

BEFORE THE  
STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

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In the Matter of

Case 07-M-0906

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.

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January 2008

Prepared Testimony of Policy  
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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

1 12223.

2 Q. Mr. D'Ambrosia, by whom are you employed and in  
3 what capacity?

4 A. I am employed by the New York State Department  
5 of Public Service as a Supervisor in the Office  
6 of Accounting, Finance, and Economics.

7 Q. Please outline your educational background and  
8 professional background.

9 A. I graduated in 1980 from Saint John Fisher  
10 College in Rochester, New York with a Bachelor  
11 of Science degree in Accounting. I joined the  
12 Department of Public Service in September 1980  
13 as a Public Utility Auditor Trainee and advanced  
14 to my current position through competitive  
15 examinations.

16 As a supervisor of Accounting, Finance, and  
17 Economics I am responsible for managing the  
18 activities of a unit of auditors, accountants,  
19 and financial analysts located throughout New  
20 York State on a variety of projects, including  
21 their participation in major proceedings before  
22 the Public Service Commission. Since 2002, my

1 main responsibilities have been the two Energy  
2 East affiliates operating in New York State, New  
3 York Electric and Gas Corporation (NYSEG or the  
4 company) and Rochester Gas & Electric  
5 Corporation (RG&E). In addition, I directly  
6 participate in proceedings before the Public  
7 Service Commission involving NYSEG and RG&E.

8 Activities that I or my Staff have been  
9 involved in include examinations of accounts,  
10 records, documentation, policies and procedures  
11 of regulated utilities to develop issues for  
12 electric, gas, and telecommunications rate  
13 proceedings, settlements, financing approvals,  
14 fuel and gas adjustment clause reviews, rate of  
15 return reviews, asset sales (including RG&E's  
16 sale of its Ginna nuclear plant and its share of  
17 the Nine Mile Point #2 Nuclear Plant--see Case  
18 03-E-1231 Order Approving Transfer, Subject to a  
19 Modification, (issued May 20, 2004) and Case 01-  
20 E-0011 Authorizing Asset Transfers, (NMP-2 Sale  
21 Order, issued on October 26, 2001), use of  
22 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:

1 electric revenue requirements; electric  
2 commodity options; and on its embedded cost of  
3 service in it's 2005 electric rate proceeding  
4 (see Case 05-E-1222 New York State Electric and  
5 Gas, Order Adopting Recommended Decision with  
6 Modifications, issued August 23, 2006, NYSEG  
7 2005 Rate Order).

8 Q. Mr. D'Ambrosia, as part of your activities in  
9 your role as a Supervisor of Accounting,  
10 Finance, and Economics have you participated in  
11 other ways in NYSEG's and RG&E's formal  
12 proceedings?

13 A. Yes. Recently, among other things, I was  
14 extensively involved in the development of NYSEG  
15 and RG&E's compliance filings establishing its  
16 electric fixed prices (FPO) and fixed non-  
17 bypassable wires charges (NBC) for the 2005-2008  
18 commodity options periods. I was also involved  
19 in Case 06-M-1413-Proceeding on Motion of the  
20 Commission Concerning New York State Electric &  
21 Gas Corporation's Accounting Practices for Other  
22 Post Employment Benefits and the Company's Use

1 of the Interest Earned on the OPEB Reserve  
2 Account (see Order Adopting the Terms of a Joint  
3 Proposal, issued and effective September 20,  
4 2007, the NYSEG OPEB case).

5 Q. Mr. D'Ambrosia, what is your role in this  
6 proceeding?

7 A. I, along with Michael Salony, serve as the Staff  
8 team leaders. In addition, I directly  
9 supervised the work of Mssrs. Benedict,  
10 Haslinger, and Barry on this proceeding.

11 Q. Mr. Barry, please describe your duties for the  
12 Office of Accounting, Finance, and Economics.

13 A. My responsibilities include analyzing financing  
14 petitions, testifying in rate proceedings, and  
15 performing financial forecasting, economic  
16 analysis, audits, and other investigations and  
17 studies. Regarding financings, recommendations  
18 are made to the Commission concerning petitions  
19 to issue debt and equity securities. Issues  
20 that are addressed include the need and the  
21 basis for the issuance, the selection of the  
22 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.

1 Q. Please briefly describe your current  
2 responsibilities with the Department and  
3 previous responsibilities with the Consumer  
4 Protection Board.

5 A. In my work with the Department of Public Service  
6 I have been responsible for analyzing a number  
7 of policy issues, including stand-by rates for  
8 distributed resources, utility commodity hedging  
9 portfolios, renewable portfolio standards,  
10 purchase of receivable (POR) programs, advanced  
11 and competitive metering, cost allocation and  
12 rate design, unbundling of utility services,  
13 unbundled utility bill formats, and  
14 implementation of changes to the Home Energy  
15 Fair Practices Act (HEFPA). In my previous  
16 position with the Consumer Protection Board, I  
17 was responsible for analyses related to  
18 competitive energy and telecommunications  
19 policy, cost recovery, sales forecasts, revenue  
20 allocation, rate design, utility consumer  
21 protections, as well as other issues.

22 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

1 Electrical Engineering from Pratt Institute in  
2 1974. I joined the Department of Public Service  
3 in May 1976. My responsibilities have included  
4 analysis of various rate and regulatory issues,  
5 including rate design, gas sales and revenue  
6 forecasts, operating and maintenance expenses,  
7 depreciation and rate base, and I have testified  
8 on these topics in several proceedings before  
9 the Commission.

10 Q. Panel, did you prepare exhibits supporting this  
11 testimony?

12 A. Yes, we prepared 25 Exhibits, referenced  
13 throughout this testimony as Exhibit \_\_\_(PP-1)  
14 through Exhibit\_\_ (PP-25).

15 Q. In your testimony, will you refer to, or  
16 otherwise rely upon, any information produced  
17 during the discovery phase of this and other  
18 proceedings?

19 A. Yes. We relied upon a number of Petitioner's  
20 responses to Staff Information Requests. These  
21 are attached as Exhibit \_\_\_(PP-2).

1 OVERVIEW

2 Q. Please describe the Petition filed in this  
3 proceeding.

4 A. On August 1, 2007, Iberdrola, S.A. (Iberdrola),  
5 Green Acquisition Capital, Inc. (Green  
6 Acquisition), Energy East Corporation (Energy  
7 East), RGS Energy Group Inc. (RGS), New York  
8 State Electric & Gas Corporation (NYSEG), and  
9 Rochester Gas and Electric Corporation (RG&E)  
10 (collectively, the Petitioners) filed a Petition  
11 requesting that the New York State Public  
12 Service Commission (Commission) approve, without  
13 modification or condition, Iberdrola's proposed  
14 acquisition of 100 percent of the common stock  
15 of Energy East, the parent holding company of  
16 NYSEG and RG&E (transaction or acquisition)  
17 pursuant to Section 70 of the New York State  
18 Public Service Law (PSL) and any other statutory  
19 or regulatory provisions deemed applicable. The  
20 Petitioners requested that the Commission  
21 approve the Proposed Transaction within six  
22 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

1 benefits standard, but it also fails a "no harm"  
2 test that might be used in some regulatory  
3 jurisdictions.

4 Q. Is there a clear and recent example of where the  
5 Commission applied the tangible positive  
6 benefits test in reviewing a merger and  
7 acquisition (M&A) proposal?

8 A. Yes. In the most recent electric and gas M&A  
9 proceeding to come before the Commission,  
10 involving National Grid and KeySpan, the  
11 Commission employed a tangible positive benefits  
12 standard when it performed its evaluation.

13 Q. Can you cite to specific support for the use of  
14 this standard?

15 A. Yes. Support is found in the recent Abbreviated  
16 Order Authorizing Acquisition Subject To  
17 Conditions and Making Some Revenue Requirement  
18 Determinations for KeySpan Energy Delivery New  
19 York and KeySpan Energy Delivery Long Island  
20 (issued and effective August 23, 2007) in Case  
21 06-M-0878, Joint Petition of National Grid PLC  
22 and KeySpan Corporation (Grid/KeySpan Merger).

1 The Order states on page 9: "The more than \$686  
2 million of benefits to New Yorkers can be seen  
3 as the positive side of the ledger in a simple  
4 cost-benefit analysis. They comprise a  
5 significant part of the context within which we  
6 evaluate whether the proposed terms in [the  
7 Joint Proposal] are collectively in the public  
8 interest."

9 Q. Were other benefits alleged by Grid/KeySpan?

10 A. Yes. Those benefits included:

11 in addition to the allocation of savings,  
12 KEDNY's and KEDLI's Rate Plans include  
13 several programs designed to promote the  
14 Commission's policies favoring competition  
15 in retail energy markets, implement new  
16 demand-side programs, enlarge KeySpan's low  
17 income discount rate programs, maintain  
18 service quality, and accelerate  
19 infrastructure investments over the next  
20 ten years. Each of these programs is being  
21 enhanced as a result of the proposed  
22 Transaction (Grid/KeySpan Merger Petition  
23 page 5).

24  
25 The Grid/KeySpan Merger Petition also referred  
26 to benefits such as Grid's long history of  
27 providing service, expansion of resources, and  
28 expertise in providing better service at lower  
29 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,

1 and security issues.

2 Q. Starting with vertical market power issues,  
3 explain your testimony.

4 A. The purpose of our testimony here is to address  
5 the vertical market power issues related to the  
6 proposed Iberdrola and Energy East transaction,  
7 including the effect of those policies in  
8 furthering on New York's efforts to promote the  
9 development of additional renewable power  
10 resources, in particular wind power. Vertical  
11 market power issues arise because two of Energy  
12 East's subsidiaries, New York State Electric and  
13 Gas Corporation (NYSEG) and Rochester Gas and  
14 Electric Corporation (RG&E), own electric T&D  
15 facilities, natural gas distribution facilities,  
16 and electric generating units in New York.  
17 Iberdrola subsidiaries also own wind generation  
18 facilities in New York and have plans to  
19 construct new wind generating facilities that  
20 are listed in the New York Independent System  
21 Operator (NYISO) interconnection queue.

22 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

1 contradiction to Iberdrola's claim) the  
2 acquisition could have a negative impact on the  
3 credit ratings of NYSEG and RG&E. The most  
4 recent credit opinions for NYSEG and RG&E from  
5 S&P and Moody's are presented in Exhibit\_\_\_\_(PP-  
6 4).

7 Q. Please describe Iberdrola's financial profile.

8 A. Iberdrola's financial profile (leverage) is  
9 described as "aggressive" by S&P. The  
10 significant amount of debt financing in  
11 Iberdrola's capital structure is exacerbated by  
12 both the Company's large amount of existing  
13 Goodwill (Goodwill being the excess price paid  
14 over and above depreciated historical cost) and  
15 the incremental Goodwill that will be created  
16 and assumed by the proposed transaction.

17 Q. Are there any other financial risks posed to  
18 customers by the proposed acquisition?

19 A. Yes. The proposed transaction presents a myriad  
20 of risks associated with diminished financial  
21 transparency and reporting. Differences in  
22 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 Baal 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

1 Energy East would mean the vulnerabilities of  
2 the grid system in New York would be in the  
3 hands of one more entity, raising the risk that  
4 it could wind up in the wrong hands. Also,  
5 sensitive customer information could potentially  
6 leave the country where it could be disseminated  
7 without the knowledge of the customer or the  
8 Commission.

9 Q. What benefits could Iberdrola bring to New York?

10 A. Perhaps, if it believes that it would be to its  
11 economic benefit, Iberdrola, as it suggests,  
12 might bring more wind power resources to New  
13 York beyond the substantially-sized projects it  
14 has already announced. Also, Iberdrola implies  
15 that it could bring a fresh perspective to the  
16 Energy East companies, which in theory could  
17 invigorate the companies and its employees.  
18 These benefits, however, are illusory.

19 Q. Why is Iberdrola's claimed wind power benefit  
20 illusory?

21 A. The delivery of wind power resources to New York  
22 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?

1 A. Since the only benefits Iberdrola claims to  
2 bring to New York are illusory, there is no  
3 basis for recommending approval of this  
4 acquisition as proposed.

5 Q. Did Staff attempt to identify an alternative set  
6 of terms and conditions that would enable it to  
7 support the proposed acquisition?

8 A. Yes, but we believe that the long term excess  
9 capital arising out of the M&A transaction  
10 (i.e., the premium paid), will create long term  
11 pressure on the management of the combined  
12 entity to cut corners and seek to extract a  
13 return from the utility assets which exceeds the  
14 realistic and reasonable earnings potential of  
15 those properties. The result can be financial  
16 stress and service problems over the long run.  
17 Nonetheless, if the Commission decides to  
18 approve the M&A transaction, there are a number  
19 of conditions it should require to best assure  
20 that the transaction is in the public interest.  
21 We outline those these terms and conditions near  
22 the end of this testimony.

1 Q. Would your position change if significant  
2 benefits can be found that offset some of the  
3 risks associated with the acquisition?

4 A. First, the Panel stresses that it will be  
5 difficult to find benefits of sufficient value  
6 to ratepayers to offset the risks that would be  
7 thrust upon them if the M&A transaction is  
8 approved. However, if satisfactory levels of  
9 benefits in the form of cost savings to  
10 ratepayers could found, we believe the financial  
11 conditions presented in our testimony would  
12 reduce some, but not all, of the risk that this  
13 M&A transaction presents.

14 Q. Please describe the financial risk to ratepayers  
15 in more detail.

16 A. Post transaction, Iberdrola would have Goodwill  
17 and intangible assets on its books in an amount  
18 that is equal to 46% of its equity balance.  
19 This is a significant hazard to ratepayers. It  
20 will take a great deal of savings to compensate  
21 customers for taking on the financial risk  
22 generated by this, even considering the ring

1 fencing measures we would have the Commission  
2 impose on this transaction.

3 Q. Please summarize the results of your testimony.

4 A. The acquisition should not be approved. The  
5 transaction provides no benefits to the  
6 customers of NYSEG and RG&E, while saddling the  
7 customers with the enormous financial risks we  
8 describe above. In the event the Commission  
9 finds grounds to approve the M&A transaction, we  
10 recommend that the approval be premised upon the  
11 acceptance of the conditions we present in our  
12 testimony below.

13 DESCRIPTION OF THE PROPOSED M&A TRANSACTION

14 Q. Please describe the proposed M&A transaction.

15 A. Under the terms of the proposed M&A transaction,  
16 Iberdrola will purchase all of Energy East's  
17 outstanding shares for \$28.50 per share, for a  
18 total purchase price of approximately \$4.5  
19 billion. This purchase price reflects a premium  
20 of about \$1 billion over the market value of  
21 Energy East's stock and \$2.9 billion over the  
22 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?

1 A. Yes, it has filed a Motion with the  
2 Administrative Law Judge (ALJ) requesting that  
3 production of the information be compelled.  
4 Staff reserves the right to supplement its  
5 testimony after the Motion is acted upon.

6 DESCRIPTION OF IBERDROLA

7 Q. Can you describe Iberdrola?

8 A. Yes. In the five months since the Petition was  
9 filed, Staff has attempted to research Iberdrola  
10 and attempted to learn more about it. According  
11 to the Petition, Iberdrola is a Spanish  
12 corporation that has a market capitalization of  
13 \$70 billion and provides service to 22 million  
14 and 2 million electric and gas customers  
15 worldwide, respectively. Iberdrola is described  
16 in more detail in the testimony of the  
17 Petitioner's Panel and in the Petition.

18 Q. Does Iberdrola have any business interests in  
19 the U.S. and Canada?

20 A. Yes. Iberdrola has interests in renewable and  
21 thermal generation, gas storage, and associated  
22 energy management activities in the U.S. and

1 Canada. Notably, it does not currently own any  
2 rate regulated T&D utility operations in the  
3 U.S.

4 Q. What is the scope of the Iberdrola business  
5 interests in the U.S.?

6 A. Iberdrola has the aforementioned existing  
7 business interests in the U.S. and through its  
8 2007 acquisition of ScottishPower, plc (SP),  
9 Iberdrola now owns PPM Energy, Inc. (PPM), which  
10 has additional U.S. business interests including  
11 wind generation facilities, under development  
12 and in operation, and gas storage services.

13 Q. Describe Iberdrola's U.S. business interests.

14 A. Iberdrola USA and subsidiaries own a variety of  
15 wind generation projects in the U.S. Currently,  
16 Iberdrola has ownership interests in  
17 approximately 47 such ventures (see Response  
18 IBER-0131S to DPS-75).

19 Q. Describe PPM's business interests in the U.S.

20 A. According to an April 26, 2007 presentation  
21 titled "Scottish Power-North American  
22 Businesses: PPM", the PPM businesses include:

- 1           ▪ 1,600 MW of wind power generation,
- 2           ▪ 538 MW of thermal generation,
- 3           ▪ 1.4 bcm of gas storage capacity, and
- 4           ▪ Energy management services

5 Q. Can you estimate the number of U.S. operating  
6 businesses that Iberdrola has ownership  
7 interests in?

8 A. According to organizational charts provided in  
9 Response IBER-131S to DPS-75, Iberdrola has  
10 varying ownership interests in over 100  
11 businesses in the U.S.

12 Q. Has Staff been successful in obtaining a better  
13 understanding of these entities?

14 A. We have received some, but not all, of the  
15 information we need to have a better  
16 understanding of Iberdrola's corporate  
17 relationships. Staff requested basic  
18 information on Iberdrola's U.S. businesses. In  
19 Response IBER-0131S to DPS-75, which took over  
20 two months to compile, Iberdrola provided most  
21 of the information requested. However, Response  
22 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

- 1           ▪ 5 coal units
- 2           ▪ 17 various units in other countries
- 3           Iberdrola also had equity interests in
- 4           approximately 275 entities in the fields of:
- 5           ▪ Generation
- 6           ▪ Regulated gas and energy
- 7           ▪ Supply-marketing, trading, consulting
- 8           ▪ Non-Energy-telecommunications, real
- 9           estate
- 10          ▪ Renewables
- 11          ▪ Engineering and construction
- 12          ▪ International-energy, water,
- 13           telecommunications

14 Q.   What additional business interests were acquired  
15       as a result of Iberdrola's acquisition of SP in  
16       2007?

17 A.   According to SP's 2005-2006 Annual Report and  
18       Accounts, it had ownership interests in a number  
19       of subsidiaries and other ventures, other than  
20       PPM discussed above. Besides regulated  
21       transmission and distribution (T&D) service,

1 SP's owns other business interests in  
2 construction services, asset management  
3 services, data collection, financial services,  
4 and insurance. SP also owns a 6,366 MW of  
5 generation in Great Britain, including natural  
6 gas/coal (5,413 MW), hydro (563 MW), and wind  
7 (288 MW).

8 Q. Going back to Iberdrola's business interests,  
9 are all of these businesses wholly owned by  
10 Iberdrola?

11 A. No. It appears that Iberdrola uses a variety of  
12 differing techniques, such as partnerships and  
13 joint ventures, to obtain ownership interests in  
14 these businesses. The extent of Iberdrola's  
15 ownership interests vary. Some of Iberdrola's  
16 interests are relatively straightforward (wholly  
17 owned) while others are not. For example,  
18 Iberdrola claims that it and Energias de  
19 Portugal, S.A. (EDP) each own 50% of Flat Rock  
20 Windpower (I and II), LLC. Response IBER-0097  
21 to DPS-53 (Revised) reveals that "Iberdrola,  
22 through its wholly-owned subsidiary Iberdrola

1 Portugal Electricidade e Gas, S.A., holds a 9.5%  
2 interest in EDP."

3 Q. Are there other examples of ownership  
4 complexities?

5 A. Yes. Iberdrola claims that it owns 24.4% of  
6 Gamesa. However, from Reuters reports it  
7 appears that on December 28, 2007 Iberdrola paid  
8 76.5 million euros to purchase an additional 1%  
9 ownership share in Gamesa, from IBV, a holding  
10 company owned by Iberdrola and Bank BBVA.

11 Q. What do these examples suggest to you?

12 A. With respect to Flat Rock, when Iberdrola's  
13 affiliate's ownership interest in EDP is  
14 combined with Iberdrola's interest in Flat Rock,  
15 it appears that Iberdrola owns more than 50% of  
16 Flat Rock. Also, with respect to Gamesa, it  
17 appears that Iberdrola's stated 24.4% ownership  
18 interest, directly and in combination with IBV,  
19 may carry significant weight in the management  
20 of Gamesa. The broader point is that  
21 Iberdrola's structure is not straightforward--it  
22 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

1 on that representation?

2 A. It is likely that most major corporations  
3 believe that they are socially responsible.  
4 Their perceptions of themselves are not relevant  
5 to our review. Our responsibility is to review  
6 the facts in the case.

7 Q. What facts has Staff found during its brief  
8 review?

9 A. Staff found that Iberdrola has had some  
10 regulatory compliance problems. For example:

- 11     ▪ Since 2000, 26 complaints were filed against  
12 Iberdrola with the Spanish National Energy  
13 Commission (CNE) involving interconnection  
14 (see Response IBER-0163 to DPS-102),  
15
- 16     ▪ In 2007, the Spanish Antitrust Tribunal fined  
17 Iberdrola \$50 million (€38.7 million) for  
18 abuses of dominant position by a generation  
19 affiliate during 2002-2003 (see Case File  
20 601/05 Iberdrola Castellon),  
21
- 22     ▪ In 2006, fines and sanctions were imposed  
23 against Iberdrola in Latin America and Spain  
24 for matters involving quality of service,  
25 breaches of regulation, and interruption of  
26 supply (see Response IBER-0069 to DPS-43).  
27

28 Q. Are you aware of any more recent allegations  
29 against Iberdrola?

30 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

1 as a legal basis to refuse to provide  
2 information could make it difficult to obtain a  
3 complete and accurate picture of Iberdrola in  
4 the future if the acquisition is approved.

5 Q. You indicated above that Iberdrola has extensive  
6 operations outside the United States and that  
7 you attempted to research Iberdrola. Did you  
8 run into any difficulties in your research?

9 A. Yes. While there appears to be a large quantity  
10 of translated information concerning Iberdrola  
11 in the public domain (e.g., English websites),  
12 much of that information is focused on the  
13 Iberdrola consolidated holding company and is in  
14 the form of broad-brush descriptions rather than  
15 operating level details. It is difficult to get  
16 a sense of the company's operational performance  
17 in the various and diversified business in which  
18 it operates. While investors may not need  
19 detailed operating information, because they are  
20 investing in the overall entity, regulators need  
21 the operating information to assess the  
22 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

1 only agreement between the companies was a  
2 confidentially agreement. This response was  
3 puzzling as it was publicly known from the  
4 companies' websites that Community Energy (CE, a  
5 wholly owned Iberdrola subsidiary) and the  
6 utilities had marketing relationships in place.

7 Q. Were there any other puzzling interrogatory  
8 responses provided?

9 A. Yes. In Response IBER-0155 to DPS-95, Iberdrola  
10 stated that it owned 24.4% of Gamesa, a major  
11 wind manufacturer and developer. In fact, the  
12 Iberdrola/Gamesa relationship was the subject of  
13 a lengthy front page article in the Wall Street  
14 Journal on July 9, 2007 (see Exhibit\_\_\_PP-6).  
15 However, when Staff was probing the extent of  
16 Iberdrola's wind power interests in New York,  
17 the responses provided repeatedly omitted any  
18 mention of Gamesa projects. Iberdrola claimed  
19 that it was "not aware if Gamesa is developing  
20 any generation in New York."

21 Q. Why is that response puzzling?

22 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

1 premium. As such, the Proposed Transaction is in  
2 the public interest."

3 A. ALLEGED LACK OF SYNERGY SAVINGS

4 Q. Does the proposed acquisition result in  
5 synergistic benefits?

6 A. The Petitioner's Panel responds: "No. The  
7 Proposed Transaction represents an acquisition  
8 by Iberdrola at the Energy East holding company  
9 level, rather than a combination of the  
10 operations of individual operating companies."

11 Q. Do the petitioners explain why the acquisition  
12 of Energy East does not provide the opportunity  
13 for synergistic benefits?

14 A. Yes. In Response to IBER-0004 to DPS-4, the  
15 petitioners stated "Iberdrola does not own any  
16 other regulated utilities in the United States.  
17 Therefore, the Proposed Transaction does not  
18 involve the combination or elimination of  
19 corporate or utility operating functions which  
20 are necessary to produce such savings."

21 Q. Is Iberdrola's explanation plausible?

22 A. No. While it is true that Iberdrola does not

1 own regulated utilities in the U.S., Response  
2 IBER-0131S to DPS-75 quite clearly shows that it  
3 owns significant operating energy businesses  
4 throughout the United States. These businesses  
5 have [REDACTED]

6 [REDACTED]  
7 [REDACTED] The size, scale, and scope of  
8 these businesses suggest that some level of  
9 synergistic savings could be achieved after the  
10 acquisition of the Energy East companies.

11 Q. Is there any reason why the companies cannot  
12 attempt to achieve synergies?

13 A. None that we are aware of.

14 Q. Are these businesses in states contiguous to New  
15 York State?

16 A. Some, but not all are. However, lack of  
17 proximity to New York State should not prevent  
18 seeking and achieving synergies, at least for  
19 back-office operations.

20 Q. Why do you believe that synergy savings are  
21 available?

22 A. One expects that large corporations merge

1 because of opportunities for synergies.  
2 Otherwise, they could diversify simply by  
3 purchasing stock in other companies, and avoid  
4 paying premiums above the prevailing market  
5 price of the stock. The location of corporate  
6 headquarters and operating subsidiaries in  
7 different countries has not been a barrier to  
8 synergy savings in other M&A transactions. For  
9 example, it was reported in the media that  
10 Iberdrola's recent acquisition of SP led to \$374  
11 (€260) million of synergies, which was double  
12 what was originally estimated in the merger.  
13 These synergies were achieved despite the  
14 language difference and the fact that  
15 Iberdrola's headquarters in Bilbao, Spain is  
16 over 1,000 miles from Glasgow Scotland, the  
17 headquarters of SP.

18 B. ALLEGED PUBLIC INTEREST BENEFITS

19 Q. What are the alleged benefits to the utilities  
20 customers?

21 A. In its "Public Interest Demonstration" testimony  
22 (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 COMMITMENTS

1 Q. Were benefits promised made when RGS/Energy East  
2 combined in 2002?

3 A. Yes. On page 24 of Energy East's 2002 Merger  
4 Petition in Case 01-M-0404, the conclusion  
5 states that "the merger of RGS with Energy East  
6 will have no adverse impacts. In addition, the  
7 merger will provide significant, tangible  
8 benefits to consumers of both NYSEG and RG&E."  
9 Aside from synergy savings, the merger petition  
10 committed Energy East/RGS to provide the  
11 following benefits:

- 12 1. Stronger financial base
- 13 2. Maximized physical and human resources  
14 to maintain electric and gas systems
- 15 3. No layoffs
- 16 4. RG&E will continue to provide service  
17 at stable rates
- 18 5. Competition will not be diminished
- 19 6. Customer service will not be  
20 diminished
- 21 7. The merger will strengthen RG&E's  
22 commitment to the region/commitment to  
23 have headquarters in Rochester
- 24 8. The post-merger operations and  
25 management will protect RG&E's  
26 customers by the election of three  
27 Board Members of Energy East from RGS,  
28 and by having RG&E's CEO on the Energy  
29 East, NYSEG and RG&E Boards.

30  
31 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

1 merger suggest to you?

2 Q. It suggests that benefits which are not readily  
3 enforceable, such as those propounded by  
4 Iberdrola, have no value because there is no  
5 substantive way to ensure that the post-  
6 acquisition companies will live up to them.

7 D. ALLEGED BENEFITS ARE CONTRADICTED

8 Q. You have shown that commitments made without  
9 enforcement mechanisms have little value. In  
10 addition, has Iberdrola already contradicted its  
11 commitment to some of the benefits alleged in  
12 the Petition?

13 A. Yes. We found three main contradictions.  
14 First, Iberdrola claims that its financial  
15 strength is a benefit, but the New York  
16 utilities remain on negative credit watch status  
17 by S&P in part because of the acquisition.  
18 Second, Iberdrola claims it is committed to  
19 making substantial investments in wind power  
20 investments but then argues that the wind  
21 facilities it plans to construct are de minimus  
22 in size. Third, Iberdrola claims that its

1 utility expertise will enhance New York  
2 management's performance, even though it also  
3 promises to rely upon local management without  
4 intruding upon their decisions. Responses to  
5 Information Requests indicate that: no synergy  
6 savings will result from the Proposed  
7 Transaction (see Response IBER-0004, IBER-0027,  
8 IBER-0029, and IBER-0063), no tax savings will  
9 result from the Proposed Transaction (see  
10 Response IBER-0006, IBER-0025, and IBER-0058),  
11 no consolidations of upstream entities will  
12 result from the Proposed Transaction (see  
13 Response IBER-0009, IBER-0025, and IBER-0060), no  
14 further investment in generation in New York  
15 State will result from the Proposed Transaction  
16 (see Response IBER-0008 and IBER-0037), and  
17 Iberdrola will not provide services to the  
18 operating companies after the Proposed  
19 Transaction (see Response IBER-0020).

20 Q. If this is all accurate, what is the real  
21 business purpose for the acquisition?

22 A. The business purpose for the acquisition of

1 Energy East by Iberdrola is not clear.  
2 Iberdrola does state broadly that the  
3 acquisition of Energy East provides a "platform"  
4 for its expansion in the United States. Yet, a  
5 clear explanation of how Iberdrola's expansion  
6 in the U.S. will benefit the customers of NYSEG  
7 and RG&E is lacking.

8 E. COMBINATION OF T&D AND GENERATION

9 Q. Your testimony above indicates that Iberdrola  
10 has a significant presence in the U.S. already,  
11 including significant investments in generation.  
12 Does its acquisition of Energy East's T&D  
13 companies complicate regulatory oversight?

14 A. Yes. From a regulator's perspective, it makes  
15 protecting the public interest much more  
16 difficult. Iberdrola has a strong U.S. presence  
17 in competitive wholesale generation markets,  
18 though it ownership and development of wind  
19 power facilities. This acquisition will add T&D  
20 to Iberdrola's generation business interests in  
21 New York State. Regulatory policy in New York  
22 State has moved in the opposite direction, to

1 separate ownership of generation from ownership  
2 of regulated T&D. Combining regulated T&D  
3 businesses and significant ownership interests  
4 in competitive generation that, under New York  
5 regulatory policies should remain separate, is  
6 not an improvement or benefit. Instead, the  
7 combination of Energy East and Iberdrola will  
8 create extensive vertical market power problems,  
9 as discussed in the analysis of vertical market  
10 power presented below.

11 F. PROTECTION AGAINST ADVERSE IMPACTS ON RATES

12 Q. The petitioner's claim that the transaction will  
13 have "no adverse impact on customers." Is this a  
14 benefit of the acquisition?

15 A. No. In reality, since the petitioners provided  
16 only vague rather than substantive terms or  
17 conditions regarding the companies' rates or for  
18 the protection of customers against bearing some  
19 of all of the costs of the acquisition, there  
20 are no facts or rationales to support the claim  
21 that the transaction would have no adverse  
22 impacts on customers. In fact, the size of the

1 premium that Iberdrola has agreed to pay for  
2 Energy East creates pressure for Iberdrola to  
3 find creative ways to raise rates so that it can  
4 earn a higher return and obtain the extra margin  
5 needed to service the capital used to pay the  
6 premium.

7 Q. How did the petitioners support the claim that  
8 "no adverse impact on customers" is a benefit to  
9 customers?

10 A. The Petition states "there will be no changes to  
11 the rates, terms or conditions of service  
12 provided to NYSEG and RG&E customers in  
13 connection with the Proposed Transaction. The  
14 Joint Petitioners are not seeking to modify the  
15 existing rate plans of NYSEG and RG&E as part of  
16 the Proposed Transaction" [footnote omitted]  
17 (Petition page 16).

18 Q. Do you find the petitioner's commitment to  
19 maintain the current rate plans beneficial to  
20 customers?

21 A. No. First, the rate plans expire by the end of  
22 this year so any benefit there is temporary.

1 Furthermore, as the Testimony of Staff Witnesses  
2 Haslinger and Benedict indicates, both of the  
3 utilities are over-earning either measured  
4 against the return on equity (ROE) for earnings  
5 sharing purposes or against a more current fair  
6 ROE. Most recent ROEs have ranged between 9.1%  
7 and 9.55%. Exacerbating the impact of the over-  
8 earnings, the utilities, to some extent, are  
9 deferring costs or drawing down reserves, which  
10 will put upward pressure on the utilities' rates  
11 in the future.

12 Q. Does extending the existing rate plans serve the  
13 public interest by maintaining RG&E's existing  
14 electric commodity rates?

15 A. No. When compared to NYSEG's commodity rates  
16 RG&E's commodity rates are excessive and are  
17 producing excessive earnings. Maintaining in  
18 place rates that are excessive is clearly a  
19 detriment to consumers. Therefore, offering to  
20 maintain the existing rate plans cannot be  
21 construed as a benefit justifying approval of  
22 this transaction.

1 Q. Does the commitment not to modify the current  
2 rate plans insulate customers against any of the  
3 potential adverse impacts the proposed  
4 transaction might pose?

5 A. No. Instead, the extension of the rate plans of  
6 NYSEG and RG&E places ratepayers at risk. For  
7 example, the RG&E and NYSEG rate plans that are  
8 in effect have earnings sharing provisions that  
9 have required the allocation of a portion of  
10 excess earnings that have been produced to  
11 ratepayers. As a result, should either one-time  
12 M&A transaction costs or on-going costs be  
13 misallocated to the New York utilities,  
14 customers will be deprived of excess earnings or  
15 perhaps be subject to more deferrals as a result  
16 of the interaction of the rate plan deferral and  
17 earnings sharing provisions.

18 Q. Is NYSEG electric operations currently operating  
19 under a multi-year rate plan for its electric  
20 operations?

21 A. No. NYSEG's electric rates were set in 2007  
22 after a fully litigated rate case. NYSEG's

1 electric operations are not currently subject to  
2 the earnings sharing or deferral provisions that  
3 are in place for its gas operations.

4 Q. If NYSEG's electric operations are not subject  
5 to earnings sharing or deferral mechanisms and  
6 are not subject to a multi year rate plan, is  
7 there any value, for NYSEG electric customers,  
8 in the petitioner's commitment not to modify the  
9 current rate plans as a customer protection  
10 against any potential adverse impacts of the  
11 proposed transaction?

12 A. No. Should either one-time acquisition  
13 transaction costs or on-going costs be  
14 misallocated to NYSEG's electric operation, it  
15 could drive NYSEG's electric operation's return  
16 on equity (ROE) downward. This then could form  
17 the basis for prospective rate relief (as such  
18 costs would be embedded in NYSEG's cost  
19 structure) or could assist NYSEG in any attempt  
20 to recover deferred costs through the result of  
21 a deferral petition.

22 Q. Explain how a reduced ROE could assist NYSEG in

1 an attempt to defer costs.

2 A. One of the main factors used by the Commission  
3 to evaluate a deferral petition is the current  
4 ROE of a petitioner. If the Commission finds  
5 that the ROE of a petitioner is adequate or that  
6 it is over earning, it will likely reject the  
7 deferral petition. Conversely, if it finds the  
8 ROE of a petitioner is not adequate, it will  
9 likely grant relief.

10 G. ELECTRIC AND GAS RELIABILITY AND CUSTOMER  
11 SERVICE BENEFITS ARE UNSUPPORTED

12 Q. Do you find Iberdrola's alleged expertise and  
13 commitment to customer service, reliability, and  
14 the environment of any significant value to  
15 customers?

16 A. It is very difficult to compare the expertise of  
17 Iberdrola and Energy East. There are no terms  
18 and conditions in the acquisition that ensure  
19 increased or enhanced service quality, safety,  
20 or reliability in the future. More troubling is  
21 that the petitioners did not put forward any  
22 provisions to prevent backsliding after the rate

1 plans/orders expire. Further, as noted above,  
2 while Iberdrola claims it will bring its  
3 allegedly extensive utility expertise to New  
4 York for the benefit of ratepayers, it  
5 contradicts its claim by insisting it will not  
6 interfere with existing local management at  
7 NYSEG and RG&E. The stated reliance upon  
8 current management underscores the fact that  
9 Iberdrola will not bring any meaningful  
10 improvements to the levels of customer service  
11 currently present at NYSEG and RG&E.

12 Q. Why is the lack of reliability, safety and  
13 customer service provisions especially  
14 troubling?

15 A. Such provisions are adopted as deterrents to  
16 performance degradation and provide incentives  
17 for continued electric system, gas system, and  
18 customer service improvements. The petitioners'  
19 silence on these issues suggests these utility  
20 obligations may not be as high a priority going  
21 forward as they have been in the past.

22 H. OPPORTUNITIES FOR SYNERGIES EXIST

1 Q. Earlier you referred to the petitioner's  
2 statement that the proposed transaction does not  
3 provide synergistic benefits. Does Staff agree  
4 that the transaction provides no synergistic  
5 benefit opportunities?

6 A. The petitioner's claim that the merger produces  
7 no synergy savings is not credible. The  
8 transaction does provide the opportunity for two  
9 types of potential synergistic benefits to  
10 Iberdrola and the New York utilities. First,  
11 there are opportunities to achieve cost savings;  
12 however, the petitioners have apparently not  
13 made any effort toward identifying such  
14 benefits. Second, there are other non-  
15 traditional synergistic benefits created by the  
16 acquisition, such as foreign tax savings and  
17 domestic tax credits.

18 Q. Is there an incentive for the petitioners to  
19 avoid identifying potential synergistic  
20 benefits?

21 A. Iberdrola has a strong incentive to avoid  
22 quantifying these tangible benefits in order to

1 prevent the various utility commissions from  
2 imputing those savings into the utilities rates.  
3 By denying that synergy savings exist, Iberdrola  
4 puts the onus on regulatory commissions to find  
5 any synergy savings that might be available. To  
6 the extent the commissions are unable to  
7 discover all the synergy savings, Iberdrola will  
8 be able to earn additional profit from retaining  
9 them.

10 Q. What areas appear ripe for traditional  
11 synergies?

12 A. It appears there are opportunities for the  
13 consolidation of domestic holding and service  
14 company operations. For example, based on our  
15 review of Response IBER-0095 to DPS-51, and the  
16 confidential trade secret information Iberdrola  
17 submitted in support of its response, we believe  
18 that Iberdrola may be able to consolidate  
19 information technology (IT) systems in use at  
20 various subsidiaries.

21 Q. Are there any other potential synergy savings  
22 opportunities?

1 A. Yes. Iberdrola's financial advisor has  
2 identified, through benchmarking, potential  
3 areas for achieving efficiencies in the  
4 operations of Energy East's New York companies.  
5 The Response to IBER-0011 to DPS-11 states that  
6 "the valuation [of Energy East] has not taken  
7 into account the analysis of companies' best  
8 practices...Energy East's subsidiaries show  
9 low/medium best practice levels compared to U.S.  
10 peers."

11 Q. What is the estimated savings from such efforts?

12 A. In an apparent contradiction of its claims that  
13 Iberdrola applies best practices in operating  
14 its businesses, the petitioners claimed that  
15 they "have not conducted any analysis" of best  
16 practices (see Response IBER-0065 to DPS-39).  
17 Therefore, no estimate of savings from these  
18 efforts is available.

19 Q. Has Staff obtained any information on  
20 Iberdrola's domestic operations?

21 A. Yes. As noted above, Iberdrola provides some  
22 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

1 publicly available information that currently,  
2 Iberdrola does not pay enough domestic income  
3 taxes in order to utilize the full value of its  
4 earned PTCs. Through the acquisition of Energy  
5 East, it will acquire taxable income sufficient  
6 to enable it to utilize at least some and  
7 perhaps all of the PTCs that it has generated.

8 Q. Has Iberdrola quantified the amount of PTCs that  
9 are available?

10 A. Despite repeated requests, Iberdrola has not  
11 provided this information. In the alternative  
12 however, Staff has estimated that Iberdrola  
13 could obtain up to \$50 million of PTCs per year  
14 based on the existing level of its ownership  
15 interests in wind power facilities (see  
16 Exhibit\_\_\_PP-7), assuming each wind facility  
17 qualifies for PTCs. If Iberdrola constructs all  
18 of the planned generation for 2007-2008 shown in  
19 the FERC Exh. J-2 and assuming such generation  
20 is eligible for PTCs, it could generate up to  
21 \$150 million in PTCs per year by 2008. In  
22 addition, should unused PTCs be available from

1 prior years, it appears possible for Iberdrola  
2 to carry back such PTCs and use them against  
3 Energy East's prior years tax payments. But, in  
4 a perplexing response, Petitioners state that  
5 "Iberdrola has not considered or evaluated" this  
6 possibility (see Response IBER-0133 to DPS-77),  
7 which could be of substantial benefit to it.  
8 While we concede some of the above analysis is  
9 based upon assumptions, more certain information  
10 is not available because Iberdrola's has  
11 declined the opportunity to provide better  
12 information.

13 Q. Please summarize Staff's conclusions on the  
14 alleged customer benefits of the transaction?

15 A. The stated benefits, are intangible,  
16 speculative, immaterial, and are not enforced by  
17 any substantive terms or conditions that would  
18 enable their realization in the event that they  
19 did not materialize or if future 'backsliding'  
20 occurs. In addition, Staff found that there are  
21 hundreds of millions of dollars of benefits  
22 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.

1 Q. Can you quantify how the acquisition will be  
2 accretive to EPS?

3 A. Staff sought that information but the response  
4 to the question was not helpful (Response IBER-  
5 0066 to DPS-40). However, Staff was able to  
6 perform a calculation from publicly available  
7 information that shows the transaction could be  
8 accretive to earnings (see Exhibit\_\_(PP-8).

9 Q. If Iberdrola is paying a premium above book and  
10 market values to acquire Energy East, how can  
11 the transaction be accretive to EPS if there are  
12 no synergy savings available in the acquisition?

13 A. In this instance it is simply mathematics. It  
14 occurs because Iberdrola's stock is selling at a  
15 price earnings ratio greater than the price  
16 earnings ratio of Energy East at the acquisition  
17 price. This will enable Iberdrola to issue  
18 fewer shares to finance the amount necessary to  
19 fund the acquisition price. So, Iberdrola has  
20 purchased all of Energy East's earnings with  
21 comparatively fewer shares of its stock.

22 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

1 earnings as to why Iberdrola decided to purchase  
2 Energy East.

3 B. BENEFITS TO ENERGY EAST AND OTHERS

4 Q. Will Iberdrola be the only beneficiary as a  
5 result of this transaction?

6 A. No. It is clearly evident that Energy East's  
7 shareholders and executives and third party  
8 advisors will also benefit.

9 Q. How would Energy East's shareholders benefit  
10 from this transaction?

11 A. Energy East's current shareholders would receive  
12 \$28.50 per share, a premium of \$5.85 per share  
13 based on the \$22.65 price of the stock at the  
14 time of the announcement of the acquisition.  
15 This amounts to over \$930 million in the  
16 aggregate for all 159 million Energy East shares  
17 outstanding.

18 Q. Explain how Energy East's executives will  
19 benefit as a result of this acquisition.

20 A. First, the Chief Executive Officer (CEO) has  
21 received a two year contract extension that will  
22 become effective upon closing. Next, as

1 reported in the Proxy Statement dated October 9,  
2 2007, the top executives and directors will  
3 receive approximately \$78 million in potential  
4 payments, assuming their employment is  
5 terminated in June 2008. It is important to note  
6 that actual payments to management could exceed  
7 these amounts since they do not include payments  
8 to other management employees.

9 Q. Could the payments to executives be less than  
10 the \$78 million shown above?

11 A. Yes. Should the executives remain with the  
12 company after the acquisition, they will not  
13 receive approximately \$45 million of change in  
14 control and related payments. However, they  
15 will receive approximately \$30 million of  
16 payments for stock.

17 Q. What are the estimated third party costs  
18 associated with this transaction?

19 A. According to Response IBER-0002 to DPS-2, the  
20 transaction costs are estimated to be at least  
21 \$44-\$46 million, not including transfer taxes.  
22 These payments are made primarily to investment

1 bankers, advisors, and attorneys.

2 Q. What are the total of benefits to shareholders  
3 and other parties?

4 A. Counting the \$476 million of Iberdrola tax  
5 benefits, \$150 million of production tax  
6 credits, and the benefits to Energy East  
7 shareholders, executives, and other third  
8 parties, the tangible monetary benefits that  
9 accrue to parties other than consumers exceed  
10 \$1.6 billion. That is in stark contrast to the  
11 complete lack of consumer benefits.

12 COSTS AND RISKS RESULTING FROM THE ACQUISITION

13 A. TRANSACTION COSTS

14 Q. What proposals do the petitioners and make  
15 concerning the costs resulting from the M&A  
16 transaction?

17 A. The petitioners state in general terms that they  
18 "commit not to seek recovery of costs incurred  
19 to consummate the proposed transaction from New  
20 York ratepayers" (see Panel Testimony page 25,  
21 lines 20-21).

22 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

1 NYSEG." Does that proposal require  
2 clarification?

3 A. Yes. The definition of "Goodwill" as used in  
4 the above commitment requires clarification.  
5 For regulatory purposes, Goodwill represents the  
6 excess of the purchase price over original cost.  
7 In other parlances, such as in discussions of  
8 premiums paid to enable mergers, it represents  
9 the excess of the purchase price over market  
10 value of assets. To be clear, for purposes of  
11 this transaction, Goodwill should be stated as  
12 amounts exceeding original cost and as such it  
13 should "not be recorded on the books of any of  
14 the companies acquired, including Energy East,  
15 RGS, RG&E, and NYSEG."

16 Q. Has Iberdrola made any commitments concerning  
17 the existing Goodwill associated with the Energy  
18 East/RGS transaction currently recorded on  
19 Energy East's books?

20 A. No, it has not addressed that issue. Staff  
21 recommends below that Iberdrola should also  
22 remove that Goodwill from Energy East's books.

1 Q. Why should Goodwill be removed from the books of  
2 Energy East?

3 A. The acquisition of Energy East involves the  
4 purchase of the Energy East's assets; among  
5 those assets is the Goodwill on Energy East's  
6 books. The existing Goodwill on Energy East's  
7 books has been a continuing source of  
8 controversy in the utilities' rate cases because  
9 it clouds the true picture of Energy East's  
10 financial health. So in order to improve  
11 financial transparency, and because it is being  
12 purchased by Iberdrola, the existing Goodwill  
13 (as defined by Staff above) should also be  
14 pushed up to Iberdrola. Additionally, when  
15 Energy East purchased RG&E, it was not then  
16 clear that Goodwill on its books would no longer  
17 be amortized, because, prior to 2001, Goodwill  
18 had to be amortized over a period of no more  
19 than 40 years. Consequently, the controversy of  
20 Goodwill on the books of a utility holding  
21 company as a "permanent" asset had not been  
22 considered. Now it is clear that the existence

1 of the Goodwill on utility financial statements  
2 is a drag on credit and earning and creates  
3 ongoing pressure on utility management to  
4 maintain unrealistically high earnings on  
5 utility property.

6 B. OTHER RELEVANT COSTS NOT ADDRESSED

7 Q. Has the Petitioner's Panel identified and  
8 addressed all the potential costs and risks  
9 resulting from the acquisition?

10 A. No.

11 Q. Has Staff identified any other costs and risks  
12 associated with the transaction?

13 A. Yes. There are many other potential costs and  
14 risks resulting from the proposed transaction  
15 that went unaddressed by the petitioners. These  
16 include one-time transaction fees, transfer  
17 taxes and advisor fees.

18 Q. Can you explain why the petitioners did not  
19 address these costs and risks?

20 A. From the responses we received, it appears the  
21 other costs and risks were not addressed because  
22 in the petitioner's view those costs and risks

1 were not absolutely certain to occur.

2 Generally, the responses included the phrases  
3 similar to '*we have not studied that or we have*  
4 *no plans to do that...*' We believe that these  
5 costs and risks were not properly assessed  
6 because the petitioners were assuming a best  
7 case, which is a highly unlikely scenario and a  
8 quite unreasonable "best practice".

9 Q. Describe the additional costs that seem likely  
10 to occur due to the acquisition.

11 A. We expect cost on-sets will be experienced as a  
12 result of this transaction in the form of  
13 additional one-time transaction costs and future  
14 on-going and one-time operational costs. In  
15 fact, the transaction could produce stranded  
16 costs.

17 Q. Describe the types of one-time transaction costs  
18 that the petitioners have not addressed.

19 A. There are substantial one-time transaction costs  
20 not addressed by the petitioners, such as the  
21 change in control payments described earlier in  
22 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

1 transaction costs?

2 A. Yes. We anticipate arguments over which costs  
3 are defined as transaction costs to be absorbed  
4 by Iberdrola and which are not. For example,  
5 should one of the utilities incur severance  
6 payments, it seems as though arguments may ensue  
7 concerning whether such payments were  
8 attributable to the acquisition or arose from  
9 normal assessment related to ongoing operational  
10 efficiency initiatives.

11 Q. What one-time future operational costs might be  
12 incurred?

13 A. As noted earlier, the acquisition presents  
14 Iberdrola potential opportunities to consolidate  
15 its U.S. operations (e.g., service and  
16 administrative functions) and its IT platform.  
17 In fact, Iberdrola has alluded to its intention  
18 to eliminate certain intermediate holding  
19 companies (see Petition, page 9, footnote 2).  
20 Should those changes occur, it will most likely  
21 involve one-time operational costs associated  
22 with integrating these domestic businesses and

1 operations.

2 Q. Do you have any specific concerns about  
3 potential IT consolidation of Energy East with  
4 the other U.S. operations of Iberdrola?

5 A. Yes. As discussed above, our review of  
6 Iberdrola's current IT operations indicates that  
7 it could be a candidate for consolidation (see  
8 Response IBER-0095 to DPS-51). Should  
9 consolidation occur, it could either create a  
10 stranded cost for NYSEG and RG&E's new SAP  
11 system or create the possibility for sharing of  
12 the utilities' SAP system with other Iberdrola  
13 operations, particularly those in the United  
14 States without appropriate remuneration to New  
15 York ratepayers who paid for the systems.

16 Q. Have the petitioners addressed these issues?

17 A. No. However the issue of sharing the utilities  
18 SAP system was addressed in NYSEG's 2005 rate  
19 case. In its Order Adopting Recommended  
20 Decision with Modifications (the "2006 NYSEG  
21 Rate Order"), issued on August 23, 2006 in Case  
22 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

1 all necessary services from the existing  
2 domestic holding or service companies Utility  
3 Shared Services Corporation (USSC) and Energy  
4 East Management Corporation (EEMC), allocations  
5 from Iberdrola are not justified.

6 Q. Would you have any other concerns should  
7 Iberdrola attempt to allocate foreign holding  
8 company costs to the utilities?

9 A. Yes. As noted below, Iberdrola accounts for  
10 foreign company's costs on a different  
11 international basis than the U.S. utilities. It  
12 is not clear how allocations of foreign costs  
13 would be impacted by the differences in  
14 accounting methods.

15 Q. Is it true that currently the Energy East EEMC  
16 and USSC holding and service company costs are  
17 allocated to the utilities using various  
18 formulas taking into account the relative size  
19 and magnitude of the utilities in comparison to  
20 the overall Energy East system?

21 A. Yes.

22 Q. How might that change post-acquisition?

1 A. It is not clear how the allocation processes,  
2 methods, or formulas would change. However, we  
3 have concerns about how the acquisition could  
4 affect both the total costs and allocation  
5 percentages of the current holding and service  
6 company allocations to the New York utilities.

7 Q. Please explain.

8 A. The current allocation formulas could change if  
9 other Iberdrola operations or utilities are  
10 added to the allocation process. The level of  
11 costs or the allocation formulas that spread  
12 those costs based on the relative sizes of the  
13 entities taking service could change. This  
14 could affect the level of costs allocated to New  
15 York.

16 C. OTHER RISKS NOT ADDRESSED

17 Q. Describe the additional risks that seem likely  
18 to arise due to the acquisition.

19 A. Besides the obvious financial and business risks  
20 that we address elsewhere, there are potential  
21 risks associated with this transaction because  
22 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?

1 A. Yes. Suppose that one of the Energy East  
2 service companies buys a good or service (e.g.,  
3 insurance) from an Iberdrola affiliate. Assume  
4 that the service company pays an inflated price  
5 to the Iberdrola affiliate for the good or  
6 service. This now becomes the service company's  
7 "cost" and that inflated "cost" is then  
8 allocated to the utilities. In this example,  
9 the utilities pay an inflated "cost" to the  
10 service company which they may claim does not  
11 technically violate the affiliate transaction  
12 rules that exist today.

13 Q. Why do the affiliate transaction rules require  
14 modification?

15 A. As shown above, Iberdrola has substantial  
16 interests in non-regulated lines of business,  
17 including real estate, insurance, energy  
18 consulting, and engineering, which Energy East  
19 does not have. Incentives will exist to  
20 maximize the profits of the non-regulated  
21 affiliates through sales of goods and services  
22 at inflated prices to regulated utility

1 affiliates. This will result in higher utility  
2 prices or lower earnings sharing. The non-  
3 regulated businesses must compete for business  
4 in a competitive market and are "price takers".  
5 The regulated businesses have prices set by  
6 formula and its customers do not have the same  
7 choice to go to a competitor and through  
8 regulation are "price makers". Prohibitions  
9 against this type of chaining transaction is  
10 required should the Commission approve the  
11 acquisition.

12 ii. FOREIGN CURRENCY VALUATION

13 Q. Are there any other valuation issues that will  
14 result due to the proposed acquisition of Energy  
15 East?

16 A. Yes. Should Iberdrola attempt to allocate costs  
17 or provide goods and services from a foreign  
18 entity to Energy East or the utilities, we are  
19 concerned about foreign currency valuation of  
20 such transactions.

21 Q. Why does foreign currency valuation concern you?

22 A. At present, there are no proposed guidelines for

1 the utilities concerning valuation of foreign  
2 currency transactions with Iberdrola. Relative  
3 foreign currency values can fluctuate greatly.  
4 This fluctuation provides an additional cost or  
5 risk to the utilities.

6 Q. Can you provide an example of the risk?

7 A. Yes. Assume that Iberdrola allocates a portion  
8 of the salary cost of its CEO to the New York  
9 utilities based on a percentage of his salary.  
10 If the CEO's salary did not fluctuate in a year,  
11 the allocation of cost to the utilities could  
12 change dramatically due to the valuation of  
13 Iberdrola's cost in U.S. dollars.

14 Q. How does this cause risk to the utilities?

15 A. It makes utility expenses more volatile, and  
16 additional volatility creates additional risk.

17 iii. UNRECORDED TRANSACTIONS

18 Q. What are unrecorded transactions?

19 A. These are transactions that are not recorded on  
20 the books of the utilities that are detrimental  
21 to the utilities financial results.

22 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

1 form the basis for increased rates as a  
2 component of the test period that serves as the  
3 base when the utility seeks a rate increase.

4 iv. REPORTING CONCERNS

5 Q. Is it true that the companies have committed to  
6 continue to provide regulatory reports and that  
7 such reporting is intended to provide  
8 information to assist in preventing these types  
9 of abuses?

10 A. Yes. Again however, the combination of  
11 companies will create increased risks and  
12 opportunities for abuses that cannot be detected  
13 by regulators. Simply reporting on regulated  
14 entities does not alleviate such concerns.

15 Q. Explain why periodic reporting by the utilities  
16 does not alleviate your concerns.

17 A. The utilities reports will concern transactions  
18 recorded by the utilities. These reports will  
19 not provide any information or details on the  
20 activities of the service or holding companies  
21 or the other business interests of Iberdrola.  
22 Without full knowledge of all of these entities,

1 we cannot reliably confirm that the costs of the  
2 utilities are fairly stated.

3 Q. Has financial reporting changed recently for the  
4 New York utilities and holding companies?

5 A. Yes, there have been multi-dimensional changes  
6 to the financial reporting of holding companies.  
7 Most changes have no connection to the proposed  
8 acquisition but have a bearing on the future  
9 transparency of the combined companies. The  
10 changes, taken in their totality, have reduced  
11 financial reporting for the New York utilities.

12 Q. Please explain these changes.

13 A. Due to Public Utility Holding Company Act of  
14 2005 (PUHCA-2005), which repealed earlier PUHCA  
15 requirements, Energy East no longer has to  
16 provide the same level of detailed holding  
17 company financial reports. Those reports were  
18 replaced by the streamlined FERC holding company  
19 financial report (FERC Form 60). Also, because  
20 the New York utilities no longer have publicly  
21 outstanding securities, they are no longer  
22 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

1 other checks and balances that were in place  
2 years ago have either been removed or  
3 substantially weakened. Therefore, we cannot  
4 rely on other branches of government, and this  
5 regulatory process will have to serve as the  
6 source for all accounting and transparency  
7 protections for ratepayers.

8 Q. Will this these accounting and transparency  
9 problems be exacerbated after the acquisition?

10 A. Yes. In addition to these dramatic reductions  
11 in SEC financial reporting requirements and  
12 oversight over Energy East, accounting under  
13 U.S. Generally Accepted Accounting Principles  
14 (GAAP) would cease and would be replaced by  
15 International Financial Reporting Standards  
16 (IFRS) for Iberdrola.

17 Q. Please highlight the major differences between  
18 IFRS and GAAP.

19 A. Our first real experience with IFRS came after  
20 the Iberdrola petition was filed. Since that  
21 time we have done some research on IFRS, and  
22 that research indicates concerns are raised

1 about transparency and reporting if the  
2 Iberdrola did not file audited public statement  
3 under U.S. GAAP. We found a recent publication  
4 dated October 2007 by PricewaterhouseCoopers  
5 titled "Similarities and Differences-A  
6 comparison of IFRS and U.S. GAAP." We have  
7 included the eight page summary as Exhibit\_\_\_PP-  
8 9). As the authors state in the "How to use  
9 this publication" section, "no summary  
10 publication can do justice to the many  
11 differences of detail that exist between IFRS  
12 and U.S. GAAP. Even if the overall approach  
13 taken in the guidance is similar, there can be  
14 differences in the detailed application, which  
15 could have a material impact on the financial  
16 statements...readers should consult all the  
17 relevant accounting standards and, where  
18 applicable, their national law. Listed  
19 companies should also follow relevant securities  
20 regulations - for example, the U.S. Securities  
21 and Exchange Commission requirements and local  
22 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

1 disclose the profit they derive from producing  
2 electricity." Moody's states "Electricity  
3 generation is a significant activity for these  
4 companies, but it is difficult to compare  
5 performance when they adopt different approaches  
6 to segment reporting." This article is  
7 presented as Exhibit\_\_\_\_(PP-11).

8 Q. Will Energy East continue to be subject to  
9 Sarbanes-Oxley Act (SOX) after the M&A  
10 transaction is consummated?

11 A. No.

12 Q. What is the significance of this?

13 A. SOX established stronger standards for all U.S.  
14 public company boards, managements, and public  
15 accounting firms. These standards added  
16 corporate board responsibilities and criminal  
17 penalties if these responsibilities were not  
18 upheld. SOX requires officers of corporations  
19 to certify that the signing officers have  
20 reviewed the financial reports of the company  
21 and that the financial reports do not contain  
22 any material untrue statements or material

1 omission or be considered misleading. SOX  
2 mandated that officers of a corporation attest  
3 that the financial statements and related  
4 information fairly present the financial  
5 condition and the results in all material  
6 respects. The signing officers were also made  
7 responsible for internal controls of the  
8 corporation. If his transaction is allowed, the  
9 protections of SOX will no longer apply to  
10 Energy East. Thus, stakeholders in NYSEG and  
11 RG&E will not have the same degree of confidence  
12 in any statements coming from Energy East.

13 Q. Please state your conclusions on the financial  
14 reporting implications of this M&A transaction.

15 A. After the acquisition, the dramatic increase in  
16 size and scope of the combined entity, the  
17 creation of incentives for under-reporting,  
18 reductions in financial reporting and oversight,  
19 and the introduction of differing accounting  
20 systems, regulatory oversight will be difficult  
21 at best. Therefore, any approval of this  
22 acquisition should be conditioned upon a

1 requirement that Iberdrola file audited public  
2 financial statement under U.S. GAAP.

3 DETRIMENTS OF THE M&A TRANSACTION

4 Q. Did the Panel identify any detriments of the M&A  
5 transaction, other than increased costs and  
6 risks described above?

7 A. Yes. There are real detriments resulting from  
8 the acquisition in the areas of vertical market  
9 power, deterioration of financial strength, and  
10 deterioration of regulatory oversight and  
11 transparency.

12 A. VERTICAL MARKET POWER CONCERNS

13 Q. What has been the Commission policy on vertical  
14 market power and competitive wholesale electric  
15 markets during the past decade?

16 A. Commission policy over the past decade has  
17 supported wholesale electricity markets which  
18 are competitive. An integral part of this  
19 policy has been and is the separation of the  
20 ownership of T&D from the ownership of  
21 generation. This policy was explicitly stated  
22 in Opinion No. 96-12, in which the Commission

1 said "In a wholesale...competitive model,  
2 generation...should be separated from Transmission  
3 and Distribution systems in order to prevent the  
4 onset of vertical market power. Total  
5 divestiture of generation would accomplish this  
6 most effectively and is encouraged." Opinion  
7 No. 96-12, page 99. The New York investor-  
8 owned transmission companies have divested  
9 substantially all of their generating assets  
10 located in the State. On July 17, 1998, the  
11 Commission issued a Statement of Policy  
12 Regarding Vertical Market Power (VMP Policy  
13 Statement) in Case 96-E-0900, which establishes  
14 a rebuttable presumption that the ownership of  
15 generation by an affiliate of a T&D company  
16 would unacceptably exacerbate the potential for  
17 vertical market power. In the VMP Policy  
18 Statement, the Commission stated that "vertical  
19 market power occurs when an entity that has  
20 market power in one stage of the production  
21 process leverages that power to gain advantage  
22 in a different stage of the production process.

1 A T&D company with an affiliate-owning  
2 generation may, in certain circumstances, be  
3 able to adversely influence prices in that  
4 generator's market to the advantage of the  
5 combined operation." VMP Policy Statement,  
6 Appendix I, page 1. The Commission's preferred  
7 approach for addressing vertical market power,  
8 as expressed in the VMP Policy Statement, was  
9 divestiture. "In creating a competitive  
10 electric market, the Commission has viewed  
11 divestiture as a key means of achieving an  
12 environment where the incentives to abuse market  
13 power are minimized. Recognizing that vigilant  
14 regulatory oversight cannot timely identify and  
15 remedy all abuses, it is preferable to properly  
16 align incentives in the first instance." VMP  
17 Policy Statement, Appendix I, page 1.

18 Q. Does the VMP Policy Statement comment on the  
19 ability of the Federal Energy Regulatory  
20 Commission (FERC) and the NYISO rules and  
21 regulations to prevent the exercise of vertical  
22 market power?

1 A. Yes. The discussion section of the VMP Policy  
2 Statement addresses the commenting utilities'  
3 (Central Hudson, Con Edison and NGE, an  
4 affiliate of NYSEG) argument that "the New York  
5 State Independent System Operator (NYISO),  
6 Federal Energy Regulatory Commission (FERC), and  
7 this Commission would have sufficient control  
8 over the T&D utility to prevent the exercise of  
9 vertical market power." VMP Policy Statement,  
10 Appendix I, page 1. The VMP policy Statement  
11 rejects this argument as sufficient to prevent  
12 the exercise of vertical market power. "While  
13 the utilities are correct that regulatory  
14 controls and enforcement mechanisms exist, the  
15 degree to which these mechanisms can be  
16 effective is subject to debate. For example,  
17 the NYISO can recommend, and FERC or this  
18 Commission can direct, that a utility reinforce  
19 its transmission system. That utility, however,  
20 must go through the siting process for  
21 authorization, and its role as a possibly  
22 reluctant sponsor could introduce complexities

1 and delays in the process. It is also difficult  
2 for regulators to detect an inappropriate  
3 failure to act when critical information resides  
4 with the T&D utility." VMP Policy Statement,  
5 Appendix I, page 1.

6 Q. Does the VMP Policy Statement provide an example  
7 of the type of company which might satisfy the  
8 rebuttable presumption that the ownership of  
9 generation by an affiliate would unacceptably  
10 exacerbate the potential for vertical market  
11 power?

12 A. Yes. In the VMP Policy Statement the Commission  
13 stated: "For example, a relatively small T&D  
14 utility in a large market area which has little  
15 control over the constraining transmission  
16 interfaces, little ability to restrict new entry  
17 into the broader market by making it costly to  
18 interconnect in its service territory, and  
19 little voting leverage in the NYISO, should be  
20 able to rebut the presumption that the benefits  
21 of efficiency gains are outweighed by the costs  
22 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

1 to the example company provided in the VMP  
2 Policy Statement and would not satisfy the  
3 rebuttable presumption by relying on that  
4 example.

5 Q. Are there other relevant Commission Orders or  
6 filings that address vertical market power?

7 A. Yes, the Grid/KeySpan Order and the Commission  
8 filing on Market-Based Rates in FERC Docket No.  
9 RM04-7-000 comment on vertical market power  
10 issues and provide current Commission  
11 prospective on vertical market power (see  
12 Exhibit\_\_\_(PP-12). In the Grid/KeySpan Order,  
13 in the discussion (page 13-14) of vertical  
14 market power, the Commission states: "...several  
15 initial conclusions are in order. The first is  
16 that to the extent the Petitioners argue we  
17 should simply rely on FERC's evaluation of the  
18 market power issue, they are essentially arguing  
19 there is no need for the 1998 Statement of  
20 Policy on VMP, that regulatory solutions will  
21 always be adequate to address VMP, and that  
22 structural solutions that eliminate the

1 incentives to exercise VMP are not needed. The  
2 key weakness in these contentions, however, is  
3 that none of them limit or eliminate  
4 opportunities for VMP that could be exercised in  
5 ways that would be hard or impossible to  
6 detect." The Commission also expresses the  
7 concern that relying solely on regulatory  
8 solutions would be inconsistent with the goal of  
9 ensuring a competitive generation market. In  
10 the FERC docket on Market-Based Rates the  
11 Commission filed comments in opposition to the  
12 FERC presumption that vertically integrated  
13 utilities with an Open Access Transmission  
14 Tariff (OATT) do not have market power. The  
15 filing explained how a vertically integrated  
16 utility, through its transmission repair  
17 practices, transmission investment decisions and  
18 voltage support decisions, may exercise market  
19 power without necessarily violating its OATT.

20 i. DELIVERABILITY

21 Q. What is deliverability?

22 A. Deliverability is the existence of sufficient

1 transmission infrastructure to ensure that a  
2 generator's power can flow to multiple places on  
3 the network. The NYISO filed a deliverability  
4 plan in October 2007 (Consensus Deliverability  
5 Plan of the New York Independent System  
6 Operator, Inc. and the New York Transmission  
7 Owners, October 5, 2007) with FERC which  
8 addresses the requirements a new generator must  
9 meet when interconnecting in a NYISO market.  
10 The NYISO filing proposes two levels of  
11 interconnection service: the Energy Resource  
12 Interconnection Service ("ERIS") and the  
13 Capacity Resource Interconnection Service  
14 ("CRIS"). For a generator to participate and  
15 receive revenues in the NYISO Installed Capacity  
16 (ICAP) market, the generator must qualify for  
17 CRIS. To qualify for CRIS the generator must be  
18 deliverable, using the existing transmission  
19 system, within the New York capacity market in  
20 which the generator will participate or fund the  
21 necessary transmission system investments to  
22 make the generator deliverable.

1 Q. What is the relevance of deliverability to this  
2 proceeding?

3 A. To obtain ICAP revenues, generators entering the  
4 upstate New York market (Zones A-I) would need  
5 to qualify for CRIS. If an entrant's capacity  
6 is not deliverable, funding the needed upgrades  
7 to the transmission system becomes an additional  
8 cost-of-entry. The interconnection queue of the  
9 NYISO has 11,431 MW of new generation planned  
10 for the upstate market, including approximately  
11 2840 MW of wind in the Energy East service area.  
12 Each of these planned generating units would be  
13 competing with the generating assets of the  
14 combined firm, which includes 546 MW of existing  
15 Energy East generation, 176.2 MW of Iberdrola  
16 existing wind generation, and 715 MW of  
17 Iberdrola planned wind generation. The combined  
18 firm would have the incentive to pursue  
19 transmission investment and maintenance  
20 decisions to the benefit of company-owned  
21 generation and the detriment of competing  
22 generators, including the 6870 MW of planned

1 competing wind generation in the upstate market.  
2 Although the combined firm would be subject to  
3 the rules and regulations of FERC and this  
4 Commission, the VMP Policy Statement noted, as  
5 previously discussed, that it is difficult "to  
6 detect an inappropriate failure to act when  
7 critical information resides with the T&D  
8 utility." The combined firm could delay needed  
9 transmission investments, impacting the  
10 deliverability and cost-of-entry of non-  
11 affiliated entrants to the upstate market, or  
12 conversely expedite transmission investments  
13 which assure the deliverability of its own  
14 generation.

15 ii. PETITIONERS' FAIL TO SATISFY THE  
16 REBUTTABLE PRESUMPTION  
17

18 Q. Please describe the Petitioners' filings with  
19 respect to vertical market power issues related  
20 to the proposed transaction.

21 A. The August 1, 2007 petitioners' filing with the  
22 Commission included the Affidavit of William H.  
23 Hieronymus on horizontal and vertical market

1 power which had been filed with FERC. On  
2 November 28, 2007, the petitioners' filed with  
3 the Commission the Direct Testimony of William  
4 H. Hieronymus on vertical market power.

5 Q. Please briefly summarize the conclusions of the  
6 Hieronymus testimony.

7 A. The testimony concludes that 1) the VMP Policy  
8 statement is no longer relevant; and 2) the  
9 specific facts of the proposed merger satisfy  
10 the rebuttal presumption of the VMP Policy  
11 Statement.

12 Q. Do you agree with the conclusion that the VMP  
13 Policy Statement is irrelevant to this  
14 proceeding?

15 A. No. The conclusion that "the relevance of the  
16 VMP Policy Statement has been superseded by  
17 almost ten years of significant change in the  
18 electric industry in New York" (Direct Testimony  
19 of William H. Hieronymus, page 3) is directly  
20 contradicted by the recent Commission Order on  
21 the National Grid PLC acquisition of KeySpan  
22 Corporation. In applying the VMP Policy

1 Statement, the Order requires the divestiture of  
2 the KeySpan Ravenswood generating station. The  
3 VMP Policy Statement is clearly applicable to  
4 the proposed transaction in this proceeding.

5 Q. Please briefly summarize the arguments made to  
6 satisfy the rebuttable presumptions.

7 A. The testimony argues that the rebuttable  
8 presumption is met since 1) the existing RG&E  
9 and NYSEG generation should be excluded from the  
10 analysis; 2) the existing and planned wind  
11 generation of Iberdrola's affiliates is de-  
12 minimis and not located in the RG&E or NYSEG  
13 service area; 3) the FERC and NYISO rules and  
14 regulations governing transmission eliminate  
15 potential vertical market power concerns; and  
16 4) all of the Iberdrola affiliated wind  
17 generation would be located on the low price,  
18 unconstrained side of the Central-East  
19 transmission constraint, and RG&E and NYSEG  
20 would not otherwise be able to influence  
21 congestion.

22 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

1 important in the movement of lower cost power  
2 into the upstate market. The combined firm  
3 would also have 2 major transmission lines  
4 connecting the upstate market to the PJM market.  
5 We disagree that FERC and NYISO rules and  
6 regulations eliminate vertical market power  
7 concerns, that existing and planned Iberdrola  
8 affiliate wind generation should be considered  
9 de minimis for the proposed transaction and is  
10 not located in the RG&E or NYSEG service areas  
11 and that existing RG&E and NYSEG generation  
12 should be excluded from the analysis. With  
13 respect to the location of planned Iberdrola  
14 affiliate wind generation in New York State, a  
15 recent NYSIO interconnection queue includes a  
16 150 MW wind project by Gamesa Energy USA, LLC in  
17 Schuyler, NY, and a 120 MW wind project by  
18 Gamesa Energy USA, LLC in Tioga Bradford, PA  
19 which are both planned to be interconnected to  
20 the NYSEG service area. A more recent NYISO  
21 interconnection queue does not include the 120MW  
22 wind project. Iberdrola has an approximately

1 24% equity interest in the Gamesa parent. This  
2 appears to contradict the assertion that no  
3 Iberdrola affiliate wind generation is planned  
4 for the RG&E or NYSEG service area. Moreover,  
5 Iberdrola has already acquired from Gamesa 500  
6 MW in wind farm projects under development in  
7 Illinois, Texas and neighboring Pennsylvania.  
8 Nothing prevents Iberdrola from similarly  
9 acquiring all of the Gamesa projects in New  
10 York, or a controlling interest in those  
11 projects if it does not already possess such an  
12 interest. Additionally, Horizon Wind Energy has  
13 207.45 MW of planned wind generation in the  
14 NYSEG service area, Horizon wind is a wholly  
15 owned subsidiary of Energias de Portugal, S.A.  
16 (EDP). Iberdrola has a 9.5% equity interest in  
17 EDP. As noted above, zones A-E are the same  
18 market in most hours of the year. Given this  
19 fact, the combined firm's generation and  
20 transmission would be in the same market. They  
21 would also have transmission links to adjacent  
22 markets. Market areas and transmission

1 connecting to adjacent markets are more  
2 important to the vertical market power analysis  
3 than service area boundaries.

4 Q. Why should the exiting RG&E and NYSEG generation  
5 be included in the analysis of the proposed  
6 transaction?

7 A. RG&E and NYSEG own 546 MW (nameplate rating) of  
8 generation which includes the RG&E 253 MW  
9 Russell Station and the NYSEG Energy Solutions  
10 63 MW Carthage plant.

11 Q. Please discuss the Russell Station.

12 A. In Case 03-T-1385, where an Order Granting  
13 Certificate of Environmental Compatibility and  
14 Public Need was issued December 16, 2004, RG&E  
15 committed (on the record in RTP-0051) to sell  
16 the Russell Station site to a non-affiliated  
17 company after the completion of the Rochester  
18 Transmission Project (RTP). That commitment was  
19 incorporated in the Order and is binding on  
20 RG&E.

21 Q. Are there indications that RG&E does not intend  
22 to fulfill its commitment?

1 A. Yes. In IBER-0072, it states that it intends to  
2 re-power the Russell Station as a 300 MW gas-  
3 fired facility entering service in 2013.

4 Q What other steps has RG&E taken in furtherance  
5 of its efforts to re-power the facility?

6 A. As discussed in the testimony of the Staff  
7 Electric Reliability Panel, RG&E sought certain  
8 actions from the NYISO, which it did not obtain,  
9 regarding the Russell Station.

10 Q. Please discuss the Carthage facility.

11 A. The NYSEG Energy Solutions Carthage plant is a  
12 market-based unit which would profit from price  
13 increases in the upstate market and should be  
14 included in the analysis of the proposed merger.

15 Q. Please discuss the remaining generation.

16 A. The remaining 230 MW's consist of combination  
17 turbines and hydro. The 105 MW of combustion  
18 turbines that are rate-based units should be  
19 included in the analysis since withholding these  
20 units from the market could potentially increase  
21 the market price received by the combined firm's  
22 market-based generation (a horizontal market

1 power issue).

2 Q. Do FERC and NYSIO rules and regulations  
3 eliminate vertical market power concerns?

4 A. No. As previously discussed, the VMP Policy  
5 Statement and the Grid/KeySpan Order make clear  
6 that FERC and NYISO rules and regulations do not  
7 sufficiently mitigate vertical market power  
8 concerns. With respect to rules and  
9 regulations, the Grid/KeySpan Order notes "that  
10 none of them limit or eliminate opportunities  
11 for VMP that could be exercised in ways that  
12 would be hard or impossible to detect."  
13 Detecting and verifying the exercise of vertical  
14 market power is a difficult task. For example,  
15 although the NYISO, as required by FERC, has  
16 standard procedures and agreements for  
17 generation interconnections to the transmission  
18 system designed to address transmission owner  
19 market power, disputes between non-affiliated  
20 generators and transmission owners occur. Ginna  
21 Nuclear Power Plant, LLC (Ginna), a wholly owned  
22 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

1 power would not be an issue. However, when a  
2 transmission owner does have affiliated  
3 generation, any review of this type of complaint  
4 must include an evaluation of whether there is  
5 an exercise of vertical market power.

6 Additionally, if there were an exercise of  
7 market power, the market price outcomes in the  
8 NYISO wholesale electric market would reflect  
9 non-competitive results during those hours.

10 This raises the issue of refunds not only for  
11 the generator filing the complaint but also for  
12 other market participants. Restating market  
13 price outcomes is disruptive to the market.

14 Q. Are there other illustrative examples of the  
15 types of transmission issues which are not  
16 adequately addressed by FERC and NYISO rules?

17 A. Yes. The Ithaca Transmission Upgrade Project  
18 (ITUP) is another example. In Case 05-E-1222  
19 AES Eastern Energy L.P. (AES) stated that local  
20 voltage level deterioration had required  
21 curtailments of its Cayuga Generating Facility  
22 over the past 10 years. AES argued that NYSEG

1 should commit to the transmission upgrade and a  
2 schedule for timely completion. NYSEG argued  
3 against a firm commitment, preferring an  
4 iterative approach and noted that the ITUP would  
5 take 4-5 years. This corresponds to the type of  
6 situation noted in this manner could increase  
7 the price received by the combined firm's  
8 generation, a classic example of vertical market  
9 power. More generally, there would be no  
10 incentive for a T&D company which owns market-  
11 based generation to pursue future transmission  
12 investments which would lower upstate wholesale  
13 prices. Alternatively, there would be an  
14 incentive to propose, pursue and argue for  
15 transmission investments, which would be funded  
16 by ratepayers, that would enhance the ability of  
17 own generation to reach higher priced markets in  
18 the future, regardless of society's or  
19 ratepayers' best interests.

20 Q. What does the Hieronymus testimony conclude with  
21 respect to Iberdrola wind generation and  
22 vertical market power?

1 A. The testimony maintains that Iberdrola's  
2 generation interests in New York would be  
3 approximately 795 MW (nameplate capacity),  
4 including planned generation, and questions  
5 whether the planned generation should be  
6 included in the analysis. The testimony notes  
7 that the capacity factors for wind generation in  
8 the NYISO market is 10% in the summer and 30% in  
9 the winter and that the existing and  
10 substantially complete Iberdrola wind generation  
11 of approximately 259 MW, which equates to 77.7  
12 MW after applying a 30% capacity factor,  
13 represents a de minimis amount. The testimony  
14 concludes that any incentive to manipulate  
15 transmission by RG&E or NYSEG would be de  
16 minimis.

17 Q. Do you agree with this analysis and conclusion?

18 A. No. There are several areas of disagreement.  
19 First, the estimate of nameplate capacity for  
20 existing and planned generation would be 920.2  
21 MW rather than 795 MW. The 795 MW estimate does  
22 not include the 9.5% equity interest of

1 Iberdrola in Energias de Portugal, S.A. (EDP),  
2 which owns Horizon Wind Energy. Horizon Wind  
3 Energy has a 50% interest in the Maple Ridge  
4 (Flat Rock) wind generating facility. The  
5 Hieronymus testimony does not include the 15.3  
6 MW related to this equity interest because  
7 Iberdrola does not exercise any voting rights.  
8 This reasoning does not take into account that  
9 Iberdrola receives its 9.5% share of any profits  
10 from Maple Ridge. The 15.3 MW should be  
11 included in the nameplate capacity estimate.  
12 Horizon Wind Energy also has plans for an  
13 additional 476.45 MW of wind generation in New  
14 York. Iberdrola's 9.5% equity interest would be  
15 45.2 MW. Additionally, Iberdrola has a 24%  
16 equity interest in Gamesa. Its Gamesa Energy  
17 USA LLC subsidiary has a 150 MW wind generating  
18 facility in the NYISO interconnection queue for  
19 the NYSEG service area. The 65 MW Iberdrola  
20 share of this facility should be included in the  
21 nameplate capacity estimate. The final estimate  
22 should be 920.2 MW rather than 795 MW. Second,

1 in discussing capacity market revenues from the  
2 Iberdrola wind generation, the testimony  
3 presents the summer capacity value of 79.5 MW  
4 for existing and planned generation based on 795  
5 MW of nameplate capacity and a 10% capacity  
6 factor. As explained above, the calculation  
7 should be 10% of 920.2 MW, which results in 92  
8 MW. The capacity factor for the winter capacity  
9 period is 30%, which results in 276.1 MW of  
10 capacity earning capacity revenues. The  
11 expected ICAP revenues for this capacity in the  
12 NYCA capacity market for the 2009 summer  
13 capability period and the 2009/2010 winter  
14 capability period are \$2.14 million and \$3.32  
15 million respectively. (The estimates are based  
16 on a \$4/kw-month summer price and a \$2/kw-month  
17 winter price.) To the extent that excess  
18 capacity dissipates in the future in the NYCA  
19 market, prices would increase, resulting in a  
20 corresponding increase in capacity market  
21 revenues. The potential revenue from the  
22 capacity market for new generation is contingent

1 on being deliverable, as discussed previously.  
2 New entrants which are not deliverable face an  
3 additional cost-of-entry related to transmission  
4 system upgrades. Thus, the incentive to use  
5 transmission decisions to favor own generation  
6 is not only the capacity market revenues, but  
7 avoiding system upgrade costs for affiliated  
8 generation that a non-affiliated generator may  
9 face.

10 Q. Do you have any examples of the price impacts  
11 that transmission decisions have on upstate  
12 wholesale electric prices?

13 A. Yes. Exhibit\_\_\_(PP-13) shows the real-time (RT)  
14 and day-ahead (DA) LBMPs for the Genesee and  
15 West regions for a 19-day period which includes  
16 a Ginna line outage which was discussed  
17 previously in relation to the Ginna FERC  
18 complaint. The data shows that the RT price  
19 during the outage was approximately 55% higher  
20 during the outage than the prior and following  
21 week's weekday average for the upstate market.  
22 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

1 power that hypothetically could be exercised.”

2 It is inconsistent to claim that on one hand

3 Iberdrola is planning to construct only a de

4 minimis amount of wind generation in New York

5 while on the other hand, Iberdrola’s commitment

6 to wind generation will provide substantial

7 benefits.

8 Q. Is this inconsistency your major concern?

9 A. No. The major concern is that Iberdrola

10 purchase of the T&D utilities may actually

11 retard the fulfillment of New York’s interests

12 in developing renewable wind generation.

13 Q. Please explain how the acquisition may harm the

14 state’s interest in the development of wind

15 generation.

16 A. Though the T&D utilities, Iberdrola could affect

17 the interconnection process for wind developers

18 attempting to build projects in the RG&E and

19 NYSEG service territories. To a lesser extent,

20 Iberdrola also influences the production and

21 sale of wind generation equipment, through its

22 affiliation with Gamesa, a major wind power

1 parts manufacturer. These affiliations could  
2 enable Iberdrola to discourage competing wind  
3 developers from entering and successfully  
4 competing for projects in New York.

5 Q. What would be the impact on New York's goals for  
6 promoting renewable generation?

7 A. It could prevent New York from achieving those  
8 goals. As Iberdrola itself points out,  
9 knowledgeable and financially-strong wind  
10 developers "may not be able to dedicate  
11 resources to renewable energy development in  
12 every state" (Response IBER-0202). If wind  
13 developers that are competitors of Iberdrola  
14 come to believe that Iberdrola has an advantage  
15 in New York because of its affiliations, those  
16 competitors may take their expertise and capital  
17 elsewhere. Whatever additional wind capacity  
18 Iberdrola might build in the absence of  
19 competitors is unlikely to equal what full  
20 participation by numerous competitors in a  
21 robust competitive market could have produced.  
22 New York needs more than one wind developer to

1 achieve its renewable goals.

2 Q. How could Iberdrola's exercise of its affiliate  
3 advantages otherwise discourage the development  
4 of wind generation in New York?

5 A. New York has created a renewable portfolio  
6 standard (RPS) program. Under RPS, periodic  
7 solicitations are made for renewable energy  
8 projects. Developers of renewable projects  
9 submit bids in a competitive process for an  
10 award of funding, in essence a price premium or  
11 incentive payment for the delivery of energy  
12 from renewable resources. If Iberdrola  
13 discourages competitors from entering New York,  
14 the RPS program could be disrupted by declining  
15 competition, and New Yorkers could either pay  
16 much more to fund RPS because of the supply and  
17 demand effect that would drive bid prices higher  
18 due to scarcity of supply, or the RPS goals  
19 might not be met due to an insufficient number  
20 of project to meet the targets of the program.

21 iii. NATURAL GAS INTERCONNECTION  
22 ISSUES

23

1 Q. Are there remaining vertical market power issues  
2 which have not been addressed?

3 A. Yes. According to the Hieronymus Affidavit to  
4 FERC, there is approximately 300 MW of  
5 generation in the NYISO market taking natural  
6 gas transportation service from RG&E and NYSEG,  
7 although approximately 150 MW uses natural gas  
8 as a supplement fuel. There is 314 MW of  
9 planned natural gas generation in the NYISO  
10 interconnection queue for the NYSEG service  
11 area. The combined firm would have an incentive  
12 to use natural gas delivery policies, such as  
13 negotiated rates and natural gas interconnection  
14 policies, to increase costs to competing  
15 generators. In particular, this could create  
16 advantages for the Carthage facility, which  
17 might obtain higher prices if competing gas  
18 generators are delayed or are not built as a  
19 result of the use of gas delivery affiliations  
20 to discourage competition.

21 B. CREDIT QUALITY CONSIDERATIONS

22 i. IBERDROLA CREDIT QUALITY CONCERNS

1 Q. How will Iberdrola finance the \$4.5 billion  
2 payment for the acquisition of Energy East?

3 A. On June 27, 2007, Iberdrola prefunded the  
4 acquisition with an accelerated private  
5 placement of equity. The money from this  
6 financing will pay for the acquisition of Energy  
7 East, and is a conservative means for  
8 consummating the M&A transaction. When viewed  
9 in isolation, this approach to the transaction  
10 would be less damaging to Iberdrola's capital  
11 structure than an all debt financing approach  
12 (as in the Grid/KeySpan transaction).

13 Q. Does this mean that this transaction will only  
14 add equity to Iberdrola's balance sheet?

15 A. No. Iberdrola will assume approximately \$3.7  
16 billion of debt that has been previously issued  
17 by Energy East and its subsidiaries. Thus, the  
18 transaction will add debt as well as equity to  
19 the balance sheet of Iberdrola. Furthermore,  
20 the transaction will increase Energy East's \$1.5  
21 billion of existing Goodwill by \$1.4 billion,  
22 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

1 of Goodwill necessarily concerns us.

2 Q. What is the pro forma capital structure of  
3 Iberdrola after the acquisition?

4 A. We estimate that the pro forma capital structure  
5 of Iberdrola will contain 42% equity and 58%  
6 debt. [REDACTED]

7 [REDACTED]

8 [REDACTED]

9 [REDACTED]

10 [REDACTED]

11 [REDACTED]

12 [REDACTED]

13 [REDACTED]

14 [REDACTED]

15 [REDACTED]

16 [REDACTED]

17 [REDACTED]

18 [REDACTED]

19 Q. Why did Staff not oppose treating this  
20 information as confidential?

21 A. Similar to the discussion above concerning  
22 Confidential Interrogatory Response IBER-0016 to

1 DPS-16, Staff did not want to prejudice  
2 Iberdrola in the event that the transaction is  
3 not approved, by requiring it to release  
4 information that it would have been allowed to  
5 keep secret in Europe. However, if the  
6 transaction is approved, the Commission should  
7 make it clear that Iberdrola will not be allowed  
8 to keep secret such fundamental information in  
9 the future. Staff Counsel advises that the  
10 information does not meet the standard for trade  
11 secret protection under New York law.

12 Q. Please continue with your analysis of Goodwill.

13 A. While there is no incremental Goodwill financed  
14 with debt as a result of this M&A transaction,  
15 the creation of Goodwill standing alone is  
16 problematic and exacerbates the extremely high  
17 amount of Goodwill Iberdrola already has on its  
18 balance sheet. Pro forma, Iberdrola currently  
19 has \$9.8 billion of Goodwill and other  
20 intangible assets on its books. This represents  
21 a startling 46% [REDACTED]

22 [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?

1 A. No. Credit ratings are snapshots of a company's  
2 existing circumstances and by nature are subject  
3 to change when a company's circumstances  
4 inevitably change. The Policy Panel believes  
5 that given Iberdrola's high leverage and the  
6 extensive financings it must obtain in order to  
7 absorb its recent acquisitions, build its  
8 proposed generation projects, and continue on  
9 its course of corporate expansion, it is  
10 unlikely that the Company can sustain an "A"  
11 rating. Moreover already S&P's and Moody's have  
12 downgraded Iberdrola to a rating of "A-".  
13 Moreover, as stated previously, the capital  
14 structure of Iberdrola is not consistent with an  
15 "A" rating currently and any increase in its  
16 leverage will make a downgrade or multiple  
17 downgrades more likely.

18 Q. What is the basis for your statement that  
19 Iberdrola's capital structure ratios are  
20 unlikely to support an "A" bond rating after the  
21 transaction?

22 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

1 the impact of the acquisition of Scottish Power  
2 PLC (A-/Watch Neg/A-2) and the group's organic  
3 growth plan."

4 Earlier, on September 18, 2007, S&P's  
5 issued a credit opinion on Iberdrola. In this  
6 opinion, S&P's noted weaknesses in Iberdrola  
7 that affected its risk profile: increasing  
8 competitive pressure in the domestic electricity  
9 market, exposure to pool price volatility, an  
10 ambitious growth strategy, a weakened financial  
11 profile following acquisition of SP, and  
12 exposure to volatile Mexican and Brazilian  
13 markets.

14 Q. What conclusions do you draw from S&P's reports  
15 on Iberdrola?

16 A. We believe Iberdrola is facing many challenges  
17 in maintaining its credit quality. The  
18 Company's assertion that its credit rating is a  
19 tangible benefit to NYSEG and RG&E ratepayers is  
20 transient. This is demonstrated by S&P's and  
21 Moody's both downgrading Iberdrola one rating  
22 notch just a few months after they made their

1 assertion.

2 Q. Why is S&P's ratings approach for U.S. utilities  
3 appropriate for an international holding company  
4 such as Iberdrola?

5 A. Iberdrola's operations are very similar to those  
6 of a typical U.S. integrated utility. As a  
7 result, we believe the same credit metrics that  
8 S&P applies to utilities in the United States  
9 should also be appropriate to apply to  
10 Iberdrola's operations.

11 Q. Explain how you applied S&P's domestic credit  
12 metrics to analyze Iberdrola's capital structure  
13 after the acquisition occurs.

14 A. S&P published revised bond rating guidelines for  
15 United States utilities in June 2004. The  
16 report, attached as Exhibit \_\_ (PP-16) indicates  
17 that one of the three key credit quality ratios  
18 considered by S&P is the ratio of debt to total  
19 capital (debt ratio). This report presented an  
20 approach under which S&P recognizes business  
21 risk profiles from 1 to 10 for utilities and  
22 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

1 higher profile scores can accumulate, all other  
2 things equal.

3 Q. What is Iberdrola's current business profile  
4 score?

5 A. S&P currently assigns Iberdrola a business  
6 profile of 5 versus NYSEG and RG&E's business  
7 risk profile of "3".

8 Q. What capital structure requirements does S&P  
9 have for utilities with a business profile of 5?

10 A. S&P requires respective debt ratios of 35 - 42%,  
11 42 - 50%, 50 - 60%, and 60 - 65% for AA, A, BBB  
12 and BB bond ratings, respectively, for utilities  
13 with a business profile of 5.

14 Q. What bond rating is suggested by Iberdrola's  
15 current post-acquisition 58% debt?

16 A. Based on S&P's debt ratio requirements,  
17 Iberdrola's pro forma debt ratio of 58% and its  
18 business profile of 5 are consistent with a BBB  
19 bond rating. It is important to note; however,  
20 if even half of Iberdrola's Goodwill is written  
21 down, Iberdrola's equity ratio would drop to a  
22 level typical of an entity with a junk bond.

1 Q. Is Iberdrola likely to maintain a business risk  
2 profile of 5 as a result of the acquisition of  
3 Energy East?

4 A. We believe that this is a likely scenario.  
5 Energy East is primarily a pipes and wires  
6 distribution company. The acquisition should at  
7 least temporarily offset any additional forays  
8 by Iberdrola into wholesale generation and other  
9 competitive businesses. We believe that  
10 Iberdrola will maintain its business profile  
11 rating of 5, the mid point of the range S&P  
12 typically assigns to vertically integrated  
13 holding companies.

14 Q. What is the significance of these metrics for  
15 Iberdrola's financial strength?

16 A. These metrics imply that the financial  
17 parameters of Iberdrola's bond rating are  
18 consistent with that of Energy East's BBB  
19 rating. This is significant because Iberdrola  
20 has claimed that one of the cornerstone benefits  
21 it brings to the ratepayers of NYSEG and RG&E is  
22 its financial strength. Yet the credit rating

1 of Iberdrola has already been downgraded one  
2 notch by S&P's and Moody's. Unless these  
3 metrics improve, Iberdrola's long-term credit  
4 rating would appear at risk. From a financial  
5 standpoint, the financial strength promised by  
6 Iberdrola may be fleeting.

7 Q. Energy East is currently rated BBB+ and  
8 Iberdrola A- by Moody's. Can you see any  
9 benefit to the utilities as a result of the  
10 marginal credit rating advantage Iberdrola has  
11 over Energy East?

12 A. No. The credit rating advantage that Iberdrola  
13 currently enjoys over Energy East apparently has  
14 no direct benefit to the utilities. S&P has  
15 NYSEG and RG&E on negative outlook due to issues  
16 arising from the M&A transaction. This casts  
17 doubts on Iberdrola's promise of greater  
18 financial strength for NYSEG and RG&E. In fact,  
19 S&P's credit opinion indicates that even with or  
20 because of Iberdrola ownership, a down grade is  
21 being considered.

22 Q. Did you factor S&P statements about global

1 utilities into your analysis?

2 A. Yes. An S&P report titled "Power Companies",  
3 attached as Exhibit\_\_\_(PP-17), contains a table  
4 (page 33) which shows median financial ratios  
5 for T&D utilities, generators, and vertically  
6 integrated utilities sorted by A and BBB bond  
7 ratings. This table indicates that the median  
8 debt ratio for A and BBB rated T&D companies are  
9 55% and 65% respectively. By contrast, the  
10 median debt ratios for A and BBB rated  
11 vertically integrated utilities are 45% and 56%,  
12 respectively.

13 Q. What are the implications of these ratios for  
14 this proceeding?

15 A. By the standards of this article, Iberdrola's  
16 pro forma debt ratio of 58% implies a BBB bond  
17 rating. This statement is based on the 55%  
18 median debt ratio for BBB rated vertically  
19 integrated utilities shown in S&P's article,  
20 "Power Companies." Thus, by two industry  
21 standards, one international and one domestic,  
22 Iberdrola's debt rating 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

1 Company for signs of credit deterioration.

2 Q. What conclusions do you draw from Moody's  
3 reports on Iberdrola?

4 A. Moody's points out that Iberdrola's leverage and  
5 heavy investment plans place it on the low end  
6 of an A3 rating. This analysis refutes  
7 Iberdrola's claim that its financing of the  
8 Energy East acquisition with equity is a benefit  
9 to the ratepayers of NYSEG and RG&E. The  
10 Moody's report indicates that the use of equity  
11 financing merely prevents damage to Iberdrola's  
12 financial profile. The prevention of the  
13 further erosion of Iberdrola's financial metrics  
14 is not a benefit to ratepayers. Given  
15 Iberdrola's extensive plans for making future  
16 investments, the future capital structure of  
17 Iberdrola could vary widely, depending upon how  
18 Iberdrola chooses to finance its investments,  
19 especially if Iberdrola continues its  
20 acquisition efforts. This can hardly be seen as  
21 a benefit to the customers of NYSEG and RG&E.

22 Q. Are there any other factors that concern Staff

1 regarding Iberdrola's ability to effectively  
2 finance the operations of NYSEG and RG&E?

3 A. Yes. Iberdrola's latest strategic plan  
4 indicates that the Company is embarking on a \$20  
5 billion investment program. How this program is  
6 capitalized is will determine whether Iberdrola  
7 will be downgraded. If the program is financed  
8 conservatively with a great deal of equity  
9 Iberdrola should be able to maintain its bond  
10 grading. However, if substantial amounts of  
11 debt are needed to finance this investment  
12 program, then Iberdrola's ratings could be  
13 downgraded. Also, any future acquisitions of  
14 businesses not contemplated in the strategic  
15 plan could add stress to the company's financial  
16 metrics. Finally, Iberdrola continues to  
17 increase its dividends in the midst of what is  
18 apparently a massive decade long investment  
19 program. This, too, imposes stress on  
20 Iberdrola's financial strength.

21 Q. Please summarize the risks of Iberdrola as a  
22 corporate parent for NYSEG and RG&E.

- 1 A. We are concerned about the financial strength  
2 that Iberdrola will bring to NYSEG and RG&E.  
3 Iberdrola's pro forma capitalization will use  
4 leverage consistent with a BBB rated vertically  
5 integrated utility. The non-earning Goodwill  
6 and intangible assets on its balance sheet will  
7 represent 46% of its equity. We wonder if given  
8 its extensive investment program and the capital  
9 deployed to acquire Energy East, whether their  
10 will be enough resources to effectively maintain  
11 the T&D systems of NYSEG and RG&E. It raises  
12 questions about the safety and reliability of  
13 NYSEG and RG&E's service under Iberdrola. It  
14 creates risks that need not be incurred if the  
15 Commission declines to approve the transaction.
- 16 Q. Why is it important to consider declines in the  
17 credit quality of the holding company parent of  
18 NYSEG and RG&E as a result of the transaction?
- 19 A. Utilities are responsible for providing safe and  
20 adequate service at a reasonable rate. Declines  
21 in the credit quality of Iberdrola not only  
22 affect Iberdrola's ability to raise capital in

1 the financial markets at reasonable terms but  
2 also the ability of its subsidiaries to do so as  
3 well. At this point in time, even with the  
4 downgrade by S&P's and Moody's, Iberdrola enjoys  
5 access to the capital markets. However, it  
6 seems likely that the costs it incurs in  
7 accessing debt financing will be increasing.  
8 While the cost associated with a credit quality  
9 decline within the investment grade category may  
10 not be significant given the current risk  
11 premium environment, a continued decline in  
12 credit quality to a level below investment grade  
13 credit quality could put upward pressure on  
14 utility rates. While an A-/A3 rating is a long  
15 way from a non-investment grade rating, it is  
16 also important to remember that the Company has  
17 seen its S&P credit rating fall from AA- to A-  
18 over the period November 2001 to December 2007  
19 and its Moody's credit rating fall from A1 to A3  
20 over the period November 2002 to December 2007.  
21 Iberdrola faces an ambitious investment program  
22 and a difficult integration of SP into its

1 organization. These programs could cause  
2 significant problems if Iberdrola is unable to  
3 execute its plans for these endeavors.

4 It is important to remember that NYSEG and  
5 RG&E will not operate in a vacuum from Iberdrola  
6 if the proposed acquisition meets all its  
7 regulatory approvals and is consummated. Absent  
8 adequate subsidiary financial protections, a  
9 decline in the credit quality at the parent is  
10 very likely to also precipitate a decline in the  
11 credit quality of the subsidiaries.

12 ii. NYSEG AND RG&E CREDIT QUALITY  
13 CONCERNS

14 Q. What is the basis for your statement that  
15 declines in Iberdrola's credit quality also  
16 drive down the credit quality of its utility  
17 subsidiaries?

18 A. This statement is based on the bond rating  
19 approach taken by both S&P and Moody's for  
20 holding companies with utility subsidiaries.  
21 More specifically, absent specific provisions to  
22 isolate the risks of the holding company from

1 utility subsidiaries, S&P is unlikely to assign  
2 a utility subsidiary a bond rating that differs  
3 from that of the parent. While Moody's may  
4 assign a higher bond rating to utility  
5 subsidiaries, the difference is likely to be no  
6 more than a notch. Thus, downgrades by Moody's  
7 or S&P of Iberdrola's overall bond rating will  
8 likely lead to a downgrade in the bond rating of  
9 NYSEG and RG&E.

10 Q. Have either credit agency indicated specifically  
11 that bond rating downgrades for NYSEG and RG&E  
12 are likely if the transaction is approved?

13 A. Yes, Exhibit\_\_\_(PP-4) contains two reports from  
14 S&P, one for NYSEG and one for RG&E. These  
15 reports express concern over the financial  
16 metrics, i.e., the high debt leverage; Iberdrola  
17 would exhibit as the ultimate parent of NYSEG  
18 and RG&E. These reports also expressed some  
19 concern over the last NYSEG rate decision, which  
20 lowered the Company's rates. As a result of  
21 these concerns and others, S&P has put NYSEG and  
22 RG&E on watch for a downgrade if the transaction

1 is completed.

2 Q. How much of a downgrade is likely as a result of  
3 the transaction?

4 A. Since S&P has not stated otherwise, we believe  
5 the credit agency will limit any downgrade of  
6 for NYSEG and RG&E to one rating notch. We are  
7 not confident, however, that there will not be  
8 further downgrades to both the New York  
9 utilities and Iberdrola.

10 Q. Why do you say this?

11 A. We say this for three reasons. First, the debt  
12 ratio exhibited by Iberdrola suggests a greater  
13 downgrade is possible for Iberdrola and its  
14 affiliates. When Goodwill is considered the  
15 possibility of a downgrade is further enhanced.  
16 Second, since Iberdrola is new to owning  
17 regulated utilities in New York State and its  
18 management will be occupied with the integration  
19 of SP and its large investment program, the  
20 forecasts of credit metrics to the credit  
21 agencies is likely to reflect the ratemaking and  
22 structural outcome desired by petitioners rather

1 than a rational assessment of an outcome  
2 consistent with established Commission policies  
3 and approaches for issues such as vertical  
4 market power (VMP) or capital structure. Thus,  
5 if the Commission determines that the  
6 transaction itself is in need of modification,  
7 including the development of a rate plan, to  
8 properly protect the public, the expected  
9 financial parameters from the transaction may  
10 differ from those provided by Iberdrola to the  
11 financial community. If the reality of what the  
12 Commission decides varies negatively from what  
13 the utilities or Iberdrola has told the credit  
14 agencies, then a downgrade in credit rating is  
15 possible for NYSEG and RG&E.

16 Third, Iberdrola's massive planned capital  
17 program and the company's ever-increasing  
18 dividend are two competing sources for funds  
19 that put pressure on Iberdrola to raise the  
20 dividends from NYSEG and RG&E to levels that may  
21 restrict these utilities' ability to provide  
22 safe and reliable service.

1 Q. Can any other important information be gleaned  
2 from these S&P's reports?

3 A. Yes. The S&P credit reports for both NYSEG and  
4 RG&E highlight two reasons for a downgrade: the  
5 potential Iberdrola acquisition and the recent  
6 NYSEG rate case. That the NYSEG rate case  
7 appears in both credit reports is telling. In  
8 theory, NYSEG's rate case should have no bearing  
9 on the credit quality of RG&E. They are two  
10 separate entities whose rates, in theory, should  
11 have no effect on the other. The fact that S&P  
12 appears to consider the effects of the NYSEG  
13 ratemaking in an RG&E credit analysis indicates  
14 that regardless of whether the acquisition is  
15 approved or not, additional structural  
16 separations and other financial protections are  
17 needed to shield the two subsidiaries from all  
18 of their affiliates.

19 Q. On December 26, 2007 Moody's Investor Services  
20 issued credit opinions on NYSEG, RG&E, and  
21 Energy East. These reports maintained the  
22 companies' outlooks as "negative." Did the

1 reports explain Moody's position?

2 A. Yes. The Moody's reports state: "The negative  
3 outlooks for EEC and its subsidiaries reflect,  
4 in part, the financial and operating challenges  
5 resulting from a surprisingly unfavorable  
6 decision NYSEG received in its general rate case  
7 decided in August 2006. The decision in that  
8 case introduced the risk that there could be  
9 residual negative financial effects on EEC's  
10 other utility subsidiaries in the event that the  
11 parent requires an increase in dividends from  
12 those companies to compensate for any potential  
13 reduction in the levels previously paid by  
14 NYSEG. Moreover, there are still lingering  
15 questions about whether the NYPSC's August 2007  
16 approval of a modified fixed price option for  
17 NYSEG's retail electric customers will provide  
18 the impetus for overcoming some of the earnings  
19 and cash flow pressures created by the NYPSC's  
20 September 2006 decision. The negative outlooks  
21 also recognize that while the transaction with  
22 Iberdrola is subject to numerous state and some

1 federal regulatory approvals, it is not uncommon  
2 for approvals of this nature to be conditioned  
3 upon additional rate concessions. The negative  
4 outlooks further consider the uncertainty  
5 surrounding the ultimate capital structure of  
6 EEC, and the extent to which current dividend  
7 policies may be impacted by consummation of the  
8 proposed acquisition."

9 Q. Does the Moody's report indicate that the credit  
10 agency has concerns Iberdrola's acquisition of  
11 the Energy East companies?

12 A. Yes. Moody's is concerned about the dividend  
13 policy and the capital structure of Energy East  
14 under Iberdrola management, as are we. We would  
15 be remiss; however, if we did not rebut certain  
16 misunderstandings contained in the Moody's  
17 report.

18 Q. Does Staff have any reaction Moody's discussion  
19 of the impact of NYSEG's 2006 rate decision in  
20 its reports?

21 A. Yes. We found the finding about NYSEG's rate  
22 decision, which applied to the year 2007,

1 inconsistent with Moody's statement that  
2 "although NYSEG's key credit metrics through  
3 September 30, 2007 have rebounded from the lower  
4 levels evidenced for the year ended December 31,  
5 2006, they remain more in line with the Baa  
6 rating category." The Moody's statement is odd  
7 because the rates for year ending December 2006  
8 were not addressed in NYSEG's last rate  
9 decision; instead, that decision applied to  
10 2007, which Moody's indicated was a "rebound  
11 year."

12 Q. Does Staff have any reaction to Moody's  
13 statement that "regulatory decisions in the  
14 pending acquisition by Iberdrola that do not  
15 impose harsh rate concessions could also lend  
16 stability to NYSEG's rating outlook, assuming  
17 Iberdrola does not unexpectedly introduce  
18 aggressive leveraging into its financing  
19 strategies."

20 A. Yes. The Commission policy on requiring  
21 positive benefits for approval of an M&A  
22 transaction has been known for a long time. New

1 York is not a state that has recently applied a  
2 "no harm" standard to a major electric and gas  
3 M&A transaction. The adjective "harsh" used by  
4 Moody's merely recognizes the reality that rate  
5 concessions in excess of real merger savings  
6 will have a negative impact on credit quality.  
7 So there is a natural tension between the need  
8 to provide real ratepayer benefits without  
9 damaging utility credit quality. Moody's  
10 position suggests that to the extent that credit  
11 quality is a guiding factor in the merger, rate  
12 concessions cannot be implemented without ring  
13 fencing and financial protections for ratepayers  
14 and the operating utility companies. That is,  
15 the Commission should insist on financial  
16 transparency, financial protections and ring  
17 fencing conditions and rate concessions in lieu  
18 of those protections will bring only short term  
19 benefit while raising long -term risks.

20 Q. What are the implications for the investment  
21 community in conforming the proposed transaction  
22 to established regulatory policies, guidelines

1 and procedures?

2 A. It is reasonable to expect that financial  
3 experts will assume that the acquisition will  
4 contain financial conditions similar to those  
5 recently adopted in the Grid/KeySpan merger.  
6 The rating agencies possess the experience,  
7 knowledge and expertise to evaluate and  
8 understand the extent to which utility proposals  
9 realistically conform to established Commission  
10 policies, guidelines and ratemaking practices,  
11 and to inform the investing public of potential  
12 uncertainties when utility requests conflict  
13 with those policies and practices. As a result,  
14 it should not come as a surprise to the  
15 investment community, investors, or the  
16 Petitioners for that matter, if the Commission  
17 takes predictable actions in this proceeding  
18 based on established principles related to  
19 issues such as merger benefits, vertical market  
20 power, capital structure, or financial  
21 conditions.

22 Q. Has the investment community rendered an

1 assessment on Iberdrola's affect on NYSEG and  
2 RG&E?

3 A. Yes. On November 29<sup>th</sup>, 2007, NYSEG went to the  
4 capital markets and issued debt 225 basis points  
5 above 10-year treasuries. This is significant  
6 because in the three day period, November 27  
7 through November 29, three companies deemed  
8 comparable to NYSEG by the company itself (in a  
9 compliance filing in Case 07-M-0891) issued debt  
10 that was on average 192 basis points above the  
11 10- year treasury benchmark. Therefore, these  
12 companies issued their comparable debt for 33  
13 basis points less than NYSEG obtained in the  
14 market. As shown on Exhibit\_\_\_(PP-19) which is  
15 a list of comparable debt issuances prepared by  
16 JP Morgan to justify, NYSEG's issuance rate,  
17 none of the 19 issuances presented had a spread  
18 as high as 225 basis points over 10-year  
19 treasuries.

20 Q. What are the implications for the customers of  
21 NYSEG from this issuance?

22 A. The debt issued by NYSEG was issued at 30 basis

1 points above its self-described comparable  
2 peers. NYSEG issued \$200 million of debt in  
3 this issuance. This will cost ratepayers  
4 \$600,000 basis points annually vis-à-vis the  
5 average issuance of NYSEG's peers.

6 Q. The three companies who issued November 27  
7 through November 29; Dominion Resources  
8 (Baa2/BBB), Pacific Gas & Electric (Baa1/BBB+)  
9 and Southwestern Power (Baa1/BBB), overall  
10 actually have an average credit quality less  
11 than NYSEG. What reason could be behind the  
12 discrepancy in the cost rates between NYSEG and  
13 its peers?

14 A. We believe it is the risk of a potential  
15 relationship with Iberdrola that accounts for  
16 the discrepancy in the yields. Although NYSEG  
17 has a negative outlook for reasons than just the  
18 Iberdrola merger, the effects of such a  
19 downgrade would likely be about 13 basis points.  
20 We base this estimate by interpolating the Moody  
21 data for BBB and A rated Long-Term and  
22 Intermediate Corporate Bond Yields as shown on

1 Exhibit\_\_\_(PP-19). Thus, it appears that there  
2 is another factor, and lacking any other reason  
3 for this discrepancy between NYSEG's issuance  
4 yield and that of its peers, this factor would  
5 be appear to be related to the risk of Iberdrola  
6 becoming the parent of NYSEG.

7 Q. Is there a means of protecting ratepayers from  
8 the higher issuance costs of NYSEG?

9 A. Yes. We believe that an imputation of 30 basis  
10 points should be made to NYSEG's rates to remove  
11 the effects of Iberdrola from the company's cost  
12 of debt. Accordingly in the company's cost of  
13 debt calculation (discussed later) We have  
14 removed \$600,000 of interest rate costs.

15 Q. Please summarize the risks to NYSEG and RG&E  
16 arising from this transaction.

17 A. The risks to NYSEG and RG&E are largely the same  
18 risks as described in the preceding section  
19 dealing with the risks of Iberdrola as a parent.  
20 These risks include the leveraged capital  
21 structure and the amount of dividends that NYSEG  
22 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

1 flows are of limited duration. Thus, the  
2 eventual impairment of regulated utility  
3 Goodwill is must be considered likely.

4 Q. Why is this significant for Iberdrola?

5 A. In acquiring Energy East, Iberdrola is  
6 essentially acquiring a company that is  
7 predominantly a "pipes and wires" company.  
8 Thus, virtually all of the company's revenues  
9 stem from regulated operations. Thus, it would  
10 appear that the Goodwill related to the purchase  
11 of Energy East will likely exist for only a  
12 relatively short time frame before impairment  
13 questions arise.

14 Q. Are there any circumstances where it might be  
15 appropriate to allow Goodwill to be placed on  
16 the books of a regulated utility?

17 A. If appropriately accounted for, it would be  
18 reasonable to reflect Goodwill on a regulated  
19 utility's books in the situation where an  
20 acquisition produced synergy savings and at  
21 least some portion of the savings were expected  
22 to flow to the utility's shareholders as an

1 incentive. Under such circumstances, the  
2 Goodwill balance would reflect the present value  
3 of the after tax future savings amounts.

4 Q. How should the recognition of Goodwill in this  
5 type of situation be treated over time?

6 A. Ideally, as the shareholders' portion of synergy  
7 savings is realized, the Goodwill amount would  
8 be reduced to reflect the realization of the  
9 cash flows that formed the basis for recognition  
10 of the Goodwill.

11 Q. Does this situation apply to the Iberdrola  
12 acquisition of Energy East?

13 A. No. In its testimony supporting its acquisition  
14 of Energy East, Iberdrola has not identified any  
15 synergy savings associated with the acquisition  
16 and in fact contends that there are none.

17 Without synergy savings, there is no basis for  
18 placing Goodwill on NYSEG or RG&E's books.

19 Q. Why does having a large amount of Goodwill on  
20 its balance sheet raise the risk of Iberdrola?

21 A. Iberdrola's Goodwill is supported by its capital  
22 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

1 increase the financial risk of the company who  
2 has made a charge to its earnings.

3 Q. Is Iberdrola likely to have to write down its  
4 Goodwill?

5 A. This is difficult to predict. In the short run,  
6 a write down of Goodwill seems unlikely. In  
7 good times, Iberdrola might be able to support  
8 its Goodwill through achieving efficiencies in  
9 the operations of its acquired companies; we  
10 note that Iberdrola claims those efficiencies  
11 are not present in this M&A transaction.

12 Q. What is the likely effect of the passage of time  
13 on Iberdrola's Goodwill?

14 A. As time passes, eventually all the efficiencies  
15 that might be extracted from an acquisition are  
16 achieved. Since regulators, and the operation  
17 of competitive markets for that matter, are  
18 unlikely to continue to allow Iberdrola to  
19 recover excess profits, Goodwill can not be  
20 supported in the long term.

21 Further, the passage of time will expose  
22 Iberdrola to macroeconomic forces that might

1 harm the company. A recession or other event  
2 limiting its earnings could cause a great deal  
3 of harm to Iberdrola. If earnings fall, a  
4 series of write downs could follow.

5 Most troubling is the possibility that an  
6 economic downturn might ultimately impede  
7 Iberdrola's access to the capital markets. When  
8 a business is in trouble, credit agencies, and  
9 investors will deduct the Goodwill from any  
10 calculation of residual equity because it will  
11 likely have no resale value. Currently,  
12 Iberdrola's equity ratio would fall to 34% [REDACTED]  
13 [REDACTED]  
14 (assuming a 33% tax rate) if all of its Goodwill  
15 was written off. By S&P's ratings criteria  
16 shown as Exhibit \_\_ (PP-16 and PP-17), Iberdrola  
17 would not even fit the parameters of a BBB rated  
18 utility. With a junk bond rating, it is  
19 possible Iberdrola's access to capital will be  
20 limited. Certainly, any access the Company  
21 would have to capital would come at a dear  
22 price.

1 Q. Do you have any other concerns about Goodwill?

2 A. Yes, firms in energy markets have been  
3 consolidating. When Iberdrola acquired Energy  
4 East, second generation Goodwill was created.  
5 Second generation Goodwill is Goodwill generated  
6 by the acquisition of an entity that already has  
7 Goodwill on its books. If Iberdrola is acquired  
8 at a premium, third generation Goodwill will be  
9 created. The end result of this process is that  
10 relatively fewer hard assets will have to  
11 support relatively more Goodwill. This process  
12 is not sustainable in the long run.

13 Q. Do you have any concerns about Iberdrola's  
14 reporting of Goodwill?

15 A. Yes. In its 3<sup>rd</sup> Quarter Report, Iberdrola reports  
16 that it has \$22 billion worth of intangible  
17 assets on its balance sheet. These numbers  
18 include the Goodwill and intangible assets  
19 generated by the SP transaction. However, in  
20 its presentation to the credit agencies,  
21 Iberdrola reports that it has \$13.4 billion of  
22 Goodwill and intangible assets pro forma to

1 2008, with numbers that include the acquisitions  
2 of SP and Energy East. We do not believe  
3 Iberdrola has misstated its numbers in either  
4 case. It is most likely just a difference we do  
5 not fully understand under IFRS rules. Be that  
6 what it may, it points out the enormous  
7 difficulties the Commission would encounter in  
8 dealing with Iberdrola if the M&A transaction is  
9 approved.

10 Q. Please summarize the panel's concerns about  
11 Iberdrola's Goodwill.

12 A. Iberdrola's Goodwill is an impediment to its  
13 credit quality. Any shortfall in revenues in a  
14 given year could cause a write down of the  
15 company's Goodwill which ultimately would reduce  
16 the company's equity and compel an increase in  
17 its debt leverage. Iberdrola's Goodwill and  
18 other intangible assets make up 46% of  
19 Iberdrola's equity. This represents a sizable  
20 risk that should not be placed on the customers  
21 of NYSEG and RG&E. It is yet another reason for  
22 the Commission not to approve the merger.

1 D. INADEQUACY OF PRO FORMA CAPITAL

2 STRUCTURE FOR NYSEG AND RG&E.

3 Q. Have you examined the likely ratemaking capital  
4 structure for NYSEG and RG&E after the  
5 acquisition is consummated?

6 A. Yes. We have examined Iberdrola's pro forma  
7 consolidated capital structure and made certain  
8 adjustments to account for Goodwill and proper  
9 financing of Iberdrola's operations other than  
10 NYSEG and RG&E to develop a ratemaking capital  
11 structure for NYSEG and RG&E.

12 Q. Please provide instances where the Commission  
13 has stated its preference to use the  
14 consolidated capital structure of the parent as  
15 the appropriate ratemaking capital structure for  
16 a utility subsidiary.

17 A. The Commission declared in Case 28947, Opinion  
18 No. 85-15 (issued September 26, 1985), p. 47,  
19 "When the utility itself is a subsidiary, as is  
20 National Gas Distribution Corporation, it is  
21 proper, at least in the first instance, to  
22 assume that the parent corporation's cost of

1 capital is also the subsidiary's because it is  
2 the parent that raises capital." Recently, in  
3 Case 05-E-1222, New York State Electric & Gas,  
4 Order, (issued August 23, 2005), the Commission  
5 reiterated its policy of using the parent's  
6 capital structure as the basis for setting a  
7 utility subsidiary's rates,

8 "The Commission requires financial  
9 separation and insulation for New York  
10 subsidiaries for them to obtain ratemaking  
11 recognition for their stand-alone capital  
12 structure. The record in this case does not  
13 show that Energy East has implemented any  
14 corporate restrictions or standards to separate  
15 NYSEG's capital structure from its own. This  
16 lack of separation precludes us from relying on  
17 anything other than the consolidated capital  
18 structure for ratemaking purposes."

19 Q. What assets are supported by Iberdrola's  
20 consolidated capital structure?

21 A. Iberdrola's consolidated capital structure shows  
22 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

1 capitalization that was less leveraged than the  
2 utility subsidiary's stand-alone capitalization  
3 needed to be."

4 Q. What adjustments should the Commission make to  
5 Iberdrola's capital structure to ensure that the  
6 capital structure of Iberdrola is appropriate  
7 for that of a regulated utility company?

8 A. The Commission uses subsidiary adjustments in  
9 developing the appropriate regulated capital  
10 structure from the capital structure of a parent  
11 company. These adjustments are made to ensure  
12 that the non-jurisdictional operations of a  
13 holding company are properly supported with a  
14 capital structure appropriate for the risks of  
15 its operations such that the capital structure  
16 of the regulated entity is not subsidizing the  
17 costs of the non-regulated operations.

18 Q. Please describe the mechanics of the subsidiary  
19 adjustment.

20 A. The subsidiary adjustment is performed by  
21 subtracting a hypothetical capital structure, in  
22 an amount equivalent to the total capital

1 structure of the non-jurisdictional operations,  
2 from the consolidated capital structure of the  
3 parent company. In this instance, two  
4 subsidiary adjustments would be made to  
5 Iberdrola's consolidated capital structure of  
6 Iberdrola.

7 Q. Why are two subsidiary adjustments needed to  
8 remove non-regulated operations from Iberdrola's  
9 consolidated capitalization?

10 A. Two subsidiary adjustments are needed because  
11 Iberdrola has two classes of non-jurisdictional  
12 assets that have significantly different risks.  
13 The first class is the non-jurisdictional  
14 operations of Iberdrola. The second class of  
15 assets is Goodwill. The difference in risk  
16 profiles between these two necessitates two  
17 separate adjustments to remove the risks of  
18 associated with each class of assets from  
19 Iberdrola's consolidated capital structure.

20 Q. How much of Iberdrola's consolidated  
21 capitalization supports Goodwill and non-  
22 regulated operations?

1 A. Iberdrola's capitalization supports \$13.3  
2 billion of Goodwill and \$55.4 billion of non-  
3 jurisdictional operations.

4 Q. What capitalization supports these non-  
5 jurisdictional operations?

6 A. Since Iberdrola carries an A- rating and a  
7 business profile of 5 from S&P, it is  
8 instructive to look at Exhibit\_\_\_(PP-16). S&P  
9 indicates in "New Business Profile Scores  
10 Assigned for U.S. Utility and Power Companies;  
11 Financial Guidelines Revised" that the  
12 appropriate capital structure for a company with  
13 a business profile of 5 and a low A rating is  
14 composed of 50% equity and 50% debt. Therefore,  
15 we will remove Iberdrola non-jurisdictional  
16 operations of \$55.4 billion from its pro forma  
17 capital structure at a rate of 50% equity (\$27.7  
18 billion) and 50% debt (\$27.7 billion).

19 Q. Iberdrola's consolidated capital structure  
20 includes \$13.3 billion of Goodwill on its  
21 balance sheet. What approach should the  
22 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.

1 Q. Are there any Commission guidelines as to what  
2 capitalization is appropriate for Goodwill?

3 A. In the past, the Commission has removed  
4 unregulated operations from the consolidated  
5 capitalization by assuming that these entities  
6 were financed with between 60% to 70% equity.  
7 These ratios were deemed representative of the  
8 typical competitive company.

9 As noted earlier, we believe that Goodwill  
10 carries more risk than that of the typical  
11 unregulated business operation. In general,  
12 more risky assets require a more conservative  
13 capital structure than less risky assets. Given  
14 that the Commission has used a ratio of 60% to  
15 70% equity for a competitive business when  
16 making subsidiary capital structure adjustments,  
17 a higher equity ratio is needed to remove the  
18 risks of Goodwill from Iberdrola's consolidated  
19 capital structure. Therefore, it is appropriate  
20 to remove Goodwill from Iberdrola's consolidated  
21 capital structure by using an equity ratio of  
22 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

1 billion, respectively as of December 31, 2006.  
2 Finally, Exhibit\_\_\_(PP-14) shows that the pro  
3 forma capital structure of Iberdrola adjusted  
4 for the removal of its non-regulated investments  
5 and Goodwill supports the operations of NYSEG  
6 and RG&E entirely with debt if its non-  
7 jurisdictional operations are properly  
8 capitalized. Thus, 46% of the capital structure  
9 of NYSEG and 48% of the capital structure of  
10 RG&E representing stand alone equity actually  
11 would be equity supported by debt at the  
12 consolidated level. Multiplying the 15% pre-tax  
13 return by approximately \$1.012 billion million  
14 of "debt supported equity" for NYSEG produces  
15 \$152 million in revenue requirement.  
16 Multiplying the 15% pre-tax return by  
17 approximately \$624 million of "debt supported  
18 equity" for RG&E produces \$94 million in revenue  
19 requirement. Thus, NYSEG and RG&E ratepayers  
20 would pay a total of \$246 million in rates for  
21 this portion of equity if ratemaking is set on a  
22 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.

1 A. If the transaction is approved, it would provide  
2 Iberdrola an incentive to thicken the equity  
3 ratio of NYSEG and RG&E and maintain an  
4 aggressive consolidated capital structure. In  
5 this way, if it could persuade the Commission  
6 that a stand alone ratio is acceptable, NYSEG  
7 and RG&E would return excess profits to the  
8 Iberdrola parent. This is just one more reason  
9 why the acquisition should not be approved.

10 F. FINANCIAL TRANSPARENCY AND REPORTING

11 Q. Do you have concerns about the financial  
12 transparency and reporting issues that arise  
13 from this acquisition?

14 A. Yes. After the acquisition has been  
15 consummated, Energy East will no longer be a  
16 registrant under the jurisdiction of the SEC.  
17 As a result, it will no longer be required to  
18 file SEC reports, such as Form 10-K, or an  
19 annual report to the SEC. This is because once  
20 the acquisition is closed, Energy East will  
21 become a subsidiary of Iberdrola.

22 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 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

1 replaced it with the Public Utility Holding  
2 Company Act of 2005. The new law transfers  
3 responsibility for reviewing holding company  
4 activities from the SEC to FERC. Many of the  
5 utility holding company financial statements  
6 that were required by the SEC no longer need to  
7 be filed including SEC Form U-5S and portions of  
8 SEC Form U-9C-3.

9 Q. What information was contained in SEC Form U-5S  
10 and SEC Form U-9C-3?

11 A. SEC Form U-5S presented the consolidating  
12 balance sheet of the parent company and the  
13 capitalization ratios of the parent company's  
14 direct subsidiaries. This balance sheet showed  
15 the extent to which capital reported by a  
16 subsidiary as common equity is eliminated at the  
17 consolidated holding company level because it is  
18 actually funded with some other form of holding  
19 company capital such as debt or preferred stock.  
20 SEC Form U-9C-3 contained balance sheets for  
21 each of Energy East utility and non-regulated  
22 energy subsidiaries. These balance sheets are

1 no longer required in this quarterly filing.

2 Q. What is the significance of these financial  
3 statements?

4 A. Staff used this information to analyze whether  
5 the equity ratio requested by utility  
6 subsidiaries of holding companies should be  
7 adjusted. This analysis is based on three  
8 considerations.

9 Q. What is the first consideration?

10 A. It necessary to determine if the common equity  
11 balance requested by the utility subsidiary is  
12 actually financed by debt issued at another  
13 level within the holding company. This is an  
14 important consideration for NYSEG and RG&E  
15 because failure to adjust for such fictitious  
16 equity will produce windfall profits within the  
17 holding company. Staff would not have  
18 sufficient capital structure information for all  
19 of the relevant Iberdrola business entities to  
20 reach a conclusion on this issue. In the last  
21 NYSEG rate case, Energy East refused to provide  
22 such information to Staff. In future rate

1 cases, we are doubtful Iberdrola would be any  
2 more forthcoming with the information than  
3 Energy East has been in the past since Iberdrola  
4 has stated it will not interfere with local  
5 management and indicated that most of the Energy  
6 East management will remain in place after the  
7 M&A transaction closes. Also, it is not clear  
8 that comparable financial information will be  
9 available under IFRS.

10 Q. What is the second consideration?

11 A. It is necessary to determine if the common  
12 equity ratio requested by the utility subsidiary  
13 is consistent with the ratios of other utility  
14 subsidiaries of the holding company. For  
15 example, it would be unreasonable to set the  
16 rate of return of a New York subsidiary based on  
17 a stand-alone equity ratio when the ratios of  
18 other utility subsidiaries were substantially  
19 lower. In those circumstances, ratepayers in  
20 New York would make a disproportionately larger  
21 contribution to the holding company's overall  
22 earnings than ratepayers in other jurisdictions.

1 Staff would not have sufficient capital  
2 structure information for all of the relevant  
3 Iberdrola business entities, including the  
4 parent, to reach a conclusion.

5 Q. What is the third consideration?

6 A. It is necessary to consider the sources of the  
7 financing the holding company and other  
8 affiliates use to support their non-utility  
9 investments. Such investments typically entail  
10 greater risk than utility operations and  
11 therefore require greater amounts of common  
12 equity to properly serve as a buffer for the  
13 earnings volatility that comes with greater  
14 risk. As discussed above, Iberdrola has large  
15 investments in unregulated business ventures and  
16 has recorded on its books Goodwill in a  
17 magnitude that is risky. These assets must be  
18 financed with the proper mix of debt and equity.  
19 Staff would not have sufficient capital  
20 structure information for all of the relevant  
21 Energy East business entities to reach a  
22 conclusion.

1 Q. Are there any other barriers to obtaining  
2 transparent financial information?

3 A. Yes. As discussed above, despite some  
4 convergence in recent years between IFRS,  
5 governing Iberdrola and GAAP, used in the U.S.,  
6 significant differences remain. With  
7 differences in reporting standards, the  
8 potential exists for the misinterpretation of  
9 Iberdrola's financial statements. Finally, the  
10 number and scope of Iberdrola's unregulated  
11 subsidiaries and the complexity of its  
12 organizational structure make it difficult to  
13 accurately evaluate its the financial strength  
14 and capitalization. Included within Iberdrola's  
15 corporate structure are numerous Special Purpose  
16 Entities (SPEs), which can cloak the true  
17 financial position of a utility holding company.  
18 SPEs are subsidiaries that are created to  
19 fulfill narrow, specific or temporary  
20 objectives, primarily to isolate financial risk,  
21 usually the potential for bankruptcy, but  
22 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

1 SPEs are treated under IFRS. However, we are  
2 assured by Iberdrola that all the debt  
3 associated with its SPEs is non-recourse debt  
4 and that this debt is reflected in the  
5 consolidated statements of the company. Thus,  
6 our concerns that Iberdrola might be  
7 significantly more leveraged than their  
8 financial statements would indicate are  
9 mitigated. Additionally, on the positive side,  
10 the SPE structure can be employed to shield  
11 other affiliates from bankruptcy. However, if  
12 enough SPEs owned by an entity go bankrupt as a  
13 result of the aggressive financing, it follows  
14 that the credit of the parent will suffer  
15 accordingly.

16 Q. You indicated that the enactment of SOX has lead  
17 to vigilance over financial misconduct.

18 Describe the controls that currently exist under  
19 SOX.

20 A. The officers of Energy East are currently  
21 required to attest, in periodic statutory  
22 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

1 reduction in control and oversight.

2 Q. What are the implications?

3 A. There may be a reduction of internal controls  
4 and regulatory oversight due to the loss of SOX  
5 protections. Since ratepayers s have already  
6 funded the costs of SOX compliance in rates,  
7 the utilities will keep those amounts until  
8 rates are re-set, even though SOX protections  
9 will no longer be available.

10 Q. Please summarize your concerns about financial  
11 transparency and reporting if the transaction is  
12 approved.

13 A. We are concerned that there will be a  
14 significant reduction in the Commission's  
15 ability to acquire a complete picture of  
16 Iberdrola's operations because of the company's  
17 status as a foreign holding company operating  
18 under IFRS rules and the repeal of the Public  
19 Utility Holding Company Act of 1935. These  
20 corporate transparency and reporting concerns  
21 are yet another reason why approval of the  
22 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

1 with Iberdrola's ownership of competitive  
2 businesses?

3 A. Yes. Iberdrola's ownership of competitive  
4 unregulated subsidiaries presents tremendous  
5 risks and burdens.

6 Q. Can you explain the risks and burdens placed  
7 upon the Staff due to Iberdrola's ownership of  
8 competitive businesses?

9 A. Yes. As discussed above, Iberdrola has claimed  
10 that much of the relevant information requested  
11 by Staff is trade secret due to its  
12 "competitive" interests in Europe. If and when  
13 Staff receives this relevant information,  
14 subject to protective agreements, Staff is  
15 placed in a position to guard the information,  
16 and disclosure to other parties is sometimes  
17 limited. This isolates Staff from interacting  
18 with other parties on important issues. It also  
19 restricts the public from participating fully in  
20 litigated proceedings, when the handling of  
21 trade secret information is particularly  
22 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?

1 A. Yes. The holding company is primarily motivated  
2 to provide earnings to its shareholders. This  
3 motivation can conflict with the utility  
4 subsidiaries'' obligation to provide safe and  
5 adequate service at just and reasonable rates.  
6 For example, if operating and maintenance  
7 expenses are cut at the subsidiaries to increase  
8 holding company profits, safe and adequate  
9 service by the utility might be compromised.

10 Q. To what extent can the Commission influence the  
11 actions and behaviors of a holding company if  
12 the Commission perceives that the holding  
13 company is not acting in the best interests of  
14 New York State ratepayers?

15 A. The Commission can indirectly influence the  
16 behavior of holding companies through its  
17 regulation of the utility subsidiaries that  
18 operate within New York State. Financial signals  
19 created by Commission actions in rate cases and  
20 other proceedings may influence holding company  
21 business and financial decisions.

22 Q. Under what circumstances are the actions of the

1 Commission likely to have a greater impact on  
2 holding company behavior?

3 A. Commission actions are likely to have a greater  
4 impact in those situations where New York  
5 utility operations represent a substantial part  
6 of the holding company's consolidated  
7 operations.

8 Q. Under what circumstances are the actions of the  
9 Commission likely to have less of an impact on  
10 holding company behavior?

11 A. Commission actions are likely to have less of an  
12 impact in those situations where New York  
13 utility operations represent a small part of the  
14 holding company's consolidated operations.

15 Q. How large are NYSEG and RG&E relative to Energy  
16 East?

17 A. According to the December 31, 2006 Annual  
18 Reports to the Commission by NYSEG and RG&E, the  
19 capital structures for these companies are  
20 composed of \$2.2 billion and \$1.3 billion of  
21 capital, respectively. Based on data provided  
22 in Energy East's 2006 Annual Report to

1 Shareholders, its consolidated total of long and  
2 short term debt and common stock was  
3 approximately \$6.6 billion. Thus, the combined  
4 NYSEG and RG&E capitalization of \$3.5 billion  
5 represents 53% of Energy East's total capital.  
6 Energy East's capitalization also supports about  
7 \$1.5 billion of Goodwill, leaving only \$1.6  
8 billion in other businesses. It is clear that  
9 NYSEG and RG&E together represent a significant  
10 portion of Energy East's business.

11 Q. How does the combined size of NYSEG and RG&E  
12 compare to Iberdrola?

13 A. Iberdrola's most recent Quarterly Report for the  
14 nine months ending September 30, 2007 presents  
15 the consolidated capital structure of the  
16 Company. If one uses the current 1.45 ratio of  
17 dollars to Euros, the total consolidated  
18 Iberdrola capital structure becomes \$79.5  
19 billion. Thus, NYSEG and RG&E would represent  
20 9% of Iberdrola's total business. This  
21 represents a substantial diminishment in the  
22 size of NYSEG and RG&E relative to their holding

1 company parent.

2 Q. What is the significance of this information?

3 A. The proposed transaction will limit the  
4 Commission's ability to influence the actions of  
5 NYSEG and RG&E's holding company parent in order  
6 to ensure that the interests of New Yorkers are  
7 protected, adding one more reason for finding  
8 that the proposed transaction is not in the  
9 public interest.

10 I. ACCESS TO BOOKS IS NOT SUFFICIENT

11 Q. Have the Petitioners' commitments on access to  
12 books and records assuaged your concerns?

13 A. No. The petitioner's pledge (page 17) to use  
14 the same accounting and allocation methods  
15 currently in place and allow Staff access to the  
16 utility books and records do not address the  
17 perverse incentives inherent in Iberdrola's mix  
18 of regulated and non-regulated businesses. If  
19 this transaction is approved, Staff will  
20 confront many obstacles in trying to detect and  
21 eliminate cross-subsidization.

22 J. CODE OF CONDUCT IS NOT INFALLIBLE

1 Q. Are you aware of any other risks or concerns?

2 A. Yes. As noted above Staff had concerns with  
3 Response IBER-0013 to DPS-13 regarding the  
4 contracts between the utilities and Community  
5 Energy; that relationship causes concern.

6 Q. Explain the relationship between Community  
7 Energy, Iberdrola, and the utilities.

8 A. From various sources of information, we were  
9 able to find that the utilities and Community  
10 Energy had renewable energy marketing contracts

11 [REDACTED]. These

12 contracts [REDACTED]

13 [REDACTED] In August 2006, Iberdrola and  
14 Energy East started having conversations  
15 concerning the acquisition. The XXXX contracts  
16 with the utilities were [REDACTED]

17 [REDACTED]

18 [REDACTED] The contracts between  
19 Community Energy and the utilities, which the  
20 Petitioners admit remain in effect, restrict the  
21 utilities from marketing non-Community Energy  
22 renewable energy to customers (see Article 4.2

1 (iii) which states "NYSEG shall not market  
2 Renewable Energy Attributes to NYSEG customers  
3 except as provided in this agreement." In  
4 February 5, 2006, Iberdrola issued a press  
5 release indicating that it acquired 100% of  
6 Community Energy.

7 Q. Does [REDACTED]  
8 raise any issues or concerns?

9 A. Absolutely. We found that on July 13, 2007,  
10 [REDACTED],  
11 Energy East notified FERC that it was going to  
12 "treat Iberdrola and its subsidiaries as  
13 affiliates for Code of Conduct and Standards of  
14 Conduct purposes." However, in spite of that  
15 July 13, 2007 notice, the contracts remain in  
16 effect, and, [REDACTED]  
17 [REDACTED] Through these  
18 arrangements Community Energy, a competitive  
19 affiliate deemed an affiliate of RG&E and NYSEG  
20 in a notice to FERC, has the exclusive ability  
21 to market renewable energy in the RG&E and NYSEG  
22 service territories. As a result, a distinct

1 preference was given to Community Energy.

2 Q. Explain why this causes concern.

3 A. This exclusive marketing agreement presents some  
4 stark examples of a number of violations of  
5 RG&E's and NYSEG's codes of conduct which  
6 prohibit:

- 7     ▪ The provision of sales leads,
- 8     ▪ The promotion of an affiliate,
- 9     ▪ The giving of preferential terms to an  
10       affiliate.

11 Q. What kind of impact could this have on the  
12 renewables business in New York?

13 A. [REDACTED], the  
14 Iberdrola companies could use affiliate  
15 relationships to gain a distinct competitive  
16 advantage over other developers in the marketing  
17 of their wind power in NYSEG's and RG&E's  
18 service territories. This could retard wind  
19 power development, which harms New York's  
20 interests in meeting renewables goals.

21 RECOMMENDED ALTERNATIVE TERMS AND CONDITIONS

22 Q. What is Staff's overall recommendation in this

1 proceeding?

2 A. For all the reasons above, we recommend that the  
3 Commission find that the proposed acquisition of  
4 Energy East by Iberdrola is, as filed, not in  
5 the public interest and, therefore, that it deny  
6 Petitioner's request for approval of the  
7 transaction.

8 Q. Can Staff outline some essential conditions that  
9 might attach to any approval that the Commission  
10 provides for the transaction?

11 A. We would establish conditions addressing the  
12 quality and reliability of service, vertical  
13 market power issues, and various accounting,  
14 financial and ratemaking aspects of the proposed  
15 filing.

16 A. TANGIBLE BENEFITS CAN BE ACHIEVED

17 Q. What is the first proposed condition?

18 A. To establish positive tangible benefits, the  
19 petitioners could amend their current rate  
20 plans. As Witnesses Benedict/Haslinger  
21 demonstrate, the utilities are earning in excess  
22 of what is currently considered a reasonable

1 ROE. In addition, RG&E's commodity profits are  
2 excessive. Those facts in themselves suggest  
3 the need to reduce delivery and commodity rates  
4 immediately. In addition, the utilities are  
5 deferring costs for future recovery in rates and  
6 are drawing down reserve funds which will have  
7 to be funded in future rates.

8 Q. What other conditions should be established?

9 A. The existing rate plans should be further  
10 modified to ameliorate the potential for  
11 increased risk to electric system and gas system  
12 reliability. Additional changes are also needed  
13 to ensure that gas system safety and customer  
14 service quality are maintained going forward.

15 Q. Should the utilities rates be reduced  
16 immediately?

17 A. In the short-term, yes. However, rate  
18 reductions without corresponding reductions in  
19 future costs will almost certainly lead to  
20 unpredictable rates in the long-term. It is  
21 Staff's preference that the petitioners provide  
22 significant tangible cost reductions to ensure

1 long-term rate stability.

2 Q. How can the utilities achieve tangible  
3 reductions in their costs of providing utility  
4 service?

5 A. The utilities can provide cost reductions by  
6 adjusting regulatory assets and reserves, which  
7 Mssrs. Haslinger and Benedict refer to as  
8 positive benefits adjustments (PBAs).

9 Q. The Petitioners claim that Iberdrola's purchase  
10 of Energy East is a simple upstream M&A  
11 transaction. What is the justification for  
12 reviewing the utilities rates and recommending  
13 adjustments in this proceeding?

14 A. First, Staff finds it difficult in the context  
15 of the over \$1.6 billion in merger benefits to  
16 the companies and others (see Exhibit\_\_\_PP-20)  
17 to overlook the fact that the utilities rates  
18 are excessive. Also, almost all major M&A  
19 proceedings in New York have been accompanied by  
20 rate concessions. Finally, adjustments to books  
21 are a common occurrence when a company is  
22 acquired. In this case, Iberdrola is going to

1 make significant adjustments to its books upon  
2 the closing of the transaction.

3 Q. Will the cost reductions you recommend harm the  
4 utilities finances, which in turn could threaten  
5 safe and reliable service and cause layoffs?

6 A. No. For the most part, Staff is recommending  
7 that the utilities adjust paper assets. These  
8 adjustments to non-cash assets should not impact  
9 the utilities' current cash flows. There would  
10 be no long-term impairment of the utilities  
11 finances, so the recommended adjustments would  
12 not threaten service quality or cause layoffs.

13 Q. Summarize the adjustments that Staff proposes.

14 A. Staff proposes \$403 million of PBA adjustments  
15 (after taxes) to NYSEG and RG&E in the areas of  
16 deferred costs and reserves. These adjustments  
17 were provided by Witness Benedict/Haslinger.

18 Q. Has Staff evaluated the reasonableness of the  
19 level of PBAs it recommended?

20 A. Yes. Overall, the PBAs proposed by Staff are  
21 reasonable. Since the Petitioners' have alleged  
22 that there are no merger synergies, the PBAs are

1 a reasonable substitute for such synergies,  
2 which are typically found in M&A transaction  
3 proceedings.

4 Q. How has Staff evaluated the reasonableness of  
5 its proposed PBAs?

6 A. We performed three types of comparisons. First,  
7 we looked at the sharing of merger benefits. In  
8 most recent cases (RGS/Energy East,  
9 Grid/KeySpan), merger savings were shared  
10 50%/50%. In this case, that the overall  
11 benefits exceed \$1.6 billion. 50% of that  
12 amount would yield approximately \$800 million.

13 Q. What is the next comparison?

14 A. We looked at asset sales. Typically, when a  
15 utility sells an asset at a gain, the gain is  
16 shared. The instant case is comparable in that  
17 Energy East is essentially selling all of its  
18 assets to Iberdrola. In the Ginna transaction,  
19 RG&E's most recent asset sale, customers  
20 received over 95% of the gain on that sale. If  
21 that percentage were applied to the \$1.6 billion  
22 of net benefits, an amount of \$1.5 billion would

1 result.

2 Q. What is the third comparison?

3 A. Staff reviewed recent M&A cases to determine the  
4 relative levels of savings imputed in rates.

5 For example, in the RGS/Energy East acquisition,  
6 synergy benefits captured for customers

7 represented about 13% of the companies' delivery  
8 revenues. In the recent Grid/KeySpan merger,

9 synergy benefits captured for customers

10 represented about 10% of the companies' delivery  
11 revenues. The positive benefits proposals made

12 by Staff in this case would represent about 11%

13 of delivery revenues on an equivalent basis (see

14 Exhibit\_\_\_(PP-21).

15 Q. Are there any factors which distinguish the

16 savings in the prior acquisitions from the

17 instant proceeding?

18 A. Yes. In the prior acquisitions we cited, the

19 savings are expected to be permanent. In other

20 words, the savings due to synergies would

21 continue as they would become embedded in the

22 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

1 related to low income customer protections and  
2 customer service enhancements should the merger  
3 be approved.

4 B. FINANCIAL PROTECTIONS ARE REQUIRED

5 Q. Can Staff conceive of financial conditions under  
6 which Iberdrola's acquisition of Energy East  
7 might proceed?

8 A. Staff is skeptical that the aggressive leverage  
9 employed by Iberdrola and the large amount of  
10 Goodwill on its books can be overcome  
11 sufficiently by ring fencing the subsidiaries.  
12 However, if the public interest is somehow  
13 satisfied by benefits that have not yet been  
14 presented by the Petitioners, Staff might not  
15 oppose the acquisition of Energy East, if  
16 substantial ring fencing covenants were provided  
17 for. Those provisions would protect the  
18 interests of New Yorkers by assuring that both  
19 NYSEG and RG&E are in a position to provide safe  
20 and adequate service at a reasonable price to  
21 the public. We address below the financial  
22 covenants that could serve as conditions under

1 which the transaction could be approved.

2 Q. Generally describe the financial covenants that  
3 Staff would extend to the proposed transaction.

4 A. We would establish conditions addressing the  
5 various accounting, financial and ratemaking  
6 aspects of the proposed filing consistent with  
7 the recent Grid/KeySpan merger.

8 Q. Iberdrola claims that its financial strength and  
9 credit rating are reasons sufficient to justify  
10 approval of the M&A transaction. Is Iberdrola's  
11 financial strength more favorable than National  
12 Grid's financial strength and credit rating and  
13 if so are the covenants approved in the  
14 Grid/KeySpan merger applicable to Iberdrola?

15 A. Before we answer that question, it must be  
16 emphasized that the financial protections  
17 applied in the Grid/KeySpan merger are generic  
18 in nature and would be applied regardless of the  
19 acquirer. As to this transaction, Iberdrola's  
20 bond rating has already been downgraded by S&P  
21 and it now has the same bond rating as National  
22 Grid from that credit agency. Moody's rates

1 Iberdrola (A3) slightly higher than National  
2 Grid (Baa1). Notwithstanding these credit  
3 ratings, we also conclude that Iberdrola's  
4 financial and business risks are greater than  
5 National Grid's. Iberdrola has a highly  
6 leveraged capital structure given its asset  
7 base. Its balance sheet will carry the Goodwill  
8 and intangible assets discussed above (46% of  
9 its equity balance if the acquisition is  
10 consummated). The percentage of its business  
11 devoted to non-regulated operations is much  
12 greater than National Grid's. Therefore, we  
13 believe the financial covenants adopted in the  
14 Grid/KeySpan merger are equally applicable to  
15 the Iberdrola acquisition.

16 Q. Are the concerns expressed in this proceeding  
17 and in the Grid/KeySpan merger typical of  
18 concerns these types of transactions raise?

19 A. Yes. In a National Regulatory Research  
20 Institute article (attached as Exhibit\_\_\_(PP-  
21 22), "Private Equity Buyouts of Public  
22 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'

1 inspection authority and access to books and  
2 records regarding financial transactions, cost  
3 allocations, and affiliate transactions. It  
4 resolved that the acquiring company should  
5 guarantee that U.S. regulatory authorities will  
6 have complete access to all books and records  
7 regarding financial transactions, cost  
8 allocations, and affiliate transactions directly  
9 or indirectly impacting the U.S. utility.  
10 Additionally, it resolved that the acquiring  
11 company should be required to guarantee that the  
12 ratepayers of the acquired utility shall be held  
13 harmless if the acquisition results in a higher  
14 revenue requirement for the utility than if the  
15 acquisition had not occurred.

16 Q. Why is Iberdrola's high degree of leverage and  
17 large amount of Goodwill significant for the  
18 credit quality of NYSEG and RG&E?

19 A. S&P takes the general position that the rating  
20 of an otherwise financial healthy, wholly owned  
21 subsidiary is constrained by the rating of its  
22 weaker parent. The basis for this position is

1 that a weak parent has both the ability and the  
2 incentive to siphon assets out of its  
3 financially healthy subsidiary and to burden it  
4 with liabilities during times of financial  
5 stress. The weak parent might also have an  
6 economic incentive to place the subsidiary in  
7 bankruptcy – if the parent itself were forced  
8 into bankruptcy – regardless of the subsidiary’s  
9 “stand-alone” strength. Experience suggests that  
10 insolvent corporations will often jointly file  
11 with their subsidiaries – even those  
12 subsidiaries that are not themselves  
13 experiencing financial difficulty

14 i. RATE PLAN-CAPITAL STRUCTURE ISSUES

15 Q. If the Iberdrola acquisition of Energy East is  
16 to be approved, what ratemaking capital  
17 structure should be utilized?

18 A. We believe the Commission should follow its long  
19 established precedent of looking to the  
20 consolidated capital structure of the parent  
21 company when setting the rates for utility  
22 subsidiaries. In the recent NYSEG electric rate

1 order (see Case 05-E-1222) the Commission  
2 followed this long established precedent and  
3 rejected NYSEG's argument for a stand alone  
4 structure in that case. The Commission instead  
5 employed the consolidated capital structure of  
6 Energy East to set rates. We recommend that the  
7 Commission continue its policy and condition the  
8 acquisition of Energy East on the use of the  
9 capital structure of Iberdrola for ratemaking  
10 purposes if the transaction is approved.

11 Q. Earlier in your testimony, you mentioned that if  
12 Commission precedent of using Iberdrola's  
13 adjusted consolidated capital structure were  
14 followed, the ratemaking capital structure of  
15 NYSEG and RG&E would consist entirely of debt.  
16 Do you recommend an all debt capital structure  
17 for setting rates?

18 A. No. Such a capital structure would most likely  
19 place the operating utilities in financial  
20 jeopardy. If sufficient benefits were found to  
21 merit the approval of the transaction, we  
22 believe it would be appropriate to use the

1 adjusted consolidated capital structure of  
2 Energy East for ratemaking purposes after the  
3 proper application of a subsidiary adjustment.

4 Q. What equity ratio does the adjusted consolidated  
5 capital structure of Energy East produce?

6 A. The adjusted consolidated capital structure of  
7 Energy East is 38%. We recommend that this  
8 equity ratio stay in place until the adjusted  
9 consolidated capital structure of Iberdrola  
10 produced by the subsidiary adjustment exceeds  
11 38%.

12 Q. Are there any circumstances under which Staff  
13 could recommend an alternative ratemaking  
14 capital structure be employed?

15 A. Not in this proceeding. We believe that a stand  
16 alone capital structure might be appropriate  
17 only if all Goodwill is removed from the books  
18 of Energy East, sufficient ring fencing  
19 financial protections are in place to guard the  
20 utility subsidiaries from Iberdrola's highly  
21 leveraged capital structure, and these  
22 safeguards produce greater interest rate and

1 other financial savings to ratepayers than the  
2 added cost of using the stand alone capital  
3 structure.

4 Q. Can Goodwill be transferred within a holding  
5 company structure?

6 A. We believe it can be under any circumstances.  
7 However, Iberdrola's acquisition of Energy East  
8 would facilitate the process. A merger destroys  
9 the acquired company's "old" Goodwill and  
10 creates "new" Goodwill that will appear in the  
11 consolidated books. "New" Goodwill need not be  
12 allocated to replace the "old" Goodwill. Such  
13 an approach would provide a tangible benefit to  
14 NYSEG and RG&E by removing the Goodwill  
15 generated from the merger of Energy East and  
16 RG&E from Energy East's books.

17 Q. Are there any other requirements that the  
18 Commission should put in place?

19 A. Yes. Should Iberdrola decide to infuse equity  
20 into NYSEG or RG&E, it must demonstrate that  
21 such equity funding came from external sources  
22 of equity. If it cannot make this

1 demonstration, the infusion should be treated as  
2 debt.

3 Q. Please repeat the capital structure you propose  
4 for NYSEG and RG&E in this proceeding.

5 A. We propose a capital structure with 38% equity  
6 for each company. For NYSEG, long term debt,  
7 preferred stock and customer deposits are,  
8 respectively, 60.82%, 0.74%, and 0.44% of the  
9 capital structure. For RG&E, long term debt and  
10 customer deposits are, respectively, 61.74% and  
11 0.26% of the capital structure.

12 Q. How did you calculate the capital structure?

13 A. As shown on Exhibit \_\_ (PP-23), we began with the  
14 consolidated capital structure of Energy East  
15 and then removed the effects of Goodwill from  
16 the consolidated capital structure.

17 Q. What source did you rely upon to establish NYSEG  
18 and RG&E's capital structure?

19 A. We began with the consolidated capital structure  
20 for Energy East as presented in the November 1,  
21 2007 10Q Report to the Securities and Exchange  
22 Commission.

1 Q. What assets are supported by Energy East's  
2 consolidated capital structure?

3 A. Energy East is primarily an electric combination  
4 T&D company. Their subsidiaries not only  
5 include NYSEG and RG&E but also other utilities  
6 such as Central Maine Power Company, Berkshire  
7 Gas Company, Maine Natural Gas Corporation,  
8 Connecticut Natural Gas Corporation and Southern  
9 Connecticut Gas Company. Investor-provided  
10 capital was also used to finance about \$1.5  
11 billion of non-earning Goodwill.

12 Q. Energy East's consolidated capital structure  
13 includes accumulated other comprehensive income.  
14 What approach has the Commission taken  
15 concerning the inclusion of other comprehensive  
16 income as part of the ratemaking equity balance  
17 in other cases?

18 A. In the recent NYSEG electric rate case (Case 05-  
19 E-1222), the Commission eliminated other  
20 comprehensive income from the equity ratio  
21 calculation. This is proper because it is not a  
22 permanent or easily predictable addition to or

1 subtraction from a utility's common equity  
2 balance. In developing our capital structure  
3 ratios, we have subtracted \$9.9 million of  
4 accumulated other comprehensive income from the  
5 consolidated equity balance of Energy East.

6 Q. Energy East's consolidated capital structure  
7 includes \$1.5 billion of Goodwill on its balance  
8 sheet. What approach should the Commission take  
9 concerning the inclusion of Goodwill as part of  
10 the ratemaking equity balance?

11 A. The Commission should remove Goodwill at a rate  
12 of 75% equity and 25% debt. The subsidiary  
13 adjustment removes \$1.144 billion from the  
14 consolidated equity of the Energy East and \$382  
15 million from the consolidated long-term debt of  
16 the company. As shown on Exhibit \_\_ (PP-23),  
17 this produces an equity ratio of 38% for Energy  
18 East.

19 ii. RATE PLAN-COST OF CAPITAL ISSUES

20 a) COST OF LONG TERM DEBT

21 Q. How have you calculated NYSEG and RG&E's cost of  
22 debt?

1 A. We calculated the cost of debt for each company  
2 based on information provided in the companies'  
3 December 31, 2006 Annual Reports to the  
4 Commission. The cost of debt for NYSEG is  
5 4.58%% and the cost of debt for RG&E is 6.20%,  
6 respectively.

7 Q. How did you develop your cost of debt for NYSEG  
8 and Energy East?

9 A. Using data from NYSEG's 2006 Annual Report to  
10 the Commission, we calculated the cost of debt  
11 by dividing the sum of interest expense  
12 (\$46,928,053), amortization of debt expense  
13 (\$4,246,241) less the adjustment related to  
14 Iberdrola demonstrated in NYSEG's recent debt  
15 issuance (\$600,000) and divided it by the net of  
16 the principal of NYSEG's Long Term Debt  
17 (\$1,138,000,000) and the issuance expenses on  
18 its books (-\$35,199,073).

19 Using data from RG&E's 2006 Annual Report to the  
20 Commission, we calculated the cost of debt by  
21 dividing the sum of interest expense  
22 (\$40,302,721), amortization of debt expense

1 (\$1,672,932) and divided it by the net of the  
2 principal of NYSEG's Long Term Debt  
3 (\$698,900,000) and the issuance expenses on its  
4 books (-\$21,380,305).

5 Q. You are applying a consolidated capital  
6 structure for NYSEG and RG&E. Why are you using  
7 the stand alone debt costs rates for NYSEG and  
8 RG&E?

9 A. The tax-exempt debt of NYSEG and RG&E should  
10 remain directed for the benefit of New York  
11 State customers. By using the stand alone cost  
12 rates for debt, the effect of this tax-exempt  
13 debt was captured for the benefit of customers.

14 b) COST OF CUSTOMER DEPOSITS

15 Q. What is the customer deposit rate prescribed by  
16 the Commission in 2007?

17 A. Effective January 1, 2008, the customer deposit  
18 rate prescribed by the Commission is 3.76%,

19 c) COST OF EQUITY

20 Q. How did you develop the cost of common equity  
21 for NYSEG and RG&E?

22 A. We applied the Discounted Cash Flow methodology

1 (DCF) and the Capital Asset Pricing Model (CAPM)  
2 to a proxy group of utilities to estimate the  
3 cost of equity. We then used a 2/3 DCF and 1/3  
4 CAPM weighting to develop one cost of equity  
5 estimate. This approach was relied upon by the  
6 Commission in the last NYSEG electric rate case  
7 (Case 05-E-1222)

8 Q. What proxy group do you propose to use in your  
9 cost of equity methodology?

10 A. We propose to use the 30 company proxy group  
11 shown on page 2 of Exhibit\_\_\_(PP-23).

12 Q. Please explain how you developed your proxy  
13 group.

14 A. We began with the dividend-paying electric  
15 distribution utilities covered by The Value Line  
16 Investment Survey (Value Line). We then limited  
17 this group to only those companies which had an  
18 investment grade bond rating, no ongoing merger  
19 activity, and derived 70% or more of their  
20 operating revenue from regulated operations.

21 Q. Please describe the screening criteria you used  
22 to develop the utility proxy group.

23 A. We chose companies with electric and electric  
24 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

1 Line data for the beta, earnings per share,  
2 dividends per share, book value per share and  
3 the forecasted amount of common stock shares for  
4 each company.

5 This data is used to estimate the dividends  
6 that can be expected for each company in the  
7 future. The price investors are paying for the  
8 stock (the average stock price over a six-month  
9 period) is seen as the present value of that  
10 dividend stream. By calculating the discount  
11 rate required to turn the string of expected  
12 dividend payments into the current stock price,  
13 one can determine the rate of return investors  
14 are expecting for each company.

15 Q. How are dividends projected to change over time?

16 A. We used the two-stage DCF method recommended in  
17 the GFC. In the near-term (the first four  
18 years), the estimates of Value Line are used  
19 (using growth rates implied in Value Line's 2010  
20 through 2012 dividend per share estimate). For  
21 the second stage (2013 and on), a "sustainable  
22 growth" rate is calculated for each company in  
23 the proxy group based on its projected retention  
24 of earnings and growth in common stock balances.

1 Q. What is your proxy group DCF cost of equity?

2 A. The median result, which we calculate to be an  
3 8.58% return, is used as the DCF methodology  
4 result.

5 Q. Please describe the CAPM approach that you used  
6 to develop a cost of equity for your proxy  
7 group?

8 A. We used a traditional and zero beta CAPM to  
9 develop a cost of equity for the proxy group.

10 Q. What were the inputs to the CAPM model?

11 A. Page 5 of Exhibit\_\_\_(PP-23) shows that the CAPM  
12 requires an estimate of: a) the risk free rate,  
13 b) market return, and c) the average beta of the  
14 proxy group. The risk free rate of 4.77% is the  
15 monthly average of 10-year and 30-year Treasury  
16 bond yields over the six-month period ended  
17 November 30, 2007. The S&P 500 market return of  
18 10.65% was obtained from Merrill Lynch's  
19 November 2007 edition of Quantitative Profiles  
20 which is attached as part of Exhibit\_\_\_(PP-24).  
21 Staff has used this data in the CAPM for many  
22 years. The 0.91 beta was obtained from Value  
23 Line.

24 Q. What was your CAPM cost of equity?

1 A. The traditional CAPM analysis indicated a 10.12%  
2 ROE for the proxy group and the zero beta CAPM  
3 produced a 10.25% ROE for the proxy group. The  
4 average of these two CAPM approaches is 10.19%.

5 Q. How were the DCF and CAPM results combined?

6 A. We applied the 2/3 DCF and 1/3 CAPM weights  
7 recommended in the Generic Finance Proceeding to  
8 the DCF return of 8.58% and the CAPM return of  
9 10.19%. This develops a cost of equity estimate  
10 for the proxy group of 9.12%.

11 Q. What independent analyses are available that  
12 supports your cost of equity estimate?

13 A. Merrill Lynch also publishes return on equity  
14 estimates for utilities. The November edition  
15 of Merrill Lynch's Quantitative Profiles  
16 contains DCF and CAPM estimated cost of equity  
17 returns for utilities; many of these companies  
18 are in our proxy group. The median DCF return  
19 for these companies was 9.0% and the median CAPM  
20 return was 8.8%. A copy of this publication is  
21 attached as Exhibit\_\_\_\_(PP-24).

22 Q. Is there any other information supporting the  
23 reasonableness of your proxy group cost of  
24 equity estimate?

1 A. Yes, Ibbotson also publishes a forward-looking  
2 earnings model that calculates the long-term  
3 equity market return to be 9.76%. This  
4 Publication is attached as part of  
5 Exhibit\_\_\_(PP-24). Substituting this estimate  
6 for the Merrill Lynch cost of the market  
7 estimate in our CAPM calculation produces a  
8 return on equity of 9.37% for the proxy group.  
9 This reasonably supports our cost of equity  
10 analysis.

11 Q. Will you adjust this return to account for risk  
12 differences between the proxy group and NYSEG  
13 and RG&E?

14 A. No, the average bond rating of the proxy group  
15 is "BBB+/Baa1". This is the same ratings  
16 carried by NYSEG and RG&E. Therefore, no  
17 adjustment is necessary.

18 Q. Please describe how the business and financial  
19 risk of NYSEG and RG&E relate to that of the  
20 proxy group.

21 A. The business profile of NYSEG and RG&E are rated  
22 at a level of 3 by S&P. The average business  
23 profile of the proxy group is 5. Thus, from a  
24 business risk stand point NYSEG and RG&E are

1 less risky than the proxy group. The similarity  
2 of the financial risk of NYSEG and RG&E compared  
3 to the proxy group is greater than the  
4 ratemaking equity ratios of 38% for NYSEG and  
5 RG&E and the average equity ratio of 49% for the  
6 proxy group would imply. The 38% equity ratios  
7 for NYSEG and RG&E, whose business profile is 3,  
8 indicates a BBB rating by S&P, per Exhibit\_\_(PP-  
9 16) and Exhibit\_\_PP-17). The S&P charts  
10 indicate that the equity ratio of the proxy  
11 group of 49% for a company with a business  
12 profile of 5 would imply a somewhat stronger BBB  
13 rating. However, the addition of an RDM to  
14 NYSEG and RG&E would likely lower their business  
15 profile to 2 which would align their positioning  
16 within the BBB category with the average of the  
17 proxy companies. Nevertheless, the final word  
18 on comparability is ultimately credit rating and  
19 NYSEG and RG&E's credit rating is identical to  
20 the average of the proxy companies. Therefore,  
21 no adjustment is necessary.

22 Q. Staff advocates an RDM in its testimony. Would  
23 this have any effect on the risk and return of  
24 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

1 decline in BBB rated bonds since 1982. To the  
2 extent that the cost of equity generally tracks  
3 interest rates, one would expect the cost of  
4 equity for utilities to be lower than it has  
5 been for some time.

6 Q. Please summarize your findings.

7 A. We propose a weighted average cost of capital of  
8 6.25% for NYSEG. We propose a weighted average  
9 cost of capital of 7.26% for RG&E. The  
10 calculations for these rates of return are shown  
11 on Page 1 of Exhibit\_\_\_(PP-23).  
12

13 iii. FINANCIAL PROTECTIONS

14 Q. Briefly describe the ring fencing financial  
15 protections that are necessary to protect NYSEG  
16 and RG&E from any adverse consequences of this  
17 acquisition.

18 A. Financial protections are needed to: 1) mitigate  
19 the effects of the acquisition premium related  
20 to this transaction; 2) maintain or enhance the  
21 credit quality of NYSEG and RG&E; 3) provide for  
22 dividend restrictions when threats to the  
23 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

1 structure, and a lack of financial statements  
2 for Iberdrola's U. S. operations.

3 a) ACQUISITION ADJUSTMENT CONDITIONS

4 Q. Please summarize how Goodwill should be treated  
5 if the acquisition is approved.

6 A. Goodwill, or the amount Iberdrola pays for the  
7 Energy East Corporation (together with  
8 transaction costs) in excess of the original  
9 cost of the assets and liabilities of the latter  
10 and its subsidiaries, should not be reflected on  
11 the books of Energy East, NYSEG, or RG&E and  
12 should not be reflected in the determination of  
13 NYSEG and RG&E's rates and the calculation of  
14 their earned returns.

15 Q. What financial conditions are necessary to  
16 mitigate the effects of the acquisition premium  
17 (Goodwill) arising from Iberdrola's acquisition  
18 of Energy East.

19 A. The acquisition premium (Goodwill) and any  
20 capitalized costs associated with the  
21 acquisition should not be recorded on the books  
22 of NYSEG and RG&E or Energy East. The

1 acquisition premium and related effects should  
2 not have any ratemaking effect. Additionally,  
3 each year Iberdrola should provide the results  
4 of any impairment tests made on Goodwill to the  
5 Commission.

6 Q. Are these conditions related to the acquisition  
7 premium any more stringent than those imposed in  
8 the Grid/KeySpan merger approved in Case 06-M-  
9 0878?

10 A. No.

11 b) CREDIT QUALITY CONDITIONS

12 Q. What credit quality conditions are required in  
13 order to ensure that the proposed transaction is  
14 in the public interest?

15 A. The first condition is that the measurement of  
16 credit quality needs to come from an accurate,  
17 independent major credit rating agency source.  
18 Toward that end, NYSEG, RG&E, Energy East, and  
19 Iberdrola should be required to maintain credit  
20 ratings on their securities from S&P and  
21 Moody's. This will ensure that an independent  
22 risk assessment is made of both the operating

1 utilities and its parents.

2 Q. Should NYSEG and RG&E have a credit rating goal?

3 A. Yes. As a second credit quality condition,  
4 Iberdrola, Energy East, NYSEG, and RG&E should  
5 have a stated goal of maintaining investment  
6 grade ratings on their securities. This will  
7 reassure investors, credit agencies and utility  
8 regulators that Iberdrola is committed to the  
9 financial health of itself and its utility  
10 operations.

11 Q. Should the Commission be kept aware of what  
12 Iberdrola is telling the credit agencies about  
13 itself, Energy East, NYSEG and RG&E?

14 A. Yes. Access to presentations to credit agencies  
15 would give the Commission insight to the future  
16 planning and capital needs of both Iberdrola and  
17 its jurisdictional utilities. It would also  
18 give the Commission greater insight into whether  
19 any financial threat to its jurisdictional  
20 utilities is on the horizon. Therefore, as a  
21 third credit quality condition, copies of  
22 presentations to Credit Agencies and backup

1 should be provided on an ongoing basis.

2 Q. Are there any financial conditions which may be  
3 imposed upon this M&A transaction that will  
4 shield ratepayers from the effects of  
5 deterioration in the credit quality either at  
6 NYSEG or RG&E?

7 A. Yes. The credit quality of NYSEG and RG&E must  
8 be maintained. Therefore, as a fourth credit  
9 quality condition, whenever a credit downgrade  
10 by S&P or Moody's of either NYSEG or RG&E  
11 occurs, the companies should be required to file  
12 a plan with the Commission for remedying the  
13 downgrade and its consequences.

14 Q. Are these conditions related to the credit  
15 quality of NYSEG and RG&E any more stringent  
16 than those imposed in the Grid/KeySpan merger?

17 A. No.

18 c) DIVIDEND LIMITATIONS

19 Q. What is the purpose of imposing restrictions on  
20 NYSEG and RG&E's ability to pay dividends?

21 A. Dividend restrictions would prevent Iberdrola  
22 from draining the capital of NYSEG and RG&E if

1 unforeseen circumstances create financial  
2 difficulty at Iberdrola or any of its affiliates  
3 or if Iberdrola simply wants to enhance its  
4 dividends to its shareholders.

5 Q. Under what circumstances would NYSEG and RG&E be  
6 allowed to issue dividends?

7 A. Generally, NYSEG and RG&E would be allowed to  
8 pay a dividend as long as they maintained a  
9 BBB/Baa2 credit rating at both S&P and Moody's,  
10 respectively.

11 Q. Are there limits the Commission should impose on  
12 the amount of dividends NYSEG and RG&E could  
13 send upstream in Iberdrola?

14 A. Yes. For each company, the dividend should be  
15 limited during the year to no more than the sum  
16 of the income available for common equity, plus  
17 the cumulative amount of retain earnings since  
18 the acquisition was consummated, plus the  
19 portion of additional "paid in capital" that is  
20 recorded on the books of NYSEG and RG&E as  
21 unappropriated retained earnings and  
22 unappropriated undistributed earnings less

1 accumulated other comprehensive income existing  
2 immediately prior to the consummation of the  
3 acquisition, to the extent such earnings had not  
4 already been paid out as a dividend. Given the  
5 differences between IFRS and GAAP, there might  
6 be some instances where the Commission would  
7 have to be notified about how the current year's  
8 income available for dividends would be  
9 calculated.

10 Q. What restrictions should be placed on the  
11 issuance of dividends by NYSEG and RG&E?

12 A. We recommend several dividend restrictions  
13 related to NYSEG and RG&E's credit quality.  
14 NYSEG and RG&E would each be prohibited from  
15 paying dividends at any point in time when (a)  
16 its least secure unsecured bond rating is at the  
17 lowest investment grade and a rating agency has  
18 issued outstanding negative watch or review  
19 downgrade notices, or (b) Iberdrola's least  
20 secure senior unsecured debt is rated below an  
21 investment grade by a rating agency. A dividend  
22 restriction would also be triggered if NYSEG and

1 RG&E's bond ratings are immediately downgraded  
2 to the non-investment grade category.

3 Q. Are there any other dividend restrictions the  
4 Commission should impose?

5 A. In the event that a dividend restriction is  
6 triggered, NYSEG and RG&E should not be  
7 permitted to transfer, lease, or lend any  
8 moneys, assets, rights or other items of value  
9 to any affiliate without first obtaining this  
10 Commission's permission.

11 Additionally, we recommend that a  
12 requirement should be put in place such that in  
13 any future rate proceedings, should NYSEG's or  
14 RG&E's debt or similar financing reflect a cost  
15 rate which is higher than what it would be under  
16 their present debt ratings (BBB+/Baa1), the cost  
17 of such a financing will be reduced to reflect a  
18 cost consistent with the existing ratings.

19 Q. Are these dividend conditions for NYSEG and RG&E  
20 any more stringent than those imposed in the  
21 Grid/KeySpan merger?

22 A. No.

1 d) MONEY POOL RULES

2 Q. Does Energy East currently have a money pool  
3 arrangement with Energy East?

4 A. No. However, rules should be in place if  
5 Iberdrola decides to establish a money pool in  
6 the future.

7 Q. Would you recommend any restrictions if  
8 Iberdrola institutes a money pool financial  
9 arrangement?

10 A. Yes. NYSEG, RG&E, and any future domestic  
11 regulated entities should be allowed to  
12 participate in a money pool arrangement as a  
13 borrower or lender. Iberdrola, however, should  
14 only participate in a money pool as a lender.  
15 Specifically, we recommend that non-regulated or  
16 foreign entities be prohibited from  
17 participating in a money pool with NYSEG or  
18 RG&E. Indirect loans from NYSEG and RG&E to any  
19 affiliate, either through the money pool or  
20 through other means, also should be prohibited.

21 Q. Are there any other financial protections that  
22 would ease concerns about the transaction?

1 A. Yes. As a condition of approval of the M&A  
2 transaction, Iberdrola should pledge that there  
3 are no cross default provisions for any  
4 affiliate of Iberdrola which affect NYSEG and  
5 RG&E and promise that Iberdrola and its  
6 affiliates will not enter into such arrangements  
7 in the future.

8 Q. Are these conditions related to the money pool  
9 rules of NYSEG and RG&E any more stringent than  
10 those imposed in the Grid/KeySpan merger?

11 A. No.

12 e) STRUCTURAL PROTECTIONS

13 Q. Staff has recommended numerous financial  
14 conditions related to the acquisition. Will the  
15 rating agencies find them sufficient to protect  
16 the credit quality of NYSEG and RG&E?

17 A. In its October 2006 article Ring-Fencing a  
18 Subsidiary, S&P talks about financial conditions  
19 such as we recommend above and states, "The  
20 problem with these devices is that by themselves  
21 they do not go far enough in effectively  
22 insulating or ring-fencing the subsidiary from

1 its parent." S&P goes on to state, "Covenants  
2 are generally given little weight in the  
3 analysis of whether a subsidiary might be rated  
4 higher than its parent."

5 Q. Why does S&P contend that covenants are given  
6 little weight in determining whether a  
7 subsidiary is rated higher than its parent?

8 A. S&P believes that courts rarely compel an entity  
9 to comply with the terms of its covenants. S&P  
10 contends that courts tend to limit remedies to  
11 proven monetary damages. Many of the terms we  
12 recommend deal with a parent in financial  
13 difficulty. If the parent went into bankruptcy,  
14 it is likely that any provable damages would be  
15 given a relatively low ranking in the order of  
16 creditors. S&P also cautions that "Management  
17 will, in keeping with its responsibilities to  
18 shareholders, attempt to find ways to defeat  
19 covenants that are burdensome."

20 Q. What degree of financial protection is afforded  
21 a subsidiary by relying on financial covenants  
22 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 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

1 an LPE vehicle as a condition for approving the  
2 merger?

3 A. In the MidAmerican/Pacificorp merger, a ring-  
4 fencing plan calls for a "single purpose entity"  
5 (SPE), akin to what we describe as an LPE. That  
6 SPE has an independent director unaffiliated  
7 with the parent, incurs no debt, cannot merge or  
8 consolidate with any other corporate entity, and  
9 cannot be dissolved as long as the parent and  
10 utility ownership relationship persists. The  
11 sole function of the additional corporate layer  
12 entity, according to S&P, is to prevent the  
13 parent company from filing the subsidiary into  
14 bankruptcy without the approval of the  
15 independent director of the SPE. The creation  
16 of an SPE between MidAmerican Energy Holdings  
17 Company (the unregulated parent holding company)  
18 and its regulated utility subsidiaries has been  
19 a factor in supporting a higher bond rating for  
20 the subsidiaries than for the unregulated parent  
21 holding company, which has a more leveraged  
22 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

1 as a conduit of funds, both paper and  
2 electronic, when dividend and money pool  
3 restrictions are triggered would more  
4 effectively enforce the restrictions and  
5 presumably add a level of structural separation  
6 that would enhance the credit quality of  
7 Iberdrola's utility subsidiaries. We believe  
8 that this ring fencing tool should be considered  
9 by the Commission.

10 Q. Please describe the collateral feature S&P  
11 presents in its ring fencing article.

12 A. The collateral feature that S&P describes is the  
13 level of property that is pledged to individual  
14 debt issuances. The greater the amount of  
15 property pledged, the greater the security of  
16 the bond investor and presumably the higher the  
17 bond rating. As the debt market evidences, a  
18 secured debt instrument often carries a slightly  
19 better credit rating than an unsecured debt  
20 instrument from the same company.

21 Q. Should the Commission mandate that the  
22 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.

1 C. VERTICAL MARKET POWER MUST BE MITIGATED

2 Q. What is your recommendation on vertical market  
3 power?

4 A. The Commission must adopt vertical market power  
5 protections. Approval of the transaction should  
6 not be granted if the commitment to sell the  
7 Russell site, which fulfills the Commission's  
8 vertical market power policies, is not kept. As  
9 a result, approval should be conditioned upon  
10 the sale of the Russell site to a non-affiliated  
11 company, the remaining utility generation should  
12 be divested, Energy East should divest Carthage,  
13 and Iberdrola should divest all wind generation  
14 interests in New York.

15 Q. Should the hydro and gas peaking facilities  
16 owned by RG&E and NYSEG be sold?

17 A. Yes. There is a market for even small hydro and  
18 gas peaking facilities. Other utilities like  
19 Niagara Mohawk and Orange and Rockland sold such  
20 facilities when divesting their other generation  
21 facilities. More recently, Orange and  
22 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

1 sources in New York be adversely affected?

2 A. No. Competitors could be expected to buy the  
3 Iberdrola wind interests, because of the value  
4 of those assets, and develop additional projects  
5 besides, because of the benefits of New York's  
6 policies, including RPS. In fact, the sale  
7 would encourage development of additional  
8 renewable resources because market participants  
9 could be confident New York markets will operate  
10 fairly, instead of being slanted in Iberdrola's  
11 favor by vertical market power.

12 Q. You recommend the Commission require divestiture  
13 of generation in order to mitigate vertical  
14 market power as a condition of this acquisition.  
15 Is that an unusual requirement?

16 A. No it is not. As noted above, the Commission  
17 required the divestiture of Ravenswood in the  
18 recent Grid/KeySpan transaction. In the Maine  
19 acquisition proceeding (Docket No. 2007-355),  
20 the November 6, 2007 Testimony of Dr. Richard H.  
21 Silkman, Ph.D. for the Industrial Energy  
22 Consumer Group (IECG) asked the Maine Commission

1 to place this much broader condition on the  
2 acquisition:

3 In order to ensure that Iberdrola will not  
4 use its generation assets to harm the  
5 competitive market and Maine ratepayers,  
6 the Commission should condition the  
7 acquisition on Iberdrola's written  
8 agreement that it will divest itself of CMP  
9 upon any future Commission finding of anti-  
10 competitive behavior by Iberdrola.  
11

12 Q. Did you find any other examples of divestiture  
13 requirements involving Iberdrola?

14 A. Yes. In Iberdrola's failed attempt to merge  
15 with Endesa another Spanish utility in 2001, the  
16 Spanish Competition Service required the parties  
17 to dispose of their generation assets (see  
18 Response IBER-0164 to DPS-103 Attachment 2,  
19 dated November 9, 2007). Ultimately, this  
20 condition was not fulfilled as the merger was  
21 not consummated.

22 D. CUSTOMER PROTECTIONS SHOULD BE AUGMENTED

23 i. DATA SECURITY CONCERNS

24 Q. Are there concerns about national security issue  
25 raised by the acquisition?

26 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

1 i. AFFILIATE TRANSACTION RULES

2 Q. Are there any existing safeguards in place  
3 governing affiliated transactions between and  
4 among the New York utilities and Energy East and  
5 its affiliates?

6 A. Yes. In NYSEG's 2002 Merger Joint Proposal the  
7 signatory parties proposed and the Commission  
8 adopted Appendix B Standards Pertaining to  
9 Affiliates and the Provision of Information. We  
10 have marked up these standards and included them  
11 as Exh.\_\_\_\_(PP-25). These affiliate transaction  
12 standards govern: relationships between the  
13 regulated utilities and competitive energy  
14 affiliates, access to books and records of  
15 affiliates, transfers of assets, personnel  
16 matters, royalties, sales and purchases between  
17 affiliates and the utilities, financial  
18 protections, and cost allocations.

19 Q. Do you have any observations regarding these  
20 affiliated transaction standards?

21 A. Yes. Generally, the existing affiliate  
22 transaction rules were designed to and seem

1 adequate to govern the somewhat straightforward  
2 relationship between Energy East holding and  
3 service companies, NYSEG, and RG&E. However, in  
4 the post-Iberdrola acquisition environment they  
5 are inadequate since they may not be able to  
6 capture the nuances and unknowns related to the  
7 future dealings between Iberdrola, Energy East,  
8 and the utilities. As a result, they should be  
9 continued but only if they are modified and  
10 enhanced by several additional conditions  
11 related to this M&A transaction.

12 Q. Which entities should the revised standards  
13 apply to?

14 A. The revised standards should apply to all  
15 existing entities and to any entity which is  
16 owned 10% or more, directly or indirectly, by  
17 Iberdrola or effectively owned more than 10% by  
18 Iberdrola when combined with other Iberdrola  
19 ownership interests.

20 Q. Please describe the areas where enhancements are  
21 required.

22 A. Enhancements are required to the existing

1 affiliate transaction standards governing:  
2 relationships between the regulated utilities  
3 and competitive energy affiliates, access to  
4 books and records of affiliates, transfers of  
5 assets, personnel matters, royalties, sales and  
6 purchases between affiliates and the utilities,  
7 financial protections, and cost allocations. In  
8 addition, several new requirements are  
9 necessary.

10 Q. Describe the first enhancement to the Standards  
11 of Conduct governing the relationships between  
12 the regulated utilities and competitive energy  
13 affiliates.

14 A. The first section (i) of the Standards of  
15 Conduct should be modified to prohibit any  
16 affiliate from using the same name, trade names,  
17 trademarks, service name, service mark or a  
18 derivative of a name, of the utilities or in  
19 identifying itself as being affiliated with the  
20 utilities.

21 Q. Are there any other changes to section (i) of  
22 the Standards of Conduct?

1 A. Yes. In that same section it states  
2 "unregulated affiliates are prohibited from  
3 giving any appearance that they represent the  
4 DISCO in matters involving the retail marketing  
5 of services by the DISCO or other affiliates."  
6 This should be modified to remove the word  
7 "retail" as the limitation to retail services is  
8 unnecessary.

9 Q. Are any changes recommended to section (v) of  
10 the Standards of Conduct concerning information  
11 sharing?

12 A. Yes. Currently, management company employees  
13 may receive customer or market information  
14 subject to the condition that "Management Corp.  
15 shall not disclose such information to  
16 unregulated affiliates." This should be  
17 clarified and enhanced by requiring the  
18 management corporation that receives such  
19 information to promise the utility in a legally  
20 binding document, executed by authorized  
21 personnel and specific to each transmission of  
22 information, that it will not disclose the

1 information. The utility should be required to  
2 make each such document available to Staff.

3 Q. Are any changes recommended to section (vi) of  
4 the Standards of Conduct concerning competitive  
5 complaints?

6 A. Yes. The change recognizes the need to have  
7 Staff informed about competitive issues earlier  
8 in the complaint process.

9 Q. Should the Access to Books and Records and  
10 Reports provisions be revised?

11 A. Yes. We propose than all restrictions to access  
12 to books and records in section (i) be  
13 eliminated. This proposal recognizes the  
14 potential for harm (i.e., lack of transparency,  
15 vastly holdings in competitive businesses,  
16 potential chaining and unrecorded transactions,  
17 and new incentives) associated with Iberdrola's  
18 transaction with Energy East.

19 Q. Are changes needed to section (iii) reporting  
20 requirements of the Access to Books and Records  
21 and Reports provisions?

22 A. Yes. Staff's standards are revised consistent

1 with principles described above.

2 Q. Is Staff recommending a royalty, which is  
3 addressed in Affiliate Relations section 2?

4 A. No. Because as noted in the Standards of  
5 Conduct section (i) above, there will be no use  
6 of the DISCOs name or reputation by any  
7 affiliates.

8 Q. Is Staff recommending changes to Affiliate  
9 Relations, section 3, transfers of assets?

10 A. Yes. Transfers to the utilities should be at  
11 the lower of actual cost or market price and  
12 transfers to affiliates should be at the higher  
13 of cost or market. Costs for purposes of the  
14 affiliate's transfers to the utilities should be  
15 limited to the original acquisition costs by the  
16 first non-regulated affiliate.

17 Q. Are any modifications needed to the Affiliate  
18 Relations section 4, personnel and human  
19 resources?

20 A. Yes. Personnel and human resources rules should  
21 be enhanced to include a provision comparable to  
22 the provision included in the Grid/KeySpan

1 merger: beginning three years after the merger  
2 has closed, an employee transfer credit equal to  
3 25% of the employee's base annual salary will be  
4 applied. This will compensate the utility for  
5 loss of experience and ability due to the loss  
6 of any of its employees to one of its  
7 affiliates.

8 Q. Are modifications needed to Affiliate Relations,  
9 section 5, provision of goods and services  
10 rules?

11 A. These rules should be enhanced to prohibit: cost  
12 allocations to the utilities or their holding  
13 companies, chaining transactions, and co-  
14 mingling or sharing of goods or services. Since  
15 Iberdrola has not provided any synergy savings  
16 in this acquisition, it would not be appropriate  
17 to permit Iberdrola will to impose service  
18 company cost allocations on U.S. utility  
19 affiliates.

20 Q. Are any modifications needed to the Affiliate  
21 Relations section 6, other?

22 A. Yes. These are primarily financial protections

1 and are being revised consistent with the  
2 principles above.

3 Q. Are there any new proposed enhancements?

4 A. Yes. A first enhancement would be for Iberdrola  
5 to voluntarily move its headquarters for its  
6 United States utility operations (including EEMC  
7 and USSC) to somewhere within the service  
8 territory of NYSEG or RG&E. This would improve  
9 transparency because it would remove many of the  
10 potential impediments to access to any of the  
11 books and records that might be needed in the  
12 future. In addition, it would provide an  
13 economic boost to the economy of the region.

14 ii. REPORTING REQUIREMENTS

15 Q. What are the minimum reporting requirements that  
16 should be imposed upon Iberdrola, NYSEG and RG&E  
17 as a condition for approving this acquisition?

18 A. Staff should have access to the books and  
19 records of Iberdrola and its majority owned  
20 affiliates in English and these books and  
21 records should be made available in New York  
22 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

1 Iberdrola to provide annual public financial  
2 information, including consolidating balance  
3 sheets, income statements, and cash flow  
4 statements as well as a comprehensive management  
5 discussion of results consistent with Energy  
6 East's current 10-K for Iberdrola as well as  
7 financial information about each of Iberdrola's  
8 regulated and unregulated energy companies  
9 operating in the U.S. Such filings should  
10 reflect audited U.S. GAAP financial statements  
11 in U.S. dollars. The consolidating statements  
12 will illustrate how each of Iberdrola's major  
13 regulated and non-regulated subsidiaries  
14 contribute to the overall consolidated financial  
15 statements. This information should be in the  
16 same format as the consolidated financial  
17 statements contained in SEC Form U-5S that  
18 registered utilities had been required to file  
19 under the Public Utility Holding Company Act of  
20 1935 (PUHCA). The energy utility information  
21 should be fully consistent with SEC Form U-9C-3,  
22 which registered holding companies had been

1 required to file under PUHCA.

2 Iberdrola should also file consolidated  
3 balance sheets, income statements and cash flow  
4 statements for Energy East and its direct  
5 subsidiaries in English using U.S. GAAP in all  
6 future rate cases. This information should be  
7 provided for the historic test year and be  
8 projected to the future rate year. In support  
9 of these forecasts, NYSEG and RG&E should also  
10 file balance sheets, income statements and cash  
11 flow statements for all Energy East's  
12 subsidiaries that are either utilities or  
13 operate in the energy business for the historic  
14 test year. These recommendations assure that  
15 staff and the Commission will have sufficient  
16 information to properly analyze NYSEG and RG&E's  
17 capital structure in order to assure that its  
18 rates are reasonable.

19 Q. Does your recommendation place any additional  
20 burden on Energy East, NYSEG, or RG&E?

21 A. It places an extra reporting requirement on the  
22 companies, but it should not be too cumbersome.

1 They have always filed this information as part  
2 of former SEC Forms U-5S and U-9C-3 and the  
3 costs of such requirements are embedded in  
4 rates.

5 Q. Is it possible that the information contained in  
6 these forms may be confidential?

7 A. Yes. In such circumstances it may be reasonable  
8 for NYSEG and RG&E to seek trade secret  
9 protection of the information. To the extent  
10 that such a request is reasonable, the  
11 Commission should grant the request.

12 F. RETAIL ACCESS ISSUES

13 Q. What retail access proposals are you making?

14 A. We will be addressing unbundling issues,  
15 including unresolved billing issues related to  
16 New York State Electric and Gas Corporation  
17 (NYSEG) and Rochester Gas and Electric  
18 Corporation (RG&E). Certain issues regarding  
19 the way that these utilities apply their billing  
20 charges do not conform to Commission policy and  
21 Orders and should be addressed as soon as  
22 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

1 the BIPP costs, however, they converted the  
2 back-out credit subtracted from consolidated  
3 bills, which included the charges for ESCO  
4 commodity, to a charge that was added to the  
5 bills of only utility full service customers.  
6 At that time, they also began using two separate  
7 BIPP charges, one for electric service and one  
8 for gas service. For RG&E electric service, the  
9 back-out credit still exists as unbundling of  
10 BIPP costs has not yet occurred, yet the utility  
11 has already begun applying the back-out credit  
12 incorrectly by using an RG&E gas BIPP charge and  
13 a separate RG&E electric BIPP credit.

14 Q. How does this application of the BIPP charges  
15 deviate from the Commission's requirements?

16 A. The BIPP charge should be one charge that is the  
17 same whether the customer is a single commodity  
18 service customer or a dual electric and gas  
19 commodity service customer. Requiring the dual  
20 commodity service customer to pay two BIPP  
21 charges, one for electric and one for gas,  
22 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

1 needed to prepare bills, such as ink, paper, and  
2 envelopes; the machines that print, assemble,  
3 and put the bills in envelopes; and the postage.  
4 Generally, these costs are not approximately  
5 doubled when the customer is a dual commodity  
6 customer.

7 Q. Are there any other concerns with NYSEG's and  
8 RG&E's application of the BIPP or billing  
9 charge?

10 A. Yes. In converting from a back-out credit to a  
11 charge, these utilities have also decided to  
12 change how it is applied. When it was a credit,  
13 it was applied once, whenever one or more  
14 commodity services were provided by an ESCO that  
15 included its charges on a utility consolidated  
16 bill. Now that it is being changed to a charge,  
17 it is being applied twice, separately for each  
18 commodity, in delivery rates.

19 Q. Why is this a concern?

20 A. First, there has been no change in Commission  
21 policy regarding the application of BIPP costs.  
22 It has never altered its position that BIPP

1 costs should be paid by the customer when the  
2 customer takes all commodity from the utility  
3 and by the ESCO or ESCOs when one or more  
4 commodities are purchased from competitive  
5 suppliers. The most conclusive Commission  
6 statement on this policy is "Since the billing  
7 charge is for a competitive service and is not  
8 charged to retail access customers receiving  
9 consolidated bills, from either the utility or  
10 the ESCO, it should not be subsumed within  
11 delivery." (Case 00-M-0504-Unbundling Track,  
12 Unbundled Bill Order, issued February 18, 2005,  
13 page 23) This one sentence summarizes  
14 succinctly that: 1) billing is a single  
15 competitive service, 2) is not charged to ESCO  
16 customers on consolidated billing, 3) and should  
17 not be charged as part of delivery service.

18 Q. Is there any other recent statement by the  
19 Commission that applies to this issue?

20 A. Yes. In the recent Consolidated Edison Company  
21 of New York, Inc. (Con Edison) gas proceeding,  
22 the Commission distinguished "the gas Merchant

1 Function Charge ... and the account level billing  
2 and payment processing charge." (Case 06-G-1332,  
3 Order Adopting in Part the Terms and Conditions  
4 of the Parties' Joint Proposal, issued September  
5 25, 2007, page 9) This clarifies that there  
6 should be a single BIPP charge, not two.

7 Q. If these costs are unbundled and charged as you  
8 have described, will the unbundling process for  
9 these utilities be complete?

10 A. No. They should be required to file revised  
11 tariffs that convert all existing back-out  
12 credits (these include the Merchant Function  
13 Credit and Metering back-out credits) to  
14 unbundled charges in a revenue neutral manner,  
15 in the context of any rate or rate design  
16 process established for these utilities as a  
17 condition of approval of the transaction

18 Q. What is an ESCO Referral Program?

19 A. Under an ESCO Referral Program, an electric or  
20 gas utility offers customers telephoning its  
21 call center with a non-emergency inquiry the  
22 opportunity to enroll with ESCOs that offer a

1 uniform discount, over an introductory trial  
2 period, from the price the utility charges for  
3 commodity service.

4 Q. Please describe the Commission's most recent  
5 statements regarding the referral programs.

6 A. On December 21, 2007, the Commission issued  
7 Orders in Case 06-G-1185, regarding KeySpan  
8 Corporation affiliates (KeySpan), and in Case  
9 07-G-0141, regarding National Fuel Gas  
10 Distribution Corporation (NFG). In each case,  
11 the Commission required each utility to embark  
12 upon a collaborative and to make a filing  
13 describing the relevant costs, benefits and best  
14 practices of an ESCO Referral Program, in  
15 sufficient detail to allow the Commission to  
16 reach a decision on such a program.

17 Q. What is the status of an ESCO Referral Program  
18 at RG&E?

19 A. In a filing dated September 1, 2006, RG&E filed  
20 a proposed ESCO Referral Program. The  
21 Commission has not acted on that filing.

22 Q. What is the status of an ESCO Referral Program

1 at NYSEG?

2 A. On October 23, 2006, NYSEG filed proposals for  
3 implementing an ESCO Referral Program. The  
4 Commission has not acted on that filing.  
5 Subsequently, in an Order issued August 29, 2007  
6 in Case 07-E-0479, the Commission allowed NYSEG  
7 to pursue the development of an ESCO  
8 Introduction Program that could serve as a  
9 substitute for an ESCO Referral Program. NYSEG  
10 was directed to commence a collaborative on the  
11 content and costs of an ESCO Introduction  
12 Program.

13 Q. What is the status of that collaborative?

14 A. Negotiations in that collaborative are ongoing.

15 Q. What do you recommend?

16 A. If the Commission decides to approve Iberdrola's  
17 acquisition of Energy East, as a condition of  
18 approval, it should impose on NYSEG and RG&E  
19 requirements regarding ESCO Referral Programs  
20 that are similar to the requirements imposed on  
21 KeySpan and NFG.

22 Q. What about the prior ESCO Referral Program

1 filings of NYSEG and RG&E?

2 A. Those prior filings are well over a year old.

3 The positions on program content and cost  
4 information presented in them should be updated,  
5 through the collaborative and filing process  
6 recommended above.

7 Q. What about the ongoing ESCO Introduction Program  
8 collaborative at NYSEG?

9 A. The results of that collaborative can be folded  
10 into the filing NYSEG would make. Its filing  
11 should include cost and program component  
12 information on an ESCO Introduction Program, and  
13 compare that program to the costs and best  
14 practices for implementing an ESCO Referral  
15 Program.

16 ALTERNATIVE INVESTMENT OF IBERDROLA FUNDS

17 Q. How much above the original cost of the  
18 utilities assets is Iberdrola paying to acquire  
19 Energy East?

20 A. Iberdrola is paying \$2.9 billion in excess of  
21 the original cost of the utilities assets to  
22 acquire Energy East. Iberdrola is in effect,

1 acquiring \$1.5 billion of old Energy East  
2 Goodwill plus adding another \$1.4 billion of  
3 Goodwill in this transaction.

4 Q. Does Staff consider the acquisition of utility  
5 Goodwill a productive use of capital?

6 A. No. As we have testified, since the utilities  
7 cannot realistically achieve a return on utility  
8 Goodwill over the long-term, it is not  
9 productive. The massive investment in Goodwill  
10 does not help the state's infrastructure, does  
11 not advance the state's interests in renewables,  
12 nor does it create jobs. In fact, in the long-  
13 term, this massive investment in utility  
14 Goodwill harms the state's interests because it  
15 provides pressures on management to find ways to  
16 service that unproductive capital, some of which  
17 are adverse to consumers. It harms the  
18 utilities finances, puts undue pressure on the  
19 utilities to scale back infrastructure  
20 investment, impedes economic development, and  
21 causes job losses.

22 Q. Does Staff have any suggestions for the use of

1 this capital?

2 A. Yes. Rather than invest \$2.9 billion in  
3 unproductive acquisition premium (utility  
4 Goodwill), Iberdrola should consider investing  
5 those funds in productive wind power assets.

6 Q. Why?

7 A. This will help the state achieve its renewables  
8 goals and enhance economic development.  
9 Iberdrola could use the growth in its New York  
10 wind interests to grow its other wind related  
11 businesses, such as parts distribution and  
12 engineering services.

13 Q. Does this conclude your testimony?

14 A. Yes, at this time.