STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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.

NOTICE OF SCHEDULE FOR FILING EXCEPTIONS

(Issued June 16, 2008)

Attached is the Recommended Decision of Administrative Law Judge Rafael A. Epstein in the above-captioned proceeding. Briefs on exceptions are due to be submitted electronically to secretary@dps.state.ny.us and to be served electronically on all active parties by 4:00 p.m. on Thursday, June 26, 2008, provided that the signed original and five (5) additional hard copies must also be deposited for delivery by First Class mail or courier service to the undersigned on that same date. A hard copy should also be mailed by that date to any active party requesting hard-copy service in addition to electronic service. Briefs opposing exceptions are due electronically to the undersigned and to all active parties by 4:00 p.m. on Tuesday, July 1, 2008, following the same procedures outlined above for filing and service of both electronic and hard-copy versions.

The parties' briefs should adhere to the requirements of 16 NYCRR 4.10, 3.5 and 4.8, which address page limitations, font size, spacing, margins and other requirements that will be enforced in this case. The page limitations of Rule 4.10(c)(4) are hereby modified to allow a combined total of 200 pages for the brief on exceptions and the brief opposing exceptions filed by joint petitioners and for those filed by Department of Public Service Staff, in consideration of the scope of issues addressed by those parties. All other intervenor parties are subject to the 100-page limitation of Rule 4.10 except as may be further modified by the Secretary in response to a party’s showing that its presentation would be prejudiced by enforcement of such limitation. Appendices of financial schedules and similar information in tabular form shall not be counted for purposes of the page limitation.

(SIGNED)   JACLYN A. BRILLING
                        Secretary

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RECOMMENDED DECISION

BY

ADMINISTRATIVE LAW JUDGE RAFAEL A. EPSTEIN

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RECOMMENDED DECISION

RAFAEL A. EPSTEIN, Administrative Law Judge:

I. INTRODUCTION AND BACKGROUND

A. Overview and Summary

1. Summary

The Commission has been asked to approve a transaction in which Iberdrola, S.A. (Iberdrola) would acquire Energy East Corporation (Energy East) and its subsidiaries, including New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E). In this recommended decision, the primary recommendation is that the Commission disapprove the transaction on the ground that it does not satisfy the "public interest" requirement of Public Service Law (PSL) §70. Alternatively, should the Commission approve the transaction, it is recommended that approval be subject to the following preconditions: (1) Iberdrola and its affiliates should not be allowed to own electric generating plants (whether wind powered, fossil fueled, or hydropower) interconnected with NYSEG's or RG&E's transmission or distribution systems; (2) corporate relations among Iberdrola and its New York affiliates should be subject to most of the financial and structural safeguards that have been proposed by Staff of the Department of Public Service and other parties; (3) NYSEG and RG&E customers should be credited with "positive benefit adjustments" (PBAs) of $646.4 million, including $201.6 million initially upon completion of the merger transaction (resulting in NYSEG and RG&E delivery rate reductions of $54.8 million or 4.4%, initially);[1] and (4) at the conclusion of this case, an 11-month general rate proceeding should commence to consider NYSEG's and RG&E's overall revenue requirements and related matters, including implementation of the remaining $444.8 million of PBAs, terms of retail access by independent energy service companies, and revenue decoupling mechanisms to mitigate the financial impacts that might otherwise bias NYSEG and RG&E against energy efficiency and conservation measures.

2. The Parties and Their Positions[2]

a. Petitioners

NYSEG provides delivery service to about 871,000 electric customers and 256,000 gas customers in an area comprising about 40% of upstate New York. RG&E serves about 360,000 electric customers and 297,000 gas customers in nine counties in and around the City of Rochester. Both companies are wholly owned subsidiaries of RGS Energy Group, Inc. (RGS), headquartered in Rochester, New York, which in turn is the wholly-owned subsidiary of Energy East. Energy East, based in Portland, Maine, also owns utility companies serving Maine, Connecticut, and Massachusetts.

Iberdrola, headquartered in Bilbao, Spain, is the world's fourth largest utilities company (based on its market capitalization, which is about $70 billion), serving about 22

[1] These PBA amounts are subject to slight revisions for possible updates and corrections.

[2] This section summarizes briefly the positions of parties that either submitted testimony or briefs in this proceeding.

million electric points of supply and 2 million gas points of supply in Europe, Central America, and South America. It is engaged in the natural gas business as a supplier and developer of gas infrastructure, and is the third largest independent operator of natural gas storage in North America. It does own any traditionally regulated electric or natural gas delivery systems in the United States.

Iberdrola is the largest producer of wind energy in the world, with over 6,800 MW of wind capacity. In New York, Iberdrola has interests in the Flat Rock (231 MW) and Flat Rock II (90.75 MW) wind farms in Lewis County, by virtue of its ownership of ScottishPower plc, which has a subsidiary, PPM Energy, Inc., that in turn owns 50% interests in the Flat Rock projects. A subsidiary of Iberdrola is currently developing a 110 MW wind farm in Herkimer County, which is expected to achieve commercial operation in 2009. Iberdrola has acquired renewable energy companies elsewhere in the United States since May 2006. Iberdrola owns and operates its wind projects as subsidiaries of Iberdrola Renovables, S.A. (Renewables). Renewables is owned 80% by Iberdrola, with the remaining 20% traded on the Spanish stock exchange.

In addition to NYSEG, RG&E, RGS, Energy East and Iberdrola, the petitioners in this proceeding also include Green Acquisition Capital, Inc., a wholly owned subsidiary of Iberdrola formed for purposes of the proposed merger transaction. Subject to regulatory approval, petitioners have agreed that Green Acquisition Capital, Inc. would be merged into Energy East, so that NYSEG and RG&E would remain part of Energy East which in turn would become a wholly owned subsidiary of Iberdrola. Energy East's approximately 158 million outstanding common stock shares would be purchased by Iberdrola, for about

$4.5 billion of equity which Iberdrola already has raised in the capital markets.

Petitioners assert that the proposed transaction will provide significant rate, financial, employment and public policy benefits for New York and the customers of the utility companies. They note that Iberdrola's acquisition of Energy East, NYSEG and RG&E involves the Spanish firm's first investment in regulated utility companies in the United States. As such, petitioners state that the proposed transaction will not provide any synergy savings for ratepayers or investors. Nonetheless, they claim that it will provide other immediate and quantifiable benefits for ratepayers and less quantifiable public interest benefits.

In this case, in response to other parties' concerns about the proposed transaction, petitioners have offered rate reductions, investment in renewables, and conditions addressing such things as corporate transparency and reporting, data security, credit quality, capital structure, and affiliate transactions. Petitioners believe that the Commission should approve the proposed transaction without any conditions other than the ones they have offered voluntarily.

Petitioners attest that the proposed transaction has been approved by the Maine Public Utilities Commission, the Connecticut Department of Public Utility Control, the New Hampshire Public Utilities Commission, the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission, and the Committee on Foreign Investment in the United States (chaired by the Secretary of the U.S. Treasury and composed of representatives of 12 federal agencies). Additionally, the U.S. Department of Justice and the U.S. Nuclear Regulatory Commission are said to have tacitly or expressly found it unnecessary to further review the transaction. Thus, approval by this Commission pursuant to PSL §70 is said to be the only additional regulatory approval required.

b. Department of Public Service Staff

As its primary position, Staff opposes Iberdrola's acquisition of Energy East. It also claims the transaction's potential benefits are insufficient to satisfy the PSL §70 "public interest" standard.

In the alternative, should the Commission approve the transaction, Staff advocates that customers receive Staff recommends that the proposed transaction only be approved if ratepayers receive tangible monetary relief in the rates they pay for utility service and that the Commission impose structural and financial protections to protect ratepayer interests. It has identified various sources and means, which it refers to as Positive Benefit Adjustments, for providing monetary benefits to ratepayers.

c City of Rochester

The City of Rochester submitted testimony and attended the evidentiary hearings but chose not to submit post-hearing briefs. The City generally supports the merger transaction if its concerns regarding a number of RG&E facilities can be resolved to its satisfaction. Specifically, the City seeks commitments from Iberdrola to work with the City to resolve issues relating to undergrounding of poles and lines as part of certain revitalization projects in the City; the purchase by the City of the remaining portion of its street lighting system; the maintenance and remediation of the Beebe Station; remediation of other contaminated riverfront properties; and the future use of the historic substation at 81 South Avenue in Rochester. Petitioners have offered commitments responsive to these concerns.

d. Greater Rochester Enterprise

The Greater Rochester Enterprise (GRE) has a mission to help revitalize the economy in and around Rochester. GRE favors Iberdrola's commitment to renewable energy which, it believes, is ideally suited for New York and the State economy. GRE supports petitioners' proposals dealing with vertical market power. GRE does not believe that Iberdrola should be required to divest its wind capacity nor does it believe that Iberdrola should be prohibited from further developing wind capacity. It does not believe that RG&E should be required to divest its hydroelectric generating plants. Rather than adopt the Positive Benefit Adjustments proposed by Staff, GRE believes that the $50 million in immediate rate reductions advanced by petitioners, coupled with the retention of local jobs and a $100 million investment in wind generation, would provide a sufficient basis for the Commission to approve the proposed transaction.

e. Independent Power Producers of New York

The Independent Power Producers of New York, Inc. (IPPNY) is a not-for-profit trade association that represents the independent power industry in New York. Its members include over 100 companies that develop, operate and own electric generators and that market and sell electric power in the wholesale and retail market.

IPPNY supports the development of a fully competitive electric market in the State. It favors petitioners' proposal to divest the RG&E's fossil-fuel generation facilities,[3] but IPPNY does not believe that petitioners' proposal goes far enough. It believes that the Commission should also require petitioners to divest NYSEG's and RG&E's hydroelectric

[3] IPPNY supports the proposed auction and sale of RG&E's Russell Station, Allegany Station, Peaker Stations Nos. 3 and 8, and the Cayuga Energy Carthage Peaking Unit.

generation facilities.[4] Further, IPPNY believes that petitioners and their affiliates should not seek to construct, acquire or otherwise own any interest in electric generation that is interconnected with RG&E's and NYSEG's transmission and distribution systems or have an interest in any electric generation facilities in New York that are subject to cost-based rate regulation, absent an order from the Commission.

f. International Brotherhood of Electrical Workers, System Council U-7 and Local 36

System Council U-7 and Local 36 of the International Brotherhood of Electrical Workers (IBEW) submitted testimony in this case but did not otherwise participate in the hearing or briefing stages. IBEW supports the merger, but with reservations, depending on how several of its concerns are addressed. IBEW feels that a change in management would be helpful to the future success of the Energy East utilities, due to Iberdrola's superior financial strength, management and leadership. It strongly opposes any workforce reduction as part of the transaction and instead sees the hiring of new workers and mandated infrastructure replacement as essential to improved service quality, which would provide a quantifiable, tangible benefit to ratepayers. It does not believe a divestiture of wind facilities should be required, but it supports an auction for the sale of RG&E's Russell Station as a condition for approval of the merger.

g. Multiple Intervenors

Multiple Intervenors (MI) is an unincorporated association of over 50 large industrial, commercial and

[4] They include NYSEG's hydroelectric facilities located at Cadyville, High Falls, Kent Falls, Lower Saranac, Mechanicville, Mill, Rainbow Fall and RG&E's Stations 2, 26 and 5.

institutional energy consumers with manufacturing and other facilities located throughout New York State, including in the NYSEG and RG&E service territories. It supports the proposed transaction between Iberdrola and Energy East if it is made subject to suitable conditions producing financial and other tangible benefits and enforceable protections for NYSEG and RG&E customers. The conditions MI has in mind would provide ratepayers substantial financial and rate-related benefits; would apply stringent reliability, service quality and safety performance standards; would provide customers financial protection; would contain robust reporting requirements; and would mitigate vertical market power concerns but would not preclude Iberdrola from developing wind generation.

h. Natural Resources Defense Council

The Natural Resources Defense Council (NRDC) believes that the Commission should use the opportunity of this merger proceeding to ensure and advance the State's goals and policies for increased renewables, reduced global warming, and increased investments in energy efficiency with revenue decoupling and performance-based incentive structures. If the merger is approved, NRDC opposes a requirement that Iberdrola divest itself of current interests in wind generation or be forbidden to make further investments in wind or other renewable sources of generation. Instead, NRDC advocates for procedural safeguards to deal with market power concerns.

Whether or not the merger is approved, NRDC urges the Commission to ensure that revenue decoupling mechanisms are put in place for NYSEG and RG&E and that Energy East or Iberdrola/Energy East are subject to a strong incentive plan to ensure that they achieve their share of the State's "15 x 15" goal to reduce energy use.

i. New York Association of Public Power and New York State Rural Electric Cooperative Association

The New York Association of Public Power (NYAPP) and the New York State Rural Electric Cooperative Association (NYSRECA) participated in this case on behalf of five of their members to raise certain service reliability matters.[5] In response to their concerns, petitioners' March 14, 2008 Partial Acceptance Document proposes to create a task force of representatives from the utility companies and the cooperatives to address service quality and reliability, capital investments, transmission and sub-transmission issues, a transmission study, a joint review of outage history and line performance and improvements in communications, among other things. Assuming the adoption of this task force process, NYAPP and NYSRECA do not oppose the proposed transaction.

j. Nucor Steel Auburn

Nucor Steel Auburn, Inc. (Nucor) operates a steel manufacturing facility in Auburn, New York where scrap steel is recycled and molten steel is recast into a variety of steel products. It is the largest single point electric load on NYSEG's system. Nucor supports economic development in upstate New York and it urges the Commission to use its authority to obtain specific and enforceable commitments from petitioners to retain jobs and to obtain economic development initiatives. Nucor supports the Staff-proposed Positive Benefit Adjustments and believes that they are needed to protect consumers.

With respect to the revenue decoupling mechanism being considered for NYSEG and RG&E, Nucor opposes the RDM Staff has

[5] NYAPP and NYSRECA appeared on behalf of the Delaware County Electric Cooperative, Oneida Madison Electric Cooperative, Otsego Electric Cooperative, Steuben Rural Electric Cooperative and the Village of Sherburne.

proposed. It believes the model is flawed and can produce aberrant outcomes. It does not believe that a RDM should be applied to NYSEG's transmission voltage customers with delivery rates that consist almost entirely of fixed and demand charges.

Nucor takes no position on vertical market power matters presented by the proposed transaction. It acknowledges the other parties' efforts and the Positive Benefit Adjustments and the financial and credit protections to be provided for utility customers. It acknowledges petitioners' concessions and generally supports Staff's position.

k. NYS Consumer Protection Board

The New York State Consumer Protection Board (CPB) does not believe that the quantifiable benefits expected from the proposed transaction sufficiently outweigh the risks that it creates for consumers. Therefore, CPB does not recommend that the proposed transaction be approved in its current form. Instead, CPB proposes that the Commission approve the proposed transaction with conditions for customers to obtain the rate reductions related to the $646.4 million of Positive Benefit Adjustments and the $208 million in rate adjustments advanced by DPS Staff. CPB believes that the smaller amount of Positive Benefit Adjustments that petitioners are willing to recognize is inadequate compensation for customers for the amount of risk associated with the proposed transaction.

Further, CPB urges the Commission to condition approval of the proposed transaction on adoption of financial protection measures similar to those applied to the National Grid/KeySpan merger. CPB favors the use of a limited purpose entity to prevent the inclusion of NYSEG and RG&E in any bankruptcy proceeding involving the parent holding company.

Otherwise, CPB believes that petitioners' Partial Acceptance Document adequately addresses all vertical market power issues. It does not believe any restrictions should be placed on Iberdrola's future development of wind generation other than the types of restrictions that would apply to any other transmission owner in the State.

l. NYS Department of Economic Development

The New York State Department of Economic Development (DED) supports the proposed transaction. DED urges the Commission to condition approval on terms that would apply some of the transaction's financial benefits to initiatives to stimulate business investment and job creation. DED believes that the proposed merger can provide long-term benefits for upstate New York. It specifically urges the Commission to lower rates for industrial and commercial customers; to improve the utility service delivery infrastructure; and to provide additional funding for the utility company economic development plans.

DED supports Iberdrola's proposal to invest in wind generation in New York and the mitigation measures for ensuring compliance with the Commission's policies concerning vertical market power. It also believes that the utility companies' generation assets should be sold.

m. NYS Department of Environmental Conservation

The New York State Department of Environmental Conservation (DEC) supports the transaction without any condition that would prevent Iberdrola from developing and owning wind energy facilities in New York. It believes that Iberdrola should be permitted to participate in wind energy projects because of its expertise. DEC states that it is important to fight climate change, and wind energy is needed to achieve a reduction in greenhouse gases. It foresees the need for a dramatic increase in the State's wind energy capacity and states that it will provide multiple environmental and public health benefits.

n. Strategic Power Management

Strategic Power Management (SPM) considers the proposed transaction to be in the public interest and supports its prompt approval. SPM agrees with the amount of the Positive Benefit Adjustments that DPS Staff proposed and petitioners have accepted. SPM is opposed to the other Positive Benefit Adjustments that Staff proposed and claims that they are excessive and would produce confiscatory results.

SPM believes Iberdrola will contribute to the upstate New York economy by having offered to retain all current employment and to invest at least $100 million, over three years, to develop wind generation. SPM supports the financial conditions DPS Staff has proposed for the proposed transaction, including those for acquisition costs, credit quality, dividends, money pooling arrangements and corporate structure protections.

B. Procedural History

Iberdrola, jointly with Energy East, NYSEG, RG&E and several other entities, filed its petition on August 1, 2007 seeking approval under Public Service Law §70 for Iberdrola's acquisition of Energy East. The petition was accompanied by initial prefiled testimony and exhibits in support of the request.

The parties determined to engage initially in settlement discussions regarding the petition, with the initial settlement conference on September 20, 2007. Those discussions did not result in an agreement among the parties. Instead, on November 28, 2007, the deadline established for reaching an agreement in principle or proceeding to litigation, the parties announced that they would proceed to litigation. On that same date, petitioners filed supplemental testimony on vertical integration issues. Responsive testimony and exhibits were filed on January 11, 2008 by Department of Public Service Staff, the City of Rochester, the Department of Environmental Conservation, Greater Rochester Enterprise, the International Brotherhood of Electrical Workers, System Council U-7 and Local 36, Independent Power Producers of New York, Inc., National Resources Defense Council, The New York State Rural Electric Cooperative Association, and Nucor Steel Auburn, Inc. Petitioners thereafter filed additional rebuttal testimony on January 31, 2008.

By that time, the proceeding to consider an electric and gas revenue decoupling mechanism (RDM) for NYSEG, Case 07-M-0996 had been consolidated into this case pursuant to a Notice issued October 19, 2007. Consequently, the Staff and intervenor testimony as well as the rebuttal testimony addressed an RDM requirement. Staff, among other parties, advocates an RDM for both NYSEG and RG&E.

An earlier schedule had called for an evidentiary hearing to begin on February 26, 2008 to cross examine the prefiled testimony. However, on February 5, 2008, Staff moved to suspend the litigation schedule on the ground that possible takeover attempts directed at Iberdrola required additional discovery. Petitioners opposed this motion on February 7, 2008. Before the motion was ruled upon, petitioners and Staff moved jointly on February 14, 2008 to revise the schedule to postpone the hearings in order to allow time for resumption of settlement negotiations. A revised schedule was thereafter established leading up to a March 12, 2008 target date for either an agreement in principle or resumption of litigation. On that date, the parties reported no agreement and the litigation track was resumed. Staff chose not to renew its motion to further postpone hearings in order to conduct discovery or consider additional information relating to possible takeover attempts of Iberdrola.

On March 14, 2008, petitioners filed a set of unilateral concessions regarding certain issues that had been raised by Staff and intervenors in an effort to narrow the scope of contested issues at the evidentiary hearing in a document entitled the Partial Acceptance Document.[6] Thereafter, evidentiary hearings began on March 17, 2008 and continued through March 20, 2008. Staff availed itself of the opportunity to respond to the Partial Acceptance Document through supplemental direct testimony given orally on the record at the hearing. Additional intervenor parties, in addition to those filing direct testimony, participated in cross examination or otherwise at the hearings. The record of the hearings comprises 1,908 pages of testimony and 136 exhibits.

A Commission order issued March 19, 2008 granted, in part, Staff's interlocutory appeal from a discovery ruling. A separate appeal from that discovery ruling was taken by the pro se intervenor, Mr. Mark Corbett, and remains pending before the Commission.

Post hearing briefs were submitted by 11 parties on April 11, 2008, and reply briefs of 11 parties were submitted April 25, 2008.[7]

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[6] Exh. 50.

[7] Initial briefs were submitted by petitioners, Staff, CPB, DEC, DED, IPPNY, MI, NRDC, Nucor, NYAPP/NYSRECA, and SPM. Reply briefs were submitted by all of those parties except DEC; in addition, GRE submitted a reply brief.

C. Public Input

In accordance with standard practice, we have monitored the public's reaction to the proposed acquisition of Energy East by Iberdrola S.A., through allowing the public to post comments at our web site, making available a toll-free telephone number to call any time of the day or night, by encouraging written correspondence, and by conducting public statement hearings at various locations. Public statement hearings were held on February 19-22, 2008 in Carmel, Binghamton, Ithaca, Lancaster, Rochester, and Plattsburgh. In addition to the comments made at the public statement hearings, 147 letters, e-mails and telephone comments were timely received from customers, utility employees, stockholders, retirees, and members of other concerned constituencies. Of the many issues raised by the public, most concerned: (1) objections to foreign ownership of public utilities; (2) economic concerns; (3) environmental concerns, (4) continuation of retiree pensions and other benefits; and (5) service quality.

Some speakers opposed the acquisition of Energy East by Iberdrola, some want requirements to be mandated if it is approved, and some support the merger based on economic and environmental reasons.

There is a very large number of concerns about Iberdrola being a foreign held corporation. Many people believe that it is not in New York's best interest to put control of utilities in foreign hands. There are also concerns that Iberdrola, being a foreign corporation, will be beyond the reach of the laws of the State of New York or the United States, and will not have to answer to the Securities and Exchange Commission. Some feel that Iberdrola may inappropriately reduce expenditures for maintenance and repair and thus risk reliability of the supply of energy. Many customers are worried that there will be a lack of customer service and local support when the company running their utilities is foreign based. There is also concern that Iberdrola is subject to takeover by other foreign corporations, and that utilities in New York will be at risk. There is also concern that the power of public utilities to exercise eminent domain will be passed on to foreign entities, granting them similar authority. Many people feel they are losing control of their nation’s vital interests, and that this poses a threat to national security.

At the hearings many customers expressed economic concerns. They are worried about currently high energy prices and their impact on the elderly and those who can least afford to pay high bills. These people are concerned that, with the acquisition, there will be no guarantee that rates will not increase. Many citizens are troubled by high executive payouts if the merger goes through. Many others are worried that Iberdrola stands to become a foreign monopoly supplying New York utilities, as it would be a producer (with its wind turbine electricity generators) as well as the distributor of the power it generates. Others are worried that the purchase price, which is above the book value, will be passed onto customers.

Shareholders in Energy East are concerned that the buyout will cost too much in capital gains taxes, and that they will lose dividends that they count on as part of their income to pay their bills.

Other members of the public are concerned that Iberdrola’s wind farms lack the capacity to produce enough power. They state that wind power is unreliable, inefficient, and expensive. Commenters have noted that the wind farms being built by Iberdrola produce infrasonic vibrations and too much noise and also destroy the natural beauty of upstate New York.

Many feel that New York lacks sufficient amounts of wind to make wind farms a viable option for a renewable energy source. Others are concerned that the creation of wind farms causes the destruction of natural habitats and woodlands.

Retirees of RG&E and NYSEG who are currently receiving pensions and benefits through Energy East are concerned that they might lose their benefits. They would like requirements for the continuation of those benefits if the acquisition is approved. Other employees want Iberdrola to be required to put more resources into staffing to respond to emergencies.

Proponents of the acquisition support the buyout with environmental and economic reasons. They cite Iberdrola's expertise in wind energy and its ability to use wind as a viable renewable resource. Wind is a clean, renewable, and safe source of energy. They support it economically as future costs may be lessened by producing energy in state. Supporters believe Iberdrola's presence in the community will promote job growth as well as providing financial strength which will allow for improved service. Commenters noted that Iberdrola has a history of creating jobs in foreign countries where it purchased utilities. Others in favor of the merger cite that it has been approved by all of the other state utility commissions including Maine, New Hampshire, and Connecticut, as well as having support from numerous business communities and organizations along with support by the Empire State Development Corporation and the NYS Department of Environmental Conservation.

Some members of the public appeared at public statement hearings to raise issues concerning utility billing and service problems. These included a large group of representatives of the Monroe Workers Benefit Council, who appeared at the Rochester hearing to advocate rate relief and modifications of shutoff and reconnection policies for low-income customers. These requests were said to be independent of whether the Commission approves the Iberdrola transaction, and therefore have been referred to Commission staff for review outside the scope of this proceeding.

Particularly thorough and lengthy letters in this case were submitted by U.S. Senator Charles E. Schumer and by the Green Island Power Authority. Senator Schumer addresses four main issues in the context of this transaction. First, he expresses concern that the $4.4 billion sale of Energy East is $2.9 billion above the book value for the asset, with $1.5 billion representing goodwill from the previous Energy East acquisition and the remaining $1.4 billion a purchase premium in this transaction. He asserts that this goodwill will benefit shareholders and utility executives, in stark contrast to the lack of new benefits for ratepayers and upstate New York. Consequently, Senator Schumer proposes that Iberdrola should establish a trust fund, or regulatory deferral account, to be funded by the utility for the benefit of ratepayers. According to the Senator, this fund could be used to moderate future rate increases or to fund new transmission lines or generating projects.

Second, Senator Schumer states that Iberdrola's entrance into the U.S. utility market presents an opportunity to draw on its experience and expertise in developing wind power in New York State. Given Iberdrola's expertise, the Senator feels it would be a mistake to prevent the company from owning or building new wind projects. Third, the Senator advocates provisions in the merger that would guarantee the repowering of the Russell Station to convert this coal-fired plant to a natural gas facility. He believes that continued ownership of the facility by RG&E is a factor in providing Rochester residents with some of the lowest electric rates in the region.

Finally, Senator Schumer asserts that encouraging investment in New York is important to the economic development of the State. He asserts that this case should proceed in such a manner as to send a strong message to all other potential foreign investors that New York is open and ready for their business.

The Green Island Power Authority (GIPA) echoes the views of many speakers at public statement hearings who expressed concern about ownership of critical infrastructure assets in New York State by foreign entities. According to GIPA, the shift in ownership of hydroelectric facilities away from local utilities to corporate owners motivated primarily by profit results in hydropower being sold at the highest market price available. Consequently, GIPA asserts, local areas are unable to obtain low cost power directly from the area where it is generated. GIPA asserts that §4(e) of the Federal Power Act requires the holder of a license to operate hydroelectric facilities under the Act to be a U.S. citizen or corporation. It questions whether Iberdrola's acquisition of Energy East's assets would comply with the legislative intent of this section of the Federal Power Act. It urges the Commission to direct the divestiture of RG&E and NYSEG hydroelectric facilities as more consistent both with federal law and the public interest of the people of New York.

If Iberdrola is allowed to establish a subsidiary in New York, GIPA advocates that such a subsidiary be organized as a corporation and not a partnership. It points out that Public Service Law §§69 and 70 provide for Commission oversight and approval of issuances of stocks and indebtedness by corporations, mergers by corporations and transfers of franchises and stocks by corporations, but do not, by their express terms, apply to partnerships. GIPA expresses concerns that such a loophole in the Public Service Law could enable corporations, acting as limited partners, to sell, acquire or issue stock "under the radar" of the NYPSC and FERC. Alternatively, GIPA urges the Commission to interpret PSL §§69 and 70 to apply to such business arrangements, even if they do not fall within the literal reading of the Public Service Law.

II. ISSUES PRESENTED

A. Standard of Review

1. Overview

No party disputes that the burden of proof that the proposed transaction "is in the public interest," within the meaning of PSL §70, is borne by petitioners.[8] SPM, which advocates that the Commission approve the transaction, proposes to define the §70 public interest criterion using the Appellate Division's formulation:

> We think it is plain enough that the term "public interest" is directly related to and limited by the main purposes of the Public Service Law. These purposes, so the Legislature has once said, are "to guarantee to the public safe and adequate service at just and reasonable rates, to the stockholders of public service corporations, a fair return upon their investments, and to bondholders and other creditors, protection against impairment of the security of their loans."[9]

However, a review of the Commission's decisions in recent merger cases shows that some issues--such as the issues in this case concerning the transaction's effects on economic development or investment in renewable energy--arise from an expansive interpretation of "safe and adequate service at just and

[8] See, e.g., MI's Initial Brief, note 10, citing Tr. 473.

[9] International Railway Company v. PSC, 264 A.D. 506 (3rd Dept. 1942) (citing Laws of 1929, chap. 673, §3).

reasonable rates" in which the passage quoted provides no direct guidance. SPM concedes as much; it cites the thousands of pages of testimony in this case as proof (if any were needed) that the definition of "public interest" is elusive.[10]

In defining the "public interest" under PSL §70, petitioners' and Staff's arguments evolve into a dichotomy between two possible standards: a "positive net benefits" test, which would require that petitioners demonstrate or offer discrete benefits, versus a "no harm" standard which of course would relieve petitioners of that burden. In fact, however, the choice of an appropriate standard is not that simple.[11] The complexities arise mainly because the transaction's benefits as asserted by petitioners have drawn several criticisms that differ from one another but use similar terminology.

This recommended decision assumes one should inquire, first, whether the asserted benefits are real. However, the lack of a dollar value attached to the benefit does not mean the benefit should be ignored. Some benefits are real but speculative, in the sense that one cannot predict whether they will materialize; for example, an acquisition by one firm can foreclose a less beneficial acquisition by another. Some benefits are real but unquantified (or estimated or unknown), meaning that they might be quantified when they become better known; for example, a merger can create operating efficiencies whose economic value is difficult to predict over the long term. Some benefits are real but intangible, i.e., ultimately not quantifiable; for example, a corporate reorganization can

[10] SPM's Initial Brief, note 2.

[11] For one thing, petitioners argue that Staff mischaracterizes various benefits of the proposed transaction as detriments, or "risks," as discussed in Point II.D., "Transaction Risks and Customer Safeguards," below.

improve management's performance in ways that cannot be evaluated economically.

Finally, some asserted benefits may not be real, because (for example) they are outcomes that would occur regardless of whether a merger occurred. CPB correctly defines the task of identifying unreal or illusory benefits of the transaction, by noting that there is no real benefit in advantages that would accrue to the public regardless of whether the transaction occurred;[12] in measures that merely alleviate problems caused by the transaction; or in offers to improve the acquired companies' performance in areas where they are not deficient.[13]

Thus, one difficulty in applying a positive benefits test and avoiding the use of a no harm standard in this case is that some benefits are more speculative or unquantifiable than others. Petitioners complain that Staff has mistakenly accused them of invoking a no harm standard and that petitioners actually support a net benefits standard involving benefits that are not readily quantified.[14] Under a positive benefits test, however, to the extent a particular benefit is speculative or

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[12] Citing Case 06-M-0878, National Grid and KeySpan Corp, Order Authorizing Acquisition (issued September 17, 2008), p. 119, (Grid/KeySpan Order).

[13] CPB's Initial Brief, pp. 19-20. Because protective measures designed merely to neutralize the risks of the transaction cannot be counted as positive benefits for purposes of a net benefits test, this recommended decision addresses such measures separately from its consideration of net benefits. Thus, Part C ("Vertical Market Power," below) recommends ownership restrictions to prevent the transaction from creating market power, and Part D ("Transaction Risks and Customer Safeguards," below) recommends that other risks of the transaction be mitigated by other financial and structural safeguards.

[14] Petitioners' Reply Brief, note 8.

unquantified, it deserves less weight than a benefit that is less speculative or more quantifiable.

As a result, a transaction that promises no synergy savings or other quantified benefits, like the proposal in this case as originally filed, can be approved only if the Commission applies a test that looks very similar to a no harm standard. As the identifiable benefits increase--because, for example, they become better quantified or because petitioners modify the initial filing with a series of “partial acceptance” concessions--petitioners can make a stronger argument that the transaction will satisfy a net benefits test. Petitioners therefore are correct that they are not attempting to rely on a no harm standard. Obviously, however, the “net” in the net benefits test signifies that the transaction’s identifiable benefits must outweigh its detriments.

Although no party advocates anything other than a positive benefits test, the parties disagree about two of petitioners’ assertions: (1) that the transaction can satisfy §70 even without proof that it would provide nonspeculative or quantifiable net benefits and (2) alternatively, that the transaction demonstrably would create such benefits. The following section addresses the first point. The second point is discussed subsequently (Part II.B., “Benefits of Transaction”).

2. Absence of Synergies

To interpret the §70 public interest criterion, petitioners reasonably start with the premise that the interpretation should be governed by whatever precedent may be inferred from the Commission’s previous decisions regarding other mergers. Petitioners proceed to argue that the proposed transaction is unique because it is a “first mover” acquisition, meaning apparently that it would be Iberdrola’s first foray into

North America, a region where Iberdrola has no preexisting presence as a regulated utility.[15] According to petitioners, this geographic peculiarity means that the proposed transaction would create no synergies because there would be no opportunity to consolidate Iberdrola's operations with those of the New York subsidiaries. (The present discussion accepts for argument's sake the claim that no synergies will occur. However, Staff, MI, CPB, and SPM do not concede that point; in fact, SPM cites the possibility of synergies as an argument in favor of the transaction.[16] (See Part F.1., "Rationales in Support of PBAs," below, noting that the possibility of synergies is one of Staff's justifications for its proposed PBAs.) Therefore, petitioners conclude, this case cannot properly be analogized to energy company merger cases where the transaction offered potential synergy savings which the Commission identified and captured for customers' benefit.

Instead, petitioners and SPM maintain, the Iberdrola acquisition resembles water company mergers that the Commission has approved without proof of synergies, in which the only net benefits were intangible or unquantifiable expectations that the acquired utility company would partake in a larger parent

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[15] Tr. 643, 929-42. Petitioners are not using the term "first mover" in the conventional sense, i.e., to denote the first competitor that enters a market as distinguished from subsequent entrants.

[16] See, e.g., Staff's Reply Brief, p. 4.

company's management expertise and financing opportunities.[17] According to petitioners, it is mere happenstance that this is the Commission's first merger case involving neither synergies nor a water company. However, Staff is correct that the water company cases are not analogous to this case in any relevant sense.

For one thing, Staff observes, the water company decisions were not devoid of net benefits. For example, responding to petitioners' reliance on the UWR merger decision, Staff notes that the Commission not only treated the case as an opportunity to reinforce adequate service but also extracted financial benefits. These included continuation of a preexisting rate plan as a precondition of the UWR acquisition, even though UWR was not earning its allowed return; resulting rate increases below the inflation rate; and disallowance of

[17] Petitioners cite Case 07-W-0176, Aquarion Water Co. of New York, Inc., et al., Order Approving Corporate Restructuring and Transfers Subject to Conditions (issued April 19, 2007); Case 06-W-0244, United Water New York Inc. and United Water South County, Order Approving Merger and Adopting Three-Year Rate Plan (issued Dec. 14, 2006); Case 02-W-1447, Philadelphia Suburban Corp., et al., Order Authorizing Stock Transfer (issued March 11, 2003); Case 01-W-1949, Long Island Water Corp., et al., Order Adopting Terms of a Joint Proposal (issued Nov. 27, 2002); Case 01-W-1770, Aquarion Co. and New York-American Water Co., Inc., Order Adopting Terms of Joint Proposal and Approving Stock Transfer (issued April 17, 2002); and Case 99-W-1542, United Water Resources, Inc. and Lyonnaise American Holding, Inc., Order Approving Stock Acquisition (issued July 27, 2000) (as modified by Errata Notice issued Aug. 1, 2000). Petitioners' Initial Brief, p. 15, n. 6.

other provisions that would have diminished ratepayer credits or increased the return requirement.[18]

Moreover, in regulating water utilities, the Commission's preeminent objective in recent years has been to remedy those companies' acute difficulties in maintaining even minimally safe and adequate service. Staff cites the Commission's Statement of Policy on small water company mergers[19] to illustrate the Commission's concern that many New York water utilities must either charge high rates or radically improve their access to capital, operating expertise, and economies of scale, lest they breach their statutory service obligations including objective water quality standards enforced by other public authorities. Furtherance of these goals, given their critical importance, easily qualifies as a net benefit for purposes of a §70 analysis. Even then, Staff points out, Commission decisions intended to support the acquired water companies have not always succeeded in protecting customers from the risks of such acquisitions.[20]

In contrast, as Staff observes, NYSEG and RG&E suffer from no similarly acute operational or financial deficiencies,

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[18] Case 99-W-1542 - United Water Resources, Inc. and Lyonnaise American Holding, Inc., Order Approving Stock Acquisition (issued July 27, 2000) (as modified by Errata Notice issued Aug. 1, 2000).

[19] Case 93-W-0962, Acquisition and Merger of Small Water Utilities, Statement of Policy (issued August 8, 1994) ("water companies policy statement").

[20] Staff's Initial Brief, pp. 17-18, citing Case 01-W-1949, Long Island Water Corp., et al., Order Adopting Terms of a Joint Proposal (issued Nov. 27, 2002); and Case 06-W-0490, Thames Water Aqua US Holdings, Inc. - American Water Works Co., Inc Merger, Order Authorizing Reorganization and Associated Transactions (issued July 26, 2007).

such that the Iberdrola acquisition is needed to preserve the viability of utility companies whose independent survival otherwise might require substantial rate increases. On rebuttal, petitioners responded that electric utilities face challenges of their own. However, that response ignores the qualitative difference between those challenges, which Energy East and its subsidiaries can be expected to manage using their own resources as they have in the past, and the far more exigent predicaments common to water utilities. Petitioners' response also fails to consider or rebut other important distinguishing characteristics of water companies, alleged by MI: that water service accounts for only a small portion of customers' utility bills; water bills do not play a role comparable to energy bills in driving elastic customers to other states with lower utility costs than New York; customers have more interactions with energy utility bills; and service quality, safety, and reliability are more critical for energy service than for water service.[21]

Petitioners also question Staff's inferences from the water companies policy statement, observing that Long Island Water Corp.--acquired pursuant to the Commission's decision in one of the cited cases where no synergies were identified--is hardly a "small water company" like those addressed in the policy statement, as it is New York's largest and has 200,000 customers. But this only confirms the policy statement's relevance, by highlighting that even the largest water company is dwarfed by NYSEG and RG&E. (For example, Long Island Water's

[21] MI's Reply Brief, pp. 5-6. MI adds that water companies do not raise vertical market power concerns, but market power and other potential risks of the proposed transaction are beyond the scope of this section.

customer base is only about 17% of NYSEG and RG&E's combined.)[22] Long Island Water's need for a larger parent's support was commensurately greater.

For reasons discussed below (Part II.B., "Benefits of the Transaction"), the non-synergistic benefits that petitioners claim on behalf of the Iberdrola transaction are inadequate or not real. Therefore it is incorrect to equate them with the critically important benefits realized through the water company mergers. (Alternatively, at the risk of engaging in mere semantics, one could describe the water company mergers as synergistic in the sense that the acquisitions were expected to strengthen the acquired companies.) As a result, the water utility mergers cannot support petitioners' proposition that the Commission's interpretation of §70 in past cases eliminates the need for evidence of net benefits if there is no evidence of synergies.

While invoking supposedly non-synergistic water cases as the only analogous precedent, petitioners also seek to distinguish six energy company merger cases, on which Staff relies for the proposition that merger approval requires a demonstration of synergies and a capture of synergistic savings for customers' benefit. In reciting the energy mergers as precedent, Staff notes that the merger of Consolidated Edison Company with Orange & Rockland Utilities, Inc. was conditioned on a flow-through of 75% of synergy savings to customers starting on a date certain, in the context of a case where the Commission found no offsetting, unremediated risks to customers; the merger of Brooklyn Union Gas Company with Long Island Lighting Company required a flow-through of savings and revised

[22] http://www.nyseg.com/OurCompany/whoweare.html; http://www.rge.com/OurCompany/whoweare.html; visited 5/1/08.

earnings sharing mechanisms, again in a transaction that the Commission determined was risk-free for customers; the merger of Consolidated Edison and Northeast Utilities, Inc. required a 65% allocation of synergy savings to customers; the merger of National Grid Group PLC and Niagara Mohawk Power Corp., and that of NYSEG and RG&E with Energy East, were conditioned on rate plans that reflected synergy savings (augmented, in the case of Niagara Mohawk, with a write-off of stranded costs); and the merger of KeySpan and National Grid, on which Staff primarily relies, required both remediation of risks and a rate plan that captured synergy savings.[23]

Petitioners draw two distinctions between the six energy merger cases and the present case. First, they note that the energy cases each involved a negotiated joint proposal, implying that the companies in those cases offered customers a share of synergy savings only as a negotiating concession and not because PSL §70 compelled it. However, the criteria for Commission approval of a negotiated joint proposal's terms include a requirement that the terms fall within the range of likely litigated outcomes and that they conform with relevant Commission and State policies.[24] Thus, notwithstanding that the energy cases were negotiated, the decisions in those cases imply

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[23] Grid/KeySpan Order, supra; Case 01-M-0075, Niagara Mohawk Power Corporation and National Grid plc, Opinion No. 01-6 (issued December 3, 2001); Case 98-M-0961, Consolidated Edison and Orange and Rockland Utilities, Order Authorizing Merger (issued April 2, 1999); Case 97-M-0567, Long Island Lighting Co. and Brooklyn Union Gas Co., Opinion No. 98-9 (issued April 14, 1998); Case 00-M-0095, Consolidated Edison Company of New York, Inc. and Northeast Utilities, Opinion No. 00-14 (issued November 30, 2000).

[24] Cases 90-M-0255, et al., Procedures for Settlement and Stipulation Agreements, Opinion No. 92-2 (issued March 24, 1992).

that a full litigation process would have resulted in allocations of synergy savings to customers and that the negotiated allocations were consistent with the Commission's policy objectives. Therefore, contrary to petitioners' argument, it is irrelevant that the energy cases were not fully litigated.

3. Conclusion

Petitioners' other proposed distinction between the energy merger cases and this case, besides the absence of a negotiated proposal here, is that the synergy savings allocated to customers in those cases fundamentally differ from Staff's proposed positive benefit adjustments (PBAs) here because the PBAs are not based on any known, quantified synergies. Again, petitioners declare that synergies are impossibility in a geographic first mover transaction. Thus, under petitioners' reasoning, the PBAs are not a customer share of savings in any real sense but only an arbitrary "entry fee,"[25] which Staff seeks to extort as a cost of first mover transactions generically. Petitioners conclude that Staff's position is contrary to sound public policy, and therefore inconsistent with PSL §70 properly interpreted, because Staff's proposed cost of entry would tend to deter all non-synergistic transactions like petitioners' proposal here.

That, more than any other single argument by petitioners, serves to reveal the fundamental deficiency at the heart of their case. In saying it would be bad policy to interpret PSL §70 as requiring an extraction of customer benefits, petitioners implicitly claim that the transaction, as proposed, already offers unquantified net benefits which the State unwisely will forfeit if the transaction is disapproved

[25] Petitioners' Initial Brief, pp. 17, 18, 34.

and similar transactions are deterred. But petitioners' claim is plainly erroneous, for it presumes, a priori, an affirmative answer to the very question at issue: whether disapproval of the transaction would in fact work a forfeiture of public benefits. Conversely, petitioners unjustifiably presume a negative answer to the question whether disapproval would avert a net detriment to the state and thus serve the public interest, properly defined.

The transaction's proponents argue that, at some point, the cumulative burden of the conditions the Commission is asked to attach to the transaction becomes so onerous that the transaction must become economically unattractive from petitioners' perspective.[26] The argument is entirely credible, even if the tipping point into economic unacceptability is unknown to the Commission. But petitioners' argument misses the point: it ignores the possibility that, for reasons discussed throughout this recommended decision, the transaction as currently proposed would be detrimental to the public interest rather than beneficial. More simply stated, the question the Commission should ask is why the transaction, on balance, is worthwhile for anyone but petitioners, and this record provides no cogent answer.

The perspective recommended here is that the Commission should not waive the net benefits requirement imposed in previous energy merger cases, under a supposed "rule of necessity," in order to allow a non-synergistic transaction lest it become a lost opportunity. Instead, the Commission should disapprove the transaction precisely because its lack of potential synergies or other benefits (when combined with the

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[26] See, e.g., Petitioners' Reply Brief, note 88 (citing SPM's Initial Brief, p. 25) and accompanying text.

attendant risks) means that disapproval would avert a net detriment rather than forfeit an opportunity.[27] Contrary to petitioners' argument, disapproval of the transaction would not imply that approval was contingent on an arbitrary "entry fee." Instead, disapproval would recognize that a transaction cannot be given a free pass when it does not satisfy the net positive benefits requirement that consistently has been part of the Commission's interpretation of PSL §70.

B. Benefits of Transaction

1. Summary of the Benefits Asserted

The preceding section considers and rejects petitioners' argument that, for non-synergistic transactions, PSL §70 requires no proof of real and definite benefits. As noted above, petitioners' alternative argument is that, even if §70 did require net positive benefits, the transaction as currently proposed by petitioners would satisfy that more stringent test. This section concludes that it would not. (Section D, below, addresses Staff's proposed safeguards and PBAs, and adopts Staff's position that disapproval of the transaction would be preferable to approval with Staff's proposed preconditions.)

In presentations at four different stages of the proceeding, petitioners have put forward cumulative lists of benefits or offers associated with the proposed transaction. First, the initial petition asserts that the transaction would

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[27] Metaphorically speaking, while petitioners and the transaction's other proponents argue in effect that the Commission should not "look a gift horse in the mouth," actually the transaction is more the "white elephant" representing that some gifts are best refused.

confer five broad, intangible benefits upon Energy East or its customers (quoting as follows):

- Global Energy Experience – IBERDROLA is an innovative and diversified holder and manager of utility and other energy assets with a demonstrated commitment to infrastructure investment, service quality and sustainable development. The Energy East utility subsidiaries will benefit from IBERDROLA's global utility expertise.
- Focus on Efficiency and Environment – IBERDROLA brings to New York a significant focus on energy efficiency, clean technology and the environment, key goals of Governor Spitzer's "15 x 15" energy policy.[28] IBERDROLA strives to achieve its business objectives while meeting customer needs and addressing climate change, and New York will benefit from this corporate philosophy. Moreover, IBERDROLA has the expertise, capacity and resources that could, if requested or permitted, further the state's renewable energy goals.
- Financial Stability – NYSEG and RG&E will obtain the financial stability and other benefits of becoming subsidiaries of a multi-national, widely diversified utility holding company with a long-term Standard & Poor's "A" level credit rating.
- Commitment to Customer Service and Reliability – The Energy East utility subsidiaries will benefit from IBERDROLA's proven commitment to excellence in customer service and reliability.
- Commitment to Local Communities – IBERDROLA is committed to the local communities that it serves and will encourage

[28] Note (not in original): the nickname refers to the goal of a 15% reduction in actual electric demand relative to forecasted demand for 2015, a subject of the Commission's Energy Portfolio Standard proceeding currently underway in Case 07-M-0548. Governor Paterson, who chaired the New York State Renewable Energy Task Force as Lieutenant Governor, has continued the Administration's support of the 15 x 15 objective since becoming Governor on March 17, 2008. See, e.g., "Plan to cut energy use gets a lift from PSC," McClatchy Tribune Business News, March 20, 2008, http://powermarketers.netcontentinc.net/newsreader.asp?ppa=8knpp^\jijmsysTUfb!6<"bfen_v, visited May 9, 2008.

> NYSEG and RG&E to remain actively involved in community programs. Iberdrola will not seek any reduction in the level of any existing economic development initiatives in New York in connection with the Proposed Transaction.[29]

As part of the same summary, petitioners undertake to hold New York customers harmless by forgoing all rate recovery of the acquisition premium paid for Energy East stock, and other transaction costs; forgoing any change in the terms or conditions of service; and not relocating NYSEG’s or RG&E’s central or branch offices.[30]

Second, amplifying the theme that no harm would result from the transaction, petitioners filed testimony that the transaction would not eliminate jobs[31] and would leave Energy East employees’ preexisting wages and benefits substantially unchanged for at least 18 months.[32]

Third, petitioners’ March 14, 2008 Partial Acceptance document[33] offers five categories of benefit in the form of concessions which petitioners summarize as follows (paraphrasing):

- an earnings base write-off of $201.6 million, resulting in a permanent $54.8 million (4.4%) reduction in annual delivery rates;
- divestiture of five Energy East fossil fueled generating stations, including Russell Station, sharing with customers any above-book proceeds in a manner to be determined by the Commission;
- investment, through its subsidiary, Iberdrola Renovables, S.A. (Renewables), of at least $100 million in wind

[29] Exh. 41, pp. 2-3.

[30] Ibid., p. 3.

[31] Tr. 506.

[32] Petitioners’ Initial Brief, p. 28, note 22, and accompanying text, citing Tr. 524, 636, and 665-66.

[33] Exh. 50.

generation projects in New York, over the initial three years following the transaction;

- measures to address the reliability complaints in the municipal cooperatives' testimony; and
- measures to resolve the City of Rochester's concerns about management or disposition of RG&E properties in that city.[34]

These provisions are additional to 17 other stipulations in the Partial Acceptance, related to issues that petitioners categorize as transparency and reporting, data security, credit quality, capital structure, and affiliate transactions.[35] This recommended decision addresses the latter 17 concessions in various other contexts. Petitioners properly do not cite them as additional benefits of the transaction, for they are more in the nature of compromises offered to narrow the scope of contested issues by curing alleged deficiencies in the initial version of the proposed transaction.

In subsequent press announcements by Iberdrola, the $100 million figure for New York wind generation investment has been restated as $2 billion over five years, and then restated again as $10 billion over an unspecified period. On this record, it is unclear whether these statements represent a commitment different from the $100 million originally promised or whether the revised figures would affect the parties' positions. Parties have an opportunity to address this on exceptions.

Fourth, in response to arguments in the initial briefs, petitioners' reply brief offers additional concessions whereby petitioners would (paraphrasing):

- limit their retained share of above-book fossil plant auction proceeds (pursuant to the Partial Acceptance,

[34] Petitioners' Initial Brief, pp. 3, 19-24.

[35] Ibid., pp. 4-6.

above) to as little as a 10% sales incentive, if the Commission so directed, and flow through the customers' share in a manner to be proposed on the basis of a post-auction collaborative process;

- commit to continued or enhanced use of flexible rate contracts and other economic development incentives, as determined in future rate cases;
- engage in a collaborative process to discuss allocations of NYSEG's and RG&E's hydroelectric energy output;
- forgo, in future rate cases, recovery of any acquisition premium or transaction costs related to the Energy East/RG&E merger; and
- comply with the affiliate transaction rules (sometimes described as a code of conduct) previously established in the Energy East/RG&E merger case, with Iberdrola being substituted for Energy East as the party governed by the rules.[36]

Regarding all the concessions in the Partial Acceptance and in petitioners' reply brief, particularly the rate reduction, petitioners emphasize that they are voluntary in the sense that they exceed what petitioners consider to be the requirements of PSL §70.

2. Assessing the Benefits

a. Overview

All intervenors except Staff agree with petitioners, at least in some respects, that the asserted benefits summarized above are substantial and weigh in favor of the transaction. (As discussed in other contexts throughout this recommended decision, the intervenors hold diverse views regarding the extent, if any, to which the Commission should impose the PBAs and other conditions proposed in petitioners' Partial Acceptance or advocated by Staff.) At some points, Staff asserts that benefits are unworthy of consideration in a PSL §70 analysis if they are "intangible." This recommended decision avoids that

[36] Petitioners' Reply Brief, pp. 1-3 and Attachment 1.

terminology, as a possible source of confusion. Some benefits may be intangible, yet neither illusory nor insubstantial. In the water company merger cases, for example, Staff's own argument is that intangible benefits – such as management expertise or financial stability – were relevant and material in meeting the §70 standard. More substantively, the Staff Policy Panel has testified that §70 requires "some tangible positive benefits to ratepayers, in the form of lower rates, reduced costs or other monetary value."[37] MI expressly endorses that formulation, demonstrating at length that it is consistent with Commission precedent, particularly the Grid/KeySpan merger decision.[38] MI also cites a discussion of the Grid/KeySpan case at the Commission's August 15, 2007 session, for the proposition that the Commission applies a net benefits test in preference to a "no harm" test.[39]

However, this recommended decision presupposes that tangible, quantifiable benefits may be merely one component of a set of overall benefits that could satisfy §70. The Staff Policy Panel testimony quoted above does not exclude that possibility; and a formulation that admits the significance of intangible benefits is consistent with the Grid/KeySpan decision, which was premised on benefits including not only rate adjustments but also enhanced service quality incentives. On the other hand, vague or uncertain benefits, whether tangible or not, must be discounted in the §70 analysis.

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[37] Tr. 1148.

[38] Case 06-M-0878, <u>supra</u>; MI's Initial Brief, pp. 6 <u>et</u> <u>seq</u>.

[39] <u>Ibid.</u>, pp. 8-11. However, reliance on such discussion would violate the disclaimer that accompanies session transcripts.

b. Benefits per Petition

i. Expertise

For reasons stated by Staff, the five primary benefits advanced in the initial petition are not real or are insignificant. Regarding the first type of benefit – that which NYSEG and RG&E could derive from Iberdrola's "global energy expertise" – Staff and CPB correctly note that the benefits promised are not even identifiable, much less enforceable, especially because a theme of petitioners' testimony is that Iberdrola follows a laissez faire policy toward managements at operating subsidiaries. In petitioners' formulation, Iberdrola can enhance NYSEG's and RG&E's management without closely supervising them, "through sharing of information regarding best practices without interfering with the utilities' day-to-day affairs."[40] The promise of continued managerial autonomy for the Energy East subsidiaries, combined with the geographic remoteness of Iberdrola's supervision and the likelihood that existing local management could effectively identify and implement best practices on its own without access to Iberdrola's expertise, all tend to establish that the incremental benefit of that expertise would be insubstantial and elusive. As CPB says, Iberdrola's expertise provides an affirmative answer to a threshold question whether Iberdrola is qualified to manage Energy East, but it does not confer an affirmative benefit relevant to a PSL §70 analysis. Aside from expertise, SPM regards Iberdrola's global scope of operations as an inherent diversification of business risk; but that effect presumably is subsumed in the company's bond rating and favorable access to capital (addressed separately below).

[40] Tr. 514; Petitioners' Reply Brief, p. 13.

SPM says the record would benefit from a stronger acknowledgement of Iberdrola's commitment to employee training, which SPM documents in some detail and cites as a demonstration of the company's stability or its orientation toward a permanent presence in its industry. SPM adds that the Commission should take comfort from Iberdrola's values as summarized on its website, which include, among other things, commitments to corporate ethics and to creating "a climate of confidence" in its activities.[41] Here again, however, facts or opinions that speak to Iberdrola's qualifications as an owner of Energy East cannot automatically be considered benefits resulting from the proposed transaction.

ii. Environmental Propensities

The second broad category of benefits are Iberdrola's "corporate philosophy," resources, and expertise, which assertedly could support energy efficiency and environmental protection. The NRDC places a high value on Iberdrola's commitment to renewable energy, particularly the promise of a $100 million investment in New York wind generation, and says that it justifies approval of the transaction.[42] NRDC argues that the Commission should address the related vertical market power concerns, if any, "through procedural safeguards established to prevent them and not by preventing clean energy industries from moving to the state and helping the state meet its clean energy goals."[43] In support of clean energy as a public interest criterion, NRDC cites the Regional Greenhouse

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[41] SPM's Initial Brief, p. 8, quoting Iberdrola's Web site. SPM advises to go from the home page to "About Us", and then select the "Vision and Values" tab (visited May 14, 2008).

[42] NRDC's letter in lieu of Reply Brief, p. 1.

[43] NRDC's letter in lieu of Initial Brief, p. 2.

Gas Initiative (RGGI);[44] the goals of the Renewable Energy Task Force chaired by then Lieutenant-Governor Paterson, as described in a June 24, 2007 press release; and the demand for renewable energy supplies to meet the Renewable Portfolio Standard.[45]

DEC, while not expressly endorsing the transaction on brief, strongly advocates that the Commission give substantial weight to Iberdrola's potential role in renewable energy in New York. DEC links its recommendation to an broad array of policy initiatives additional to those cited by NRDC. It says that wind energy serves the State's paramount environmental task by reducing greenhouse gases and thus counteracting climate change; reduces dependency on fossil fuels; and ameliorates the adverse health and environmental impacts of fossil-fueled generation and their disproportionate effect on low-income New Yorkers. Therefore, DEC argues, wind energy is integral to a State energy policy that builds upon the Renewables Task Force (above) which calls for "a strategy to reap the benefits of New York's wind energy potential"; the RGGI (above); the Governor's Executive Order initiating a State Energy Plan, which expressly encourages consideration of, among other things, "clean and renewable energy resources";[46] the creation of an Office of Climate Change within DEC; the State Dormitory Authority's commitment to sustainability and green building;[47] and the Commission's Long Range Energy Resource Plan proceeding.[48]

Greater Rochester Enterprise agrees with petitioners that Iberdrola has a unique affinity for renewable energy which

[44] Draft regulations, 21 NYCRR Part 507 and 6 NYCRR Part 242.

[45] NRDC's letter in lieu of Initial Brief, pp. 1-2.

[46] Executive Order 2, April 9, 2008.

[47] DASNY press release, August 28, 2007.

[48] Case 07-E-1507.

"makes them ideal partners for New York and our economy." GRE opposes any restrictions on petitioners' ownership of generation beyond those proposed in the Partial Acceptance. It concludes that the public interest would be adequately served through and petitioners' guarantee of at least a $100 million investment in renewable energy in New York, when considered together with the PBAs offered in the Partial Acceptance (rather than the level proposed by Staff) and the promised retention of local jobs (discussed below).[49]

SPM likewise views Iberdrola's environmental orientation as a significant benefit, and cites references in the record suggesting that the company excels in that respect as indicated by objective rankings and various commendations.[50] SPM also refers to the statement on Iberdrola's website that the company strives to become distinguished among its peers for its environmental policies.

This recommended decision accepts for argument's sake the consensus, among all parties addressing the point, that development of wind energy resources is a desirable State policy. However, I recommend that Iberdrola's assets as a potential wind energy developer in New York should not be deemed benefits of the proposed transaction and therefore should not figure prominently in the Commission's determination. (In light of this recommendation, it becomes unnecessary to examine whether the parties' consensus is more convincing than the public comments received in opposition to wind development ("Public Input," above).) One reason is that Iberdrola's potential contribution loses most of its relevance for a PSL §70 analysis if, as explained elsewhere in this recommended decision

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[49] GRE letter in lieu of Initial Brief, pp. 1-2.

[50] SPM's Initial Brief, note 3, citing Tr. 480, 485-86.

(Part II.C.; "Vertical Market Power"), Iberdrola should not be allowed to develop wind generation in the NYSEG and RG&E service territories. Indeed, that recommendation is based on the conclusion that Iberdrola's wind enterprises, if coupled with its ownership of distribution companies pursuant to the proposed transaction, would be a public detriment rather than a benefit because they would impair the potential economic advantages of wind generation and deter potential competitors from developing wind energy resources.

Entirely regardless of whether the Commission accepts that conclusion, moreover, it is doubtful that Iberdrola's environmentally beneficial philosophy, resources, or expertise should be regarded as features linked to the proposed transaction. As Staff points out, environmentally friendly initiatives by Iberdrola in New York cannot logically be contingent on the transaction, because petitioners deny that acquisition of Energy East would create synergies with, e.g., Iberdrola's prospective wind generation projects; they deny that wind generation would produce federal production tax credits applicable as an offset to regulated revenue requirements; and the lack of a regulated distribution subsidiary has not deterred Iberdrola from investing in wind projects elsewhere (in Pennsylvania, Oregon, and Texas), nor has the acquisition of a regulated subsidiary induced Iberdrola to plan for wind projects (in Maine).

Therefore, Staff argues, Iberdrola's pursuit of its environmentalist ethos is unrelated to its status as owner or non-owner of transmission and distribution subsidiaries.

Petitioners deny the relevance of that observation, asserting that Iberdrola's renewables investment in a jurisdiction depends not on whether it owns a distribution company there but on whether it is "familiar with market opportunities and regulatory frameworks" in the territory and whether "regulators are receptive" to such investment.[51] As proof, they note that Iberdrola undertook major investments in the United Kingdom after acquiring Scottish Power. However, this rebuttal is unconvincing because it does not directly respond to Staff's point that Iberdrola's acquisition or non-acquisition of a distribution subsidiary has not determined whether the company considers itself to have the requisite marketing and regulatory expertise to achieve a "comfort level" conducive to renewables investment in Pennsylvania, Oregon, Texas, or Maine.

As for regulatory receptivity to investment by Iberdrola, that concept implies that Iberdrola is sensitive to a jurisdiction's overall regulatory climate. That may well be true; but it is not pertinent to the questions presented here, where the Commission is challenged not to maintain all the conditions of a friendly climate but only to make a discrete decision whether this specific transaction as proposed would be beneficial. That decision entails a detailed, realistic appraisal of all the transaction's likely positive and negative economic consequences. To the extent that the proponents would portray the Commission's decision in this case as a bellwether of its ability to cultivate economic growth and a healthy business climate, they seek to impute a level of symbolism disproportionate to the issues actually presented.[52]

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[51] Petitioners' Reply Brief, p. 80.

[52] See, e.g., Petitioners' Reply Brief note 95; SPM Initial Brief p. 22 ("One can imagine Iberdrola's shock at being subjected to such a contentious process .... Instead of being courted for its investment and expertise, Iberdrola is treated as a potential corporate terrorist ....").

For a large, sophisticated enterprise like Iberdrola, one should expect that major business decisions will depend at least as much on a jurisdiction's economic climate as on the perception of "regulators' receptivity." In particular, the prospect of wind development in New York – especially for Iberdrola, as compared with smaller, less entrepreneurially experienced developers – should be expected to depend instead on whether wind development in New York is economically attractive. In fact, as Staff points out, the economics are even more favorable in New York than in the other states where Iberdrola already has been induced to invest in wind generation, insofar as New York offers financial incentives for investment that will promote fulfillment of the Renewable Portfolio Standard.[53]

Moreover, one can expect that if the economics are attractive to Iberdrola, they are no less attractive to any other wind developer; and this hypothesis is confirmed by the fact that, as petitioners have argued, New York's backlog of wind project proposals already exceeds the State's capacity to absorb those projects' projected output.[54] Petitioners deny the significance of the backlog, on the ground that nearly half the proposals for projects since 1999 have been withdrawn and few have proceeded to construction. They say Iberdrola, in

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[53] Case 03-E-0188, Proceeding on Motion of the Commission Regarding a Retail Renewable Portfolio Standard, Order Approving Implementation Plan, Adopting Clarifications, and Modifying Environmental Disclosure Program (issued April 14, 2005).

[54] At year end 2007, there were about 7,000 MW of proposed wind generation projects in the New York Independent System Operator interconnection queue. NYISO 2007 Annual Report, Sec. 1, p. 22. (DEC, relying on the February 2008 Report of the Renewable Energy Task Force, reports the figure as "more than 5,000 MW." (DEC's Initial Brief, p. 4)).

contrast, has a track record of bringing wind projects into reality.[55]

According to petitioners' testimony, however, the factors that create uncertainty as to how many projects Iberdrola will build include "market conditions, regulatory approvals, available financing, etc."[56] Since all these factors can be expected to affect all wind developers at any given time, it is unclear how, or whether, Iberdrola differs from other developers in terms of the likelihood that it will complete a project. Petitioners might respond by pointing to their assertions that "Iberdrola is not just another player" but has uniquely large-scale wind operations and unparalleled resources.[57]

But the record provides no reasoned demonstration that other developers in the queue are less likely to bring their projects to fruition purely because they have more modest resources than Iberdrola. Conceivably, all developers, even those that pursue relatively limited projects, have the capability of executing whatever projects they propose if regulatory approvals are forthcoming. Nor does the record support even an intuitive reference that New York's reliance on developers less robust than Iberdrola would impede the fulfillment of the State's renewable energy goals, considering that the queue will include more capacity than the State can use even if the weakest developers abandon a substantial portion of the queued projects.

Indeed, although New York's commitment to develop a State energy plan was announced only two days before initial

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[55] Petitioners' Reply Brief, pp. 79-80, quoting Tr. 520, 665.

[56] Tr. 816.

[57] Petitioners' Reply Brief, p. 79.

briefs were filed in this case,[58] parties given more time could reasonably have argued that the queue itself is symptomatic of the lack of an energy plan defining the appropriate role and scale of wind energy in New York relative to other renewable and non-renewable resources. Under that view, a decision in this case calculated to affirmatively encourage Iberdrola's participation in wind development not only would be misconceived, for the reasons already discussed; it also might be premature, because the Commission's stronger encouragement of expanded wind energy may be exactly the sort of policy that should not be adopted without guidance from a State energy plan systematically formulated on the basis of participation by all interested parties. Under the instituting Executive Order, the draft plan and final plan respectively are to be issued March 31 and June 30, 2009,[59] meaning that the Commission could begin to rely on it less than a year after the decision in this case. If one accepts the premise that the Commission should approve the Iberdrola transaction because it represents a unique opportunity to obtain Iberdrola's participation in the wind industry, it would be an irreversible mistake to defer a decision about the Commission's proper role in wind development to next March or June; but the recommendation herein is that the Commission reject that premise for the reasons discussed above.

In summary, even under the doubtful supposition that the Commission's disapproval of the transaction would cause Iberdrola to move against its own business interests by forgoing economically viable investments in efficiency and renewables in New York, the presence of other firms adequately ensures that Iberdrola's withdrawal from this market would not deter such

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[58] Executive Order No. 2, supra.

[59] Ibid.

investments and therefore would not be inimical to the public interest. Finally, the presence of other developers proves that the benefits logically attributable to the transaction do not include Iberdrola's corporate attitudes or its ability to provide the expertise and resources necessary for implementation of New York's energy goals.

iii. Financial Strengths

The third category of benefits are the financial advantages said to be conferred on Iberdrola's subsidiaries by its status as a multinational, diversified firm with an "A" rating. (From the company's Web site, SPM offers the related claim that a hallmark of its operations is the fulfillment of financial objectives.) These benefits are potentially impermanent, for several reasons noted by Staff and CPB.

For example, Iberdrola's ascension in six years from the world's 19th largest utility company to the fourth largest, thanks to its $67 billion capitalization, was coincident with some of the other firms' equally precipitous declines in relative size.[60] This demonstrates that an enterprise such as Iberdrola can abruptly lose its dominant size, for reasons that have not been examined on this record and probably are too varied to identify or predict. Analogously, while Iberdrola's present credit ratings exceed those of Energy East and its subsidiaries, any number of developments could change that differential. Petitioners acknowledge that one cannot quantify the value of Iberdrola's currently superior creditworthiness relative to that of NYSEG and RG&E, according to petitioners' own testimony. Such value becomes all the more speculative when one attempts to factor in the equally unknown likelihood that Iberdrola's and the acquired companies' relative

[60] Exh. 42, sheets 33-34.

creditworthiness will change. Petitioners seek to diminish these concerns by asserting that a credit rating is a long-term view of anticipated future events affecting the firm under review (thus countering Staff's dismissal of credit ratings as mere "snapshots"); and that in response to market volatility over the past year, credit spreads for higher rated debt have remained more stable than for lower rated debt, and the differential between spreads on higher and lower rated debt has increased.[61] However, neither observation directly rebuts the concern that Iberdrola's rating itself is susceptible to decreases not adequately foreseeable by rating agencies.

iv. Service Quality

The fourth asserted benefit of the transaction – Iberdrola's "commitment to excellence" in service and reliability – is subject to the same criticism as the claim (discussed above) that the subsidiaries would benefit from Iberdrola's expertise as a global energy firm. As indicia of excellence, petitioners cite Iberdrola's 100 years' experience in the utility industry, its customer base of 24 million points of supply, and its relatively favorable Customer Average Interruption Index (CAIDI) and System Average Interruption Frequency Index (SAIFI). But here again, as Staff says, the prospect that Iberdrola would impart best practices to NYSEG and RG&E is clouded by the ambiguity of Iberdrola's policies regarding local managerial autonomy, its remoteness from the subsidiaries, and the impossibility of enforcing such an intangible, ill-defined commitment. Additionally, to the extent that Iberdrola's asserted expertise concerns customer service, the company presumably has no relevant experience in a North American climatic, cultural, and legal environment. Moreover,

[61] Petitioners' Reply Brief, note 101, citing Tr. 509.

petitioners cannot even show that Iberdrola's commitment surpasses that of NYSEG and RG&E if left to their own devices, as illustrated by petitioners' testimony that, at present, NYSEG and RG&E already seek out every opportunity to improve service. Finally, where service and reliability are concerned, the Commission has ample authority to impose appropriate standards in rate cases regardless of whether it approves the proposed transaction.

v. Commitment to Communities

The fifth general benefit asserted in the petition – Iberdrola's commitment to local communities – reveals itself, on examination, to be not a benefit but a hold harmless provision. That is, petitioners promise that NYSEG and RG&E will "remain actively involved in community programs" and that "existing economic development initiatives" will not be curtailed. Staff is correct in criticizing the commitment to community programs as unenforceable, because it is too vague to be monitored by reference to objective criteria. (The statement on Iberdrola's website that it cultivates "strong and permanent ties with its interest groups," cited by SPM,[62] is even more difficult to interpret.) Continuation of economic development initiatives, on the other hand, does lend itself to enforcement because such programs generally involve specific rates and discounts. However, with respect to community programs and economic development alike, petitioners' commitments are promises only to maintain the current status quo. Therefore they cannot properly be counted among the transaction's benefits, whether enforceable or not.

[62] SPM's Initial Brief, p. 8.

vi. Preserving the Status Quo

Finally, the additional commitments in the petition ancillary to the five broad promises above – viz., to forgo rate recovery of transaction costs including the premium for acquisition of Energy East, seek no change in the terms and conditions of service, and maintain the existing NYSEG and RG&E offices – likewise are hold harmless provisions that would preserve the status quo despite the transaction, and therefore should not be considered benefits of the transaction. Additionally, regarding non-recovery of the acquisition premium in particular, Staff and SPM show that petitioners err in seeking to rely on the Maine Public Utility Commission's analysis of that concession. According to petitioners, the Maine commission regards petitioners' waiver of recovery as a benefit of the Iberdrola transaction. But in fact, that commission's decision concludes that recovery of the acquisition premium would be unavailable, except to the extent that recovery could be funded from synergy savings. Since the identified synergy savings were applied to reduce the allowed revenue requirement, none were available to support recovery of the acquisition premium. Consequently, the waiver of recovery in Maine was a concession of purported rights that petitioners actually did not have under that commission's decision.

c. Benefits per Petitioners' Testimony

Moving beyond petitioners' presentation in the initial petition, the second set of asserted benefits appears in their testimony that jobs at NYSEG and RG&E would not be eliminated and that wages and employee benefits would remain unaffected for at least 18 months after the transaction closed.[63] For the

[63] Petitioners' Initial Brief, p. 28, citing Tr. 524, 636, 665-66.

following reasons, these commitments also deserve little weight for purposes of a PSL §70 analysis.

Initially, regarding job retention – as well as many of the other benefits discussed above – Staff and CPB say a lesson of the NYSEG/RG&E merger is that benefits promised in support of this transaction are unenforceable because similar commitments were effectively revoked upon closure of the NYSEG/RG&E transaction, by means of language in the Agreement and Plan of Merger that indirectly contradicted the commitments or recited that they would not survive the merger. Petitioners note that Staff's allegations of broken promises are part of a long-running dispute between Energy East and Staff, and have been challenged on rebuttal both here and in prior proceedings. Without the need to reexamine a Staff narrative that petitioners claim has been litigated before, it is fair to conclude that Staff's criticism is unconvincing because it could be overcome simply by means of careful drafting, in either a stipulation or the compliance filing (once the intended terms of the commitment are established). Some commitments are indeed unenforceable due to vagueness or subjectivity, as noted above, but objective requirements as to job retention, wages, and employee benefits ought to be reducible to explicit written guarantees.

Nevertheless, in their present form, petitioners' promises regarding jobs, wages, and benefits should not be counted as benefits of the transaction, either because they are vague and uncertain or because they are not attributable to the transaction. First, as Staff points out, the job retention commitment does not even purport to remain operative for any specific period after the transaction closes. More basically, Staff and CPB note that (as discussed above) the record is ambivalent as to whether Iberdrola favors or disfavors local managerial autonomy, and the resulting ambiguity makes it impossible to judge the duration of petitioners' commitment to maintain existing jobs for a given period or predict whether it means there would be literally no change in employment levels.

Moreover, these uncertainties are significant and unacceptable because utility employment practices and the terms and conditions of employment are affected by several constraints working at cross purposes. First, if NYSEG and RG&E voluntarily retained jobs beyond the merger date or left the terms of employment unchanged beyond 18 months, and thereby forfeited achievable efficiency gains, management would be violating its obligations to shareholders.

Second, if the Commission set expense and employee benefit allowances at a level calculated to wring out inefficiencies, as the "just and reasonable rates" standard probably requires, payroll and employee benefits would approach their optimum level from a ratemaking standpoint; therefore, commitments by petitioners inconsistent with that result would be contrary to the public interest as defined in the PSL's ratemaking provisions. Conversely, petitioners' witness Rude's testimony seems to explain the promise of employment stability by predicting that employment levels are more likely to increase, if anything, because NYSEG and RG&E will need additional labor to support capital programs and maintain service quality.[64] Again, however, assuming that the existing regulatory regime is well designed to encourage NYSEG and RG&E to pursue optimal labor efficiency, the workforce should be expected to increase or decrease in response to the companies' future needs and not as an outcome attributable to the Iberdrola transaction.

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[64] Petitioners' Initial Brief, note 97, citing Tr. 667-68.

Third, the relation between economic development (another promised benefit of the transaction) and, on the other hand, payroll and employee benefits calls for a complex, analytically difficult trade-off between the local economic benefit of full employment versus the local benefit of minimizing energy prices through the efficient use of labor inputs. Contrary to petitioners' objection, it is not at all "absurd" to question whether high employment at a utility company economically benefits the service territory; and it is a non sequitur for petitioners to suggest that the question is rendered absurd by the anticipated stability of utility employment after the transaction.[65]

Nucor's testimony, unchallenged in cross-examination, provides more reasoned documentation that New York manufacturing employment (as distinguished from utility employment in particular) is a powerful stimulus to job creation in other sectors and is inversely correlated with New York's costs of doing business including retail electricity prices.[66] To the extent that utility employment contributes to those costs in upstate New York, its benefit to the local economy has at least some tendency to exacerbate the overall loss of manufacturing employment in a part of the State where economic development is most acutely needed. For that reason, as well as uncertainty as to whether local Energy East management would determine workforce levels and whether the parent company in Spain would attach sufficient importance to economic conditions in upstate New York, Nucor shares Staff's skepticism about the efficacy of utility job retention as a benefit to economic development. (Nucor thinks it would be more valuable for the Commission to

[65] See Petitioners' Reply Brief, pp. 82-83.

[66] Tr. 711-13.

require specific commitments regarding rate design and other economic initiatives.)

Given these competing indications as to the desirability of workforce changes, a promise to maintain preexisting levels of employment, payroll, and employee benefits, on its face, would not necessarily serve the public interest within the meaning of PSL §70 even if petitioners had identified the duration and specific terms of their promise to retain jobs. And finally, as discussed above in connection with other purported benefits, these promises are another example of the hold harmless provisions that petitioners have mischaracterized as benefits when in fact they are not attributable to the transaction.

d. Benefits per Partial Acceptance

The third set of benefits that petitioners impute to the transaction are those offered in petitioners' Partial Acceptance document. As explained above, they include, first, permanent rate adjustments associated with $201.6 million of PBAs. The main issue arising from this offer is the disparity among the $201.6 million in concessions by petitioners, Staff's proposed $646.4 million of PBAs and its rate adjustments, and the supposed $1.6 billion of potential benefits which Staff cites as a basis for the PBAs. For reasons discussed elsewhere, this recommended decision accepts Staff's position regarding the PBAs. The $201.6 million will be addressed in that context, except to note here that the shortfall relative to Staff's $646.4 million prevents the petitioners' proposed concessions from being counted as a net benefit on behalf of the transaction.

The second offer in the Partial Acceptance is that Energy East would divest its fossil fueled generation. This recommended decision concludes that NYSEG and RG&E should be excluded from owning generation connected to their transmission and distribution systems. Petitioners' proposal will be addressed below as an aspect of the market power issue. However, just as $201.6 million in concessions does not constitute a benefit when offered as an alternative to $646.4 million, it would be inconsistent to categorize petitioners' limited divestiture offer as a benefit when offered in lieu of complete divestiture. As for petitioners' offer to share above-book auction proceeds with customers, while it is "beneficial" insofar as it obviates rate case litigation over the disposition of the proceeds, in a more substantive sense it is not a benefit contingent on the proposed transaction because it is merely an outcome that the Commission would have the authority to require regardless of whether petitioners proposed it as part of the transaction.[67]

Third, the Partial Acceptance proposes that Iberdrola invest at least $100 million in New York wind generation projects over three years. GRE and SPM count this as a significant benefit. Again, however, for reasons explained elsewhere, Iberdrola's involvement in generation would not be a public benefit. And even if it were, Staff and CPB observe, the offer is hedged with contingencies, related to economics and pricing,[68] sufficient to raise doubts that it would be enforceable.

Moreover, should the Commission determine (contrary to the recommendations herein) that Iberdrola's ownership of wind generation would confer a public benefit, Iberdrola says the $100 million "guaranteed" commitment is only a small fraction of

[67] Energy Ass'n v. PSC, 169 Misc.2d 924 (Sup. Ct. Alb. Cty. 1996).

[68] Partial Acceptance, p. 2.

a substantially greater amount the company intends to invest in wind generation in New York.[69] Based on petitioners' forecast of megawatts (MW) of New York wind generation planned by Iberdrola in the next five years, and petitioners' witness Azagra's estimate of development costs per MW, CPB calculates that the proposed $100 million investment over three years represents only 5% to 6% of Iberdrola's five-year wind development program.[70] Thus, as Staff asserts, the offer in the Partial Acceptance is merely that petitioners will pursue the few most profitable projects from among its plans, which, as such, would be the projects least contingent on Commission approval of the transaction. Considering the cherry-picking implicit in the $100 million investment, together with the economic attractiveness of wind investment generally for any firm regardless of whether it acquires NYSEG and RG&E (already cited above), the $100 million in particular should not be counted as a benefit logically attributable to the transaction.

Fourth, the Partial Acceptance provides that petitioners would undertake to remedy NYSEG's reliability shortcomings alleged in the municipal cooperatives' testimony, through measures such as a task force, a NYSEG transmission study, and adoption or consideration of new protocols for service restoration priorities, communications, and enforcement. This concession, endorsed by SPM, has induced the cooperatives to withdraw their opposition to the transaction; and, inasmuch as petitioners had challenged the cooperatives' complaints on rebuttal, the concession provides the benefit of eliminating a litigation issue. Nor is there any reason to question the cooperatives' judgment that petitioners' concessions adequately

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[69] Petitioners' Initial Brief, p. 25; Tr. 682 et seq.

[70] CPB's Initial Brief, p. 29, citing Tr. 626 and Exh. 57.

compensate them for dropping their opposition. For purposes of a PSL §70 analysis, however, the public benefit of addressing the reliability problems is insubstantial because the implicit promise to remedy those problems appears unenforceable should the parties' efforts fail; it is within the range of litigated outcomes likely to result if the cooperatives were to pursue a formal complaint before the Commission; and even if the concession is a benefit, it is not attributable to the transaction because, as petitioners themselves point out, the cooperatives' underlying reliability complaints involve only matters unrelated to the transaction.

Fifth and finally, the Partial Acceptance offers concessions to the City of Rochester regarding remediation and public access at old RG&E facilities, above-ground electric distribution facilities, and street lighting. As in the case of the reliability concessions (above), these offers (supported by SPM) have induced the City to withdraw its opposition and so they benefit the administrative process by narrowing the scope of litigation. Here again, however, the benefit of petitioners' commitment itself is insubstantial for PSL §70 purposes because the commitment is hedged with qualifications such that success or enforcement is not assured; the concessions are within the range of litigated outcomes if the City's issues were litigated; and the concessions are not attributable to the transaction, because the City's complaints themselves are unrelated to the transaction.

e. Benefits per Petitioners' Reply Brief

Because petitioners' fourth set of proposals appeared initially in their reply brief, other parties have had no opportunity to respond. This timing arguably was not improper on petitioners' part, as the proposals are in some degree responsive to the initial briefs and they serve to narrowing the scope of the issues. Nevertheless, the record probably would benefit from responsive comments in briefs on exception. To facilitate that process, the following are offered as tentative conclusions.

First, the proposal that shareholders forgo all but 10% of fossil plant auction proceeds differs only in degree from the proposal in the Partial Acceptance that an unspecified portion of the proceeds be shared with customers. Both versions of the proposal are subject to the criticism (discussed above) that the proposed sharing is not properly considered a benefit contingent on the proposed transaction, because the Commission has the authority to mandate sharing as a litigation outcome independent of the transaction.

Second, the commitment to pursue economic development rates and incentives as determined in rate cases responds to concerns such as those expressed by Nucor and Empire State Development. But, by its very terms, it would be merely an expected feature of the ratemaking process with or without the Iberdrola acquisition, rather than a benefit contingent on the proposed transaction.

Third, the same is true of hydropower allocation: the Commission's authority to mandate such allocations in a rate case includes the lesser authority to institute a collaborative process for that purpose. Indeed, it includes the authority to require that the process lead to a rate proposal, in contrast to petitioners' commitment only to engage in discussion. Here again, therefore, petitioners are not identifying a benefit of the transaction as such.

Fourth, the offer to forgo rate recovery of an acquisition premium or transaction costs related to the Energy East/RG&E merger, like the economic development rates offer (above), is merely a commitment to take a position within the range of possible litigated outcomes in a rate case. As such, it cannot be deemed a benefit contingent on the proposed transaction.

Finally, petitioners' initial brief proposes that Iberdrola be subjected to the code of conduct now applicable to Energy East pursuant to the Energy East/RG&E merger decision. For reasons discussed elsewhere, this recommended decision concludes that if the Commission approves the transaction, it should adopt the affiliate transaction rules proposed by Staff. Consequently, the less stringent rules applicable under petitioners' proposal offer less than adequate mitigation of the risks of the transaction and therefore should not be

C. Vertical Market Power (VMP)

The most contentious question in the case has been whether, if the Commission approves the transaction, it should impose conditions designed to prevent petitioners from exercising vertical market power (VMP). At issue are wind powered, fossil fueled, and hydropower generation facilities. Wind is the more extensively litigated issue and will be addressed first. Wind power was discussed above in the somewhat different context of whether Iberdrola's expertise in, and commitment to, renewables should be counted as a benefit that justifies the transaction in light of New York's own commitment to renewable energy resources. That part of the discussion concluded, among other things, that the economics of wind development should be just as attractive to providers other than Iberdrola who would not insist on conditions such as the proposed transaction. In the following section the emphasis is not so much on whether Iberdrola's participation as a renewable energy provider would be beneficial, but whether this opportunity to enlist Iberdrola's resources can be exploited consistently with sound policies and applicable precedent regarding VMP.

1. Wind Generation

a. VMP Issues

For wind power, the specific proposal in controversy is that the Commission, as a precondition of the transaction, limit the extent to which Iberdrola and its affiliates may own or operate wind generation. Affiliates would include at least NYSEG , RG&E, and Renewables. (They might also include other firms currently operating wind generation in New York. To avoid ambiguity, the following discussion assumes that the Commission would include these among the Iberdrola "affiliates" to be subject to ownership restrictions, although the parties have not expressly so stated.)

Staff advocates divestiture of all wind generation in New York by Iberdrola and, presumably, all the petitioners and their affiliates.[71] Petitioners, GRE, NRDC, and SPM oppose any such restrictions, NRDC at least implicitly and the others explicitly. CPB, MI, and DEC argue that petitioners should be free to engage in wind generation in a manner consistent with the Commission's VMP policies, a position that Staff reasonably interprets as meaning that no restrictions should be adopted except pursuant to a case-by-case review of specific wind project proposals. MI adds that its relatively permissive approach might be inappropriate in other contexts and may increase the customer risks in the transaction, thus necessitating more protections or customer benefits than would otherwise be appropriate. IPPNY says petitioners and their affiliates should be barred from owning any generation interconnected with NYSEG's or RG&E's transmission or

[71] See Tr. 1420.

distribution systems and any generation in New York that is subject to cost of service regulation, i.e., included in regulated rate base. In addition to the public input described above, Iberdrola's wind generation ownership also has engendered an unusual amount of commentary by editorial boards and public officials, uniformly opposing ownership restrictions as contrary to the State's interests and even "stone-headed." In response, Governor Paterson's administration has stressed that the Commission is expected to conduct a reasoned analysis of the issue on the merits.

The recommendation herein is that, if the Commission approves the transaction, it should impose a precondition that petitioners and their affiliates may not own or operate, and must divest, any wind generation interconnected with NYSEG's or RG&E's transmission or distribution facilities. In addition to the specific arguments discussed below, the general perspective underlying this conclusion is that all parties appear to recognize the great importance of including in the State's energy portfolio a sufficient proportion of renewable resources such as wind; and of encouraging economic growth, particularly in upstate areas such as the NYSEG and RG&E territories. Nor is this a case where those goals must be traded off against each other. However, the conclusions herein are that Iberdrola's ownership of wind generation in those territories would undermine both objectives, i.e., would interfere with the provision of economically priced wind energy and would encumber upstate economic growth with the dead weight of excessive energy prices.

These conclusions are counterintuitive, at least superficially, because it is difficult not to value petitioners' offer of a massive infrastructure investment (on the order of $100 million or $2 billion) more highly than the unquantified, intangible economic benefits to be expected from effective competition among energy providers and resources if the Commission takes the necessary steps to prevent petitioners from acquiring market power. Regardless of whether they are quantified, however, the economic benefits of competition are no less real than an immediate infrastructure investment. Indeed, it is axiomatic that an effectively functioning market will better serve the State’s environmental and economic growth objectives than one in which the Commission allows inefficiencies to occur through the exercise of market power. A secondary, but important, consideration involves symbolism: although petitioners and other proponents of the transaction warn that restrictions on Iberdrola’s wind ownership would signal that New York is hostile to investment, IPPNY notes that the Commission could issue a more genuinely “business friendly” signal by ensuring potential investors in energy facilities that they can expect fair treatment in New York because an offer like petitioners’ will not induce the Commission to waver in its commitment to maintaining a level playing field among competitors.

Similarly, some of the proponents argue for approval of the transaction as a symbol of the Commission’s commitment to renewables; but the prospect of fair competition among providers of renewable energy resources would provide a more inviting signal, without altering the fundamental economics that should make New York attractive to Iberdrola as an owner of generation even if the transaction does not occur. Petitioners claim that the ample queue of potential developers with wind project proposals disproves Staff’s argument that Iberdrola’s vertical integration under this transaction would deter competing investment; and SPM cites petitioners’ testimony that their witness had never detected any dampening of competitors’ interest in territories where Iberdrola already owns both transmission and distribution (T&D)operations and generation. However, the Commission's resolution of the VMP issues in this case is still awaited and therefore has yet to affect investors' perceptions, as Staff says; and Staff's testimony about investors in already vertically integrated markets is merely anecdotal and probably not even susceptible of proof.

Turning to the Commission's previous decisions on this subject, for about 13 years the Commission has pursued an effort to separate generation from T&D in the expectation that competitive generation moderates energy prices, encourages efficient choices among energy resources, enhances customer choice, and relieves customers of risks of generation investment that should be borne by investors.[72] The Commission spelled out role of this divestiture policy as an antidote to vertical market power in a 1998 policy statement, which defines vertical market power and includes the observation – of particular significance to this case – that divestiture of generation is a superior alternative to reliance on continuing regulatory supervision:

> In creating a competitive electric market, the Commission has viewed divestiture as a key means of achieving an environment where the incentives to abuse market power are minimized. Recognizing that vigilant regulatory oversight cannot timely identify and remedy all abuses, it is preferable to properly align incentives in the first instance. Vertical market power occurs when an entity that has market power in one stage of the production process leverages that power to gain advantage in a different stage of the production process. A transmission and distribution company (T&D company) with an affiliate owning generation may, in certain circumstances, be able to

[72] Case 94-E-0952 et al., Competitive Opportunities, Opinion No. 96-12 (May 20, 1996).

> adversely influence prices in that generator's market to the advantage of the combined operation.[73]

The policy statement goes on to provide that a T&D operator may rebut the presumption of VMP, essentially by showing that its T&D territory serves only a geographically small portion of the "energy market" in which it operates, that vertical integration will provide "substantial ratepayer benefits," and/or that the operator is offering mitigation measures.[74] NYSEG and RG&E operate a geographically vast T&D system, as Staff's testimony describes, such that petitioners have not claimed an exemption from the policy statement based on size. Nor have they provided an effective rebuttal based on customer benefits, because, as previously discussed, Iberdrola's acquisition of the T&D system has no valid causal relationship to its investment in upstate New York wind generation or vice versa. Instead, petitioners argue primarily that the VMP policy itself lacks relevance in this case or that it addresses arrangements other than what petitioners propose.

One of petitioners' arguments against the policy statement's application to this case is that the policy statement has been superseded by a lengthening history of regulation under the supervision of FERC and the NYISO. Petitioners cite an extensive array of FERC and NYISO regulations and oversight mechanisms which, they say, render obsolete and excessive the more radical remedy of divestiture. Similarly, SPM says it would be irrational, and therefore unlikely, for a generation owner such as Iberdrola to exploit

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[73] Cases 96-E-0900 et al., Orange & Rockland Utilities, Inc. - Rate Restructuring, App. I, Statement of Policy Regarding Vertical Market Power (July 17, 1998), p. 1.

[74] Ibid., pp. 1, 2.

market power for the assertedly minimal profits obtainable from wind generation, given the risk that regulators will discover and sanction such manipulation.

Staff and IPPNY provide two decisive counterarguments. One, the short answer, is that the Commission has reasserted the policy statement's preference for divestiture even against the background of the subsequently developed FERC and NYISO regulatory oversight regime. One example cited by Staff is the Commission's decision just last year to require KeySpan to divest the Ravenswood generating facility as a precondition of its merger with National Grid, partly because "a decision by us to rely solely on regulatory solutions would signal, and in fact would amount to, a weakening of our resolve to ensure a competitive generation market and its attendant benefits."[75] Initially, petitioners, through their witness on cross-examination, made a broad assertion that the Ravenswood divestiture could not rationally be justified by VMP concerns, to support their theory that the VMP policy statement has lost its relevance. CPB, for its part, suggests that the burden of proof to justify the Ravenswood divestiture was less onerous than the burden in this case because the Commission already had decided to require the Ravenswood divestiture in other proceedings before it received the KeySpan petition;[76] thus, according to CPB, the burden of proof belonged to the opponents of divestiture rather than the proponents, as here. However, the Commission's explanation in the divestiture order rules out

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[75] Case 06-M-0878, National Grid PLC and KeySpan Corp. – Petition, Order Authorizing Acquisition (September 17, 2007), p. 134.

[76] Case 96-E-0891, NYS Elec. & Gas Corp. – Electric Rate/Restructuring, Opinion No. 98-6 (issued March 5, 1998).

petitioners' interpretation and provides no explicit support for CPB's.

As a more factually based argument, petitioners would distinguish the Ravenswood plant from upstate wind generation on the basis that Ravenswood operates in a highly constrained area, in contrast to potential wind generation sites upstate. But, as discussed below, characterization of the wind generation cites as unconstrained or low-price leads to faulty conclusions for purposes of this proceeding. Petitioners also note that, in the same decision that required the Ravenswood divestiture, KeySpan—despite being one of the T&D operators in the merger—was allowed to continue operating generation under long-term contracts with LIPA. Petitioners seem to argue (possibly as rebuttal to an unrelated argument by IPPNY) that a long-term contract involving a T&D operator is analogous to vertical integration because the parties can exert control over price, and thus mitigate the risk of energy market price changes, as would an equity investor in the generating project. Thus, petitioners apparently see the Commission's toleration of the long-term LIPA contracts as a sign of increased acceptance of vertical integration or a weakening of the policy statement's presumption against it. Petitioners draw similar inferences from the Electric Resource Plan case, where the Commission commented on the need for long-term contracts as an incentive to investment in generation.

However, any analogy between long-term contracts and equity ownership is irrelevant for purposes of the VMP issue. As the cross-examination illustrated, the undesirable effects of generation ownership by a vertically integrated T&D operator include the T&D company's ability to recover from its customers the excess costs associated with its market power, such as costs caused by the T&D owner's inefficiencies or the absence of competing energy providers that could offer lower prices.

Nothing inherent in a long-term contract, however, provides the T&D operator those advantages. Thus, Staff justly characterizes the reference to long-term contracts in the Electric Resource Plan case as completely irrelevant to the VMP policy statement. The same can even more readily be said of the LIPA contracts allowed in the KeySpan merger case, where the dispositive fact was that the contracts were regulated by FERC. Indeed, the Electric Resource Plan decision expressly cites the Commission's continuing concern that utilities' ownership of generation would impose excessive costs on customers.[77]

The second objection to petitioners' invocation of FERC and NYISO oversight, aside from the Commission's adherence to the VMP policy statement in recent cases, is the substantive principle that regulatory micromanagement is unlikely to be the more effective option if, as here, the Commission can instead use a remedy such as divestiture to remove the underlying incentives for the type of behavior the regulations are intended to police. Staff describes some uses of market power as too "subtle" to be detected by regulators, leading petitioners to downplay Staff's concerns as fanciful.[78] However, the policy statement itself gives two examples of conduct that would have a real and significant effect on prices notwithstanding its subtlety.

One is that the vertically integrated owner of generation and T&D facilities can make it difficult for competitive generators to interconnect with the grid. Staff and IPPNY, citing examples such as RG&E's divested Ginna generating plant and the service disruptions complained of by NYAPP and

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[77] Cases 07-E-1507 et al., Long-Range Electric Resource Plan, Order Initiating Electricity Reliability and Infrastructure Planning (issued December 24, 2007), p. 5.

[78] Petitioners' Reply Brief, p. 24-25.

NYSRECA, offer illustrations of how grid access is inherently vulnerable to conduct by the T&D operator. These range from active biases in favor of the T&D operator's own generation to mere indifference or nonfeasance in response to other generators' needs. The point is not that market power actually has induced NYSEG or RG&E to engage in such discrimination – which petitioners deny – but, again, that reliance on regulation instead of divestiture creates the preconditions of this type of mischief, to the detriment of customers whose energy prices are inflated insofar as competitive generators are excluded from the market. As Staff points out, such conduct likely will not attract regulatory attention and, in the absence of imprudence, will not lead to sanctions; or, even if it does, any ex post remedy will be too late to prevent the harm.

Another possible effect of market power, cited as the second example in the policy statement, is that a vertically integrated T&D operator on the high cost side of a transmission constraint will have an incentive to "maintain" the constraint and thus exclude lower cost energy supplies from its market.[79] What makes this type of conduct subtle and resistant to regulatory remedies is that perpetuation of a constraint most likely will occur passively through nonfeasance; that is, the vertically integrated T&D operator will have a disincentive to build a transmission line, for example, that would relieve the constraint. In this case, the parties opposing divestiture make much of the fact that the NYSEG and RG&E territories are on the low-cost ("unconstrained") side of the Central-East transmission interface, as if that obviates the policy statement's expressed concern about a vertically integrated utility on the high-cost

[79] Cases 96-E-0900 et al., Orange & Rockland Utilities, Inc. - Rate Restructuring, App. I, Statement of Policy Regarding Vertical Market Power (July 17, 1998), p. 1.

side. Ignored in this framing of the issue, however, is that energy transmission crosses state boundaries, so that the NYSEG and RG&E territories can be not only the low-cost side relative to the Central-East constraint, but also simultaneously the high-cost side relative to lower cost supplies from PJM or Canada. These lower cost supplies may be excluded from the NYSEG and RG&E territories due to transmission constraints. Therefore, as Staff explains, those territories are not immune to the anticompetitive impact of the undetectable “transmission line that doesn’t get built,” a facility whose very nonexistence perpetuates inflated energy prices for New Yorkers because the vertically integrated T&D operator in those territories has a disincentive to build and faces no regulatory penalty for failure to build. Staff points out that vertical integration similarly creates a disincentive to effective implementation of demand-side management programs.

It also is important to consider that, although the relative prices of competing supplies may vary over time – so that, for example, a transmission reinforcement that might become necessary sometime in the future has no strong economic justification today – approval of vertical integration for Iberdrola may be relatively permanent, or at least difficult to reverse in response to new developments affecting the NYSEG and RG&E territories’ access to lower cost supplies. Even if the Commission believes that the Central-East interface is the only relevant transmission constraint at this time, Iberdrola’s vertical integration would hobble the Commission’s ability to maintain competitive markets if (as is likely) market conditions evolve in an unforeseen manner.

Staff and IPPNY observe that yet another shortcoming of regulatory supervision, as opposed to divestiture, is the exemption of wind generation units no larger than 80 MW (by operation of PSL §2(2-b)) from the Commission review process that might otherwise lead to disapproval of individual projects on VMP grounds. CPB describes the statute as an expression of legislative intent to exempt such plants from a VMP analysis. In a related, but broader argument, CPB questions why the Commission should bar NYSEG and RG&E from constructing generation while no other New York utility is similarly constrained. However, CPB cites no evidence that the statute's intended purpose was to allow vertical integration, whereas many other potential purposes readily come to mind. As for the selective imposition of restrictions on NYSEG and RG&E, IPPNY responds that these are the only T&D utilities that have proposed to build or acquire generation in the 12 years since issuance of the VMP policy statement (except Con Edison's East River Repowering Project, which was justified as supporting a load pocket). IPPNY argues correctly that suspension of the policy statement for NYSEG and RG&E, rather than elevating those companies to the same status as New York's other T&D companies, would offer the latter the possibility of a privilege they do not currently enjoy and open the floodgates to permit applications completely contrary to the competition policies the Commission has expressed in the policy statement and followed until now.

Another issue concerning regulatory intervention is the claim, by petitioners, GRE, and SPM, that the policy statement has been rendered irrelevant in this case by FERC's approval of the proposed transaction. Staff and IPPNY respond that the FERC decision says "the New York Commission is the appropriate body to determine whether the merger is consistent with the [policy statement]."[80] Thus, while it may be unclear what specific questions FERC intended to leave for this Commission's consideration, FERC clearly did not intend to preempt an application of the policy statement.

NRDC argues that the transaction presents no "serious market power issues … since demand for renewable energy is driven by the requirements of the Renewable Portfolio Standard."[81] It is unclear how this should affect the analysis because, where market power is a problem, demand is one component of the problem regardless of what causes the demand. In any event, although there are some retail access arrangements in which customers can elect to pay differing prices for energy from renewable versus non-renewable resources, energy from renewable resources is not a distinct energy product for which the demand moves independently of demand in other energy markets.

b. Other Market Power Issues

Some of the remaining arguments, by petitioners and Staff alike, seem relevant only to possible horizontal market power concerns which no party actually has raised directly. While the policy statement addresses vertical market power, resulting from a firm's integration of multiple production phases such as T&D and generation, horizontal market power enables a firm to profit from its dominance over a single enterprise such as generation or a commodity such as wind turbine components. Thus, as long as the issue is VMP, it is difficult to see the relevance of the arguments by petitioners and other opponents of divestiture that Iberdrola-affiliated

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[80] National Grid plc, KeySpan Corporation, 117 FERC ¶61,080 at ¶48 (2006).

[81] NRDC's letter in lieu of reply brief, p. 1.

wind generators would be price takers, would generate less output than their rated capacity because wind is intermittent, could sell only in real time rather than into the day-ahead market, and could not constitute more than a minor percentage of New York’s generating capacity.

The magnitude of wind-powered output might give the appearance of being a VMP issue insofar as petitioners argue that the output is insufficient to affect market-clearing prices or contribute to NYISO congestion. In reality, however, the market clearing price under NYISO bidding procedures is determined by the highest bid regardless of how much wind or other resources may be available or marginal; and, as discussed previously, the potential for exercise of VMP in the NYSEG and RG&E territories is not contingent on the existing pattern of transmission constraints.

Likewise, Staff’s claims concerning Iberdrola’s allegedly surreptitious extension of its control over other affiliates in which it has an interest, such as Gamesa, appear to have little significance except as an incipient horizontal market power issue that never was fully developed on this record. These affiliate relationships may raise concerns about Iberdrola’s competitive practices or the amenability of its activities to regulatory oversight, as Staff says, but such concerns can be viewed as aspects of the transaction risks discussed elsewhere in this recommended decision rather than as VMP problems.

c. Scope of Remedies

The remaining issues related to wind generation (and, in some instances, fossil fueled and hydropower generation) involve the nature and extent of remedies the Commission might impose pursuant to the VMP policy statement if it approved the merger transaction. First, while Staff is the only party advocating a statewide prohibition against petitioners' ownership of wind generation, Staff seems to offer no express rationale for extending the restriction statewide instead of limiting only interconnection between petitioners' generation and their T&D facilities (as IPPNY proposes). The other parties, favoring either a narrower prohibition or none, likewise have not explained why a statewide prohibition is necessary; nor is it clear whether Iberdrola affiliates, based on siting or financial considerations, would have an interest in retaining or expanding their investment in New York wind generation projects outside the NYSEG and RG&E territories if the transaction were approved with or without conditions.

The recommendation here, without the benefit of further discussion on exceptions, is that the Commission (if it approves the transaction) should prohibit petitioners and Iberdrola's affiliates from owning generation but only if it is interconnected with their T&D facilities. Staff has identified no scenario in which ownership of generation interconnected elsewhere in New York would subvert the Commission's objectives, in its VMP policy statement or related decisions, by actually creating market power. (The Ravenswood divestiture has been cited to support a contrary inference. However, that decision is distinguishable from the present case, for reasons noted previously and also because National Grid's operation of its transmission system would have enabled it to use Ravenswood to exercise VMP even though the plant is outside the Grid and KeySpan service territories.) Instead, the only rationale for a statewide ownership restriction seems to be symbolic, in the sense that it would convey the seriousness of the Commission's commitment to excluding T&D owners from the generation function; or procedural, on the theory that the policy statement gives petitioners the burden of rebutting a presumption of market power. The symbolism communicated by a statewide prohibition, in the absence of a credible market power scenario to support it, would not be worth the resulting connotations that the Commission is unreceptive toward infrastructure investment or indifferent toward expansion of renewable energy resources. As for the rebuttable presumption, petitioners should not be assigned the burden of proof regarding generation unconnected to their own T&D grid, because nothing in the policy statement seems to imply a presumption that generation ownership creates market power in that circumstance.

A second issue is that SPM offers three alternative proposals for divestiture of wind generation. (1) The Iberdrola affiliate (Renewables) could enter a long-term contract with NYSEG or RG&E for each wind project at a fixed per-kWh rate (subject to operating and maintenance expense adjustments) calculated to compensate investors for the special risks of wind investment; the rate would be negotiated or determined by the Commission for individual projects in the permit process; the rate would be offered to other developers unaffiliated with Iberdrola, unless they opted for a market based rate; and the non-Iberdrola developers could interconnect with petitioners' T&D grids under the supervision of a "special monitor" or the NYISO; (2) Renewables could enter such a contract with a third party rather than the T&D companies; and (3) petitioners could be required to divest the RG&E and NYSEG transmission assets. Parties have an opportunity to respond to these proposals on exceptions, as they did not appear initially until SPM's reply brief.

A third issue, addressed in this section for convenience' sake, although it is relevant to fossil and hydro generation as well, is IPPNY's contention that approval of the transaction should be conditioned on a prohibition against petitioners' ownership of generating plants subject to cost of service regulation wherever located in New York. IPPNY supports its proposal by noting that no party has attempted to rebut the policy statement's VMP presumption with respect to fossil or hydro units. IPPNY also argues that inclusion of generation in rate base exposes customers to rate recovery of project cost overruns, citing the East River Repowering Project, where the Commission capped allowable expenditures at $788 million, far exceeding the original $406 million estimate; and RG&E's Rochester Transmission Project, approved at an estimated cost of $75 million and currently estimated to cost $125 million.[82]

The recommendation here is that the Commission not impose the general prohibition advocated by IPPNY. While the harm of VMP from the customers' standpoint is that it enables a vertically integrated firm to recover from customers the costs of its own inefficiency, such as project cost overruns (short of imprudence), the mere existence of such costs does not establish VMP or trigger an application of the policy statement. If the prospect of cost overruns per se raises no VMP issue, its use as a rationale for a complete prohibition against petitioners' ownership of regulated generation in New York would create at least an appearance of discrimination against NYSEG and RG&E for which the Commission would have relatively little rational, legally defensible basis. Meanwhile, if the Commission adopts the recommendation herein that (as IPPNY contends) VMP concerns justify a prohibition against petitioners' and affiliates' ownership of generation interconnected with their T&D grid, the

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[82] Data in IPPNY's Initial Brief, notes 44 and 46 and accompanying text, citing Case 05-S-1376, Consolidated Edison Co. of N.Y., Inc. – Rates, Order Determining Revenue Requirement and Rate Design (issued September 22, 2006) and Case 03-T-1385, RG&E Corp. – Russell – RTP Project, Order Granting Certificate (issued December 16, 2004).

interconnection criterion obviates IPPNY’s proposed criterion based on cost of service regulation.

Finally, the parties favoring divestiture of Iberdrola affiliates’ existing wind projects have not addressed the specifics of how the divestiture might be accomplished, as they have in the case of fossil and hydro generation. This omission is appropriate insofar as customers, having contributed no capital to the projects, have no direct interest in the financial terms of a divestiture. However, they may have an interest in the timing of the process, especially in view of some parties’ expressed dissatisfaction with the Russell generating station divestiture process. Also, as noted above, it is unclear whether parties would accept the continued ownership of wind generation in which an Iberdrola affiliate other than Renewables has a controlling interest. Absent alternate proposals on exceptions, the recommendation here is that, if divestiture is required, all wind facilities owned by Renewables or other Iberdrola affiliates should be divested on the same schedule as RG&E’s fossil fueled facilities.

2. Fossil Fueled Generation

If the Commission approves the transaction, petitioners’ Partial Acceptance offers to divest all fossil generation owned by Energy East and merchant generator Cayuga Energy, comprising 257 MW at Russell Station and 158 MW at four other units.[83] According to the Partial Acceptance, any above-book proceeds from sale of the Energy East plants would be shared with customers in a manner to be determined by the

[83] One of the units is designated in the Partial Acceptance as “the 14 MW Peaker Station 9.” Petitioners should verify this on exceptions because, as MI notes, an interrogatory response referred instead to Peaker Station 4. MI’s Initial Brief, note 49.

Commission. This offer has been superseded by petitioners' proposal, among the additional concessions in their reply brief, that shareholders retain as little as 10% of the proceeds if the Commission so directs; and that the remainder be flowed through to customers in a manner to be proposed on the basis of a post-auction collaborative process.

GRE, MI, CPB, and SPM have endorsed the Partial Acceptance's provisions on fossil-fueled generation as a complete remedy for any VMP concerns, obviating the divestiture of wind and hydro generation (discussed in the preceding and succeeding sections). CPB urges that the Commission allow enough time for design of the auction protocol to ensure that the sales generate the maximum potential proceeds and that artificial time limits do not give undue leverage to potential buyers. IPPNY, on the other hand, urges a requirement that the sale be completed within nine months to avoid a prolonged process like the Russell Station divestiture. The best solution may be to initiate the collaborative at the conclusion of this case, rather than after the auction as petitioners propose, so the parties will have an opportunity to return to the Commission with a proposed protocol and timetable that the parties have thoroughly considered instead of litigating the matter at the exceptions stage in this case.

Because petitioners' proposed 10% auction incentive appeared initially in their reply brief, no party has yet addressed it directly. MI had suggested an incentive limited to the lesser of 5% or $3 million, citing the 5% approved by the Commission for RG&E's divestiture of the Ginna generating plant and the precedents, noted by the Commission at that time, ranging from 5% to 15%.[84] CPB cites the same Ginna decision to support a 10% incentive,[85] although the shareholders' 10% was subject to a $10 million cap which effectively reduced it to the 5% advocated here by MI. This record offers little support for adopting one incentive or cap rather than another, because, for example, it does not suggest whether divestiture of Energy East's fossil generation would be more or less complex or difficult than the Ginna sale. Here again, the parties more likely can identify the optimum percentage incentive and dollar cap by means of an auction planning collaborative at the close of this proceeding than through litigation on exceptions.

3. Hydropower Generation

NYSEG and RG&E own about 118 MW of hydropower generation at eight locations.[86] Staff and IPPNY advocate that the Commission require divestiture of these facilities as a precondition of the transaction. Petitioners oppose such a requirement and (as noted above) GRE, MI, CPB, and SPM contend that divestiture of fossil units pursuant to the Partial Acceptance would satisfy VMP concerns. The recommendation herein is that the Commission require divestiture of the hydro generation as well.

Petitioners' analysis of the issue is basically that concerns about VMP in this case are overstated. However, for reasons discussed above, such concerns do require the Commission intervention in furtherance of its policies against ownership of generation interconnected with the owner's T&D system. Petitioners and CPB also contrast the hydro facilities with the

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[84] Cases 03-E-0765 et al., RG&E Corp. – Rates, Order Adopting Provisions of Joint Proposals (issued May 20, 2004), p. 21.

[85] Ibid., note 31.

[86] IPPNY's Initial Brief, note 10.

Ravenswood unit whose divestiture was required in the Grid/KeySpan merger, on the ground that the former are small, sub-marginal units on the low-priced side of a transmission constraint; but, as discussed above in connection with wind generation, these distinctions do not provide a valid rationale for dismissing Ravenswood as a unique and irrelevant case.

From a procedural perspective, indirectly responding to IPPNY's observation that the VMP policy statement's rebuttable presumption of VMP has not been the subject of rebuttal from any party in the hydropower context, CPB says the proponents of hydropower divestiture bear the burden of proof because the Commission deliberately chose not to require divestiture when it reviewed NYSEG's and RG&E's restructuring proposals in 1998.[87] (In that sense, according to CPB, the burden of proof here is opposite to that prevailing in the Grid/KeySpan merger case concerning the Ravenswood plant, which the Commission previously had decided should be divested.) More fundamentally, petitioners and CPB deny that hydropower divestiture is even an appropriate subject for consideration in this case, as there is no causal connection between the proposed transaction and Energy East's pre-existing ownership of these units.

However, these arguments are misguided. First, in the orders requiring divestiture of NYSEG's and RG&E's non-hydro units in 1998, there seems to be no indication of a principled decision against divestiture of hydropower. Rather, the orders can more reasonably be read as decisions by the Commission to

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[87] Case 96-E-0891, NYS Elec. & Gas Corp. – Electric Rate/Restructuring, Opinion No. 98-6 (issued March 5, 1998); Case 96-E-0898, Rochester Gas & Elec. Corp. – Electric Rate/Restructuring, Opinion No. 98-1 (issued January 14, 1998).

proceed incrementally, as it commonly does, by dealing with non-hydro units first without foreclosing additional measures to further implement the policy of separating generation from T&D ownership in the future. Second, as IPPNY says, this case offers the Commission a favorable opportunity to consider such additional measures because the wind and fossil generation aspects already have created an occasion to review Energy East's entire generation portfolio as it relates to VMP issues. To exclude hydropower from the analysis, essentially on the ground that the Commission has never examined it before, would compel the Commission to arbitrarily ignore a significant portion of that portfolio.

On a more substantive level, petitioners and CPB (and Nucor, in its testimony) argue that Energy East's continuing ownership of these facilities will confer a benefit on customers by generating net margins which partially offset RG&E and NYSEG delivery rates. However, absent further explanation on exceptions, it is not clear that retention would be economically more beneficial for customers than divestiture. First, Energy East could capture the economic benefits of hydropower on behalf of its customers by entering into supply contracts with the new owners of the divested plants, thus offsetting at least some of the loss of the direct benefits that are available under Energy East's ownership at present. Second, as Staff and IPPNY observe, customers would have the opportunity to retain a share of the auction proceeds. Third, IPPNY cites RG&E's plans to upgrade its Genesee River hydro generation as an illustration that divestiture would relieve customers of the risks, capital expenditures including potential cost overruns, and operating and maintenance expense associated with continued ownership by Energy East. Finally, of course, divestiture would assure customers the unquantified but real benefit of eliminating a source of VMP, with its attendant inefficiencies and excess costs, while issuing potential investors a clear signal of the Commission's commitment to maintaining effective competition in New York.

D. Transaction Risks and Customer Safeguards

From their review and evaluation of the proposed transaction and Iberdrola, several parties are concerned about the risks presented for NYSEG, RG&E and utility customers.

1. Risks

a. DPS Staff

DPS Staff is concerned about Iberdrola's vast and complex corporate structure which spans three continents and includes many regulated firms and competitive holdings. Staff does not believe that NYSEG and RG&E are adequately protected to operate in this corporate environment without a ring-fencing mechanism like the one the Commission implemented in the case involving National Grid's acquisition of KeySpan Corporation.[88]

Staff does not accept petitioners' assertion that the traditional "regulatory compact" will provide utility customers in New York adequate protection from any potential holding company abuse. Staff doubts that a regulatory compact would have served well 30 years ago when full and traditional ratemaking prevailed. Moreover, in today's circumstances, it believes that any such compact cannot withstand Iberdrola's capability to operate beyond the Commission's control. As a

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[88] Ring-fencing conditions included in an order permitting Iberdrola to acquire NYSEG and RG&E would draw a clear demarcation line between these regulated operations and the remainder of the holding company structure. Such conditions would limit the potential for inter-company subsidization, cash transfers and any other means the parent or an affiliate could use to impair the financial health of the regulated firms.

matter of law, DPS Staff does not believe New York courts recognize any regulatory compact not found in the provisions of the Public Service Law.

Staff fears that the holding company, and its affiliates, would cause service degradation for utility service customers. It believes the Commission should require a limited purpose entity or a “golden share” mechanism similar to the one that was used for the merger of the Mid-American Energy Holding Company and PacifiCorp.

In contrast to the financial strength and economic benefits Iberdrola has claimed, Staff sees an onset of holding company risks for utility consumers. It states that Iberdrola is a much larger and more involved business organization than is Energy East. With its many holdings and complex business arrangements, Staff believes that Iberdrola could expose the utility companies to risks that are not present in the current holding company structure. Staff notes that Iberdrola frequently acquires and divests firms and Staff believes it would be difficult for the Commission to exercise its regulatory oversight in this environment.

Staff cites fines and sanctions that have been imposed on Iberdrola as evidence of a troubling pattern of poor regulatory compliance. In 2000, numerous complaints were filed in Spain about the interconnection practices of Iberdrola’s delivery utilities. Staff also points to a $50 million fine imposed in Spain, in 2007, for market power abuse in the generation sector.

According to Staff, communications with Iberdrola’s holding company headquarters in Spain can be difficult, and the firm has not always provided prompt translations of its Spanish documents that are needed for regulatory purposes. To improve the transparency of Iberdrola’s operations and corporate relationships, Staff believes that Iberdrola must provide its business information to the Commission in English.

Staff is also concerned that, with its vast holdings, Iberdrola may engage in improper cross-subsidizations. In contrast to the 53% portion of the Energy East holding company structure composed of NYSEG and RG&E, the two New York utilities would only amount to 9% of Iberdrola's total business operations. In this environment, Staff believes there could be cost shifting from competitive firms to the regulated companies.

According to Staff, the complexity of Iberdrola's operations presents a real risk that transactions with NYSEG and RG&E may not be susceptible to adequate audit and examination by regulators. It believes that the tracking of intricate business dealings and complex ownership interests could easily strain Staff's resources and the transactions with affiliates would remain obscure. Staff states that it has made financial inquiries about Iberdrola affiliates in the United States and, to date, it has not been able to ascertain their true financial circumstances due to the complex arrangements. It states that the firms' debt structure is so involved that it is beyond Staff's ability to monitor. Staff states further that it has been unable to determine whether any cross-subsidization risks are present among this group of subsidiary companies.

Staff is also concerned about Iberdrola exercising market power, and engaging in cross-subsidization and preferential practices, in the renewable energy market. It points out that Iberdrola has interests in wind developers and in Community Energy, a firm that has an exclusive contract with NYSEG and RG&E to market renewable energy attributes. According to Staff, such a contract violates affiliate transaction rules once the companies become affiliated. Staff fears that additional similar conflicts will arise if Iberdrola acquires NYSEG and RG&E.

Staff is also concerned about Iberdrola's claims of confidentiality of business information that could interfere with the public scrutiny of its regulated operations. It notes that some of this information, while considered to be public in the United States, is deemed confidential in Spain and Europe. Chief among Staff's concerns is the secrecy that Iberdrola claims for its corporate structure. If Staff must treat this information as a trade secret, it states that it will be unable to interact with third parties to ferret out potential cross-subsidies and improper business dealings.

Staff is also concerned about the confidentiality claimed for Iberdrola's credit quality metrics. It believes that Iberdrola's financial condition and prospects should be public to the extent that this information affects the finances of the New York public utilities.

Staff disputes petitioners' assertion that Iberdrola's credit rating (which is better than Energy East's) provides NYSEG and RG&E a benefit, as discussed above (Section II.B (2)(b)(iii)). Staff believes that Iberdrola's finances present a risk for the New York public utilities and its credit rating will not lead to lower cost capital for NYSEG and RG&E. Staff states that Iberdrola may not be able to sustain its ratings if the proposed transaction harms its fiscal health. It notes that the proposed transaction will be funded with equity capital and Iberdrola will inherit $3.7 billion of debt on Energy East's books. According to Staff, the $2.9 billion of goodwill related to the transaction will eliminate the benefits of using equity capital for the acquisition. As a result, Iberdrola's post-acquisition capital structure would consist of 42% equity and 58% debt, and almost half the equity would be goodwill.

Impairment of the goodwill component of the equity, according to Staff, would increase Iberdrola's debt ratio to as much as 66%.

Staff believes that the amount of debt Iberdrola carries does not qualify for an "A" rating under Standard & Poor's (S&P) standards. Were Iberdrola's goodwill impaired, its rating could fall to junk status, according to Staff. Staff notes that Iberdrola's credit rating was recently downgraded by S&P and by Investor's Service (Moody's) and the proposed transaction could lead to further downgrades. Were this to occur, Iberdrola may not be able to provide the financial strength it promises to provide NYSEG and RG&E. Staff supports its analysis by pointing to a six-year decline in Iberdrola's bond rating and to the Company's strategic plan and ambitious program to grow its investments by as much as $38 billion. Further, Staff states that Iberdrola's dividend payment policy places pressure on the Company's financial metrics. In Staff's view, petitioners have not shown that NYSEG's and RG&E's affiliation with Iberdrola would provide them any improvement in their credit ratings. Staff also believes that their affiliation with Iberdrola will not provide the New York utility companies any better access to capital markets than they currently have with Energy East.

Not only from its assessment of Iberdrola's financial risks but also from examining its business risks, Staff has concluded that the company's capital structure is more consistent with a "BBB" rated utility. According to Staff, holding companies, like Iberdrola, that concentrate less on regulated utility operations and engage more in competitive businesses only rank as "satisfactory" on business profile risk evaluations instead of either "excellent" or "strong" as do companies that focus on regulated businesses.

Also, from evaluating cash flow metrics, Staff has concluded that Iberdrola's financial indicators place it in a lower rating range. Staff considers the ratings picture presented by Iberdrola as being overly optimistic and as containing more risk than the company would admit.

Addressing goodwill, Staff states that it is not sufficient that petitioners have agreed to keep goodwill off of NYSEG's and RG&E's books. According to it, the goodwill on Energy East's and Iberdrola's books masks the firms' true credit quality. Staff also believes that a write-down or write-off of Iberdrola's goodwill is likely in the long term. Staff is concerned about any such impairment of the goodwill. Staff suggests that a recession, or another adverse event, could limit Iberdrola's earnings and trigger a write-down that, in turn, would adversely affect the company's access to capital. If no synergy savings result from the proposed transaction, Staff observes, the goodwill will be unsupported and remain at risk. Staff also observes that future transactions could increase the amount of goodwill and increase financial risk in the holding company structure.

Staff also discusses, as a risk presented in this case, the differences in the methods that petitioners and the Commission have used to calculate NYSEG's and RG&E's capital structure. Staff insists that the Commission's consolidated capital structure used for ratemaking purposes is correctly executed with the kinds of adjustments Staff has sponsored for unregulated assets and goodwill. Staff states that goodwill must be removed from the balance sheet to adhere to the practice of not allowing goodwill to affect utility customers' rates.

Staff also addresses the risks associated with the possibility of Iberdrola being the target of a hostile takeover. It believes that such a takeover could be adverse for NYSEG, RG&E and utility customers. The cost of the anti-takeover measures Iberdrola uses could impair its financial health to the detriment of NYSEG and RG&E. Also, were the acquiring company to break up Iberdrola and spin off its assets, such action could be detrimental to NYSEG and RG&E. Staff believes that the Commission should either reject the proposed transaction for these reasons, or postpone action on it until the risk of a hostile takeover is fully known.

b. Petitioners

Petitioners respond to Staff's many concerns about Iberdrola's becoming the upstream holding company of NYSEG and RG&E by pointing to the regulatory tools the Commission has to address affiliate transactions. Petitioners are willing to accept and impose on Iberdrola the responsibilities that Energy East has under the existing Standards Pertaining to Affiliates and the Provision of Information (affiliate transaction rules).[89] They are also willing to make additional commitments in this case. However, they oppose the changes Staff has proposed to the affiliated transaction rules which they consider to be unnecessary and inappropriate.

Petitioners state that the Commission's available tools can fully protect ratepayers. Not only can the Commission use its broad powers to set rates,[90] it can also exercise express authority over affiliate transactions.[91] Petitioners note that

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[89] These are set forth in Appendix B to the Joint Proposal approved by the Commission in Case 01-M-0404 - Joint Petition of Energy East Corporation, RGS Energy Group, Inc. New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation and Eagle Merger Corp. for Approval of Merger and Stock Acquisition, Order Adopting Provisions of Joint Proposal with Modifications (issued February 27, 2002).

[90] PSL §§ 65 and 72.

[91] PSL §110.

the Commission can review the accounts and records for affiliate transactions and the records for joint and general expenses.[92] Further, the Commission can disapprove contracts that are not in the public interest.[93] Petitioners state that nothing about Iberdrola's becoming the upstream owner of Energy East would change the Commission's ability to protect ratepayers.

Moreover, to allay concerns and provide additional protections, petitioners are willing to commit to the following measures:

- The continued use of Energy East's cost allocation method and a commitment that Energy East will allocate to NYSEG and RG&E the centralized costs incurred by Iberdrola only to the extent such costs are properly chargeable to utility operations and they are accepted by the Commission.
- The maintenance by NYSEG and RG&E of separate and independent accounting records and financial statements from those of Iberdrola and other affiliates.
- Strict limits on asset transfers from NYSEG and RG&E.
- Strict limits on NYSEG's and RG&E's ability to make loans to Iberdrola or any unregulated affiliate.
- Strict limits on the provision by NYSEG and RG&E of guarantees, collateral, pledges, or any other type of credit support for Iberdrola or any affiliate.
- The continued application of the affiliate transaction rules, with Iberdrola stepping into the shoes of Energy East for their application.

Unlike Staff, petitioners believe that a "regulatory compact" exists in New York, which sets compensation for the owners of utility companies in relation to the adequacy and quality of the service that they provide to the public. If the

[92] PSL §110(2).

[93] PSL §110(3).

public is not well served, regulators, pursuant to the compact, can apply specific sanctions. According to petitioners, this cornerstone of the regulatory compact, and of cost-of-service regulation, operates in New York and it has not been set aside by the courts. Petitioners firmly believe that the traditional principles of utility regulation provide the Commission ample ability to protect ratepayers from any potential harm due to the proposed transaction.

Petitioners also dismiss Staff's claims that Iberdrola's organizational structure is complex and difficult to track and provides the potential for Iberdrola to exercise market power. They state that the organizational structure is not overly complex and it is similar to those used by other firms with regulated and unregulated holdings. They assert that Iberdrola has solid experience owning both types of companies and nothing will prevent the Commission from regulating NYSEG and RG&E as it has always done.

Petitioners also state that the sanctions and fines Iberdrola and some of its operating utilities incurred elsewhere do not evidence any real problem with regulatory compliance. They assert that Staff has not compared Iberdrola's record of regulatory compliance with any other firm's, and Staff has little, if any, basis for claiming that there is an overall regulatory compliance problem.

Addressing Community Energy's marketing contract with NYSEG, petitioners point out that the contract precedes the merger discussions and arrangements made between Iberdrola and Energy East. In any event, petitioners are committed to complying fully with the Commission's and FERC's applicable standards for instances such as this one. Further, petitioners are committed to additional measures to ensure that there are no incentives for cross-subsidization between the unregulated affiliates and NYSEG and RG&E.

Responding to Staff's concerns about the confidentiality of Iberdrola business information that could be needed in regulatory proceedings, petitioners state that Staff has had access to such information, it has been able to review such materials, and it will continue to be provided necessary information in future proceedings. They believe that the Commission, and its presiding officers, will be able to handle confidential information matters adequately in future proceedings.

Addressing the possibility of a hostile takeover of Iberdrola, petitioners state that the Commission's authority would not be reduced by a takeover bid, and PSL §70 would apply to any entity that attempts to acquire Iberdrola. In response to Staff's concerns about a potential upstream acquisition, they state that no credit or consideration should be given to unsubstantiated press reports and no one should speculate as to whether various suitors seeking to acquire Iberdrola would be successful or unsuccessful in a takeover attempt. They would also avoid speculation about the Energy East assets being spun off or sold after an upstream transfer. Petitioners state that none of the speculation is based on facts.

Petitioners oppose the conditions proposed by MI that seek to address any future acquirer of upstream interests. They state that no such conditions are necessary because regulatory compliance concerns exist with every upstream owner of utility interests and the Commission's statutory powers and regulations are sufficient to address any new developments. For these reasons, petitioners urge the Commission to reject MI's proposed conditions suggesting a dividend freeze and rate reductions to address a hostile takeover bid. They state that any such action would be drastic, premature and entirely unnecessary.

c. Multiple Intervenors

MI concurs with DPS Staff and CPB that the proposed transaction presents many risks for NYSEG, RG&E and utility customers. To protect the public interest, MI believes that protections and benefits must be obtained from petitioners, including stringent reliability performance standards, robust reporting requirements and financial and rate-related benefits.

MI believes that the proposed transaction exposes utility customers to at least four types of financial risk. It considers the goodwill on Iberdrola’s books a risk for customers should it be impaired and have to be written off. A reduction in the Company’s common equity would increase debt requirements and could increase financial costs for NYSEG and RG&E.

Another financial risk relates to Iberdrola’s plans to acquire other businesses and to expand its operations aggressively. MI fears that a credit downgrade could occur from the company’s adherence to such a corporate policy that would adversely affect NYSEG’s and RG&E’s financing costs.

Third, MI states that NYSEG and RG&E are financially sound and they could be used by Iberdrola to fund and assist weaker affiliates or to boost dividends to shareholders. Were this to occur, MI is concerned that NYSEG’s and RG&E’s funds may not be available to provide safe and adequate service for customers. Finally, MI shares other parties’ concerns about NYSEG and RG&E being forced into bankruptcy proceedings against the public interest.

d. CPB

CPB is concerned about effective regulatory oversight of NYSEG and RG&E. It states that the size of the combined entities, the scope of their activity, fewer reporting requirements and differing accounting systems will complicate the process. CPB also notes that fluctuations in foreign currency values could contribute to volatility in utility company expenses. It states that a series of inter-company transactions, and unrecorded activity, could also increase utility company costs. Further, CPB is concerned about the amount of goodwill and intangible assets included in Iberdrola's equity position following the proposed transaction and the pressure it would place on the utility companies' credit ratings and financing costs. If NYSEG's and RG&E's financial condition were weakened, CPB fears they would incur higher costs and customers would pay higher rates.

According to CPB, these concerns should be addressed and mitigated by the Commission's adopting reporting and accounting requirements and financial protections. CPB also believe that offsetting value should be obtained for customers, and rate mitigation measures should be employed.

CPB supports the financial protection conditions proposed by DPS Staff. Specifically, it favors acquisition adjustment conditions, credit quality conditions, dividend limitations, money pool rules, and structural protections. It states that the Staff-proposed conditions are consistent with those the Commission applied to National Grid's acquisition of the KeySpan Corporation. CPB believes that these protections are needed in this period of multi-state and multi-national utility holding company consolidations and with the elimination of the protections that were once provided by the Public Utility Holding Company Act of 1935. CPB does not believe that Commission adoption of the Staff-proposed conditions reflects poorly on Iberdrola. It states that they are needed from a realistic appraisal of the electric and energy industry.

CPB believes that structural protection for NYSEG and RG&E should be achieved by using a “golden share” provision and a limited purpose entity.[94] According to it, a weak parent company that seeks protection in bankruptcy should not be able to drag a solvent utility company subsidiary into a bankruptcy proceeding if it is not in the public interest to do so.

CPB also supports the treatment of goodwill that petitioners have agreed to use. No goodwill from the proposed transaction would be recorded on NYSEG’s and RG&E’s books. Nor would the goodwill have any impact on NYSEG and RG&E or be used in setting of their rates.

In light of the risks of the proposed transaction for NYSEG, RG&E and utility customers, CPB insists that the transaction should only be approved with sufficient conditions, significant added value and tangible benefits for ratepayers.

e. SPM

Strategic Power Management (SPM) credits petitioners for committing themselves to abide by the Commission’s and FERC’s standards, regulations and policies that govern the relationship between regulated and unregulated affiliates. SPM also views favorably their commitment to use Energy East’s prevailing cost allocation methods and to allocate Iberdrola’s costs to NYSEG and RG&E only to the extent that they are properly chargeable to the utility operations.

SPM also observes that petitioners have agreed to separate and independent accounting records and financial statements, and to no sales of any public utility assets without

[94] Such a mechanism would install an independent director in the holding company structure between the parent company and the utility company subsidiaries. The director can act to prevent the parent company from placing the utility subsidiaries in bankruptcy if such action would be adverse to the public interest.

the Commission's approval. A sale to an affiliate would be conducted at arm's length using market and book value tests. SPM states that it is also clear that NYSEG and RG&E will not loan money to Iberdrola or provide credit support or any guarantees. SPM also favors petitioners' commitment not to seek recovery of the acquisition premium or the transaction costs.

Nonetheless, SPM believes that additional protection is needed for NYSEG, RG&E and utility customers in the event that Iberdrola were to suffer adverse financial conditions. It supports the Staff-proposed acquisition adjustment and credit quality conditions, dividend limitation provisions, money pool rules and structural protections.

2. Safeguards Proposed by Staff

In light of the financial and operating risks it sees for NYSEG, RG&E and utility service customers, Staff supports the application of conditions to the proposed transaction like the ones the Commission applied to National Grid's acquisition of KeySpan Corporation. Staff states that its proposed protections are needed due to evolving circumstances, decreased transparency and foreign ownership of domestic utility companies. The proposed conditions are as follows:

a. Goodwill and Acquisition Costs (Staff-proposed Conditions 1 – 3)

Condition 1 – The acquisition premium and costs associated with the pending and all past transactions will not be recorded on the books of NYSEG and RG&E or Energy East.

Condition 2 – The acquisition premium and related costs associated with the transaction will not affect rates.

Condition 3 - Each year, Iberdrola shall provide the results of any goodwill impairment test.

Petitioners observe that there is no dispute among the parties about the goodwill that Iberdrola will book for the proposed transaction. They also point out that there is no dispute about the ratemaking actions for NYSEG and RG&E that will be based on the original cost of utility plant and not on any acquisition premium associated with the price paid for shares of Energy East. Thus, petitioners are firm in their commitment not to recover any of the goodwill in NYSEG or RG&E rates.

Petitioners consider Staff's concerns about Iberdrola's having to write off its goodwill to be unrealistic, unlikely and speculative. They believe that growth in earnings and growth in business operations around the world will support the goodwill on Iberdrola's books. In an adverse economic climate, they would not expect the poor business conditions would completely impair the goodwill. Even in extreme circumstances, petitioners would not expect there to be any material effect on the rates or the quality of service provided by NYSEG and RG&E. They insist that Staff has not provided any evidence, or precedent, to show that goodwill impairment at the holding company level would negatively impact the utility companies' service quality.

Addressing the three conditions Staff has proposed, petitioners state that the commitments that they are willing to make would suffice. Specifically, they are committed not to seek recovery of costs incurred to consummate the proposed transaction from New York ratepayers. The premium paid for Energy East common stock resulting from the proposed transaction will remain on the books of Iberdrola and its wholly-owned affiliates. It will not be recorded on the books of any of the companies acquired, including Energy East, RGS, RG&E and NYSEG.

Petitioners state that Iberdrola has not made any specific commitment to report annual impairment tests made on goodwill. They believe no such commitment is needed so long as the goodwill is only booked at the holding company level.

Petitioners claim that Staff's request that Iberdrola commit to not seeking recovery of the costs and premiums associated with "all past transactions" is beyond the scope of this proceeding and Staff's request is not relevant to this case and transaction. Nonetheless, petitioners acknowledge that goodwill remains on the books of RGS and they are willing to stipulate that they will not seek recovery of costs associated with the RGS transaction in future rates.

b. Credit Quality
(Staff-proposed Conditions 4 – 8)

Condition 4 - NYSEG, RG&E and Iberdrola shall maintain S&P and Moody's credit ratings on their securities.

Condition 5 - Iberdrola, Energy East, NYSEG and RG&E shall have a stated goal to maintain the investment grade ratings of their securities.

Condition 6 - Copies of presentations made to credit agencies, and backup information, shall be provided to regulators on a ongoing basis.

Condition 7 – A NYSEG or RG&E credit downgrade by S&P or Moody's will require that a plan be filed with the Commission to remedy the downgrade.

Condition 8 – In future NYSEG and RG&E rate proceedings, customers shall not be responsible for the effect of any downgrading from NYSEG's and RG&E's present debt ratings (BBB+/Baa1).

Petitioners believe that Staff has exaggerated the credit rating risks of the proposed transaction. They emphasize that Iberdrola has a better credit rating than Energy East and they deny that the Iberdrola credit rating will deteriorate in the future. Petitioners criticize Staff for departing from the credit rating agencies' evaluations and claim that Staff has misapplied selected financial ratios. While Iberdrola has committed itself to undertake some of the steps advanced by Staff to address financial risk, petitioners believe that most of the conditions Staff has proposed are overreaching and unreasonable.

Petitioners disagree with Staff's assessment and assertion of a potential credit downgrade following the proposed transaction. They state that the credit ratings agencies foresee a stable outlook. They also state that the major credit ratings agencies have affirmed an "A" rating for Iberdrola and that Iberdrola's debt ratio is lower than Staff believes it to be. They urge the Commission not to accept Staff's second-guesses on credit ratings as a substitute for the actual credit ratings and analyses that have been provided by the major credit rating agencies.

Petitioners also state that the pressure that the proposed transaction places on Iberdrola's credit rating relates more to the possibility of adverse regulatory action and merger approval conditioned upon additional rate concessions like those Staff is seeking in this case.

Addressing Staff's five credit quality conditions, petitioners state that they will commit to Conditions 4 and 5 in all material respects. With regards to Condition 6, petitioners agree to provide their slide presentations to credit agencies and copies of credit reports relating to NYSEG and RG&E. According to them, any additional backup information provided to the credit agencies is unnecessary and bears no relationship to Staff requirements to maintain effective regulation over NYSEG and RG&E.

As to Condition 7, petitioners state that they have addressed its concerns by being willing to commit to: (1) filing with the Commission a notice in the event that there is a "Credit Event" (defined as the downgrade of Iberdrola's, Energy East's, NYSEG's or RG&E's credit rating below BBB/Baa3 or credit rating of BBB-/Baa3 with a "Watch Negative" by at least two major credit reporting agencies (e.g., S&P and Moody's)) and (2) identifying the current credit rating during such Credit Event, and providing a plan to remedy such Credit Event, until it is eliminated.

Petitioners disagree with Condition 8 which attempts to shield ratepayers from any downgrade of NYSEG or RG&E's present debt ratings. Petitioners agree that ratepayers should be held harmless from Iberdrola actions but they are unwilling to provide ratepayers protection from a downgrade related to actions taken by the Commission. They believe that Condition 8 could create a negative spiral for NYSEG and RG&E, where a decline in the credit rating would cause a disallowance of interest expense which in turn could cause a further decline in the credit rating.

c. Dividend Restrictions
(Staff-proposed Conditions 9 – 13)

Condition 9 – For each company, the amount of dividends it can send upstream to Iberdrola is limited during a year to no more than the sum of the income available for common equity, plus the cumulative amount of retained earnings since the acquisition was consummated, plus the portion of additional "paid in capital" that is recorded on the books of NYSEG and RG&E as unappropriated retained earnings and unappropriated undistributed earnings less accumulated other comprehensive income existing immediately prior to the consummation of the acquisition, to the extent such earnings had not already been paid out as a dividend.

Condition 10 – NYSEG and RG&E are each prohibited from paying a dividend at any point in time when their least secure unsecured bond rating is at the lowest investment grade and a rating agency has issued outstanding negative watch or review downgrade notices.

Condition 11 – NYSEG and RG&E are each prohibited from paying a dividend if Iberdrola's least secure senior unsecured debt is rated below an investment grade by a rating agency.

Condition 12 – NYSEG and RG&E are each prohibited from paying a dividend if their respective bond ratings are immediately downgraded to the non-investment grade category.

Condition 13 – When under a dividend restriction, NYSEG and RG&E are not permitted to transfer, lend or lease any items of value to any affiliate without prior Commission approval.

Petitioners oppose the dividend restriction provisions Staff has lifted from the order approving National Grid's acquisition of KeySpan Corporation. They do not believe the provisions are warranted in this case and they point to the differences in the two transactions. They state that this transaction does not carry the same financial risks as the National Grid/KeySpan merger and it would be unreasonable to apply the conditions designed for other parties to the circumstances presented here.

Iberdrola also stands by its current dividend policy which, it states, is an integral part of the company's Strategic Plan. Petitioners state that the policy helps to avoid difficult financial circumstances and it assisted Iberdrola to earn its current "A" rating. Petitioners state further that dividend payments will be made in a prudent manner and Staff's speculation that capital would be drained from NYSEG and RG&E is unwarranted and disregards Iberdrola's intentions and actual practices.

Addressing these five conditions, petitioners state that they are unnecessary. Instead, they are willing to commit to the following: (1) NYSEG and RG&E will maintain their respective dividend policies with due regard for the financial performance and needs of NYSEG and RG&E, irrespective of the financial performance and needs of Iberdrola; (2) Iberdrola will report to the Commission in the event that the dividend payout for any year is more than 100% of income available for dividends calculated on a two-year rolling (eight calendar quarter) average basis. According to petitioners, these commitments are sufficient to fully mitigate Staff's concerns. With respect to the conditions the Commission ultimately adopts, petitioners state they should not operate eternally. They believe the Commission should re-examine any such conditions periodically with an eye towards removing them.

d. Money Pool Arrangements
(Staff-proposed Conditions 14 – 18)

Condition 14 – NYSEG, RG&E, and any future domestic regulated entities may participate in money pool arrangements as either a borrower or lender.

Condition 15 – Iberdrola may participate in a money pool only as a lender.

Condition 16 – Non-regulated and foreign entities may not participate in a money pool with NYSEG or RG&E.

Condition 17 – No cross-default provisions for any affiliate of Iberdrola are to affect NYSEG and REG&E. Iberdrola and its affiliates promise that they will not enter into such arrangements in the future.

Condition 18 – Indirect loans from NYSEG and RG&E to any affiliate are prohibited.

With respect to the money pooling rules Staff has proposed, petitioners state that they generally accept and do not contest them. No money pools currently exist for Energy East, NYSEG and RG&E.

Nonetheless, two minor differences remain between petitioners and Staff. Staff believes that indirect loans from the utility companies to an affiliate should be prohibited; however, Staff has not specified or defined what would constitute an indirect loan. According to petitioners, Iberdrola is committed not to borrow from any money pool in which NYSEG and RG&E are participants. They believe that this commitment should mitigate Staff's concern.

Staff has also proposed that there not be any Iberdrola affiliate cross-default provisions affecting NYSEG and RG&E. Specifically, Staff has proposed that Iberdrola and its affiliates promise not to enter into any such arrangements in the future. Petitioners believe that the Commission should retain some flexibility to consider and approve cross-default provisions and money pooling arrangements that could change in the future and differ from the current ones.

e. <u>Ring Fencing, Golden Share, LPE</u>

(Staff-proposed Conditions 19 and 20)

Condition 19 – A golden share is required to prevent a bankruptcy of Iberdrola or any of its affiliates from triggering a voluntary bankruptcy of NYSEG or RG&E.

Condition 20 – A limited purpose entity is required to ensure compliance with dividend and money pool restrictions.

According to petitioners, the Commission need not impose a limited purpose entity in this case. Petitioners point to critical and important distinctions between this transaction and the National Grid acquisition of KeySpan Corporation, where a limited purpose entity was imposed. According to petitioners, this case does not involve a financially weak acquirer; instead, they observe that the acquiring company is an “A” category global, diversified utility. For this reason, they do not believe that the National Grid/KeySpan merger order provisions provide a “one-size-fits-all, black-letter standard” for ring fencing requirements.

Petitioners consider Staff’s ring fencing and limited purpose entity proposals to be counterproductive and unduly severe. They state that a golden share is an extraordinary measure that is rarely used. They point to Iberdrola’s “A” rating as a benefit for NYSEG and RG&E that could improve their ratings, allow them to escape their currently negative outlooks and reduce their debt costs. They also note that the proposed transaction will be financed entirely with equity and not with debt. On these scores, petitioners distinguish the proposed transaction from the National Grid/KeySpan merger.

Petitioners also believe that the golden share provision, which was designed to protect the Portland General Electric Company from its parent, Enron Corporation, has no application to the circumstances presented here. They point out that the golden share mechanism was not created until after Enron declared bankruptcy and they note that the Oregon Public Utilities Commission did not select the shareholder of the limited purpose entity.

Petitioners also distinguish the use of a limited purpose entity in the Mid-American Holding Company/PacifiCorp merger. In that case, according to petitioners, a special purpose entity was created to include standard provisions for separating corporate entities, including separate books and records, financial statements and arm’s-length relationships with affiliates. The limited purpose entity is not controlled by a third party appointed by a regulatory commission or its staff.

According to petitioners, a golden share is not an industry standard. Instead, it may be used to address specific concerns of a kind that are not present here. They state that a limited purpose entity, or a golden share, would serve no good purpose and it could create unanticipated problems and costs for Iberdrola and ratepayers. They urge the Commission to reject Staff's proposal because they have committed to other sufficient protections and measures addressing dividends and money pool arrangements.

f. Reporting and Financial Transparency
(Staff-proposed Conditions 21 – 28)

Condition 21 – Energy East shall continue to use U.S. Generally Accepted Accounting Principles (GAAP) for all financial reporting purposes.

Condition 22 – Staff shall have access to the books and records of Iberdrola and its majority-owned affiliates in English. The books and records shall be made available in New York.

Condition 23 – NYSEG and RG&E shall continue to satisfy the current reporting requirements that apply to them.

Condition 24 – Energy East shall continue to be subject to the existing, applicable legal requirements of the Sarbanes-Oxley Act (SOX). Its periodic, statutory financial reports should include certifications provided by Energy East officers concerning the six SOX requirements.

Condition 25 – Energy East, NYSEG and RG&E shall remain subject to annual attestation audits by independent auditors.

Condition 26 – Iberdrola shall provide annual public financial information, including consolidated balance sheets, income statements, and cash flow statements, and a comprehensive management discussion of its results consistent with Energy East’s current SEC 10-K concerning Iberdrola’s regulated and unregulated energy companies in the United States. Such filings shall include audited U.S. GAAP financial statements stated in U.S. dollars.

Condition 27 – The consolidated financial statements described in Condition 26 shall illustrate how each of Iberdrola’s major regulated and non-regulated subsidiaries contribute to the overall consolidated financial statements. This information shall be provided in the same format as the consolidated financial statements made in SEC Form U-5S that registered utilities have filed under the Public Utility Holding Company Act of 1935. The energy utility information shall be fully consistent with the SEC Form U-9C-3 that registered holding companies had to file under PUHCA.

Condition 28 – In all future rate cases, Iberdrola shall file consolidated balance sheets, income statements and cash flow statements for Energy East, and its direct subsidiaries, in English using U.S. GAAP. This information shall be provided for the historic test year and be projected into the future rate year. In support of the forecasts, NYSEG and RG&E shall file balance sheets, income statements and cash flow statements for all the Energy East subsidiaries that are either utility companies or operate in the energy business during the historic test year.

In general, petitioners accept all, or parts, of the reporting requirements that Staff has proposed. Nonetheless, differences remain between petitioners’ commitments and the conditions proposed by Staff.

Petitioners agree to provide access to Iberdrola’s (and its majority-owned affiliates’) books and records in

English in New York, but they would limit their commitment to provide affiliates' information that is related to NYSEG or RG&E. For example, they do not believe it would be necessary for Iberdrola to provide any financial information for a wind project in Brazil that has no dealings with the public utility companies.

Staff also proposes that NYSEG and RG&E continue to satisfy their current reporting requirements. Petitioners state that Energy East will continue to use U.S. GAAP for its financial reporting. However, petitioners do not plan to prepare or provide any reports that are no longer required by the Public Utility Holding Company Act of 2005.

Next, in response to Staff's proposal that the requirements of the Sarbanes-Oxley Act (SOX) continue to apply to Energy East, petitioners observe that SOX requirements will no longer apply to Energy East after the proposed transaction because Energy East will no longer be an SEC registrant. Instead, petitioners propose that Energy East continue to assess, monitor and provide an attestation of management concerning the adequacy of controls. Petitioners state that the commitment they are offering goes beyond the requirements of existing law and it should be more than adequate to address Staff's concerns.

Finally, addressing Conditions 26 and 27, petitioners state that they are committed to providing Iberdrola's consolidated balance sheets, income statements and cash flow statements in English and in New York on an annual basis and in a format that is mutually agreeable to Iberdrola and Staff. However, the audited financial statements would be in accordance with the International Financial Reporting Standards (IFRS), consistent with SEC requirements. They oppose Staff's proposal calling for the financial information be provided in accordance with U.S. GAAP.

Petitioners state that there are no pronounced differences between U.S. GAAP and IFRS and the SEC has adopted a final rule which accepts financial statements from foreign private issuers prepared in accordance with IFRS without requiring any reconciliation to U.S. GAAP. Petitioners urge the Commission to respect the judgment of the SEC and to reject Staff's demand that Iberdrola use U.S. GAAP.

g. Affiliate Transactions; Code of Conduct (Staff -proposed Conditions 29-32)

Condition 29 – Affiliates are prohibited from using the same name, trade names, trademarks, service names, service marks or derivatives of the names of the utility companies or identify themselves as being affiliated with the utility companies.

Condition 30 – Unregulated affiliates are prohibited from giving any appearance that they represent the energy distribution company in matters involving the marketing of the distribution company's services or the services of other affiliates.

Condition 31 – Any management corporation that receives customer information shall promise to the utility company, in a legally binding document executed by authorized personnel, in each specific instance that it will not disclose customer information. These documents shall be available for Staff's review and inspection.

Condition 32 – To prevent chaining transactions that could increase the cost of goods and services provided to the utility companies, the price of goods and services provided by affiliates shall be limited to the original acquisition cost incurred by the first non-regulated affiliate.

Staff states that the existing affiliate transaction rules were designed to govern the relationship between Energy East and NYSEG and RG&E. However, Staff claims that the existing rules are inadequate in the new environment to handle the dealings between Iberdrola and the utility companies. In contrast, Iberdrola is willing to commit to the existing affiliate transaction rules; petitioners oppose the Staff-proposed revisions.

According to petitioners, the most problematic of Staff’s proposed changes are the ones that have nothing to do with transactions between regulated and unregulated affiliates. They state that Staff is attempting to expand the scope of the affiliate transaction rules beyond such transactions and would have them control all possible business, operational and financial aspects of the affiliated businesses regardless of whether they have any contractual dealings or business relationships with NYSEG or RG&E.

Petitioners state that the three changes to the affiliate transaction rules discussed in Staff’s Initial Brief present minor concerns and no significant problems. However, they also state that other changes not discussed in Staff’s Initial Brief contain significant modifications to the rules to which they object. Such changes include the elimination of an affiliate transaction qualifier from the preface to the books and record provisions of the rules, and a proposed prohibition that would preclude Iberdrola affiliates from providing any goods and services to NYSEG and RG&E. Petitioners also claim that Staff’s proposed revisions contain errors and illogical provisions that make them impractical for the Commission to adopt.

3. Safeguards Proposed by Multiple Intervenors

To address the alleged financial risks, MI supports the conditions DPS Staff has proposed. It believes that Staff's proposals are needed to shield NYSEG, RG&E and customers from potential adverse consequences. At a minimum, it urges the Commission to adopt the Staff-proposed financial protection provisions that address goodwill, credit quality, dividend limitations, money pooling and structural protection.

MI also concurs with the others that goodwill and acquisition transaction costs should not be reflected on NYSEG's and RG&E's books and they should be excluded from rate determinations and earned return calculations.

With respect to credit quality matters, MI supports Staff's proposal calling for independent financial risk assessments of Iberdrola, Energy East, NYSEG and RG&E, and the proposal for individual security credit ratings from S&P and Moody's. It also supports Staff's proposal for each company to declare a corporate goal to maintain investment grade ratings. Further, MI believes that Staff should be able to obtain copies of the presentations (and backup information) to credit agencies. Finally, MI supports the notion that any downgrade in the NYSEG and RG&E credit ratings should trigger a requirement that the utility company file with the Commission a plan to counteract the downgrade.

To preclude Iberdrola from being able to drain capital from NYSEG and RG&E, MI supports the Staff-proposed restrictions on the amount of dividends the utility companies can pay, and conditions for issuing dividends and restrictions on the total value of dividends issued.

With respect to participation in money pools, MI supports Staff's proposal that Iberdrola only be permitted to act as a lender, and NYSEG and RG&E be prohibited from participating in money pools with any non-regulated foreign entities and from loaning money to affiliates. MI believes that cross-default provisions should not be permitted to affect NYSEG and RG&E.

As to structural protections, MI supports Staff's proposal for a limited purpose entity with an independent director to represent the public's interest in NYSEG and RG&E.

MI also supports the financial protections advanced by DPS Staff. In particular, MI favors Staff's proposal for a limited purpose entity and a "golden share" to isolate NYSEG and RG&E from Iberdrola's financial risks. MI fails to see how the imposition of a limited purpose entity would harm petitioners. It states that, if the prospects of a bankruptcy are remote, adoption of Staff's proposal should not have any impact on Iberdrola's future operations.

MI also favors Staff's proposal to restrict NYSEG and RG&E dividend payments if certain thresholds are not met. MI states that this requirement would continue the utility companies' existing dividend policies and preclude changes that could be used to drain their resources at inappropriate times.

In sum, MI believes the Commission should adopt all of the customer protections petitioners have agreed to provide together with the limited purpose entity and the dividend restrictions provisions that petitioners do not accept. If not all of the Staff-proposed protections are adopted, MI believes that a greater amount of financial and rate-related benefits should be captured for utility customers to offset the financial risks they would face.

MI believes that robust reporting requirements must be in place for the proposed transaction. It states that Energy East would no longer be subject to certain federal reporting requirements, and domestic accounting standards, if the proposed transaction goes forward. It also observes that the operations affecting the utility companies would be less transparent and more difficult for Staff and others to evaluate. While petitioners are willing to make some commitments and continue certain regulatory reports, MI believes that greater access is needed to information about the holding companies' activities and Iberdrola's business interests.

In support of its position, MI points out that Energy East would no longer provide SEC reports that DPS Staff and others have used to audit and examine NYSEG and RG&E. It also notes that reporting requirements were affected by the Public Utility Holding Company Act of 2005 which transferred holding company audit responsibility from the SEC to FERC. Further, it notes that Energy East would no longer be subject to the Sarbanes-Oxley Act as a result of the proposed transaction. Finally, MI notes that the use of different accounting standards would make less financial information available.

MI supports the five reporting requirements proposed by DPS Staff. Like Staff, it believes that English versions of Iberdrola's books and records, and the books and records of the majority owned affiliates, should be available in New York. It also believes that the reporting requirements that currently apply to NYSEG and RG&E should continue without interruption. Thirdly, MI favors the Staff proposal for the continued use of an outside auditor to perform annual audits of NYSEG, RG&E and Energy East. Further, MI supports continuation of the requirements of NYSEG's August 16, 2000 information order in Case 9187 and it proposes that these requirements be extended to include RG&E. Finally, MI supports Staff's proposal that Iberdrola report financial information annually for itself, Energy East and its direct subsidiaries using the Generally

Accepted Accounting Principles (GAAP) and figures stated in U.S. dollars.

Finally, MI states its concern about the risks of Iberdrola being acquired and taken over about another company. It notes that Iberdrola is a takeover candidate by various European utility companies. MI believes that, if the proposed transaction is approved, the Commission should use its jurisdiction to review any post-merger attempt to acquire Iberdrola. It states that the Commission has authority pursuant to Public Service Law § 70 to consider the impact of a takeover on NYSEG, RG&E and their customers. MI believes that a takeover of Iberdrola could harm NYSEG and RG&E if any new ownership interest found to be not in the public interest.

Fearing that a European corporation may acquire Iberdrola in a hostile takeover and not concede to the Commission's authority, MI proposes that the Commission act to ensure that the foreign corporation would file for its approval before acquiring Iberdrola. Specifically, it recommends, as a condition, that Energy East, NYSEG and RG&E be barred from transmitting any dividends upstream should an agreement to acquire Iberdrola become public. It also recommends, as a condition, that if the Commission's jurisdiction over the acquisition of Iberdrola is not recognized or is contested, the Commission could implement a 25 percent reduction in NYSEG's and RG&E's delivery rates. These conditions, according to MI, should cease to be operate when the Commission authority to pass upon the takeover is recognized.

4. Discussion and Conclusions

At this stage, the record suffers from the lack of a clear focus on the relevance of the transaction's risks as alleged by Staff and other parties. Under closer consideration, it would become evident that the alleged risks are relevant for two distinct purposes. One is that they relate to the merits of the proposed transaction. In that context, I recommend that the Commission accept the opponents' assertions as persuasive, for two reasons.

The first, more general reason is that petitioners, as such, bear the burden of showing that the transaction would satisfy the public interest requirement of PSL §70, and they have not overcome the opponents' demonstration that the alleged risks are, at least, realistic concerns. (Petitioners could argue that they have shifted the burden to the opponents by documenting the transaction's benefits in the public interest; but that argument would be unavailing because, as discussed elsewhere, the benefits alleged by the proponents are insufficient or not real.)

The second and more important reason is that, no matter how thoroughly the parties may analyze and debate the alleged risks, the nature of the allegations is such that the Commission ultimately will not be able to identify an objective or quantifiable level of risk associated with the transaction. For example, the risks of goodwill write-offs and credit deratings due to unforeseeable circumstances may be identifiable, yet they are unquantifiable. Instead, the Commission will be relegated to concluding only that the transaction involves at least some indeterminate degree of risk, based on the fact that Staff and other parties have provided a credible analysis of potential risks together with a detailed rebuttal of petitioners' counterarguments.

Even if the Commission finds that the risks are real or significant in some indefinite degree, that judgment would be only a secondary, supplemental rationale for denying the petition if (as recommended herein) the Commission finds that the transaction would confer no benefits sufficient for purposes of PSL §70. Alternatively, should the Commission find that the transaction would be beneficial, a weighing of benefits versus risks nevertheless would remain unnecessary, at least for those risks which are moot because the Commission can simply neutralize them by adopting the protective or remedial measures advocated by Staff and other parties. (As explained previously, this recommended decision treats the transaction's alleged risks as a subject for possible remedies rather than attempting to weigh them in the balance vis-à-vis the transaction's asserted benefits.)

The second purpose for which the risk allegations are relevant is to establish whether the Commission should impose protective measures.[95] Throughout the arguments on this subject, the pattern is that the transaction's opponents allege risks; they propose remedial or protective measures as a precondition should the Commission approve the transaction; petitioners and proponents respond that the risks are overstated; nevertheless, as a compromise, petitioners offer to accept remedies less comprehensive than those the opponents advocate; and, finally, the proponents say the Commission should reject, as superfluous and unnecessary, any proposed conditions more restrictive than the compromise offer.

However, considering the difficulty of objectively determining the gravity of a particular risk or the likelihood that it will materialize, this entire framing of the arguments seems to proceed backwards. That is, the briefs attempt to address whether each protective measure is necessary, which requires a subjective determination as to the significance of

[95] One aspect of this question, whether the transaction would create market power and whether the Commission therefore should impose restrictions on petitioners' ownership of generation, is considered separately.

the particular risk sought to be remedied. Instead, a better reasoned decision would result if the parties and, thus, the Commission examined first not whether the specific protective or remedial measures are necessary but whether they are burdensome. If a proposed measure were found burdensome, then the next step would be to examine whether the burden would be reasonably commensurate with the risk to be remedied. Alternatively, if the protective measure is not burdensome, then the Commission can and reasonably should adopt it as a prudent conservatism without attempting to definitively assess the gravity of the risk. Either because the parties have not followed this conceptual approach or because the proposed protective measures may in fact not be onerous, petitioners have asserted merely that measures beyond those offered in compromise would be unnecessary. Except in a few significant instances, petitioners have not asserted that the allegedly unnecessary measures would also be burdensome. Therefore, absent a further demonstration on exceptions that the protective measures proposed by the transaction’s opponents would be unreasonably burdensome relative to the alleged risks, the recommendation here is that the Commission adopt all the proposed measures except as follows.

The first objectionable proposal involves the code of conduct currently applicable to transactions among Energy East, NYSEG, and RG&E, and Staff’s proposals for modifying it to include transactions involving Iberdrola. First, petitioners are correct at least conceptually that the revised code would be overbroad insofar as it might curtail Iberdrola’s authority to engage in transactions that do not involve Energy East’s subsidiaries. If that criticism is based solely on the proposed terms that restrict Iberdrola affiliates’ use of the subsidiaries’ trade names or trade dress in enterprises independent of the subsidiaries' T&D functions, the criticism is not dispositive because such conduct really is not unrelated to the subsidiaries. Instead, the more salient consideration would be whether the restriction would be analogous to restrictions the Commission has imposed in other situations involving analogous potential abuses or customer confusion related to trade names. However, it is unclear whether the allegedly overbroad restrictions would prevent other non-Energy East conduct besides the use of trade names. Unless the transaction's opponents can show that the proposed restrictions would affect only conduct involving Energy East and its affiliates or that such a criterion is inappropriate, the Commission should not impose affiliate transaction restrictions other than petitioners' proposal to substitute Iberdrola for Energy East in the current code of conduct.

An additional impediment to adoption of the expanded code of conduct is that it appears unsuitable for adoption unless it is redrafted to eliminate various ambiguities and inconsistencies.[96] Parties could attempt to address this problem on exceptions, by means of either arguments or revisions; or they might find it more efficient to await the Commission's decision whether to require an expanded code of conduct and then revise the expanded code, if necessary, as part of a compliance filing.

A second unreasonable proposed remedy is that petitioners promise to hold NYSEG and RG&E customers harmless from the increased capital cost resulting from any credit derating of those companies as a result of Iberdrola's financial condition. Whether customers are granted such protection certainly is important. But, for that very reason, the proposal

[96] See Petitioners' Initial Brief, pp. 77-78.

is a recipe for endless conflict centered on whether the derating occurred because of the acquisition. If the subsidiaries could not exclude Iberdrola as a cause of the derating, as petitioners correctly observe, they could become caught in a vicious circle of rate disallowances pursuant to the hold harmless measure – in effect, caused not by the transaction but by the Commission – followed by further derating. If anything, the rating agencies' potentially negative reactions to a hold harmless provision demonstrate not that the provision should be adopted, but that the transaction is contrary to the public interest because some of its risks are beyond the reach of practical remedies.

A third provision, proposed by MI, is that the Commission reserve the option of enjoining dividend payments from Energy East to Iberdrola and reducing the Energy East subsidiaries' revenues up to 25% in the event that another firm acquires Iberdrola and its New York subsidiaries without the Commission's approval under PSL §70. Petitioners oppose both provisions as unnecessary, and Staff opposes the rate reduction mechanism. Again, the question is whether the proposed protective measure is burdensome. Under that criterion, the Commission should adopt the dividend restriction provision but not the rate reduction mechanism. The former would merely maintain the status quo as a safeguard against unforeseen changes in dividend policies due to the change in ownership. However, the rate reduction would expose the Energy East subsidiaries, and, by extension, their customers, to new (and punitive) financial risks for reasons beyond their control.

Finally, petitioners claim that unreasonable burdens would result from two additional protective measures proposed by Staff. First, they say the golden share and/or SPE provisions would be costly (because of administrative requirements) and could function counterproductively by impairing Iberdrola's ability to provide financial support to Energy East. Second, they say it would be burdensome to furnish English language translations of financial information on Iberdrola's affiliates other than the Energy East companies. Again, the parties may have underestimated the significance of whether a particular remedy would be burdensome. But, for whatever reason, petitioners have provided no explanation to support the claim that these requirements would be onerous. Moreover, on a prima facie basis, the claim does not seem credible, because neither measure seems likely to entail significant costs and because the golden share provision presumably could be structured so as not to include any counterproductive restraints. Accordingly, absent some further explanation on exceptions, the Commission should adopt both provisions.

E. Positive Benefit Adjustments

Aside from vertical market power, the subject that has generated probably the most intense opposition to Staff's position are the "positive benefit adjustments" (PBAs) that Staff advocates as a precondition of Commission approval of the transaction. Staff proposes PBAs of $646.4 million which, in Staff's calculations, equate to an 8.1% reduction in overall NYSEG and RG&E delivery revenues (including reductions as high as 19.2%, for RG&E electric delivery revenues).[97] The PBAs would reduce NYSEG's and RG&E's revenue requirements by eliminating certain regulatory assets and increasing certain regulatory reserves. The assets to be eliminated, and the companies affected, would be deferrals related to losses on refunding of debt issuances (NYSEG, RG&E), provision of gas service (NYSEG,

[97] Staff's Initial Brief, Att. 1, p. 1.

RG&E), remediation of gasification sites (NYSEG), 2003 ice storm repairs (RG&E), and property taxes (RG&E). The reserves to be credited would be those related to storm and repair costs (NYSEG, RG&E), stray voltage programs (NYSEG), pension expense (NYSEG), and gasification site remediation (RG&E).

As discussed previously, petitioners' Partial Acceptance proposes that PBAs be limited to $201.6 million and take effect immediately upon closure of the transaction. Staff, MI, and CPB would reject petitioners' proposal as inadequate, generally on the ground that the appropriate order of magnitude is much greater for the reasons discussed in the ensuing sections. As for the other parties, GRE deems the $201.6 million adequate as part of an outcome that also would include petitioners' commitments involving retention of upstate jobs and Renovables' investment of at least $100 million in renewables projects in New York. DED favors a decision that would enable rates to be reduced promptly, although it does not join in the debate over specific amounts of PBAs or other benefits. As discussed previously, SPM favors adoption of the PBAs offered in the Partial Acceptance and, on a temporary basis, half the difference between that amount and Staff's proposed amount; in response, Staff and Nucor express misgivings about the rate uncertainties that might result from that approach. For the reasons cited below, this recommended decision concludes that the Commission should require PBAs in the amount advocated by Staff.

1. Rationales in Support of PBAs

a. <u>Proxy Theory</u>

Staff presents two distinct theories to justify a capture of customer benefits by means of PBAs. One is that PBAs are needed as a proxy for synergy savings, on the ground that such savings should be expected--despite petitioners' denial that the transaction will create synergies--and will redound entirely to the shareholders' benefit unless the Commission takes some action to reserve them for customers now. Staff asserts that the prospective savings are real, albeit not yet quantified, regardless of petitioners' claim that none will materialize because this is a "non-synergy" transaction. Staff cites petitioners' admission that they did not analyze the possibility of synergy savings, and that savings likely will result from sources such as scale economies and sharing of best practices and information technology. Staff observes that Iberdrola seriously underestimated the synergy savings realized through its acquisition of Scottish Power. (Petitioners reply that the unexpected Scottish Power savings resulted primarily from information technology efficiencies which could not be replicated in this transaction, to which Staff responds with speculation that the complexity of petitioners' computer systems may obscure the savings achievable here.) Staff also implies that Iberdrola entered the present transaction on the basis of a professed expectation of potential synergies.[98] Petitioners dismiss the notion of "hidden synergies" as frivolous, arguing that their strategic interests in this proceeding would have been better served by identifying, disclosing, and proposing a disposition of synergy savings if any were possible.

Even if one does not share Staff's mistrust of petitioners' presentation on this subject, a third, more credible explanation of petitioners' strategy may be, not that they have sought to conceal identifiable savings, but that this case gives petitioners little incentive to perform and defend a quantitative analysis of synergy expectations, because synergy

[98] The unredacted version of Staff's Initial Brief discusses this last point more specifically, but need not be relied upon here.

savings remain almost entirely speculative at this time and an estimate might give other parties an entrée to impute savings exceeding those which petitioners might reasonably expect to achieve. Viewing petitioners' case from that perspective, it is relatively unimportant whether petitioners should have accepted synergy savings as a possibility, as such an acknowledgement would not have helped quantify any savings that should be captured through PBAs. Moreover, the acceptance of $201.6 million of PBAs in petitioners' Partial Acceptance is the practical equivalent of the acknowledgement that Staff has been demanding, except for the divergence between the PBA amounts proposed by petitioners and Staff respectively. That divergence in turn highlights the main weakness of using PBAs as a proxy for synergies: even if some unquantifiable, future synergy savings are considered a certainty, one cannot justify any specific amount of PBAs and associated rate reductions as an appropriate proxy for those savings.

Ultimately, the proxy theory's limited value is not that the theory per se justifies PBAs in excess of $201.6 million, but that it bolsters Staff's other arguments for additional PBAs. As a matter of proof, Staff's suggestions of potential synergies put petitioners under an obligation to rebut them or present an alternative analysis. Petitioners' insistence that no synergies whatsoever will occur, in the face of Staff's reasonable suggestions that some are conceivable, is too extreme to constitute a credible prediction. Consequently, the record requires a recognition that the transaction will create some synergy savings; yet it also precludes an estimate that they will reach a specific level, or exceed the revenue impact associated with PBAs beyond $201.6 million. The proxy theory therefore stands only for the proposition that some indeterminate amount of PBAs is appropriate.

To determine that amount, the best methods available are to use the indicia proposed by Staff as part of its argument (discussed in the next section) that PBAs are needed not as a proxy for projected synergy savings but as a source of customer benefits mandated by a net benefits test under PSL §70.

b. PSL §70 Theory

From Iberdrola's perspective, the fate of NYSEG, RG&E, and New York customers in this transaction must be subordinated if they conflict with Iberdrola's own shareholders' interests, which in turn are defined by the ongoing saga of mergers and acquisitions among relatively gargantuan firms including Iberdrola. Such activities may themselves create public benefits for some participants, for reasons beyond the scope of this discussion. But it would be naive to suppose that, in structuring the transaction, Iberdrola's primary objective was to benefit NYSEG and RG&E customers in alien service territories with which Iberdrola has no present relationship. Unsurprisingly, then, the transaction proposed is one in which benefits for New York customers and territories are unquantified or not real; petitioners' own case posits that synergy benefits are unidentifiable or nonexistent; and, as Staff has shown, the only identifiable, material benefits of the transaction are those accruing to other participants such as petitioners' management, Energy East shareholders, and lawyers, financiers, and consultants facilitating the transaction.

From a broad societal perspective, there may be nothing inherently objectionable about this balance of interests among those affected by the transaction. However, if anything is clear from the Commission's past interpretations of PSL §70, it is that the statutory "public interest" criterion refers more parochially to the interests of the customers under the Commission's jurisdiction in New York. If the transaction provides them no significant benefits (as this recommended decision concludes), the statute requires that the transaction be restructured to include PBAs before the Commission can approve it. The primary reason for this conclusion is that (as all parties acknowledge; see above) the Commission's established interpretation of §70 entails a "net benefits" test rather than a "no harm" test.

Another, supplemental or alternative rationale for PBAs could be that a transaction benefiting all parties except customers violates the public interest because it is intrinsically inequitable. This is a less satisfactory basis for decision because its appeal, if any, rests not on PSL §70 and the Commission's precedents interpreting the statute, but on the Commission's subjective notions of fairness, which find no support in the objective criteria that should determine just and reasonable rates.[99] The subjective rationale for PBAs is mentioned here only because it is easy to misinterpret Staff's case as primarily an equitable theory based on subjective fairness. The theme of fairness is not inconsistent with Staff's rationale: for example, Staff says the transaction reflects distorted priorities insofar as it was designed to provide $4.5 billion in payments to shareholders and other participants but no monetized benefits to customers. (This criticism should be qualified by noting that the modifications subsequently proposed in the PA do include PBAs equivalent to a $54.8 million decrease in annual revenues from rates.)

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[99] Plato suggested, more famously than helpfully, that to determine abstract fairness we can only rely on our inborn sense of justice, a "memory" dimly perceived. Phaedrus, Jowett, p. 22; http://www.ellopos.net/elpenor/greek-texts/ancient-greece/plato/plato-phaedrus.asp?pg=22,visited May 20, 2008.

Instead, however, Staff's case (and the recommendation herein) relies primarily on PSL §70. The distinction is important because a PBA requirement is supported more convincingly by the net benefits test, under the Commission's past interpretations of §70, than by an abstract equitable criterion; and because one of petitioners' arguments against the PBAs is that Staff has identified no synergies or other benefits available to be shared with customers. By extension, petitioners add, the PBAs would set a precedent contrary to sound public policy because they would deter other transactions like this one in an era when New York needs infusions of investment in electric infrastructure.

To be relevant, petitioners' argument requires an erroneous presumption that the PBAs have the manifestly irrational purpose of giving customers an equitable share of benefits that, according to petitioners, do not actually exist. In fact, however, the PBAs are intended to satisfy §70 by providing customers net benefits which may have to be underwritten by shareholders precisely because the transaction itself may not produce sufficient real benefits available for sharing. Viewing the transaction from that perspective, the PBAs are a necessary remedy for the transaction's alleged lack of synergies. And, contrary to petitioners' warning that a PBA requirement will tend to deter infrastructure investment, the Commission will continue to have a legal obligation to allow regulated returns sufficient to attract investment regardless of whether it approves this transaction. Meanwhile, a PBA requirement here would set a salutary precedent by raising the bar for other mergers that cannot satisfy §70 by means of synergistic benefits.

c. Quantification of PBAs

If one accepts Staff's and this recommended decision's premise that the amount of PBAs need not be limited to quantifiable, synergistic benefits generated by the transaction itself, the next step is to identify an alternative measure of the proper amount. To support its proposed $646.4 million of PBAs, Staff invokes three indicia of reasonableness. First, Staff refers to the Commission's determination, in other mergers, that at least half of any benefits should be allocated to customers. Staff estimates that this transaction will generate $1.6 billion in benefits to participants other than customers.[100] It concludes that the $646.4 million of PBAs is conservative relative to other approved mergers because it represents only 40% of that total. Second, Staff characterizes this transaction as a sale of assets, comparing it with transactions such as RG&E's divestiture of the Ginna generating station from which the gain was allocated 95% to customers. Third, Staff calculates that benefits allocated to customers, expressed as a percentage of the participating utilities' delivery revenues, amounted to 6% in the Energy East acquisition and 10% in the Grid/KeySpan merger. Staff cites those results to confirm the reasonableness of the PBAs here, which it says equate to 11% of NYSEG and RG&E revenues when calculated on a comparable basis.

Clearly, none of Staff's three benchmarks purports to establish anything other than a range of reasonableness, as opposed to a direct calculation linking specific PBAs to specifically estimated benefits of the transaction. I recommend that the Commission nevertheless accept Staff's $646.4 million of PBAs despite that shortcoming, because Staff's case

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[100] Exh. 106.

represents the only reasoned methodology presented on this record; and because petitioners, in challenging the details of Staff's calculation, have made no valid points sufficient to materially affect the numbers Staff uses when comparing the proposed PBAs with the range indicated by the three benchmarks.

Even if the Commission shares petitioners' dissatisfaction with the imprecision inherent in Staff's methodology, it should accept that uncertainty as an unavoidable consequence of the circumstances in this case. That is, Staff's analysis is necessary by default, if (as Staff contends) petitioners should have sustained the evidentiary burden of quantifying synergies hidden in the transaction. Alternatively, if (as petitioners contend) petitioners bear no such burden because the transaction as proposed promises no synergies, Staff's analysis is necessary because the transaction simply does not qualify for approval on the merits under the net benefits criterion the Commission heretofore has applied when interpreting PSL §70, unless the transaction is modified to include PBAs on a scale comparable to the precedents Staff cites as benchmarks. Under either supposition, the most that can be inferred from petitioners' methodological criticisms is that the numbers Staff uses as benchmarks are marginally inaccurate. The criticisms do not support an inference either that the benchmarks are seriously miscalculated; or that, because the estimation of an appropriate level of PBAs is problematic in the absence of known synergies, the Commission should substantively reinterpret §70 to require no net positive benefits.

2. Rationales in Opposition to PBAs

a. Magnitude of Non-Customer Benefits

Petitioners summarize their critique of the proposed PBAs as a threefold argument. First, they object to Staff's calculation that the transaction will generate $1.6 billion in benefits to non-customer participants, which Staff cites to justify the $646.4 million in proposed PBAs. Petitioners argue that most of the $1.6 billion either represents costs — rather than benefits — to petitioners, or is based on unsupported or irrelevant suppositions.

Specifically, first, the $1.6 billion includes a $930 million acquisition premium payable by Iberdrola to Energy East shareholders. That, of course, is a cost to Iberdrola. Moreover, petitioners argue, Staff's attempted comparison between the sale of Energy East stock and the sale of the Ginna plant is misplaced because the Commission (and, for that matter, Staff), in the ConEd/O&R merger case, directly rejected an intervenor's argument that customers should share in an acquisition premium as if it were proceeds from the sale of an asset such as a generating plant.

Another element of the $1.6 billion consists of payments to parties facilitating the transaction such as underwriters, advisors, and attorneys. These payments obviously are another transaction cost rather than a benefit from petitioners' perspective.

The $1.6 billion also comprises production tax credits (PTCs) of $150 million which Staff claims are potentially available to petitioners in connection with renewable generation projects. Petitioners deny that the PTCs are causally related to the merger transaction. They also object that if the PTCs are captured for customers through PBAs, they will cease to operate as an incentive for renewables investment, contrary to the public policies that led to the design of the tax benefit. (Petitioners seem to imply that, of the $150 million of PTCs in Staff's calculation, $50 million associated with preexisting Iberdrola projects already has been used by third party investors and therefore is unavailable to petitioners, but Staff denies that its calculations include that $50 million.) Moreover, petitioners argue, PTCs associated with future projects are sheerly speculative because the projects may not be built; the legislation authorizing the PTCs is due to expire this December 31 and may not be renewed; the amount of the PTC for a given project depends on actual kWh output; and the availability and disposition of PTCs depends on how Iberdrola Renovables, rather than Iberdrola S.A. itself, structures the projects and its overall operations.

Finally, petitioners object that the $1.6 billion includes $476 million in tax benefits, created by Spanish law, related to amortization of goodwill that results from the premium paid by a Spanish company for acquisition of a qualifying foreign subsidiary. Petitioners argue that, because they propose to absorb the acquisition premium in this transaction and not recover it through NYSEG and RG&E rates, tax benefits derived from the acquisition premium likewise should not be recognized for regulatory purposes. As in the case of the PTCs, petitioners argue that PBAs based on the tax benefit would subvert the intended purpose of the tax legislation, which in this instance is to encourage Spanish companies to invest abroad. Here too, petitioners say the tax benefit is uncertain, because of rulings that cast doubt on this transaction’s eligibility for goodwill amortization; and because Iberdrola might have to take the benefit not by means of a deduction, but only as a deferred tax liability subject to possible reversal should Iberdrola sell Energy East.

Petitioners’ arguments do not effectively discredit Staff’s estimate of the transaction’s benefits. Initially, as explained above, the idea that PBAs can serve as a proxy for actual benefits of the transaction is only a secondary justification for Staff’s proposed PBAs; the primary justification is that customers should receive benefits via PBAs, commensurate with the transaction's benefits to other parties, if there is no expectation that the transaction itself will yield shareholder benefits that could be allocated partly to customers.

If the Commission accepts that rationale (as recommended herein), the petitioners' arguments summarized above become moot to the extent they complain that Staff has mischaracterized costs as benefits. Specifically, it becomes immaterial that the acquisition premium and the fees paid to facilitators of the transaction are costs to petitioners; that customers have no claim to a portion of sale proceeds, whether the sale is of stock or of physical assets; that petitioners should not forfeit tax benefits intended to promote certain public policies; that some PTCs allegedly included in Staff's calculations (assuming for present purposes that they are included) already have flowed to third parties; and that the potential Spanish tax benefits are related to the acquisition premium for which petitioners seek no rate recovery. In each instance, petitioners' argument proves only that PBAs, if required, must be funded from some source other than the items mentioned.

Looking further at the role of tax benefits in Staff's calculations, petitioners' and Staff's arguments leave the record unclear whether the $150 million in PTCs is overstated by $50 million related to preexisting projects.[101] It is tentatively assumed here that Staff properly excluded the $50 million. The matter is subject to further discussion on exceptions if necessary, but the Commission should bear in mind

[101] See Tr. 1214, Exh. 93, Petitioners' Initial Brief, p. 39, and Staff's Initial Brief, p. 119.

that even the erroneous inclusion of $50 million would not materially affect the merits of Staff’s basic argument that the transaction’s non-customer benefits total $1.6 billion for which PBAs of $646.4 million are only a modest counterbalance.

As for petitioners’ claim that the availability of PTCs for future projects depends on Renovables’ management, Staff correctly observes that it is inconsistent with petitioners’ argument in other contexts that Iberdrola exercises sufficient control over Renovables to cause the latter to invest specific amounts in renewables projects in New York. Moreover, the uncertainty whether future projects will qualify for PTCs and whether the tax legislation will be renewed beyond 2008 is negated, roughly speaking, by Staff’s conservatism in recognizing only one year’s worth of its PTC estimate. As for petitioners’ criticism that any PTCs actually realized will not constitute benefits of the transaction because they will “exist regardless of whether the Proposed Transaction is consummated,”[102] petitioners initially cited among the transaction’s benefits the opportunity to use PTCs to offset NYSEG’s and RG&E’s taxable revenues, and even now petitioners do not explain the scenario that might induce Renovables or petitioners to forgo that opportunity. Regarding the transaction’s eligibility for the Spanish tax benefit related to goodwill amortization, there is no indication that petitioners have a specific reason for doubt on that point, other than the mere commonplace that regulatory approval by the Spanish authorities cannot be presumed until granted. Finally, the possibility that Iberdrola would lose the Spanish tax benefit by divesting Energy East is irreconcilable with the proposition,

[102] Petitioners’ Initial Brief, p. 41.

permeating petitioners' case in all other respects, that Iberdrola should acquire Energy East.

b. Synergistic Benefits

Petitioners' second argument against the PBAs is that they are not supported by any realistic expectation of synergy savings. Most fundamentally, petitioners emphasize their view that no synergies should be expected from a "first mover" transaction such as this. In particular, petitioners say the entire potential to achieve synergies through consolidation of the companies' administrative functions has already been exhausted by Energy East's most recent acquisition of an operating company, namely RG&E. They add that restrictions on interaffiliate transactions, advocated by Staff as a precondition of the Commission's approving the transaction, would systematically prevent all potentially synergistic transactions between the Energy East companies and Iberdrola and its affiliates.

Staff responds that Iberdrola already has substantial North American operations, diminishing the significance of the fact that this transaction would be its first acquisition of regulated distribution companies in North America. Staff argues that Iberdrola's preexisting presence here can lead to potential synergies, as will any best practices imparted to NYSEG and RG&E as a result of the transaction. And the proposed affiliate rules, Staff says, affect only the provision of goods and services from parent to subsidiary; they would not preclude the Energy East subsidiaries from exploiting profitable opportunities to provide services to Iberdrola and its affiliates.

More fundamentally, the preceding discussion demonstrates nothing definitively except that estimation of synergy savings in this case is a highly speculative exercise.

As discussed in detail above, that is one reason why the extent of potential synergies is not the better criterion for deciding whether to impose PBAs. Again, the recommendation here is that the Commission adopt Staff's proposed PBAs not in the expectation that they can be funded entirely from synergies, but for the opposite reason: PBAs are needed because the Commission cannot reliably expect that synergy savings alone will supply the net benefits for customers that PSL §70 has been construed to require.

c. Comparisons with Other Mergers

i. Grid/KeySpan Merger

Petitioners' third general objection to Staff's PBA proposals is that Staff analogizes them to the positive benefits allocated to customers in other mergers. One issue involves Staff's contention that its proposed PBAs as a percentage of NYSEG and RG&E revenues (11%) resemble the comparable percentages in the Grid/KeySpan case (10%) and the Energy East acquisition case (6%).

To begin, petitioners would distinguish the other two cases as involving mergers of neighboring companies that preexisted in New York and therefore could achieve synergy savings. As discussed above, however, the possibility of synergies in this transaction has not been ruled out, and in any event, the PBAs are not predicated primarily on that possibility.

In addition, petitioners say Staff's calculated percentages overstate the positive benefits and understate the revenue base in the KeySpan case. Staff quantifies the benefits as $602.8 million. According to petitioners, Staff should have reduced that figure to $407.9 million, to recognize only those savings which the Commission deemed causally related to the merger; and then should further have reduced it to $317.7

million to remove the portion of benefits attributable to synergy savings, in recognition of the absence of synergies in the Iberdrola transaction. Finally, petitioners would divide the $317.6 million by the sum of Niagara Mohawk, KeySpan, and Long Island Power Authority (LIPA) revenues, instead of excluding Niagara Mohawk and LIPA revenues as in Staff's calculation. Petitioners thereby derive a benefits-to-revenue ratio of 1.3%, in contrast to Staff's 10%. Thus, according to petitioners, a proper application of Staff's own methodology to the KeySpan results would support PBAs of only $87 million, as compared with the $201.6 million offered in the Partial Acceptance or the $646.4 million advocated by Staff for the Iberdrola transaction.[103]

For reasons noted by Staff, petitioners' proposed "corrections" appear misguided. To begin, petitioners are correct to remove $194.9 million (the difference between $602.8 million and $407.9 million, above) from the Grid/KeySpan benefits on the ground that the Commission found they were not benefits of the transaction, i.e., that they would have occurred regardless of whether the Grid/KeySpan transaction were approved. After making that finding, however, the Commission's order proceeds through an extended series of calculations, stated largely in terms of net present value (NPV) dollars. Initially, it reduces the $602.8 million (nominal dollars) to $407.9 million (nominal) for lack of a causal relationship to the transaction, and then converts the latter to $328.2 million in NPV terms. To that number, it adds $366.4 million NPV to reflect additional benefits anticipated over the five-year period following the initial five years recognized in the $328.2

[103] Exh. 79. Alternatively, disregarding LIPA revenues, petitioners calculate a 2.1% ratio indicating PBAs of $134.3 million for the Iberdrola transaction. Ibid.

million NPV. From the sum of $328.2 million NPV and $366.4 million NPV for the first and second five-year periods, it subtracts $32.0 million NPV to reflect an overhead reallocation necessitated by divestiture of the Ravenswood generating facility, and adds $24.0 million NPV to reflect Niagara Mohawk's adoption of a KeySpan costing methodology. The end result is a sum of $686.5 million NPV in benefits, more than compensating for the Commission's $194.9 million nominal ($112.8 million NPV) disallowance based on lack of causation. Ultimately the Commission relied on that result, plus other benefits possibly worth $90 million in nominal dollars[104] in approving the Grid/KeySpan transaction.[105]

The $90 million should be disregarded because the Commission apparently would not vouch for it as a forecast at the time of the decision.[106] Otherwise, however, the add-backs, after the initial reduction to $407.9 million (nominal), consist of either (1) seemingly immediate savings (KeySpan costing methodology) net of immediate expense increases (overhead allocation) or, for the most part, (2) $366.4 million NPV of benefits attributable to the second five-year period. The briefs in the present case do not explicitly address the merits of assuming that the relevant benefits are those expected over ten years rather than five, although (as just illustrated) that assumption is essential to Staff's claim that the recognizable Grid/KeySpan benefits equaled or surpassed the $602.8 million

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[104] This seems to refer to the effect of increasing imputed net margins from temperature controlled service. See Case 06-M-0878, National Grid PLC and KeySpan Corp. – Petition, Order Authorizing Acquisition (issued September 17, 2007), p. 84.

[105] Ibid., pp. 116-21.

[106] Ibid., p. 121. ("The actual could be more or less than $90 million.")

(nominal) of benefits used to derive Staff's 10% benefits/ revenues ratio in this case. The only comment on the subject is Staff's assertion that benefits imposed by the Commission in the Grid/KeySpan case or here would permanently continue to accrue each year. That not only is factually accurate, but also appears relevant unless petitioners can explain why it is not. Therefore, the $602.8 million used in Staff's calculation does not overstate the amount the Commission deemed causally related to the Grid/KeySpan merger.

Second, petitioners' removal of synergy savings from the Grid/KeySpan benefits is contrary to Staff's rationale for using the Grid/KeySpan benefits as a benchmark for PBAs here. The reason for PBAs (at a level indicated by benchmarks such as Grid/KeySpan) is the presumption, under the primary theory recommended herein, that no synergy savings are available in this case. Accordingly, the PBAs are intended as an alternate source of benefits. To remove the synergy component from the Grid/KeySpan benefits would not put it on a comparable basis with the Iberdrola benefits proposed by Staff, but would merely constitute an arbitrary a priori judgment that the Iberdrola transaction does not warrant a level of benefits as high as in the Grid/KeySpan case.

Third, petitioners' inclusion of Niagara Mohawk and LIPA revenues in the revenue base ignores the rationale for calculating a benefits/revenues ratio, which is that the ratio makes it possible to compare the magnitude of the benefits in various mergers on a consistent basis relative to the size of the companies whose customers benefit. In the Grid/KeySpan case, Staff says, the benefits flowed primarily to customers of the acquired company, KeySpan, just as the PBAs here would benefit only NYSEG and RG&E customers. Petitioners object that the direction of the benefits is irrelevant because customer benefits in a merger are supported by the revenues of all the participating firms. By that reasoning, however, the revenue denominator in the ratio for the Iberdrola transaction should include not only NYSEG's and RG&E's revenues but also Iberdrola's. Such expansion of the revenue base not only would be illogical, but would artificially bolster Staff's position by making Staff's proposed PBAs seem infinitesimal (as a ratio of revenues) when compared with the benefits provided customers in the Grid/KeySpan case.

ii. Energy East Acquisition

Turning to Staff's calculation that benefits represented 6% of revenues in the Energy East acquisition case, petitioners again raise the objection that this case is distinguishable because the Energy East transaction involved synergy savings. This argument should be dismissed for the reasons discussed above.

Additionally, petitioners say the numerator in the Energy East case – $383.4 million, according to Staff, after correcting an earlier Staff figure of $822 million – should be reduced to $164.3 million. The latter, petitioners observe, represented the estimate of total benefits for NYSEG and RG&E for the initial five years in the acquisition case; Staff's $383.4 million, on the other hand, was derived by taking the annual benefit of $76.7 million for the fifth year and multiplying it times five. Then petitioners would reduce the $164.3 million by half, to $82.2 million, to reflect that the initial five years of projected synergy savings were to be allocated equally between shareholders and customers. Substituting $82.2 for Staff's $383.4 in the numerator would reduce Staff's calculated 6% benefits/revenues ratio to 1.3%.

Staff's reason for multiplying the fifth year benefits by five, instead of using the Commission's estimated total for the initial five years, is that synergy benefits—like the proposed PBAs—are permanent. Staff's reason for disregarding the shareholders' 50% allocation is that, after five years, all synergy savings would flow to customers. Here, therefore, as in the Grid/KeySpan calculations, the issue really is whether benefits estimated over a ten-year horizon are more relevant than an estimate for the initial five years.

The parties do not seem to have discussed that question directly, or explained why they have quantified the benefits of the various merger cases primarily on the basis of a five-year estimate. Absent additional discussion on exceptions, however, I conclude that Staff's use of ten years, disregarding the average synergy level and 50% sharing associated with the initial five years of the Energy East acquisition, is more valid than reliance on the initial five years' benefits, Since the purpose of the comparison is to test whether the proposed PBA amount in this case would achieve a sharing of benefits similar to the results in the Energy East acquisition, the ten year horizon better accounts for the fact that the initial five years in the Energy East case were atypical of the permanent results in that case.

iii. Maine – Central Maine Power Acquisition

As additional support for PBAs, Staff cites the terms on which the Maine Public Utilities Commission has approved this transaction with respect to Central Maine Power (CMP), an Energy East subsidiary. According to Staff, the Maine commission's decision provides customers benefits of $306 million inasmuch as CMP will forgo rate recovery of the acquisition premium, and $86 million representing the value of an agreement whereby CMP will forgo carrying charges on deferred costs of an Advanced Metering Infrastructure (AMI) initiative.

Staff says the combined $392 million in benefits represents 34% of CMP's revenues, as compared with the 11% ratio resulting from the PBAs proposed in this case. Staff also cites the $392 million as evidence that the Maine commission, applying a "no harm" test rather than New York's positive benefits test, must have perceived a need for benefits sufficient to offset massive risks inherent in the transaction. Even greater benefits are necessary in New York, Staff argues, not only because of the positive benefits requirement but also because the Maine decision reflects significant safeguards such as ring fencing and the Maine commission's authority to compel Iberdrola to divest CMP if necessary for the protection of the subsidiary.

Petitioners respond that the unrecovered $306 million acquisition premium is an illusory benefit because CMP never sought, and therefore did not forgo, any recovery of an acquisition premium beyond $8.8 million. Under the Maine commission's policies, petitioners argue, not even the $8.8 million portion would have been recoverable in the absence of a negotiated settlement proposal, and CMP's forbearance therefore cannot be counted as a consequence of the present transaction. As for the $86 million AMI benefit, petitioners say that figure is merely a newspaper's unverifiable quotation of an intervenor, whereas the only evidence this Commission may properly notice shows that the benefit was worth only $1.6 million. Petitioners calculate that the corrected benefit amounts of $10.4 million, compared with CMP delivery revenues of $311 million, result in a benefits/revenues ratio of only 3.3% rather than the 34% asserted by Staff.

In principle, i.e., assuming the accuracy of petitioners' data, which Staff has not rebutted, 3.3% is the more accurate ratio. As discussed previously, nonrecovery of the acquisition premium is properly excluded from recognition as a benefit of this transaction because it leaves the customer in no better position than if the transaction did not occur. By the same reasoning, the $306 million so-called forbearance by CMP, and to some extent the nonrecovery of the $8.8 million portion whose recovery was subject to litigation risk, should not be counted as customer benefits created by the Maine commission's decision. As for the AMI amount, the figure of $1.6 million is more credible than $86 million for the reasons noted.

That said, the 34% benefits/revenues ratio appears to have been intended not as a direct mathematical basis for a PBA calculation but only as a makeweight argument that would add some qualitative persuasiveness to the ratios of 11%, 10%, and 6% for the Iberdrola, Grid/KeySpan, and Energy East acquisition cases, respectively. Thus, reducing it to 3.3% does not provide a method for making a specific reduction in the PBAs, but it deprives Staff of one general argument supporting the reasonableness of the PBA amounts Staff has proposed.

F. Further Proceedings on Rates

1. Procedural Proposals

Should the Commission approve the transaction, thereby rejecting Staff's primary position, Staff's fallback position is that the Commission should institute an expedited Phase 2 of this proceeding to modify the current rate plans so that new electric and gas rates for NYSEG and RG&E would take effect January 1, 2009. Staff bases the January 1 target date on the premise (with which MI agrees) that all the NYSEG and RG&E rate plans will have expired by December 31, 2008. As petitioners explain, this is an oversimplification. Specifically, the Commission set NYSEG's electric rates for a specified term, in a litigated proceeding with no agreement on a rate plan.[107] NYSEG's present gas rates were established pursuant to a plan for a multi-year rate period ending December 31, 2008, with the understanding that they would remain in effect beyond that date until altered by the Commission.[108] RG&E's electric and gas rates likewise were set as a multi-year plan continuing through December 31, 2008;[109] but RG&E, pursuant to the terms of the plan adopted in that case, submitted a request on February 1, 2008 that the Commission allow its rates to remain in effect beyond 2008.

The Phase 2 rate proceeding proposed here by Staff would result in new rates effective on a permanent basis on January 1, 2009 if the proceeding can be completed by then. If it cannot, Staff proposes two alternatives effective from January 1 until completion of Phase 2. One is that the "existing" rates would become temporary as of January 1, subject to refund to the extent consistent with the rate changes proposed by Staff in this case.[110] Staff's proposal to extend the existing rates does not clearly acknowledge petitioners' intention that the $54.8 million (4.4%) rate reduction effectively offered by petitioners, by means of the $201.6 million of PBAs proposed in their Partial Acceptance, would take

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[107] Case 05-E-1222, NYS Elec. & Gas Corp. – Rates, Order Adopting Recommended Decision with Modifications (issued August 23, 2006).

[108] Case 01-G-1668, NYS Elec. & Gas Corp. - Rates, Order Establishing Rates (issued November 20, 2002) and Order Concerning Rate Design, Economic Development, and Affordable Energy Programs (issued September 23, 2004).

[109] Cases 03-E-0765 et al., Rochester Gas & Elec. Corp. – Rates, Order Adopting Provisions of Joint Proposals With Conditions (issued May 20, 2004).

[110] Staff's Initial Brief, p. 172.

effect immediately upon the Commission's approval of the transaction. Petitioners do not seem to interpret Staff's proposal to mean that temporary rates would be set on January 1 at present levels without first reflecting the 4.4% reduction.[111] It is unclear whether petitioners' interpretation misreads Staff's proposal, or reflects a difference of opinion as to whether present rates may be changed before January 1. This recommended decision assumes Staff's proposal is that the Commission would set temporary rates at the levels in effect now. However, Staff can clarify its position on exceptions if necessary.[112]

Staff's second proposed alternative, should Phase 2 not be completed by January 1, is that the Commission adopt new earnings sharing mechanisms (ESMs) for delivery rates at that date. The ESMs would be based on earnings calculations that incorporate Staff's proposed PBAs and, for RG&E, a redesigned fixed price option and a revised commodity earnings ESM.[113]

In response, petitioners take the position that the transaction would deserve approval under PSL §70 even without the $201.6 million of PBAs proposed in petitioners' Partial Acceptance; that any rate adjustments by the Commission should be implemented immediately at the conclusion of this proceeding but should be limited to the uncontested $201.6 million; and that there is no immediate need for further rate proceedings.

The other parties offer a variety of proposals. GRE, as noted above, regards the $201.6 million (combined with petitioners' other proposed commitments) as sufficient to satisfy PSL §70 and justify approval of the transaction. MI

[111] Petitioners' Reply Brief, p. 128.

[112] Staff's Initial Brief, p. 172; Staff's Reply Brief, p. 36.

[113] Staff's Initial Brief, p. 172.

says the Commission should adopt Staff's proposed PBAs in this proceeding,[114] and either adopt the other rate adjustments that Staff advocates here or state that it will consider them in future rate proceedings. MI also advocates that NYSEG and RG&E be barred from filing new rate applications within two years after approval of the transaction; and that the Commission, at the close of this proceeding, order the companies to show cause why their rates should not be reduced, unless the order approving the transaction includes other terms ensuring that customers receive the benefits of PBAs and other rate adjustments immediately. SPM proposes that the Commission approve the transaction and make the uncontested $201.6 million of PBAs effective immediately; make temporary the portion of the companies' rates corresponding to the difference between the $201.6 million of PBAs per petitioners and half the $646.4 million per Staff; and make all rates permanent effective January 1, 2010, at the conclusion of a rate proceeding that would start four to six months after the close of this case. Nucor says it attaches more importance to rate predictability and avoidance of rate litigation, than to the amount of customer benefits; it therefore favors the Partial Acceptance's approach of implementing PBAs immediately and not mandating a rate proceeding, although Nucor does not state whether it favors the amount of PBAs specified in the Partial Acceptance.[115] CPB deems the $201.6 million of PBAs inadequate; it says the decision at the close of this proceeding should approve the transaction but require that NYSEG and RG&E file electric and gas rate cases within 90 days, and show cause why temporary rates should not be

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[114] MI's Initial Brief, p. 23.

[115] Nucor's Reply Brief, pp. 3-4.

set at a level reflecting all PBAs approved in this proceeding and Staff's proposed adjustments for overearnings.

2. Recommendation in Case of Disapproval

As noted, my primary recommendation is that the Commission disapprove the transaction. As to the ratemaking process after a decision approving or disapproving the transaction, no party's proposal seems compellingly preferable or inferior to any of the others. Moreover, the parties on exceptions, and the Commission in its decision, could readily devise other variations upon those proposals or upon the following recommendations.[116] Subject to those qualifications, I recommend the following.

If the Commission's order concluding this phase of the proceeding disapproves the transaction, the order also should postpone consideration of Staff's proposed regulatory adjustments (other than PBAs, which would be moot because of the disapproval);[117] and institute a plenary Phase 2 rate proceeding, as an exercise of the Commission's authority under PSL §72 and the current rate plans' reopener provisions, to be completed in 11 months with the establishment of new permanent rates.

These recommendations are based on several premises. First, although the Commission could decide the Staff ratemaking adjustments on the basis of the present record, petitioners are correct that these adjustments are unrelated to a PSL §70

[116] In other words, the Commission could adopt a plan differing from all other proposals and recommendations in terms of the starting date and length of rate cases, the portion of revenues made temporary, the timing of any temporary rate order, and the timing of a decision on ratemaking issues raised in this case.

[117] Staff's term, "regulatory adjustments," is used here as shorthand to denote the Staff adjustments categorized by petitioners as either "one-time adjustments" or "rate order and rate plan modifications."

analysis. In that sense, they belong in a rate case and raise issues that the Commission could defer while preserving the existing record for official notice in a phase 2.

Another possible reason to postpone consideration of Staff's regulatory adjustments is that the present record on other, related issues suffers from significant deficiencies. Potentially, petitioners claim that adoption of the non-PBA adjustments implies a substantial delivery rate decrease, by as much as 16.3% for NYSEG and RG&E overall if the Commission were to adopt all the non-PBA adjustments. It is such action by the Commission would necessitate a comprehensive rate proceeding because the present record will not adequately support decisions as to how the decrease should be allocated among service classifications; whether the indicated revenue reduction would unacceptably impair interest and indenture coverages, and, if so, whether it could be implemented in such a way as to mitigate cash flow effects; and whether the companies can identify unrelated, countervailing factors tending to increase the revenue requirement.

Finally, I recommend a Phase 2 rate proceeding scheduled so that new permanent rates are established not on an expedited basis, but at the end of the 11 month period that would be applicable for a statutorily suspended rate application. Even on a conventional 11 month schedule, as CPB observes, comprehensive electric and gas rate cases for two companies simultaneously would substantially burden the parties' resources. Absent some valid reason, that burden should not be compounded by attempting to accelerate the process; but no sufficient reason for an expedited process presents itself here. Even if customers receive no rate reduction for 11 months pending the outcome of Phase 2, other than the 4.4% reduction associated with the PBAs in the Partial Acceptance, they still will be better positioned than if the Commission had initiated a rate proceeding this summer without this PSL §70 proceeding as a preliminary phase.

Moreover, Staff's commitment to a January 1, 2009 effective date for a rate reduction not only overlooks the Commission's practice of avoiding gas rate changes in the middle of a heating season, but also seems to originate in a misplaced concern about expiration of the current RG&E electric rate plan and the NYSEG and RG&E gas rate plans. The existing rate plans' supposed December 31, 2008 expiration date lacks the significance that Staff would ascribe to it, because the RG&E electric and gas rate plans are subject to extension on the basis of RG&E's pending February 1, 2008 request, and the NYSEG gas rate plan provides for continuation of current rates as the default mode if no new rates are adopted by the end of the plan's prescribed rate period. As for NYSEG's present electric rates, the Commission's use of a rate year, as in the NYSEG electric case, ordinarily creates no implicit expiration date. Thus, there is no calendar driven imperative that Phase 2 proceed on an expedited basis.

3. Recommendation in Case of Approval

In the alternative scenario, the Commission approves the transaction. In that event, the recommendations here are similar to the recommendations for the disapproval scenario, except with respect to the PBAs. Thus, if the Commission's order concluding this phase of the proceeding approves the transaction subject to conditions involving PBAs, the order also should (1) rule upon the PBA amounts that have been contested here, (2a) immediately implement the 4.4% overall rate reductions associated with the $201.6 million of PBAs in petitioners' Partial Acceptance, by means of an equal across-the-board decrease for all classes in each company after allocating PBAs of about $81 million and $120 million to NYSEG and RG&E respectively; (2b) declare the resulting rates temporary to the extent of any other, contested PBAs adopted by the Commission, and (3) institute a plenary Phase 2 rate proceeding to consider other regulatory adjustments and establish permanent rates on a conventional 11-month schedule.

These recommendations are supported by considerations similar to those suggested above for the non-approval scenario. That is, decisions on contested regulatory adjustments can be postponed even if the record on specific adjustments already is adequate. On the other hand, there is no reason to postpone a decision on the $201.6 million of PBAs in which petitioners have acquiesced (although it must be understood, of course, that petitioners presupposed the Commission would reject the additional PBAs, regulatory adjustments, and other conditions recommended herein). Moreover, if the Commission is approving the transaction, there are two additional arguments for deferring a decision on regulatory adjustments besides those applicable in the disapproval scenario.

First, the acquisition agreement among the petitioners defines the expiration date of the agreement (and any extensions) by reference to a complex set of ill-defined contingencies including, among other things, whether the Commission imposes onerous conditions on the transaction and, if so, the likelihood that these impediments can be overcome. While these provisions clearly do not bind the Commission to any particular course of action, the more responsible course for the Commission would be to eliminate any uncertainties that might compromise the agreement’s durability if they are unnecessary. Petitioners can best construe their own agreement, but they may agree that the Commission could best avoid unnecessary interference with the agreement by relegating most of the PBAs and other regulatory adjustments to a separate phase 2 rather than deciding them now for implementation at the conclusion of phase 2.

It was noted above that in the disapproval scenario, an additional reason to institute a rate proceeding promptly is that the substantial revenue effects of the non-PBA regulatory adjustments, if adopted here, would make it necessary to develop a record on the adjustments' rate design and cash flow implications. The same consideration applies more forcefully under the approval scenario. Approval of the transaction would require the Commission to decide at some point not only whether to adopt Staff's non-PBA regulatory adjustments, as in the disapproval scenario; but also whether to adopt the PBAs, because they, unlike the non-PBA adjustments, are intended as preconditions of the transaction to ensure that customers benefit if it goes forward. Assuming for illustrative purposes that the Commission adopted all the proposed PBAs in addition to all the non-PBA regulatory adjustments attendant on the disapproval scenario, the potential cumulative impact of the proposed PBAs and non-PBA adjustments would be a 26.3% revenue decrease for NYSEG and RG&E collectively (as compared with the 16.3% decrease cited above if the transaction were disapproved and only the non-PBA adjustments were adopted). Thus, depending on the extent to which the Commission accepts the PBAs and non-PBA adjustments, a prompt rate case to deal with the consequences might be all the more necessary if the transaction were approved.

Finally, the disapproval and approval scenarios call for somewhat differing analyses of why January 1, 2009 is not a legally significant date that constrains the Commission's options in setting rates. The discussion above regarding the disapproval scenario concludes that petitioners have no vested right to continue current rates until January 1, because the NYSEG electric rate year has expired; and because the RG&E electric and gas rate plans (whether extended or not) and the NYSEG gas rate plan are subject to foreshortening according to the underlying joint proposals. It was noted also that, on the other hand, a rate decision effective January 1 is unnecessary because all four rate regimes continue by default until new rates supersede them.

Under the approval scenario, these principles remain applicable. (For that reason, as well as the resource considerations noted in the discussion of the disapproval scenario, the Phase 2 rate proceeding should not be conducted on an expedited schedule.) But an additional consideration, identified by MI, is that the Commission's adoption of PBAs and other regulatory adjustments would constitute conditional approval of the transaction. Obviously the reason the transaction requires Commission review of a petition under PSL §70 is that petitioners have no vested entitlement to approval of the transaction in the first place, and consequently they have no due process entitlement to an approval free of conditions. As a result, if the Commission granted approval subject to conditions that would supersede current rate plans, petitioners' rights would not be violated. Rather, petitioners would have to either reject the Commission's terms, or voluntarily accept those terms and proceed with the transaction accordingly. Thus the approval scenario, like the disapproval scenario, entails no requirement that current rates remain undisturbed until January 1 (or that they remain undisturbed until expiration of the RG&E rate plans, should the plans be extended beyond January 1).

G. ESCO Collaborative

Staff takes the position in this proceeding that the Commission should impose on NYSEG and RG&E requirements regarding ESCO referral programs that are similar to the requirements that the Commission imposed on KeySpan and National Fuel Gas in deciding their recent rate cases.[118] Petitioners object, arguing that such a requirement is unrelated to this proceeding and "should be rejected by the Commission for that reason alone."[119] Petitioners assert that consideration of ESCO referral programs should be resolved within the context of the Commission's ongoing generic retail access proceeding.[120] Both Staff and petitioners note that RG&E has a proposal to institute an ESCO referral program, filed October 23, 2006, pending for Commission action. NYSEG similarly has an ESCO referral program pending; however, in NYSEG's recent commodity supply services case, the Commission adopted a provision directing NYSEG to collaborate with the parties on an "ESCO Introduction Program" which would replace the pending ESCO referral program and result in the withdrawal of the pending proposal.[121] Collaborative negotiations on the content and costs of an ESCO introduction program for NYSEG are ongoing.

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[118] Cases 06-G-1185 and 06-G-1186, KeySpan Corporation – Gas Rates, Order Adopting Gas Rate Plans for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued December 21, 2007); Case 07-G-0141, National Fuel Gas Distribution Corporation – Gas Rates, Order Establishing Rates for Gas Service (issued December 21, 2007).

[119] Petitioners' Reply Brief, p. 152.

[120] Case 07-M-0458, Retail Energy Markets Policy Review, Order on Review of Retail Access Policies and Notice Soliciting Comments (issued April 24, 2007).

[121] Case 07-E-0479, NYSEG – Commodity Supply Service, Order Establishing Commodity Program (issued August 29, 2007).

It is recommended that the Commission refrain from deciding the issue of ESCO referral programs in the context of this merger proceeding. As the parties point out, there are already several open dockets in which the relevant proposals are under consideration, and the matters can be decided there. Alternatively, the issues surrounding ESCO referral programs could also be resolved in the context of future rate proceedings for NYSEG and RG&E, which are recommended elsewhere herein to begin promptly. The parties have not presented a persuasive countervailing reason why the issues of ESCO referral programs for NYSEG or RG&E must be decided in this case. There is no allegation that the outcome would affect or be affected by Iberdrola's acquisition of Energy East. Such programs are not listed as a condition ameliorating any harm from the merger, nor are they cited as benefits flowing from the merger. Therefore, in the interests of keeping this current proceeding focused on the matters bearing most directly on petitioners' filing, the Commission should address the ESCO referral program issues elsewhere.

H. Revenue Decoupling Mechanism

There is general consensus among the parties to this case that the Commission should not decide the issues surrounding a revenue decoupling mechanism (RDM) or establish an RDM for NYSEG or RG&E as part of this order. Staff, petitioners, MI and CPB all point to the need for "rate case quality" data, which assertedly are not sufficiently developed on this record to support a decision at this time. MI and Nucor highlight the complexity of an RDM and the pitfalls that can result from a poorly constructed mechanism. For this reason, Nucor asserts that the Staff proposals in this case are only "a starting point" for the development of RDMs for NYSEG and

RG&E.[122] MI asserts that the establishment of an RDM for NYSEG or RG&E is irrelevant to the transaction being considered in this case and has no bearing as to whether the acquisition would be in the public interest. MI further asserts that there has been inadequate public notice that institution of an RDM for RG&E is within the scope of this proceeding.

Staff and petitioners both agree that the issue of RDMs should be considered in separate proceedings following a decision on the acquisition that is the subject of this case. Petitioners have offered to make filings to begin the consideration of RDMs by July 1, 2008. NRDC apparently supports this prompt consideration of the RDM issue, expressing its hope that, once merger matters are settled, the parties can begin working immediately toward compliance with the Commission’s RDM order.

Consequently, as CPB explains, the only real issue of difference among the parties is the precise procedural vehicle and schedule for consideration of RDMs for NYSEG and RG&E following the conclusion of this case. Whereas Staff and petitioners support proceedings to consider RDMs separately from other issues, CPB agrees with MI that RDMs should instead be considered in the context of rate cases for each company. CPB and MI assert that, in the rate case context, a fully developed record on sales levels, rates and revenues can be considered in designing an RDM. Also, they continue, a rate case can consider the RDM’s effect on risk and any corresponding adjustment to return on equity. CPB asserts that, since Staff has called for the prompt filing of rate cases for both RG&E and NYSEG in any event, those rate cases will provide the proper forums for consideration of an RDM. If there are to be rate cases in any

[122] Nucor Initial Brief, p. 13.

event, no significant delay will result from inclusion of the RDM issue in those proceedings. Therefore, CPB concludes, there is nothing to be gained from treating the issues separately.

CPB's arguments are particularly persuasive here. As several of the parties point out, consideration of RDMs in a proceeding divorced from other revenue and rate issues is problematic. Therefore, that procedural vehicle should be avoided where there is instead the opportunity to consider an RDM in the context of a traditional rate proceeding. In this case, where the commencement of such rate cases is recommended, there is no reason for the separate consideration of RDMs. Consequently, if the Commission follows the recommendation herein to order the prompt filing of rate cases for both companies, to be considered on a traditional rate case schedule, RDMs for each company should be included in the scope of those rate cases.

June 16, 2008
RAE/jrw