of that document, the first
13 sentence on that page states that, "Standard & Poor's
14 overall assessment of goodwill is related to the
15 economic viability or synergistic fit of the proposed
16 acquisition."
17 A. Yes.
18 Q. And Standard and Poor's believes that if those
19 factors are not satisfied then it will not get
20 comfortable with the valuation of goodwill. You can see
21 that in the fourth paragraph down.
22 A. Can you point me to where it says that, or are
23 those your words?
24 Q. That's my summary.

A. Then that's your summary. Go ahead.

Q. Could you turn to page 32 of your testimony. There you set forth a comparison of approved returns on equity among states; is that correct?

A. Yes. That is the comparison from Regulatory Research Associates.

Q. Are you aware that in New York a multi-year settlement is accorded a higher rate of return than a single stand alone one-year litigated rate case?

A. Yes. I have been parts of those cases, in fact, I think I was part of the first one for Brooklyn Union Gas in the late 1980s.

Q. Have you done an analysis of the New York figures shown on the chart as to how many are litigated one-year rate cases and how many are multi-year settlements?

A. Have I done an analysis. I am aware of multi-year settlements in New York and a number of other states on that chart. If what you are asking is that I know things about particular utilities in different states that bear on the level of the bars that are shown in the different states, the answer would be yes, I know things about New York and other states that bear on the level of the heights of those bars.

Q. So you can tell us how many cases in New York

1 that were based on one-year litigated cases and how many
2 were based on multi-year settlements and do that for
3 each of the other states.
4 A. Oh, no. I can't deal with that much precision.
5 I know that there are such things, but we have many
6 utilities in many states, many different time periods.
7 The point of this chart and the data behind it, that's
8 provided by a subscription publication, Regulatory
9 Research Associates, is to inform investors with the
10 information that's tangible and usable on the table from
11 which these numbers are derived have a number of things.
12 States lags and months for decisions and various
13 other things to try to help the reader evaluate those
14 various numbers that come from the RRA, Regulatory
15 Research Associates, table. I wouldn't expect that
16 investors know as much about New York as you do or as
17 much about other states as your counterpart in other
18 states do. Nevertheless, this table is still provided
19 to educate investors with what you can provide in a
20 single table.
21 MR. VAN RYN: A moment.
22 Q. Could you please turn to page 15 of your
23 testimony? In there, you describe a concept known as
24 regulatory compact?

A. Yes.

Q. When you were preparing that testimony, did you review any New York law?

A. I read the statutes, both the original one created in 1907 and the one that is in current effect, yes.

Q. Did you read the court's decision in Energy Association versus Commission set forth at 169 Miscellaneous 2d 924 from the year 1996?

A. That does not ring a bell.

Q. The court there describes the regulatory concept as?

A. Did you say concept?

Q. Compact. Excuse me.

MR. GERGEN: Excuse me, Your Honor, we are going to object again. We don't have the document in front of us. Do you have a copy?

MR. VAN RYN: This is a cited decision. There are other cited decisions in Mr. Makholm's testimony that we have not been provided copies.

MR. GERGEN: Your Honor, I believe that it is unfair to cross-examine a witness on a document that is not before him. Yes, it may be a publicly available document, but we don't have it, he doesn't have it.

JUDGE EPSTEIN: The fairness depends on what level of detail we are going to get into. Are you confining your questions to one short excerpt that you were about to read, or would the witness need to have a working knowledge of the case?

MR. VAN RYN: I will rephrase the question.

Q. You did not take that opinion or other opinions of the New York courts into account in preparing your analysis of the regulatory compact in New York?

A. Sounds like a multiple-part question.

Q. Would you like me to break it down?

A. No. I can do it. The first part of the question was, did I review the orders. The answer is no. The second part has to do with the issue of the regulatory compact in New York.

I have been witnessing the regulatory compact in the 20 years I've been dealing with New York utilities and this Commission. It's alive and well in New York. I don't know what those decisions say about it, but a regulatory compact is a general measure and it's generally understood, works as well in this state as it does any other in the United States.

MR. VAN RYN: I have nothing further.

BY MR. MAGER:

1 Q. Good afternoon. I have a few quick questions.
2 If you could turn to the -- pages 11 and 12 of your
3 rebuttal testimony, please?
4 A. That's the big list of what's to come, correct?
5 Starting at the bottom at 11. I am sorry, 11 and 12.
6 Q. Going on to 12.
7 A. It's a list that starts on page 10?
8 Q. Yes. Specifically, I want to draw your attention
9 to page 11, line 37 and continuing, where you state that
10 "The Commission in New York will lose none of its
11 ability to use its broad legislatively-granted powers to
12 protect the public interest in New York through direct
13 regulation of NYSEG and RG&E as a result of this
14 transaction," do you see that?
15 A. Yes.
16 Q. Okay. I am not asking about the Commissions --
17 withdrawn.
18 One of the things the Commission would not be
19 able to do would be to undo the transaction should it be
20 approved, would you agree with that?
21 A. I agree on -- I think it may be a part of a data
22 request response that this Commission has not been
23 granted by the legislature's power to dissolve the
24 holding of an operating company by a holding company. I

1 believe that's correct. Other states do. Not this one.
2 Q. So that while the Commission would still have
3 certain regulatory powers over NYSEG and RG&E it would
4 not be able to undo this transaction if it turned out
5 that if at some later point in time the Commission
6 concluded that the transaction had not been in the
7 public interest?
8 A. The hypothetical that you ended that sentence
9 with I don't understand. If there were things that were
10 happening not in the public interest. In terms of
11 service, quality, costs or rates the Commission has the
12 power to affect those things. If your implication is,
13 in that question, that there's something about the
14 ownership of the equity, in and of itself, that bears on
15 the public interest, I reject that assertion to the
16 extent that the Commission still holds, as I say, its
17 broad legislatively-granted powers to affect service,
18 quality and rates.
19 The identity of this stockholder is irrelevant.
20 This Commission does not regulate who the stockholder
21 is. So I would challenge you to describe more fully
22 what it would be about the ownership of that equity that
23 would somehow circumvent the Commission's broad
24 legislative authority to oversee service, quality and

rates, as it always has done.

Q. Let's use this as a hypothetical then. One of the benefits touted of this merger is the acquiring entity is financially stronger than Energy East; are you with me so far?

A. Yes, better credit rating and they're bigger and more experienced.

Q. Let's say that circumstances change for any number of reasons, such as that Iberdrola's ratings fall below where Energy East is currently?

A. Like in the Grid-KeySpan merger?

Q. Yes.

A. Yes.

Q. If having a stronger credit rating than Energy East is a benefit of the merger would the acquiring company falling below Energy East be considered a harm or risk of the merger?

A. Your question doesn't flow from your previous questions. I agreed to the statement that Iberdrola is financially stronger and hence can do things like raise equity at lower costs than the stand alone company could, because as we all know, selling an issuance expense, what happens is costs for equity goes down as the equity issuance goes up. And the size of the one

getting the issuance gets bigger. I didn't tie it to credit ratings as such. You tied it to credit ratings.

I already said that I worked for an operating company whose consumers were well protected in terms of rates, charges and service quality, despite being owned by Enron. I won't agree that the rating of the parent as such has anything to do with the Commission's power to make sure that rates and service quality for consumers in New York are well protected. Always have to.

Q. I think you have kind of changed the question that I was getting at. Let's try to break it down a little simpler. If the acquiring company, if Iberdrola is financially stronger than Energy East and that's seen as a benefit of merger?

A. Let's make it even simpler and say bigger.

Q. Okay.

A. Bigger financial entity, hence has the ability to raise equity at a lower unit cost.

Q. So, you believe -- so the ability to raise equity at a low cost is based solely on size?

A. Well, that's one of the most important elements of the cost of issuing equity is size. The greater the equity issuance, the smaller the proportion of selling

1 an issuance expense to the equity offer.
2 Q. Now, when -- to what extent are costs impacted
3 by credit ratings?
4 A. To the extent that a credit rating, in and of
5 itself, separate from other things, affects the rate
6 that you can issue debt at in the market, then it can
7 affect the cost of debt raised to support, in this case,
8 operating utilities.
9 Q. And so let's use that example that Iberdrola has
10 identified, its higher debt rating as a benefit of the
11 merger. Would you agree that should Iberdrola's debt
12 rating fall below where Energy East is today, that would
13 be a potential harm or cost of the merger?
14 A. No.
15 Q. Why not?
16 A. As I have said, the circumstances of the parent,
17 twice I mentioned Enron, and twice I mentioned Enron and
18 in that case you have a catastrophically bankrupt
19 parent, that has had no material effect on how customers
20 get served and what price in Oregon.
21 Q. So as I understand what you are saying, and I
22 know you will correct me if I am wrong, if a better
23 rating is a positive and a lower rating has no impact --
24 is irrelevant; am I understanding you correctly?

A. I put it this way: I don't want to inject any hyperbole in the ratings game -- well, let me put it my own way. Iberdrola is a large and successful and savvy international energy company that's many times the size of these two companies that it proposes to take over. That size has benefits for consumers in terms of the ability to raise equity at low cost, and there are other benefits that Mr. Meehan described just before I was here.

To the extent that you had a parent that had a weaker credit rating, it may be -- it may ring a bell, may be trip wire for some concern and greater scrutiny for other reasons, but that bell doesn't get rung here, because we don't have the Grid-KeySpan case, we have the Iberdrola-Energy East case.

I don't see it as a quantitative scale whereby the credit quality of the parent vis-a-vis the operating company has a positive or negative benefit with respect to the operating company, depending on the gap between the ratings one way or the other. I don't view it that way, I don't think the market views it that way. I don't think the Commission should view it that way.

The way I view it is, because the acquirer has a better credit rating it avoids a concern that might be

appropriate to look further at what damage it might cause if you had a worse company acquiring better-rated subsidiaries. I think the possible detrimental effect is slim to non-existent for the reason of Enron that I gave you, but if the acquiring entity like Iberdrola has a better credit rating, you don't even have to look.

Q. You keep mentioning the Enron-Portland example. Are there other examples where the financial health of the parent had a detrimental impact on the utility?

A. I said that was a case where it didn't.

Q. I know. I am asking you are you aware of any examples where it did?

A. No.

Q. All else being equal, do you consider an aggressive expansion plan to create more or less risk in terms of how a company may be rated by agencies?

A. I think my belief, no one should care what I believe, you should care what investors --

Q. Does that go for the rest of your testimony?

A. No. Good question, but I am the one who told you I think that I try not to use the word "believe". I may conclude, I may take inferences from evidence, I may draw examples from elsewhere, but my personal beliefs don't really matter here. My personal beliefs on credit

quality don't matter either, that's what the rating agencies say, and whether they conclude there's any problem here.

As far as Iberdrola is concerned, their aggressive expansion to the extent that has anything to do with Energy East has been funded by equity. Equity holders in Iberdrola aren't concerned, why should we be concerned? And S&P and Moody's and Fitch, who provide this interested analyses for the market aren't concerned, why should we be concerned. In both those cases Iberdrola has shown the market that those with money to invest that it can readily absorb this transaction.

Q. To what extent should the Commission defer to the credit rating agencies in evaluating risk?

A. As opposed to what, substituting its own judgment?

Q. Yes.

A. What we have seen in the case in terms of the Staff policy panel.

Q. No. I am asking about the Commission.

A. The Commission, I don't think that commissions anywhere substitute their judgment for the judgment of the rating agencies. I think ultimately this Commission

1 and every other looks at bond ratings and credit
2 ratings, because they know that the ultimate regulator
3 of the process of running investor-owned utilities is
4 the market for capital.
5 And indeed, that's the highest authority that
6 comes into play in rate cases is the 1944 Pope decision
7 from the Supreme Court that said that ultimately it was
8 the ability to raise capital upon reasonable terms that
9 is the judge of whether or not regulation is successful,
10 my terms.
11 So I have never seen a Commission ignore or
12 substitute its own judgment for those of the rating
13 agencies. I think they have a healthy respect for that
14 institution in the United States.
15 Q. And I think you didn't answer the question I
16 guess that I intended, and I may not have phrased it as
17 accurately as I should have.
18 In deciding whether this merger is in the public
19 interest or whether certain customer protections are
20 needed, the Commission would rely on its own judgment,
21 not that of a credit rating agency; would you expect
22 that?
23 A. Yes. Public interest is the Commission's
24 responsibility to judge.

Q. One last thing I would like to just discuss with you. Could you turn to page 42 of your rebuttal testimony. At the bottom of 42, starting on line 16, you discuss, I guess, the degree to which the Commission need involve itself in a parent company's operations; do you see that?

A. Yes.

Q. When shared services are done or there are other allocations by a parent among multiple subsidiaries, wouldn't the Commission and its Staff need to regulate how those allocations are performed?

A. Of course, and that's a long-standing practice of American regulators to use allocation factors or methods to split, for instance, central office costs. They've been doing that for decades. Using formulae that use objective input like the Massachusetts formula or the KN formula for allocating central office costs among regulated and unregulated operations.

Q. And so I guess that portion of the testimony that I had referred you to, you are not objecting to the need for the Commission and Staff to get into, I guess, the books of Iberdrola or whatever entity it is that is performing the allocation to make sure that costs are allocated fairly?

A. That's correct. EPACT of 2005, Energy Policy Act of Congress of 2005 gives this Commission a great power to ask for books and records of everybody involved and, so Congress has given this Commission the ability to ask for whatever it wants to. I distinguish that from regulating -- from the business of regulating the parent, which is something that is and should lie outside of the Commission's jurisdiction.

MR. MAGER: Thank you. I have nothing further.

JUDGE EPSTEIN: Other cross? Mr. Prestemon?

MR. PRESTEMON: Just a couple quick questions.

BY MR. PRESTEMON:

Q. Dr. Makholm, you described Iberdrola as a big savvy international energy company, correct?

A. Yes.

Q. Do you think most people would have given a similar description to Enron in 1998; but not you, you know?

A. No. I think in 1998, yes, although even I would have called them unusually aggressive, because the international oil and gas and investment community knew very well Enron had the steepest compensation formula

for its local country managers than any oil or gas company in the world, meaning that its executives got paid for deals more so, as a part of their total compensation, than anybody else. That was the thing that was distinguishing and a little bit creepy about Enron, that everybody knew who was -- worked in those fields long in advance.

Q. My only point in this was that current perception of the size, strength and capability of the Company doesn't necessarily obviate the need for protective mechanisms to be in place by companies, in this case regulated companies acquired by those bigger companies?

A. Nothing about the size of Iberdrola could lead this Commission to let go of the ways and means that it uses to protect ratepayers and to set rates.

Q. Your view is the protective mechanisms that were in place at the time at the state of Oregon set at the time of the Enron collapse were adequate and perhaps necessary to protect the ratepayers of Portland General?

A. Yes.

Q. And is it your view that comparable mechanisms are in place in the State of New York to protect the ratepayers in case we are all wrong about Iberdrola?

A. Yes.

MR. PRESTEMON: Thank you.

JUDGE EPSTEIN: Mr. Duthie.

MR. DUTHIE: Just one question, Doctor.

BY MR. DUTHIE:

Q. I asked this question of Mr. Meehan. I want to ask the question a slightly different way to you. Are unfunded revenue reductions consistent with the regulatory compacts?

A. Not really. I view it as more of a concession to make a deal happen in the practical real world. But, as Mr. Meehan said, simply taking money out of one pocket and putting it another cannot, in itself, be called a benefit. It's not a benefit by any economic standard, benefit being cost reduction or synergy, simply puts money from one pocket into another, but we are not naive enough to know that concessions don't go along with big deals like this, and that's a concession.

MR. DUTHIE: I have nothing further, Your Honor.

JUDGE EPSTEIN: Any other cross? Redirect?

MR. GERGEN: Could we have two minutes with the witness, Your Honor.

(Recess taken.)

MR. GERGEN: Your Honor, we have no

redirect.

JUDGE EPSTEIN: Okay. Thank you very much, Mr. Makholm, you are excused. We will be in recess for one hour.

(Recess taken.)

MR. VAN RYN: Your Honor, I present the Staff policy panel. If they could introduce themselves.

A. (D'Ambrosia) Thomas D'Ambrosia.

(Barry) Patrick Barry.

(Bowman) Maynard Bowman.

(Salony) Michael Salony.

(Berger) Stephen Berger.

THOMAS D'AMBROSIA, PATRICK BARRY, MAYNARD BOWMAN, MICHAEL SALONY and STEPHEN BERGER, after first having been duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. VAN RYN:

Q. I show the Panel the revised as of March 12, 2008, the testimony of the policy panel. And the trade secret confidential testimony of the policy panel and the highly sensitive trade secret testimony of the policy panel.

I ask if you prepared these testimonies?

A. (Panel) Yes.

Q. And do you have corrections to these testimonies?

A. (D'Ambrosia) Yes.

MR. VAN RYN: Your Honor, I distributed a set of new pages to the original testimony that revises the original redacted version to all the parties. Your Honor has a copy.

JUDGE EPSTEIN: I am sorry, because you mailed it to me?

MR. VAN RYN: Just handed it to you a few minutes ago.

JUDGE EPSTEIN: It's redacted, not revised.

MR. VAN RYN: These are the revised redacted pages. None of the confidential information has changed.

JUDGE EPSTEIN: Okay.

MR. VAN RYN: Would you like me to read these into the record or would you rather have it marked as an exhibit?

JUDGE EPSTEIN: The revised pages?

MR. VAN RYN: The corrections.

JUDGE EPSTEIN: Let's go off the record for discussion of paperwork.

(Off the record.)

JUDGE EPSTEIN: While we were off the record we had a discussion to clarify what documents have just been handed out and how they will be introduced, which we are now about to do.

BY MR. VAN RYN:

Q. Could you read the corrections into the record.

A. (D'Ambrosia) Yes. To the Staff prefiled testimony the following corrections should be made: Starting on page 65, line 16, the word "watch" should be replaced by the word "outlook."

On page 149, line 19 it says "9.8 billion." It should say "13.3 billion."

On pages 167 beginning on line 21 and continuing through page 168 it says, "S&P has put NYSEG and RG&E on watch for downgrade if the transaction is completed." It should say, "S&P has designated the credit outlooks for NYSEG and RG&E as 'negative' making a downgrade likely upon completion of the transaction."

Page 177, line 4, it says "basis points." Those two words should be stricken -- deleted.

On page 191, line 11, the word "resale" should say "residual."

Page 236, line 14, the amount "403 million" should say "387 million." On page 238, line 7, "13

percent" should read "6 percent."

On line 238, line 14, it says "Exhibit 21." It should say "revised Exhibit 21." And on page 278, line 17, the date "October 2006" should read "October 1999."

MR. SCHWARTZ: Your Honor, I think Mr. D'Ambrosia may have missed one along the way.

MR. VAN RYN: Page 159?

A. (D'Ambrosia) I'm sorry. Moving back to page 159, line 22, the word "rating" should say "ratio."

Q. With those corrections if you were asked the questions today would your answers be the same as in the prepared testimony?

A. (Panel) Yes.

MR. VAN RYN: Your Honor, I ask that the revised prepared testimony of the policy panel be copied into the record as if given orally.

JUDGE EPSTEIN: Yes. Thank you.

(The following is the prefiled testimony of the Staff Policy Panel:)

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31

32 INTRODUCTION OF WITNESSES

33 Q. Please state your names and business addresses.

34 A. Our names are Thomas A. D'Ambrosia, Patrick J.

35 Barry, Maynard Bowman, Michael Salony, and

36 Stephen A. Berger. Our business address is

37 Three Empire State Plaza, Albany, New York

12223.

Q. Mr. D'Ambrosia, by whom are you employed and in what capacity?

A. I am employed by the New York State Department of Public Service as a Supervisor in the Office of Accounting, Finance, and Economics.

Q. Please outline your educational background and professional background.

A. I graduated in 1980 from Saint John Fisher College in Rochester, New York with a Bachelor of Science degree in Accounting. I joined the Department of Public Service in September 1980 as a Public Utility Auditor Trainee and advanced to my current position through competitive examinations.

As a supervisor of Accounting, Finance, and Economics I am responsible for managing the activities of a unit of auditors, accountants, and financial analysts located throughout New York State on a variety of projects, including their participation in major proceedings before the Public Service Commission. Since 2002, my

main responsibilities have been the two Energy East affiliates operating in New York State, New York Electric and Gas Corporation (NYSEG or the company) and Rochester Gas & Electric Corporation (RG&E). In addition, I directly participate in proceedings before the Public Service Commission involving NYSEG and RG&E.

Activities that I or my Staff have been involved in include examinations of accounts, records, documentation, policies and procedures of regulated utilities to develop issues for electric, gas, and telecommunications rate proceedings, settlements, financing approvals, fuel and gas adjustment clause reviews, rate of return reviews, asset sales (including RG&E's sale of its Ginna nuclear plant and its share of the Nine Mile Point #2 Nuclear Plant--see Case 03-E-1231 Order Approving Transfer, Subject to a Modification, (issued May 20, 2004) and Case 01-E-0011 Authorizing Asset Transfers, (NMP-2 Sale Order, issued on October 26, 2001), use of revenues cases, mergers and acquisitions,

1 reorganizations and restructurings, Article VII
2 transmission reviews, and other general
3 accounting and financial investigations. I have
4 also previously testified on the determination
5 of the overall utility cost of capital
6 (including estimating the cost of equity) and
7 capital structure.
8 Q. Mr. D'Ambrosia do you hold any professional
9 licenses?
10 A. Yes. I am a Certified Public Accountant.
11 Q. Have you previously testified before the New
12 York Public Service Commission?
13 A. Yes, I have testified in numerous proceedings,
14 including NYSEG's last electric rate case, as
15 well all of RG&E's rate cases over the last two
16 decades. A summary listing of the testimony I
17 have given is included in Exhibit___(PP-1). As
18 Exhibit___(PP-1) shows, I have testified in a
19 number of proceedings before the Public Service
20 Commission on electric, gas, telecommunications
21 matters. Most recently, I testified as a Staff
22 witness on three panels concerning NYSEG's:

electric revenue requirements; electric commodity options; and on its embedded cost of service in it's 2005 electric rate proceeding (see Case 05-E-1222 New York State Electric and Gas, Order Adopting Recommended Decision with Modifications, issued August 23, 2006, NYSEG 2005 Rate Order).

Q. Mr. D'Ambrosia, as part of your activities in your role as a Supervisor of Accounting, Finance, and Economics have you participated in other ways in NYSEG's and RG&E's formal proceedings?

A. Yes. Recently, among other things, I was extensively involved in the development of NYSEG and RG&E's compliance filings establishing its electric fixed prices (FPO) and fixed non-bypassable wires charges (NBC) for the 2005-2008 commodity options periods. I was also involved in Case 06-M-1413-Proceeding on Motion of the Commission Concerning New York State Electric & Gas Corporation's Accounting Practices for Other Post Employment Benefits and the Company's Use

of the Interest Earned on the OPEB Reserve Account (see Order Adopting the Terms of a Joint Proposal, issued and effective September 20, 2007, the NYSEG OPEB case).

Q. Mr. D'Ambrosia, what is your role in this proceeding?

A. I, along with Michael Salony, serve as the Staff team leaders. In addition, I directly supervised the work of Mssrs. Benedict, Haslinger, and Barry on this proceeding.

Q. Mr. Barry, please describe your duties for the Office of Accounting, Finance, and Economics.

A. My responsibilities include analyzing financing petitions, testifying in rate proceedings, and performing financial forecasting, economic analysis, audits, and other investigations and studies. Regarding financings, recommendations are made to the Commission concerning petitions to issue debt and equity securities. Issues that are addressed include the need and the basis for the issuance, the selection of the mode of financing, and the cost of the

1 securities issued. In rate proceedings,
2 recommendations are made relating to matters of
3 the fair rate of return, cash flow
4 considerations and ratemaking policy issues, and
5 cost of service adjustments. Additionally,
6 financial forecasts and economic analyses are
7 made in light of proposed actions by various
8 utilities.
9 Q. Mr. Barry, do you have experience testifying in
10 rate cases?
11 A. Yes. I have testified numerous times before the
12 New York State Public Service Commission and I
13 have also presented testimony in several cases
14 before the Federal Energy Regulatory Commission.
15 I have filed testimony in proceedings involving
16 the following companies: KeySpan Energy Delivery
17 New York, KeySpan Energy Delivery Long Island,
18 New York State Electric & Gas Corporation,
19 Tennessee Gas Pipeline Company, Transcontinental
20 Gas Pipe Line Corporation, CNG Transmission
21 Corporation, Corning Natural Gas Company, St.
22 Lawrence Natural Gas Company, Consolidated

1 Edison Company of New York, Inc., Long Island
2 Lighting Company, Niagara Mohawk Power Company,
3 Central Hudson Gas & Electric Corporation,
4 National Fuel Gas Corporation, Spring Valley
5 Water Company, New York Water Service
6 Corporation, Shorewood Water Company, Citizen's
7 Water Company, and New Rochelle Water Company.
8 My testimony has primarily addressed rate of
9 return and other financial issues.
10 Q. Mr. Berger, please briefly state your
11 educational background and professional
12 experience.
13 A. I received a Bachelor of Science degree (1975)
14 and a Master of Science degree (1987) from the
15 Rensselaer Polytechnic Institute in Troy, New
16 York. I am a member of the national mathematics
17 honor society, Pi Mu Epsilon. From 1979 until
18 2001, I was employed by the New York State
19 Consumer Protection Board in various positions,
20 ultimately as Associate Utility Rates Analyst.
21 From 2001 through the present, I have been
22 employed by the Department.

Q. Please briefly describe your current responsibilities with the Department and previous responsibilities with the Consumer Protection Board.

A. In my work with the Department of Public Service I have been responsible for analyzing a number of policy issues, including stand-by rates for distributed resources, utility commodity hedging portfolios, renewable portfolio standards, purchase of receivable (POR) programs, advanced and competitive metering, cost allocation and rate design, unbundling of utility services, unbundled utility bill formats, and implementation of changes to the Home Energy Fair Practices Act (HEFPA). In my previous position with the Consumer Protection Board, I was responsible for analyses related to competitive energy and telecommunications policy, cost recovery, sales forecasts, revenue allocation, rate design, utility consumer protections, as well as other issues.

Q. Have you previously testified before the

1 Commission or other regulatory agencies?
2 A. I have submitted testimony in over 50 energy-
3 related proceedings before the Commission on
4 numerous topics including: management and
5 executive compensation, forecasting, revenue
6 allocation, rate design, standby rates,
7 unbundling and other issues related to retail
8 competition. I have prepared formal comments
9 before the Federal Energy Regulatory Commission
10 and Federal Communication Commission. I also
11 served as co-chair of one of the four main
12 committees in the 00-M-0504 Competitive Markets
13 Proceeding and participated in and contributed
14 to the other three committees.
15 Q. Mr. Bowman, please describe your educational and
16 professional background.
17 A. I have a B.S. in Mathematics from the University
18 of North Carolina at Chapel Hill and I completed
19 all the requirements for a Ph.D. in Economics
20 with the exception of completing a dissertation
21 at the University of Virginia at
22 Charlottesville. While at the University of

1 Virginia, I was a research assistant in the
2 areas of macroeconomic modeling and regulatory
3 economics. Prior to joining NYSDPS, I was
4 Director of Forecasting at the New York State
5 Energy Office. I have previously testified
6 before the New York Public Service Commission in
7 Niagara Mohawk Power Corporation's Case 95-G-
8 1095 as a member of the Performance-based
9 Regulation Panel, in Rochester Gas and Electric
10 Corporation's Case 96-E-0898 as a member of the
11 Settlement Panel and in Long Island Lighting and
12 KeySpan Case 97-M-0567 as a member of the Staff
13 Panel.
14 Q. Mr. Salony, by whom are you employed and in what
15 capacity?
16 A. I am employed by the New York State Department
17 of Public Service. I am an engineer and
18 supervisor in the Gas Rates Section of the
19 Office of Electric, Gas & Water.
20 Q. Would you please state your educational
21 background and professional experience?
22 A. I received a Bachelor of Science degree in

Electrical Engineering from Pratt Institute in 1974. I joined the Department of Public Service in May 1976. My responsibilities have included analysis of various rate and regulatory issues, including rate design, gas sales and revenue forecasts, operating and maintenance expenses, depreciation and rate base, and I have testified on these topics in several proceedings before the Commission.

Q. Panel, did you prepare exhibits supporting this testimony?

A. Yes, we prepared 25 Exhibits, referenced throughout this testimony as Exhibit ___(PP-1) through Exhibit__ (PP-25).

Q. In your testimony, will you refer to, or otherwise rely upon, any information produced during the discovery phase of this and other proceedings?

A. Yes. We relied upon a number of Petitioner's responses to Staff Information Requests. These are attached as Exhibit ___(PP-2).

OVERVIEW

Q. Please describe the Petition filed in this proceeding.

A. On August 1, 2007, Iberdrola, S.A. (Iberdrola), Green Acquisition Capital, Inc. (Green Acquisition), Energy East Corporation (Energy East), RGS Energy Group Inc. (RGS), New York State Electric & Gas Corporation (NYSEG), and Rochester Gas and Electric Corporation (RG&E) (collectively, the Petitioners) filed a Petition requesting that the New York State Public Service Commission (Commission) approve, without modification or condition, Iberdrola's proposed acquisition of 100 percent of the common stock of Energy East, the parent holding company of NYSEG and RG&E (transaction or acquisition) pursuant to Section 70 of the New York State Public Service Law (PSL) and any other statutory or regulatory provisions deemed applicable. The Petitioners requested that the Commission approve the Proposed Transaction within six months of the date of the filing (or February 1,

1 2008) "so that the closing of the Proposed
2 Transaction may occur as soon as possible
3 thereafter, permitting New York to obtain the
4 benefits of the Proposed Transaction as
5 expeditiously as possible."
6 Q. What is the purpose of this testimony?
7 A. This testimony explains why Staff, after a
8 comprehensive analysis of the risks, costs and
9 benefits of the proposed transaction, has
10 reached the conclusion that the proposed
11 acquisition of Energy East Corporation (Energy
12 East) by Iberdrola, S.A., (Iberdrola) is not in
13 the public interest, and as such, should not be
14 approved by the Commission. While we believe
15 the problems created by the acquisition are
16 unprecedented, and that the transaction should
17 not be approved, we will also provide our
18 recommendations for modification or conditional
19 approval, in the event that the Petitioners seek
20 guidance on amending their proposal or the
21 Commission does authorize the transaction.
22 Q. What standard did you employ when determining

1 that the proposed transaction was not in the
2 public interest?
3 A. The standard that we use is that the proposal
4 should provide some tangible positive benefits
5 to ratepayers, in the form of lower rates,
6 reduced costs or other monetary value. We
7 reviewed the Direct Testimony of the Benefits
8 and Public Interest Panel (Petitioners' Panel)
9 and the Direct Testimony of William H.
10 Hieronymus, which explained why the Petitioners
11 believed that the proposed transaction was in
12 the public interest and did not create vertical
13 market power concerns, in order to determine if
14 the positive benefits test was met. In
15 evaluating the petitioners' proposals, we also
16 considered how the proposed transaction would
17 adversely affect the ability of NYSEG and RG&E
18 to meet their most basic public service
19 responsibility: the provision of safe and
20 adequate service at a reasonable price. We
21 conclude that, as filed, the proposed
22 transaction not only cannot meet the positive

benefits standard, but it also fails a "no harm" test that might be used in some regulatory jurisdictions.

Q. Is there a clear and recent example of where the Commission applied the tangible positive benefits test in reviewing a merger and acquisition (M&A) proposal?

A. Yes. In the most recent electric and gas M&A proceeding to come before the Commission, involving National Grid and KeySpan, the Commission employed a tangible positive benefits standard when it performed its evaluation.

Q. Can you cite to specific support for the use of this standard?

A. Yes. Support is found in the recent Abbreviated Order Authorizing Acquisition Subject To Conditions and Making Some Revenue Requirement Determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued and effective August 23, 2007) in Case 06-M-0878, Joint Petition of National Grid PLC and KeySpan Corporation (Grid/KeySpan Merger).

The Order states on page 9: "The more than $686 million of benefits to New Yorkers can be seen as the positive side of the ledger in a simple cost-benefit analysis. They comprise a significant part of the context within which we evaluate whether the proposed terms in [the Joint Proposal] are collectively in the public interest."

Q. Were other benefits alleged by Grid/KeySpan?

A. Yes. Those benefits included:

> in addition to the allocation of savings, KEDNY's and KEDLI's Rate Plans include several programs designed to promote the Commission's policies favoring competition in retail energy markets, implement new demand-side programs, enlarge KeySpan's low income discount rate programs, maintain service quality, and accelerate infrastructure investments over the next ten years. Each of these programs is being enhanced as a result of the proposed Transaction (Grid/KeySpan Merger Petition page 5).

The Grid/KeySpan Merger Petition also referred to benefits such as Grid's long history of providing service, expansion of resources, and expertise in providing better service at lower cost (see page 20). Nonetheless, extensive

1 conditions were imposed in the Order to ensure
2 that the safety, reliability and quality of
3 service were preserved and enhanced. In
4 addition, the Order required the divestiture of
5 Ravenswood generation facility, because
6 otherwise Grid/KeySpan could not comply with the
7 Commission's vertical market power guidelines.
8 Notwithstanding these determinations, however,
9 the Commission, as stated above, found that
10 monetary benefits were the most "significant"
11 consideration in its evaluation of the
12 acquisition. As shown below, the proposed
13 Iberdrola transaction in this case offers no
14 tangible monetary benefits to ratepayers and
15 should not be approved as filed.
16 Q. How did you reach your conclusion?
17 A. We have studied and analyzed the information
18 contained in the M&A petition, the testimony and
19 exhibits filed in support of the petition,
20 hundreds of interrogatory responses, and other
21 relevant information, including publicly
22 available information concerning Iberdrola. Our

1 recommendation is the product of this thorough
2 analysis.
3 Q. Is Staff's recommendation based on speculation
4 or a worst case scenario?
5 A. Neither. The information we studied provides
6 clear and convincing support for the conclusion
7 that the transaction not only lacks tangible
8 benefits but imposes real, tangible costs and
9 risks on customers. The preponderance of the
10 evidence we found is heavily weighted against
11 the approval of the proposed transaction.
12 Q. What areas was the Policy Panel responsible for
13 examining?
14 A. We examined the overall costs, risks, and
15 benefits of the acquisition in order to make a
16 determination on whether it is in the public
17 interest. Besides concluding that there were no
18 tangible benefits, we specifically examined
19 vertical market power, financial risks (credit
20 quality, financial reporting as well as "non-
21 reporting" and lack of transparency), corporate
22 incentives, cost allocation, code of conduct,

and security issues.

Q. Starting with vertical market power issues, explain your testimony.

A. The purpose of our testimony here is to address the vertical market power issues related to the proposed Iberdrola and Energy East transaction, including the effect of those policies in furthering on New York's efforts to promote the development of additional renewable power resources, in particular wind power. Vertical market power issues arise because two of Energy East's subsidiaries, New York State Electric and Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E), own electric T&D facilities, natural gas distribution facilities, and electric generating units in New York. Iberdrola subsidiaries also own wind generation facilities in New York and have plans to construct new wind generating facilities that are listed in the New York Independent System Operator (NYISO) interconnection queue.

Q. Please summarize your conclusions regarding

1 vertical market power.

2 A. The combined firm would possess vertical market

3 power because of the combined ownership of

4 transmission, distribution, generation and

5 natural gas distribution assets and would have

6 an incentive to exercise that vertical market

7 power to the benefit of its own generation, the

8 detriment of customers, and the disadvantage of

9 competing generation. In particular, the

10 exercise of vertical market power could

11 adversely affect New York's efforts to develop

12 its wind resources and meet its Renewable

13 Portfolio Standard (RPS) targets. As a result,

14 the proposed M&A transaction is not in the

15 public interest absent divestiture of all

16 generating assets by the combined firms.

17 Next, please explain why you have concluded from

18 a financial perspective that the risks

19 associated with the M&A justify the conclusion

20 that the proposed transaction is not in the

21 public interest.

22 A. Iberdrola's ownership of Energy East, as

1 envisioned in the proposed transaction, creates
2 an unreasonably high number of future financial
3 risks and uncertainties for New York ratepayers.
4 Iberdrola has embarked upon an extensive capital
5 investment program. Based upon its 2008-2010
6 Strategic Plan presented in Madrid on October
7 24, 2007, this program will continue. This
8 capital investment program has caused concern at
9 the credit agencies and that concern affects the
10 rating of all the entities in the Iberdrola
11 holding company system. The credit agencies are
12 also concerned about the high degree of leverage
13 Iberdrola plans to deploy and how its large
14 investment program will be financed. Over the
15 last six years, Iberdrola's credit rating has
16 decreased from AA- to A- at Standard % Poor's
17 (S&P) and from A1 to A3 at Moody's and its
18 equity ratio has declined from 63% to 42% over
19 the period 1997 through 2006 (see Exhibit___(PP-
20 3). Even though Energy East's credit rating is
21 currently slightly lower than Iberdrola's,
22 Standard & Poor's indicates that (in

contradiction to Iberdrola's claim) the acquisition could have a negative impact on the credit ratings of NYSEG and RG&E. The most recent credit opinions for NYSEG and RG&E from S&P and Moody's are presented in Exhibit___(PP-4).

Q. Please describe Iberdrola's financial profile.

A. Iberdrola's financial profile (leverage) is described as "aggressive" by S&P. The significant amount of debt financing in Iberdrola's capital structure is exacerbated by both the Company's large amount of existing Goodwill (Goodwill being the excess price paid over and above depreciated historical cost) and the incremental Goodwill that will be created and assumed by the proposed transaction.

Q. Are there any other financial risks posed to customers by the proposed acquisition?

A. Yes. The proposed transaction presents a myriad of risks associated with diminished financial transparency and reporting. Differences in accounting standards and language, coupled with

1 a complex organizational structure, and the
2 unfamiliarity of Iberdrola with New York
3 regulators and their policies all pose risk for
4 the customers of NYSEG and RG&E.
5 Q. What concerns do you have about Iberdrola's
6 incentives to operate the U.S. utility
7 subsidiaries in a manner that is not beneficial
8 to utility ratepayers?
9 A. Currently, NYSEG and RG&E are managed by a
10 holding company, Energy East, over which the
11 Commission can indirectly exert considerable
12 influence. By contrast, the proposed
13 transaction would subject NYSEG and RG&E
14 ratepayers to the management of a much larger
15 multi-national, vertically integrated holding
16 company over which the Commission's ability to
17 influence behavior will be substantially
18 diminished. This becomes a significant issue if
19 the holding company adopts policies and
20 practices that are not in the best interests of
21 New York ratepayers.
22 Q. Recently, the Commission dealt with similar

1 issues in the Grid/KeySpan M&A proceeding. How
2 do the risks of Iberdrola compare with the risks
3 of National Grid?
4 A. Generally, the rating agencies view the risk of
5 National Grid and Iberdrola as similar. S&P has
6 the exact same credit rating of A- for Iberdrola
7 and National Grid. Moody's views National Grid
8 as slightly more risky than Iberdrola. National
9 Grid carries a bond rating of Baa1 from Moody's
10 as opposed to Iberdrola's A3 rating. The credit
11 rating agencies, however, address the risks to
12 bond holders. The risks to customers are
13 broader than risks that affect a credit rating.
14 Q. What risks do customers face from the Iberdrola
15 transaction that are not emphasized by credit
16 agencies?
17 A. A significant risk to customers is how remote
18 the corporate parent will be from the operating
19 utilities and the language, foreign currency,
20 and accounting differences between the parent
21 company and its utility subsidiaries. We are
22 concerned about our ability to monitor affiliate

1 transactions which may take place overseas, may
2 be recorded in a foreign currency (Euros), may
3 be treated on an international accounting basis,
4 and may be in a foreign language (Spanish).
5 Another substantial risk is posed by the
6 multitude and scope of the unregulated
7 businesses in which Iberdrola is engaged and the
8 complexity of its capital structure. The
9 magnitude of its unregulated operations creates
10 an incentive to misallocate costs and the
11 complexity of its corporate structure would make
12 it difficult to follow audit trails for its
13 complex transactions.
14 It is of concern to Staff that Iberdrola
15 may not be familiar with New York regulation or
16 even U.S. regulation. Coupled with language
17 differences, especially given Iberdrola's
18 initial position regarding translations for U.S.
19 regulators, the chances for misunderstandings
20 are enhanced.
21 Finally, there are data security
22 considerations. Iberdrola's acquisition of

Energy East would mean the vulnerabilities of the grid system in New York would be in the hands of one more entity, raising the risk that it could wind up in the wrong hands. Also, sensitive customer information could potentially leave the country where it could be disseminated without the knowledge of the customer or the Commission.

Q. What benefits could Iberdrola bring to New York?

A. Perhaps, if it believes that it would be to its economic benefit, Iberdrola, as it suggests, might bring more wind power resources to New York beyond the substantially-sized projects it has already announced. Also, Iberdrola implies that it could bring a fresh perspective to the Energy East companies, which in theory could invigorate the companies and its employees. These benefits, however, are illusory.

Q. Why is Iberdrola's claimed wind power benefit illusory?

A. The delivery of wind power resources to New York is a decision that Iberdrola should make

1 independent of whether the M&A transaction is
2 consummated. Moreover, wind developers that are
3 Iberdrola's competitors, when confronted with
4 the vertical market power that the transaction
5 will create, might scale back their projects, or
6 even withdraw from New York. The outcome would
7 be that less wind power would be developed in
8 New York, overall, even if Iberdrola builds more
9 than it has announced. The outcome would be
10 that New York as a whole would be prevented from
11 achieving its renewable generation goals.
12 Q. Why is Iberdrola's claim that it will bring a
13 fresh perspective to Energy East's management
14 illusory?
15 A. Iberdrola undermines the value of its claimed
16 intentions with contradictory pronouncements
17 that it will distance itself from Energy East's
18 operations and will decline to intervene in
19 local management decisions. Its own statements
20 therefore contradict its claim that it will
21 bring a fresh perspective to Energy East.
22 Q. What do you conclude?

A. Since the only benefits Iberdrola claims to bring to New York are illusory, there is no basis for recommending approval of this acquisition as proposed.

Q. Did Staff attempt to identify an alternative set of terms and conditions that would enable it to support the proposed acquisition?

A. Yes, but we believe that the long term excess capital arising out of the M&A transaction (i.e., the premium paid), will create long term pressure on the management of the combined entity to cut corners and seek to extract a return from the utility assets which exceeds the realistic and reasonable earnings potential of those properties. The result can be financial stress and service problems over the long run. Nonetheless, if the Commission decides to approve the M&A transaction, there are a number of conditions it should require to best assure that the transaction is in the public interest. We outline those these terms and conditions near the end of this testimony.

Q. Would your position change if significant benefits can be found that offset some of the risks associated with the acquisition?

A. First, the Panel stresses that it will be difficult to find benefits of sufficient value to ratepayers to offset the risks that would be thrust upon them if the M&A transaction is approved. However, if satisfactory levels of benefits in the form of cost savings to ratepayers could found, we believe the financial conditions presented in our testimony would reduce some, but not all, of the risk that this M&A transaction presents.

Q. Please describe the financial risk to ratepayers in more detail.

A. Post transaction, Iberdrola would have Goodwill and intangible assets on its books in an amount that is equal to 46% of its equity balance. This is a significant hazard to ratepayers. It will take a great deal of savings to compensate customers for taking on the financial risk generated by this, even considering the ring

fencing measures we would have the Commission impose on this transaction.

Q. Please summarize the results of your testimony.

A. The acquisition should not be approved. The transaction provides no benefits to the customers of NYSEG and RG&E, while saddling the customers with the enormous financial risks we describe above. In the event the Commission finds grounds to approve the M&A transaction, we recommend that the approval be premised upon the acceptance of the conditions we present in our testimony below.

DESCRIPTION OF THE PROPOSED M&A TRANSACTION

Q. Please describe the proposed M&A transaction.

A. Under the terms of the proposed M&A transaction, Iberdrola will purchase all of Energy East's outstanding shares for $28.50 per share, for a total purchase price of approximately $4.5 billion. This purchase price reflects a premium of about $1 billion over the market value of Energy East's stock and $2.9 billion over the collective earning rate base of the U.S.

1 operating utilities at the time the Energy East
2 and Iberdrola reached their agreement.
3 A. COMPARISONS TO OTHER OFFERS
4 Q. Did Energy East entertain other offers or
5 strategic initiatives prior to its acceptance of
6 Iberdrola's offer?
7 A. Yes. According to Energy East's Schedule 14A
8 Proxy Statement filed September 26, 2007: "At a
9 meeting on May 23, 2007, management updated the
10 Board of Directors regarding…other potential
11 strategic initiatives that the Company was
12 considering and the status of those initiatives.
13 As previously mentioned, one of those
14 initiatives involved the possible acquisition of
15 a small electric utility by the company and the
16 other involved the sale by the company of
17 certain of its operating subsidiaries" (page
18 22). The Proxy Statement continues: "The Board
19 of Directors discussed the potential benefits of
20 the two other pending strategic transactions
21 under consideration at the time and determined
22 that the benefits of completing those

1 transactions were outweighed by the benefits
2 associated with the proposed transaction with
3 Iberdrola" (page 24).
4 Q. Does this suggest that the public benefits of
5 the Iberdrola transaction outweighed the public
6 benefits of the other transactions?
7 A. No. As expected, the Board of Directors of
8 Energy East (Board) acted solely in the interest
9 of Energy East shareholders. The Board believes
10 that it is in the best interest of shareholders
11 for Energy East to be acquired by Iberdrola,
12 presumably because of the substantial premium in
13 the stock purchase price offered by Iberdrola.
14 Although the Board, all else equal, can hardly
15 be faulted for choosing the acquisition that
16 provides the greatest benefit for shareholders,
17 the purpose of public utility regulation is to
18 provide for appropriate checks and controls over
19 the ultimate transaction. In that regard, the
20 Board should have considered whether the
21 transaction conforms to the regulatory policies
22 in all the jurisdictions where its subsidiary

1 utilities operate. Fundamentally, the M&A
2 transaction must meet the public interest
3 standard for approval in States having that
4 jurisdiction, and, at a minimum, compliance with
5 that standard requires that the operating
6 utilities remain financially sound after the
7 transaction is consummated. This transaction,
8 however, leaves NYSEG and RG&E under great
9 financial strain.
10 Q. How does the financial strain this transaction
11 creates relate to the consideration of
12 alternative transactions under the public
13 interest test?
14 A. In evaluating several competing proposals,
15 Energy East's Board should have considered each
16 option's chances of being approved in all
17 jurisdictions, including New York. The proposed
18 M&A transaction the Board selected, with
19 Iberdrola, is clearly inconsistent with this
20 Commission's positive benefits standard and its
21 long standing policy on vertical market power.
22 Since there were competing proposals, by

1 proceeding with the Iberdrola transaction,
2 Energy East could be forgoing or could have
3 forgone other transactions that offered synergy
4 savings for customers. Although the Commission
5 cannot compel a utility to seek a particular
6 type of M&A opportunity, it can recognize that
7 Energy East may have reduced, forestalled, or
8 eliminated the possibility for a merger with
9 synergy savings benefits or less risks for
10 customers than the Iberdrola transaction.
11 Q. Is your conclusion based upon an analysis of
12 those other potential transactions?
13 A. No. Energy East has refused to provide any
14 information on the proposed transactions (see
15 Responses IBER-141 to DPS-81 revised and IBER-
16 143 to DPS-83 revised). While KeySpan provided
17 Staff information about alternative transactions
18 which its Board of Directors considered via
19 confidential interrogatories, Energy East has
20 yet to provide this information.
21 Q. Has Staff pursued compelling the Petitioners to
22 provide this information?

A. Yes, it has filed a Motion with the Administrative Law Judge (ALJ) requesting that production of the information be compelled. Staff reserves the right to supplement its testimony after the Motion is acted upon.

DESCRIPTION OF IBERDROLA

Q. Can you describe Iberdrola?

A. Yes. In the five months since the Petition was filed, Staff has attempted to research Iberdrola and attempted to learn more about it. According to the Petition, Iberdrola is a Spanish corporation that has a market capitalization of $70 billion and provides service to 22 million and 2 million electric and gas customers worldwide, respectively. Iberdrola is described in more detail in the testimony of the Petitioner's Panel and in the Petition.

Q. Does Iberdrola have any business interests in the U.S. and Canada?

A. Yes. Iberdrola has interests in renewable and thermal generation, gas storage, and associated energy management activities in the U.S. and

Canada. Notably, it does not currently own any rate regulated T&D utility operations in the U.S.

Q. What is the scope of the Iberdrola business interests in the U.S.?

A. Iberdrola has the aforementioned existing business interests in the U.S. and through its 2007 acquisition of ScottishPower, plc (SP), Iberdrola now owns PPM Energy, Inc. (PPM), which has additional U.S. business interests including wind generation facilities, under development and in operation, and gas storage services.

Q. Describe Iberdrola's U.S. business interests.

A. Iberdrola USA and subsidiaries own a variety of wind generation projects in the U.S. Currently, Iberdrola has ownership interests in approximately 47 such ventures (see Response IBER-0131S to DPS-75).

Q. Describe PPM's business interests in the U.S.

A. According to an April 26, 2007 presentation titled "Scottish Power-North American Businesses: PPM", the PPM businesses include:

- 1,600 MW of wind power generation,
- 538 MW of thermal generation,
- 1.4 bcm of gas storage capacity, and
- Energy management services

Q. Can you estimate the number of U.S. operating businesses that Iberdrola has ownership interests in?

A. According to organizational charts provided in Response IBER-131S to DPS-75, Iberdrola has varying ownership interests in over 100 businesses in the U.S.

Q. Has Staff been successful in obtaining a better understanding of these entities?

A. We have received some, but not all, of the information we need to have a better understanding of Iberdrola's corporate relationships. Staff requested basic information on Iberdrola's U.S. businesses. In Response IBER-0131S to DPS-75, which took over two months to compile, Iberdrola provided most of the information requested. However, Response IBER-0131S is lacking most of the requested

1 financial information on some of the U.S
2 entities listed on the organizational chart.
3 Indeed, Iberdrola was able to provide detailed
4 financial information on only [redacted] of its
5 operating affiliates and subsidiaries.
6 Q. What is the scope of Iberdrola's overall foreign
7 and domestic interests?
8 A. According to Iberdrola's most recent Annual
9 (Sustainability) Report for 2006, pre-merger
10 with SP, it held ownership interests in
11 businesses located outside the U.S. in Spain,
12 Brazil, Chile, and many other countries in
13 Europe and Latin America. Iberdrola's ownership
14 interests included:
15 Generation
16 ▪ 377 hydro units
17 ▪ 12 combined cycle units
18 ▪ 286 renewable units
19 ▪ 403 MW of cogeneration
20 ▪ 9 thermal units
21 ▪ 7 nuclear units

- 5 coal units
- 17 various units in other countries

Iberdrola also had equity interests in approximately 275 entities in the fields of:

- Generation
- Regulated gas and energy
- Supply-marketing, trading, consulting
- Non-Energy-telecommunications, real estate
- Renewables
- Engineering and construction
- International-energy, water, telecommunications

Q. What additional business interests were acquired as a result of Iberdrola's acquisition of SP in 2007?

A. According to SP's 2005-2006 Annual Report and Accounts, it had ownership interests in a number of subsidiaries and other ventures, other than PPM discussed above. Besides regulated transmission and distribution (T&D) service,

SP's owns other business interests in construction services, asset management services, data collection, financial services, and insurance. SP also owns a 6,366 MW of generation in Great Britain, including natural gas/coal (5,413 MW), hydro (563 MW), and wind (288 MW).

Q. Going back to Iberdrola's business interests, are all of these businesses wholly owned by Iberdrola?

A. No. It appears that Iberdrola uses a variety of differing techniques, such as partnerships and joint ventures, to obtain ownership interests in these businesses. The extent of Iberdrola's ownership interests vary. Some of Iberdrola's interests are relatively straightforward (wholly owned) while others are not. For example, Iberdrola claims that it and Energias de Portugal, S.A. (EDP) each own 50% of Flat Rock Windpower (I and II), LLC. Response IBER-0097 to DPS-53 (Revised) reveals that "Iberdrola, through its wholly-owned subsidiary Iberdrola

Portugal Electricidade e Gas, S.A., holds a 9.5% interest in EDP."

Q. Are there other examples of ownership complexities?

A. Yes. Iberdrola claims that it owns 24.4% of Gamesa. However, from Reuters reports it appears that on December 28, 2007 Iberdrola paid 76.5 million euros to purchase an additional 1% ownership share in Gamesa, from IBV, a holding company owned by Iberdrola and Bank BBVA.

Q. What do these examples suggest to you?

A. With respect to Flat Rock, when Iberdrola's affiliate's ownership interest in EDP is combined with Iberdrola's interest in Flat Rock, it appears that Iberdrola owns more than 50% of Flat Rock. Also, with respect to Gamesa, it appears that Iberdrola's stated 24.4% ownership interest, directly and in combination with IBV, may carry significant weight in the management of Gamesa. The broader point is that Iberdrola's structure is not straightforward--it is more complex than Energy East's current

1 structure.

2 Q. Have Iberdrola's business ownership interests

3 changed?

4 A. Yes. Recently, Iberdrola spun off 20% of its

5 renewables subsidiary, Ibernova, through an

6 initial public offering (IPO). As a result,

7 Iberdrola now owns 80% of its former interests

8 in the renewables ventures.

9 Q. Does the IPO substantively change the way

10 Iberdrola controls Ibernova?

11 A. It appears not. Iberdrola still owns a large

12 majority (80%) of Ibernova, has three seats on

13 Ibernova's Board of Directors and has an

14 interlocking Chairman. As majority shareholder

15 it appears in effect that Iberdrola will retain

16 substantive control over Ibernova.

17 A. IBERDROLA'S BUSINESS PRACTICES

18 Q. The Petitioners claim that "Iberdrola's policies

19 and plans affecting customers, shareholders, and

20 employees are guided by principles of corporate

21 social responsibility" (Petitioner Panel

22 Testimony page 10, lines 1-3). Can you comment

on that representation?

A. It is likely that most major corporations believe that they are socially responsible. Their perceptions of themselves are not relevant to our review. Our responsibility is to review the facts in the case.

Q. What facts has Staff found during its brief review?

A. Staff found that Iberdrola has had some regulatory compliance problems. For example:

- Since 2000, 26 complaints were filed against Iberdrola with the Spanish National Energy Commission (CNE) involving interconnection (see Response IBER-0163 to DPS-102),

- In 2007, the Spanish Antitrust Tribunal fined Iberdrola $50 million (€38.7 million) for abuses of dominant position by a generation affiliate during 2002-2003 (see Case File 601/05 Iberdrola Castellon),

- In 2006, fines and sanctions were imposed against Iberdrola in Latin America and Spain for matters involving quality of service, breaches of regulation, and interruption of supply (see Response IBER-0069 to DPS-43).

Q. Are you aware of any more recent allegations against Iberdrola?

A. Yes. On December 3, 2007, Platt's reported that

1 the CNE (Spanish Regulator) had opened up two
2 more inquiries into the pricing practices of
3 Iberdrola and other utilities' power plants.
4 Platt's reported that the CNE was attempting to
5 "weed out" alleged abuses such as price-fixing
6 in Spanish power markets.
7 Q. Is it typical for a business the size of
8 Iberdrola to have a number of regulatory
9 compliance issues?
10 A. Yes, but it is not the number of compliance
11 issues that concerns us, it is the nature of the
12 issues raised by Iberdrola's regulators. These
13 allegations concerning interconnection, abuse of
14 dominant position, and price fixing are
15 particularly troubling in the context of this
16 acquisition and could presage problems if it
17 were to acquire vertical market power in New
18 York.
19 B. IBERDROLA'S OPERATIONS LACK TRANSPARENCY
20 Q. Do you expect that any future difficulties may
21 result from having Iberdrola's headquarters in
22 Spain?

1 A. Yes. It is instructive that, in the Maine
2 proceeding on the Iberdrola transaction (Docket
3 No. 2007-355), the attorneys representing
4 Iberdrola argued that Iberdrola is under no
5 obligation to translate documents from Spanish
6 to English (see Exhibit___(PP-5), letter from
7 Verrill Dana, LLP. to Maine PUC, dated October
8 17, 2007). The pleading argued that "the United
9 States Court of Appeals for the First
10 Circuit…held…there was no duty on the producing
11 party…to translate documents from their original
12 Spanish to English".
13 Q. Has Iberdrola made this same argument in the New
14 York proceeding?
15 A. No. However, some voluminous information that
16 the parties requested was culled by the
17 Petitioners because translation would have been
18 required. In addition, in some circumstances
19 there have been long delays in obtaining
20 information because it had to be translated.
21 Q. Why does this concern you?
22 A. The language barrier and the attempt to use it

as a legal basis to refuse to provide information could make it difficult to obtain a complete and accurate picture of Iberdrola in the future if the acquisition is approved.

Q. You indicated above that Iberdrola has extensive operations outside the United States and that you attempted to research Iberdrola. Did you run into any difficulties in your research?

A. Yes. While there appears to be a large quantity of translated information concerning Iberdrola in the public domain (e.g., English websites), much of that information is focused on the Iberdrola consolidated holding company and is in the form of broad-brush descriptions rather than operating level details. It is difficult to get a sense of the company's operational performance in the various and diversified business in which it operates. While investors may not need detailed operating information, because they are investing in the overall entity, regulators need the operating information to assess the company's regulated businesses.

1 Q. Why is Iberdrola's operational detail relevant
2 to regulators?
3 A. First, operational detail can give a sense of
4 how efficient operations actually are. If that
5 detail were available, the relative costs of
6 Iberdrola's key lines of businesses, such as
7 distribution and nuclear generation, could be
8 evaluated more fully. For example, the costs of
9 Iberdrola's nuclear generation ($/MW of capital
10 costs and $/mWh of operating costs) could be
11 benchmarked against other nuclear operators or
12 compared to the costs of Iberdrola's other
13 business units.
14 Q. Are there any other uses of this information?
15 A. Yes. Operational detail is very useful as a
16 screen to help detect potential cross-
17 subsidization of non-regulated entities by
18 regulated utilities. This detail could be used
19 to detect any unusual patterns or results
20 concerning a competitive operation's expenses.
21 If unusual results or patterns are detected, it
22 may signal potential cross-subsidization of

1 competitive businesses by regulated businesses.
2 Where regulated businesses (price makers) are
3 under the same corporate umbrella as competitive
4 businesses (price takers) there is always a
5 potential and "incentive" for the management of
6 corporate operations to misallocate costs.
7 Q. Do you have a sense as to why there is a lack of
8 operational detail available for Iberdrola?
9 Q. Perhaps it is due to different accounting
10 requirements (International Financial Reporting
11 Standards as compared to U.S. Generally Accepted
12 Accounting Principles – discussed later),
13 regulatory requirements, or perhaps it is due to
14 the differences in the Spanish and other
15 European approaches to regulating European
16 utilities, when compared to New York's
17 practices, or a combination of all three
18 factors.
19 Q. Did you obtain regulatory financial and
20 operating reports concerning Iberdrola's Spanish
21 utility operations?
22 A. Yes. After a 77 day lag from the August 21,

1 2007 request date, Iberdrola provided translated
2 copies of quarterly reports it deemed "trade
3 secret" that it files with the Spanish regulator
4 CNE on November 16, 2007 (see Response IBER-0016
5 to DPS-16, deemed by Iberdrola as a trade
6 secret).
7 Q. Are these reports analogous to the FERC Form 1
8 Annual Report or PSC Annual Report?
9 A. No. Although we requested reports analogous to
10 the comparable state and federal annual reports,
11 the reports Iberdrola provided are highly
12 condensed and contain little more than basic
13 balance sheets, income statements, and cash flow
14 statements with little narrative detail. They
15 contain no where near the level of detail that
16 is provided in the U.S. federal or state
17 regulatory annual reports.
18 Q. Why did Staff not oppose treating this
19 information as confidential?
20 A. Staff did not want to prejudice Iberdrola in the
21 event that the transaction is not approved, by
22 requiring it to release information that it

1 would have been allowed to keep secret in
2 Europe. However, if the transaction is
3 approved, the Commission should make it clear
4 that Iberdrola will not be allowed to keep
5 secret such fundamental information in the
6 future. Staff Counsel advises that the
7 information does not meet the standard for trade
8 secret protection under New York law.
9 C. IBERDROLA'S RELATIONSHIP WITH THE UTILITIES
10 Q. Has Staff encountered any other problems with
11 Iberdrola's responses to interrogatories which
12 concern you?
13 A. Yes. As we note above, Iberdrola is a complex
14 organization. We asked several interrogatories
15 which probed the scope of Iberdrola's operations
16 and we received puzzling responses.
17 Q. Please describe these responses.
18 A. The first involved Response IBER-0013 to DPS-13
19 which was provided on August 31, 2007. Staff
20 asked for all contracts between Energy East, the
21 New York utilities and Iberdrola and its
22 affiliates. The response indicated that the

only agreement between the companies was a confidentially agreement. This response was puzzling as it was publicly known from the companies' websites that Community Energy (CE, a wholly owned Iberdrola subsidiary) and the utilities had marketing relationships in place.

Q. Were there any other puzzling interrogatory responses provided?

A. Yes. In Response IBER-0155 to DPS-95, Iberdrola stated that it owned 24.4% of Gamesa, a major wind manufacturer and developer. In fact, the Iberdrola/Gamesa relationship was the subject of a lengthy front page article in the Wall Street Journal on July 9, 2007 (see Exhibit___PP-6). However, when Staff was probing the extent of Iberdrola's wind power interests in New York, the responses provided repeatedly omitted any mention of Gamesa projects. Iberdrola claimed that it was "not aware if Gamesa is developing any generation in New York."

Q. Why is that response puzzling?

A. It is publicly known that Iberdrola had a large

1 stake in Gamesa. It was also publicly known
2 that Gamesa was pursuing the potential
3 development of 270 MW of wind projects in New
4 York as they are listed in the October 2007
5 NYISO queue, which is known to market
6 participants (including NYSEG who participates
7 in the NYISO as a transmission owner) and was
8 relied upon by Iberdrola in the market power
9 testimony of its Witness Hieronymus. In fact,
10 both of the Gamesa projects noted above in the
11 October NYISO queue are located in NYSEG's
12 service territory. Moreover, Iberdrola was in
13 the process of buying projects under development
14 from Gamesa in Illinois, Texas and next door in
15 Pennsylvania. It does not foretell accurate and
16 transparent reporting or information flow to
17 regulators if the company personnel that we are
18 dealing with are either unaware of its own
19 business relationships or are unwilling to
20 reveal those relationships.
21 Q. What conclusions can you reach from these facts?
22 A. The facts shown above suggests that the

1 Commission should scrutinize this acquisition
2 very thoroughly, especially the promises and
3 assertions made by the Petitioners. Should the
4 Commission consider approval of this
5 transaction, it should do so with strict
6 enforceable conditions and sanctions that assure
7 that Iberdrola will use fair business practices
8 in New York State and provide Staff with the
9 ability, access, and information necessary for
10 Staff to take a transparent look at its
11 operations and corporate relationships.
12 THE ALLEGED BENEFITS TO CUSTOMERS
13 Q. What specific benefits did the Petitioner's
14 Panel identify?
15 A. The Petitioner's Panel stated (pages 8-9) that
16 "the Proposed Transaction should be approved
17 because it will result in numerous benefits for
18 NYSEG and RG&E customers and New York generally.
19 Furthermore, Iberdrola and Energy East are
20 making commitments that protect NYSEG and RG&E
21 ratepayers from costs incurred to consummate the
22 Proposed Transaction, including any acquisition

premium. As such, the Proposed Transaction is in the public interest."

A. ALLEGED LACK OF SYNERGY SAVINGS

Q. Does the proposed acquisition result in synergistic benefits?

A. The Petitioner's Panel responds: "No. The Proposed Transaction represents an acquisition by Iberdrola at the Energy East holding company level, rather than a combination of the operations of individual operating companies."

Q. Do the petitioners explain why the acquisition of Energy East does not provide the opportunity for synergistic benefits?

A. Yes. In Response to IBER-0004 to DPS-4, the petitioners stated "Iberdrola does not own any other regulated utilities in the United States. Therefore, the Proposed Transaction does not involve the combination or elimination of corporate or utility operating functions which are necessary to produce such savings."

Q. Is Iberdrola's explanation plausible?

A. No. While it is true that Iberdrola does not

own regulated utilities in the U.S., Response IBER-0131S to DPS-75 quite clearly shows that it owns significant operating energy businesses throughout the United States. These businesses have [redacted] The size, scale, and scope of these businesses suggest that some level of synergistic savings could be achieved after the acquisition of the Energy East companies.

Q. Is there any reason why the companies cannot attempt to achieve synergies?

A. None that we are aware of.

Q. Are these businesses in states contiguous to New York State?

A. Some, but not all are. However, lack of proximity to New York State should not prevent seeking and achieving synergies, at least for back-office operations.

Q. Why do you believe that synergy savings are available?

A. One expects that large corporations merge

because of opportunities for synergies. Otherwise, they could diversify simply by purchasing stock in other companies, and avoid paying premiums above the prevailing market price of the stock. The location of corporate headquarters and operating subsidiaries in different countries has not been a barrier to synergy savings in other M&A transactions. For example, it was reported in the media that Iberdrola's recent acquisition of SP led to $374 (€260) million of synergies, which was double what was originally estimated in the merger. These synergies were achieved despite the language difference and the fact that Iberdrola's headquarters in Bilbao, Spain is over 1,000 miles from Glasgow Scotland, the headquarters of SP.

B. ALLEGED PUBLIC INTEREST BENEFITS

Q. What are the alleged benefits to the utilities customers?

A. In its "Public Interest Demonstration" testimony (pages 19-27), the Petitioner's Panel spells out

1 the following benefits:

2 ▪ Iberdrola's utility expertise,

3 ▪ Iberdrola's commitment to energy efficiency

4 and the environment,

5 ▪ Iberdrola's financial strength,

6 ▪ Iberdrola's commitment to customer service

7 and reliability,

8 ▪ No adverse impact on ratepayers,

9 ▪ No enhancement of the ability to exercise

10 market power in New York.

11 Q. What is Staff's reaction to these alleged

12 benefits?

13 A. The benefits promised by Iberdrola are

14 intangible, unquantifiable, and speculative.

15 Moreover, they are not backed by any substantive

16 terms or conditions that would enable

17 enforcement in the event that these benefits did

18 not materialize or if 'backsliding' occurred.

19 Further, most of the alleged benefits either

20 already exist or can be obtained without the

21 pending acquisition. Finally, many of the

1 benefits alleged in the Petition present a
2 puzzling series of contradictions.
3 Q. Which benefits promised by Iberdrola already
4 exist or can be obtained without the
5 acquisition?
6 A. Arguably, all of the alleged benefits already
7 exist in the New York utilities. Energy East
8 already claims that its utilities are committed
9 to efficiency and the environment, customer
10 service, and reliability. The New York
11 utilities combined have been providing utility
12 service for more than 262 years. We see little
13 more to be gained in these areas as a result of
14 the proposed transaction, and given the
15 substantial potential for harm discussed
16 earlier, much is lost.
17 Q. Did the companies appear to struggle to identify
18 potential public benefits resulting from this
19 acquisition?
20 A. Apparently so. According to the Proxy Statement
21 dated September 26, 2007, the petitioners during
22 their discussions of this transaction found a

1 need to clarify the public interest benefits.
2 The Proxy Statement says: "after extensive
3 discussion of the terms of the proposed
4 transaction and the potential benefits that it
5 could bring to the Company's shareholders,
6 customers, employees, among others, and the
7 related risks, both management and the Board
8 concluded that the public benefits of a
9 transaction with Iberdrola had not been
10 developed with sufficient specificity, raising
11 concerns regarding the prospects for obtaining
12 regulatory approvals."
13 Q. Has this concern been borne out?
14 A. Yes. As our testimony shows quite clearly,
15 public benefits do not exist. If one did not
16 envision synergies and public benefits before
17 putting together the terms of the transaction,
18 it would be difficult to describe those benefits
19 after the fact.
20 Q. The cornerstone benefit alleged by Iberdrola is
21 its financial strength relative to Energy East.
22 Does Staff consider "Iberdrola's financial

1 strength" a tangible benefit?

2 A. No. As explained more fully later, Iberdrola's

3 alleged relative financial strength is arguable

4 and more importantly is of no consequence to the

5 New York utilities. Additionally, without a

6 clear and definitive "ring fencing" of utility

7 operations, those operations are influenced by

8 the credit implications of whatever Iberdrola's

9 business success is in unregulated markets, as

10 well as its changing financial policies with

11 respect to debt leverage and financing. In fact,

12 as a result of this acquisition, on November 14,

13 2007 S&P changed the reasoning supporting the

14 New York utilities outlook of "negative" to note

15 that their "ratings could be lowered one notch

16 depending on Iberdrola's ultimate financing

17 structure for the acquisition." These credit

18 reports are shown in Exhibit___(PP-4).

19 Furthermore, since the acquisition was

20 announced, S&P downgraded Iberdrola from A to A-

21 and Moody's downgraded Iberdrola from A2 to A3.

22 C. FAILURE TO KEEP PRIOR MERGER COMITTMENTS

Q. Were benefits promised made when RGS/Energy East combined in 2002?

A. Yes. On page 24 of Energy East's 2002 Merger Petition in Case 01-M-0404, the conclusion states that "the merger of RGS with Energy East will have no adverse impacts. In addition, the merger will provide significant, tangible benefits to consumers of both NYSEG and RG&E." Aside from synergy savings, the merger petition committed Energy East/RGS to provide the following benefits:

1. Stronger financial base
2. Maximized physical and human resources to maintain electric and gas systems
3. No layoffs
4. RG&E will continue to provide service at stable rates
5. Competition will not be diminished
6. Customer service will not be diminished
7. The merger will strengthen RG&E's commitment to the region/commitment to have headquarters in Rochester
8. The post-merger operations and management will protect RG&E's customers by the election of three Board Members of Energy East from RGS, and by having RG&E's CEO on the Energy East, NYSEG and RG&E Boards.

Q. Did Energy East follow through on its

1 commitments when it acquired RGS?
2 A. Not completely. Actions taken by Energy East
3 after the merger with RGS show that it did not
4 live up to most of these commitments. For
5 example, the Energy East/RGS merger petition
6 stated that "RG&E will continue to provide
7 service at stable rates." However, shortly
8 after the merger, RG&E proposed a rate filing
9 with 6+% rate increases. Rather than increasing
10 its financial strength, RG&E's debt was
11 downgraded just after the merger, which showed
12 the merger weakened RG&E's financial position,
13 because it was now tied to Energy East. RG&E
14 announced layoffs following the merger.
15 Customer service was diminished with customer
16 office closings. RG&E's commitment to the
17 region was weakened when Energy East moved its
18 headquarters out of state to Maine. Key
19 corporate governance provisions were also
20 undermined. For example, three RGS Directors
21 were not placed on Energy East's Board.
22 Q. What does the history of the Energy East/RGS

merger suggest to you?

Q. It suggests that benefits which are not readily enforceable, such as those propounded by Iberdrola, have no value because there is no substantive way to ensure that the post-acquisition companies will live up to them.

D. ALLEGED BENEFITS ARE CONTRADICTED

Q. You have shown that commitments made without enforcement mechanisms have little value. In addition, has Iberdrola already contradicted its commitment to some of the benefits alleged in the Petition?

A. Yes. We found three main contradictions. First, Iberdrola claims that its financial strength is a benefit, but the New York utilities remain on negative credit outlook status by S&P in part because of the acquisition. Second, Iberdrola claims it is committed to making substantial investments in wind power investments but then argues that the wind facilities it plans to construct are de minimus in size. Third, Iberdrola claims that

its utility expertise will enhance New York management's performance, even though it also promises to rely upon local management without intruding upon their decisions. Responses to Information Requests indicate that: no synergy savings will result from the Proposed Transaction (see Response IBER-0004, IBER-0027, IBER-0029, and IBER-0063), no tax savings will result from the Proposed Transaction (see Response IBER-0006, IBER-0025, and IBER-0058), no consolidations of upstream entities will result from the Proposed Transaction (see Response IBER-0009,IBER-0025, and IBER-0060), no further investment in generation in New York State will result from the Proposed Transaction (see Response IBER-0008 and IBER-0037), and Iberdrola will not provide services to the operating companies after the Proposed Transaction (see Response IBER-0020).

Q. If this is all accurate, what is the real business purpose for the acquisition?

A. The business purpose for the acquisition of

Energy East by Iberdrola is not clear. Iberdrola does state broadly that the acquisition of Energy East provides a "platform" for its expansion in the United States. Yet, a clear explanation of how Iberdrola's expansion in the U.S. will benefit the customers of NYSEG and RG&E is lacking.

E. COMBINATION OF T&D AND GENERATION

Q. Your testimony above indicates that Iberdrola has a significant presence in the U.S. already, including significant investments in generation. Does its acquisition of Energy East's T&D companies complicate regulatory oversight?

A. Yes. From a regulator's perspective, it makes protecting the public interest much more difficult. Iberdrola has a strong U.S. presence in competitive wholesale generation markets, though it ownership and development of wind power facilities. This acquisition will add T&D to Iberdrola's generation business interests in New York State. Regulatory policy in New York State has moved in the opposite direction, to

separate ownership of generation from ownership of regulated T&D. Combining regulated T&D businesses and significant ownership interests in competitive generation that, under New York regulatory policies should remain separate, is not an improvement or benefit. Instead, the combination of Energy East and Iberdrola will create extensive vertical market power problems, as discussed in the analysis of vertical market power presented below.

F. PROTECTION AGAINST ADVERSE IMPACTS ON RATES

Q. The petitioner's claim that the transaction will have "no adverse impact on customers." Is this a benefit of the acquisition?

A. No. In reality, since the petitioners provided only vague rather than substantive terms or conditions regarding the companies' rates or for the protection of customers against bearing some of all of the costs of the acquisition, there are no facts or rationales to support the claim that the transaction would have no adverse impacts on customers. In fact, the size of the

premium that Iberdrola has agreed to pay for Energy East creates pressure for Iberdrola to find creative ways to raise rates so that it can earn a higher return and obtain the extra margin needed to service the capital used to pay the premium.

Q. How did the petitioners support the claim that "no adverse impact on customers" is a benefit to customers?

A. The Petition states "there will be no changes to the rates, terms or conditions of service provided to NYSEG and RG&E customers in connection with the Proposed Transaction. The Joint Petitioners are not seeking to modify the existing rate plans of NYSEG and RG&E as part of the Proposed Transaction" [footnote omitted] (Petition page 16).

Q. Do you find the petitioner's commitment to maintain the current rate plans beneficial to customers?

A. No. First, the rate plans expire by the end of this year so any benefit there is temporary.

Furthermore, as the Testimony of Staff Witnesses Haslinger and Benedict indicates, both of the utilities are over-earning either measured against the return on equity (ROE) for earnings sharing purposes or against a more current fair ROE. Most recent ROEs have ranged between 9.1% and 9.55%. Exacerbating the impact of the over-earnings, the utilities, to some extent, are deferring costs or drawing down reserves, which will put upward pressure on the utilities' rates in the future.

Q. Does extending the existing rate plans serve the public interest by maintaining RG&E's existing electric commodity rates?

A. No. When compared to NYSEG's commodity rates RG&E's commodity rates are excessive and are producing excessive earnings. Maintaining in place rates that are excessive is clearly a detriment to consumers. Therefore, offering to maintain the existing rate plans cannot be construed as a benefit justifying approval of this transaction.

Q. Does the commitment not to modify the current rate plans insulate customers against any of the potential adverse impacts the proposed transaction might pose?

A. No. Instead, the extension of the rate plans of NYSEG and RG&E places ratepayers at risk. For example, the RG&E and NYSEG rate plans that are in effect have earnings sharing provisions that have required the allocation of a portion of excess earnings that have been produced to ratepayers. As a result, should either one-time M&A transaction costs or on-going costs be misallocated to the New York utilities, customers will be deprived of excess earnings or perhaps be subject to more deferrals as a result of the interaction of the rate plan deferral and earnings sharing provisions.

Q. Is NYSEG electric operations currently operating under a multi-year rate plan for its electric operations?

A. No. NYSEG's electric rates were set in 2007 after a fully litigated rate case. NYSEG's

electric operations are not currently subject to the earnings sharing or deferral provisions that are in place for its gas operations.

Q. If NYSEG's electric operations are not subject to earnings sharing or deferral mechanisms and are not subject to a multi year rate plan, is there any value, for NYSEG electric customers, in the petitioner's commitment not to modify the current rate plans as a customer protection against any potential adverse impacts of the proposed transaction?

A. No. Should either one-time acquisition transaction costs or on-going costs be misallocated to NYSEG's electric operation, it could drive NYSEG's electric operation's return on equity (ROE) downward. This then could form the basis for prospective rate relief (as such costs would be embedded in NYSEG's cost structure) or could assist NYSEG in any attempt to recover deferred costs through the result of a deferral petition.

Q. Explain how a reduced ROE could assist NYSEG in

an attempt to defer costs.

A. One of the main factors used by the Commission to evaluate a deferral petition is the current ROE of a petitioner. If the Commission finds that the ROE of a petitioner is adequate or that it is over earning, it will likely reject the deferral petition. Conversely, if it finds the ROE of a petitioner is not adequate, it will likely grant relief.

G. ELECTRIC AND GAS RELIABILITY AND CUSTOMER SERVICE BENEFITS ARE UNSUPPORTED

Q. Do you find Iberdrola's alleged expertise and commitment to customer service, reliability, and the environment of any significant value to customers?

A. It is very difficult to compare the expertise of Iberdrola and Energy East. There are no terms and conditions in the acquisition that ensure increased or enhanced service quality, safety, or reliability in the future. More troubling is that the petitioners did not put forward any provisions to prevent backsliding after the rate

plans/orders expire. Further, as noted above, while Iberdrola claims it will bring its allegedly extensive utility expertise to New York for the benefit of ratepayers, it contradicts its claim by insisting it will not interfere with existing local management at NYSEG and RG&E. The stated reliance upon current management underscores the fact that Iberdrola will not bring any meaningful improvements to the levels of customer service currently present at NYSEG and RG&E.

Q. Why is the lack of reliability, safety and customer service provisions especially troubling?

A. Such provisions are adopted as deterrents to performance degradation and provide incentives for continued electric system, gas system, and customer service improvements. The petitioners' silence on these issues suggests these utility obligations may not be as high a priority going forward as they have been in the past.

H. OPPORTUNITIES FOR SYNERGIES EXIST

Q. Earlier you referred to the petitioner's statement that the proposed transaction does not provide synergistic benefits. Does Staff agree that the transaction provides no synergistic benefit opportunities?

A. The petitioner's claim that the merger produces no synergy savings is not credible. The transaction does provide the opportunity for two types of potential synergistic benefits to Iberdrola and the New York utilities. First, there are opportunities to achieve cost savings; however, the petitioners have apparently not made any effort toward identifying such benefits. Second, there are other non-traditional synergistic benefits created by the acquisition, such as foreign tax savings and domestic tax credits.

Q. Is there an incentive for the petitioners to avoid identifying potential synergistic benefits?

A. Iberdrola has a strong incentive to avoid quantifying these tangible benefits in order to

prevent the various utility commissions from imputing those savings into the utilities rates. By denying that synergy savings exist, Iberdrola puts the onus on regulatory commissions to find any synergy savings that might be available. To the extent the commissions are unable to discover all the synergy savings, Iberdrola will be able to earn additional profit from retaining them.

Q. What areas appear ripe for traditional synergies?

A. It appears there are opportunities for the consolidation of domestic holding and service company operations. For example, based on our review of Response IBER-0095 to DPS-51, and the confidential trade secret information Iberdrola submitted in support of its response, we believe that Iberdrola may be able to consolidate information technology (IT) systems in use at various subsidiaries.

Q. Are there any other potential synergy savings opportunities?

A. Yes. Iberdrola's financial advisor has identified, through benchmarking, potential areas for achieving efficiencies in the operations of Energy East's New York companies. The Response to IBER-0011 to DPS-11 states that "the valuation [of Energy East] has not taken into account the analysis of companies' best practices…Energy East's subsidiaries show low/medium best practice levels compared to U.S. peers."

Q. What is the estimated savings from such efforts?

A. In an apparent contradiction of its claims that Iberdrola applies best practices in operating its businesses, the petitioners claimed that they "have not conducted any analysis" of best practices (see Response IBER-0065 to DPS-39). Therefore, no estimate of savings from these efforts is available.

Q. Has Staff obtained any information on Iberdrola's domestic operations?

A. Yes. As noted above, Iberdrola provides some financial information on its U.S. operations in

1 Response IBER-0131S to DPS-75. This data in
2 that response shows that Iberdrola's existing
3 U.S. operations are [redacted] but
4 are fragmented in location and operation. These
5 facts suggest more consolidation could occur.
6 Such consolidations could produce synergy
7 savings.
8 Q. Has Iberdrola alluded to consolidations in its
9 Petition?
10 A. Yes. In the Petition (page 9), the Petitioners
11 state "IBERDROLA may seek to eliminate certain
12 Energy East intermediate holding companies,
13 thereby causing one or more of Energy East's
14 operating subsidiaries to become direct
15 subsidiaries of IBERDROLA."
16 I. OTHER SYNERGISTIC BENEFITS EXIST
17 Q. What non-traditional synergistic tax benefits
18 have you identified?
19 A. Staff has obtained information indicating that
20 Iberdrola will reap very significant tax
21 benefits as a result of this M&A transaction.
22 These tax benefits come in the form of United

1 States Production Tax Credits (PTC) and Spanish
2 tax credits.
3 Q. Have the petitioner's identified, quantified,
4 and explained these tax benefits?
5 A. The petitioners have addressed Spanish tax
6 benefits but have not adequately addressed the
7 domestic tax benefits, despite repeated attempts
8 to obtain such information.
9 Q. Describe the Spanish tax benefits.
10 A. According to the response to IBER-0148 to DPS-
11 88, question 1 "Article 12(5) of the CIT Law
12 [Spanish Corporate Income Tax law] provides that
13 the financial Goodwill connected with the
14 acquisition of shares in qualifying foreign
15 subsidiaries may be amortized for tax purposes
16 at a maximum yearly rate of 5% over 20 years."
17 The response indicates that the tax benefits to
18 Iberdrola at the 30% Spanish tax rate could be
19 between $125 million to $476 million in nominal
20 dollars.
21 Q. Will Iberdrola be eligible for any other tax
22 credits on this M&A transaction under Spanish

1 Corporate Income Tax law?

2 A. Possibly. According to the response to IBER-

3 0147 to DPS-87, question 2 "Article 37 of the

4 [CIT Law], as originally enacted, allowed

5 companies purchasing shareholdings in foreign

6 companies directly to offset up to 15% of the

7 price paid against tax to the extent to which

8 the purchase leads to increased export

9 activities."

10 Q. Has Iberdrola quantified these potential tax

11 benefits?

12 A. Yes. The response to IBER-0147 to DPS-87,

13 question 3 indicates that these tax benefits

14 could be worth at least [redacted] and

15 possibly more. The Response does note that the

16 Spanish tax benefits "are mutually exclusive" so

17 Iberdrola cannot avail itself of both Spanish

18 tax credits on the same amount of purchase

19 price.

20 Q. What are PTCs?

21 A. PTCs are tax credits against U.S. federal income

22 taxes. PTCs are not refundable, so their use is

1 dependent on earning a level of U.S. income tax
2 liabilities equal to or greater than the value
3 of the credits. Generally, according to
4 Internal Revenue Service (I.R.S.) Form 8835 for
5 2006, the credit is 1.9¢ per kilowatt-hour (kWh)
6 for the sale of electricity produced by the
7 taxpayer from qualified energy resources at a
8 qualified facility. The PTC for electricity
9 produced is proportionately phased out over a
10 3cent per kWh range when the reference price
11 exceeds an 8-cent threshold price.
12 Q. Does Iberdrola have qualifying facilities in the
13 U.S. which may be eligible for the PTC?
14 A. Iberdrola's responses to the interrogatories
15 concerning PTCs are at best confusing, however,
16 it appears that Iberdrola has interests in
17 domestic wind power facilities that are eligible
18 for PTCs (see Response to IBER-0006 to DPS-6).
19 Q. How could the proposed transaction affect these
20 tax benefits?
21 A. Iberdrola's responses to the interrogatories are
22 not clear; however it can be inferred from

publicly available information that currently, Iberdrola does not pay enough domestic income taxes in order to utilize the full value of its earned PTCs. Through the acquisition of Energy East, it will acquire taxable income sufficient to enable it to utilize at least some and perhaps all of the PTCs that it has generated.

Q. Has Iberdrola quantified the amount of PTCs that are available?

A. Despite repeated requests, Iberdrola has not provided this information. In the alternative however, Staff has estimated that Iberdrola could obtain up to $50 million of PTCs per year based on the existing level of its ownership interests in wind power facilities (see Exhibit___PP-7), assuming each wind facility qualifies for PTCs. If Iberdrola constructs all of the planned generation for 2007-2008 shown in the FERC Exh. J-2 and assuming such generation is eligible for PTCs, it could generate up to $150 million in PTCs per year by 2008. In addition, should unused PTCs be available from

prior years, it appears possible for Iberdrola to carry back such PTCs and use them against Energy East's prior years tax payments. But, in a perplexing response, Petitioners state that "Iberdrola has not considered or evaluated" this possibility (see Response IBER-0133 to DPS-77), which could be of substantial benefit to it. While we concede some of the above analysis is based upon assumptions, more certain information is not available because Iberdrola's has declined the opportunity to provide better information.

Q. Please summarize Staff's conclusions on the alleged customer benefits of the transaction?

A. The stated benefits, are intangible, speculative, immaterial, and are not enforced by any substantive terms or conditions that would enable their realization in the event that they did not materialize or if future 'backsliding' occurs. In addition, Staff found that there are hundreds of millions of dollars of benefits related to the merger that are tangible and

1 significant, but that are not presented as
2 customer benefits.
3 THE BENEFITS TO SHAREHOLDERS AND OTHERS
4 A. BENEFITS TO IBERDROLA
5 Q. You concluded above that the transaction
6 provides no real benefits to New York consumers.
7 Is it your conclusion also that there are no
8 benefits to any stakeholders of Energy East and
9 Iberdrola as a result of this transaction?
10 A. No. As we noted above, Iberdrola will reap
11 enormous tangible benefits as a result of this
12 transaction. It will also apparently use the
13 acquisition of Energy East as a platform for
14 growth of its U.S. energy businesses. In
15 addition, as noted above earlier, the
16 acquisition provides Iberdrola future
17 consolidation opportunities that will present
18 the opportunity to generate cost savings.
19 Q. How will Iberdrola's earnings per share (EPS) be
20 affected by the acquisition?
21 A. Iberdrola claims that the acquisition will be
22 accretive to EPS.

Q. Can you quantify how the acquisition will be accretive to EPS?

A. Staff sought that information but the response to the question was not helpful (Response IBER-0066 to DPS-40). However, Staff was able to perform a calculation from publicly available information that shows the transaction could be accretive to earnings (see Exhibit___(PP-8).

Q. If Iberdrola is paying a premium above book and market values to acquire Energy East, how can the transaction be accretive to EPS if there are no synergy savings available in the acquisition?

A. In this instance it is simply mathematics. It occurs because Iberdrola's stock is selling at a price earnings ratio greater than the price earnings ratio of Energy East at the acquisition price. This will enable Iberdrola to issue fewer shares to finance the amount necessary to fund the acquisition price. So, Iberdrola has purchased all of Energy East's earnings with comparatively fewer shares of its stock.

Q. Do your calculations take into account any tax

1 or other benefits resulting from the M&A
2 transaction?
3 A. No they do not, but neither did Iberdrola's. So
4 if Iberdrola receives tax benefits or other
5 savings, it will further enhance its EPS.
6 Q. Iberdrola indicates that the acquisition will be
7 accretive to earnings per share. Will Iberdrola
8 be able to service the capital invested in
9 Energy East?
10 A. Yes, but the amount of non-earning assets
11 created by this merger places a great deal of
12 stress on utility operations to produce an
13 adequate return to meet the needs of all of
14 Energy East's operations. Goodwill already on
15 the books of Energy East and Goodwill related to
16 this transaction will make up approximately 63%
17 of the equity of Iberdrola's investment in
18 Energy East. Assuming that Energy East's
19 regulated companies earn a 12% ROE, it would
20 mean Iberdrola would see an ROE of just over 4%
21 on its investment in Energy East. Clearly,
22 other factors are in play other than utility

earnings as to why Iberdrola decided to purchase Energy East.

B. BENEFITS TO ENERGY EAST AND OTHERS

Q. Will Iberdrola be the only beneficiary as a result of this transaction?

A. No. It is clearly evident that Energy East's shareholders and executives and third party advisors will also benefit.

Q. How would Energy East's shareholders benefit from this transaction?

A. Energy East's current shareholders would receive $28.50 per share, a premium of $5.85 per share based on the $22.65 price of the stock at the time of the announcement of the acquisition. This amounts to over $930 million in the aggregate for all 159 million Energy East shares outstanding.

Q. Explain how Energy East's executives will benefit as a result of this acquisition.

A. First, the Chief Executive Officer (CEO) has received a two year contract extension that will become effective upon closing. Next, as

reported in the Proxy Statement dated October 9, 2007, the top executives and directors will receive approximately $78 million in potential payments, assuming their employment is terminated in June 2008. It is important to note that actual payments to management could exceed these amounts since they do not include payments to other management employees.

Q. Could the payments to executives be less than the $78 million shown above?

A. Yes. Should the executives remain with the company after the acquisition, they will not receive approximately $45 million of change in control and related payments. However, they will receive approximately $30 million of payments for stock.

Q. What are the estimated third party costs associated with this transaction?

A. According to Response IBER-0002 to DPS-2, the transaction costs are estimated to be at least $44-$46 million, not including transfer taxes. These payments are made primarily to investment

bankers, advisors, and attorneys.

Q. What are the total of benefits to shareholders and other parties?

A. Counting the $476 million of Iberdrola tax benefits, $150 million of production tax credits, and the benefits to Energy East shareholders, executives, and other third parties, the tangible monetary benefits that accrue to parties other than consumers exceed $1.6 billion. That is in stark contrast to the complete lack of consumer benefits.

COSTS AND RISKS RESULTING FROM THE ACQUISITION

A. TRANSACTION COSTS

Q. What proposals do the petitioners and make concerning the costs resulting from the M&A transaction?

A. The petitioners state in general terms that they "commit not to seek recovery of costs incurred to consummate the proposed transaction from New York ratepayers" (see Panel Testimony page 25, lines 20-21).

Q. Does the Panel address the acquisition premium

1 paid?

2 A. Yes. Again in general terms the Panel testimony

3 states: "the premium paid for Energy East common

4 stock resulting from the Proposed Transaction

5 will remain on the books of Iberdrola and its

6 wholly-owned affiliates, and will not be

7 recorded on the books of any of the companies

8 acquired, including Energy East, RGS, RG&E, and

9 NYSEG. To be clear, the Joint Petitioners will

10 not seek recovery of any acquisition premium

11 associated with the Proposed Transaction in

12 rates from New York ratepayers."

13 Q. Do the Panel's proposals concerning the costs of

14 the transaction, including Goodwill satisfy

15 Staff?

16 A. No. At best, the Panel's proposals are general

17 and at worst, they are vague or non-existent.

18 The proposals concerning Goodwill therefore

19 require clarification and modification.

20 Q. Iberdrola has committed that Goodwill "will not

21 be recorded on the books of any of the companies

22 acquired, including Energy East, RGS, RG&E, and

NYSEG." Does that proposal require clarification?

A. Yes. The definition of "Goodwill" as used in the above commitment requires clarification. For regulatory purposes, Goodwill represents the excess of the purchase price over original cost. In other parlances, such as in discussions of premiums paid to enable mergers, it represents the excess of the purchase price over market value of assets. To be clear, for purposes of this transaction, Goodwill should be stated as amounts exceeding original cost and as such it should "not be recorded on the books of any of the companies acquired, including Energy East, RGS, RG&E, and NYSEG."

Q. Has Iberdrola made any commitments concerning the existing Goodwill associated with the Energy East/RGS transaction currently recorded on Energy East's books?

A. No, it has not addressed that issue. Staff recommends below that Iberdrola should also remove that Goodwill from Energy East's books.

Q. Why should Goodwill be removed from the books of Energy East?

A. The acquisition of Energy East involves the purchase of the Energy East's assets; among those assets is the Goodwill on Energy East's books. The existing Goodwill on Energy East's books has been a continuing source of controversy in the utilities' rate cases because it clouds the true picture of Energy East's financial health. So in order to improve financial transparency, and because it is being purchased by Iberdrola, the existing Goodwill (as defined by Staff above) should also be pushed up to Iberdrola. Additionally, when Energy East purchased RG&E, it was not then clear that Goodwill on its books would no longer be amortized, because, prior to 2001, Goodwill had to be amortized over a period of no more than 40 years. Consequently, the controversy of Goodwill on the books of a utility holding company as a "permanent" asset had not been considered. Now it is clear that the existence

of the Goodwill on utility financial statements is a drag on credit and earning and creates ongoing pressure on utility management to maintain unrealistically high earnings on utility property.

B. OTHER RELEVANT COSTS NOT ADDRESSED

Q. Has the Petitioner's Panel identified and addressed all the potential costs and risks resulting from the acquisition?

A. No.

Q. Has Staff identified any other costs and risks associated with the transaction?

A. Yes. There are many other potential costs and risks resulting from the proposed transaction that went unaddressed by the petitioners. These include one-time transaction fees, transfer taxes and advisor fees.

Q. Can you explain why the petitioners did not address these costs and risks?

A. From the responses we received, it appears the other costs and risks were not addressed because in the petitioner's view those costs and risks

were not absolutely certain to occur. Generally, the responses included the phrases similar to *'we have not studied that or we have no plans to do that…'* We believe that these costs and risks were not properly assessed because the petitioners were assuming a best case, which is a highly unlikely scenario and a quite unreasonable "best practice".

Q. Describe the additional costs that seem likely to occur due to the acquisition.

A. We expect cost on-sets will be experienced as a result of this transaction in the form of additional one-time transaction costs and future on-going and one-time operational costs. In fact, the transaction could produce stranded costs.

Q. Describe the types of one-time transaction costs that the petitioners have not addressed.

A. There are substantial one-time transaction costs not addressed by the petitioners, such as the change in control payments described earlier in this testimony. In addition, there are

1 potential transfer taxes and outside advisor
2 fees.
3 Q. Is Iberdrola's commitment "not to seek recovery
4 of costs incurred to consummate the proposed
5 transaction from New York ratepayers" sufficient
6 to protect ratepayers?
7 A. As noted throughout this testimony, the
8 reporting requirements for the combined company,
9 and that company's structure and organization,
10 lack sufficient transparency for U.S. accounting
11 and ratemaking. There are no procedures,
12 checks, or processes spelled out by the
13 petitioners that would ensure that costs of the
14 acquisition are removed from or not flowed to
15 the utilities. For example, the timing of
16 substantial change in control payments may not
17 occur for several years (due to the 18 month
18 employment commitment). The burden would be put
19 on Staff to detect such payments and if
20 improperly allocated remove them from the rate
21 setting process.
22 Q. Do you foresee any potential issues concerning

transaction costs?

A. Yes. We anticipate arguments over which costs are defined as transaction costs to be absorbed by Iberdrola and which are not. For example, should one of the utilities incur severance payments, it seems as though arguments may ensue concerning whether such payments were attributable to the acquisition or arose from normal assessment related to ongoing operational efficiency initiatives.

Q. What one-time future operational costs might be incurred?

A. As noted earlier, the acquisition presents Iberdrola potential opportunities to consolidate its U.S. operations (e.g., service and administrative functions) and its IT platform. In fact, Iberdrola has alluded to its intention to eliminate certain intermediate holding companies (see Petition, page 9, footnote 2). Should those changes occur, it will most likely involve one-time operational costs associated with integrating these domestic businesses and

operations.

Q. Do you have any specific concerns about potential IT consolidation of Energy East with the other U.S. operations of Iberdrola?

A. Yes. As discussed above, our review of Iberdrola's current IT operations indicates that it could be a candidate for consolidation (see Response IBER-0095 to DPS-51). Should consolidation occur, it could either create a stranded cost for NYSEG and RG&E's new SAP system or create the possibility for sharing of the utilities' SAP system with other Iberdrola operations, particularly those in the United States without appropriate remuneration to New York ratepayers who paid for the systems.

Q. Have the petitioners addressed these issues?

A. No. However the issue of sharing the utilities SAP system was addressed in NYSEG's 2005 rate case. In its Order Adopting Recommended Decision with Modifications (the "2006 NYSEG Rate Order"), issued on August 23, 2006 in Case 05-E-1222, because of concerns about sharing of

1 costs, the Commission directed NYSEG to "report
2 and disclose to the Director of Accounting and
3 Finance all contacts, discussions and meetings
4 with its corporate affiliates concerning the
5 shared use or transfer of the Customer Care
6 System." Should the SAP system be used by
7 entities outside the New York utilities,
8 Iberdrola should be bound by the same reporting
9 requirements.
10 Q. Will there be potential on-going operational
11 cost on-sets after the transaction is
12 consummated?
13 A. Yes. It appears likely that Iberdrola could
14 allocate costs from its central holding or
15 service company to domestic operations. The
16 petitioners have not addressed how such
17 allocations will be treated or why they are
18 justified.
19 Q. Are allocations from Iberdrola justified?
20 A. Given the lack of synergies, tangible, or other,
21 customer benefits, and the fact that the
22 utilities are already paying for and receiving

all necessary services from the existing domestic holding or service companies Utility Shared Services Corporation (USSC) and Energy East Management Corporation (EEMC), allocations from Iberdrola are not justified.

Q. Would you have any other concerns should Iberdrola attempt to allocate foreign holding company costs to the utilities?

A. Yes. As noted below, Iberdrola accounts for foreign company's costs on a different international basis than the U.S. utilities. It is not clear how allocations of foreign costs would be impacted by the differences in accounting methods.

Q. Is it true that currently the Energy East EEMC and USSC holding and service company costs are allocated to the utilities using various formulas taking into account the relative size and magnitude of the utilities in comparison to the overall Energy East system?

A. Yes.

Q. How might that change post-acquisition?

A. It is not clear how the allocation processes, methods, or formulas would change. However, we have concerns about how the acquisition could affect both the total costs and allocation percentages of the current holding and service company allocations to the New York utilities.

Q. Please explain.

A. The current allocation formulas could change if other Iberdrola operations or utilities are added to the allocation process. The level of costs or the allocation formulas that spread those costs based on the relative sizes of the entities taking service could change. This could affect the level of costs allocated to New York.

C. OTHER RISKS NOT ADDRESSED

Q. Describe the additional risks that seem likely to arise due to the acquisition.

A. Besides the obvious financial and business risks that we address elsewhere, there are potential risks associated with this transaction because the combination of companies will greatly expand

1 the size, scope, and geographic reach of the
2 ultimate parent and affiliates of NYSEG and
3 RG&E. This could lead to the potential co-
4 mingling or misallocation of costs and assets.
5 Q. Is it true that there are controls and
6 procedures intended to prevent these types of
7 abuses?
8 A. Yes. However, the ability to detect such
9 problems will be greatly compromised due to the
10 combination of companies. These concerns will
11 grow exponentially due to the size, scope, and
12 geographic reach of the combined companies, as
13 well as the different accounting standards in
14 place in the U.S. and in Europe.
15 Q. Is it true that the companies have committed to
16 using the same cost accounting and allocation
17 methods as utilized today together with limited
18 access to books and records of affiliates?
19 A. Yes. However, the existence of these controls
20 does not alleviate Staff's concerns about
21 incentives for cross-subsidization. Incentives
22 for cross-subsidization exist and Iberdrola has

1 the means to implement it through chaining
2 transactions, unrecorded transactions, and
3 improper allocations of costs.
4 i. CHAINING TRANACTIONS
5 Q. What are chaining transactions?
6 A. Chaining transactions may occur when a good or
7 service is provided to the regulated utility by
8 another affiliate or service company that was
9 originally obtained from a third non-regulated
10 affiliate. In effect, the utility is the third
11 and final link in the chain of transactions.
12 Q. Do the existing affiliate transaction rules
13 limit the prices paid by the utilities to
14 affiliates for goods and services to fully
15 loaded costs (all appropriate direct and
16 indirect costs)?
17 A. Yes. However, those rules will require
18 modification should the M&A transaction be
19 approved because the existing rules do not
20 explicitly prevent chaining transactions.
21 Q. Can you provide an example of a chaining
22 transaction?

A. Yes. Suppose that one of the Energy East service companies buys a good or service (e.g., insurance) from an Iberdrola affiliate. Assume that the service company pays an inflated price to the Iberdrola affiliate for the good or service. This now becomes the service company's "cost" and that inflated "cost" is then allocated to the utilities. In this example, the utilities pay an inflated "cost" to the service company which they may claim does not technically violate the affiliate transaction rules that exist today.

Q. Why do the affiliate transaction rules require modification?

A. As shown above, Iberdrola has substantial interests in non-regulated lines of business, including real estate, insurance, energy consulting, and engineering, which Energy East does not have. Incentives will exist to maximize the profits of the non-regulated affiliates through sales of goods and services at inflated prices to regulated utility

affiliates. This will result in higher utility prices or lower earnings sharing. The non-regulated businesses must compete for business in a competitive market and are "price takers". The regulated businesses have prices set by formula and its customers do not have the same choice to go to a competitor and through regulation are "price makers". Prohibitions against this type of chaining transaction is required should the Commission approve the acquisition.

ii. FOREIGN CURRENCY VALUATION

Q. Are there any other valuation issues that will result due to the proposed acquisition of Energy East?

A. Yes. Should Iberdrola attempt to allocate costs or provide goods and services from a foreign entity to Energy East or the utilities, we are concerned about foreign currency valuation of such transactions.

Q. Why does foreign currency valuation concern you?

A. At present, there are no proposed guidelines for

the utilities concerning valuation of foreign currency transactions with Iberdrola. Relative foreign currency values can fluctuate greatly. This fluctuation provides an additional cost or risk to the utilities.

Q. Can you provide an example of the risk?

A. Yes. Assume that Iberdrola allocates a portion of the salary cost of its CEO to the New York utilities based on a percentage of his salary. If the CEO's salary did not fluctuate in a year, the allocation of cost to the utilities could change dramatically due to the valuation of Iberdrola's cost in U.S. dollars.

Q. How does this cause risk to the utilities?

A. It makes utility expenses more volatile, and additional volatility creates additional risk.

iii. UNRECORDED TRANSACTIONS

Q. What are unrecorded transactions?

A. These are transactions that are not recorded on the books of the utilities that are detrimental to the utilities financial results.

Q. Can you provide an example of an unrecorded

1 transaction?

2 A. Yes. Assume that a competitive affiliate of

3 Iberdrola (e.g., an entity operating out of

4 state, market-priced, generation), needs repairs

5 or maintenance and requests assistance from a

6 utility. A New York utility then sends a work

7 crew to repair the Iberdrola equipment.

8 Ideally, the New York utility would bill the

9 Iberdrola affiliate for the value of the

10 services provided. If the utility should

11 inadvertently fail to bill the Iberdrola

12 affiliate, there would be no transaction to

13 audit. This is an example of an unrecorded

14 transaction.

15 Q. How does that harm the utilities?

16 A. In this example, the utility would lose income

17 (reimbursement) and incur expenses (e.g.,

18 overtime) for the benefit of the competitive

19 affiliate. These factors would lower the

20 earnings of the regulated utility. Those lower

21 earnings would either lower the shared earnings

22 under an earnings sharing mechanism or could

form the basis for increased rates as a component of the test period that serves as the base when the utility seeks a rate increase.

iv. REPORTING CONCERNS

Q. Is it true that the companies have committed to continue to provide regulatory reports and that such reporting is intended to provide information to assist in preventing these types of abuses?

A. Yes. Again however, the combination of companies will create increased risks and opportunities for abuses that cannot be detected by regulators. Simply reporting on regulated entities does not alleviate such concerns.

Q. Explain why periodic reporting by the utilities does not alleviate your concerns.

A. The utilities reports will concern transactions recorded by the utilities. These reports will not provide any information or details on the activities of the service or holding companies or the other business interests of Iberdrola. Without full knowledge of all of these entities,

we cannot reliably confirm that the costs of the utilities are fairly stated.

Q. Has financial reporting changed recently for the New York utilities and holding companies?

A. Yes, there have been multi-dimensional changes to the financial reporting of holding companies. Most changes have no connection to the proposed acquisition but have a bearing on the future transparency of the combined companies. The changes, taken in their totality, have reduced financial reporting for the New York utilities.

Q. Please explain these changes.

A. Due to Public Utility Holding Company Act of 2005 (PUHCA-2005), which repealed earlier PUHCA requirements, Energy East no longer has to provide the same level of detailed holding company financial reports. Those reports were replaced by the streamlined FERC holding company financial report (FERC Form 60). Also, because the New York utilities no longer have publicly outstanding securities, they are no longer required to file their own individual detailed

1 SEC reports, such as Form 10-K annual and 10-Q
2 quarterly reports. All SEC reporting is now
3 done at the Energy East consolidated level.
4 Q. Did the enactment of PUHCA-2005 have any other
5 ramifications?
6 A. Yes. Prior to the enactment of PUHCA-2005, the
7 SEC had direct oversight over utility holding
8 companies. One of the important oversight
9 activities the SEC provided was comprehensive
10 audits of utility holding companies. Our Staff
11 was regularly involved in these audits, given
12 New York State's strong interests in holding
13 company impacts on its consumers. We understand
14 that that FERC will continue the holding company
15 audit program, but it is not clear that the
16 audits will be in the same depth or frequency as
17 the former SEC audits, or if the this Commission
18 will be asked to participate in them. The
19 possible weakening of those audits is a concern,
20 especially if larger, more complex international
21 holding companies become more prevalent in New
22 York. The main point is, however, that the

other checks and balances that were in place years ago have either been removed or substantially weakened. Therefore, we cannot rely on other branches of government, and this regulatory process will have to serve as the source for all accounting and transparency protections for ratepayers.

Q. Will this these accounting and transparency problems be exacerbated after the acquisition?

A. Yes. In addition to these dramatic reductions in SEC financial reporting requirements and oversight over Energy East, accounting under U.S. Generally Accepted Accounting Principles (GAAP) would cease and would be replaced by International Financial Reporting Standards (IFRS) for Iberdrola.

Q. Please highlight the major differences between IFRS and GAAP.

A. Our first real experience with IFRS came after the Iberdrola petition was filed. Since that time we have done some research on IFRS, and that research indicates concerns are raised

about transparency and reporting if the Iberdrola did not file audited public statement under U.S. GAAP. We found a recent publication dated October 2007 by PricewaterhouseCoopers titled "Similarities and Differences-A comparison of IFRS and U.S. GAAP." We have included the eight page summary as Exhibit___PP-9). As the authors state in the "How to use this publication" section, "no summary publication can do justice to the many differences of detail that exist between IFRS and U.S. GAAP. Even if the overall approach taken in the guidance is similar, there can be differences in the detailed application, which could have a material impact on the financial statements…readers should consult all the relevant accounting standards and, where applicable, their national law. Listed companies should also follow relevant securities regulations - for example, the U.S. Securities and Exchange Commission requirements and local stock exchange listing rules." They continue in

1 the preface by stating "it needs to be stressed
2 that this slim book deals with the main
3 differences only. Many hundreds of pages would
4 be needed in order to be comprehensive, but that
5 was not our objective with this publication."
6 Q. Have any authorities expressed concerns about
7 IFRS?
8 A. Yes. Moody's issued an Announcement titled
9 "European Electricity Producers financials lack
10 key data" dated October 30, 2007 which
11 recognized the shortcomings of IFRS reporting.
12 Specifically, Moody's stated "the usefulness of
13 Europe's Electricity Producers' financial
14 statements would be significantly enhanced if
15 the companies provided more information about
16 their electricity generation activities and
17 power plants." This article is presented as
18 Exhibit___(PP-10). In October 2007 Moody's
19 issued a report entitled "Europe's Electricity
20 Producers -- Is Comparability Compromised by
21 Different Accounting Practices?" in which it
22 "notes that only two of the eight companies

disclose the profit they derive from producing electricity." Moody's states "Electricity generation is a significant activity for these companies, but it is difficult to compare performance when they adopt different approaches to segment reporting." This article is presented as Exhibit___(PP-11).

Q. Will Energy East continue to be subject to Sarbanes-Oxley Act (SOX) after the M&A transaction is consummated?

A. No.

Q. What is the significance of this?

A. SOX established stronger standards for all U.S. public company boards, managements, and public accounting firms. These standards added corporate board responsibilities and criminal penalties if these responsibilities were not upheld. SOX requires officers of corporations to certify that the signing officers have reviewed the financial reports of the company and that the financial reports do not contain any material untrue statements or material

omission or be considered misleading. SOX mandated that officers of a corporation attest that the financial statements and related information fairly present the financial condition and the results in all material respects. The signing officers were also made responsible for internal controls of the corporation. If his transaction is allowed, the protections of SOX will no longer apply to Energy East. Thus, stakeholders in NYSEG and RG&E will not have the same degree of confidence in any statements coming from Energy East.

Q. Please state your conclusions on the financial reporting implications of this M&A transaction.

A. After the acquisition, the dramatic increase in size and scope of the combined entity, the creation of incentives for under-reporting, reductions in financial reporting and oversight, and the introduction of differing accounting systems, regulatory oversight will be difficult at best. Therefore, any approval of this acquisition should be conditioned upon a

requirement that Iberdrola file audited public financial statement under U.S. GAAP.

DETRIMENTS OF THE M&A TRANSACTION

Q. Did the Panel identify any detriments of the M&A transaction, other than increased costs and risks described above?

A. Yes. There are real detriments resulting from the acquisition in the areas of vertical market power, deterioration of financial strength, and deterioration of regulatory oversight and transparency.

A. VERTICAL MARKET POWER CONCERNS

Q. What has been the Commission policy on vertical market power and competitive wholesale electric markets during the past decade?

A. Commission policy over the past decade has supported wholesale electricity markets which are competitive. An integral part of this policy has been and is the separation of the ownership of T&D from the ownership of generation. This policy was explicitly stated in Opinion No. 96-12, in which the Commission

said "In a wholesale…competitive model, generation…should be separated from Transmission and Distribution systems in order to prevent the onset of vertical market power. Total divestiture of generation would accomplish this most effectively and is encouraged." Opinion No. 96-12, page 99. The New York investor-owned transmission companies have divested substantially all of their generating assets located in the State. On July 17, 1998, the Commission issued a Statement of Policy Regarding Vertical Market Power (VMP Policy Statement) in Case 96-E-0900, which establishes a rebuttable presumption that the ownership of generation by an affiliate of a T&D company would unacceptably exacerbate the potential for vertical market power. In the VMP Policy Statement, the Commission stated that "vertical market power occurs when an entity that has market power in one stage of the production process leverages that power to gain advantage in a different stage of the production process.

A T&D company with an affiliate-owning generation may, in certain circumstances, be able to adversely influence prices in that generator's market to the advantage of the combined operation." VMP Policy Statement, Appendix I, page 1. The Commission's preferred approach for addressing vertical market power, as expressed in the VMP Policy Statement, was divestiture. "In creating a competitive electric market, the Commission has viewed divestiture as a key means of achieving an environment where the incentives to abuse market power are minimized. Recognizing that vigilant regulatory oversight cannot timely identify and remedy all abuses, it is preferable to properly align incentives in the first instance." VMP Policy Statement, Appendix I, page 1.

Q. Does the VMP Policy Statement comment on the ability of the Federal Energy Regulatory Commission (FERC) and the NYISO rules and regulations to prevent the exercise of vertical market power?

A. Yes. The discussion section of the VMP Policy Statement addresses the commenting utilities' (Central Hudson, Con Edison and NGE, an affiliate of NYSEG) argument that "the New York State Independent System Operator (NYISO), Federal Energy Regulatory Commission (FERC), and this Commission would have sufficient control over the T&D utility to prevent the exercise of vertical market power." VMP Policy Statement, Appendix I, page 1. The VMP policy Statement rejects this argument as sufficient to prevent the exercise of vertical market power. "While the utilities are correct that regulatory controls and enforcement mechanisms exist, the degree to which these mechanisms can be effective is subject to debate. For example, the NYISO can recommend, and FERC or this Commission can direct, that a utility reinforce its transmission system. That utility, however, must go through the siting process for authorization, and its role as a possibly reluctant sponsor could introduce complexities

and delays in the process. It is also difficult for regulators to detect an inappropriate failure to act when critical information resides with the T&D utility." VMP Policy Statement, Appendix I, page 1.

Q. Does the VMP Policy Statement provide an example of the type of company which might satisfy the rebuttable presumption that the ownership of generation by an affiliate would unacceptably exacerbate the potential for vertical market power?

A. Yes. In the VMP Policy Statement the Commission stated: "For example, a relatively small T&D utility in a large market area which has little control over the constraining transmission interfaces, little ability to restrict new entry into the broader market by making it costly to interconnect in its service territory, and little voting leverage in the NYISO, should be able to rebut the presumption that the benefits of efficiency gains are outweighed by the costs associated with the potential for vertical

1 market power."

2 Q. Is the proposed combined company representative

3 of this example company?

4 A. No. The proposed combined company covers a

5 significant area in the upstate market; it would

6 not be a small T&D utility. There are

7 approximately 3000 MW of existing generation in

8 the Energy East service area and approximately

9 4000 MW of planned generation in the NYISO

10 interconnection queue for the Energy East

11 service area. The company would have 2433 miles

12 of transmission and 2 major transmission lines

13 connecting the upstate market to the PJM

14 Regional Transmission Organization (RTO). The

15 company would provide natural gas service to

16 approximately 300 MW of gas-fired generation and

17 there are 314 MW of planned gas-fired generation

18 for the Energy East service area in the NYISO

19 interconnection queue. Additionally,

20 Petitioners have not identified any benefits or

21 efficiency gains from the proposed transaction.

22 So, the proposed combined company is not similar

to the example company provided in the VMP Policy Statement and would not satisfy the rebuttable presumption by relying on that example.

Q. Are there other relevant Commission Orders or filings that address vertical market power?

A. Yes, the Grid/KeySpan Order and the Commission filing on Market-Based Rates in FERC Docket No. RM04-7-000 comment on vertical market power issues and provide current Commission prospective on vertical market power (see Exhibit___(PP-12). In the Grid/KeySpan Order, in the discussion (page 13-14) of vertical market power, the Commission states: "…several initial conclusions are in order. The first is that to the extent the Petitioners argue we should simply rely on FERC's evaluation of the market power issue, they are essentially arguing there is no need for the 1998 Statement of Policy on VMP, that regulatory solutions will always be adequate to address VMP, and that structural solutions that eliminate the

incentives to exercise VMP are not needed. The key weakness in these contentions, however, is that none of them limit or eliminate opportunities for VMP that could be exercised in ways that would be hard or impossible to detect." The Commission also expresses the concern that relying solely on regulatory solutions would be inconsistent with the goal of ensuring a competitive generation market. In the FERC docket on Market-Based Rates the Commission filed comments in opposition to the FERC presumption that vertically integrated utilities with an Open Access Transmission Tariff (OATT) do not have market power. The filing explained how a vertically integrated utility, through its transmission repair practices, transmission investment decisions and voltage support decisions, may exercise market power without necessarily violating its OATT.

i. DELIVERABILITY

Q. What is deliverability?

A. Deliverability is the existence of sufficient

transmission infrastructure to ensure that a generator's power can flow to multiple places on the network. The NYISO filed a deliverability plan in October 2007 (Consensus Deliverability Plan of the New York Independent System Operator, Inc. and the New York Transmission Owners, October 5, 2007) with FERC which addresses the requirements a new generator must meet when interconnecting in a NYISO market. The NYISO filing proposes two levels of interconnection service: the Energy Resource Interconnection Service ("ERIS") and the Capacity Resource Interconnection Service ("CRIS). For a generator to participate and receive revenues in the NYISO Installed Capacity (ICAP) market, the generator must qualify for CRIS. To qualify for CRIS the generator must be deliverable, using the existing transmission system, within the New York capacity market in which the generator will participate or fund the necessary transmission system investments to make the generator deliverable.

Q. What is the relevance of deliverability to this proceeding?

A. To obtain ICAP revenues, generators entering the upstate New York market (Zones A-I) would need to qualify for CRIS. If an entrant's capacity is not deliverable, funding the needed upgrades to the transmission system becomes an additional cost-of-entry. The interconnection queue of the NYISO has 11,431 MW of new generation planned for the upstate market, including approximately 2840 MW of wind in the Energy East service area. Each of these planned generating units would be competing with the generating assets of the combined firm, which includes 546 MW of existing Energy East generation, 176.2 MW of Iberdrola existing wind generation, and 715 MW of Iberdrola planned wind generation. The combined firm would have the incentive to pursue transmission investment and maintenance decisions to the benefit of company-owned generation and the detriment of competing generators, including the 6870 MW of planned

competing wind generation in the upstate market. Although the combined firm would be subject to the rules and regulations of FERC and this Commission, the VMP Policy Statement noted, as previously discussed, that it is difficult "to detect an inappropriate failure to act when critical information resides with the T&D utility." The combined firm could delay needed transmission investments, impacting the deliverability and cost-of-entry of non-affiliated entrants to the upstate market, or conversely expedite transmission investments which assure the deliverability of its own generation.

ii. PETITIONERS' FAIL TO SATISFY THE REBUTTABLE PRESUMPTION

Q. Please describe the Petitioners' filings with respect to vertical market power issues related to the proposed transaction.

A. The August 1, 2007 petitioners' filing with the Commission included the Affidavit of William H. Hieronymus on horizontal and vertical market

power which had been filed with FERC. On November 28, 2007, the petitioners' filed with the Commission the Direct Testimony of William H. Hieronymus on vertical market power.

Q. Please briefly summarize the conclusions of the Hieronymus testimony.

A. The testimony concludes that 1) the VMP Policy statement is no longer relevant; and 2) the specific facts of the proposed merger satisfy the rebuttal presumption of the VMP Policy Statement.

Q. Do you agree with the conclusion that the VMP Policy Statement is irrelevant to this proceeding?

A. No. The conclusion that "the relevance of the VMP Policy Statement has been superseded by almost ten years of significant change in the electric industry in New York" (Direct Testimony of William H. Hieronymus, page 3) is directly contradicted by the recent Commission Order on the National Grid PLC acquisition of KeySpan Corporation. In applying the VMP Policy

Statement, the Order requires the divestiture of the KeySpan Ravenswood generating station. The VMP Policy Statement is clearly applicable to the proposed transaction in this proceeding.

Q. Please briefly summarize the arguments made to satisfy the rebuttable presumptions.

A. The testimony argues that the rebuttable presumption is met since 1) the existing RG&E and NYSEG generation should be excluded from the analysis; 2) the existing and planned wind generation of Iberdrola's affiliates is de-minimis and not located in the RG&E or NYSEG service area; 3) the FERC and NYISO rules and regulations governing transmission eliminate potential vertical market power concerns; and 4) all of the Iberdrola affiliated wind generation would be located on the low price, unconstrained side of the Central-East transmission constraint, and RG&E and NYSEG would not otherwise be able to influence congestion.

Q. Do you agree that the arguments presented in the

1 testimony are sufficient to rebut the
2 presumption of vertical market power?
3 A. No. Although we agree with some of the reasons
4 given in the Hieronymus testimony to rebut the
5 presumption of vertical market power, there are
6 several important arguments presented with which
7 we disagree. We agree that all of the existing
8 and planned Iberdrola affiliated wind generation
9 would be on the low-price unconstrained side of
10 the central-east transmission constraint. We
11 also agree with Exhibit WHH-3 which contains
12 average hourly prices by NYISO zone for January
13 2005 through September 2007 and the conclusion
14 that the price differentials among zones A-E are
15 primarily the result of marginal losses,
16 implying that for most hours zones A-E are one
17 market with respect to the wholesale electricity
18 price. It is important to note that the upstate
19 market (zone A-E) lies next to two other
20 important markets, the PJM market and the
21 Canadian market. The transmission connections
22 between the upstate market and these markets are

important in the movement of lower cost power into the upstate market. The combined firm would also have 2 major transmission lines connecting the upstate market to the PJM market. We disagree that FERC and NYISO rules and regulations eliminate vertical market power concerns, that existing and planned Iberdrola affiliate wind generation should be considered de minimis for the proposed transaction and is not located in the RG&E or NYSEG service areas and that existing RG&E and NYSEG generation should be excluded from the analysis. With respect to the location of planned Iberdrola affiliate wind generation in New York State, a recent NYSIO interconnection queue includes a 150 MW wind project by Gamesa Energy USA, LLC in Schuyler, NY, and a 120 MW wind project by Gamesa Energy USA, LLC in Tioga Bradford, PA which are both planned to be interconnected to the NYSEG service area. A more recent NYISO interconnection queue does not include the 120MW wind project. Iberdrola has an approximately

24% equity interest in the Gamesa parent. This appears to contradict the assertion that no Iberdrola affiliate wind generation is planned for the RG&E or NYSEG service area. Moreover, Iberdrola has already acquired from Gamesa 500 MW in wind farm projects under development in Illinois, Texas and neighboring Pennsylvania. Nothing prevents Iberdrola from similarly acquiring all of the Gamesa projects in New York, or a controlling interest in those projects if it does not already possess such an interest. Additionally, Horizon Wind Energy has 207.45 MW of planned wind generation in the NYSEG service area, Horizon wind is a wholly owned subsidiary of Energias de Portugal, S.A. (EDP). Iberdrola has a 9.5% equity interest in EDP. As noted above, zones A-E are the same market in most hours of the year. Given this fact, the combined firm's generation and transmission would be in the same market. They would also have transmission links to adjacent markets. Market areas and transmission

connecting to adjacent markets are more important to the vertical market power analysis than service area boundaries.

Q. Why should the exiting RG&E and NYSEG generation be included in the analysis of the proposed transaction?

A. RG&E and NYSEG own 546 MW (nameplate rating) of generation which includes the RG&E 253 MW Russell Station and the NYSEG Energy Solutions 63 MW Carthage plant.

Q. Please discuss the Russell Station.

A. In Case 03-T-1385, where an Order Granting Certificate of Environmental Compatibility and Public Need was issued December 16, 2004, RG&E committed (on the record in RTP-0051) to sell the Russell Station site to a non-affiliated company after the completion of the Rochester Transmission Project (RTP). That commitment was incorporated in the Order and is binding on RG&E.

Q. Are there indications that RG&E does not intend to fulfill its commitment?

A. Yes. In IBER-0072, it states that it intends to re-power the Russell Station as a 300 MW gas-fired facility entering service in 2013.

Q What other steps has RG&E taken in furtherance of its efforts to re-power the facility?

A. As discussed in the testimony of the Staff Electric Reliability Panel, RG&E sought certain actions from the NYISO, which it did not obtain, regarding the Russell Station.

Q. Please discuss the Carthage facility.

A. The NYSEG Energy Solutions Carthage plant is a market-based unit which would profit from price increases in the upstate market and should be included in the analysis of the proposed merger.

Q. Please discuss the remaining generation.

A. The remaining 230 MW's consist of combination turbines and hydro. The 105 MW of combustion turbines that are rate-based units should be included in the analysis since withholding these units from the market could potentially increase the market price received by the combined firm's market-based generation (a horizontal market

power issue).

Q. Do FERC and NYSIO rules and regulations eliminate vertical market power concerns?

A. No. As previously discussed, the VMP Policy Statement and the Grid/KeySpan Order make clear that FERC and NYISO rules and regulations do not sufficiently mitigate vertical market power concerns. With respect to rules and regulations, the Grid/KeySpan Order notes "that none of them limit or eliminate opportunities for VMP that could be exercised in ways that would be hard or impossible to detect." Detecting and verifying the exercise of vertical market power is a difficult task. For example, although the NYISO, as required by FERC, has standard procedures and agreements for generation interconnections to the transmission system designed to address transmission owner market power, disputes between non-affiliated generators and transmission owners occur. Ginna Nuclear Power Plant, LLC (Ginna), a wholly owned indirect subsidiary of Constellation Energy

1 Group, Inc. filed a complaint against RG&E with
2 FERC on June 25, 2007 (Docket No. EL77-07)
3 alleging a violation of the Interconnection
4 Agreement (IA) between RG&E and Ginna. Ginna
5 states that it has been required by RG&E to
6 substantially reduce its output on two occasions
7 for planned outages of only a single line and
8 will be required to do so on an ongoing basis
9 due to planned maintenance activities by RG&E
10 (it should be noted that while the NYISO has the
11 authority to deny a transmission owner's request
12 for an outage, that authority is limited to
13 reliability impacts and does not include price
14 impacts). As part of the Rochester Transmission
15 Project, RG&E's work at substation 13A includes
16 taking a single transmission line exiting that
17 substation out of service. A transmission owner
18 with no affiliated generating assets would have
19 no perverse incentive to require a generator to
20 reduce output in a situation similar to the
21 Ginna complaint. The regulatory body would have
22 to evaluate the complaint but vertical market

power would not be an issue. However, when a transmission owner does have affiliated generation, any review of this type of complaint must include an evaluation of whether there is an exercise of vertical market power. Additionally, if there were an exercise of market power, the market price outcomes in the NYISO wholesale electric market would reflect non-competitive results during those hours. This raises the issue of refunds not only for the generator filing the complaint but also for other market participants. Restating market price outcomes is disruptive to the market.

Q. Are there other illustrative examples of the types of transmission issues which are not adequately addressed by FERC and NYISO rules?

A. Yes. The Ithaca Transmission Upgrade Project (ITUP) is another example. In Case 05-E-1222 AES Eastern Energy L.P. (AES) stated that local voltage level deterioration had required curtailments of its Cayuga Generating Facility over the past 10 years. AES argued that NYSEG

should commit to the transmission upgrade and a schedule for timely completion. NYSEG argued against a firm commitment, preferring an iterative approach and noted that the ITUP would take 4-5 years. This corresponds to the type of situation noted in this manner could increase the price received by the combined firm's generation, a classic example of vertical market power. More generally, there would be no incentive for a T&D company which owns market-based generation to pursue future transmission investments which would lower upstate wholesale prices. Alternatively, there would be an incentive to propose, pursue and argue for transmission investments, which would be funded by ratepayers, that would enhance the ability of own generation to reach higher priced markets in the future, regardless of society's or ratepayers' best interests.

Q. What does the Hieronymus testimony conclude with respect to Iberdrola wind generation and vertical market power?

A. The testimony maintains that Iberdrola's generation interests in New York would be approximately 795 MW (nameplate capacity), including planned generation, and questions whether the planned generation should be included in the analysis. The testimony notes that the capacity factors for wind generation in the NYISO market is 10% in the summer and 30% in the winter and that the existing and substantially complete Iberdrola wind generation of approximately 259 MW, which equates to 77.7 MW after applying a 30% capacity factor, represents a de minimis amount. The testimony concludes that any incentive to manipulate transmission by RG&E or NYSEG would be de minimis.

Q. Do you agree with this analysis and conclusion?

A. No. There are several areas of disagreement. First, the estimate of nameplate capacity for existing and planned generation would be 920.2 MW rather than 795 MW. The 795 MW estimate does not include the 9.5% equity interest of

Iberdrola in Energias de Portugal, S.A. (EDP), which owns Horizon Wind Energy. Horizon Wind Energy has a 50% interest in the Maple Ridge (Flat Rock) wind generating facility. The Hieronymus testimony does not include the 15.3 MW related to this equity interest because Iberdrola does not exercise any voting rights. This reasoning does not take into account that Iberdrola receives its 9.5% share of any profits from Maple Ridge. The 15.3 MW should be included in the nameplate capacity estimate. Horizon Wind Energy also has plans for an additional 476.45 MW of wind generation in New York. Iberdrola's 9.5% equity interest would be 45.2 MW. Additionally, Iberdrola has a 24% equity interest in Gamesa. Its Gamesa Energy USA LLC subsidiary has a 150 MW wind generating facility in the NYISO interconnection queue for the NYSEG service area. The 65 MW Iberdrola share of this facility should be included in the nameplate capacity estimate. The final estimate should be 920.2 MW rather than 795 MW. Second,

in discussing capacity market revenues from the Iberdrola wind generation, the testimony presents the summer capacity value of 79.5 MW for existing and planned generation based on 795 MW of nameplate capacity and a 10% capacity factor. As explained above, the calculation should be 10% of 920.2 MW, which results in 92 MW. The capacity factor for the winter capacity period is 30%, which results in 276.1 MW of capacity earning capacity revenues. The expected ICAP revenues for this capacity in the NYCA capacity market for the 2009 summer capability period and the 2009/2010 winter capability period are $2.14 million and $3.32 million respectively. (The estimates are based on a $4/kw-month summer price and a $2/kw-month winter price.) To the extent that excess capacity dissipates in the future in the NYCA market, prices would increase, resulting in a corresponding increase in capacity market revenues. The potential revenue from the capacity market for new generation is contingent

on being deliverable, as discussed previously. New entrants which are not deliverable face an additional cost-of-entry related to transmission system upgrades. Thus, the incentive to use transmission decisions to favor own generation is not only the capacity market revenues, but avoiding system upgrade costs for affiliated generation that a non-affiliated generator may face.

Q. Do you have any examples of the price impacts that transmission decisions have on upstate wholesale electric prices?

A. Yes. Exhibit___(PP-13) shows the real-time (RT) and day-ahead (DA) LBMPs for the Genesee and West regions for a 19-day period which includes a Ginna line outage which was discussed previously in relation to the Ginna FERC complaint. The data shows that the RT price during the outage was approximately 55% higher during the outage than the prior and following week's weekday average for the upstate market. The average load and natural gas prices were

1 approximately the same in these periods as shown
2 in Exhibit___(PP-13). These examples illustrate
3 possible price impacts that are associated with
4 decisions made by a transmission owner with
5 respect to transmission outages, maintenance,
6 and investments. A transmission owner which
7 owns generation has an incentive to make
8 decisions that favor own generation, resulting
9 in increasing market prices.
10 Q. Do you have any other comments with the analysis
11 in the Hieronymus testimony which concludes that
12 the affiliates of Iberdrola currently own and
13 plan to construct a de minimis amount of wind
14 generation in New York?
15 A. Yes. Mr. Hieronymus states on page 31 beginning
16 on line 11 that "Iberdrola's expertise in and
17 commitment to renewable generation development
18 in New York State, when combined with the other
19 valuable benefits of the Proposed Transaction,
20 will result in 'substantial ratepayer benefits'
21 that should be sufficient to more than offset
22 the at most trivial amount of vertical market

power that hypothetically could be exercised." It is inconsistent to claim that on one hand Iberdrola is planning to construct only a de minimis amount of wind generation in New York while on the other hand, Iberdrola's commitment to wind generation will provide substantial benefits.

Q. Is this inconsistency your major concern?

A. No. The major concern is that Iberdrola purchase of the T&D utilities may actually retard the fulfillment of New York's interests in developing renewable wind generation.

Q. Please explain how the acquisition may harm the state's interest in the development of wind generation.

A. Though the T&D utilities, Iberdrola could affect the interconnection process for wind developers attempting to build projects in the RG&E and NYSEG service territories. To a lesser extent, Iberdrola also influences the production and sale of wind generation equipment, through its affiliation with Gamesa, a major wind power

parts manufacturer. These affiliations could enable Iberdrola to discourage competing wind developers from entering and successfully competing for projects in New York.

Q. What would be the impact on New York's goals for promoting renewable generation?

A. It could prevent New York from achieving those goals. As Iberdrola itself points out, knowledgeable and financially-strong wind developers "may not be able to dedicate resources to renewable energy development in every state" (Response IBER-0202). If wind developers that are competitors of Iberdrola come to believe that Iberdrola has an advantage in New York because of its affiliations, those competitors may take their expertise and capital elsewhere. Whatever additional wind capacity Iberdrola might build in the absence of competitors is unlikely to equal what full participation by numerous competitors in a robust competitive market could have produced. New York needs more than one wind developer to

achieve its renewable goals.

Q. How could Iberdrola's exercise of its affiliate advantages otherwise discourage the development of wind generation in New York?

A. New York has created a renewable portfolio standard (RPS) program. Under RPS, periodic solicitations are made for renewable energy projects. Developers of renewable projects submit bids in a competitive process for an award of funding, in essence a price premium or incentive payment for the delivery of energy from renewable resources. If Iberdrola discourages competitors from entering New York, the RPS program could be disrupted by declining competition, and New Yorkers could either pay much more to fund RPS because of the supply and demand effect that would drive bid prices higher due to scarcity of supply, or the RPS goals might not be met due to an insufficient number of project to meet the targets of the program.

iii. NATURAL GAS INTERCONNECTION ISSUES

Q. Are there remaining vertical market power issues which have not been addressed?

A. Yes. According to the Hieronymus Affidavit to FERC, there is approximately 300 MW of generation in the NYISO market taking natural gas transportation service from RG&E and NYSEG, although approximately 150 MW uses natural gas as a supplement fuel. There is 314 MW of planned natural gas generation in the NYISO interconnection queue for the NYSEG service area. The combined firm would have an incentive to use natural gas delivery policies, such as negotiated rates and natural gas interconnection policies, to increase costs to competing generators. In particular, this could create advantages for the Carthage facility, which might obtain higher prices if competing gas generators are delayed or are not built as a result of the use of gas delivery affiliations to discourage competition.

B. CREDIT QUALITY CONSIDERATIONS

i. IBERDROLA CREDIT QUALITY CONCERNS

Q. How will Iberdrola finance the $4.5 billion payment for the acquisition of Energy East?

A. On June 27, 2007, Iberdrola prefunded the acquisition with an accelerated private placement of equity. The money from this financing will pay for the acquisition of Energy East, and is a conservative means for consummating the M&A transaction. When viewed in isolation, this approach to the transaction would be less damaging to Iberdrola's capital structure than an all debt financing approach (as in the Grid/KeySpan transaction).

Q. Does this mean that this transaction will only add equity to Iberdrola's balance sheet?

A. No. Iberdrola will assume approximately $3.7 billion of debt that has been previously issued by Energy East and its subsidiaries. Thus, the transaction will add debt as well as equity to the balance sheet of Iberdrola. Furthermore, the transaction will increase Energy East's $1.5 billion of existing Goodwill by $1.4 billion, which will be added to Iberdrola's consolidated

1 balance sheet.

2 Q. Discuss the impact of the transaction on

3 Iberdrola's balance sheet and capital structure.

4 A. Iberdrola will add approximately $4.5 billion of

5 equity and will assume approximately $3.7

6 billion of Energy East's debt and reflect it in

7 its balance sheet capital structure.

8 Exhibit___(PP-14) shows the balance sheet of

9 Iberdrola before and after the Energy East

10 transaction. The exhibit shows that Iberdrola's

11 mix of debt and equity will slightly improve as

12 a result of the transaction. However, much of

13 the credit enhancement from the change in the

14 equity ratio is illusory as the transaction

15 creates $2.9 billion of Goodwill on the balance

16 sheet of Iberdrola, including the former

17 Goodwill of Energy East.

18 Q. Is the nature of the transaction a concern to

19 the panel?

20 A. Yes. Any transaction to purchase a New York

21 State jurisdictional utility that involves the

22 creation or assumption of a significant amount

of Goodwill necessarily concerns us.

Q. What is the pro forma capital structure of Iberdrola after the acquisition?

A. We estimate that the pro forma capital structure of Iberdrola will contain 42% equity and 58% debt. [redacted]

Q. Why did Staff not oppose treating this information as confidential?

A. Similar to the discussion above concerning Confidential Interrogatory Response IBER-0016 to

DPS-16, Staff did not want to prejudice Iberdrola in the event that the transaction is not approved, by requiring it to release information that it would have been allowed to keep secret in Europe. However, if the transaction is approved, the Commission should make it clear that Iberdrola will not be allowed to keep secret such fundamental information in the future. Staff Counsel advises that the information does not meet the standard for trade secret protection under New York law.

Q. Please continue with your analysis of Goodwill.

A. While there is no incremental Goodwill financed with debt as a result of this M&A transaction, the creation of Goodwill standing alone is problematic and exacerbates the extremely high amount of Goodwill Iberdrola already has on its balance sheet. Pro forma, Iberdrola currently has $13.3 billion of Goodwill and other intangible assets on its books. This represents a startling 46% [redacted] of Iberdrola's common

1 equity. Since corporate creditworthiness is
2 substantially affected by a company's debt
3 burden and the quality of its assets,
4 Iberdrola's creditworthiness is a major concern.
5 Q. Do you think that the pro forma consolidated
6 capital structure after Iberdrola's acquisition
7 of Energy East would benefit New York
8 ratepayers?
9 A. No. The leverage reflected in Iberdrola's pro
10 forma capital structure puts downward pressure
11 on its credit quality. This is because the debt
12 ratio of 58% for a company of Iberdrola's
13 business profile is more consistent with a BBB
14 rated company. Moreover, when the effects of
15 the write down of Goodwill are considered, the
16 capital structure ratios are not fully
17 consistent with investment grade bond ratings.
18 Q. In its direct testimony. Iberdrola claims that
19 one of the tangible benefits that it brings to
20 the ratepayers of NYSEG and RG&E is its "A"
21 rating. Do you agree with the Company in its
22 assertion?

A. No. Credit ratings are snapshots of a company's existing circumstances and by nature are subject to change when a company's circumstances inevitably change. The Policy Panel believes that given Iberdrola's high leverage and the extensive financings it must obtain in order to absorb its recent acquisitions, build its proposed generation projects, and continue on its course of corporate expansion, it is unlikely that the Company can sustain an "A" rating. Moreover already S&P's and Moody's have downgraded Iberdrola to a rating of "A-". Moreover, as stated previously, the capital structure of Iberdrola is not consistent with an "A" rating currently and any increase in its leverage will make a downgrade or multiple downgrades more likely.

Q. What is the basis for your statement that Iberdrola's capital structure ratios are unlikely to support an "A" bond rating after the transaction?

A. This statement is based on our knowledge of

1 utility finance issues and on reports by both
2 S&P and Moody's.
3 Q. What S&P reports did you use to make this
4 determination?
5 A. Four S&P reports were used. Two reports focus
6 on Iberdrola itself. They are presented in
7 Exhibit___(PP-15). One report focuses on United
8 States utilities while the other report
9 considers power companies on a global scale.
10 Q. Please describe S&P's research into Iberdrola.
11 A. On November 26, 2007, S&P's announced that it
12 was downgrading Iberdrola to a credit rating of
13 "A-" and was keeping its credit outlook as
14 negative depending on the success of Iberdrola's
15 partial spin off of its renewable businesses,
16 Ibernova. Ultimately, the Ibernova deal was
17 successfully consummated and yielded proceeds
18 adequate to change Iberdrola's outlook to
19 stable. S&P's stated that "the downgrade
20 reflects our view that Iberdrola's financial
21 profile and credit protection measures are no
22 longer compatible with an 'A' rating, owing to

the impact of the acquisition of Scottish Power PLC (A-/Watch Neg/A-2) and the group's organic growth plan."

Earlier, on September 18, 2007, S&P's issued a credit opinion on Iberdrola. In this opinion, S&P's noted weaknesses in Iberdrola that affected its risk profile: increasing competitive pressure in the domestic electricity market, exposure to pool price volatility, an ambitious growth strategy, a weakened financial profile following acquisition of SP, and exposure to volatile Mexican and Brazilian markets.

Q. What conclusions do you draw from S&P's reports on Iberdrola?

A. We believe Iberdrola is facing many challenges in maintaining its credit quality. The Company's assertion that its credit rating is a tangible benefit to NYSEG and RG&E ratepayers is transient. This is demonstrated by S&P's and Moody's both downgrading Iberdrola one rating notch just a few months after they made their

assertion.

Q. Why is S&P's ratings approach for U.S. utilities appropriate for an international holding company such as Iberdrola?

A. Iberdrola's operations are very similar to those of a typical U.S. integrated utility. As a result, we believe the same credit metrics that S&P applies to utilities in the United States should also be appropriate to apply to Iberdrola's operations.

Q. Explain how you applied S&P's domestic credit metrics to analyze Iberdrola's capital structure after the acquisition occurs.

A. S&P published revised bond rating guidelines for United States utilities in June 2004. The report, attached as Exhibit __(PP-16) indicates that one of the three key credit quality ratios considered by S&P is the ratio of debt to total capital (debt ratio). This report presented an approach under which S&P recognizes business risk profiles from 1 to 10 for utilities and then establishes debt ratio guidelines for

1 various bond ratings across that spectrum of
2 business risk profiles.
3 Q. What is the meaning of the business risk
4 profiles?
5 A. Utilities with lower business risks have lower
6 business profile numbers assigned them by S&P.
7 Utilities with higher business risk have higher
8 profile numbers assigned to them. S&P notes
9 that most T&D utilities would have business
10 profiles in the 1 to 3 range. Vertically
11 integrated utilities with transmission,
12 distribution and generation/production
13 activities would have profiles of 4 to 6.
14 Generators, power marketers and other
15 competitive players in utility markets will have
16 profiles of 7 and higher. A vertically
17 integrated utility holding company's risk will
18 be a blend of the risks of its operations. All
19 else equal, lower risk companies, having lower
20 business profile scores can accumulate higher
21 amounts of debt while still maintaining given
22 bond rating than higher risk companies with

higher profile scores can accumulate, all other things equal.

Q. What is Iberdrola's current business profile score?

A. S&P currently assigns Iberdrola a business profile of 5 versus NYSEG and RG&E's business risk profile of "3".

Q. What capital structure requirements does S&P have for utilities with a business profile of 5?

A. S&P requires respective debt ratios of 35 - 42%, 42 - 50%, 50 - 60%, and 60 - 65% for AA, A, BBB and BB bond ratings, respectively, for utilities with a business profile of 5.

Q. What bond rating is suggested by Iberdrola's current post-acquisition 58% debt?

A. Based on S&P's debt ratio requirements, Iberdrola's pro forma debt ratio of 58% and its business profile of 5 are consistent with a BBB bond rating. It is important to note; however, if even half of Iberdrola's Goodwill is written down, Iberdrola's equity ratio would drop to a level typical of an entity with a junk bond.

Q. Is Iberdrola likely to maintain a business risk profile of 5 as a result of the acquisition of Energy East?

A. We believe that this is a likely scenario. Energy East is primarily a pipes and wires distribution company. The acquisition should at least temporarily offset any additional forays by Iberdrola into wholesale generation and other competitive businesses. We believe that Iberdrola will maintain its business profile rating of 5, the mid point of the range S&P typically assigns to vertically integrated holding companies.

Q. What is the significance of these metrics for Iberdrola's financial strength?

A. These metrics imply that the financial parameters of Iberdrola's bond rating are consistent with that of Energy East's BBB rating. This is significant because Iberdrola has claimed that one of the cornerstone benefits it brings to the ratepayers of NYSEG and RG&E is its financial strength. Yet the credit rating

of Iberdrola has already been downgraded one notch by S&P's and Moody's. Unless these metrics improve, Iberdrola's long-term credit rating would appear at risk. From a financial standpoint, the financial strength promised by Iberdrola may be fleeting.

Q. Energy East is currently rated BBB+ and Iberdrola A- by Moody's. Can you see any benefit to the utilities as a result of the marginal credit rating advantage Iberdrola has over Energy East?

A. No. The credit rating advantage that Iberdrola currently enjoys over Energy East apparently has no direct benefit to the utilities. S&P has NYSEG and RG&E on negative outlook due to issues arising from the M&A transaction. This casts doubts on Iberdrola's promise of greater financial strength for NYSEG and RG&E. In fact, S&P's credit opinion indicates that even with or because of Iberdrola ownership, a down grade is being considered.

Q. Did you factor S&P statements about global

utilities into your analysis?

A. Yes. An S&P report titled "Power Companies", attached as Exhibit___(PP-17), contains a table (page 33) which shows median financial ratios for T&D utilities, generators, and vertically integrated utilities sorted by A and BBB bond ratings. This table indicates that the median debt ratio for A and BBB rated T&D companies are 55% and 65% respectively. By contrast, the median debt ratios for A and BBB rated vertically integrated utilities are 45% and 56%, respectively.

Q. What are the implications of these ratios for this proceeding?

A. By the standards of this article, Iberdrola's pro forma debt ratio of 58% implies a BBB bond rating. This statement is based on the 55% median debt ratio for BBB rated vertically integrated utilities shown in S&P's article, "Power Companies." Thus, by two industry standards, one international and one domestic, Iberdrola's debt ratio implies a BBB rating.

1 This rebuts the alleged benefit of the financial
2 strength that Iberdrola claims to bring to NYSEG
3 and RG&E, since by all indications that ratings
4 advantage is not due to Iberdrola's intrinsic
5 financial strength and will most likely
6 disappear.
7 Q. Turning to information from Moody's, what is the
8 basis for your statement that Iberdrola's
9 capital structure ratios are unlikely to support
10 an "A" bond rating after the transaction?
11 A. The Panel has relied on two reports from
12 Moody's. Each is a credit opinion on Iberdrola
13 and each is presented in Exhibit___(PP-18).
14 Additionally, Moody's default predictor rating
15 for Iberdrola is Baa2.
16 Q. Please describe Moody's research on Iberdrola.
17 A. In a December 13, 2007 Credit Opinion, Moody's
18 downgraded Iberdrola's A2 credit rating to A3.
19 Moody's took note Of Iberdrola's increasing
20 business risk stating, "This risk assessment
21 factors a degree of integration and execution
22 risk as the company has expanded into new

1 markets in which it has had less prior
2 experience, and, in addition the group has
3 ambitious growth targets which may not be
4 achieved if operating conditions become more
5 difficult." Moody's continued, "Ambitious
6 growth targets in the UK may be challenged by
7 competitive activity and there are a number of
8 regulatory and political challenges in Spain as
9 the electricity system is transitioning only
10 gradually to a fully liberalised market."
11 Moody's continued, "The rating outlook is stable
12 although Iberdrola's ratios are expected to be
13 positioned at the low end of the rating range
14 for the A3 rating category applied for its
15 business risk (RCF/debt of 12-16%, FFO/debt of
16 >17% FFO/interest of >4x). Should the company
17 fail to achieve growth targeted, or should
18 negative regulatory or pricing developments
19 affect the company, then pressure could develop
20 on these ratios." Thus, despite Moody's stable
21 outlook for Iberdrola, it appears the credit
22 agency will be keeping a sharp eye on the

Company for signs of credit deterioration.

Q. What conclusions do you draw from Moody's reports on Iberdrola?

A. Moody's points out that Iberdrola's leverage and heavy investment plans place it on the low end of an A3 rating. This analysis refutes Iberdrola's claim that its financing of the Energy East acquisition with equity is a benefit to the ratepayers of NYSEG and RG&E. The Moody's report indicates that the use of equity financing merely prevents damage to Iberdrola's financial profile. The prevention of the further erosion of Iberdrola's financial metrics is not a benefit to ratepayers. Given Iberdrola's extensive plans for making future investments, the future capital structure of Iberdrola could vary widely, depending upon how Iberdrola chooses to finance its investments, especially if Iberdrola continues its acquisition efforts. This can hardly be seen as a benefit to the customers of NYSEG and RG&E.

Q. Are there any other factors that concern Staff

regarding Iberdrola's ability to effectively finance the operations of NYSEG and RG&E?

A. Yes. Iberdrola's latest strategic plan indicates that the Company is embarking on a $20 billion investment program. How this program is capitalized is will determine whether Iberdrola will be downgraded. If the program is financed conservatively with a great deal of equity Iberdrola should be able to maintain its bond grading. However, if substantial amounts of debt are needed to finance this investment program, then Iberdrola's ratings could be downgraded. Also, any future acquisitions of businesses not contemplated in the strategic plan could add stress to the company's financial metrics. Finally, Iberdrola continues to increase its dividends in the midst of what is apparently a massive decade long investment program. This, too, imposes stress on Iberdrola's financial strength.

Q. Please summarize the risks of Iberdrola as a corporate parent for NYSEG and RG&E.

A. We are concerned about the financial strength that Iberdrola will bring to NYSEG and RG&E. Iberdrola's pro forma capitalization will use leverage consistent with a BBB rated vertically integrated utility. The non-earning Goodwill and intangible assets on its balance sheet will represent 46% of its equity. We wonder if given its extensive investment program and the capital deployed to acquire Energy East, whether their will be enough resources to effectively maintain the T&D systems of NYSEG and RG&E. It raises questions about the safety and reliability of NYSEG and RG&E's service under Iberdrola. It creates risks that need not be incurred if the Commission declines to approve the transaction.

Q. Why is it important to consider declines in the credit quality of the holding company parent of NYSEG and RG&E as a result of the transaction?

A. Utilities are responsible for providing safe and adequate service at a reasonable rate. Declines in the credit quality of Iberdrola not only affect Iberdrola's ability to raise capital in

the financial markets at reasonable terms but also the ability of its subsidiaries to do so as well. At this point in time, even with the downgrade by S&P's and Moody's, Iberdrola enjoys access to the capital markets. However, it seems likely that the costs it incurs in accessing debt financing will be increasing. While the cost associated with a credit quality decline within the investment grade category may not be significant given the current risk premium environment, a continued decline in credit quality to a level below investment grade credit quality could put upward pressure on utility rates. While an A-/A3 rating is a long way from a non-investment grade rating, it is also important to remember that the Company has seen its S&P credit rating fall from AA- to A- over the period November 2001 to December 2007 and its Moody's credit rating fall from A1 to A3 over the period November 2002 to December 2007. Iberdrola faces an ambitious investment program and a difficult integration of SP into its

organization. These programs could cause significant problems if Iberdrola is unable to execute its plans for these endeavors.

It is important to remember that NYSEG and RG&E will not operate in a vacuum from Iberdrola if the proposed acquisition meets all its regulatory approvals and is consummated. Absent adequate subsidiary financial protections, a decline in the credit quality at the parent is very likely to also precipitate a decline in the credit quality of the subsidiaries.

ii. NYSEG AND RG&E CREDIT QUALITY CONCERNS

Q. What is the basis for your statement that declines in Iberdrola's credit quality also drive down the credit quality of its utility subsidiaries?

A. This statement is based on the bond rating approach taken by both S&P and Moody's for holding companies with utility subsidiaries. More specifically, absent specific provisions to isolate the risks of the holding company from

utility subsidiaries, S&P is unlikely to assign a utility subsidiary a bond rating that differs from that of the parent. While Moody's may assign a higher bond rating to utility subsidiaries, the difference is likely to be no more than a notch. Thus, downgrades by Moody's or S&P of Iberdrola's overall bond rating will likely lead to a downgrade in the bond rating of NYSEG and RG&E.

Q. Have either credit agency indicated specifically that bond rating downgrades for NYSEG and RG&E are likely if the transaction is approved?

A. Yes, Exhibit___(PP-4) contains two reports from S&P, one for NYSEG and one for RG&E. These reports express concern over the financial metrics, i.e., the high debt leverage; Iberdrola would exhibit as the ultimate parent of NYSEG and RG&E. These reports also expressed some concern over the last NYSEG rate decision, which lowered the Company's rates. As a result of these concerns and others, S&P has designated the credit outlooks for NYSEG and RG&E as "negative," making a downgrade likely upon the

completion of the transaction.

Q. How much of a downgrade is likely as a result of the transaction?

A. Since S&P has not stated otherwise, we believe the credit agency will limit any downgrade of for NYSEG and RG&E to one rating notch. We are not confident, however, that there will not be further downgrades to both the New York utilities and Iberdrola.

Q. Why do you say this?

A. We say this for three reasons. First, the debt ratio exhibited by Iberdrola suggests a greater downgrade is possible for Iberdrola and its affiliates. When Goodwill is considered the possibility of a downgrade is further enhanced. Second, since Iberdrola is new to owning regulated utilities in New York State and its management will be occupied with the integration of SP and its large investment program, the forecasts of credit metrics to the credit agencies is likely to reflect the ratemaking and structural outcome desired by petitioners rather

than a rational assessment of an outcome consistent with established Commission policies and approaches for issues such as vertical market power (VMP) or capital structure. Thus, if the Commission determines that the transaction itself is in need of modification, including the development of a rate plan, to properly protect the public, the expected financial parameters from the transaction may differ from those provided by Iberdrola to the financial community. If the reality of what the Commission decides varies negatively from what the utilities or Iberdrola has told the credit agencies, then a downgrade in credit rating is possible for NYSEG and RG&E.

Third, Iberdrola's massive planned capital program and the company's ever-increasing dividend are two competing sources for funds that put pressure on Iberdrola to raise the dividends from NYSEG and RG&E to levels that may restrict these utilities' ability to provide safe and reliable service.

Q. Can any other important information be gleaned from these S&P's reports?

A. Yes. The S&P credit reports for both NYSEG and RG&E highlight two reasons for a downgrade: the potential Iberdrola acquisition and the recent NYSEG rate case. That the NYSEG rate case appears in both credit reports is telling. In theory, NYSEG's rate case should have no bearing on the credit quality of RG&E. They are two separate entities whose rates, in theory, should have no effect on the other. The fact that S&P appears to consider the effects of the NYSEG ratemaking in an RG&E credit analysis indicates that regardless of whether the acquisition is approved or not, additional structural separations and other financial protections are needed to shield the two subsidiaries from all of their affiliates.

Q. On December 26, 2007 Moody's Investor Services issued credit opinions on NYSEG, RG&E, and Energy East. These reports maintained the companies' outlooks as "negative." Did the

reports explain Moody's position?

A. Yes. The Moody's reports state: "The negative outlooks for EEC and its subsidiaries reflect, in part, the financial and operating challenges resulting from a surprisingly unfavorable decision NYSEG received in its general rate case decided in August 2006. The decision in that case introduced the risk that there could be residual negative financial effects on EEC's other utility subsidiaries in the event that the parent requires an increase in dividends from those companies to compensate for any potential reduction in the levels previously paid by NYSEG. Moreover, there are still lingering questions about whether the NYPSC's August 2007 approval of a modified fixed price option for NYSEG's retail electric customers will provide the impetus for overcoming some of the earnings and cash flow pressures created by the NYPSC's September 2006 decision. The negative outlooks also recognize that while the transaction with Iberdrola is subject to numerous state and some

federal regulatory approvals, it is not uncommon for approvals of this nature to be conditioned upon additional rate concessions. The negative outlooks further consider the uncertainty surrounding the ultimate capital structure of EEC, and the extent to which current dividend policies may be impacted by consummation of the proposed acquisition."

Q. Does the Moody's report indicate that the credit agency has concerns Iberdrola's acquisition of the Energy East companies?

A. Yes. Moody's is concerned about the dividend policy and the capital structure of Energy East under Iberdrola management, as are we. We would be remiss; however, if we did not rebut certain misunderstandings contained in the Moody's report.

Q. Does Staff have any reaction Moody's discussion of the impact of NYSEG's 2006 rate decision in its reports?

A. Yes. We found the finding about NYSEG's rate decision, which applied to the year 2007,

inconsistent with Moody's statement that "although NYSEG's key credit metrics through September 30, 2007 have rebounded from the lower levels evidenced for the year ended December 31, 2006, they remain more in line with the Baa rating category." The Moody's statement is odd because the rates for year ending December 2006 were not addressed in NYSEG's last rate decision; instead, that decision applied to 2007, which Moody's indicated was a "rebound year."

Q. Does Staff have any reaction to Moody's statement that "regulatory decisions in the pending acquisition by Iberdrola that do not impose harsh rate concessions could also lend stability to NYSEG's rating outlook, assuming Iberdrola does not unexpectedly introduce aggressive leveraging into its financing strategies."

A. Yes. The Commission policy on requiring positive benefits for approval of an M&A transaction has been known for a long time. New

York is not a state that has recently applied a "no harm" standard to a major electric and gas M&A transaction. The adjective "harsh" used by Moody's merely recognizes the reality that rate concessions in excess of real merger savings will have a negative impact on credit quality. So there is a natural tension between the need to provide real ratepayer benefits without damaging utility credit quality. Moody's position suggests that to the extent that credit quality is a guiding factor in the merger, rate concessions cannot be implemented without ring fencing and financial protections for ratepayers and the operating utility companies. That is, the Commission should insist on financial transparency, financial protections and ring fencing conditions and rate concessions in lieu of those protections will bring only short term benefit while raising long -term risks.

Q. What are the implications for the investment community in conforming the proposed transaction to established regulatory policies, guidelines

and procedures?

A. It is reasonable to expect that financial experts will assume that the acquisition will contain financial conditions similar to those recently adopted in the Grid/KeySpan merger. The rating agencies possess the experience, knowledge and expertise to evaluate and understand the extent to which utility proposals realistically conform to established Commission policies, guidelines and ratemaking practices, and to inform the investing public of potential uncertainties when utility requests conflict with those policies and practices. As a result, it should not come as a surprise to the investment community, investors, or the Petitioners for that matter, if the Commission takes predictable actions in this proceeding based on established principles related to issues such as merger benefits, vertical market power, capital structure, or financial conditions.

Q. Has the investment community rendered an

assessment on Iberdrola's affect on NYSEG and RG&E?

A. Yes. On November 29th, 2007, NYSEG went to the capital markets and issued debt 225 basis points above 10-year treasuries. This is significant because in the three day period, November 27 through November 29, three companies deemed comparable to NYSEG by the company itself (in a compliance filing in Case 07-M-0891) issued debt that was on average 192 basis points above the 10- year treasury benchmark. Therefore, these companies issued their comparable debt for 33 basis points less than NYSEG obtained in the market. As shown on Exhibit___(PP-19) which is a list of comparable debt issuances prepared by JP Morgan to justify, NYSEG's issuance rate, none of the 19 issuances presented had a spread as high as 225 basis points over 10-year treasuries.

Q. What are the implications for the customers of NYSEG from this issuance?

A. The debt issued by NYSEG was issued at 30 basis

points above its self-described comparable peers. NYSEG issued $200 million of debt in this issuance. This will cost ratepayers $600,000 annually vis-à-vis the average issuance of NYSEG's peers.

Q. The three companies who issued November 27 through November 29; Dominion Resources (Baa2/BBB), Pacific Gas & Electric (Baa1/BBB+) and Southwestern Power (Baa1/BBB), overall actually have an average credit quality less than NYSEG. What reason could be behind the discrepancy in the cost rates between NYSEG and its peers?

A. We believe it is the risk of a potential relationship with Iberdrola that accounts for the discrepancy in the yields. Although NYSEG has a negative outlook for reasons than just the Iberdrola merger, the effects of such a downgrade would likely be about 13 basis points. We base this estimate by interpolating the Moody data for BBB and A rated Long-Term and Intermediate Corporate Bond Yields as shown on

Exhibit___(PP-19). Thus, it appears that there is another factor, and lacking any other reason for this discrepancy between NYSEG's issuance yield and that of its peers, this factor would be appear to be related to the risk of Iberdrola becoming the parent of NYSEG.

Q. Is there a means of protecting ratepayers from the higher issuance costs of NYSEG?

A. Yes. We believe that an imputation of 30 basis points should be made to NYSEG's rates to remove the effects of Iberdrola from the company's cost of debt. Accordingly in the company's cost of debt calculation (discussed later) We have removed $600,000 of interest rate costs.

Q. Please summarize the risks to NYSEG and RG&E arising from this transaction.

A. The risks to NYSEG and RG&E are largely the same risks as described in the preceding section dealing with the risks of Iberdrola as a parent. These risks include the leveraged capital structure and the amount of dividends that NYSEG and RG&E will have to upstream to Iberdrola once

1 the merger is consummated. Notably, these risks
2 are already present in NYSEG's latest cost of
3 debt issuance. More problems in the future can
4 be avoided if the Commission does not approve
5 the transaction.
6 Q. Please summarize the risks to NYSEG and RG&E
7 arising from this transaction.
8 A. The risks to NYSEG and RG&E are largely the same
9 risks as described in the preceding section,
10 dealing with the risks of Iberdrola as a parent.
11 These risks include the leveraged capital
12 structure and the amount of dividends that NYSEG
13 and RG&E will have to upstream to Iberdrola once
14 the merger is consummated. These problems can
15 be avoided if the Commission does not approve
16 the transaction.
17 C. RISKY NATURE OF GOODWILL
18 Q. What is Goodwill?
19 A. Goodwill is an intangible asset. Intangible
20 assets are non-physical in form. Other examples
21 of intangible assets are patents, trademarks,
22 and copyrights. Goodwill shares the common

1 characteristics of all intangible assets: it is
2 difficult to measure and account for.
3 Q. Why is Goodwill difficult to measure and account
4 for?
5 A. Goodwill as a term was originally used to
6 reflect the fact that an ongoing business had
7 some value beyond that of its physical assets,
8 such as the reputation the firm enjoyed with its
9 clients. The accounting sense of Goodwill
10 followed, as an explanation of why a firm that
11 is being acquired sells for more than the value
12 of its net assets.
13 For a regulated utility, Goodwill in
14 financial statements is generated when a company
15 is purchased for more than its book value. The
16 acquiring company must recognize Goodwill as an
17 asset on its financial statements and present it
18 as a separate line item on the balance sheet,
19 according to the current rules for purchase
20 accounting methods. In this sense, Goodwill
21 serves as the balancing sum that allows one firm
22 to provide accounting information regarding its

1 purchase of another firm for a price
2 substantially different from its book value.
3 Q. Please describe the accounting treatment of
4 Goodwill.
5 A. The carrying value of an asset with associated
6 Goodwill is no longer amortized under U.S. GAAP
7 (FAS 142). As of January 1, 2005, it is also no
8 longer amortized under International Accounting
9 Standards. Goodwill can now be removed from the
10 balance sheet only when it is shown that it is
11 "impaired."
12 Instead of deducting the amortization of
13 Goodwill annually over a period of up to 40
14 years, companies are now required to develop a
15 fair value for their reporting units, using the
16 present value of future cash flows, and
17 comparing that to its carrying value (booked
18 value of assets plus Goodwill minus
19 liabilities.) If the fair value is less than
20 carrying value (called impairment), the Goodwill
21 value needs to be reduced so the carrying value
22 is equal to the fair value of the Goodwill. The

1 impairment loss is reported as a separate line
2 item on the income statement, and the new
3 adjusted value of Goodwill is reported on the
4 balance sheet. If Goodwill is impaired and
5 written down, ultimately equity will be reduced
6 by a corresponding net of tax amount. Iberdrola
7 operates under IFRS rules that generally mirror
8 U.S. GAAP treatment of Goodwill.
9 Q. Are there risks posed for a company that has
10 Goodwill on its balance sheet?
11 A. Yes. As described above Goodwill is subject to
12 impairment analyses which are performed
13 annually. To the extent Goodwill on a parent's
14 books is related to the direct or indirect
15 acquisition of a regulated utility, there is a
16 significant chance of Goodwill ultimately being
17 impaired.
18 Q. What is Staff's general position regarding the
19 recording of Goodwill on a regulated utility's
20 books?
21 A. Generally, we oppose recording Goodwill on the
22 books of regulated utilities. We view

1 Iberdrola's promise not to push Goodwill down to
2 NYSEG and RG&E a necessary element to any
3 proposal. However, it must be emphasized that
4 Staff does not view this promised accounting
5 treatment as a benefit of the acquisition. In
6 fact, as discussed above, we view the issues
7 concerning the compounding of Goodwill on
8 Iberdrola's books as a detriment.
9 Q. What is the basis for your opposition to the
10 recognition of Goodwill on a regulated utility's
11 balance sheet?
12 A. Goodwill reflects the value in a utility in
13 excess of the underlying book value of its
14 common equity. However, the Commission is
15 required to set utility prices at levels
16 intended to recover all prudently incurred
17 utility costs including a fair return on
18 investor provided capital. This means that a
19 utility's revenue requirement collects only
20 moneys that are needed to cover a utility's
21 underlying costs.
22 Q. How are the costs associated with utility

1 investments in plant addressed by the ratemaking
2 process?
3 A. Investments in plant are recovered on the basis
4 of their original cost through a return of the
5 investments (depreciation) and a return on the
6 investment (rate of return). When the ownership
7 of rate regulated assets changes as the result
8 of a sale, the amount collected in rates for the
9 assets remains at the original cost rather than,
10 and regardless of, the price paid at the time of
11 the sale. Under this regime, no moneys or cash
12 flows come to the utility that do not already
13 match a cost that has been incurred or is
14 expected to be incurred. Thus, there is no
15 economic basis for reflecting Goodwill from a
16 utility sales transaction if rates are set
17 properly to recover underlying costs. As a
18 result, the recognition by regulated utilities
19 of Goodwill, unsupported by future cash flows,
20 creates a real risk of financial problems when
21 that asset is inevitably deemed impaired and, as
22 a result, written off to common equity.

1 Q. Why is Staff concerned about Goodwill in this
2 proceeding?
3 A. We are concerned by the fact that Iberdrola will
4 likely have over $13.4 billion of Goodwill and
5 other intangible assets on its books after the
6 proposed transaction, an amount that represents
7 approximately 46% of its consolidated common
8 equity book value balance. Approximately $2.9
9 billion of the Goodwill on Iberdrola's balance
10 sheets would be as a result of this M&A
11 transaction.
12 Q. How does Iberdrola propose to treat the $1.4
13 billion difference between the purchase price
14 and Energy East's book value treated for
15 accounting purposes?
16 A. The $1.4 billion difference between Energy
17 East's book value and the amount paid by
18 Iberdrola will be recorded as Goodwill on the
19 asset side of the balance sheet of Iberdrola and
20 its wholly owned affiliates. Iberdrola has
21 asserted that none of this Goodwill will be
22 pushed down to NYSEG and RG&E and that they will

1 not seek recovery of the premium in rates.
2 Q. Iberdrola promises that Goodwill will not be
3 pushed down to the subsidiary level. Does that
4 ease your concerns about the estimated $13.4
5 billion of Goodwill that will be recorded on the
6 consolidated books of Iberdrola after the
7 acquisition is consummated?
8 A. No, whether or not the Goodwill is pushed down,
9 the massive amount of Goodwill recorded on the
10 books of Iberdrola is a major concern affecting
11 whether this acquisition should be approved.
12 Q. Is the impairment of Goodwill related to the
13 acquisition of regulated utilities inevitable
14 for a parent company with regulated utilities
15 operating under a regulatory regime that
16 generally sets cost based rates using the
17 concept of original costs?
18 A. Goodwill impairment is very likely for regulated
19 utilities whose rates are set on an original
20 cost basis. While the temporary sharing of
21 synergy savings may make it possible for
22 utilities to realize free cash flows, these cash

flows are of limited duration. Thus, the eventual impairment of regulated utility Goodwill is must be considered likely.

Q. Why is this significant for Iberdrola?

A. In acquiring Energy East, Iberdrola is essentially acquiring a company that is predominantly a "pipes and wires" company. Thus, virtually all of the company's revenues stem from regulated operations. Thus, it would appear that the Goodwill related to the purchase of Energy East will likely exist for only a relatively short time frame before impairment questions arise.

Q. Are there any circumstances where it might be appropriate to allow Goodwill to be placed on the books of a regulated utility?

A. If appropriately accounted for, it would be reasonable to reflect Goodwill on a regulated utility's books in the situation where an acquisition produced synergy savings and at least some portion of the savings were expected to flow to the utility's shareholders as an

incentive. Under such circumstances, the Goodwill balance would reflect the present value of the after tax future savings amounts.

Q. How should the recognition of Goodwill in this type of situation be treated over time?

A. Ideally, as the shareholders' portion of synergy savings is realized, the Goodwill amount would be reduced to reflect the realization of the cash flows that formed the basis for recognition of the Goodwill.

Q. Does this situation apply to the Iberdrola acquisition of Energy East?

A. No. In its testimony supporting its acquisition of Energy East, Iberdrola has not identified any synergy savings associated with the acquisition and in fact contends that there are none. Without synergy savings, there is no basis for placing Goodwill on NYSEG or RG&E's books.

Q. Why does having a large amount of Goodwill on its balance sheet raise the risk of Iberdrola?

A. Iberdrola's Goodwill is supported by its capital structure. By itself, Goodwill is an intangible

1 value. Thus, the capitalization of the company
2 is supported only by the hard, tangible assets
3 of the Company. As the proportion of Goodwill
4 to total assets grows, the hard assets must work
5 harder and harder to generate a return that not
6 only covers the hard assets themselves, but also
7 earns enough to keep Goodwill from being
8 impaired. At the same time, the value of the
9 acquired hard assets becomes smaller and smaller
10 as they are depreciated. When Goodwill is
11 impaired, it not only requires a write down of
12 Goodwill, but it also produces a charge against
13 earnings that ultimately lowers returned
14 earnings. Thus, as Goodwill increases and as
15 time goes on, the likelihood that the Goodwill
16 can be completely supported grows less and less.
17 Q. What is the significance of any charges to
18 earnings resulting from the write off or write
19 down of Goodwill?
20 A. Any charges to earnings will decrease the
21 retained earnings of a company and will lower
22 the equity ratio of the company. This will

increase the financial risk of the company who has made a charge to its earnings.

Q. Is Iberdrola likely to have to write down its Goodwill?

A. This is difficult to predict. In the short run, a write down of Goodwill seems unlikely. In good times, Iberdrola might be able to support its Goodwill through achieving efficiencies in the operations of its acquired companies; we note that Iberdrola claims those efficiencies are not present in this M&A transaction.

Q. What is the likely effect of the passage of time on Iberdrola's Goodwill?

A. As time passes, eventually all the efficiencies that might be extracted from an acquisition are achieved. Since regulators, and the operation of competitive markets for that matter, are unlikely to continue to allow Iberdrola to recover excess profits, Goodwill can not be supported in the long term.

Further, the passage of time will expose Iberdrola to macroeconomic forces that might

harm the company. A recession or other event limiting its earnings could cause a great deal of harm to Iberdrola. If earnings fall, a series of write downs could follow.

Most troubling is the possibility that an economic downturn might ultimately impede Iberdrola's access to the capital markets. When a business is in trouble, credit agencies, and investors will deduct the Goodwill from any calculation of residual equity because it will likely have no residual value. Currently, Iberdrola's equity ratio would fall to 34% [redacted] (assuming a 33% tax rate) if all of its Goodwill was written off. By S&P's ratings criteria shown as Exhibit __(PP-16 and PP-17), Iberdrola would not even fit the parameters of a BBB rated utility. With a junk bond rating, it is possible Iberdrola's access to capital will be limited. Certainly, any access the Company would have to capital would come at a dear price.

Q. Do you have any other concerns about Goodwill?

A. Yes, firms in energy markets have been consolidating. When Iberdrola acquired Energy East, second generation Goodwill was created. Second generation Goodwill is Goodwill generated by the acquisition of an entity that already has Goodwill on its books. If Iberdrola is acquired at a premium, third generation Goodwill will be created. The end result of this process is that relatively fewer hard assets will have to support relatively more Goodwill. This process is not sustainable in the long run.

Q. Do you have any concerns about Iberdrola's reporting of Goodwill?

A. Yes. In its 3rd Quarter Report, Iberdrola reports that it has $22 billion worth of intangible assets on its balance sheet. These numbers include the Goodwill and intangible assets generated by the SP transaction. However, in its presentation to the credit agencies, Iberdrola reports that it has $13.4 billion of Goodwill and intangible assets pro forma to

2008, with numbers that include the acquisitions of SP and Energy East. We do not believe Iberdrola has misstated its numbers in either case. It is most likely just a difference we do not fully understand under IFRS rules. Be that what it may, it points out the enormous difficulties the Commission would encounter in dealing with Iberdrola if the M&A transaction is approved.

Q. Please summarize the panel's concerns about Iberdrola's Goodwill.

A. Iberdrola's Goodwill is an impediment to its credit quality. Any shortfall in revenues in a given year could cause a write down of the company's Goodwill which ultimately would reduce the company's equity and compel an increase in its debt leverage. Iberdrola's Goodwill and other intangible assets make up 46% of Iberdrola's equity. This represents a sizable risk that should not be placed on the customers of NYSEG and RG&E. It is yet another reason for the Commission not to approve the merger.

D. INADEQUACY OF PRO FORMA CAPITAL STRUCTURE FOR NYSEG AND RG&E.

Q. Have you examined the likely ratemaking capital structure for NYSEG and RG&E after the acquisition is consummated?

A. Yes. We have examined Iberdrola's pro forma consolidated capital structure and made certain adjustments to account for Goodwill and proper financing of Iberdrola's operations other than NYSEG and RG&E to develop a ratemaking capital structure for NYSEG and RG&E.

Q. Please provide instances where the Commission has stated its preference to use the consolidated capital structure of the parent as the appropriate ratemaking capital structure for a utility subsidiary.

A. The Commission declared in Case 28947, Opinion No. 85-15 (issued September 26, 1985), p. 47, "When the utility itself is a subsidiary, as is National Gas Distribution Corporation, it is proper, at least in the first instance, to assume that the parent corporation's cost of

capital is also the subsidiary's because it is the parent that raises capital." Recently, in Case 05-E-1222, New York State Electric & Gas, Order, (issued August 23, 2005), the Commission reiterated its policy of using the parent's capital structure as the basis for setting a utility subsidiary's rates,

"The Commission requires financial separation and insulation for New York subsidiaries for them to obtain ratemaking recognition for their stand-alone capital structure. The record in this case does not show that Energy East has implemented any corporate restrictions or standards to separate NYSEG's capital structure from its own. This lack of separation precludes us from relying on anything other than the consolidated capital structure for ratemaking purposes."

Q. What assets are supported by Iberdrola's consolidated capital structure?

A. Iberdrola's consolidated capital structure shows how all of its subsidiaries and other assets are

1 financed with investor provided capital. After
2 the acquisition, these subsidiaries would not
3 only include Energy East companies, but also
4 many other subsidiaries, such as its
5 "liberalized" operations and regulated business
6 in Spain, its renewable businesses, and SP.
7 Additionally, the company owns smaller interests
8 in unregulated businesses such as gas
9 exploration and production, gas storage, retail
10 electric marketing, and engineering and
11 consulting services. Currently, the overall
12 business operations of Iberdrola carry a
13 business profile rating of 5, a level typical
14 for a vertically integrated utility holding
15 company. Investor provided capital was also
16 used to finance about $13.4 billion of non-
17 earning Goodwill.
18 Q. In Case 28947, the Commission went on to state,
19 "That is not to say, however, that a parent's
20 capitalization would not be adjusted, were we to
21 find that the parent's investments in
22 unregulated subsidiaries required it to build a

capitalization that was less leveraged than the utility subsidiary's stand-alone capitalization needed to be."

Q. What adjustments should the Commission make to Iberdrola's capital structure to ensure that the capital structure of Iberdrola is appropriate for that of a regulated utility company?

A. The Commission uses subsidiary adjustments in developing the appropriate regulated capital structure from the capital structure of a parent company. These adjustments are made to ensure that the non-jurisdictional operations of a holding company are properly supported with a capital structure appropriate for the risks of its operations such that the capital structure of the regulated entity is not subsidizing the costs of the non-regulated operations.

Q. Please describe the mechanics of the subsidiary adjustment.

A. The subsidiary adjustment is performed by subtracting a hypothetical capital structure, in an amount equivalent to the total capital

structure of the non-jurisdictional operations, from the consolidated capital structure of the parent company. In this instance, two subsidiary adjustments would be made to Iberdrola's consolidated capital structure of Iberdrola.

Q. Why are two subsidiary adjustments needed to remove non-regulated operations from Iberdrola's consolidated capitalization?

A. Two subsidiary adjustments are needed because Iberdrola has two classes of non-jurisdictional assets that have significantly different risks. The first class is the non-jurisdictional operations of Iberdrola. The second class of assets is Goodwill. The difference in risk profiles between these two necessitates two separate adjustments to remove the risks of associated with each class of assets from Iberdrola's consolidated capital structure.

Q. How much of Iberdrola's consolidated capitalization supports Goodwill and non-regulated operations?

A. Iberdrola's capitalization supports $13.3 billion of Goodwill and $55.4 billion of non-jurisdictional operations.

Q. What capitalization supports these non-jurisdictional operations?

A. Since Iberdrola carries an A- rating and a business profile of 5 from S&P, it is instructive to look at Exhibit___(PP-16). S&P indicates in "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised" that the appropriate capital structure for a company with a business profile of 5 and a low A rating is composed of 50% equity and 50% debt. Therefore, we will remove Iberdrola non-jurisdictional operations of $55.4 billion from its pro forma capital structure at a rate of 50% equity ($27.7 billion) and 50% debt ($27.7 billion).

Q. Iberdrola's consolidated capital structure includes $13.3 billion of Goodwill on its balance sheet. What approach should the Commission take concerning the inclusion of

1 Goodwill as part of the ratemaking capital
2 structure?
3 A. The Commission should continue its practice of
4 not allowing Goodwill to impact the rates of
5 jurisdictional customers.
6 Q. How should Goodwill be removed from the
7 consolidated capital structure of Iberdrola?
8 A. A second subsidiary adjustment should be used to
9 remove Goodwill from the consolidated
10 capitalization to derive a regulated capital
11 structure for NYSEG and RG&E.
12 Q. What are the implications of the risk of
13 Goodwill for the subsidiary adjustment
14 mechanism?
15 A. Generally speaking, Goodwill is a risky paper
16 asset. In this instance it was booked, at best,
17 in anticipation of shareholders receiving
18 savings or other benefits from an acquisition.
19 At worst, the Goodwill was booked as an
20 accounting convention and shareholders may never
21 receive value for it. If such savings do not
22 appear achievable, the Goodwill becomes impaired

1 and it should be written down to a more
2 realistic level. Goodwill is a particularly
3 risky asset for businesses with regulated
4 affiliates. For Iberdrola to realize the value
5 of the Goodwill on its books it must not only
6 produce savings and benefits consistent with the
7 Goodwill balance, it must also convince its
8 regulators that the savings could not and should
9 not have been generated but for the acquisition
10 and that it is reasonable to flow such benefits
11 to shareholders, rather than ratepayers, for an
12 extended time period. Such an approach may be
13 appropriate in the short run when synergy
14 savings exist; however, actions state regulatory
15 bodies may take to protect ratepayers make such
16 an approach far less certain in the long run.
17 Finally, to the extent that expected cash flows
18 do not support Goodwill, the balance must be
19 written down or written off. Given these
20 uncertainties, it is sound financial policy for
21 utilities to finance these large Goodwill
22 balances very conservatively.

Q. Are there any Commission guidelines as to what capitalization is appropriate for Goodwill?

A. In the past, the Commission has removed unregulated operations from the consolidated capitalization by assuming that these entities were financed with between 60% to 70% equity. These ratios were deemed representative of the typical competitive company.

As noted earlier, we believe that Goodwill carries more risk than that of the typical unregulated business operation. In general, more risky assets require a more conservative capital structure than less risky assets. Given that the Commission has used a ratio of 60% to 70% equity for a competitive business when making subsidiary capital structure adjustments, a higher equity ratio is needed to remove the risks of Goodwill from Iberdrola's consolidated capital structure. Therefore, it is appropriate to remove Goodwill from Iberdrola's consolidated capital structure by using an equity ratio of 75% and a debt ratio of 25%. Iberdrola

1 currently carries $13.4 billion of Goodwill on
2 its books. The subsidiary adjustment removes
3 approximately $10.0 billion from Iberdrola's
4 consolidated equity and approximately $3.3
5 billion from its consolidated long-term debt.
6 Q. What ratemaking capital structure for NYSEG and
7 RG&E is developed after implementing both
8 subsidiary adjustments?
9 A. The ratemaking capital structure after these two
10 adjustments produces an untenable capital
11 structure (it implies a negative equity ratio).
12 These two adjustments show that, after the
13 merger, Iberdrola's pro forma capitalization
14 would be over-leveraged. There is not enough
15 equity to adequately support an A3 rating for
16 Iberdrola's current operating assets, its
17 Goodwill and the operating assets of Energy
18 East.
19 Q. What are the implications of the ratemaking
20 capitalization?
21 A. Simply put, the ratemaking capital structure for
22 NYSEG and RG&E that would be developed through

1 subsidiary adjustments to Iberdrola's capital
2 structure is unacceptable. Therefore, a
3 hypothetical calculation would have to be used.
4 The subsidiary adjustments expose the depth and
5 breadth of the risks attending Iberdrola's
6 overall capitalization. The Commission assures
7 just and reasonable rates through the subsidiary
8 adjustment process by assuming that non-
9 jurisdictional operations are not being
10 subsidized by the capital structure of the
11 jurisdictional companies. As this calculation
12 shows, the Iberdrola's leverage, exacerbated by
13 its Goodwill position, precludes making the
14 otherwise-applicable adjustment because it would
15 produce an untenable ratemaking capital
16 structure.
17 Q. Please comment of the use of a hypothetical
18 ratemaking capital structure for NYSEG and RG&E.
19 A. If the merger had already occurred and the
20 utilities were filing for rates the Commission
21 would have no choice but to allow a capital
22 structure that would enable Iberdrola to benefit

1 from the regulated operations of NYSEG and RG&E
2 to the detriment of the utilities' customers.
3 This scenario can be avoided if the Commission
4 not approve this transaction.
5 Q. Please summarize the ratemaking risks posed by
6 Iberdrola's pro forma consolidated
7 capitalization after the merger is consummated.
8 A. Simply put, the pro forma consolidated capital
9 structure of Iberdrola is too leveraged given
10 the business profiles of its operations. The
11 burden of supporting this aggressive capital
12 structure would fall squarely onto the shoulders
13 of the ratepayers of NYSEG, RG&E and the rest of
14 the Energy East utilities. It is one on the
15 many reasons why the Commission should reject
16 this transaction.
17 E. RATEMAKING CAPITAL STRUCTURE RISKS
18 Q. Does the acquisition of Energy East by Iberdrola
19 change the corporate incentives to thicken the
20 utilities' accounting equity ratios?
21 A. Yes. Iberdrola has much greater levels of
22 competitive business interests and Goodwill than

1 Energy East. The incentives to shift capital
2 costs to regulated businesses via the equity
3 ratio to support competitive businesses and
4 Goodwill would be exacerbated. Iberdrola would
5 see a significant incentive to support the use
6 of a stand alone capital structure, which would
7 result in ratepayers supporting a level of
8 credit quality that is not achievable.
9 Q. How does this occur?
10 A. Based upon data presented in NYSEG and RG&E 2006
11 Annual Report to the Commission, setting rates
12 on a stand alone basis would rely upon equity
13 ratios of 48% and 46% for NYSEG and RG&E,
14 respectively. Based upon S&P and Moody's
15 guidelines already discussed, this level of
16 equity ratio implies a strong A bond rating for
17 a low risk T&D utility. However, the rating
18 agencies do not, absent ring-fencing provisions,
19 isolate the credit quality of utility
20 subsidiaries from the utility holding company's
21 overall credit quality. Because Iberdrola's
22 credit quality is adversely affected by its

1 increase in debt leverage and ongoing ambitious
2 investment program, NYSEG and RG&E cannot obtain
3 the strong A rating implied by their respective
4 equity ratios. Thus, NYSEG and RG&E would
5 charge customers rates based on implied equity
6 ratios and credit quality that are not
7 obtainable.
8 Q. Is it possible to illustrate the effect on
9 customers and shareholders of Iberdrola's
10 proposal to earn a return on stand alone equity
11 that is not supported by equity on the
12 consolidated level?
13 A. Yes, although Iberdrola's extreme use of
14 leverage necessarily makes the example's results
15 quite extreme. Assume that the costs of equity
16 and debt for Iberdrola of 9% and 6%,
17 respectively, and a tax rate of 40%. The pre-
18 tax equity return is 15% (9%/(1-40%)). This
19 return reflects the amount of revenues needed to
20 provide the assumed 9% return after taxes are
21 paid. We also know that the capitalizations of
22 NYSEG and RG&E are $2.2 billion and $1.3

billion, respectively as of December 31, 2006. Finally, Exhibit___(PP-14) shows that the pro forma capital structure of Iberdrola adjusted for the removal of its non-regulated investments and Goodwill supports the operations of NYSEG and RG&E entirely with debt if its non-jurisdictional operations are properly capitalized. Thus, 46% of the capital structure of NYSEG and 48% of the capital structure of RG&E representing stand alone equity actually would be equity supported by debt at the consolidated level. Multiplying the 15% pre-tax return by approximately $1.012 billion million of "debt supported equity" for NYSEG produces $152 million in revenue requirement. Multiplying the 15% pre-tax return by approximately $624 million of "debt supported equity" for RG&E produces $94 million in revenue requirement. Thus, NYSEG and RG&E ratepayers would pay a total of $246 million in rates for this portion of equity if ratemaking is set on a stand alone capital structure. This revenue

1 amount is needed to pay the 9% return on the
2 "equity" and cover income taxes.
3 By contrast, because Iberdrola would use
4 debt to support this equity, the amount it must
5 pay investors to cover its actual financing cost
6 for this equity is $61 million for NYSEG ($1.012
7 billion of debt times the 6% interest rate) and
8 $37 million for NYSEG ($624 million of debt
9 times the 6% interest rate). Together these
10 amounts show that ratepayers would pay $148
11 million annually over and above Iberdrola's
12 actual financing cost in their rates ($246
13 million-$98 million) if stand alone capital
14 structures are employed. The $148 million of
15 excess revenue requirement translates into $87
16 million of excess profits after taxes ($148
17 million *(1-40%)). Thus, rates set on a stand
18 alone capitalization for NYSEG and RG&E would
19 far overstate the actual financing costs of
20 Iberdrola.
21 Q. Please summarize the capital structure
22 ratemaking risks posed by transaction.

A. If the transaction is approved, it would provide Iberdrola an incentive to thicken the equity ratio of NYSEG and RG&E and maintain an aggressive consolidated capital structure. In this way, if it could persuade the Commission that a stand alone ratio is acceptable, NYSEG and RG&E would return excess profits to the Iberdrola parent. This is just one more reason why the acquisition should not be approved.

F. FINANCIAL TRANSPARENCY AND REPORTING

Q. Do you have concerns about the financial transparency and reporting issues that arise from this acquisition?

A. Yes. After the acquisition has been consummated, Energy East will no longer be a registrant under the jurisdiction of the SEC. As a result, it will no longer be required to file SEC reports, such as Form 10-K, or an annual report to the SEC. This is because once the acquisition is closed, Energy East will become a subsidiary of Iberdrola.

Q. Will Iberdrola be required to file an annual

1 report with the SEC?

2 A. It is our understanding that Iberdrola is not

3 required to file an annual report with the SEC.

4 Thus, the three major sources of information

5 (SEC Form U-5S, portions of SEC Form U-9C-3, and

6 Form 10-K) regarding the capitalization of the

7 parents of NYSEG and RG&E will no longer exist.

8 Q. Why is it significant that the SEC Form 10-K

9 data will no longer be available?

10 A. While the utility subsidiary financial

11 information presented in Form 10-K is only a

12 limited picture of the manner in which a company

13 finances its various operations, the report

14 contains information on many other financial and

15 accounting matters that are valuable to

16 investors and regulators alike.

17 Q. Are any there any other factors that limit the

18 transparency of Energy East's financial

19 statements and pose difficulties for their

20 review?

21 A. Yes. The Energy Policy Act of 2005 repealed the

22 Public Utility Holding Company Act of 1935 and

replaced it with the Public Utility Holding Company Act of 2005. The new law transfers responsibility for reviewing holding company activities from the SEC to FERC. Many of the utility holding company financial statements that were required by the SEC no longer need to be filed including SEC Form U-5S and portions of SEC Form U-9C-3.

Q. What information was contained in SEC Form U-5S and SEC Form U-9C-3?

A. SEC Form U-5S presented the consolidating balance sheet of the parent company and the capitalization ratios of the parent company's direct subsidiaries. This balance sheet showed the extent to which capital reported by a subsidiary as common equity is eliminated at the consolidated holding company level because it is actually funded with some other form of holding company capital such as debt or preferred stock. SEC Form U-9C-3 contained balance sheets for each of Energy East utility and non-regulated energy subsidiaries. These balance sheets are

no longer required in this quarterly filing.

Q. What is the significance of these financial statements?

A. Staff used this information to analyze whether the equity ratio requested by utility subsidiaries of holding companies should be adjusted. This analysis is based on three considerations.

Q. What is the first consideration?

A. It necessary to determine if the common equity balance requested by the utility subsidiary is actually financed by debt issued at another level within the holding company. This is an important consideration for NYSEG and RG&E because failure to adjust for such fictitious equity will produce windfall profits within the holding company. Staff would not have sufficient capital structure information for all of the relevant Iberdrola business entities to reach a conclusion on this issue. In the last NYSEG rate case, Energy East refused to provide such information to Staff. In future rate

cases, we are doubtful Iberdrola would be any more forthcoming with the information than Energy East has been in the past since Iberdrola has stated it will not interfere with local management and indicated that most of the Energy East management will remain in place after the M&A transaction closes. Also, it is not clear that comparable financial information will be available under IFRS.

Q. What is the second consideration?

A. It is necessary to determine if the common equity ratio requested by the utility subsidiary is consistent with the ratios of other utility subsidiaries of the holding company. For example, it would be unreasonable to set the rate of return of a New York subsidiary based on a stand-alone equity ratio when the ratios of other utility subsidiaries were substantially lower. In those circumstances, ratepayers in New York would make a disproportionately larger contribution to the holding company's overall earnings than ratepayers in other jurisdictions.

Staff would not have sufficient capital structure information for all of the relevant Iberdrola business entities, including the parent, to reach a conclusion.

Q. What is the third consideration?

A. It is necessary to consider the sources of the financing the holding company and other affiliates use to support their non-utility investments. Such investments typically entail greater risk than utility operations and therefore require greater amounts of common equity to properly serve as a buffer for the earnings volatility that comes with greater risk. As discussed above, Iberdrola has large investments in unregulated business ventures and has recorded on its books Goodwill in a magnitude that is risky. These assets must be financed with the proper mix of debt and equity. Staff would not have sufficient capital structure information for all of the relevant Energy East business entities to reach a conclusion.

Q. Are there any other barriers to obtaining transparent financial information?

A. Yes. As discussed above, despite some convergence in recent years between IFRS, governing Iberdrola and GAAP, used in the U.S., significant differences remain. With differences in reporting standards, the potential exists for the misinterpretation of Iberdrola's financial statements. Finally, the number and scope of Iberdrola's unregulated subsidiaries and the complexity of its organizational structure make it difficult to accurately evaluate its the financial strength and capitalization. Included within Iberdrola's corporate structure are numerous Special Purpose Entities (SPEs), which can cloak the true financial position of a utility holding company. SPEs are subsidiaries that are created to fulfill narrow, specific or temporary objectives, primarily to isolate financial risk, usually the potential for bankruptcy, but sometimes a specific taxation or regulatory

1 risk.

2 Q. Does Iberdrola's use of SPEs concern the panel?

3 A. We have some general concerns with Iberdrola's

4 use of these entities. The history of SPEs is

5 troubling. They have been used in the past by

6 companies like Enron in complex financial

7 schemes to avoid taxes and manipulate financial

8 results. However, we have not discovered any

9 information that would lead us to believe

10 Iberdrola is engaged in any, and, since the

11 Enron collapse, U.S. regulators, under SOX, have

12 become more vigilant. Moreover, under both GAAP

13 and IFRS, a number of accounting standards apply

14 to SPEs that set out the consolidation treatment

15 of these entities.

16 Q. Does tighter oversight by regulators make you

17 comfortable with the preponderance of SPEs in

18 Iberdrola's corporate structure?

19 A. Not entirely. The presence of SPEs lends a

20 complexity to Iberdrola's operations that

21 potentially could make ratemaking difficult. We

22 are still not completely sure of how Iberdrola's

SPEs are treated under IFRS. However, we are assured by Iberdrola that all the debt associated with its SPEs is non-recourse debt and that this debt is reflected in the consolidated statements of the company. Thus, our concerns that Iberdrola might be significantly more leveraged than their financial statements would indicate are mitigated. Additionally, on the positive side, the SPE structure can be employed to shield other affiliates from bankruptcy. However, if enough SPEs owned by an entity go bankrupt as a result of the aggressive financing, it follows that the credit of the parent will suffer accordingly.

Q. You indicated that the enactment of SOX has lead to vigilance over financial misconduct. Describe the controls that currently exist under SOX.

A. The officers of Energy East are currently required to attest, in periodic statutory financial reports, that: 1) the signing officers

1 have reviewed the report; 2) the report does not
2 contain any material untrue statements or
3 material omissions that could be considered
4 misleading; 3) the financial statements and
5 related information fairly present the financial
6 condition and the results in all material
7 respects; 4) the signing officers are
8 responsible for internal controls and have
9 evaluated these internal controls within the
10 previous ninety days and have reported on their
11 findings; 5) a list of all deficiencies in the
12 internal controls and information on any fraud
13 that involves employees who are involved with
14 internal activities; and 6) any significant
15 changes in internal controls or related factors
16 that could have a negative impact on the
17 internal controls.
18 Q. Will SOX continue to apply after the acquisition
19 by Iberdrola?
20 A. While SOX currently applies to Energy East, it
21 is our understanding that SOX will not apply
22 after the M&A transaction. This will lead to a

reduction in control and oversight.

Q. What are the implications?

A. There may be a reduction of internal controls and regulatory oversight due to the loss of SOX protections. Since ratepayers s have already funded the costs of SOX compliance in rates, the utilities will keep those amounts until rates are re-set, even though SOX protections will no longer be available.

Q. Please summarize your concerns about financial transparency and reporting if the transaction is approved.

A. We are concerned that there will be a significant reduction in the Commission's ability to acquire a complete picture of Iberdrola's operations because of the company's status as a foreign holding company operating under IFRS rules and the repeal of the Public Utility Holding Company Act of 1935. These corporate transparency and reporting concerns are yet another reason why approval of the transaction would not be in the public interest.

1 G. CORPORATE INCENTIVES WILL CHANGE

2 Q. Please describe Energy East's current operating
3 environment.
4 A. Currently, the Energy East companies are located
5 in the northeast United States and are primarily
6 engaged in regulated utility distribution
7 businesses. The New York utilities make up a
8 substantial part of the Energy East, whose
9 service and holding companies provide services
10 to the utilities. Cost shifting between these
11 regulated businesses and service companies
12 generally should not result in any long-term
13 advantage to Energy East as cost increases to
14 one regulated business will result in cost
15 reductions in another regulated business.
16 Q. Explain how corporate incentives will change
17 after the M&A transaction.
18 A. Iberdrola has many competitive business
19 ventures. When competitive businesses enter the
20 mix, there are real advantages to cost shifting
21 from competitive to regulated businesses. This
22 is known as "cross subsidization." Competitive

1 businesses are price takers, and any shift of
2 costs to regulated businesses that are
3 undetected by regulators translate directly into
4 shareholders profits or management bonuses.
5 Q. Given your familiarity with the current Energy
6 East organization, please compare and contrast
7 Iberdrola to Energy East.
8 A. Energy East owns regulated T&D companies in the
9 northeast U.S., together with management and
10 service companies that provide services
11 primarily to the regulated utilities. While it
12 has some non-regulated energy businesses
13 (primarily energy services and generation),
14 those are very small in relationship to Energy
15 East as a whole. On the other hand, Iberdrola
16 is vastly larger in size, scale, and scope, and,
17 significantly, its non-regulated operations make
18 up a much larger proportion of its holdings.
19 Q. As regulators with over 100 years of combined
20 experience, what does this suggest to you?
21 A. Putting the language and international
22 accounting differences aside, the size, scope,

1 scale, and scope of Iberdrola's non-regulated
2 businesses poses real and potential concerns.
3 Most significantly, the incentive to cross-
4 subsidize non-regulated businesses is a real
5 concern.
6 Q. Did these concerns exist in the Energy East
7 structure?
8 A. Yes, but there was not nearly as much
9 opportunity for Energy East to engage in cross-
10 subsidization because the vast majority of its
11 operations were regulated, domestic utilities.
12 Energy East mainly held regulated businesses in
13 a much simpler, and, at least initially,
14 transparent corporate structure. That will not
15 be the case with Iberdrola. Iberdrola holds
16 vastly more interests in both domestic and
17 foreign non-regulated businesses. These
18 enhanced incentives for Iberdrola puts greater
19 risks on customers and is another reason why the
20 Commission should not approve this transaction.
21 H. BURDENS/RISKS ON REGULATORS AND CUSTOMERS
22 Q. Are there any other risks and burdens associated

with Iberdrola's ownership of competitive businesses?

A. Yes. Iberdrola's ownership of competitive unregulated subsidiaries presents tremendous risks and burdens.

Q. Can you explain the risks and burdens placed upon the Staff due to Iberdrola's ownership of competitive businesses?

A. Yes. As discussed above, Iberdrola has claimed that much of the relevant information requested by Staff is trade secret due to its "competitive" interests in Europe. If and when Staff receives this relevant information, subject to protective agreements, Staff is placed in a position to guard the information, and disclosure to other parties is sometimes limited. This isolates Staff from interacting with other parties on important issues. It also restricts the public from participating fully in litigated proceedings, when the handling of trade secret information is particularly burdensome. Even with the limitations on

1 confidentiality proposed above, Iberdrola's
2 extensive unregulated operations and reliance on
3 circumstances in Europe will make
4 confidentiality a burdensome and constant
5 concern.
6 Q. Are holding companies that own utility
7 subsidiaries operating in New York subject to
8 the same level of Commission review as their New
9 York utility subsidiaries?
10 A. No, under New York law, the Commission does not
11 have the same level of authority to review and
12 approve the actions of the holding company. For
13 example, the Commission does not have the
14 authority to directly consider and approve
15 holding company security issuances, holding
16 company expansions into unregulated operations
17 or holding company acquisitions of entities not
18 subject to Commission regulation.
19 Q. Are these areas in which actions of the holding
20 company might conflict with the Commission's
21 responsibility of assuring safe and adequate
22 service at a reasonable price?

A. Yes. The holding company is primarily motivated to provide earnings to its shareholders. This motivation can conflict with the utility subsidiaries'' obligation to provide safe and adequate service at just and reasonable rates. For example, if operating and maintenance expenses are cut at the subsidiaries to increase holding company profits, safe and adequate service by the utility might be compromised.

Q. To what extent can the Commission influence the actions and behaviors of a holding company if the Commission perceives that the holding company is not acting in the best interests of New York State ratepayers?

A. The Commission can indirectly influence the behavior of holding companies through its regulation of the utility subsidiaries that operate within New York State. Financial signals created by Commission actions in rate cases and other proceedings may influence holding company business and financial decisions.

Q. Under what circumstances are the actions of the

Commission likely to have a greater impact on holding company behavior?

A. Commission actions are likely to have a greater impact in those situations where New York utility operations represent a substantial part of the holding company's consolidated operations.

Q. Under what circumstances are the actions of the Commission likely to have less of an impact on holding company behavior?

A. Commission actions are likely to have less of an impact in those situations where New York utility operations represent a small part of the holding company's consolidated operations.

Q. How large are NYSEG and RG&E relative to Energy East?

A. According to the December 31, 2006 Annual Reports to the Commission by NYSEG and RG&E, the capital structures for these companies are composed of $2.2 billion and $1.3 billion of capital, respectively. Based on data provided in Energy East's 2006 Annual Report to

Shareholders, its consolidated total of long and short term debt and common stock was approximately $6.6 billion. Thus, the combined NYSEG and RG&E capitalization of $3.5 billion represents 53% of Energy East's total capital. Energy East's capitalization also supports about $1.5 billion of Goodwill, leaving only $1.6 billion in other businesses. It is clear that NYSEG and RG&E together represent a significant portion of Energy East's business.

Q. How does the combined size of NYSEG and RG&E compare to Iberdrola?

A. Iberdrola's most recent Quarterly Report for the nine months ending September 30, 2007 presents the consolidated capital structure of the Company. If one uses the current 1.45 ratio of dollars to Euros, the total consolidated Iberdrola capital structure becomes $79.5 billion. Thus, NYSEG and RG&E would represent 9% of Iberdrola's total business. This represents a substantial diminishment in the size of NYSEG and RG&E relative to their holding

company parent.

Q. What is the significance of this information?

A. The proposed transaction will limit the Commission's ability to influence the actions of NYSEG and RG&E's holding company parent in order to ensure that the interests of New Yorkers are protected, adding one more reason for finding that the proposed transaction is not in the public interest.

I. ACCESS TO BOOKS IS NOT SUFFICIENT

Q. Have the Petitioners' commitments on access to books and records assuaged your concerns?

A. No. The petitioner's pledge (page 17) to use the same accounting and allocation methods currently in place and allow Staff access to the utility books and records do not address the perverse incentives inherent in Iberdrola's mix of regulated and non-regulated businesses. If this transaction is approved, Staff will confront many obstacles in trying to detect and eliminate cross-subsidization.

J. CODE OF CONDUCT IS NOT INFALLIBLE

Q. Are you aware of any other risks or concerns?

A. Yes. As noted above Staff had concerns with Response IBER-0013 to DPS-13 regarding the contracts between the utilities and Community Energy; that relationship causes concern.

Q. Explain the relationship between Community Energy, Iberdrola, and the utilities.

A. From various sources of information, we were able to find that the utilities and Community Energy had renewable energy marketing contracts [redacted]. These contracts [redacted] In August 2006, Iberdrola and Energy East started having conversations concerning the acquisition. The [redacted] contracts with the utilities were [redacted] The contracts between Community Energy and the utilities, which the Petitioners admit remain in effect, restrict the utilities from marketing non-Community Energy renewable energy to customers (see Article 4.2

(iii) which states "NYSEG shall not market Renewable Energy Attributes to NYSEG customers except as provided in this agreement." In February 5, 2006, Iberdrola issued a press release indicating that it acquired 100% of Community Energy.

Q. Does [redacted] raise any issues or concerns?

A. Absolutely. We found that on July 13, 2007, [redacted], Energy East notified FERC that it was going to "treat Iberdrola and its subsidiaries as affiliates for Code of Conduct and Standards of Conduct purposes." However, in spite of that July 13, 2007 notice, the contracts remain in effect, and, [redacted] Through these arrangements Community Energy, a competitive affiliate deemed an affiliate of RG&E and NYSEG in a notice to FERC, has the exclusive ability to market renewable energy in the RG&E and NYSEG service territories. As a result, a distinct

preference was given to Community Energy.

Q. Explain why this causes concern.

A. This exclusive marketing agreement presents some stark examples of a number of violations of RG&E's and NYSEG's codes of conduct which prohibit:

- The provision of sales leads,
- The promotion of an affiliate,
- The giving of preferential terms to an affiliate.

Q. What kind of impact could this have on the renewables business in New York?

A. [redacted], the Iberdrola companies could use affiliate relationships to gain a distinct competitive advantage over other developers in the marketing of their wind power in NYSEG's and RG&E's service territories. This could retard wind power development, which harms New York's interests in meeting renewables goals.

RECOMMENDED ALTERNATIVE TERMS AND CONDITIONS

Q. What is Staff's overall recommendation in this

proceeding?

A. For all the reasons above, we recommend that the Commission find that the proposed acquisition of Energy East by Iberdrola is, as filed, not in the public interest and, therefore, that it deny Petitioner's request for approval of the transaction.

Q. Can Staff outline some essential conditions that might attach to any approval that the Commission provides for the transaction?

A. We would establish conditions addressing the quality and reliability of service, vertical market power issues, and various accounting, financial and ratemaking aspects of the proposed filing.

A. TANGIBLE BENEFITS CAN BE ACHIEVED

Q. What is the first proposed condition?

A. To establish positive tangible benefits, the petitioners could amend their current rate plans. As Witnesses Benedict/Haslinger demonstrate, the utilities are earning in excess of what is currently considered a reasonable

ROE. In addition, RG&E's commodity profits are excessive. Those facts in themselves suggest the need to reduce delivery and commodity rates immediately. In addition, the utilities are deferring costs for future recovery in rates and are drawing down reserve funds which will have to be funded in future rates.

Q. What other conditions should be established?

A. The existing rate plans should be further modified to ameliorate the potential for increased risk to electric system and gas system reliability. Additional changes are also needed to ensure that gas system safety and customer service quality are maintained going forward.

Q. Should the utilities rates be reduced immediately?

A. In the short-term, yes. However, rate reductions without corresponding reductions in future costs will almost certainly lead to unpredictable rates in the long-term. It is Staff's preference that the petitioners provide significant tangible cost reductions to ensure

long-term rate stability.

Q. How can the utilities achieve tangible reductions in their costs of providing utility service?

A. The utilities can provide cost reductions by adjusting regulatory assets and reserves, which Mssrs. Haslinger and Benedict refer to as positive benefits adjustments (PBAs).

Q. The Petitioners claim that Iberdrola's purchase of Energy East is a simple upstream M&A transaction. What is the justification for reviewing the utilities rates and recommending adjustments in this proceeding?

A. First, Staff finds it difficult in the context of the over $1.6 billion in merger benefits to the companies and others (see Exhibit___PP-20) to overlook the fact that the utilities rates are excessive. Also, almost all major M&A proceedings in New York have been accompanied by rate concessions. Finally, adjustments to books are a common occurrence when a company is acquired. In this case, Iberdrola is going to

make significant adjustments to its books upon the closing of the transaction.

Q. Will the cost reductions you recommend harm the utilities finances, which in turn could threaten safe and reliable service and cause layoffs?

A. No. For the most part, Staff is recommending that the utilities adjust paper assets. These adjustments to non-cash assets should not impact the utilities' current cash flows. There would be no long-term impairment of the utilities finances, so the recommended adjustments would not threaten service quality or cause layoffs.

Q. Summarize the adjustments that Staff proposes.

A. Staff proposes $387 million of PBA adjustments (after taxes) to NYSEG and RG&E in the areas of deferred costs and reserves. These adjustments were provided by Witness Benedict/Haslinger.

Q. Has Staff evaluated the reasonableness of the level of PBAs it recommended?

A. Yes. Overall, the PBAs proposed by Staff are reasonable. Since the Petitioners' have alleged that there are no merger synergies, the PBAs are

a reasonable substitute for such synergies, which are typically found in M&A transaction proceedings.

Q. How has Staff evaluated the reasonableness of its proposed PBAs?

A. We performed three types of comparisons. First, we looked at the sharing of merger benefits. In most recent cases (RGS/Energy East, Grid/KeySpan), merger savings were shared 50%/50%. In this case, that the overall benefits exceed $1.6 billion. 50% of that amount would yield approximately $800 million.

Q. What is the next comparison?

A. We looked at asset sales. Typically, when a utility sells an asset at a gain, the gain is shared. The instant case is comparable in that Energy East is essentially selling all of its assets to Iberdrola. In the Ginna transaction, RG&E's most recent asset sale, customers received over 95% of the gain on that sale. If that percentage were applied to the $1.6 billion of net benefits, an amount of $1.5 billion would

result.

Q. What is the third comparison?

A. Staff reviewed recent M&A cases to determine the relative levels of savings imputed in rates. For example, in the RGS/Energy East acquisition, synergy benefits captured for customers represented about 6% of the companies' delivery revenues. In the recent Grid/KeySpan merger, synergy benefits captured for customers represented about 10% of the companies' delivery revenues. The positive benefits proposals made by Staff in this case would represent about 11% of delivery revenues on an equivalent basis (see Revised Exhibit___(PP-21).

Q. Are there any factors which distinguish the savings in the prior acquisitions from the instant proceeding?

A. Yes. In the prior acquisitions we cited, the savings are expected to be permanent. In other words, the savings due to synergies would continue as they would become embedded in the utilities rates. In the instant proceeding, the

1 approach that Staff used would yield one-time
2 positive benefits. In effect, the comparisons
3 above are highly conservative as the synergies
4 produced in the other transactions will continue
5 but the one-time positive benefits produced in
6 this transaction will not.
7 Q. How will the PBA adjustments impact NYSEG and
8 RG&E rates?
9 A. They will result in an immediate reduction in
10 expenses and rate base. This will reduce the
11 companies cost of providing service. The lower
12 cost of providing service could be used to
13 enable rate reductions or provide for longer
14 term rate stability.
15 Q. Has Staff forecast the level of NYSEG's and
16 RG&E's post-PBA rates and returns on equity?
17 A. No. The petition filed by the companies did not
18 include financial forecast data which would have
19 enabled such a forecast.
20 Q. How can the Commission evaluate the impact of
21 Staff's PBAs on NYSEG's and RG&E's rates?
22 A. We recommend that, if the Commission decides to

1 approve the M&A transaction, notwithstanding
2 Staff's many objections, it should also adopt
3 Staff's PBA proposals as a condition of
4 approval, and require that a second step of this
5 proceeding be immediately commenced to evaluate
6 the impact of the PBAs on NYSEG and RG&E's
7 future electric and gas rates. That stage
8 should examine the level of future rates
9 effective on January 1, 2009 and it should take
10 into account the reductions in expenses and rate
11 base associated with the PBAs, changes in
12 earnings sharing proposals, RDMs, and AMI. This
13 concept is similar to the approach taken in the
14 Grid/KeySpan proceeding.
15 Q. What other modifications would you make to the
16 RG&E and NYSEG rate plans?
17 A. The rate plans require modification in the areas
18 of earnings sharing, uncontrollable costs as
19 well as enhanced customer and system reliability
20 measures to ensure companies continued
21 investment in infrastructure to maintain and
22 improve system reliability and safety. In

1 addition, the safety, reliability and service
2 quality provisions require modification to
3 ensure the companies continue to perform
4 adequately in those crucial areas.
5 Q. Summarize the modifications to maintain and
6 improve system reliability and safety. The
7 Electric Reliability Panel presents electric
8 reliability matrices to minimize service outages
9 and Witness Dickens and the Gas Rates Panel
10 present proposals to ensure the continuation of
11 electric and gas infrastructure work, to
12 eliminate a gas commodity incentive proposal and
13 propose the adoption of rate design changes that
14 will help to promote electric and gas energy
15 efficiency.
16 The Gas Safety Panel present necessary changes
17 to gas safety performance matrices for the
18 replacement of leak-prone gas facilities and
19 establish incentives to enhance the number of
20 gas leaks repaired and improve the response time
21 to potentially dangerous conditions.
22 The Consumer Service Panel addresses issues

related to low income customer protections and customer service enhancements should the merger be approved.

B. FINANCIAL PROTECTIONS ARE REQUIRED

Q. Can Staff conceive of financial conditions under which Iberdrola's acquisition of Energy East might proceed?

A. Staff is skeptical that the aggressive leverage employed by Iberdrola and the large amount of Goodwill on its books can be overcome sufficiently by ring fencing the subsidiaries. However, if the public interest is somehow satisfied by benefits that have not yet been presented by the Petitioners, Staff might not oppose the acquisition of Energy East, if substantial ring fencing covenants were provided for. Those provisions would protect the interests of New Yorkers by assuring that both NYSEG and RG&E are in a position to provide safe and adequate service at a reasonable price to the public. We address below the financial covenants that could serve as conditions under

which the transaction could be approved.

Q. Generally describe the financial covenants that Staff would extend to the proposed transaction.

A. We would establish conditions addressing the various accounting, financial and ratemaking aspects of the proposed filing consistent with the recent Grid/KeySpan merger.

Q. Iberdrola claims that its financial strength and credit rating are reasons sufficient to justify approval of the M&A transaction. Is Iberdrola's financial strength more favorable than National Grid's financial strength and credit rating and if so are the covenants approved in the Grid/KeySpan merger applicable to Iberdrola?

A. Before we answer that question, it must be emphasized that the financial protections applied in the Grid/KeySpan merger are generic in nature and would be applied regardless of the acquirer. As to this transaction, Iberdrola's bond rating has already been downgraded by S&P and it now has the same bond rating as National Grid from that credit agency. Moody's rates

Iberdrola (A3) slightly higher than National Grid (Baa1). Notwithstanding these credit ratings, we also conclude that Iberdrola's financial and business risks are greater than National Grid's. Iberdrola has a highly leveraged capital structure given its asset base. Its balance sheet will carry the Goodwill and intangible assets discussed above (46% of its equity balance if the acquisition is consummated). The percentage of its business devoted to non-regulated operations is much greater than National Grid's. Therefore, we believe the financial covenants adopted in the Grid/KeySpan merger are equally applicable to the Iberdrola acquisition.

Q. Are the concerns expressed in this proceeding and in the Grid/KeySpan merger typical of concerns these types of transactions raise?

A. Yes. In a National Regulatory Research Institute article (attached as Exhibit___(PP-22), "Private Equity Buyouts of Public Utilities: Preparation for Regulators" by

1 Stephen G. Hill, the author explains concerns
2 that regulators around the country have about
3 utility mergers. The author states at page 21
4 that, "the overriding public interest in any
5 change of corporate control of a public utility
6 is the continued provision over the long term of
7 reliable utility service at the lowest
8 reasonable cost. That public interest includes,
9 of course, the ability of the company to provide
10 investors their cost of capital and, thereby, to
11 be able to attract the capital necessary to
12 maintain the present utility infrastructure
13 build that needed in the future."
14 The author goes on to say at page 21 that
15 "There are aspects of a change in ownership of a
16 utility operation by merger or acquisition that
17 could negatively affect that defined public
18 interest. If the new company operates less
19 efficiently, at current or higher cost, is
20 forced to sell necessary assets to buy down
21 acquisition debt, installs management unfamiliar
22 with a regulatory environment, compensates that

1 management based on performance criteria
2 inconsistent with the utility's public service
3 function, or cuts costs in areas necessary for
4 the maintenance of and improvement its service
5 quality, utility customers would be
6 disadvantaged. Also, if the change of control is
7 able to effect substantial cost savings, and
8 those cost savings are not passed on to
9 customers, regulatory legal obligations are not
10 being realized because utility service is not
11 being provided at the lowest reasonable cost."
12 ` These are all concerns we seek to address
13 in proposing conditions to approval of M&A
14 transactions.
15 Q. Does this article offer advice on the conditions
16 regulators should impose when approving a buyout
17 of a utility?
18 A. The author recommends that regulators limit the
19 leverage involved in the acquisition
20 transaction, maintain the utility as a separate
21 subsidiary with separate books and records and a
22 separate bond rating, disallow any debt

1 guarantees by the utility, employ a single
2 purpose entity to prevent parent-induced
3 bankruptcy of the utility, monitor cash flow
4 transactions between the utility and its
5 affiliates, restrict participation in a
6 corporate money pool unless it can be
7 demonstrated that such participation results in
8 lower borrowing costs that the utility would
9 have on a stand alone basis, determine the
10 regulatory treatment of the company's
11 consolidated debt and taxes, monitor the
12 utility's resource plans, and monitor its
13 service quality.
14 The Grid/KeySpan merger conditions and the
15 recommendations we include here are consistent
16 with these recommendations.
17 Q. Has any organization voiced concerns about
18 utility mergers with international corporations?
19 A. Yes. On March 8, 2000, the National Association
20 of Regulated Utility Commissioners adopted a
21 resolution voicing a concern that foreign
22 ownership could impede State regulators'

inspection authority and access to books and records regarding financial transactions, cost allocations, and affiliate transactions. It resolved that the acquiring company should guarantee that U.S. regulatory authorities will have complete access to all books and records regarding financial transactions, cost allocations, and affiliate transactions directly or indirectly impacting the U.S. utility. Additionally, it resolved that the acquiring company should be required to guarantee that the ratepayers of the acquired utility shall be held harmless if the acquisition results in a higher revenue requirement for the utility than if the acquisition had not occurred.

Q. Why is Iberdrola's high degree of leverage and large amount of Goodwill significant for the credit quality of NYSEG and RG&E?

A. S&P takes the general position that the rating of an otherwise financial healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is

that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to place the subsidiary in bankruptcy – if the parent itself were forced into bankruptcy – regardless of the subsidiary's "stand-alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries – even those subsidiaries that are not themselves experiencing financial difficulty

i. RATE PLAN-CAPITAL STRUCTURE ISSUES

Q. If the Iberdrola acquisition of Energy East is to be approved, what ratemaking capital structure should be utilized?

A. We believe the Commission should follow its long established precedent of looking to the consolidated capital structure of the parent company when setting the rates for utility subsidiaries. In the recent NYSEG electric rate

order (see Case 05-E-1222) the Commission followed this long established precedent and rejected NYSEG's argument for a stand alone structure in that case. The Commission instead employed the consolidated capital structure of Energy East to set rates. We recommend that the Commission continue its policy and condition the acquisition of Energy East on the use of the capital structure of Iberdrola for ratemaking purposes if the transaction is approved.

Q. Earlier in your testimony, you mentioned that if Commission precedent of using Iberdrola's adjusted consolidated capital structure were followed, the ratemaking capital structure of NYSEG and RG&E would consist entirely of debt. Do you recommend an all debt capital structure for setting rates?

A. No. Such a capital structure would most likely place the operating utilities in financial jeopardy. If sufficient benefits were found to merit the approval of the transaction, we believe it would be appropriate to use the

adjusted consolidated capital structure of Energy East for ratemaking purposes after the proper application of a subsidiary adjustment.

Q. What equity ratio does the adjusted consolidated capital structure of Energy East produce?

A. The adjusted consolidated capital structure of Energy East is 38%. We recommend that this equity ratio stay in place until the adjusted consolidated capital structure of Iberdrola produced by the subsidiary adjustment exceeds 38%.

Q. Are there any circumstances under which Staff could recommend an alternative ratemaking capital structure be employed?

A. Not in this proceeding. We believe that a stand alone capital structure might be appropriate only if all Goodwill is removed from the books of Energy East, sufficient ring fencing financial protections are in place to guard the utility subsidiaries from Iberdrola's highly leveraged capital structure, and these safeguards produce greater interest rate and

other financial savings to ratepayers than the added cost of using the stand alone capital structure.

Q. Can Goodwill be transferred within a holding company structure?

A. We believe it can be under any circumstances. However, Iberdrola's acquisition of Energy East would facilitate the process. A merger destroys the acquired company's "old" Goodwill and creates "new" Goodwill that will appear in the consolidated books. "New" Goodwill need not be allocated to replace the "old" Goodwill. Such an approach would provide a tangible benefit to NYSEG and RG&E by removing the Goodwill generated from the merger of Energy East and RG&E from Energy East's books.

Q. Are there any other requirements that the Commission should put in place?

A. Yes. Should Iberdrola decide to infuse equity into NYSEG or RG&E, it must demonstrate that such equity funding came from external sources of equity. If it cannot make this

demonstration, the infusion should be treated as debt.

Q. Please repeat the capital structure you propose for NYSEG and RG&E in this proceeding.

A. We propose a capital structure with 38% equity for each company. For NYSEG, long term debt, preferred stock and customer deposits are, respectively, 60.82%, 0.74%, and 0.44% of the capital structure. For RG&E, long term debt and customer deposits are, respectively, 61.74% and 0.26% of the capital structure.

Q. How did you calculate the capital structure?

A. As shown on Exhibit __(PP-23), we began with the consolidated capital structure of Energy East and then removed the effects of Goodwill from the consolidated capital structure.

Q. What source did you rely upon to establish NYSEG and RG&E's capital structure?

A. We began with the consolidated capital structure for Energy East as presented in the November 1, 2007 10Q Report to the Securities and Exchange Commission.

Q. What assets are supported by Energy East's consolidated capital structure?

A. Energy East is primarily an electric combination T&D company. Their subsidiaries not only include NYSEG and RG&E but also other utilities such as Central Maine Power Company, Berkshire Gas Company, Maine Natural Gas Corporation, Connecticut Natural Gas Corporation and Southern Connecticut Gas Company. Investor-provided capital was also used to finance about $1.5 billion of non-earning Goodwill.

Q. Energy East's consolidated capital structure includes accumulated other comprehensive income. What approach has the Commission taken concerning the inclusion of other comprehensive income as part of the ratemaking equity balance in other cases?

A. In the recent NYSEG electric rate case (Case 05-E-1222), the Commission eliminated other comprehensive income from the equity ratio calculation. This is proper because it is not a permanent or easily predictable addition to or

subtraction from a utility's common equity balance. In developing our capital structure ratios, we have subtracted $9.9 million of accumulated other comprehensive income from the consolidated equity balance of Energy East.

Q. Energy East's consolidated capital structure includes $1.5 billion of Goodwill on its balance sheet. What approach should the Commission take concerning the inclusion of Goodwill as part of the ratemaking equity balance?

A. The Commission should remove Goodwill at a rate of 75% equity and 25% debt. The subsidiary adjustment removes $1.144 billion from the consolidated equity of the Energy East and $382 million from the consolidated long-term debt of the company. As shown on Exhibit __(PP-23), this produces an equity ratio of 38% for Energy East.

ii. RATE PLAN-COST OF CAPITAL ISSUES

a) COST OF LONG TERM DEBT

Q. How have you calculated NYSEG and RG&E's cost of debt?

A. We calculated the cost of debt for each company based on information provided in the companies' December 31, 2006 Annual Reports to the Commission. The cost of debt for NYSEG is 4.58%% and the cost of debt for RG&E is 6.20%, respectively.

Q. How did you develop your cost of debt for NYSEG and Energy East?

A. Using data from NYSEG's 2006 Annual Report to the Commission, we calculated the cost of debt by dividing the sum of interest expense ($46,928,053), amortization of debt expense ($4,246,241) less the adjustment related to Iberdrola demonstrated in NYSEG's recent debt issuance ($600,000) and divided it by the net of the principal of NYSEG's Long Term Debt ($1,138,000,000) and the issuance expenses on its books (-$35,199,073).

Using data from RG&E's 2006 Annual Report to the Commission, we calculated the cost of debt by dividing the sum of interest expense ($40,302,721), amortization of debt expense

($1,672,932) and divided it by the net of the principal of NYSEG's Long Term Debt ($698,900,000) and the issuance expenses on its books (-$21,380,305).

Q. You are applying a consolidated capital structure for NYSEG and RG&E. Why are you using the stand alone debt costs rates for NYSEG and RG&E?

A. The tax-exempt debt of NYSEG and RG&E should remain directed for the benefit of New York State customers. By using the stand alone cost rates for debt, the effect of this tax-exempt debt was captured for the benefit of customers.

b) COST OF CUSTOMER DEPOSITS

Q. What is the customer deposit rate prescribed by the Commission in 2007?

A. Effective January 1, 2008, the customer deposit rate prescribed by the Commission is 3.76%,

c) COST OF EQUITY

Q. How did you develop the cost of common equity for NYSEG and RG&E?

A. We applied the Discounted Cash Flow methodology

(DCF) and the Capital Asset Pricing Model (CAPM) to a proxy group of utilities to estimate the cost of equity. We then used a 2/3 DCF and 1/3 CAPM weighting to develop one cost of equity estimate. This approach was relied upon by the Commission in the last NYSEG electric rate case (Case 05-E-1222)

Q. What proxy group do you propose to use in your cost of equity methodology?

A. We propose to use the 30 company proxy group shown on page 2 of Exhibit___(PP-23).

Q. Please explain how you developed your proxy group.

A. We began with the dividend-paying electric distribution utilities covered by The Value Line Investment Survey (Value Line). We then limited this group to only those companies which had an investment grade bond rating, no ongoing merger activity, and derived 70% or more of their operating revenue from regulated operations.

Q. Please describe the screening criteria you used to develop the utility proxy group.

A. We chose companies with electric and electric combination distribution operations as a

1 starting point for our analysis since that is
2 the principal business of NYSEG and RG&E. The
3 analysis is limited to only dividend-paying
4 companies since performing a DCF analysis on
5 non-dividend-paying companies is quite
6 speculative. Companies whose debt was not of
7 investment grade quality were eliminated in
8 order to consider only companies with similar
9 credit quality to NYSEG and RG&E. Companies
10 that were involved in ongoing mergers were
11 removed because it is likely that the price of
12 the company being acquired is determined not by
13 market forces, but the offering price. Finally,
14 companies which derive significant sources of
15 their operating revenue from non-utility sources
16 were removed as not representative of NYSEG and
17 RG&E. This step helps assure that the risks of
18 the holding company parents in the proxy group
19 generally approximate the risks of an electric
20 and gas distribution utility. After all the
21 screenings, 30 companies remained candidates for
22 the group.
23 Q. Are the remaining companies in your proxy group
24 pure electric or electric combination

1 distribution utilities?
2 A. No, the companies in our proxy group are not
3 pure distribution utilities. There are no pure
4 distribution companies that are publicly traded.
5 Thus, the goal should be to select proxy
6 companies that are closest to the risk profile
7 of a pure electric and gas combination
8 distribution company.
9 Q. Are your criteria supportive of a viable proxy
10 group?
11 A. Yes. First, these criteria produce a 30 company
12 group, which is large enough to derive a
13 representative estimate of what the return on
14 equity is for an electric combination
15 distribution utility. Second, while the
16 threshold of 70% utility operating revenues
17 creates the opportunity for an upward bias to
18 enter into the calculation of the cost of equity
19 for a electric combination distribution company,
20 diversification of businesses and the use of the
21 median return of a large group minimizes the
22 amount and probability of an error in the
23 estimation of the cost of equity caused by these
24 unregulated operations. Furthermore, the

1 admission of companies with an investment grade
2 bond rating different from NYSEG and RG&E
3 expands the proxy group to a size that will lead
4 to a more accurate cost of equity estimate.
5 Finally, to the extent that there is any
6 discrepancy between the credit quality of NYSEG
7 and RG&E and the proxy group, that difference is
8 readily quantifiable in a yield spread analysis
9 between the credit rating of the Energy East and
10 that of the average credit rating of the proxy
11 group. Thus, these criteria produce a group
12 which can reasonably calculate the cost of
13 equity for electric combination distribution
14 companies like NYSEG and RG&E.
15 Q. Please describe the DCF model which you used to
16 estimate the cost of equity for the proxy group
17 and its result.
18 A. The calculation of the DCF for the proxy group
19 is shown on Pages 3 and 4 of Exhibit___(PP-23).
20 For each company in the proxy group, there is a
21 six-month average stock price (calculated by
22 averaging the high and low price for each
23 month). The six-month period ending November
24 2007 was used. The model also contains *Value*

Line data for the beta, earnings per share, dividends per share, book value per share and the forecasted amount of common stock shares for each company.

This data is used to estimate the dividends that can be expected for each company in the future. The price investors are paying for the stock (the average stock price over a six-month period) is seen as the present value of that dividend stream. By calculating the discount rate required to turn the string of expected dividend payments into the current stock price, one can determine the rate of return investors are expecting for each company.

Q. How are dividends projected to change over time?

A. We used the two-stage DCF method recommended in the GFC. In the near-term (the first four years), the estimates of Value Line are used (using growth rates implied in Value Line's 2010 through 2012 dividend per share estimate). For the second stage (2013 and on), a "sustainable growth" rate is calculated for each company in the proxy group based on its projected retention of earnings and growth in common stock balances.

Q. What is your proxy group DCF cost of equity?

A. The median result, which we calculate to be an 8.58% return, is used as the DCF methodology result.

Q. Please describe the CAPM approach that you used to develop a cost of equity for your proxy group?

A. We used a traditional and zero beta CAPM to develop a cost of equity for the proxy group.

Q. What were the inputs to the CAPM model?

A. Page 5 of Exhibit___(PP-23) shows that the CAPM requires an estimate of: a) the risk free rate, b) market return, and c) the average beta of the proxy group. The risk free rate of 4.77% is the monthly average of 10-year and 30-year Treasury bond yields over the six-month period ended November 30, 2007. The S&P 500 market return of 10.65% was obtained from Merrill Lynch's November 2007 edition of Quantitative Profiles which is attached as part of Exhibit___(PP-24). Staff has used this data in the CAPM for many years. The 0.91 beta was obtained from Value Line.

Q. What was your CAPM cost of equity?

A. The traditional CAPM analysis indicated a 10.12% ROE for the proxy group and the zero beta CAPM produced a 10.25% ROE for the proxy group. The average of these two CAPM approaches is 10.19%.

Q. How were the DCF and CAPM results combined?

A. We applied the 2/3 DCF and 1/3 CAPM weights recommended in the Generic Finance Proceeding to the DCF return of 8.58% and the CAPM return of 10.19%. This develops a cost of equity estimate for the proxy group of 9.12%.

Q. What independent analyses are available that supports your cost of equity estimate?

A. Merrill Lynch also publishes return on equity estimates for utilities. The November edition of Merrill Lynch's Quantitative Profiles contains DCF and CAPM estimated cost of equity returns for utilities; many of these companies are in our proxy group. The median DCF return for these companies was 9.0% and the median CAPM return was 8.8%. A copy of this publication is attached as Exhibit___(PP-24).

Q. Is there any other information supporting the reasonableness of your proxy group cost of equity estimate?

A. Yes, Ibbotson also publishes a forward-looking earnings model that calculates the long-term equity market return to be 9.76%. This Publication is attached as part of Exhibit___(PP-24). Substituting this estimate for the Merrill Lynch cost of the market estimate in our CAPM calculation produces a return on equity of 9.37% for the proxy group. This reasonably supports our cost of equity analysis.

Q. Will you adjust this return to account for risk differences between the proxy group and NYSEG and RG&E?

A. No, the average bond rating of the proxy group is "BBB+/Baa1". This is the same ratings carried by NYSEG and RG&E. Therefore, no adjustment is necessary.

Q. Please describe how the business and financial risk of NYSEG and RG&E relate to that of the proxy group.

A. The business profile of NYSEG and RG&E are rated at a level of 3 by S&P. The average business profile of the proxy group is 5. Thus, from a business risk stand point NYSEG and RG&E are

less risky than the proxy group. The similarity of the financial risk of NYSEG and RG&E compared to the proxy group is greater than the ratemaking equity ratios of 38% for NYSEG and RG&E and the average equity ratio of 49% for the proxy group would imply. The 38% equity ratios for NYSEG and RG&E, whose business profile is 3, indicates a BBB rating by S&P, per Exhibit__(PP-16) and Exhibit___PP-17). The S&P charts indicate that the equity ratio of the proxy group of 49% for a company with a business profile of 5 would imply a somewhat stronger BBB rating. However, the addition of an RDM to NYSEG and RG&E would likely lower their business profile to 2 which would align their positioning within the BBB category with the average of the proxy companies. Nevertheless, the final word on comparability is ultimately credit rating and NYSEG and RG&E's credit rating is identical to the average of the proxy companies. Therefore, no adjustment is necessary.

Q. Staff advocates an RDM in its testimony. Would this have any effect on the risk and return of the NYSEG and RG&E?

1 A. The RDM reduces risk by making the level of
2 profit more indifferent to sales. Thus,
3 volatility in earnings is constrained. It is
4 very difficult to calculate the effect of an RDM
5 on return, however. The direction is clear
6 (less risk requires less return), but the
7 magnitude is not. The Commission in Case 07-G-
8 0141 reduced National Fuel Gas's return on
9 equity by 10 basis points to reflect the effect
10 of an RDM. In this case, absent a definitive
11 study on the matter, we will use the same 10
12 basis points authorized by the Commission to
13 reduce the return of NYSEG and RG&E. Thus, the
14 appropriate return on equity for NYSEG and RG&E
15 given its risk factors is 9.0%. The RDM also
16 serves as further support for allowing a 38%
17 ratemaking equity ratio since much of the
18 utility's volatility in earnings will be reduced
19 by this mechanism.
20 Q. Is your recommendation consistent with interest
21 conditions?
22 A. Yes, current interest rates are near historical
23 lows for the last 25 years. Exhibit __ (PP-24)
24 demonstrates this point graphically showing the

decline in BBB rated bonds since 1982. To the extent that the cost of equity generally tracks interest rates, one would expect the cost of equity for utilities to be lower than it has been for some time.

Q. Please summarize your findings.

A. We propose a weighted average cost of capital of 6.25% for NYSEG. We propose a weighted average cost of capital of 7.26% for RG&E. The calculations for these rates of return are shown on Page 1 of Exhibit___(PP-23).

iii. FINANCIAL PROTECTIONS

Q. Briefly describe the ring fencing financial protections that are necessary to protect NYSEG and RG&E from any adverse consequences of this acquisition.

A. Financial protections are needed to: 1) mitigate the effects of the acquisition premium related to this transaction; 2) maintain or enhance the credit quality of NYSEG and RG&E; 3) provide for dividend restrictions when threats to the financial health of other affiliates pose a

1 threat to the financial health of the utility
2 subsidiaries; 4) provide for a money pool under
3 rules that facilitate the delivery of capital to
4 NYSEG and RG&E while providing protection for
5 these companies from excessive siphoning of
6 funds; and 5) maintain a transparent view of
7 NYSEG, RG&E and its affiliates through timely,
8 accurate financial reporting and unencumbered
9 access to the books and records of both the
10 utility subsidiaries and any affiliate which
11 have direct or indirect transactions with the
12 utility subsidiaries.
13 Q. Why are these financial protections needed?
14 A. Financial protections are needed for the utility
15 subsidiary because the interests of the utility
16 and its parents are not always aligned. For
17 example, the corporate parent's pursuit of
18 profits may conflict with the utility
19 subsidiaries' obligation to provide safe and
20 reliable service. We also have concerns related
21 to the level of Iberdrola's post-acquisition
22 Goodwill balance relative to its overall capital

structure, and a lack of financial statements for Iberdrola's U. S. operations.

a) ACQUISITION ADJUSTMENT CONDITIONS

Q. Please summarize how Goodwill should be treated if the acquisition is approved.

A. Goodwill, or the amount Iberdrola pays for the Energy East Corporation (together with transaction costs) in excess of the original cost of the assets and liabilities of the latter and its subsidiaries, should not be reflected on the books of Energy East, NYSEG, or RG&E and should not be reflected in the determination of NYSEG and RG&E's rates and the calculation of their earned returns.

Q. What financial conditions are necessary to mitigate the effects of the acquisition premium (Goodwill) arising from Iberdrola's acquisition of Energy East.

A. The acquisition premium (Goodwill) and any capitalized costs associated with the acquisition should not be recorded on the books of NYSEG and RG&E or Energy East. The

acquisition premium and related effects should not have any ratemaking effect. Additionally, each year Iberdrola should provide the results of any impairment tests made on Goodwill to the Commission.

Q. Are these conditions related to the acquisition premium any more stringent than those imposed in the Grid/KeySpan merger approved in Case 06-M-0878?

A. No.

b) CREDIT QUALITY CONDITIONS

Q. What credit quality conditions are required in order to ensure that the proposed transaction is in the public interest?

A. The first condition is that the measurement of credit quality needs to come from an accurate, independent major credit rating agency source. Toward that end, NYSEG, RG&E, Energy East, and Iberdrola should be required to maintain credit ratings on their securities from S&P and Moody's. This will ensure that an independent risk assessment is made of both the operating

utilities and its parents.

Q. Should NYSEG and RG&E have a credit rating goal?

A. Yes. As a second credit quality condition, Iberdrola, Energy East, NYSEG, and RG&E should have a stated goal of maintaining investment grade ratings on their securities. This will reassure investors, credit agencies and utility regulators that Iberdrola is committed to the financial health of itself and its utility operations.

Q. Should the Commission be kept aware of what Iberdrola is telling the credit agencies about itself, Energy East, NYSEG and RG&E?

A. Yes. Access to presentations to credit agencies would give the Commission insight to the future planning and capital needs of both Iberdrola and its jurisdictional utilities. It would also give the Commission greater insight into whether any financial threat to its jurisdictional utilities is on the horizon. Therefore, as a third credit quality condition, copies of presentations to Credit Agencies and backup

should be provided on an ongoing basis.

Q. Are there any financial conditions which may be imposed upon this M&A transaction that will shield ratepayers from the effects of deterioration in the credit quality either at NYSEG or RG&E?

A. Yes. The credit quality of NYSEG and RG&E must be maintained. Therefore, as a fourth credit quality condition, whenever a credit downgrade by S&P or Moody's of either NYSEG or RG&E occurs, the companies should be required to file a plan with the Commission for remedying the downgrade and its consequences.

Q. Are these conditions related to the credit quality of NYSEG and RG&E any more stringent than those imposed in the Grid/KeySpan merger?

A. No.

c) DIVIDEND LIMITATIONS

Q. What is the purpose of imposing restrictions on NYSEG and RG&E's ability to pay dividends?

A. Dividend restrictions would prevent Iberdrola from draining the capital of NYSEG and RG&E if

unforeseen circumstances create financial difficulty at Iberdrola or any of its affiliates or if Iberdrola simply wants to enhance its dividends to its shareholders.

Q. Under what circumstances would NYSEG and RG&E be allowed to issue dividends?

A. Generally, NYSEG and RG&E would be allowed to pay a dividend as long as they maintained a BBB/Baa2 credit rating at both S&P and Moody's, respectively.

Q. Are there limits the Commission should impose on the amount of dividends NYSEG and RG&E could send upstream in Iberdrola?

A. Yes. For each company, the dividend should be limited during the year to no more than the sum of the income available for common equity, plus the cumulative amount of retain earnings since the acquisition was consummated, plus the portion of additional "paid in capital" that is recorded on the books of NYSEG and RG&E as unappropriated retained earnings and unappropriated undistributed earnings less

accumulated other comprehensive income existing immediately prior to the consummation of the acquisition, to the extent such earnings had not already been paid out as a dividend. Given the differences between IFRS and GAAP, there might be some instances where the Commission would have to be notified about how the current year's income available for dividends would be calculated.

Q. What restrictions should be placed on the issuance of dividends by NYSEG and RG&E?

A. We recommend several dividend restrictions related to NYSEG and RG&E's credit quality. NYSEG and RG&E would each be prohibited from paying dividends at any point in time when (a) its least secure unsecured bond rating is at the lowest investment grade and a rating agency has issued outstanding negative watch or review downgrade notices, or (b) Iberdrola's least secure senior unsecured debt is rated below an investment grade by a rating agency. A dividend restriction would also be triggered if NYSEG and

RG&E's bond ratings are immediately downgraded to the non-investment grade category.

Q. Are there any other dividend restrictions the Commission should impose?

A. In the event that a dividend restriction is triggered, NYSEG and RG&E should not be permitted to transfer, lease, or lend any moneys, assets, rights or other items of value to any affiliate without first obtaining this Commission's permission.

Additionally, we recommend that a requirement should be put in place such that in any future rate proceedings, should NYSEG's or RG&E's debt or similar financing reflect a cost rate which is higher than what it would be under their present debt ratings (BBB+/Baa1), the cost of such a financing will be reduced to reflect a cost consistent with the existing ratings.

Q. Are these dividend conditions for NYSEG and RG&E any more stringent than those imposed in the Grid/KeySpan merger?

A. No.

d) MONEY POOL RULES

Q. Does Energy East currently have a money pool arrangement with Energy East?

A. No. However, rules should be in place if Iberdrola decides to establish a money pool in the future.

Q. Would you recommend any restrictions if Iberdrola institutes a money pool financial arrangement?

A. Yes. NYSEG, RG&E, and any future domestic regulated entities should be allowed to participate in a money pool arrangement as a borrower or lender. Iberdrola, however, should only participate in a money pool as a lender. Specifically, we recommend that non-regulated or foreign entities be prohibited from participating in a money pool with NYSEG or RG&E. Indirect loans from NYSEG and RG&E to any affiliate, either through the money pool or through other means, also should be prohibited.

Q. Are there any other financial protections that would ease concerns about the transaction?

A. Yes. As a condition of approval of the M&A transaction, Iberdrola should pledge that there are no cross default provisions for any affiliate of Iberdrola which affect NYSEG and RG&E and promise that Iberdrola and its affiliates will not enter into such arrangements in the future.

Q. Are these conditions related to the money pool rules of NYSEG and RG&E any more stringent than those imposed in the Grid/KeySpan merger?

A. No.

e) STRUCTURAL PROTECTIONS

Q. Staff has recommended numerous financial conditions related to the acquisition. Will the rating agencies find them sufficient to protect the credit quality of NYSEG and RG&E?

A. In its October 1999 article Ring-Fencing a Subsidiary, S&P talks about financial conditions such as we recommend above and states, "The problem with these devices is that by themselves they do not go far enough in effectively insulating or ring-fencing the subsidiary from

its parent." S&P goes on to state, "Covenants are generally given little weight in the analysis of whether a subsidiary might be rated higher than its parent."

Q. Why does S&P contend that covenants are given little weight in determining whether a subsidiary is rated higher than its parent?

A. S&P believes that courts rarely compel an entity to comply with the terms of its covenants. S&P contends that courts tend to limit remedies to proven monetary damages. Many of the terms we recommend deal with a parent in financial difficulty. If the parent went into bankruptcy, it is likely that any provable damages would be given a relatively low ranking in the order of creditors. S&P also cautions that "Management will, in keeping with its responsibilities to shareholders, attempt to find ways to defeat covenants that are burdensome."

Q. What degree of financial protection is afforded a subsidiary by relying on financial covenants alone?

1 A. S&P states that a subsidiary so protected is
2 constrained to three credit notches (one full
3 bond rating category) above the credit quality
4 of the consolidated entity. More telling is S&P
5 belief that a regulated utility subsidiary will
6 not often achieve this differential because not
7 many utility subsidiaries are "actively
8 regulated."
9 Q. Does S&P provide any guidance for obtaining an
10 increase in the credit rating of the subsidiary
11 to a full rating category above the credit
12 quality of the consolidated entity?
13 A. In its article on ring fencing the subsidiary,
14 S&P states that a package of enhancements that
15 include financial covenants, a pledge of
16 collateral, and structural features might be
17 enough to achieve this goal.
18 Q. To this point, have your recommendations
19 achieved the package S&P speaks of?
20 A. No. While we believe our financial covenants
21 are sufficient for their own purposes, our
22 recommendations thus far have not included

1 structural separations that could create a
2 barriers at NYSEG and RG&E protecting them from
3 adverse consequences attributable to Iberdrola's
4 actions. Therefore, our proposal requires the
5 addition of a structural feature and a
6 collateral feature.
7 Q. What is the structural feature that S&P speaks
8 of?
9 A. The structural feature S&P speaks of is a
10 limited purpose entity (LPE). An LPE acts as a
11 shield between the parent and its operating
12 subsidiaries. The characteristics of this
13 entity, which facilitates effective ring
14 fencing, are as follows. An LPE is "single
15 purpose", in that is its existence is premised
16 on performing one specific task. An LPE incurs
17 no debt of its own beyond what it might need for
18 its working capital requirements. An LPE is
19 permanent. It cannot be terminated or merged
20 into another entity. The most important feature
21 of an LPE is that it has a director independent
22 from the parent company.

1 Q. What is the significance of an independent
2 director?
3 A. A company's directors are accountable to
4 shareholders. The directors of a subsidiary are
5 expected to carry out the wishes of a parent
6 company. This becomes an important issue when
7 the parent company is in distress. A subsidiary
8 is obligated to follow its parent's orders, even
9 an order to move the subsidiary voluntarily into
10 bankruptcy. An LPE would have the public
11 interest of the subsidiary as its primary focus.
12 The public interest would include the interests
13 of its customers and debt holders. An
14 independent director would vote those interests
15 based upon the authority it was granted in the
16 charter of the LPE. Given that its duty would
17 be to customers and debt holders, it is unlikely
18 that a subsidiary would ever be placed
19 voluntarily into bankruptcy as a result of the
20 actions of its parent.
21 Q. Has the Commission ever compelled the creation
22 of an LPE as a condition to approval a merger or

1 acquisition?

2 A. In the Grid/KeySpan merger, the Commission

3 imposed the additional condition that the KEDNY

4 and KEDLI subsidiaries commit to modify

5 corporation by-laws as necessary and establish a

6 golden share in order to prevent a bankruptcy of

7 National Grid or any other affiliate from

8 triggering a bankruptcy of KEDNY or KEDLI.

9 KEDNY and KEDLI were ordered to each file a

10 petition seeking authority to establish a class

11 of preferred stock having one share, subordinate

12 to any existing preferred stock, and to issue

13 such share of stock to a party to be determined

14 by the Commission who would protect the

15 interests of New York and would be independent

16 of the parent company and its subsidiaries. The

17 "golden share" will have voting rights, which

18 limit KEDNY's and KEDLI's right to commence any

19 voluntary bankruptcy, liquidation, receivership,

20 or similar proceedings without the consent of

21 the holder of that share of stock.

22 Q. Have any other mergers or acquisitions included

an LPE vehicle as a condition for approving the merger?

A. In the MidAmerican/Pacificorp merger, a ring-fencing plan calls for a "single purpose entity" (SPE), akin to what we describe as an LPE. That SPE has an independent director unaffiliated with the parent, incurs no debt, cannot merge or consolidate with any other corporate entity, and cannot be dissolved as long as the parent and utility ownership relationship persists. The sole function of the additional corporate layer entity, according to S&P, is to prevent the parent company from filing the subsidiary into bankruptcy without the approval of the independent director of the SPE. The creation of an SPE between MidAmerican Energy Holdings Company (the unregulated parent holding company) and its regulated utility subsidiaries has been a factor in supporting a higher bond rating for the subsidiaries than for the unregulated parent holding company, which has a more leveraged capital structure.

1 Q. Is an LPE device such as a golden share
2 necessary as a condition to approve this
3 acquisition?
4 A. We believe it is an important tool, perhaps the
5 most important tool that the Commission can use
6 to isolate NYSEG and RG&E from the risks of
7 Iberdrola. Given those risks, discussed above,
8 a golden share that controls whether a utility
9 may voluntarily be placed into bankruptcy is
10 essential. The Commission might also consider
11 an LPE as an instrument for ensuring compliance
12 with dividend and money pool restrictions.
13 These vehicles would create greater structural
14 separation between Iberdrola and its
15 subsidiaries. S&P notes that a utility
16 subsidiary will always be constrained by a weak
17 parent and as it states in its "Ring-Fencing A
18 Subsidiary" article, "The basis for this
19 position is that a weak parent has both the
20 ability and the means to siphon assets out of
21 its financially healthy subsidiary". An LPE
22 controlled by an independent director that acted

as a conduit of funds, both paper and electronic, when dividend and money pool restrictions are triggered would more effectively enforce the restrictions and presumably add a level of structural separation that would enhance the credit quality of Iberdrola's utility subsidiaries. We believe that this ring fencing tool should be considered by the Commission.

Q. Please describe the collateral feature S&P presents in its ring fencing article.

A. The collateral feature that S&P describes is the level of property that is pledged to individual debt issuances. The greater the amount of property pledged, the greater the security of the bond investor and presumably the higher the bond rating. As the debt market evidences, a secured debt instrument often carries a slightly better credit rating than an unsecured debt instrument from the same company.

Q. Should the Commission mandate that the subsidiaries issue only secured debt going

1 forward?

2 A. We think that S&P's focus in these features is

3 on decreasing the risk to the bond holders. The

4 interests of customers and bond holders converge

5 on the issues of financial covenants and

6 structural separations. It is less clear that

7 issuing secured debt benefits customers to any

8 great extent. The extra fees associated with

9 mortgage bonds are subtracted from the savings

10 realized out of the yield from a slightly higher

11 bond rating. More importantly, requiring that

12 NYSEG and RG&E issue secured securities overly

13 constrains the company's financial flexibility,

14 which could ultimately prove counterproductive

15 to customers. Therefore, we recommend that the

16 Commission issue no conditions relating to this

17 collateral feature.

18 Q. Are these conditions related to the structural

19 separation of NYSEG and RG&E from Iberdrola any

20 more stringent than those imposed in the

21 Grid/KeySpan merger?

22 A. No.

C. VERTICAL MARKET POWER MUST BE MITIGATED

Q. What is your recommendation on vertical market power?

A. The Commission must adopt vertical market power protections. Approval of the transaction should not be granted if the commitment to sell the Russell site, which fulfills the Commission's vertical market power policies, is not kept. As a result, approval should be conditioned upon the sale of the Russell site to a non-affiliated company, the remaining utility generation should be divested, Energy East should divest Carthage, and Iberdrola should divest all wind generation interests in New York.

Q. Should the hydro and gas peaking facilities owned by RG&E and NYSEG be sold?

A. Yes. There is a market for even small hydro and gas peaking facilities. Other utilities like Niagara Mohawk and Orange and Rockland sold such facilities when divesting their other generation facilities. More recently, Orange and Rockland's former hydro and gas peaking

1 facilities were sold to a new owner, Central
2 Hudson successfully sold a small hydro facility,
3 and there have been other similar transactions.
4 With the sale of these facilities, Energy East
5 would exit the generation market entirely,
6 eliminating incentives to exercise VMP to the
7 detriment of ratepayers and ending disputes over
8 VMP issues.
9 Q. Should NYSEG Solutions Carthage facility be
10 divested?
11 A. Yes, the NYSEG Energy Solutions Carthage plant
12 is a market-based unit which would profit from
13 price increases in the upstate market when
14 vertical market power is exercised.
15 Q. What about wind generation in New York?
16 A. Yes, the New York wind generation of the merged
17 firm would be market-based units which would
18 benefit from price increases in the upstate
19 market that could be achieved from an exercise
20 of vertical market power.
21 Q. If Iberdrola had to sell its wind interests,
22 would the development of renewable energy

sources in New York be adversely affected?

A. No. Competitors could be expected to buy the Iberdrola wind interests, because of the value of those assets, and develop additional projects besides, because of the benefits of New York's policies, including RPS. In fact, the sale would encourage development of additional renewable resources because market participants could be confident New York markets will operate fairly, instead of being slanted in Iberdrola's favor by vertical market power.

Q. You recommend the Commission require divestiture of generation in order to mitigate vertical market power as a condition of this acquisition. Is that an unusual requirement?

A. No it is not. As noted above, the Commission required the divestiture of Ravenswood in the recent Grid/KeySpan transaction. In the Maine acquisition proceeding (Docket No. 2007-355), the November 6, 2007 Testimony of Dr. Richard H. Silkman, Ph.D. for the Industrial Energy Consumer Group (IECG) asked the Maine Commission

to place this much broader condition on the acquisition:

> In order to ensure that Iberdrola will not use its generation assets to harm the competitive market and Maine ratepayers, the Commission should condition the acquisition on Iberdrola's written agreement that it will divest itself of CMP upon any future Commission finding of anti-competitive behavior by Iberdrola.

Q. Did you find any other examples of divestiture requirements involving Iberdrola?

A. Yes. In Iberdrola's failed attempt to merge with Endesa another Spanish utility in 2001, the Spanish Competition Service required the parties to dispose of their generation assets (see Response IBER-0164 to DPS-103 Attachment 2, dated November 9, 2007). Ultimately, this condition was not fulfilled as the merger was not consummated.

D. CUSTOMER PROTECTIONS SHOULD BE AUGMENTED

i. DATA SECURITY CONCERNS

Q. Are there concerns about national security issue raised by the acquisition?

A. We have several concerns in this regard.

1 Sensitive customer information should remain at
2 NYSEG and RG&E and their transfer to Iberdrola
3 or any of its other affiliates should be
4 prohibited.
5 After the transaction, the vulnerabilities
6 of the New York electric grid system and its
7 network of gas pipelines could become available
8 in more locations. Any time there is more
9 access to this information, it raises the
10 possibility that this information could wind up
11 in the wrong hands. Therefore, this
12 information, in all media formats, should remain
13 within the headquarters of NYSEG and RG&E.
14 Similarly, the personal data NYSEG and RG&E
15 compile on a their customers (names, addresses,
16 telephone numbers, social security number,
17 credit reports, etc.) should remain, in all
18 media formats, within the headquarters or
19 customer centers of NYSEG and RG&E. This will
20 help insure the privacy of the customers of
21 NYSEG and RG&E.
22 E. ACCOUNTING PROTECTIONS

i. AFFILIATE TRANSACTION RULES

Q. Are there any existing safeguards in place governing affiliated transactions between and among the New York utilities and Energy East and its affiliates?

A. Yes. In NYSEG's 2002 Merger Joint Proposal the signatory parties proposed and the Commission adopted Appendix B Standards Pertaining to Affiliates and the Provision of Information. We have marked up these standards and included them as Exh.___(PP-25). These affiliate transaction standards govern: relationships between the regulated utilities and competitive energy affiliates, access to books and records of affiliates, transfers of assets, personnel matters, royalties, sales and purchases between affiliates and the utilities, financial protections, and cost allocations.

Q. Do you have any observations regarding these affiliated transaction standards?

A. Yes. Generally, the existing affiliate transaction rules were designed to and seem

adequate to govern the somewhat straightforward relationship between Energy East holding and service companies, NYSEG, and RG&E. However, in the post-Iberdrola acquisition environment they are inadequate since they may not be able to capture the nuances and unknowns related to the future dealings between Iberdrola, Energy East, and the utilities. As a result, they should be continued but only if they are modified and enhanced by several additional conditions related to this M&A transaction.

Q. Which entities should the revised standards apply to?

A. The revised standards should apply to all existing entities and to any entity which is owned 10% or more, directly or indirectly, by Iberdrola or effectively owned more than 10% by Iberdrola when combined with other Iberdrola ownership interests.

Q. Please describe the areas where enhancements are required.

A. Enhancements are required to the existing

affiliate transaction standards governing: relationships between the regulated utilities and competitive energy affiliates, access to books and records of affiliates, transfers of assets, personnel matters, royalties, sales and purchases between affiliates and the utilities, financial protections, and cost allocations. In addition, several new requirements are necessary.

Q. Describe the first enhancement to the Standards of Conduct governing the relationships between the regulated utilities and competitive energy affiliates.

A. The first section (i) of the Standards of Conduct should be modified to prohibit any affiliate from using the same name, trade names, trademarks, service name, service mark or a derivative of a name, of the utilities or in identifying itself as being affiliated with the utilities.

Q. Are there any other changes to section (i) of the Standards of Conduct?

A. Yes. In that same section it states "unregulated affiliates are prohibited from giving any appearance that they represent the DISCO in matters involving the retail marketing of services by the DISCO or other affiliates." This should be modified to remove the word "retail" as the limitation to retail services is unnecessary.

Q. Are any changes recommended to section (v) of the Standards of Conduct concerning information sharing?

A. Yes. Currently, management company employees may receive customer or market information subject to the condition that "Management Corp. shall not disclose such information to unregulated affiliates." This should be clarified and enhanced by requiring the management corporation that receives such information to promise the utility in a legally binding document, executed by authorized personnel and specific to each transmission of information, that it will not disclose the

information. The utility should be required to make each such document available to Staff.

Q. Are any changes recommended to section (vi) of the Standards of Conduct concerning competitive complaints?

A. Yes. The change recognizes the need to have Staff informed about competitive issues earlier in the complaint process.

Q. Should the Access to Books and Records and Reports provisions be revised?

A. Yes. We propose than all restrictions to access to books and records in section (i) be eliminated. This proposal recognizes the potential for harm (i.e., lack of transparency, vastly holdings in competitive businesses, potential chaining and unrecorded transactions, and new incentives) associated with Iberdrola's transaction with Energy East.

Q. Are changes needed to section (iii) reporting requirements of the Access to Books and Records and Reports provisions?

A. Yes. Staff's standards are revised consistent

with principles described above.

Q. Is Staff recommending a royalty, which is addressed in Affiliate Relations section 2?

A. No. Because as noted in the Standards of Conduct section (i) above, there will be no use of the DISCOs name or reputation by any affiliates.

Q. Is Staff recommending changes to Affiliate Relations, section 3, transfers of assets?

A. Yes. Transfers to the utilities should be at the lower of actual cost or market price and transfers to affiliates should be at the higher of cost or market. Costs for purposes of the affiliate's transfers to the utilities should be limited to the original acquisition costs by the first non-regulated affiliate.

Q. Are any modifications needed to the Affiliate Relations section 4, personnel and human resources?

A. Yes. Personnel and human resources rules should be enhanced to include a provision comparable to the provision included in the Grid/KeySpan

merger: beginning three years after the merger has closed, an employee transfer credit equal to 25% of the employee's base annual salary will be applied. This will compensate the utility for loss of experience and ability due to the loss of any of its employees to one of its affiliates.

Q. Are modifications needed to Affiliate Relations, section 5, provision of goods and services rules?

A. These rules should be enhanced to prohibit: cost allocations to the utilities or their holding companies, chaining transactions, and co-mingling or sharing of goods or services. Since Iberdrola has not provided any synergy savings in this acquisition, it would not be appropriate to permit Iberdrola will to impose service company cost allocations on U.S. utility affiliates.

Q. Are any modifications needed to the Affiliate Relations section 6, other?

A. Yes. These are primarily financial protections

and are being revised consistent with the principles above.

Q. Are there any new proposed enhancements?

A. Yes. A first enhancement would be for Iberdrola to voluntarily move its headquarters for its United States utility operations (including EEMC and USSC) to somewhere within the service territory of NYSEG or RG&E. This would improve transparency because it would remove many of the potential impediments to access to any of the books and records that might be needed in the future. In addition, it would provide an economic boost to the economy of the region.

ii. REPORTING REQUIREMENTS

Q. What are the minimum reporting requirements that should be imposed upon Iberdrola, NYSEG and RG&E as a condition for approving this acquisition?

A. Staff should have access to the books and records of Iberdrola and its majority owned affiliates in English and these books and records should be made available in New York State. NYSEG and RG&E should continue to meet

1 their current reporting requirements. This will
2 provide for the access to information needed to
3 regulate NYSEG and RG&E.
4 Q. Should the U. S. entities remain subject to the
5 reporting requirements under which they are
6 currently obligated?
7 A. Yes. Energy East should continue to be subject
8 to the legal requirements of SOX. Periodic
9 statutory financial reports should include
10 certifications by Energy East officers that: 1)
11 the signing officers have reviewed the report;
12 2) the report does not contain any material
13 untrue statements or material omissions or [?]be
14 considered misleading; 3) the financial
15 statements and related information fairly
16 present the financial condition and the results
17 in all material respects; 4) the signing
18 officers are responsible for internal controls
19 and have evaluated these internal controls
20 within the previous ninety days and have
21 reported on their findings; 5) a list of all
22 deficiencies in the internal controls and

1 information on any fraud that involves employees
2 who are involved with internal activities; and
3 6) any significant changes in internal controls
4 or related factors that could have a negative
5 impact on the internal controls.
6 Finally we recommend that Energy East,
7 NYSEG, and RG&E remain subject to annual
8 attestation audits by independent auditors.
9 This will provide some confidence that the
10 financial statements of these entities fairly
11 reflect the financial condition of the
12 companies.
13 Q. Please continue with your recommendations on the
14 reporting requirements necessary to approve the
15 acquisition.
16 A. The requirements of NYSEG's August 16, 2000
17 information order in Case 9187 should be
18 continued and extended to RG&E.
19 Q. Do you have a recommendation concerning the
20 future lack of relevant capital structure
21 information?
22 A. Yes. We recommend that the Commission require

Iberdrola to provide annual public financial information, including consolidating balance sheets, income statements, and cash flow statements as well as a comprehensive management discussion of results consistent with Energy East's current 10-K for Iberdrola as well as financial information about each of Iberdrola's regulated and unregulated energy companies operating in the U.S. Such filings should reflect audited U.S. GAAP financial statements in U.S. dollars. The consolidating statements will illustrate how each of Iberdrola's major regulated and non-regulated subsidiaries contribute to the overall consolidated financial statements. This information should be in the same format as the consolidated financial statements contained in SEC Form U-5S that registered utilities had been required to file under the Public Utility Holding Company Act of 1935 (PUHCA). The energy utility information should be fully consistent with SEC Form U-9C-3, which registered holding companies had been

required to file under PUHCA.

Iberdrola should also file consolidated balance sheets, income statements and cash flow statements for Energy East and its direct subsidiaries in English using U.S. GAAP in all future rate cases. This information should be provided for the historic test year and be projected to the future rate year. In support of these forecasts, NYSEG and RG&E should also file balance sheets, income statements and cash flow statements for all Energy East's subsidiaries that are either utilities or operate in the energy business for the historic test year. These recommendations assure that staff and the Commission will have sufficient information to properly analyze NYSEG and RG&E's capital structure in order to assure that its rates are reasonable.

Q. Does your recommendation place any additional burden on Energy East, NYSEG, or RG&E?

A. It places an extra reporting requirement on the companies, but it should not be too cumbersome.

They have always filed this information as part of former SEC Forms U-5S and U-9C-3 and the costs of such requirements are embedded in rates.

Q. Is it possible that the information contained in these forms may be confidential?

A. Yes. In such circumstances it may be reasonable for NYSEG and RG&E to seek trade secret protection of the information. To the extent that such a request is reasonable, the Commission should grant the request.

F. RETAIL ACCESS ISSUES

Q. What retail access proposals are you making?

A. We will be addressing unbundling issues, including unresolved billing issues related to New York State Electric and Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E). Certain issues regarding the way that these utilities apply their billing charges do not conform to Commission policy and Orders and should be addressed as soon as possible. As well, the unbundling of rates from

1 back-out credits to unbundled charges for
2 service should be completed. While this
3 proceeding addresses issues surrounding the M&A
4 transaction, it is not unlikely that the
5 potential outcome of this proceeding could
6 include rate plans or stay-outs for these
7 utilities. If that should occur, the issues we
8 address here should be resolved in conformance
9 with Commission policy. Moving to another
10 topic, we will address the establishment of an
11 ESCO Referral Program for both NYSEG and RG&E.
12 Q. What is the Commission's policy on bill issuance
13 and payment processing (BIPP)?
14 A. The Commission has addressed this issue twice,
15 once in regard to billing credits in the Billing
16 Proceeding in an Order issued in Cases 98-M-1343
17 and 99-M-0631 on May 18, 2001 and again in the
18 Competitive Opportunities Case - Unbundling
19 Track, Case 00-M-0504, Order issued February 18,
20 2005. In both cases, the Commission ruled that
21 the customer should only pay a utility for BIPP
22 service when receiving from the utility both

1 delivery and all commodity services taken. When
2 the customer receives a consolidated bill from
3 the utility (a bill that includes ESCO as well
4 as utility charges), the utility should collect
5 a billing fee equal to the amount of the BIPP
6 charge from the ESCO or ESCOs. Where a single
7 ESCO serves the customer for either all
8 commodity or one of two commodities taken, it
9 still is required by the Commission to pay the
10 entire BIPP fee. Where there are two ESCOs
11 serving the customer, one for electricity and
12 one for natural gas, the ESCOs would each pay
13 half of the BIPP fee. As a result, where an
14 ESCO is providing all or one part of a dual
15 commodity service, the companies should not
16 charge the customer for billing services because
17 the ESCO is paying them.
18 Q. Please describe NYSEG's and RG&E's application
19 of the BIPP charge.
20 A. These companies have generally applied their
21 back-out credits in conformance with the above-
22 described Orders. When they began to unbundle

the BIPP costs, however, they converted the back-out credit subtracted from consolidated bills, which included the charges for ESCO commodity, to a charge that was added to the bills of only utility full service customers. At that time, they also began using two separate BIPP charges, one for electric service and one for gas service. For RG&E electric service, the back-out credit still exists as unbundling of BIPP costs has not yet occurred, yet the utility has already begun applying the back-out credit incorrectly by using an RG&E gas BIPP charge and a separate RG&E electric BIPP credit.

Q. How does this application of the BIPP charges deviate from the Commission's requirements?

A. The BIPP charge should be one charge that is the same whether the customer is a single commodity service customer or a dual electric and gas commodity service customer. Requiring the dual commodity service customer to pay two BIPP charges, one for electric and one for gas, imposes on them a total BIPP charge

1 approximately double the amount a single
2 commodity service customer pays.
3 Q. Does this mean that the companies are recovering
4 twice as much BIPP revenue from their dual
5 service its customers?
6 A. No. They are reducing other rates charged to
7 customers equal the amounts reflected in the
8 billing charges. Further, the BIPP charges are
9 not necessarily identical for each commodity
10 service, primarily due to time lags between the
11 rate cases in which they were calculated for the
12 two services.
13 Q. Why then is this a concern?
14 A. Besides being inconsistent with Commission
15 orders and policy, and inconsistent with the
16 BIPP charge practices of the other New York
17 utilities, the companies' approach does not
18 reflect the actual costs they experience in
19 providing BIPP. The cost of bill issuance and
20 payment processing is per bill, not per
21 commodity. A large part of the costs assigned
22 BIPP are related to the costs of the supplies

needed to prepare bills, such as ink, paper, and envelopes; the machines that print, assemble, and put the bills in envelopes; and the postage. Generally, these costs are not approximately doubled when the customer is a dual commodity customer.

Q. Are there any other concerns with NYSEG's and RG&E's application of the BIPP or billing charge?

A. Yes. In converting from a back-out credit to a charge, these utilities have also decided to change how it is applied. When it was a credit, it was applied once, whenever one or more commodity services were provided by an ESCO that included its charges on a utility consolidated bill. Now that it is being changed to a charge, it is being applied twice, separately for each commodity, in delivery rates.

Q. Why is this a concern?

A. First, there has been no change in Commission policy regarding the application of BIPP costs. It has never altered its position that BIPP

costs should be paid by the customer when the customer takes all commodity from the utility and by the ESCO or ESCOs when one or more commodities are purchased from competitive suppliers. The most conclusive Commission statement on this policy is "Since the billing charge is for a competitive service and is not charged to retail access customers receiving consolidated bills, from either the utility or the ESCO, it should not be subsumed within delivery." (Case 00-M-0504-Unbundling Track, Unbundled Bill Order, issued February 18, 2005, page 23) This one sentence summarizes succinctly that: 1) billing is a single competitive service, 2) is not charged to ESCO customers on consolidated billing, 3) and should not be charged as part of delivery service.

Q. Is there any other recent statement by the Commission that applies to this issue?

A. Yes. In the recent Consolidated Edison Company of New York, Inc. (Con Edison) gas proceeding, the Commission distinguished "the gas Merchant

Function Charge … and the account level billing and payment processing charge." (Case 06-G-1332, Order Adopting in Part the Terms and Conditions of the Parties' Joint Proposal, issued September 25, 2007, page 9) This clarifies that there should be a single BIPP charge, not two.

Q. If these costs are unbundled and charged as you have described, will the unbundling process for these utilities be complete?

A. No. They should be required to file revised tariffs that convert all existing back-out credits (these include the Merchant Function Credit and Metering back-out credits) to unbundled charges in a revenue neutral manner, in the context of any rate or rate design process established for these utilities as a condition of approval of the transaction

Q. What is an ESCO Referral Program?

A. Under an ESCO Referral Program, an electric or gas utility offers customers telephoning its call center with a non-emergency inquiry the opportunity to enroll with ESCOs that offer a

uniform discount, over an introductory trial period, from the price the utility charges for commodity service.

Q. Please describe the Commission's most recent statements regarding the referral programs.

A. On December 21, 2007, the Commission issued Orders in Case 06-G-1185, regarding KeySpan Corporation affiliates (KeySpan), and in Case 07-G-0141, regarding National Fuel Gas Distribution Corporation (NFG). In each case, the Commission required each utility to embark upon a collaborative and to make a filing describing the relevant costs, benefits and best practices of an ESCO Referral Program, in sufficient detail to allow the Commission to reach a decision on such a program.

Q. What is the status of an ESCO Referral Program at RG&E?

A. In a filing dated September 1, 2006, RG&E filed a proposed ESCO Referral Program. The Commission has not acted on that filing.

Q. What is the status of an ESCO Referral Program

at NYSEG?

A. On October 23, 2006, NYSEG filed proposals for implementing an ESCO Referral Program. The Commission has not acted on that filing. Subsequently, in an Order issued August 29, 2007 in Case 07-E-0479, the Commission allowed NYSEG to pursue the development of an ESCO Introduction Program that could serve as a substitute for an ESCO Referral Program. NYSEG was directed to commence a collaborative on the content and costs of an ESCO Introduction Program.

Q. What is the status of that collaborative?

A. Negotiations in that collaborative are ongoing.

Q. What do you recommend?

A. If the Commission decides to approve Iberdrola's acquisition of Energy East, as a condition of approval, it should impose on NYSEG and RG&E requirements regarding ESCO Referral Programs that are similar to the requirements imposed on KeySpan and NFG.

Q. What about the prior ESCO Referral Program

filings of NYSEG and RG&E?

A. Those prior filings are well over a year old. The positions on program content and cost information presented in them should be updated, through the collaborative and filing process recommended above.

Q. What about the ongoing ESCO Introduction Program collaborative at NYSEG?

A. The results of that collaborative can be folded into the filing NYSEG would make. Its filing should include cost and program component information on an ESCO Introduction Program, and compare that program to the costs and best practices for implementing an ESCO Referral Program.

ALTERNATIVE INVESTMENT OF IBERDROLA FUNDS

Q. How much above the original cost of the utilities assets is Iberdrola paying to acquire Energy East?

A. Iberdrola is paying $2.9 billion in excess of the original cost of the utilities assets to acquire Energy East. Iberdrola is in effect,

acquiring $1.5 billion of old Energy East Goodwill plus adding another $1.4 billion of Goodwill in this transaction.

Q. Does Staff consider the acquisition of utility Goodwill a productive use of capital?

A. No. As we have testified, since the utilities cannot realistically achieve a return on utility Goodwill over the long-term, it is not productive. The massive investment in Goodwill does not help the state's infrastructure, does not advance the state's interests in renewables, nor does it create jobs. In fact, in the long-term, this massive investment in utility Goodwill harms the state's interests because it provides pressures on management to find ways to service that unproductive capital, some of which are adverse to consumers. It harms the utilities finances, puts undue pressure on the utilities to scale back infrastructure investment, impedes economic development, and causes job losses.

Q. Does Staff have any suggestions for the use of

this capital?

A. Yes. Rather than invest $2.9 billion in unproductive acquisition premium (utility Goodwill), Iberdrola should consider investing those funds in productive wind power assets.

Q. Why?

A. This will help the state achieve its renewables goals and enhance economic development. Iberdrola could use the growth in its New York wind interests to grow its other wind related businesses, such as parts distribution and engineering services.

Q. Does this conclude your testimony?

A. Yes, at this time.

BY MR. VAN RYN:

Q. Is it correct that the policy panel filed -- prefiled 25 exhibits that were prepared by you or under your supervision?

A. (Panel) Yes.

Q. Do you have any corrections to make to those exhibits?

A. (D'Ambrosia) Yes. Exhibit 20, which is a one-page exhibit, there are two words misspelled. The line that says "tax benits" is misspelled. It should say "tax benefits -- goodwill." And the line should say "tax benefits -- PTC."

Exhibit 21, there are a number of changes to some dollar amounts and some percentages. For the Iberdrola/Energy East transaction in the cumulative reductions column for RG&E it should be negative 386.5. In the NYSEG column for cumulative reductions it should be 346.4. The total column, 732.9. Those are all negative numbers.

And the percentage of delivery line for the same category for RG&E, negative 14.9 percent. For NYSEG, negative 6.8 percent. Total, negative 11.3 percent.

MR. CONNOLLY: Could I ask a clarifying question. Tom, the exhibit you passed out has different numbers

for the percentage of revenue than you just read. For the percentage of revenue it's 14.7 rather than 14.9. And 11.2 rather than 11.3. I just wonder if you could clarify.

A. (D'Ambrosia) I am sorry. I think I was reading form the wrong sheet. The page had the wrong cover sheet. It only affects what I just read, just those percentages in dollars.

MR. SCHWARTZ: Can you clarify that for the record. I don't know where you are.

A. (D'Ambrosia) In the exhibit section of the corrections in the box I just read, which is the first box in Exhibit 21, those dollars and percentages that I just read, that's the only box that changes.

Mr. Haslinger, the witness for the RG&E rate plan, is going to provide a slightly revised number for his positive benefits. This would reflect that revised number.

The one that was passed out did not. So, I am going to read these. So the RG&E number under the Iberdrola/Energy East box cumulative reductions is 381.6. The NYSEG dollars do not change. The total then becomes 728.0.

Again, for RG&E the 14.9 becomes 14.7. The NYSEG

1 does not change. The total, as Mr. Connolly points out,
2 is now 11.2. I apologize for that.
3 The same exhibit, 21, the original for the RG&E
4 -- I'm sorry, Energy East/RGS cumulative reductions
5 was 285.2 for RG&E, 536.5 for NYSEG, 821.7 total. Those
6 are all negative figures.
7 Percentage of delivery, negative 11 for RG&E,
8 negative 13.7 for NYSEG, negative 12.6 for total. Those
9 should be for Energy East/RGS. Cumulative reduction
10 should read 137.9 for RG&E, 245.4 for NYSEG, and 383.4
11 total.
12 The percentage of delivery would be 5.3, 6.3 for
13 NYSEG and 5.9 total. And those are all negative
14 figures.
15 Finally, on Exhibit 25, page 15, there was a
16 clause 6-8 was deleted -- I am sorry, 6-H was
17 deleted. And the rest of the clauses are now relettered
18 H through O.
19 MR. VAN RYN: Your Honor, I ask that the
20 exhibits, including the revised exhibits, be marked for
21 identification.
22 JUDGE EPSTEIN: That's fine. There are 25
23 consecutively numbered exhibits, right?
24 MR. VAN RYN: Yes.

JUDGE EPSTEIN: Those are going to be 87 through 111, respectively.

(Exhibits 87 through 111 marked for identification, respectively.)

MR. VAN RYN: Next we have the trade secret and highly trade secret testimony for the record.

JUDGE EPSTEIN: I will take possession of the trade secret version and the highly sensitive trade secret version of those pages of prefiled testimony.

MR. FITZGERALD: Your Honor, we already had a confidential version and HST special transcript. So that would be, I would assume, in the transcripts; is that correct?

MR. VAN RYN: No.

(Off the record.)

JUDGE EPSTEIN: I just want to make the following remarks to summarize and maybe clarify the discussion that we just had off the record. And these remarks should be put in the confidential transcript and in the highly sensitive trade secret transcript. And the remarks are that Mr. Van Ryn has provided the reporter with a confidential version of certain pages of prefiled testimony and a highly sensitive trade secret version of those same pages. And they are being --

1 the confidential version is being added to the
2 pre-existing transcript of confidential material which
3 we initiated yesterday. And the highly sensitive trade
4 secret version is being added to the highly sensitive
5 trade secret transcript, which we are initiating right
6 now with the insertion of these pages.
7 You provided the exhibits to the reporter;
8 is that correct?
9 MR. VAN RYN: Yes, Your Honor.
10 JUDGE EPSTEIN: The witnesses are available
11 for cross?
12 MR. VAN RYN: First a preliminary matter.
13 Yesterday Staff was asked for the date of the material
14 provided at policy panel 17. We have looked into that
15 and have a date and some other information on policy
16 panel 17.
17 A. (Barry) Yes. The date of the Global Power
18 Company article is August 24, 1998. It was part of
19 publication rating methodology corporate rating's
20 criteria. And it's been parsed on the Standard & Poor's
21 ratings direct site just to the article.
22 If you don't want to have the trouble I had
23 trying to find it, I'll give you the key words for
24 search. It's rating methodology for global power

1 companies. Power companies itself doesn't get you
2 anywhere, which is the title of the article.
3 MR. VAN RYN: As we discussed previously, Staff
4 had a chance to examine Exhibit 50, which is the joint
5 petitioners' policy panel number 9, which was presented
6 on March 14, 2008. And Staff has some supplemental
7 direct on that issue.
8 Q. So, I ask the panel, are you familiar with that
9 Exhibit 50 in this proceeding dated March 14, 2008?
10 A. (Panel) Yes.
11 (D'Ambrosia) Yes. We received the document the
12 day before hearings and we've reviewed the document.
13 Q. Have you conducted discovery on the document?
14 A. (D'Ambrosia) No.
15 Q. Do you have any general comments on the proposal
16 and body of the document?
17 A. (D'Ambrosia) Yes. The petitioners contend that
18 the document -- acceptance document is intended to see
19 issues as part of these hearings as we will explain more
20 fully below. The proposal actually creates differences
21 on the issue of vertical market power.
22 The proposal also leaves many important questions
23 unresolved and raises several others.
24 Q. Does the joint petitioners' partial acceptance

document solve all the vertical market power issues related to this proposed merger?

A. (D'Ambrosia) No. The Companies commit to divest the 67 megawatt Carthage market-based unit, but the supplemental response to IBER 0008-S indicates an additional 364 megawatts of market-based wind generation is to be developed, including three projects which would be inter-connected to the NYSEG service territory.

Therefore, the vertical market power concerns addressed in our direct testimony remain.

Q. Please comment on the positive benefit adjustments proposed in the partial acceptance document.

A. (D'Ambrosia) There are fundamental problems with the PBA's proposal and the Company's acceptance document. First, the dollar amount is entirely inadequate to compensate for costs and risks associated with this transaction.

Second, the proposal to reduce rates immediately is problematic. Finally, the proposal fails to address in any way the fact that the utility's rates currently are excessive. And in the instance of RG&E its commodity rates are excessive, as well.

MR. CONNOLLY: Could you read that last sentence back, please.

A. (D'Ambrosia) The proposal failed to address in any way the fact that the utility's delivery rates are currently excessive and in the instance of RG&E its commodity rates are excessive, as well.

Q. Please explain why the PBA amounts proposed by the petitioners are inadequate.

A. (D'Ambrosia) Yes. The $201.6 million PBA figure on page 1 of the acceptance document has an effective date on July 1, 2008 and not December 31, 2008. This change in date overstates the actual amount of PBAs by several million dollars.

This is because the costs underlying the amounts of PBAs are already reflected in the Company's delivery rate structures until their current rate plans end, which would be December 31, 2008.

Q. Could you explain further why the petitioners' PBA proposal is inadequate.

A. (D'Ambrosia) It's inadequate because it does not fully offset the substantial risks and costs of the transaction.

Q. At the level the PBAs offered would this transaction create a net tangible positive benefit to consumers of the type the Commission looks for when approving a merger?

A. (D'Ambrosia) No, the PBAs proposed do not offset the costs and risks of the transaction.

Q. Please explain further.

A. (D'Ambrosia) In our prefiled direct testimony we've identified many risks to customers. One of the significant risks is the risk of exercise of vertical market power. Even a minor impact on customer prices could produce millions of dollars of excessive costs to consumers in a market as vast as the market in New York State or millions of kilowatt hours trades.

Those risks were not present in the other transactions the petitioners compared to the Iberdrola/Energy East transaction, such as the KeySpan-Grid transaction.

Q. In the KeySpan-Grid transaction did the consumers receive over 600 million in tangible monetary benefits?

A. (D'Ambrosia) Yes. In that order, risks due to vertical market power were eliminated. And none of the other risks, such as risks due to cross subsidies and misallocations and inflated costs, which are inherent in this transaction, were present.

In fact, in the KeySpan-Grid merger the petitioners agreed to substantial ring fencing measures, which the petitioners do not commit to here.

Q. Are there other costs that could be caused by this proposed transaction?

A. (D'Ambrosia) Yes. Costs are a result from the incentives the combined Company has to use its regulated utility to cross subsidize non-regulated and competitive operations.

Further, absent ring fencing conditions, it is likely that the utility's credit rating could be adversely impacted as a result of this acquisition. These costs could be substantial over time.

Q. Could you compare the level of the PBAs offered by the petitioners in the partial acceptance documents to the benefits that the petitioners offered and were accepted in the State of Maine?

A. (D'Ambrosia) Yes. In the Maine Order in docket 2007-355 dated February 7, 2008, which was an exhibit we had yesterday, we found that the Energy East affiliate in Maine, Central Maine Power, agreed to somewhere in the neighborhood of $300 to $400 million in positive benefits.

That amount consisted of approximately 306 million of acquisition adjustment foregone and approximately $86 million of carrying charges on automated metering investments which were also foregone.

That amount of PBAs, which is about 392 million, when viewed against Central Maine's Power delivery rates, about 235 million, is substantially higher in proportion over five years, about 34 percent than the amount offered in the partial acceptance document here. That proportion here would be about 3 percent of delivery revenues.

Q. What standard do you believe Maine employs in reviewing approval of mergers?

A. (D'Ambrosia) According to the order in Maine, which I just referenced, they use a no net harm to consumers standard.

Q. Why do you believe that additional monetary benefits were provided in Maine?

A. (D'Ambrosia) From reading the orders in the documents in that case I believe the Maine Commission perceived substantial risks to consumers.

Q. Did the Maine decision provide for any other protections to ratepayers that are not present in the petitioners' acceptance --

MR. CONNOLLY: I'm going to object to this, Your Honor. This goes far beyond the document put into evidence yesterday -- or the other day, far beyond. This is in the nature of surebuttal.

1 MR. VAN RYN: Your Honor, this is just a
2 comparison to what was done in Maine. They proposed an
3 amount so we are looking at what was done in Maine.
4 MR. CONNOLLY: What was done in Maine is not
5 particularly relevant here. Why don't we look at
6 Connecticut and New Hampshire, as well, if we're going
7 to look at other states.
8 MR. VAN RYN: You can look at those.
9 MR. SCHWARTZ: Your Honor, what Iberdrola
10 would like to comment on too is the issue that
11 Mr. Van Ryn mentioned that brings up this topic is the
12 partial acceptance document.
13 Partial acceptance document as Mr. Van Ryn
14 stated is, in his view, prime game for purposes of
15 introducing further direct testimony on that document.
16 What Mr. Van Ryn is now eliciting from Mr. D'Ambrosia,
17 however, is not just a commentary and views on that
18 document but everything else that that document does not
19 happen to include.
20 That document, as we stated before, is a
21 partial acceptance of the conditions and provisions.
22 Mr. D'Ambrosia has taken issue with some of that. We
23 have not objected to that aspect of it.
24 But where Mr. D'Ambrosia is saying, In here

are the many other items that you happened to not accept, that is going substantially beyond the scope of the partial acceptance document.

MR. VAN RYN: Your Honor, I believe we are entitled to explore what was not accepted as well as what was accepted. I understand they accepted certain conditions. They opened the door to discussion of the ones they did not accept.

MR. CONNOLLY: We could look at the PBAs that we did not accept, Your Honor, we could look at other assets that we did not accept, but I don't think it's appropriate to look at what the Company may or may not have done in Maine, what the Company may or may not have done in Connecticut, and what the Company may or may not have done at the FERC, at the Federal Trade Commission in New Hampshire or wherever.

MR. SCHWARTZ: In addition to that, Your Honor, we do not think -- Iberdrola does not believe it's appropriate to explore that -- to examine all of the other conditions in Staff's over 300 pages of testimony that happened to not be included in the partial acceptance document.

MR. VAN RYN: Your Honor, I have only one more. In fact, that was the last question on this line.

1 You can take that into account.
2 MR. CONNOLLY: I would ask that everything
3 with regard to the State of Maine be stricken.
4 JUDGE EPSTEIN: Well, it's not clear to me
5 whether if we take the partial acceptance document into
6 the record will we have any way of judging the
7 reasonableness of the PBA level of the Company that the
8 petitioners exceed to, or the reasonableness of the
9 level that they decline to exceed to unless you conduct
10 some kind of examination of how it was derived.
11 And it seems to me the import of Mr. Van
12 Ryn's last series of questions was how would this
13 acceptance level of PBAs look in comparison with what
14 happened in Maine using that as a test. After one
15 considers what factors were at play in Maine which is
16 why --
17 MR. CONNOLLY: The problem, Your Honor, is
18 that the witnesses who knew what happened in Maine were
19 on yesterday and they weren't asked the questions. If
20 we have to reserve the right to come back and rebut is
21 what Mr. D'Ambrosia is saying.
22 He doesn't know. He wasn't there. He
23 doesn't know what the level was. The $86 million, I
24 believe, was not in the record. He's coming up with a

calculation of it. With regard to the acquisition premium that he testified to, he doesn't know what the cases that underline the merger case.

In other words, we have a rate proceeding going on at the same time. He doesn't know how that juxtaposed with the merger case. That is something that could have been answered yesterday by the Company's policy panel. They weren't asked the question. It's too late now to bring it up.

In responding to a document that has no -- makes no mention of the State of Maine or mention of any other regulatory approvals--the other eight regulatory approvals that the petitioners have gone through and have received approvals for, there's no mention of any of the others.

MR. VAN RYN: Your Honor, the Commission would be very surprised to hear that the benefits offered in New York could not compare to the benefits offered in Maine.

MR. SCHWARTZ: One other point I think it's important to consider here, which is there is no factual basis for the statements that have been offered with respect to these levels in Maine. There's no foundation with respect to them. There's no analysis that has been

1 undertaken with respect to the impacts of those alleged
2 numbers.
3 And as Mr. Connolly had stated, which I
4 think is very significant, the petitioners' policy panel
5 was up and was available for review. In fact, at the
6 very beginning when the joint acceptance -- when the
7 partial acceptance document was discussed at the
8 beginning of this hearing we were under the impression
9 -- I was under the impression that, in fact, the
10 petitioners' policy panel would be asked numerous
11 questions on the partial acceptance document, including
12 where these numbers came from and how they compared with
13 other possible proxies. And none of those questions
14 were asked.
15 MR. VAN RYN: That's because we had three
16 days of notice. Now, if they want to extend the
17 schedule so we can fully testify in the rate
18 proceedings, we will happily agree.
19 JUDGE EPSTEIN: That's what I was about to
20 say before. There are kind of two different problems
21 that we have to make sure we take care of. One is that
22 we have to come out of here with a record that makes
23 sense, by which I mean it's cogent. And if somebody
24 comes in here with a number, for example, for PBAs, we

have to have a record that provides an understanding of how that number was derived and the merits of using that number.

That's one category of problems. The record has to be completed. And I am really not sure it is with respect to the PBA figure and the partial acceptance document because it just stands there and, as far as I know, we don't have facts on the record that would permit an appraisal of the validity of that number.

The other problem is -- the second category of problems is that, as Mr. Van Ryn was just getting into, we are trying to make the best of a situation in which a fairly significant substantive list of modifications of the petitioners' positions came in on Friday, the last day before the start of hearings. And so whatever has to be done to make the remainder of the proceeding fair for both sides, we have to do it.

That means if Staff wants to investigate this document, they should -- they are entitled to an adequate opportunity to do so. You can argue whether they had an adequate opportunity or not, but I think the reason why we find ourselves listening to extended supplemental direct testimony is because Staff is trying

to shortcut this in comparison, for example, with having demanded two more weeks for discovery and opportunity to do an additional prefiling.

What I understood Staff to be doing on Monday was reserving their rights, whatever those might be, to add to the record. Now -- and under those circumstances I don't think--it's simply not accurate to say that because the petitioners' policy panel has left the building, it's too late to question the petitioners' policy panel on that. I don't think the second working day after receipt of this Exhibit 50 was necessarily the date by which Staff could reasonably have been expected to prepare to cross the petitioners' policy panel or even to have it occur to them they should be crossing the petitioners' panel.

In sum, I don't know what it's going to take. If -- frankly, if I were sitting at the petitioners' table worrying about how I was going to cross on your supplemental direct, Mr. Van Ryn, I would feel uneasy not having a transcript of what you have just done, but just having my own notes.

And I think also the Staff witness, Mr. D'Ambrosia, drew some comparisons that could be fairly complex when you get into them. I don't know

1 whether -- just as I don't know whether it was fair to
2 expect that Staff's last chance to examine the
3 petitioners' policy panel would have been yesterday, I
4 don't know whether it's fair to expect that -- I don't
5 know whether it's fair to conclude that petitioners had
6 had an adequate opportunity to prepare cross on this
7 supplemental direct sitting right here.
8 It may well be necessary to work out a more
9 elaborate and prolonged hearing phase of coming back in
10 a couple of days or whatever the case may be. I am not
11 going to come out of here with an incomplete record just
12 for the sake of sticking to the procedures that were
13 previously anticipated and may no longer be appropriate.
14 MR. DUTHIE: Your Honor, could I be heard.
15 JUDGE EPSTEIN: I guess Mr. Mager was first.
16 MR. MAGER: Thank you, Your Honor. It seems
17 to me that this line of supplemental direct is entirely
18 appropriate, as Your Honor noted. This partial
19 acceptance document was provided to the parties the
20 business day before hearings so I don't think it's fair
21 to expect Staff to test that document or to comment on
22 that document solely through cross-examination.
23 It seems entirely reasonable for them to be
24 able to ask the Staff panel to address the document

rather than to only having to do it through cross-examination. So, I think it's entirely appropriate for Staff to conduct direct on the topic.

In terms of the substance of Staff's direct, I also believe it's entirely appropriate on the grounds that petitioners have made a partial acceptance on dollars and other issues. And, therefore, Staff should have an opportunity to comment on whether those dollars are sufficient or not.

And certainly one of the ways to address whether the dollars are sufficient or not is to compare it to financial concessions or agreements made by other states in which Energy East also operates. So, I don't think anything Staff has done up to this point has been inappropriate or inequitable to anyone given the timing of this and I think, as Your Honor notes, that we really have two choices. We have to try to plow through and give parties the fair chance to address the document in the current schedule for hearings, or we have to amend it, in which case it's going to take longer to complete the situation.

JUDGE EPSTEIN: Amend what?

MR. MAGER: Amend the schedule. And so I viewed what Staff is doing as an attempt to try to work

within the existing schedule. To the extent petitioners have it difficult now, it's no more difficult than other parties and having to respond to the partial acceptance document.

MR. DUTHIE: Your Honor, first I would like to note my partial acceptance of Mr. Mager's comments. More importantly, I think we can solve this problem through an objective briefing of the various opinions from these Commissions.

It is inappropriate, in my view, to have any party testifying as to what interpretations they attach to a Commission order. Commission orders speak for themselves. To the extent that we can look at the Connecticut order or the Maine order or the New Hampshire order or any order that has been published, we're allowed to do that. And that can be a matter for briefing. I don't think it's appropriate to turn what's in Commission orders into the basis of interpretive testimony.

MR. VAN RYN: I'll disagree with that one. It's done all the time.

JUDGE EPSTEIN: If it's time to argue about what Mr. Duthie has just said, I have problems with it also because what Mr. D'Ambrosia was trying to address,

1 I think, was he was taking the Maine order and what he
2 was talking about doesn't speak for itself because he's
3 trying to put that in the context of how was Maine
4 different.
5 I mean, he's looking at the Maine Order and
6 saying, well, they came out this way. But to what
7 extent is that because of the extrinsic reasons that
8 Maine presented a different situation from New York.
9 And you won't get that from the order.
10 MR. DUTHIE: Your Honor, I think that's a
11 very slippery slope to go down because you're
12 essentially trying to get into the minds of the folks
13 that either settled it or made a decision.
14 I think traditionally orders speak for
15 themselves. We can write briefs about it. We can do
16 analyses of what's in those orders. I think that's the
17 more appropriate way to proceed. And it will also
18 eliminate any problems with the schedule.
19 Mr. D'Ambrosia, I don't believe, sat in the
20 Maine proceedings. There may be some other people here
21 who did, but I still think it would be inappropriate to
22 hear testimony from them when we have a Commission
23 order. It's sort of like everything gets resolved.
24 It's a final order and people can do with it what they

1 will.

2 But to sort of go back, it's almost like

3 peeling the onion skin off the settlement agreement. I

4 think it's totally inappropriate. And that's my final

5 word, Your Honor.

6 JUDGE EPSTEIN: All right. Let's --

7 MR. CONNOLLY: Can we proceed, Your Honor.

8 JUDGE EPSTEIN: -- put that into the

9 hopper.

10 Mr. Prestemon, what did you want to say?

11 MR. PRESTEMON: Yes, Your Honor. First I

12 wanted to concur with the comments of Mr. Mager and I

13 wanted to express my appreciation to the Staff for

14 trying to find a way to deal with this document in a

15 manner that doesn't unnecessarily prolong the

16 proceedings.

17 I do think part of the problem we're

18 experiencing here is arising from a difference of

19 interpretation of the meaning of this partial

20 acceptance. I am hoping maybe petitioners can clarify

21 it for us.

22 But I had interpreted this document much

23 like an acceptance of the position of another party

24 through rebuttal testimony. An issue is taken off the

1 table. It doesn't matter whether another issue wasn't
2 taken off the table or another issue wasn't addressed at
3 all. One issue is taken off.
4 So I interpret this from CPB as being a
5 document which had the effect of establishing a floor on
6 certain issues. If we -- all issues remain on the
7 table for litigation as to PBAs and benefits and so
8 forth, but my interpretation was if none of the parties
9 presented any information on positive benefits, we'd
10 still be entitled to the dollar amount which the
11 petitioners put in the partial acceptance. It's an
12 accepted amount.
13 If we prove nothing, that amount is on the
14 table, having been accepted out of all the proposals
15 that were presented. The same, I assume, was true with
16 vertical market power. They may not have taken a
17 position that is consistent with everything we'd have
18 asked for or Staff would have asked for or they would
19 have asked for, but those issues on which they did
20 accept, including the divestiture of the fossil fuel
21 generation, are now off the table. It is a floor if we
22 present no evidence on vertical market power from here
23 on out.
24 We are entitled to that in the Commission

order. That was my interpretation. So Staff and we have lost no opportunity to litigate any other issue that they didn't address on the partial acceptance. That was my view.

JUDGE EPSTEIN: Thank you, Mr. Prestemon.

Mr. Brew.

MR. BREW: Your Honor, at the risk of agreeing with the CPB, I had read the document as their list of concessions, not an offer of settlement of the docket. For example, on the PBAs what I read was that they -- of Staff's 646 million PBAs they were accepting 208.

So I didn't see the document as raising new issues. I just saw it as them making concessions. As Mr. Prestemon said, we no longer have to argue about it.

The questions I have for both the Company and Staff are: Does this document raise new issues or does it simply concede issues that have already been identified? Because I read it as the latter.

MR. VAN RYN: No, it raises new issues because it raises the adequacy of their concessions.

MR. CONNOLLY: We made no concessions before so I guess you said that was clearly inadequate.

MR. PRESTEMON: You can only be inadequate

1 if it is intended to be complete. And our understanding
2 was it was not intended to be a complete offer.
3 MR. BREW: My question then would be to the
4 petitioners. What I understand the letter was we
5 conceded the following: Our position remains the same
6 on everything else. If that's true then there are no
7 new issues because we are not talking about sufficiency
8 of the case because you haven't changed your position.
9 MR. SCHWARTZ: That is a correct
10 characterization.
11 MR. VAN RYN: Then what is it? If it's not
12 a new position that deserves to be explored, then why
13 are we considering it at all? Why don't we just say,
14 Thank you, go back to settlement talks, we'll take it
15 up.
16 Other than that, we'll take it right off the
17 record. If there is nothing new and we are not
18 concerned with the adequacy of it, why is it on the
19 record at all?
20 MR. SCHWARTZ: Your Honor, I think taking
21 one example is a good example. The Russell Station is
22 on there and eliminates whether Russell Station should
23 be divested or not because it commits to such
24 divestiture so that Your Honor would not need to make a

determination on that on the merits under this record.

So the obvious answer is a partial acceptance document removes certain issues that need to be determined. There are many other issues, Your Honor, that you will still need to determine. And tried to make clear to Mr. Van Ryn and the other parties that this document was not intended to seek to resolve all issues in the proceeding. It was only intended to try to minimize them at some level.

MR. VAN RYN: Even if it does that, Staff is entitled to explore the relationship among various factions. If partial acceptance does not resolve this case, what parts does it resolve? What's the relationship to the part that it doesn't?

Those are issues that need to be explored.

JUDGE EPSTEIN: I am proceeding from the assumption -- maybe this is a misunderstanding on my part, but I am proceeding from the assumption that confronted with this -- let's say, confronted with this 201.6 million figure, the Commission will have to consider the merits of it, whether it's an appropriate number.

Now, I am trying to follow your analogy to Russell Station. Russell Station is a discrete object

and you can understand whether it's divested or it's not divested, whether it's in rate base or not. The 201.6 million of Staff's proposed 646, I am not sure whether that's itemized.

In other words, is that really a statement that if you go through the Benedict exhibit and Haslinger exhibit line by line, you will find the petitioners agree with some lines and not others, or it's just kind of a fungible 201.6 million?

MR. CONNOLLY: The former, Your Honor.

Can I make a suggestion, Your Honor, that we move on. And we have heard everybody's arguments. Let us do examination, cross-examination, and see where we wind up at the end of the day.

We don't think with that adequate notice and due process we'll raise our issue again if we think resolve it. And it may be moot and saved some hearing time.

JUDGE EPSTEIN: Mr. Van Ryn, did you complete your supplemental direct?

MR. VAN RYN: On the Maine topic we have the unanswered question and that's the last one I wanted to ask.

JUDGE EPSTEIN: Mr. Connolly, your proposal

sounds unexceptional if Mr. Van Ryn can complete his supplemental direct.

MR. VAN RYN: Not much longer, Your Honor. This is the last Maine. I only have two or three others.

JUDGE EPSTEIN: Do you want to withdraw your objection to that series of questions?

MR. CONNOLLY: Why don't I withdraw it subject to renewal at the end of the examination or cross-examination.

JUDGE EPSTEIN: Thank you.

BY MR. VAN RYN:

Q. Did the Maine stipulation provide for any other protections which are absent from the partial acceptance document?

A. (D'Ambrosia) Yes. The Maine stipulation, which was entered as an exhibit during the Company policy panel testimony as well as the Maine Order, which was also entered as an exhibit and the Maine bench analysis, those documents do contain ring fencing and divestiture provisions.

You need to look at paragraphs 23 and 58 of the Maine stipulation, again, which was an exhibit yesterday.

Q. Besides the PBA issue do you have any other concerns with the petitioners' proposal?

A. (D'Ambrosia) Yes. As highlighted earlier the proposal does not address in any way the fact that the utility delivery rates and RG&E's commodity rates are currently excessive.

In addition, it does not address the fact that the levels of earnings sharing under the current rate plans are excessive. In fact, this proposal would appear to --

MR. CONNOLLY: Can I object again, Your Honor. This is in the direct testimony of the Staff policy panel. Doesn't have to be reiterated.

JUDGE EPSTEIN: Is that correct?

MR. VAN RYN: If you -- yes, we did address -- I think there is two points. I think, first, the effect of this document on the currently excessive earnings is something new and we could explore that.

To the extent that we have our remaining objections in the testimony to the adequacy of current rate and regulatory adjustments that we're going to pursue, all we want to do is make clear we are pursuing those despite the acceptance document.

MR. CONNOLLY: So noted.

MR. VAN RYN: I have no further questions on the supplemental direct.

JUDGE EPSTEIN: Thank you.

The witnesses are available for cross?

MR. VAN RYN: Yes, Your Honor.

MR. CONNOLLY: Thank you, Your Honor.

CROSS EXAMINATION

BY MR. CONNOLLY:

Q. Mr. D'Ambrosia, you are the person who is responsible, you just testified, with regard to the central Maine power issues; is that correct?

A. (D'Ambrosia) I gave the testimony; that is correct.

Q. Are you the person I should address my questions to with regard to it?

A. (D'Ambrosia) You can address them to the panel. We'll, through the appropriate witness, will address your answers.

Q. When did you become aware of the numbers you gave us?

A. (D'Ambrosia) When did I become aware of the numbers?

Q. Yes, the acquisition premium?

A. (D'Ambrosia) Sometime between today and when the settlement was approved by the Maine Commission.

Q. Let's -- that was about six weeks ago so let's see if we can do better than between today and six weeks ago.

A. (D'Ambrosia) It wasn't today so somewhere between those dates. I don't remember exactly when, probably earlier rather than later.

Q. How did you receive it?

A. (D'Ambrosia) The --

Q. How did you receive the information? Was it verbal, was it in writing?

A. (D'Ambrosia) No. The Maine Commission has a website and I monitor the website routinely to examine the various Energy East cases in Maine. And the website provides documents whenever they are loaded on the website.

Q. Would it be fair to say you had it before you received the petition exhibit offer of concessions?

A. (D'Ambrosia) Yes.

Q. Did you receive it a week or two weeks before that time?

A. (D'Ambrosia) Probably more than that.

Q. More than two weeks ago.

You were here yesterday for the cross-examination of the staff of the petitioners' policy panel; is that correct?

A. (D'Ambrosia) For, I think, most of it, yes.

Q. Were those documents introduced into evidence?

A. (D'Ambrosia) Yes.

Q. Was there any cross-examination with regard to the amount of concessions that the Companies might have given?

A. (D'Ambrosia) I didn't conduct cross-examination, but I believe Staff counsel did.

MR. VAN RYN: Your Honor, I am going to object. Whether Staff proceeds through cross or supplemental direct is not the Company's concern.

MR. CONNOLLY: Oh, it is.

MR. VAN RYN: No, it's not. We are allowed to choose the manner and presentation of our case.

JUDGE EPSTEIN: On a simpler level, Mr. D'Ambrosia doesn't know the answer to the question and it can be answered by reference to the transcript.

BY MR. CONNOLLY:

Q. Mr. D'Ambrosia, how many times has the State of New York allowed the recovery of an acquisition premium in rates?

A. (D'Ambrosia) I haven't studied that question for this testimony. It's outside the scope of my testimony.

Q. Does anybody on the panel know?

A. (Barry) No.

Q. Would it be fair to say it has never allowed a recovery of acquisition premium? Would you take that subject to check?

MR. VAN RYN: Objection. How are they going to check that without going through hundreds of years of decisions?

Q. Do you know of any time in your working at the Commission, your collective periods of time, where an acquisition premium has been allowed to be recovered in the State of New York?

A. (D'Ambrosia) It's possible that there were some small or medium-size cases in which acquisition premium was an element of the rate plan, but I did not study that for preparation of this testimony.

Q. Do you know -- does any of the panel members know whether or not an acquisition premium has been allowed for recovery in the State of New York?

A. (D'Ambrosia) As I said, Mr. Connolly, that's outside the scope of our testimony. If that was something in our testimony we'd know, I think.

Q. Do you know how many times in the State of Maine an acquisition premium has been allowed to be recovered?

A. (D'Ambrosia) Again, that's outside the scope of our testimony. We did not testify to acquisition adjustment in Maine.

Q. If the Company gave up on acquisition premium issue and the recovery of it, isn't the value determined on the likelihood of retaining recovery of that acquisition premium?

A. (D'Ambrosia) Are you asking generically or in the case of Central Maine Power?

Q. Let's just take generically?

A. I am sorry. You'd have to rephrase the question.

Q. Let me ask you this: Let's say Energy East and Iberdrola sought the recovery of the acquisition premium in this case. What odds would you attach to the recovery of that acquisition premium?

A. (D'Ambrosia) There would be no justification for it so there would be -- because there are no synergies present so there would be no justification. And, therefore, no likelihood whatsoever.

Q. Do you know whether or not the same is true in Maine?

A. The same what is true?

Q. Whether or not the likelihood of success is minimal?

A. (D'Ambrosia) In Maine, as I read the bench analysis and rate case document as I went through those -- I think Mr. Rude actually conceded yesterday it was a claim the Company made in a rate case in Maine. That's pretty much bench analysis which is on the record. So there was an entitlement to claim that money and Company did, in fact, make the claim.

Q. Do you know what the claim was?

A. (D'Ambrosia) 306 million.

Q. Do you know how the Company sought to recover the monies in the pending rate case before the Commission?

A. The Maine rate case asked for recovery -- the Company asked for amount of recovery of acquisition premium.

Q. What was the amount they sought to recover?

A. Off the top of my head it was somewhere in the neighborhood of -- it was a percentage of the 306 million. I am thinking 9 to 15 million per year.

Q. Would you take subject to check 9 million?

A. (D'Ambrosia) I can accept that.

Q. What they gave up was the present value -- do you know how long the ARP was proposed for?

A. (D'Ambrosia) I could check that if you have a number.

Q. If we are looking at 9 million for the year do you know what the levelized AMI carrying charges was worth?

A. (D'Ambrosia) Yes. The Office of Public Advocate in Maine made a statement in the Bangor Daily News on Saturday January 12, 2008. And I will quote, "By replacing the original proposal we reduce costs by about $86 million in the next 23 years that they [consumers] otherwise would have been asked to pay," a Mr. Davies of the Office of Public Advocate in Maine said.

Q. Do you think that's a realistic figure?

A. (D'Ambrosia) Do I think so? I think the Office of Public Advocates thinks so.

Q. I am asking you, Thomas D'Ambrosia, do you know?

A. (D'Ambrosia) I know how they calculated it.

Q. If the Companies accepted the same proposition here in New York would you take the levelized amount as a benefit that could be added to the string of benefits?

A. (D'Ambrosia) I believe Mr. Benedict did allude to that in his testimony.

Q. If New York companies are probably twice as large as the Maine companies, would you take that subject to

check?

A. (D'Ambrosia) Twice as large -- Central Maine has 235 million of delivery revenues. New York utilities have a billion three, so about one-sixth.

Q. So if we did a levelized on that are you saying it's about eight times more?

A. (D'Ambrosia) I have no idea.

Q. You threw out a figure of $87 million -- or $86 million as being the value to the State of Maine. I am saying if we accepted the same proposition in New York or AMI what value would you ascribe to it?

A. (D'Ambrosia) I have no idea. I haven't done the study.

Q. I asked you whether or not you thought the Public Advocates' $87 million was an appropriate number. You don't know? You haven't studied it?

A. (D'Ambrosia) Yes, I have. I did say yes because the amount that that was based upon was based on the cost factors and the investment in Maine over a certain period of years. In fact, there is an attachment to the Maine stipulation that lays out those figures. Whether those figures would translate on a proportional basis to NYSEG and RG&E, I have no idea.

Q. If the Companies made the -- or the petitioners

made the same concessions here, would you consider that to be a benefit?

A. (D'Ambrosia) I already answered that question.

Q. You would?

A. (D'Ambrosia) Yes.

Q. Mr. D'Ambrosia, you talked about distribution revenues. Do you know whether or not Maine separates out transmission revenues?

A. (D'Ambrosia) Separates out?

Q. They record it separately from distribution revenues?

A. (D'Ambrosia) I would have to go look in what came out of the rate case analysis. So whatever is in there is what it is.

Q. Would you take subject to check that does not include transmission revenues?

A. (D'Ambrosia) I am sorry. How would I check that?

Q. You have access to the Maine website. You can look at all the files made up there?

A. (D'Ambrosia) I am not sure they are concerned with transmission. They are delivery revenues.

Q. As you pass through, you'll see it in any of the reports.

A. (D'Ambrosia) In that vein, I could check that,

1 but you have to realize, too, the numbers I gave for the
2 New York utilities is just delivery revenues. It does
3 not include transmission revenues either.
4 Q. Are transmission revenues included in
5 distribution revenues in the State of New York?
6 A. (D'Ambrosia) No.
7 Q. Do you understand in the State of Maine that
8 transmission revenues goes down to the residential and
9 commercial and industrial customers? It's not just
10 wholesale customers?
11 A. (D'Ambrosia) I don't understand the question.
12 Q. Do you understand how transmission revenues are
13 calculated in the State of Maine?
14 A. (D'Ambrosia) No. I believe it's a FERC question.
15 Q. You do not understand it?
16 A. (D'Ambrosia) No.
17 Q. Do they calculate it the same way that
18 transmission revenues are included in revenues in the
19 State of New York?
20 A. (D'Ambrosia) It's a FERC jurisdictional matter.
21 We don't have anything to do with that.
22 Q. Do you know whether or not the State of New York
23 whether for rate making purposes transmission revenues
24 are included in total costs of service here in the State

of New York?

A. (D'Ambrosia) In delivery cost of service?

Q. Yes.

A. No, they are federal jurisdiction.

Q. You're clear on that?

A. (D'Ambrosia) I am not sure what you are asking me. We don't set transmission rates.

Q. No, but you include the revenues and expenses in determining the proper distribution rates for your electric jurisdictional companies?

A. (D'Ambrosia) Let me try it a different way to answer your question as simply as I can.

To the extent there are transmission revenues received they may offset the delivery revenue requirement. Is that what you are asking me?

Q. Yes.

A. (D'Ambrosia) I accept that.

Q. Do you know whether or not that happens in the State of Maine?

A. (Panel) I don't know.

Q. Could you look at the website and check.

A. (D'Ambrosia) If you could help me. If you could provide me something I will be willing to accept it.

Q. Will you take, subject to check, that they do

not?

MR. VAN RYN: All the witness is asking is for the document to check it against.

MR. CONNOLLY: The witness hasn't needed much help in finding what's going on in the State of Maine by looking at their website.

MR. VAN RYN: There again, if you ask someone subject to check you got to tell him what the document is.

JUDGE EPSTEIN: On this specifically I don't know. I guess he's asking is there a rate case decision, is there a regulation.

BY MR. CONNOLLY:

Q. Do you want to take a look at cost of service filed by the CMP in the current pending rate case to see how the transmission revenues are accounted for?

A. (D'Ambrosia) I will look at whatever you point me to look at and give you whatever comments you want me to give you.

Q. I just did.

MR. VAN RYN: We need more identification than that. If they want to provide us with the document for us to look at a later time, that's fine. We'll look at whatever they point us to.

MR. CONNOLLY: We will.

Q. Do you know what the Company valued the levelized AMI at?

A. (D'Ambrosia) What the Company valued?

Q. Yes, CMP?

A. (D'Ambrosia) We asked Mr. Rude yesterday about that and he didn't know. If he doesn't know, I doubt I would know.

MR. CONNOLLY: Your Honor, do you want to take the afternoon break?

JUDGE EPSTEIN: It's fine with me. Is there any objection to that? 15 minutes.

(A RECESS WAS TAKEN.)

JUDGE EPSTEIN: Mr. Connolly, do you want to continue?

MR. CONNOLLY: Yes, Your Honor. I only have a couple more questions on this topic with regards to Maine. However, I may revisit tomorrow after I look at the website.

Q. Mr. D'Ambrosia, do you know what Maine law provides with regards to holding company divesting of operating utility in the State of Maine?

A. (D'Ambrosia) I am not a lawyer. If you are asking me for a legal opinion?

Q. I am asking you whether or not you know what the law is in Maine with regard to a public utility Commission ordering a holding company to divest of wholly-owned operating utility?

A. (D'Ambrosia) I will try to answer the question as best I can. I'm referring to the stipulation dated January 9, 2008 in the Maine Iberdrola proceeding. And one of the conditions in that docket, which -- this is an exhibit. It's in the 50's. I don't know what number. It's on page 14 of that exhibit, condition 58. It says "divestiture."

Says here, "The parties agree that the provisions of section 708 authorize the Commission to order reasonable, remedial measures, including the divestiture of CMP and MNG, provided such divestiture is found after appropriate notice and opportunity for hearing necessary to protect the interest of the utility, ratepayers or investors."

MR. CONNOLLY: So, I will yield to Mr. Schwartz, Your Honor. I have a number of other areas to get into that I may be able to start today. If not, I will start tomorrow morning.

MR. SCHWARTZ: One moment, Your Honor.

Q. Mr. D'Ambrosia, I just have a follow-up question

1 -- I just have a question on that same provision you
2 just read in paragraph 58 of that stipulation.
3 Do you still have that in front of you?
4 A. (D'Ambrosia) Yes, I do.
5 Q. Thank you.
6 There is a reference to a section of a statute
7 that you read. Do you know what statute they are
8 referring to?
9 A. (D'Ambrosia) Actually I have read it. I have it
10 here somewhere so I guess I will say yes.
11 Q. Can you pull that statute in front of you.
12 A. (D'Ambrosia) I have got a lot of binders here.
13 Q. I have time.
14 JUDGE EPSTEIN: What exhibit are you on,
15 again?
16 MR. SCHWARTZ: Your Honor, I am reading from
17 the stipulation in Maine when -- hold on one second--
18 which is Exhibit 52.
19 JUDGE EPSTEIN: Thanks.
20 MR. SCHWARTZ: This is the document
21 Mr. D'Ambrosia was reading from a moment ago.
22 A. (D'Ambrosia) Actually I think I left it back at
23 my office which is not located in Albany. I am thinking
24 of the binder where it is.

1 Q. But you have read that section, that law, once
2 before?
3 A. (D'Ambrosia) Yes.
4 Q. Do you know what that law says sort of
5 paraphrasing based on your recollection?
6 MR. VAN RYN: Your Honor, I'd like to point
7 out that it's acceptable for the panel to give its
8 layman's opinion of legal requirements. The actual
9 content and extent of any legal requirement would be a
10 matter reserved for brief.
11 MR. SCHWARTZ: I accept that, Your Honor.
12 And with that I would like Mr. D'Ambrosia's layman's
13 view of section 708.
14 A. (D'Ambrosia) I think it's not too off from the
15 definition that's in the stipulation that I just read
16 from. That would be a good layman's description.
17 Q. Do you think, as -- sitting here today, as a
18 non-lawyer, that what this might mean is that section
19 708 of this statute may permit the Commission in Maine
20 to order divestiture?
21 A. (D'Ambrosia) It says authorize. I don't know if
22 that's may permit. It says authorize so I guess it
23 gives them the authorization to do that.
24 Q. Thank you. Do you know if there is a similar

law, to your knowledge, as a non-lawyer sitting here -- look at me, Mr. D'Ambrosia. Thank you. I wanted to make sure --

A. (D'Ambrosia) I am not getting coached.

Q. To your knowledge, do you know if there is a similar provision or similar law that permits or authorizes divestiture under New York law?

A. (D'Ambrosia) It's not clear to me there is such a procedure in New York.

Q. Thank you.

I think we are done with that exhibit for now. I had some questions about cost allocation. One of your exhibits -- and I believe that it's Exhibit 111, which is revised Exhibit 111 policy panel-25. Hold on one second. Let's confirm that. That should be one of the exhibits that was just marked today.

A. (D'Ambrosia) Yes, I have that.

Q. Thank you.

What is the title of this exhibit? Could you read the title not on the cover sheet but on the main page that starts with Appendix B.

A. (D'Ambrosia) Yes. It says "Standards Pertaining to Affiliates and the Provision of Information."

Q. Thank you.

1 This is -- these are -- what are these?
2 Could you explain what this document is intended to do.
3 A. This document is initiated in a -- originated
4 in -- I am sorry -- in, I believe, the NYSEG 2002
5 agreement. And from that we then made certain
6 modifications as described in our testimony.
7 Q. Are those modifications reflected in this
8 Appendix B?
9 A. (D'Ambrosia) To the best of my knowledge, they
10 are, yes.
11 Q. Would you turn to page 13 of this Appendix B,
12 which is Exhibit 111.
13 On the very top the starting paragraph begins
14 with a little a. There is a -- if you could read the
15 first few sentences for me, please.
16 A. (D'Ambrosia) Yes. "Corporate services such as
17 corporate governance, administrative, legal, purchasing
18 and accounting currently provided by Management Corp or
19 another affiliate of Energy East including RGS for the
20 disco and other affiliates on a fully loaded cost basis
21 may continue. Iberdrola or its affiliates may not
22 provide goods and services to the disco."
23 Q. Thank you.
24 That last sentence, is that one of the

1 recommendations for a condition in this proceeding if,
2 in fact, the Commission were to approve this merger with
3 conditions?
4 Can I withdraw the question please, and I'll just
5 restate it for you. I am sorry.
6 You were requesting as a condition of this merger
7 that this document, in Appendix B, this Exhibit 111, be
8 adopted and included as part of the conditions
9 associated with approval of this acquisition if this
10 acquisition is approved by the Commission; is that
11 right?
12 A. (D'Ambrosia) That is correct.
13 Q. Thank you.
14 And in that last sentence you read which states
15 that Iberdrola or its affiliates may not provide goods
16 and services to the disco, what types of goods and
17 services do you think that includes?
18 A. (D'Ambrosia) From Iberdrola?
19 Q. What types of goods and services do you think is
20 meant by that sentence?
21 A. (D'Ambrosia) Any service.
22 Q. Any service. Thank you. Does that include any
23 services -- does that include O&M services?
24 A. (D'Ambrosia) Yes.

Q. How about back office services?

A. (D'Ambrosia) Yes.

Q. How about accounting services?

A. (D'Ambrosia) Yes.

Q. How about information technology services?

A. (D'Ambrosia) Yes.

Q. Thank you. Panel, do you know whether the State of New York has undertaken efforts to promote the development of renewable wind generation within the state?

(Pause in the proceeding.)

Q. I can repeat the question for you.

Panel, do you know whether the State of New York has undertaken efforts to promote the development of renewable wind generation within the State of New York?

A. (Berger) Yes.

Q. And so are you familiar with the particular efforts that have been undertaken by the State of New York to encourage the development of wind generation?

A. (Berger) I am familiar generally with the RPS program and other efforts of the State, yes.

Q. Can you describe or summarize your understanding of what those efforts are by the State to encourage wind generation?

A. (Berger) It is not just wind. It's renewables in general. We made an effort to increase from 19 percent to 25 percent the amount of renewable generation in the State of New York.

Q. Do you think that's reflective of the development of wind generation in New York being important to the State of New York?

A. (Berger) I would say so.

Q. Have you read the report of the New York State Renewable Energy Task Force that was released in February 2008?

A. (Berger) I don't believe I had a chance to read that yet.

MR. SCHWARTZ: Your Honor, I would like to mark an exhibit if you could bear with me for a moment.

A. (D'Ambrosia) What was the date of that?

MR. SCHWARTZ: February 2008. We will be handing out a copy right now.

JUDGE EPSTEIN: 112.

(Exhibit 112 marked for identification.)

MR. SCHWARTZ: I am going to give everyone a few minutes to receive copies before I ask questions.

A. (D'Ambrosia) Just for the record, I've read a great deal of this. Mr. Berger didn't look at me, but I

was going to interject in a minute.

Q. I would be happy, Mr. D'Ambrosia, to have you or Mr. Berger or anyone else on the panel respond.

Does the panel have this document that we just handed out and labeled Exhibit 112 in front of them?

A. (D'Ambrosia) Yes.

Q. Mr. D'Ambrosia, could you read the title of this document, please.

A. (D'Ambrosia) Sure. "Clean Secure Energy and Economic Growth: A Commitment to Renewable Energy and Enhanced Energy Independence."

Q. Does the panel know whether the New York Department of Public Service participated in producing this report?

A. (Berger) Yes.

Q. Do you know if members -- withdrawn.

Do you know if members of the New York Department of Public Service were members of the task force?

A. (Berger) Yes. There is a page that lists several members.

Q. Who was listed on that page from the New York Department of Public Service?

A. (Berger) Under the task force designees there are Christina Palmiero, John Stewart, both of the Department

of Public Service, and Michael Corso.

Q. Who lead the efforts to undertake this report? Who lead the report?

A. (Berger) Lieutenant Governor at the time.

Q. Now is that person Governor of the state?

A. (Berger) That is correct.

Q. Are you familiar, Mr. Berger or Mr. D'Ambrosia, with the major recommendations made by the task force in this report?

A. (D'Ambrosia) I have read them. I don't know --

Q. Would you turn to -- Mr. D'Ambrosia, would you turn to -- I am sorry. Were you finished or were you still responding?

A. (D'Ambrosia) No.

Q. Would you turn to page v. Mr. D'Ambrosia, the first category on this page is part of the summary recommendations and deals with the renewable portfolio standard; is that correct?

A. Yes, that's what it says.

Q. Would you read or summarize the point made in the first summary recommendation?

A. (D'Ambrosia) You are talking about the bullet that starts with "Recommit to meeting the state's"?

Q. Yes, please.

A. (D'Ambrosia) "Recommit to meeting the state's renewable portfolio standard goal and evaluate raising renewable energy target."

Would you like me to read the entire paragraph?

Q. You can either read or summarize in a way you think is complete.

A. (D'Ambrosia) You are looking for full funding of the RPS program and a revised cost study to authorize collection of all funding needed to achieve RPS goals.

Q. Thank you.

Would you turn the page to vi and review the first item on the top of that page, please. You can read the title and summarize the remainder in a way you think is complete.

A. (D'Ambrosia) Under "Develop a Strategy to Reap the Benefits of New York's Wind Energy Potential." They're looking for the State to commit to realizing the potential of wind energy by addressing local siting and permitting issues and conducting studies to address transmission and infrastructure limitations.

Q. Thank you.

Mr. D'Ambrosia, would you turn to page 11 of this document.

A. Is that Xi?

Q. Arabic 11.

A. Got it.

Q. The top of the page there is a bullet that's called "Facilitate Permitting." Would you be so kind to summarize what that paragraph states or read it at your discretion.

A. (D'Ambrosia) They're looking for the agencies to ensure their policies and programs are consistent and mutually reinforce the goal of economically and environmentally sound wind energy development.

Q. Is there something about that that deals with the permitting of wind generation facilities?

A. (D'Ambrosia) Permitting?

Q. Would you say that this provision indicates that permitting of wind generation facilities is a priority in the State. Would you characterize that as what this provision says?

A. (D'Ambrosia) It's under the permitting recommendation. It doesn't mention that word in the actual document.

Q. Do you believe that the permitting of wind generation facilities -- the facilitation of permitting of wind generation facilities is a priority of New York State?

A. (D'Ambrosia) That's what it appears to suggest.

Q. Do you know that to be true as a matter of policy in New York aside from this document?

A. (D'Ambrosia) I may be the wrong person to address that question.

Q. Does anyone on the panel feel adequately prepared to indicate whether the permitting of wind generation facilities is a priority in New York State or not?

A. (Berger) It states here it should be a priority. Doesn't state it currently is, but I believe the intent of the document is to promote renewable energy in New York. And included in that would be wind.

And reducing the problems with permitting is the part that you are referring to right here, are that they are expect -- talk about Article 10 here. Article 10 has not been active for a while. I am not sure when it expired. There has been several attempts to restart it up. I don't know how long or well that will go if in the future.

Q. Thank you, Mr. Berger.

I would like to move on to another topic. In the Grid-KeySpan merger proceeding do you know whether National Grid was a lower-rated Company than KeySpan prior to the announcement of that acquisition?

A. (Barry) I believe National Grid was lower.

Q. Thank you.

Mr. Barry, do you know whether National Grid used equity or debt to fund its acquisition of KeySpan?

A. (Barry) I know it used a large portion of debt. I don't know whether -- I think there might be equity involved, definitely debt was in the transaction.

Q. Do you think that -- what portion of debt do you think funded that acquisition, do you know?

A. (Barry) Not at the tip of my fingers. I can get the information for you.

Q. I would like to request that you take that as a record request.

Panel, one of the exhibits that you all revised and had marked today, I believe it's Exhibit 106, and it states on the document "I received today revised Exhibit 106 policy panel-20."

Please let me know when you get that in front of you.

A. (D'Ambrosia) Okay. Got it.

Q. Mr. D'Ambrosia, would you read the title of this document, please.

A. (D'Ambrosia) "Benefits to Iberdrola/Energy East and others."

1 Q. There are a number of items listed on that page.
2 Do you see an item that is identified as gains to
3 shareholders?
4 A. (D'Ambrosia) Yes.
5 Q. What is the amount that you list in that item on
6 that line?
7 A. 930 million.
8 Q. Is it true the 930 million -- withdrawn.
9 Is it true the 930 million is reflective of the
10 amount that Iberdrola is paying in above-market premiums
11 for Energy East stock from Energy East shareholders?
12 A. (D'Ambrosia) Yes.
13 Q. Are you aware of how this premium is paid?
14 A. (D'Ambrosia) I am not sure I understand how it's
15 paid.
16 Q. Who's making the payment?
17 A. (D'Ambrosia) Iberdrola is paying.
18 Q. Who is receiving the payment?
19 A. (D'Ambrosia) Current shareholders and management
20 of the Company.
21 Q. In exchange for what?
22 A. (D'Ambrosia) All the common stock of the Company.
23 Q. In that exchange the premium goes to whom?
24 A. (D'Ambrosia) To the current -- well, the

1 shareholders that own the stock and the management of
2 the Company.
3 Q. Thank you.
4 So Iberdrola -- neither Iberdrola nor any of
5 its affiliates keep that premium; is that correct?
6 A. (D'Ambrosia) Yes.
7 Q. You have testified this amount nonetheless would
8 be considered as part of the total amount of benefits to
9 shareholders; is that right?
10 A. (D'Ambrosia) I don't believe I testified that it
11 be -- it's just one of the benefits of the merger. It
12 happened to be going to the shareholders, so I guess
13 yes, correct.
14 Q. Are there any examples that you know of merger
15 cases at this Commission that has ever viewed
16 above-market premium that's paid to shareholders in an
17 upstream stock transfer of an electric utility as a
18 benefit of an acquisition?
19 A. (D'Ambrosia) I think the Commission is always
20 aware that there is a benefit to shareholders. When
21 there is an acquisition it's always on the record.
22 Q. Let me restate the question: Are you aware of
23 any examples of merger cases at this Commission where
24 the above-market premium, that portion which you have

identified is worth 930 million, has been identified as a benefit that should be taken into consideration of the acquisition?

A. (D'Ambrosia) As I said in my prior answer, the Commission is always aware of these benefits. They are always a part of the cases. You can't really avoid looking at a merger acquisition case without understanding the transactional values.

These things are all boilerplate things and items in a merger petition. They're always aware of that.

Q. Excuse me for interrupting. I just want to make sure I understand it.

So in every utility merger case that you know of the Commission has quantified and considered a benefit of the acquisition that should be shared with ratepayers the amount of the acquisition -- I am sorry, the amount of the premium that is going to shareholders?

A. (D'Ambrosia) That question you added additional element about the sharing of that. In that question the answer would be that while the Commission is always aware of the fact that there is an acquisition premium and how much it is because that's typically boilerplate.

And in the merger and acquisition cases we studied, that was not shared, but in those cases there

1 were significant synergies and other tangible rate
2 benefits that were shared.
3 Q. Have you ever heard of an instance where that
4 amount was quantified as a benefit with an eye towards
5 possible sharing?
6 A. (D'Ambrosia) It wasn't then and isn't here. This
7 is just a way to evaluate the PBA amounts that
8 Mr. Benedict and Mr. Haslinger quantified. And it's a
9 way to do it in a case there really isn't any guidance
10 in the precedents we looked at as to how to develop
11 positive benefits to ratepayers.
12 Q. Have you ever known any party or has --
13 withdrawn.
14 Has Staff or any Intervenor in a merger case, to
15 your knowledge, ever taken the position that the premium
16 paid to shareholders should be considered a benefit of
17 the acquisition that should be taken into consideration
18 for purposes of possible sharing with ratepayers?
19 A. I am not aware of any. We are not doing that
20 here.
21 MR. SCHWARTZ: One second, Your Honor.
22 Q. Mr. D'Ambrosia, in this schedule that is marked
23 as Exhibit 106, where the 930 million is listed and you
24 come up with total benefits of 1.68 billion, isn't that

amount intended to be reflective of some justification of levels of benefits that you think should be used in calculation of benefits to ratepayers resulting from this acquisition?

A. (D'Ambrosia) I wouldn't agree with the way you worded it. Let me try it a different way to try to answer your question as best I can.

This amount here is the amount of benefits to Iberdrola, Energy East and others, including executives and senior management. We don't have any other way of evaluating the benefits that Mr. Benedict and Mr. Haslinger presented.

So this is one way, as you say, I think the word justification, evaluation, that's what this is. I would note this is more -- if you took half of this amount it's more than what the amount that Mr. Benedict and Mr. Haslinger came up with.

In addition to that, most of these dollars are after tax so you'd have to gross this up for taxes that would take that number quite a bit higher yet. Even if we took half of whatever the hypothetical number is, it would be way greater than what the benefits that Mr. Haslinger or Mr. Benedict presented.

But again, yes, in your word, it's a

justification. This justifies the PBAs.

Q. If this Commission were to find that any of these items were not indeed a benefit of the merger would that reduce the effectiveness of your justification?

A. (D'Ambrosia) I could agree to that.

Q. Thank you.

The item that we have been talking about is the 930 million entry, which is the largest item in this column on Exhibit 106; is that right?

A. (D'Ambrosia) That line item is the largest, but, again, some of these things need to be grossed up for income taxes.

Q. Thank you.

A. (D'Ambrosia) Again, this is only one of several ways to evaluate the benefits.

Q. Are you familiar with the Orange & Rockland-Con Ed merger and the Commission's order that was dated April 2, 1999?

I can provide you a copy if you need.

A. (D'Ambrosia) Con-Ed O&R?

Q. Yes, Mr. D'Ambrosia.

A. (D'Ambrosia) Somewhat familiar.

Q. Let's make sure we have the same document that we are referring to. The document I have in front of me

1 says "Case 98M0961."
2 Do you have a document that states that on your
3 first page?
4 A. (D'Ambrosia) Yes.
5 Q. Are you looking at a document entitled, "Order
6 Authorizing Merger Issued and Effective April 2, 1999"?
7 A. Yes.
8 Q. Would you turn to page 16 of this decision.
9 Are you on page 16?
10 A. (D'Ambrosia) Yes.
11 Q. Do you see a paragraph entitled "O&R Stock
12 Acquisition Premium"?
13 A. (D'Ambrosia) Yes.
14 Q. Would you read that -- the entirety of that
15 paragraph out loud, please.
16 A. (D'Ambrosia) The first paragraph?
17 Q. The paragraph that's right under the title, "O&R
18 Stock Acquisition Premium"?
19 A. (D'Ambrosia) To acquire O&R CEI will pay
20 shareholders a premium of about 400 million above book
21 value. Petitioners say this premium is in the range
22 established by the utility company mergers since 1998.
23 But Rockland objects to O&R shareholders receiving an
24 increase. The County believes that such gains should

1 inure to ratepayers as they would obtain the gain on any
2 sale of O&R to another Company. It considers the latter
3 result proper under traditional regulation and
4 appropriate during the transition period to competitive
5 energy market, as long as utility companies claim they
6 are entitled to recover 'stranded costs' from
7 ratepayers."
8 Q. Thank you.
9 In the paragraph that follows it seems to
10 summarize the petitioners' position. Would you read the
11 last two sentences of that paragraph -- would you
12 agree the word "they" means the petitioners?
13 A. (D'Ambrosia) Yes, I would agree "they" is
14 referring to the prior sentence which is petitioners.
15 Q. Would you read the last two sentences of that
16 paragraph.
17 A. Sure. "They say O&R will continue to own all of
18 its own assets, including the transmission and
19 distribution system for which it has the local franchise
20 rights. They deny any basis for comparing the proposed
21 merger to a sale of utility property. Staff also
22 distinguishes asset transfer cases from those involving
23 stock acquisitions and mergers."
24 Q. Thank you.

1 Would you turn to page 21 of this decision,
2 please. The first full paragraph on that page, would
3 you read the first sentence of that first full paragraph
4 beginning with the words "With respect."
5 A. "With respect to Rockland's claims that the CEI
6 acquisition of O&R's common stock is the same as the
7 transfer of the Company's assets and franchise rights,
8 neither the facts here nor the applicable legal
9 requirements provide any reason to recast the proposed
10 merger".
11 Q. Thank you.
12 This case resulted in a settlement resolution
13 rather than a litigated outcome; is that correct?
14 A. (D'Ambrosia) Yes. On page 3 does indicate at the
15 bottom there was a settlement agreement.
16 Q. Mr. D'Ambrosia, do you know whether the Staff
17 supported that settlement agreement or not?
18 A. (D'Ambrosia) It does say on page 3, "The
19 Department of Public Service Staff entered into the
20 settlement."
21 Q. Do you know whether Staff took a position in that
22 proceeding on the issue about which you read excerpts
23 from into the record a moment ago?
24 A. (D'Ambrosia) What pages were those on?

Q. Page 16 -- 16 and 21.

A. (D'Ambrosia) The discussion on page 16, I don't believe it shows response by Staff to the argument.

Q. Do you happen to know from recollection or knowledge by other means what Staff's position was on that issue in that proceeding?

A. (D'Ambrosia) We do not know.

MR. SCHWARTZ: Thank you.

We'd like to hand around a document and mark it as an exhibit, please.

JUDGE EPSTEIN: Just identify it.

MR. SCHWARTZ: This document, Your Honor, I guess called Staff's reply statement in case 98-M-0961, the joint petition of Consolidated Edison, Inc. and Consolidated Edison Company of New York, Inc. and Orange & Rockland Utilities, Inc. for approval of a certificate of merger and stock acquisition. This document appears to be authored by one Paul Agresta, assistant counsel to the Department of Public Service.

JUDGE EPSTEIN: 113.

(Exhibit 113 marked for identification.)

MR. SCHWARTZ: Thank you, Your Honor.

Q. Mr. D'Ambrosia, would you turn to page 9 of this document. Do you see a section called "E, claim to

1 portion of stock acquisition premium"?
2 A. (D'Ambrosia) Yes.
3 MR. SCHWARTZ: I know it's a little lengthy
4 and, Your Honor, I hope you wouldn't, but would you mind
5 if we had Mr. D'Ambrosia read this paragraph into the
6 record.
7 JUDGE EPSTEIN: Sure.
8 BY MR. SCHWARTZ:
9 Q. Mr. D'Ambrosia, would you read the entirety of
10 this paragraph into the record?
11 A. (D'Ambrosia) Sure. Before I do that, I notice
12 that the copy of the order you passed out is not
13 complete.
14 Q. The order or the last document?
15 A. (D'Ambrosia) Actually both of these. I don't
16 think are complete. I am sorry, the order, the '99
17 order -- April 2nd, '99 order is missing attachment.
18 Q. Missing the settlement?
19 A. (D'Ambrosia) Yeah.
20 Q. We certainly could retrieve the settlement for
21 you if you'd like. It's obviously available to all of
22 us on the website.
23 A. (D'Ambrosia) Page 9 section E, "Rockland's
24 argument that ratepayers have a claim on a portion of

1 the stock premium proposed to be paid by CEI
2 shareholders to O&R shareholders is not borne out by the
3 authorities cited. All the authorities cited by
4 Rockland refer to instances where utility assets were
5 transferred out of ownership by the regulated utility.
6 In the instant proceeding no assets will be transferred
7 out of ownership by either regulated utility. In fact,
8 the settlement specifically provides that the Companies
9 have not identified the need for any transfer of assets
10 to effectuate the merger, and that the settlement will
11 not be construed as authorization for any transfer of
12 assets.
13 It is not true, despite Rockland's profession,
14 that utilities can circumvent ratepayer entitlement
15 since virtually any sale of an operating asset can be
16 structured as a sale of stock. If a portion of the
17 assets of a regulated utility were to be transferred out
18 of ownership of the regulated utility in the form of a
19 stock sale, the transfer out of ownership of the
20 regulated utility would trigger ratepayer entitlement
21 regardless of the fact that it was a stock sale.
22 The distinguishing factor is that the regulated
23 utility would no longer retain title to the assets,
24 either directly or as a holder of stocks. That

distinguishing factor is not present in this proceeding.

What Rockland proposes, in essence, is a tax on the stock transfer even though the regulated entity has not given up a single asset. Staff knows of no precedent for such a proposal and sees no regulatory principle that would justify such a proposal as the ratepayer interest in the assets remain unaffected by the merger and stock transfer."

Q. Thank you.

MR. SCHWARTZ: That's all I have for this line of questioning. I notice on my watch it's almost ten past 5:00. Should we break for now?

JUDGE EPSTEIN: Break here, sure. Staff, do you have any problem with that?

MR. VAN RYN: No.

JUDGE EPSTEIN: So, we will temporarily excuse the Panel until we reconvene at 9:00 tomorrow.

I would like to point out that the Commission today acted upon Staff's appeal from a discovery ruling. And you may already be aware of it, I don't know, but the Commission granted the appeal to the extent that they -- the order is already posted on the website, but I just want to mention it now for one reason.

1 The Commission granted the appeal to the
2 extent that Staff thought that petitioners should
3 disclose the names of the entities that were involved in
4 a proposed transaction that Board of Directors decided
5 not to pursue, if you recall that aspect of the appeal.
6 And the Commission said that the petitioners
7 need not disclose the financial data that Staff wanted
8 which, as I recall, was essentially earnings before
9 EBITDA. And I am mentioning it because the Commission
10 said that the Company should comply within ten days and
11 the order will speak for itself.
12 The order also said, though, that Staff is
13 at liberty to renew its request for the financial data.
14 If there are further reasons to justify that request,
15 but with respect to the ten days, I think we could all
16 agree that the information to be disclosed under the
17 Commission's order is -- could be disclosed in a
18 matter of minutes.
19 MR. CONNOLLY: I will disclose to Counsel
20 within a couple of minutes orally the names and tonight
21 follow up in e-mail in writing with the names.
22 JUDGE EPSTEIN: Unless petitioners want to
23 pursue further remedies, which I am not by any means
24 precluding you from doing. All I wanted to say is the

1 information probably could be disclosed quickly. And if
2 all parties are inclined to have the information change
3 hands quickly so as to maximize your opportunities to
4 pursue the rest of the case quickly, that would be a
5 good thing. That's all I have to say.
6 MR. CONNOLLY: As I said, I will tell Len
7 within a couple minutes and follow up in writing with
8 e-mail.
9 JUDGE EPSTEIN: Of course, you do want to
10 look at the order before you rely on my representation.
11 MR. CONNOLLY: We have.
12 JUDGE EPSTEIN: So with that we are
13 adjourned.
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