BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

Joint Petition of IBERDROLA, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by IBERDROLA, S.A.	Case No. 07-M-0906

DIRECT TESTIMONY OF MARK D. YOUNGER

January 11, 2008

DIRECT TESTIMONY OF MARK D. YOUNGER

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

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

Q. Please briefly describe your educational background.

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

Q. Please summarize your background.

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

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

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

DIRECT TESTIMONY OF MARK D. YOUNGER

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

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

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

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[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").

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

COMMISSION POLICIES TO SEPARATE GENERATION FROM T&D

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

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

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

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

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

Q. How does shifting investment risks of new generation from captive utility ratepayers to private investors benefit consumers?

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

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

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

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

Q. Has the Commission defined VMP?

A. Yes, in 1998, the Commission issued its VMP policy statement.[12] The Commission stated: "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 transmission and distribution company (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."[13]

[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.

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

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

> 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 place.[14]

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

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

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

A. The Commission identified the potential for VMP when: 1) company owned generation 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.

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

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

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

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

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

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

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[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.

requirements, sold, or shut down."[18] In the RTP Order, the Commission then cited RG&E's commitment to auction the Russell Station upon the RTP's completion.[19]

Q. Since it issued its VMP Statement, has the Commission applied its VMP Statement to require divestiture of utility generation?

A. Yes. As recently as just four months ago, the Commission reaffirmed its position on VMP issues. In its order addressing the National Grid/KeySpan proposed merger issued on September 17, 2007, the Commission conditioned approval of the merger upon, *inter alia*, National Grid's agreement to divest KeySpan's 2,450 MW Ravenswood generating facilities.[20] In establishing this condition, the Commission noted, "[f]or more than 12 years, this Commission has taken numerous actions to develop competitive markets for generation products in New York. The long-term goal is that customers should be able to obtain generation products by paying prices resulting from a fully competitive generation market in lieu of regulated prices (or rates) based on the costs of generation."[21] Finding other alternatives insufficient to adequately address VMP concerns, the Commission held: "We agree with IPPNY and others that a decision by us to rely solely on regulatory

[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

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[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.

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

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

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

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

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

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

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

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

Q. Please describe the NYISO's planning process.

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

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

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

Q. Notwithstanding the fact that the Russell Station repowering regulated backstop proposal was not triggered by the NYISO, has RG&E taken any steps to repower Russell Station?

A. Despite the NYISO's determination that the Russell Station repowering project is not needed to meet the reliability need, RG&E is actively pursuing the interconnection of this new facility to the transmission system. RG&E has filed an interconnection request with the NYISO to interconnect a 300 MW natural gas fired combined cycle facility at the Russell Station site. Before its interconnection request can be granted, a project must complete a System Reliability Impact Study ("SRIS") to determine the impacts of the new interconnection on the transmission system. The SRIS study scope for the Russell Station repowering was approved by the NYISO's Operating Committee on November 30, 2007.

Q. How does RG&E plan to recover its costs for the repowered Russell Station?

A. RG&E indicated in response to information request IBER-0214 that "any costs associated with the project are being treated as capital costs" and that RG&E intends to recover such costs through regulated cost-based rates.

Q. Is it appropriate for RG&E to recover costs from ratepayers associated with its Russell Station repowering project?

A. No. RG&E's intent to recover the costs from ratepayers is inconsistent with the Commission's directives to avoid regulated generation in the ERP Order and its commitments to the PSC to auction the site. RG&E has not received any authorization to take any steps to repower Russell Station. It is inappropriate for ratepayers to bear any of the costs RG&E has incurred and continues to incur with respect to the Russell Station repowering project particularly where, as here, RG&E has committed to the Commission to auction the Russell Station site to an unaffiliated third party, the NYISO has not determined that the project should be triggered to meet a reliability need and the Commission has not found that it would be in the public interest to proceed with this alternative to address reliability needs.

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

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

There is also a significant risk that RG&E's initial estimates significantly understate the cost of the project and the uneconomic costs that are ultimately borne by ratepayers are much worse than currently estimated by RG&E. The recent experience with both Con Edison's ERRP and with the RTP show the potential for costs to ultimately be much higher than the utility originally estimated. There was also numerous cost overruns on generation facilities before restructuring. In addition, the competitive markets are harmed by regulated generation because the addition of the uneconomic generation artificially depresses the market clearing price from competitive levels. This artificially reduces the prices to the merchant generators that rely upon market revenues to cover their costs and return on costs. The potential for regulated subsidized entry also raises the risk faced by existing and future merchant facilities, and this raises their costs to the customers' ultimate harm.

VERTICAL MARKET POWER CONCERNS

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

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

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

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

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

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

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

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

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

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

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

[30] *See* Hieronymus Testimony at 21.

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

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

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

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

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

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

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

A. Yes. While there are some regulatory controls to attempt to address the interconnection process and operation of the transmission system, the problem remains that it is very difficult to differentiate between actions that are part of normal and appropriate operations and those that are part of a VMP strategy. As DPS Staff testified in the National Grid/KeySpan Merger case, "there are innumerable ways a utility could undermine any long run goals and processes to improve transmission flows without 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

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

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

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

Q. Is this surprising?

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

[34] *Id*. at 154.

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

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

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

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

A. No. RG&E has invested over $125 million to construct the RTP to resolve all of the issues to allow its system to operate reliably without Russell Station. To the extent issues remain notwithstanding that significant investment or they are forecasted to recur in the future, they can be adequately addressed through contracts with the new owner of the site or by pursuing non-generation solutions to the reliability problem. For example, when it divested its generating assets, NYSEG, RG&E's sister company, executed the Milliken Operating Agreement to address voltage issues in the Ithaca area. Likewise, capacitor banks have been installed in New York State to address voltage problems.

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

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

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

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

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

2) commit to divest all of their other existing regulated electric generating facilities and to not construct or otherwise acquire an ownership interest in any electric generation in New York that will be subject to cost-based rate regulation, unless otherwise ordered by the Commission; and

3) commit to not construct or otherwise acquire any ownership interests in other electric generating facilities located in RG&E's and NYSEG's respective service territories.

Q. Does this conclude your testimony?

A. Yes, at this time.

Exh __ (MDY-1)

MARK D. YOUNGER

Mr. Younger is Vice President of Slater Consulting and has over twenty-five years of experience in energy analysis.

EDUCATION

MBA, Cornell University, 1983

M.E., Operations Research
Cornell University, 1983

B.S., Engineering, Major - Operations Research
Cornell University 1981

PROFESSIONAL EXPERIENCE

Vice President
Slater Consulting (1994 - Present)
Specialist on electric deregulation, market structure issues and deregulated electric energy, ancillary service and capacity market design. Specialist in electric utility system planning and simulation modeling. Specialist in New York Independent System Operator rules and operation. Extensive modeling experience of California's utilities and the New York Independent System Operator Market. Experienced with PROMOD, ELFIN and EGEAS production cost models.

Senior Project Manager
Morse, Richard, Weisenmiller & Associates, Inc. (1986-1994)
Head of MRW's New York office. Responsible for directing MRW's projects on production cost modeling. Directed MRW's analysis of East Coast utility operations. Prepared extensive analysis on avoided costs in California, New York, Pennsylvania and New Jersey. Prepared expert witness testimony on avoided costs in California and New York. Performed analyses of electric utility emissions reductions associated with cogeneration projects.

Energy Economist
Pacific Gas & Electric Company (1983-1986)
Responsible for developing models and methods for integrated supply and demand-side resource analysis. Performed least-cost utility resource planning, Developed and performed an analysis of resource planning under uncertainty using Monte Carlo techniques. Performed extensive analysis for electric peak and load shape forecasting.

Research Specialist
Duane Chapman, Professor of Resource Economics
Cornell University (1982-1983)
Formulated the financial simulation section of the University Research Group on Energy's (URGE) integrated model of the electric utility industry. Performed an analysis of the impact on New York Pollution levels and New York utilities of proposed acid rain abatement strategies.

Exh __ (MDY-2)

Iberdrola, S.A. Acquisition of Energy East

PSC Case No. 07-M-0906

Information Request

Requesting Party and No.: (DPS-74) DPS Staff

New York Response No.: IBER-0130S

Request Date: October 3, 2007

Information Requested of: Robert E. Rude

Reply Date: January 4, 2008

Responsible Witness: Robert E. Rude

QUESTION:

In comments to FERC in Docket EC07-122 dated September 17, 2007, US Senator Schumer stated:

"I am particularly concerned about [Iberdrola's] plans to re-power Russell Station.. .RG&E has stated that they will convert this dirty and inefficient plant to a combined-cycle, natural gas facility. Given the need for power that the region will face in the coming years, it is critical that Iberdrola give an iron-clad commitment that they will build this new plant as a natural gas and not a 'clean coal' facility before the merger is give[n] sign-off by FERC."

1. Please estimate the overall costs and annual bill impacts to RG&E's ratepayers, in dollars and percentages, of converting Russell to a combined-cycle, natural gas facility, for each of the first five years of its operation as a rate-based facility. Please describe in full all assumptions made, including costs of fuel and market prices for energy and capacity. Please itemize all costs, including: the total cost of construction, return on rate base, depreciation, non-fuel operating expenses, fuel expenses, taxes, and interconnection costs.

RESPONSE:

1. See the attached response, which has been redacted for public disclosure. The complete un-redacted response is confidential and subject to Trade Secret Protection.

Technology/Scenario: 300 MW Russell NGCC - Base Reference Case 05-01-2007

Customer Impact

	2013	2014	2015	2016	2017
Energy Generated (GWH)					
	2013	2014	2015	2016	2017
Fuel Costs ($1,000)					
Variable O&M Costs ($1,000)					
Direct O&M ($1,000)					
Corporate Overhead ($!,000)					
Property Taxes ($1,000)					
Return on Rate Base ($1,000)					
Depreciation Expense ($1,000)					
Plant Costs ($1,000)	$174,728	$185,925	$194,342	$194,455	$194,913
	2013	2014	2015	2016	2017
Energy Value ($1,000)					
Capacity Value ($1,000)					
Ancillary Services Value ($1,000)					
Output Value ($1,000)	$161,381	$171,853	$179,328	$176,684	$177,692
	2013	2014	2015	2016	2017
Net Cost of Plant to Customers ($1,000)	$13,348	$14,072	$15,015	$17,771	$17,222
Estimated Metered Load (1,000 MWH)	7,597	7,654	7,711	7,769	7,827
NBC Net Customer Impact (Cents/kwh)	0.176	0.184	0.195	0.229	0.220

Technology/Scenario: 300 MW Russell NGCC - National CO_2 Case 05-01-2007

Customer Impact

	2013	2014	2015	2016	2017
Energy Generated (GWH)					
	2013	**2014**	**2015**	**2016**	**2017**
Fuel Costs ($1,000)					
Variable O&M Costs ($1,000)					
Direct O&M ($1,000)					
Corporate Overhead ($!,000)					
Property Taxes ($1,000)					
Return on Rate Base ($1,000)					
Depreciation Expense ($1,000)					
Plant Costs ($1,000)	$181,940	$195,749	$207,134	$201,743	$211,945
	2013	**2014**	**2015**	**2016**	**2017**
Energy Value ($1,000)					
Capacity Value ($1,000)					
Ancillary Services Value ($1,000)					
Output Value ($1,000)	$171,799	$184,687	$194,871	$186,655	$197,293
	2013	**2014**	**2015**	**2016**	**2017**
Net Cost of Plant to Customers ($1,000)	$10,141	$11,061	$12,263	$15,088	$14,652
Estimated Metered Load (1,000 MWH)	7,597	7,654	7,711	7,769	7,827
NBC Net Customer Impact (Cents/kwh)	0.133	0.145	0.159	0.194	0.187

Redacted Public Version

Technology/Scenario: 300 MW Russell NGCC - 05-01-2007

Capital Cost Element	($1,000)
ENGINEERING	
FEEDWATER & MISC BOP EQUIPMENT PROCUREMENT	
COMBUSTION TURBINE/ACCESSORIES PROCUREMENT	
DUCTWORK & STACK EQUIPMENT PROCUREMENT	
STEAM TURBINE GENERATOR EQUIPMENT PROCUREMENT	
COOLING WATER SYSTEM EQUIPMENT PROCUREMENT	
ACCESSORY ELECTRICAL EQUIPMENT PROCUREMENT	
I&C EQUIPMENT PROCUREMENT	
SITE IMPROVEMENT EQUIPMENT PROCUREMENT	
CONSTRUCTION	
COMMISSIONING	
OWNER'S COSTS-SITING & LICENSING STUDIES	
OWNER'S COSTS- LEGAL	
ELECTRICAL INTERCONNECTION	
OWNER'S COSTS-SUPERVISION & PROJECT MANAGEMENT	
MISC. COSTS	
Sub-Total	
PROPERTY TAXES	
AFUDC	
Total	$276,319

Redacted Public Version

Technology/Scenario: 300 MW Russell NGCC - 05-01-2007

Common Equity Return =	
Debt Cost =	
Combined Tax Rate =	
Common Equity =	45%
Total Debt =	55%