STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 12-M-0066 - New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation, RGS Energy Group, Inc., Iberdrola USA Networks, Inc., Iberdrola USA, Inc., and Iberdrola Finance UK Limited - Petition of for Approval of an Internal Reorganization Pursuant to Public Service Law §70.

CASE 12-E-0065 – Iberdrola Renewables Holdings, Inc. - Petition for a Declaratory Ruling Regarding the Application of Public Service Law §70.

CASE 10-M-0551 – Comprehensive Management Audit of Iberdrola, S.A., Iberdrola USA, Inc., New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation.

ORDER ADOPTING STAFF REPORT AND APPROVING REORGANIZATION, SUBJECT TO CONDITIONS AS MODIFIED AND CLARIFIED, AND MAKING FINDINGS ON MANAGEMENT AUDIT COMPLIANCE

(Issued and Effective November 5, 2013)

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PUBLIC SERVICE COMMISSION

At a session of the Public Service
Commission held in the City of
Albany on October 17, 2013

COMMISSIONERS PRESENT:

Audrey Zibelman, Chair
Patricia L. Acampora
Garry A. Brown
Gregg C. Sayre
Diane X. Burman

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BY THE COMMISSION:

## BACKGROUND

In a Staff Report on Reorganization and Related Management Audit Issues (Staff Report) dated March 25, 2013, conditions are proposed concerning the plans of Iberdrola, S.A. (IBE) to reorganize the corporate structure for its subsidiaries (collectively, the Companies) that conduct its U.S. operations.[1] Also presented in the Staff Report are resolutions to the corporate governance and organizational issues raised in Case 10-M-0551, the management audit of IBE and its U.S. affiliates, that were transferred to Case 12-M-0066 for further consideration in the Audit Recommendations Order.[2] A procedural history further detailing the course of these proceedings, and summaries of the Companies' petition and subsequent filings in Cases 12-M-0066 and 12-E-0065, are provided in the Staff Report.

The Companies describe their proposed reorganization as beginning with the existing corporate holding company structure upstream from NYSEG and RG&E. Currently, those two operating utilities are owned directly by RGS, an intermediate holding company that is, in turn, owned directly by IUSA, which is a direct, wholly owned subsidiary of IBE.

The corporate reorganization would be accomplished by inserting Networks, as a newly-created company, into the ownership structure between IUSA and RGS,[3] so that it becomes a direct wholly-owned subsidiary of IUSA and the direct owner of all interests in RGS. Networks would thereby serve as the

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[1] The affiliates are: New York State Electric & Gas Corporation (NYSEG), Rochester Gas and Electric Corporation (RG&E), RGS Energy Group, Inc. (RGS), Iberdrola USA, Inc. (IUSA), Iberdrola USA Networks, Inc. (Networks) (which will be created at the time the transaction is consummated), and Iberdrola Renewable Holdings, Inc. (IRHI) (which operates in competitive markets).

[2] Case 10-M-0551, et al., supra, Order Directing the Submission of Management Audit Implementation Plan and Establishing Further Procedures on Corporate Structure and Governance Issues (issued August 28, 2012).

[3] While RGS remains in the corporate structure as an intermediate holding company, it is not actively managed and is a corporate shell whose activities need not be considered further (to the extent it remains primarily inactive).

indirect owner of NYSEG and RG&E. The final feature of the corporate reorganization is the consolidation of IRHI, now an indirect subsidiary of IBE that owns and operates wind generation facilities and other competitive market operations in the U.S., into the newly-created holding company structure as a direct subsidiary of IUSA.[4]

The corporate reorganization, the Petitioners claim, will not alter the ownership of interests in NYSEG and RG&E that was approved in the Merger Order,[5] with IBE remaining the ultimate upstream parent owning all of the interests in NYSEG and RG&E, and without any transfer of any of those interests to any third party. The Petitioners contend that the reorganization is purely an intra-corporate restructuring that will not modify the management structure in place at NYSEG or RG&E, change the composition of their Boards of Directors, or affect the safe and adequate provision of electric and gas service by NYSEG or RG&E under their existing rates, terms or conditions.

In its Report, Staff concludes that, although the proposed reorganization does not result in any change in the ultimate ownership of NYSEG and RG&E as indirect wholly-owned subsidiaries of IBE, the reorganization nonetheless poses the potential for harms to the interests of captive utility ratepayers. Since the proposed restructuring more closely links New York's regulated utilities and their ratepayers to IBE's U.S. affiliates that operate in competitive markets, it raises risks not present under the prior structure.

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[4] The Companies have withdrawn a proposal to also insert into the U.S. corporate structure an IBE affiliate organized in Great Britain.

[5] Case 07-M-0906, Iberdrola, S.A., Order Authorizing Acquisition Subject to Conditions (issued January 6, 2009).

To further the public interest and forestall harms that might attend the risks, Staff proposes twenty-seven Conditions, listed at Staff Report Appendix A, which couple to the reorganization the intangible benefits that advance the public interest, and mitigate the risks attending the transaction to the extent practicable. Staff's proposed Conditions address: financial protections that shield ratepayers from the potential for adverse consequences that could attend the reorganization; corporate governance requirements that further protect ratepayers and tie into issues raised in the audit; and, affiliate relationship requirements that separate the regulated utilities and their ratepayers from the risks posed by the affiliations with IBE's competitive market subsidiaries through IUSA's common ownership of Networks and IRHI.

Also reviewed in the Staff Report are 13 audit Recommendations -- twelve where remedial actions were proposed and one where no action was developed -- which were remanded for consideration here in the Audit Recommendations Order. The Recommendations and the resolutions of the issues they raise are listed in Staff Report Appendix B.

Eleven of the audit Recommendations were resolved in the Staff Report as audit compliance matters, with the audit implementation filings made to date in compliance with the Audit Recommendations Order meeting the spirit of seven of the Recommendations. The Staff Report provides, however, that compliance with three Recommendations requires further clarification and action by the Companies, and, for one Recommendation, the Companies' implementation filing explication should be deemed unsatisfactory.[6] Compliance efforts for that

[6] See Staff Report Appendix B, Recommendations 2.4, 2.5, 2.6, and 14.5

Recommendation would begin anew, as guided here. Review of compliance efforts and enforcement of requirements concerning these eleven audit matters will be addressed in the audit review and implementation process that is ongoing in Case 10-M-0551.

The remaining two of the 13 audit recommendations -- Recommendation 2.1, concerning the relationship between RG&E and NYSEG and their engineering services affiliate, Iberdrola Energy Projects, Inc. (IEP),[7] and Recommendation 2.2, concerning the utilities' management of their gas businesses -- were set for resolution through the Staff Report Conditions. The Audit Recommendations Order also remanded for additional consideration two other issues; the reversal in that Order of the audit finding that consolidation of NYSEG and RG&E into one utility would not produce appreciable savings, and the interpretation of the Merger Order's Sarbanes-Oxley Act (SOX) requirements relied upon in the audit.[8] Those issues are reviewed in the Staff Report as well, where they are also resolved through the Conditions. The issues raised by the Staff Report Conditions addressing these four audit-related matters are addressed below, and compliance with these decisions are transferred to and will be enforced in Case 12-M-0066, except that additional relief regarding IEP will be considered in another proceeding.

In a Notice Soliciting Comments on Staff Report issued March 25, 2013 in these proceedings, interested parties were invited to comment on the Staff Report by April 5, 2013.

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[7] IEP is an indirect subsidiary of IBE that provides engineering services to NYSEG, RG&E and other customers that are not New York utilities in U.S. competitive markets.

[8] The scope and extent of a Merger Order condition obligating IUSA to comply with SOX was not interpreted or considered in sufficient detail in the audit.

Comments were received on that date from the Companies. Moreover, on April 29, 2013, the Companies filed unauthorized supplemental comments which, they say, raise new and significant concerns. Most of those concerns are directed towards the Staff Report Condition that would require NYSEG and RG&E to issue public securities in the future only through registration with the Securities and Exchange Commission (SEC). Both comments are summarized below.

Notice of the petition was also provided in conformance with the State Administrative Procedure Act (SAPA) §202(1), as published in the State Register on March 21, 2012. The SAPA §202(1)(a) period for submitting comments in response to the notice expired on May 7, 2012. No comments were received.

## THE COMPANIES' COMMENTS

### The Initial Comment

The Companies begin by noting they agree with the majority of the 27 Conditions proposed in the Staff Report without revision or modification. They also agree with the proposals made concerning all but two of the 11 remaining audit resolutions. Pointing out that their petition in Case 12-M-0066 was filed in February 2012, the Companies ask for prompt action on their comment and the Staff Report.

The Companies complain Staff Report Conditions 1 and 13 -- which address access to governance materials, the reporting of financial information, and the availability of books and records -- unreasonably expand access to corporate governance materials and records IBE maintains in Spain for the purpose of conducting its world-wide operations, and to the records of IBE's U.S. affiliates that operate in competitive markets.[9] Any expanded access in Spain, the Companies claim, should be limited to the extent necessary to determine if the rates and charges of NYSEG and RG&E are just and reasonable. Access to books and records, the Companies add, should not extend to the competitive market operations of IEP and IRHI because they are not subject to PSL rate regulation and intrusive inquiries could unduly disrupt their ability to perform effectively in those markets.

In opposing these Conditions, the Companies argue that the Merger Order standards on access to books and records remain sufficient to protect the public interest. Moreover, the Companies protest that access to sensitive IBE parent company Board materials held in Spain, such as Board minutes, cannot be justified when that material is irrelevant to NYSEG or RG&E operations. The Companies add that any information on the relationship between NYSEG and RG&E and IEP and IRHI can be obtained through the regulated utilities, without requiring additional access to IEP or IRHI books and records.

The Companies also oppose the language in Staff Report Condition 1 that addresses the provision of information in management audits. That provision, the Companies argue, is outside the scope to this proceeding. They assert further that the provision is not properly bounded by a requirement that the information sought be relevant to the regulated New York utilities. Consequently, the Companies would remove the management audit information provision from the Condition in its entirety.

Under Staff Report Condition 2, the Companies state, NYSEG and RG&E would be required to issue securities only

[9] As discussed below, the contents of those conditions have been distributed among §5(a), (e), & (h) and §8(a) of Appendix I hereto.

through registration with the SEC,[10] instead of retaining the option to issue unregistered securities through the private placement market as they do now. The Companies maintain that the private placements, which do not require full SEC registration, are currently the most cost effective approach to issuing securities, and that requiring full SEC registration will result in higher costs to ratepayers. The Companies believe it is in the best interests of customers to afford NYSEG and RG&E the flexibility to continue selecting the forum for security issuances on a case-by-case basis, taking into account extant market conditions, which at this time favor private placements.

Criticizing the Staff Report analysis of issuance costs, the Companies describe a Federal Reserve Report relied upon in the analyses as outdated and premised upon stale data. The Companies also assert the Report does not support Staff's prediction that 40 basis point savings can be realized when debt securities are issued through full SEC registrations instead of through private placements. The Companies interpret the Report as showing instead that companies capable of issuing debt in either market do not experience statistically significant savings if they choose the SEC registration market. The Companies claim that NYSEG and RG&E's current practice of selecting between the two markets on a case-by-case basis is therefore supported by the Report.

Turning to the analysis of issuance costs that Staff performed, the Companies see distortion and bias in that, of the 41 issuances analyzed, only two were private placements. And, the Companies claim, one of those was not actually a private placement, but was instead an issuance made under §144A of the

[10] This Condition is now found at Appendix I, §5(i).

Securities and Exchange Act (SECA)(which provides for less extensive compliance and oversight requirements than full SEC registration).

Asserting that savings can be realized from SEC registration only when issuances of $250 million or more are made routinely, the Companies claim that their issuances are sized at about $150 million, and are made infrequently. Small size and infrequent issuance, the Companies argue, results in an illiquidity premium that would offset any savings achieved through realizing lower yields on SEC registered debt.

Finding fault with other aspects of the Staff analysis, the Companies assert that Staff underestimated the number and magnitude of private placements. Those placements, the Companies argue, are not widely reported, while the SEC registered issuances that Staff relied upon are easily found because widely reported. The Companies also maintain that biased criteria were used to select the issuances that were analyzed, and they criticize the savings calculation because it is based on issuance yields, which fail to reflect the influence of treasury prices on yields, instead of based on spreads at the time of issuance, which do reflect that influence.

According to the Companies, the intangible benefits Staff asserts are associated with SEC registration are exaggerated. Contrary to Staff's claim that SEC registration results in greater transparency, the Companies argue that existing books and records requirements result in all the transparence that is necessary. Moreover, the Companies posit, disclosures made upon private placements generally are substantially the same as the disclosures that are made upon issuance of SEC registered securities.

The Companies conclude by asserting that, while Staff has failed to support the benefits purported for SEC registration, the costs of that registration remain formidable. Staff's own analysis of those costs, the Companies point out, are estimated at $1.78 million annually.

Turning to Condition 25,[11] the Companies note it replaces Audit Recommendation 2.1, which would have suspended all procurement of engineering services from IEP, the IBE subsidiary, with an interim limitation on the amounts NYSEG and RG&E can expend on the purchase of engineering services from IEP. The Companies perceive that the limitation, set at $1.07 million per month, is premised upon the levels of IEP services utilization that NYSEG and RG&E are currently experiencing, which have been translated into a monetary ceiling amount on expenditures that could be incurred in procuring IEP services in the future.

Noting that the data used to set the ceiling amount was the 6-month period ending in October 2012, the Companies assert that more recent data should be used, which would reflect increases in expenditures made to purchase IEP services since October 2012. Incorporating the most recent data, the Companies argue, would increase the ceiling to approximately $1.35 million per month, which, they insist, better reflects current levels of utilization than use of data from the period ending October 2012.

Another feature of the Condition, the Petitioners continue, is the requirement that they fill internal engineering position vacancies at NYSEG and RG&E. The Companies detail their progress in complying with that requirement, and propose clarifications to the language of the requirement they believe would facilitate their compliance efforts.

[11] As discussed below, this Condition is addressed in an Ordering Clause; the issues it raises will also be considered further in another proceeding.

The Companies also propose numerous clarifications to the language of various Conditions. They suggest what they characterize as improvements to what they describe as the overbroad wording of Condition 5 (now found at §8(c) of Appendix I), which insulates NYSEG and RG&E from adverse tax consequences that might attend the reorganization.

The Companies argue that the definition of the qualifications required of an "independent Director," at Condition 9 (now found at §7(b) of Appendix I), is overly stringent, in that ten years of relevant work experience is required to qualify. They also object to rotating the position of lead independent Director annually, as that condition would require, and would instead provide for rotation "periodically."[12]

The Companies question the expansion of the prohibition, at Condition 11 (now found at §7(g) of Appendix I) against appointing the same person to both the CEO and the Chair of the Board positions to include IUSA. They argue that since IUSA is not a fully regulated New York utility, the provision should not apply to it.

Under Condition 26, the Companies note, they would be required to file notes taken at meetings of the Gas Strategic Planning Committee.[13] The Companies propose to make the notes available to Staff upon request, rather than through a filing mandate.

[12] The Companies would not match the Condition's independence requirements against those adopted under the Central Hudson Merger Order, because the circumstances there are not comparable to the circumstances here. Case 12-M-0192, Central Hudson Gas & Electric Corporation, Order Authorizing Acquisition Subject to Conditions (issued June 26, 2013).

[13] As discussed below, this Condition is addressed in an Ordering Clause.

The Companies would re-word two of the proposals regarding compliance with the management audit recommendations transferred to this proceeding. Under Recommendation 2.6, where IUSA personnel are impelled to engage in more effective communications with IBE executives and the IBE Board in Spain, the Companies ask for more flexibility in achieving compliance than Staff proposed, in that they would not require that communications take place at regularly scheduled times or compel confirmation of receipt of communications.

Under Recommendation 14.5, the Companies relate, they would be required to show that the ethics Compliance Officer has access to high-level corporate officers. They state that they have already demonstrated that such access is in place, and will continue to affirm that demonstration in the audit compliance process.

Turning to Appendix C of the Staff Report, which the Companies note is a revision of Appendix 1 to the Merger Order that reflects Staff's proposed Conditions, the Companies state it appears that an inadvertent error has been written into §1(a) of the Appendix, which has been modified to prohibit reflecting goodwill on the books of RGS, Networks and IUSA. Previously, the prohibition applied only to the books of NYSEG and RG&E. While the Companies concede that the Merger Order prohibits IBE from pushing down goodwill created by its indirect acquisition of NYSEG and RG&E to either of those utility subsidiaries, and that no goodwill of any kind may be reflected on the books of the two regulated utilities, they point out that goodwill from transactions prior to IBE's indirect acquisition has properly been shown on books of IUSA and RGS. They ask for correction of the perceived error.

The Companies also propose substantive and wording changes to Staff Report Appendix C. The Companies would not require that Networks be rated by credit rating agencies as proposed there because Networks does not plan to incur debt. Therefore, they elaborate, no rating would be needed unless and until Networks changes its plans and seeks to incur debt. They also propose other wording changes to the Appendix that they say would improve clarity.

The Supplemental Comment

In their Supplemental Comment, the Companies indicate that their independent external auditor, PriceWaterhouseCoopers (PwC), has advised that registering NYSEG and RG&E with the SEC will subject them to certain SEC requirements, in conformance with generally accepted accounting principles (GAAP).[14] Under GAAP, the Companies assert, NYSEG and RG&E will be required to adopt purchase accounting of the costs IBE expended in 2008 to acquire their upstream parent, Energy East Corporation (Energy East), pursuant to the Merger Order. Under purchase accounting, if the purchase price paid by an acquiring company like IBE exceeds the fair value of the acquired company's identifiable net assets, the excess is recorded as goodwill.

The Companies state that if NYSEG and RG&E register their securities with the SEC, it will require a review of the goodwill IBE incurred upon its acquisition of Energy East, to determine if it must be assigned or "pushed down" to the balance sheets of the acquired subsidiaries, which would include NYSEG and RG&E. If the goodwill is pushed down as a result of that review, the Companies contend, a violation would be triggered of the Merger Order condition requiring that no goodwill be

[14] The Companies in their filing also reiterate arguments made previously on the treatment of goodwill in Staff Report Appendix C, and the ceiling on the services NYSEG and RG&E may purchase from their IEP engineering affiliate; these reiterated arguments need not be summarized again.

reflected on the books of NYSEG and RG&E as a result of IBE's acquisition of Energy East.

According to the Companies, PwC has determined that if, instead of pushing down the goodwill, they were required to write off that goodwill without an impairment, the result would be a material violation of GAAP. Such a violation of GAAP, would, in turn: (i) violate an existing Merger Order condition requiring compliance with GAAP; (ii) prevent external auditors, such as PwC, from providing unqualified audit opinions, making it difficult if not impossible to issue public or private debt; and, (iii) cause certain of the Companies to default under their revolving credit facilities. The Companies protest that they cannot accept the SEC registration condition even if the existing Merger Order condition were revised to permit the push down of goodwill from IBE's acquisition of Energy East to the books of NYSEG and RG&E, and they were assured of full recovery of any increased costs that result from the requirement, including any such costs upstream parent companies experience as a result of the financial and accounting implications accompanying SEC registration.

## DISCUSSION

The Staff Report and its Conditions are adopted, and the corporate holding company reorganization IBE and its affiliated Companies propose is approved, subject to the modifications and clarifications of the Conditions, and with the understandings, set forth below. Because no new owners are brought into the ownership structure through the reorganization, the Companies need not show the transaction will result in the substantial tangible benefits to ratepayers that were required to justify IBE's acquisition of Energy East, NYSEG and RG&E in the Merger Order, where new ownership was at issue. Instead, approval is warranted premised upon a showing that intangible benefits have been obtained through or because of the reorganization, and that risks to ratepayer interests have been mitigated to the extent practicable, with any remaining risk offset by the intangible benefits.

Those intangible benefits, which are sufficient to support approval and offset risks, are found in the Staff Report Conditions that, as modified and clarified, provide for enhancements to ring fencing, improved and more transparent access to corporate governance and other books and records, and implementation of corporate governance best practices beyond the requirements of the Merger Order. Several clarifications to the Conditions the Companies propose are adopted below because they better effectuate the intent of the Conditions or smooth their implementation. However, many of the substantive changes they propound are rejected, because they would disturb that balancing of intangible benefits and risk mitigation.

The management audit issues remanded to these proceedings in the Audit Recommendations Order were resolved in the Staff Report. Those issues consisted of the 13 audit recommendations, the consolidation of NYSEG and RG&E, and the interpretation of the Merger Order SOX condition. Eleven of the 15 issues are resolved in Appendix II, which will be enforced through the audit compliance process. The four remaining issues -- the NYSEG and RG&E purchases of services from their IEP engineering affiliate; gas business management and Gas Strategic Planning Committee reporting; the consolidation of NYSEG and RG&E into one utility; and, the interpretation of the Merger Order SOX condition relied upon in the audit -- are decided here, with compliance transferred to and enforced in Case 12-M-0066, except for the additional relief regarding the IEP relationship that will be considered in another proceeding.

Access to Books and Records

Access to the Companies books and records is enhanced through several Staff Report Conditions. The Staff Report requires the Companies to provide agendas presented for Board meetings conducted at IBE, IUSA, Networks, IRHI and IEP. Moreover, clarifications to the Merger Order conditions would expand access to other Board materials at both IBE in Spain and at the U.S. competitive affiliates, IRHI and IEP, and address access to Board materials during management audits. The Companies would also continue to locate the books and records of NYSEG and RG&E in New York, and would provide greater access to the books and records of IBE affiliates that engage in transactions with NYSEG and RG&E.[15] While modification and clarification of the requirements is needed, they are otherwise justified because they ensure that the interests of New York ratepayers are adequately protected.

The Companies maintain that the requirements on the provision of books, records and information proposed at Staff Report Conditions are unduly burdensome. The Companies object in particular to providing access to materials presented to IBE's Board of Directors and other information located in Spain, and greater access to records at IEP and IRHI, IBE's unregulated U.S. affiliates. The Companies point out that the Merger Order currently requires that they must provide Staff with access to the books and records of IBE and its affiliates "to the extent necessary for Staff to determine whether the rates and charges of NYSEG and RG&E are just and reasonable."[16] The Companies claim that the existing access is adequate, and that the overly

[15] These requirements, formerly set forth at Staff Report Conditions 1 and 13, have been distributed among the provisions at Appendix I, §5(e)&(h) and §8(a).

[16] Merger Order, App. 1, p. 6.

intrusive access proposed in the Staff Report would unduly and unreasonably disrupt the operations of IBE in Spain that are not subject to PSL regulation and similarly interfere with the ability of IRHI and IEP to operate in competitive U.S. markets.

As noted in the Audit Recommendations Order, the auditor raised "significant concerns about the Companies (including IBE) and IUSA organization, but does not offer meaningful solutions. Corporate governance issues are arguably the most important ones raised by the audit, and...these issues [should] be analyzed fully and vetted carefully." To resolve those concerns, access to information on IBE's corporate operations, as they affect New York ratepayer interests, must be transparent, both in Spain and in the U.S. That access can be obtained through clarification of the requirements IBE, and the other parents in the corporate chain of ownership for NYSEG and RG&E, must meet on the provision of books and records.

In particular, clarification of the Merger Order language the Companies cite is needed to avoid potential misinterpretations that might overly restrict rights to access under the PSL. However, the Staff Report Conditions, which were intended as that clarification, are not suitable because their wording also lacks the clarity sufficient to avoid misinterpretations.

More suitable language less amenable to misinterpretation may instead be found in provisions governing access to books and records under other holding company arrangements similar to IBE's, such as those in place for Niagara Mohawk Power Corporation d/b/a National Grid (Niagara

Mohawk) and its upstream parents and affiliates.[17] The Niagara Mohawk provision, which reiterates similar provisions adopted previously in holding company proceedings, is reworded, at Appendix I, §5(e), to apply to IBE, as follows:

> Staff will have full access, on reasonable notice, and subject to resolution of confidentiality and privilege issues, to 1) the books and records, in English, of IBE and of its subsidiaries that own majority interests in NYSEG and RG&E directly or indirectly (currently, IUSA, Networks and RGS), where such books and records are relevant to the Public Service Commission's exercise of authority under the Public Service Law or any other statute; and, 2) the books and records of all other IBE subsidiaries or affiliates (currently, IEP and IRHI), in English, to the extent necessary to audit and monitor any transactions that have occurred between NYSEG and RG&E and such subsidiaries or affiliates, subject to Public Service Law §110 or any other provision of law.

The revised provision properly applies the PSL to IBE and its affiliates and is otherwise reasonable.

Under the revised provision, which, again, is consistent with the provisions governing access to information at other holding companies operating utility subsidiaries in New York, inquiring into IBE Board materials and other information located in Spain would focus on information relevant to the protection of NYSEG and RG&E ratepayer interests. That information includes, but is not limited to, matters related to the rates those utilities charge, the provision of safe and adequate service, strategic planning for the U.S. utility businesses, capital investment decisions affecting those

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[17] Case 12-E-0201, Niagara Mohawk Power Corporation d/b/a National Grid, Order Approving Electric and Gas Rate Plans in Accord With Joint Proposal (issued March 15, 2013); Joint Proposal §3.4.

businesses, and storm preparation and restoration performance. Inquiries into the Board materials and information at IEP and IRHI in the U.S. would be directed to that information relevant to transactions they engage in with NYSEG and RG&E (and, for IRHI, tax matters related to the consolidated income tax return IUSA will file jointly for its subsidiaries). The Companies cannot argue that Staff should be obstructed in pursuit of this relevant information, because otherwise Staff would not be able to fulfill its functions under the PSL. Those functions include the full panoply of interests delineated in the statute.

On the other hand, IBE's supposition that Staff might disrupt aspects of IBE's worldwide operations, or the competitive operations of IBE's affiliates in the U.S., are unfounded, as the bulk of such information would be irrelevant to New York ratepayer interests and would not be investigated. The legal principles restricting inquiries into irrelevant information are well-established under U.S. law, including principles governing inquiries into materials to determine if they are relevant. Any dispute over relevance between Staff and IBE would, of course, fall within our jurisdiction to resolve, subject to judicial review.

In a clarification of the Staff Report, its language on access to Board agendas for IBE, IUSA, Networks, IRHI and IEP is reworded and moved to Appendix I §5(h)(iv).[18] As provided for there, agendas would be submitted on a regular basis as a component of a quarterly report, which will ensure notice when the Boards of these IBE parents and affiliates discuss matters concerning NYSEG or RG&E, and will assist in limiting inquiries to those matters that are relevant to that purpose.

[18] Clarification the Staff Report Condition 1 includes moving the provision on access to IRHI's tax information to the provision relevant to that matter at Appendix I, §8(a).

The Companies also oppose pursuing in these proceedings the discovery that may be required in future management audits, as provided for in the Staff Report. Since we have full and independent authority to order all discovery needed in a management audit, that authority need not be addressed here. It is emphasized, however, that none of the information-gathering provisions adopted in this proceeding, or adopted in the Merger Order previously, can be interpreted as restricting in any way the discovery that Staff or an auditor authorized under PSL §66(19) may pursue, or we may order, in future management or operations audit proceedings.

Therefore, the Staff Report Conditions are modified by removing references to management audit discovery. Moreover, as the Companies point out, revisions to the wording of the Conditions are needed to improve clarity and avoid redundancies. These changes are incorporated into Appendix I.

SEC Registration

The Companies oppose the requirement, proposed in the Staff Report, that would limit NYSEG and RG&E to issuing future securities only through the full SEC registration process. Arguing that the Staff Report analysis justifying the requirement is flawed, the Companies assert that their current practice of issuing NYSEG and RG&E debt through private placements that are not subject to SEC reporting and enforcement is less costly and more efficient than SEC registration, which, they point out, carries with it significant filing preparation costs and fees.

The Companies' various objections to issuing debt through SEC registration lack merit because a properly performed analysis of savings demonstrates that, under historically normal market conditions, savings will substantially exceed costs to the benefit of ratepayers. Nor does the prospect for the push down of goodwill onto the books of NYSEG and RG&E, which could attend registration, pose an obstacle that cannot be surmounted. Nonetheless, current market conditions are not normal, because interest rates persist at unusually low levels. Therefore, as discussed below, full SEC registration will not be required now. Instead, interim relief is appropriate, along with establishing a process for moving promptly to full registration once market conditions return to normal.

A. The Staff Savings Analysis

As noted in the Staff Report, fundamental financial theory supports the conclusion that the market value of the greater transparency and liquidity attending SEC registration of securities results in lower interest costs or yield on those debt securities in comparison to private placement debt. Two studies, one published by the Federal Reserve Bank of San Francisco (the Reserve Study) and the second performed by Staff analyzing electric and gas utility issuance data from 2012, are presented in the Staff Report that support the conclusion that the lower interest rates on SEC registered debt in comparison to private placement rates result in substantial savings, even after SEC registration costs are offset against the savings. Both studies support the conclusion that SEC registration achieves savings of about 40 basis points when compared to private placement costs.[19]

The Staff Report savings analysis shows NYSEG and RG&E will save between $5.6 million and $23.1 million (net present value) over the next ten years if they issue debt through SEC

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[19] Indications of spreads ranging from 10 to 50 basis points are found in studies performed after 2009 by Asset Management Viewpoint-Conning, Aviva Investors, and AAM Insurance Investment Management; a study by Marquette University also indicates that spreads have been significant historically.

registrations instead of through private placements, even after offset of SEC registration costs estimated at $1.8 million annually, assuming their debt issuances total between $150 million and $300 million annually. Analysis of recent NYSEG and RG&E issuances indicates that the annual amount predicate will likely be met; it appears that in each of the next three years, each will finance approximately $170 million annually, for a total of $340 million.[20] To realize savings once the predicate is satisfied, NYSEG and RG&E need only achieve interest rate differentials through SEC registration of more than 14 basis points. Since interest rate yields on SEC-registered debt are generally lower in comparison to private placement debt, because the public placement of SEC registered debt results in the greater transparency and liquidity that translates into the reduced risk which justifies lower yields, it is likely that, under normal market conditions, the differential would be achieved.

B. The Companies' Criticisms of the Staff Analysis

The criticisms the Companies level against the Staff analysis are not persuasive. The Companies complain that private placement issuances were insufficiently represented in the data upon which Staff relied. In their search to find more private placement data, however, the Companies expanded the scope of inquiry to encompass a wide variety of issuers, including generation-only, transmission and international companies. Those issuers also incurred debt in a wide range of maturities, including some of only one year in duration. The

[20] See Case 11-M-0342, New York State Electric & Gas Corporation, Order Authorizing Issuance of Securities (issued September 16, 2011); Case 12-M-0561, Rochester Gas and Electric Corporation, Order Authorizing Issuance of Securities (issued April 13, 2013).

Staff analysis, in contrast, relies only upon distribution utility company issuances, that generally extend substantially beyond one year in duration. That only one private placement could be found in that category indicates that few such companies find private placements beneficial in comparison to SEC registration.

The Companies contend further that the lack of data from a sufficient number of private placements prevents the comparison of the private placements to the SEC Registration yield necessary for an accurate calculation of savings. The Companies, however, provide no historic private placement cost data on distribution utility issuances in support of their position on savings. Consequently, they have failed to support their criticisms of those Staff Report calculations that show the SEC registration achieves savings in comparison to private placements.[21]

If the sizes of debt issuances are too small, or issuances are made too infrequently, the Companies argue, an illiquidity premium would result that would offset any savings from lower yields on SEC-registered debt. The Companies, however, have not demonstrated that size premium affects only SEC-registered debt, and is not also present when private placement debt is issued. Moreover, on one hand, New York utilities have issued debt in amounts of less than $100 million through SEC registration in the past, while, on the other hand, larger sized issuances will likely be necessary in the future to support policy initiatives like severe storm hardening, the

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[21] As to the claim that the savings calculations are inaccurate because premised upon issuance yields rather than spreads at issuance, the Companies have not shown that use of their approach would result in an outcome different from the average 40 basis point yield benefit cited above.

Energy Highway and the capitalized costs of transmission reliability projects. As a result, the illiquidity argument has not been supported on either the theory or the facts.

C. The Companies' Other Claims

The Companies claim that the private placement market is more flexible than the SEC registration market. While even if, as the Companies suppose, one feature of private placements is flexibility in delaying the timing of draws upon an issuance, restrictive covenants are generally attached to private placements that otherwise constrain flexibility and increase costs. These covenants can include limitations on future debt issuances, restrictions on sales of assets and changes of control and authorizations of calls upon disadvantageous terms.

In another effort to show private placements enhance flexibility, the Companies assert that switching between SEC registrations and private placements on a case-by-case basis would enable them to select the less costly alternative. This argument is flawed, because once any SEC-registered debt is issued, compliance with the registration requirements insulates against risk for some time thereafter, justifying lower yields for even private placement debt than could be obtained without SEC registration. But, since the Companies have not issued SEC-registered debt since their acquisition by IBE, they cannot avail themselves of the benefit they posit, because they have lost over time the risk-reducing influence of SEC registration.

The Companies' argument that SEC disclosure requirements will not materially improve transparency lacks merit. SEC registration carries with it SEC oversight and enforcement, which leads to accountable and transparent financial reporting. Another obligation attending SEC registration is the filing of public Form 10-k reports. Those reports must contain extensive discussions of various risks that may confront a company -- discussions not available elsewhere. Moreover, additional information on ongoing financial activities, such as losses suffered on derivatives, and costs incurred, such as executive compensation payments, are provided. Because they are often the earliest available source of information on developments affecting utility credit quality and financial stability, SEC reports can serve as an alert for the potential that problems might be experienced. Therefore, transparency is an additional and important benefit of SEC registration.[22]

D. The Appropriate Relief

While SEC registration substantially benefits ratepayers under historically normal market conditions, presently, low interest rates persist, which is not consistent with normal market conditions. The interest rate spread supporting the Staff savings calculations may be less than expected if interest rates remain at these low levels. Because of the ongoing persistence of these unusual conditions, there are indications that recent issues of privately placed unregistered securities debt carry yields that are close to those for SEC registered securities. Moreover, the intangible benefits to ratepayers accompanying registration in the form of SEC oversight and enforcement of accountable and transparent financial reporting are difficult to quantify. These intangible benefits do not offset the risk that, if savings are substantially less than anticipated, ratepayers might not

[22] The Companies complain that the SEC registration issue is beyond the scope of this proceeding, but, as their reorganization increases risk by moving regulated and unregulated affiliates into closer proximity within the corporate structure, any means for reducing that risk and increasing transparency, including SEC registration, is open to consideration here.

realize an overall advantage that would justify incurring the costs of registration.

An additional risk is found in the SEC policies that, absent waiver, require the push down of goodwill from the IBE holding company parents to the books of NYSEG and RG&E. Contrary to the Companies' arguments and as discussed below, however, push down accounting can be accomplished on terms and conditions that adequately protect ratepayers. Even if an impairment of goodwill were to occur, and a write off were required as a result, ratepayers can be shielded against adverse consequences. Nonetheless, the risk that additional costs will be incurred because of changes in goodwill accounting cannot be entirely eliminated.

Once interest rates spreads return to normal levels, however, the balancing of savings and benefits attending SEC registration against the risks fully justifies issuing debt through registration rather than through private placement (as NYSEG and RG&E do now). Moreover, while awaiting the return to normal conditions, interim relief in the form of issuance of securities through SEC Rule 144A offerings is available. Following implementation of this interim relief, a process is needed for moving to full SEC registration at the appropriate time.

Rule 144A was instituted in 1990 to foster the development of a more liquid and efficient institutional resale market for unregistered securities, through facilitating the resale of securities that are placed privately without SEC registration. While Rule 144A offerings are not as transparent, and issuers are not as accountable, when compared to fully registered debt offerings, they are more liquid than private placements, which should reduce the cost of debt somewhat without incurring the substantial costs of fully registering securities and accounting for goodwill. Accordingly, NYSEG and RG&E shall issue new debt under Rule 144A beginning January 1, 2014.

Beyond that interim relief, NYSEG and RG&E shall move promptly to full SEC registration when market conditions become favorable. In order to achieve that goal, the utilities are directed to include in any future petitions requesting financing authority an analysis of existing interest rate spreads between Rule 144A and fully registered securities at the time of the petition; a forecast of those spreads for one year following the date of the petition; an analysis of if and when full SEC registration should commence based upon those spreads and the costs of registration; and, a discussion of the timeframe needed for the preparation and filing of the necessary registration documents.

Moreover, NYSEG and RG&E are advised that the issue of commencing full SEC registration can be raised in other proceedings or that a separate proceeding may be instituted for that purpose, to the extent appropriate. Full SEC registration may commence under such terms and conditions as are decided through any of these procedural vehicles.

The Push Down of Goodwill

The Companies' assumption that SEC registration will carry with it a requirement to push down goodwill from IBE holding company parents to the NYSEG and RG&E utilities appears properly premised upon SEC policies. Contrary to the Companies' arguments, however, push down accounting can be accomplished on terms and conditions that adequately protect ratepayers.[23] Given

[23] Since, as the Companies note, waivers of the push down requirements can be sought from the SEC, it is expected that the NYSEG and RG&E would seek such a waiver if it is in the best interests of their customers.

the benefits attending SEC registration, revision of the Merger Order conditions and policies against the recording of goodwill on the books of NYSEG and RG&E is appropriate, to accommodate the push down of goodwill subject to the accounting necessary to protect ratepayers once normal market conditions return and movement to full SEC registration can be completed.

A. Goodwill and Ratemaking

Arriving at the ratemaking and accounting mechanisms that need be deployed to mitigate risks to ratepayers upon push down accounting begins with the identification of the changes that the accounting would bring to NYSEG and RG&E financial statements. Those changes are attributable to the revaluation of their balance sheet assets and liabilities, to recognize the step up of the existing original book cost to market values determined as of the date IBE acquired Energy East. At the same time, however, corresponding and offsetting adjustments to regulatory assets and liabilities would be made, leaving NYSEG and RG&E earnings and cash flows unaffected by the step up of the balance sheet to market value.

Another effect of push down accounting is that it could eliminate retained earnings at NYSEG and RG&E. The loss of those earnings, however, will not translate into a reduction to the utilities' equity, since the retained earnings effect can be offset by a corresponding increase to recorded capital accounts that will leave equity levels at the utilities unchanged.

As a result, utility rates will continue to reflect balance sheet items at their original book values instead of at the market based valuations that reflect goodwill. With those revaluations excluded from the ratemaking process, goodwill will not be recognized in rates and impacts adverse to ratepayers will be avoided.

B. Goodwill and Credit Quality

The Companies suggest push down accounting could be detrimental to the financial health of the NYSEG and RG&E, albeit the Companies in their Supplemental Comment did not illustrate any specific detriment. After an examination of the possibility that financial health would deteriorate if the credit metrics that determine credit quality and ratings suffer because of push down accounting, however, no specific adverse impacts on NYSEG or RG&E credit metrics emerge from the cash flows or leverage calculations that would result from push down accounting. Credit metrics will not degrade because cash flows will remain strong and leverage will not increase.

Because of the offsetting accounting adjustments discussed above, cash flows at the utilities remain the same both before and after the push down event, at the revenues produced by the regulated utility rates that are set by excluding the effects of goodwill. Steady cash flow is a factor that supports continuation of existing credit ratings. Although the leverage, as the ratio of debt to total capital, that is reported for credit rating purposes will deviate from the leverage recognized for ratemaking purposes, credit rating leverage will actually decline upon push down accounting.[24] That is because pushing down the goodwill assets to NYSEG and RG&E results in a corresponding increase in shareholder equity in the same amount, so that leverage automatically decreases as debt remains the same. Since reducing leverage is an improvement to credit metrics, credit ratings should not fall as a result.

[24] The $1.0 billion of goodwill and equity that the Companies estimate will be added to each of the books at NYSEG and RG&E is forecast to reduce the utilities' debt ratios to 34% and 30%, respectively.

That the returns on equity NYSEG and RG&E report will be substantially reduced as a result of push down accounting will not affect their credit ratings. Reported returns will fall because goodwill, as a non-earning asset, will be supported by creating additional equity when it is pushed down to the utilities. These greater amounts of equity will be introduced into the earnings calculations. But, as the credit rating agencies have indicated, lower reported returns on equity do not adversely affect cash flow, and so would have no impact on credit ratings.

C. Goodwill and Financial Risk

The Companies protest that the sheer magnitude of the goodwill that could be created and placed on the books of NYSEG and RG&E, which they estimated at about $2.0 billion in total, opens the possibility that it would become necessary to record impairments at NYSEG and RG&E, by writing off equity as a loss after push down accounting is implemented.[25] A write off attending impairment, the Companies suggest, could potentially have an adverse effect on credit ratings, and increase the cost of debt even if the ratings remain the same.[26]

The Companies, however, may have overstated the magnitude of the goodwill. They did not support their estimate of $2.0 billion with any backup information, notwithstanding

[25] The Companies admit that complex asset valuations, and the consideration of impacts attending IBE's sales of affiliates, will affect the ultimate calculations of goodwill.

[26] IBE recorded $0.8 billion (€585 million per the 2008 IBE Audit Report, p. 55) of goodwill upon the acquisition of Energy East on its books under International Financial Accounting Standards (IFRS). Under IFRS, goodwill is recorded based upon the difference between the fair value of identifiable net assets and acquisition cost.

that the circumstances have changed since the acquisition of Energy East by IBE pursuant to the Merger Order. After the close of that Merger Order transaction, the goodwill created for NYSEG, RG&E, and other Energy East affiliates, including a Maine electric utility, two Connecticut gas utilities, and two energy services companies (ESCOs), was estimated at $1.2 billion. Subsequent to the Merger Order transaction, IBE sold the two Connecticut gas utilities and the two ESCOs, so any goodwill attributable to those businesses would no longer exist. Given these circumstances, the accuracy of the Companies' $2.0 billion estimate for the goodwill that would be pushed down to NYSEG and RG&E cannot be confirmed.

If goodwill is of the magnitude that the Companies estimate, however, its size alone could be of some concern. This concern is alleviated somewhat, however, because the push down accounting transaction will generate an increase in shareholder equity at NYSEG and RG&E in an amount that corresponds to the amount of goodwill. Nonetheless, goodwill would then constitute an overly large proportion of the equity at the utilities. Cash flow may not be adequate to support that inflated equity because, as noted in the Merger Order, utility rates are set at costs excluding goodwill. The outcome of such circumstances, however, is that some of the goodwill could be impaired and written off.

Although the Companies are correct in pointing out that impairments must be recognized if SEC or GAAP accounting so requires, the Companies have not demonstrated that their arguments concerning harms attending impairment have merit. Even if, as the Companies estimate, a goodwill asset of $2.0 billion that attends the acquisition of Energy East would be pushed down from IBE's books to the NYSEG and RG&E balance sheets upon SEC registration, equity would remain ample because it would increase by the same amount as the goodwill.

Because the push down of goodwill is accompanied by that equal enhancement to the value of shareholder equity, if the goodwill is written off, it is against the equally inflated value of that equity, even if the impairment results in a write off of all the goodwill. Since utility rates are set by excluding the impact of goodwill, the absence of goodwill has no impact on the continuing cash flow revenues those rates yield, on the leverage recognized in setting those rates, or on the earnings realized from those rates. As a result, neither the utilities nor their ratepayers are adversely affected as a direct result of an impairment write off.

The push down of goodwill to NYSEG and RG&E that would attend SEC registration has not harmed other utilities in analogous circumstances. In New York, $1.289 billion of goodwill has been on the books of Niagara Mohawk Power Corporation (Niagara Mohawk) since 2007 and has resulted in no consequences adverse to that utility or its customers, since it is excluded from the rate making process and removed from the utility's capital structure. Nor did the push down of goodwill to the books of Niagara Mohawk result in impairment charges, reductions in cash flow, or credit rating downgrades.

Moreover, in September 2000, prior to its merger into the holding company predecessor to IBE, Central Maine Power Company (CMP) was acquired in a transaction that resulted in the recording of over $300 million of goodwill on its books. The acquisition was accounted for under the purchase method of accounting and adjustments were made to CMP's financial statements in conformance with push down accounting. As with Niagara Mohawk, no impacts adverse to CMP or its credit have occurred as a result of push down accounting, nor have there been any impairment charges. Therefore, push down accounting is not a deterrent to resumption of SEC registration.

D. The Impact of Resuming SEC Registration

Circumstances have occurred that are directly comparable to the resumption of SEC registration that is required of NYSEG and RG&E. In 2010, the Kentucky Public Service Commission (KPSC) authorized Louisville Gas and Electric Company (LG&E) and Kentucky Utilities Company (KU) to push down goodwill upon their acquisition by PPL Corporation, as a prerequisite to resuming SEC registration.[27] Specifically, the KPSC approved a Settlement Agreement which stated, at Article III, §3.2, that: "LG&E and KU commit to exclude expenses, such as depreciation or amortization, if any, associated with other push-down accounting adjustments when determining amounts to be recovered from ratepayers."

LG&E and KU subsequently recorded $389 million and $607 million of goodwill, respectively, that was pushed down to their financial statements. LG&E and KU both noted that "the regulatory assets and liabilities created to offset the fair value adjustments meet the recognition criteria established by existing accounting guidance and eliminate any ratemaking impact of the fair value adjustments."[28] A review of recent financial statements for LG&Es and KU, at SEC Form 10Q (March 31, 2013), indicates that this goodwill remains on their respective financial statements and so has not been impaired.

In addition, the Chief Financial Officer of LG&E and KU, Mr. S. Bradford Rives, addressed push down and SEC

[27] Case 2010-00204, PPL Corporation and E.ON AG, Order (Ken. PSC, September 30, 2010).

[28] LG&E Financial Statements and Additional Information As of December 31, 2010 and 2009 and for the years ended December 31, 2010, 2009 and 2008, pp. 77-78.

registration issues at a hearing conducted by the KPSC. To the question "will the regulatory reporting of KU and LG&E be affected by the 'pushdown accounting,'" Mr. Rives replied: "No." He continued, "LG&E and KU intend to report...on a historical cost basis as they have in the past and there will be no impact on [utility] ratemaking books."[29]

Mr. Rives also testified that push down accounting was being pursued as a prerequisite to issuing debt through SEC registered securities, which he asserted was the most cost effective method. He explicitly stated that: "because the companies hope to issue First Mortgage Bonds as the least cost financing alternative for the utilities after the completion of the merger, the utilities will most likely again be subject to SEC financial reporting (emphasis added)."[30]

The experience of LG&E and KU confirms that the push down accounting does not adversely affect regulated utility rates or utility financial statements if regulatory accounting is properly applied. In addition, credit reports for LG&E and KU from 2010 - 2013 do not mention goodwill or impairment concerns, further supporting the conclusion that risks attending push down of goodwill can be successfully mitigated. Therefore, the push down accounting of goodwill that accompanies that SEC registration does not pose an obstacle that would prevent NYSEG and RG&E from resuming SEC registration.

## E. Goodwill Conclusions

Given the above, substantial adverse impacts are unlikely to attend push down accounting, and the Companies' arguments and representations to the contrary are rejected. As

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[29] Case 2010-00204, supra, Testimony of S. Bradford Rives, page 3, lines 16-20 (May 28, 2010).

[30] Id., page 2, line 21 to page 3, line 1.

the above analysis demonstrates, the concern expressed in the Merger Order -- that impairment could harm ratepayers -- is overstated and the Companies' reliance on that concern is misplaced. Moreover, the additional ring fencing measures recommended in the Staff Report, including use of a minimum equity ratio to determine when NYSEG and RG&E can dividend earnings upwards to their parents, further protect ratepayers from adverse impacts that could attend impairments, if, for example, the credit ratings of the utilities' upstream parents suffer as a result of an impairment.

Consequently, the Merger Order requirements and policies are revised, to permit the push down of goodwill from IBE to NYSEG and RG&E, to the extent that the SEC so requires upon registration at the time NYSEG and RG&E return to it. Appendix I hereto has been revised to accommodate the changes necessary to accomplish push down accounting when necessary, and also to provide that the minimum equity ratio identified at Staff Report Condition 8, now residing at Appendix I, §2(b)(ii), shall be calculated net of goodwill.

Properly accomplishing the complex accounting changes necessary to protect ratepayers upon the push down of goodwill from IBE to NYSEG and RG&E may await the time it is decided that SEC registration is of benefit and its implementation should proceed. Nonetheless, the utilities are advised that neither goodwill costs nor any write off or similar impacts attending push down accounting may be recovered in NYSEG and RG&E rates or reflected on the regulatory books of the utilities. Moreover, the potential for requesting a waiver of goodwill accounting from the SEC, and more detailed accounting and ratemaking issues, will have to be addressed at the time push down accounting is implemented. The latter issues include: the valuation of goodwill, with all necessary supporting documentation justifying that valuation; any actions necessary to ensure the push down of goodwill does not adversely affect credit metrics; any means necessary for insulating the minimum equity ratio, the capital structure for ratemaking, and the utility financial statements for ratemaking from any effects associated with goodwill and its push down; all necessary accounting; and, the journal entries needed to accomplish these requirements.

The IEP Issues

A. IEP and the Code of Conduct

Under the Code of Conduct adopted in 2009,[31] NYSEG and RG&E may purchase services from affiliates at the lesser of market prices or the internal fully loaded costs of the provider. It was envisioned in the Code of Conduct that the utilities would enter into those fully loaded cost arrangements with those affiliates that restrict their service offerings to utility companies. The resulting charges would be predicated upon synergies that translate into greater efficiencies, which would ultimately yield lower costs to ratepayers. Those charges are also readily allocated among regulated utility affiliates. Taking the fully-loaded cost approach, NYSEG and RG&E entered into contracts with utility service companies affiliated with them through common IUSA ownership. These arrangements have worked reasonably well, and disagreements over the charges have been resolvable.

When IUSA utility services affiliates price their services to NYSEG and RG&E at fully-loaded costs, the incentive for misallocation is minimal. While higher allocations to one regulated affiliate may increase its rates, the offsetting reductions to other regulated affiliates will reduce their

[31] Case 07-M-0906, supra, Untitled Order (issued June 24, 2009).

rates, so that over time, overall shareholder profits at IUSA and IBE remain at the same level. The allocations are also more easily audited than the separation of costs at an affiliate like IEP that provides services both to utilities at the fully-loaded cost standard and to willing non-utility purchasers in competitive markets.[32]

The Code of Conduct also addressed relationships with competitive market providers. Under those Code of Conduct provisions, it was expected that market-based providers would compete against each other through a bidding process where the lowest price that could be achieved in the market would be arrived at. That price would create a yardstick against which service company affiliates limited to relationships with regulated utilities could show their internal fully loaded costs were less than market costs. As a result, it was believed that ratepayers could benefit from purchases from both service company affiliates and competitive market providers.

It was not envisioned, however, that a competitive market participant would also be an affiliate of NYSEG and RG&E. When IEP first sought to commence providing services, it argued it was a competitive market participant notwithstanding that it was such an affiliate. Consistent with that stance, it petitioned for permission to participate in bidding solicitations that NYSEG and RG&E conducted. As detailed in the IEP Code Order, the utilities, in their petition, claimed that IEP was a world leader in the engineering sector, and allowing it to provide services to NYSEG and RG&E would result in "the lowest obtainable costs."[33] The utilities further emphasize the

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[32] Service companies are subject to Federal Energy Regulatory Commission accounting rules and reporting requirements.

[33] Case 07-M-0906, supra, Order Denying Petition (issued April 21, 2011), p. 4.

benefits attending the purchase of services, stating that "the financial benefits to consumers would be in minimizing the capital costs associated with the engineering of various capital projects."[34]

The petition was denied in the IEP Code Order, because it was apparent that NYSEG and RG&E could manipulate the bidding process to the advantage of IEP and undermine the competitive process. NYSEG and RG&E then turned to the already existing Code of Conduct provisions for purchases of services from utility services companies, and entered contractual relationships with IEP priced at what they claimed was their IEP affiliate's internal fully-loaded costs -- the utility service company standard -- which, they argued, were less than market prices.

This approach was accepted in the IEP Code Order as compliant with the Code of Conduct, on the theory that pricing services obtained from IEP, as an IBE affiliate, at fully-loaded costs ensures that ratepayers enjoy the synergies and economies of scale foreseen when NYSEG and RG&E were allowed to merge into IBE. It was also thought that the benefits of the greater scale achieved through affiliation would be properly priced at the fully-loaded cost standard. These expectations have not been realized.

During the management audit process, the contractual arrangements between NYSEG and RG&E and IEP were called into question, and the benefits the utilities touted were deemed suspect. The utilities were criticized for using the wrong baseline, by comparing IEP's costs to the costs of external competitive market service provider, instead of against the

[34] Responses to the Department of Public Service Staff questions regarding 9/24/10 petition to amend Code of Conduct (December 1, 2010), p. 6.

appropriate yardstick, which is the cost of using internal utility personnel. Reliance upon IEP, instead of on internal utility personnel, was also posited as the cause of delays in the engineering of projects. Claims that use of IEP would result in better loyalty to ratepayer interests, greater familiarity with local conditions and higher quality performance, in comparison to use of internal utility personnel, were dismissed as counter-intuitive.[35] As detailed in the Audit Recommendations Order, two recommendations arose out of the management audit analysis.

B. The IEP Management Audit Recommendations

As discussed in the Staff Report issued March 25, 2013 in these proceedings, and the Audit Recommendations Order, Recommendations 2.1 and 11.1 establish that an in-depth analysis is needed of the relationship between NYSEG and RG&E and IEP, IBE's engineering affiliate that offers engineering services in the U.S. At issue is the purchase of engineering services from professional consulting firms at the competitive market prices they charge, in particular when a firm is an affiliate like IEP that nonetheless claims it also operates in competitive markets, instead of relying upon the expertise of internal utility engineering personnel. Audit Recommendation 2.1 addressed the relationship between NYSEG and RG&E and IEP by propounding that all utility purchases of services from IEP be suspended, while the issue of the appropriate mixture of obtaining engineering services through use of internal personnel and procurement from outside contractors was evaluated pursuant to Audit

[35] Case 10-M-0551, Iberdrola, S.A. – Management Audit, Order Directing Submission of a Management Audit Implementation Plan and Establishing Further Procedures on Corporate Structure and Governance Issues (issued August 28, 2012)(Audit Recommendations Order), p. 6.

Recommendation 11.1. In the Audit Recommendations Order, Recommendation 2.1 was remanded for consideration here, while implementation of Recommendation 11.1 was delegated to the management audit process. There, an Engineering Resource Plan (the Engineering Plan) that the Companies were directed to prepare would be reviewed. The Engineering Plan was filed on February 4, 2013.

To prevent the further embedment of IEP services into utility operations through escalating purchases during the interim before measures adopted under Recommendation 11.1 could be implemented after receipt of the Engineering Plan, a ceiling on those purchases, and a floor to the minimum staffing levels acceptable at NYSEG and RG&E, were propounded at Condition 25 of the Staff Report. As discussed further below, the Companies have objected to the purchase ceiling while stating their willingness to maintain minimum staffing at the floor suggested in Condition 25, albeit they have progressed slowly towards achieving the minimum staffing level needed to reach that floor.[36]

As indicated in the Audit Recommendations Order, the issues related to the use of IEP are of paramount importance. Insufficient availability of internal utility personnel resources and excessive reliance on outside contractors, who may be inadequately supervised or perform unsatisfactorily, can adversely affect the provision of safe and adequate service to utility customers and can lead to burdening ratepayers with excessive costs. The goals of trimming costs or shifting workload to an unregulated affiliate subsidiary must be balanced against the loss of the internal expertise that poses risks to

[36] As of the latest information available, NYSEG and RG&E have filled 18 of the 25 positions recommended as the floor.

the safe and reliable operation of utility electric systems. Moreover, serious questions are raised by the structuring of the arrangements NYSEG and RG&E have made for procuring engineering services from IEP. Those arrangements may not be adequate to ensure that IEP is relied upon only where the services it provides are efficacious, efficient, and cost-effective.

The proposal at audit Recommendation 2.1 was to prohibit the use of IEP entirely while the review under Recommendation 11.1 took place. That prohibition was postponed on the theory that a more appropriate substitute remedy needed to be pursued. While this proceeding has been pending, however, NYSEG and RG&E have deepened their dependence on IEP, through a rapid expansion of the use of its services to a level that continued in the months following October 2012 and after, even though that very dependency was undergoing review here and through Recommendation 11.1. Although any further relief necessary or appropriate to guard against the decline of internal staffing expertise to inadequately low levels, or over-reliance on outside engineering contractors generally, will be ordered at the conclusion of the Recommendation 11.1 review, relief against excessive use of IEP to the detriment of ratepayers should be implemented as soon as possible, especially in light of its deepening embedment into NYSEG and RG&E operations.

## C. The Engineering Plan and Code of Conduct Report

Sufficient time has passed since the filing of the Engineering Plan to review it and complete an analysis of the effects the purchase of services from IEP has on NYSEG and RG&E ratepayers. That analysis shows that the costs NYSEG and RG&E incur in purchasing services from IEP are more expensive than the costs of employing internal utility personnel with engineering expertise and indicates that IEP and the utilities may not have complied with the Code of Conduct requirements in arriving at the charges IEP bills and the utilities pay.

The Companies' Engineering Plan itself demonstrates that use of IEP costs on average $15 more per hour than the use of in-house utility employees, which is 19% greater than utility internal personnel costs, on a full time equivalent (FTE) basis. This follows the conclusion in the audit that internal utility personnel cost $32 per hour, or 42% less, than external resources, on an FTE basis. Moreover, cost disparities between internal and IEP resources may be even greater than supposed in the Engineering Plan, because it appears the Companies made errors in performing that study which overstate internal costs and understate the apparent difference between those costs and IEP costs.

In addition to the Engineering Plan, IUSA, according to its Code of Conduct Annual Report filed on June 25, 2013, conducted an internal audit (the IEP Audit) of the transactions with IEP in 2012 "to provide reasonable assurance that the [IEP] charges are compliant with regulatory and accounting requirements, including that charges billed by IEP represent fully-loaded actual costs and that those fully-loaded actual costs are below comparable market prices." Review of the IEP Audit, and its predecessor for 2011, indicates IEP may not have met standards for implementing the Code of Conduct that establish the proper methods for setting the fully-loaded cost amounts it charges. Included among the charges IEP had billed to NYSEG and RG&E were special expatriate allowances.[37] In

[37] Under an IBE International Mobility program, IUSA disburses, to Spanish employees in the U.S. as a host country, relocation expenses, housing allowances, cost-of-living adjustments, foreign service premiums, education allowances, and other special allowances and payments. IUSA does not charge those costs to NYSEG and RG&E. See Liberty Report, p. III-45.

comparison, IUSA does not bill the utilities for the expatriate charges it incurs. If charging those costs is not compliant with the standards implementing the Code of Conduct, the costs should be IBE’s responsibility. Other IEP billing practices may also be questionable.

Moreover, to justify billing at fully-loaded costs at all, IEP must show that the price it charges is less than market prices. As found in the management audit, market prices tend to significantly exceed utility internal costs. This may occur because these outside competitive market providers are generally best relied upon only when performing unusual or extraordinary work not normally within the expertise or capabilities of internal utility personnel (sometimes for the reason that the scope of work exceeds the level of internal resources the utility would be expected to retain).

Because, in charging “fully loaded costs,” IEP can substantially exceed internal utility costs without crossing the “market price threshold,” the result is an incentive for IEP to inflate its fully-loaded costs in order to bring them as close as possible to market prices without actually exceeding that threshold, further increasing the risk that ratepayers incur excessive costs in the purchase of services from IEP in comparison to internal resource alternatives. IEP may have in fact deployed methods for enhancing its costs in comparison to market prices without reaching the threshold, thereby overcharging ratepayers for work that could be done internally. Another outcome adverse to ratepayers is that this practice enhances the incentive to outsource engineering services to IEP because IEP’s profits to the benefit of IUSA and IBE are enhanced. Therefore, the fully loaded cost standard may not have adequately protected ratepayers from incurring overcharges when services are purchased from IEP.

## D. Interim Relief

To prevent the further embedment of IEP services into utility operations through escalating purchases, a ceiling on those purchases is set in Staff Report Condition 25 at 105%, on a dollar basis, of payments made to IEP during the six-month period ending as of October 2012. The result is a ceiling of $1.12 million per month. That ceiling is needed as an interim protection while the relationships and contracts between IEP and its NYSEG and RG&E affiliates are under the further review discussed below.

The Companies insist that data more recent than the six-month period ending October 2012 should be used, to reflect increases in expenditures on purchases of services from IEP in place in the period following that date. At $1.35 million per month, the increase that the Companies propose to the $1.12 million per month ceiling recommended in the Staff Report is substantial and unwarranted. Moreover, that the utilities continued IEP's embedment into their operations at enhanced levels even after the Audit Recommendation Order was issued in August 2012 calling that embedment into question indicates that their incentive to benefit the IEP affiliate may have undermined ratepayer interests.

If NYSEG and RG&E were not held to the ceiling and other requirements of Staff Report Condition 25, the risks to safe and adequate service excessive reliance on IEP poses might be exacerbated. Moreover, the ongoing review under Recommendation 11.1 should proceed expeditiously, and a more permanent resolution of this issue should not be unduly delayed. Consequently, the condition adopted in this proceeding on the use IEP is a temporary measure intended to preserve the status quo while the further review of use of outside contractor and internal staffing issues at NYSEG and RG&E takes place through

Recommendation 11.1. While any relief necessary or appropriate to guard against the decline of internal staffing expertise to inadequately low levels or over-reliance on outside engineering contractors generally can be ordered at the conclusion of that review, implementing that relief could be impeded if IEP were allowed to continue to deepen its embedment into NYSEG and RG&E operations.

To the extent the Staff Report ceiling might result in circumstances that create an emergency where ratepayers might be harmed if services are not purchased from IEP, the Companies may pursue the purchase of those additional resources under the existing contracts as Staff Report Condition 25 permits. Such an expenditure may be made, if, after first consulting with Staff concerning the nature of the hardship circumstances, the imminence of harm to ratepayers can be demonstrated. If the Companies can show the circumstances attending reductions in purchases from the levels now in place because of the new pricing ceiling mechanism would create such a harm, they may avail themselves of this provision. The Companies are advised, however, that claims of hardship creating emergency circumstances made on questionable or suspect grounds will trigger appropriate relief enforcing the limitation.

Consequently, the interim relief proposal NYSEG and RG&E make is rejected. Instead, they shall to implement the Staff Report $1.12 ceiling beginning with the month of December 2013. Moreover, the excessive use of IEP to the detriment of ratepayers shall be addressed in the further proceeding discussed below.

## E. Further Proceedings

In light of Recommendations 2.1 and 11.1 and the concerns identified above, the prior decision in the IEP Code Order permitting IEP to provide engineering services at its fully loaded costs will be reopened for additional consideration. The issues raised upon reopening include whether the continued use of IEP services is cost effective and of benefit to ratepayers; revisions to the Code of Conduct necessary to protect ratepayers in circumstances where an affiliate like IEP seeks to provide services at fully-loaded costs even though it is not a service company affiliate dedicated solely to serving utilities and instead participates in competitive markets; and, disapproval of IEP's existing master contract with NYSEG and RG&E pursuant to PSL §110(3). These issues shall be examined in additional proceedings conducted pursuant to the Order Instituting Proceeding issued herewith today in Case 13-M-0483.

The Other Audit Recommendation Order Issues

A. Gas Business Management

Management Audit Recommendation 2.2 suggested that the gas businesses of NYSEG and RG&E should be consolidated under single executives that reported directly to each utility's Chief Operating Officer. In these proceedings, the Companies submitted substantial information demonstrating that they had made improvements to the structuring of their gas businesses and that these improvements rendered consolidation under a single gas executive unnecessary. The Companies' improvements and explanations justify a conclusion that the creation of another executive position is not necessary to the successful functioning of the gas businesses.

One of the improvements to the NYSEG and RG&E gas businesses, however, was the creation of a Gas Strategic Planning Committee (GSPC) that would meet on a regular basis to discuss strategic gas issues and develop long-term plans for addressing those issues. At Staff Report Condition 26, it was recommended that the Companies demonstrate that the GSPC has been created, detail that it meets on a regular basis, and be required to submit notes from each meeting of the GSPC within 30 days of the meeting. While conceding that notes taken at the meetings of the GSPC should be available to Staff, the Companies believe they should provide the notes only if requested, and should not be required to file them on a regular basis.

In order for Staff to monitor the Companies' management of its gas business in compliance with the Recommendation, however, the notes from each such meeting are needed. As a result, the Staff Report filing requirement is appropriate and the Companies' arguments to the contrary are rejected.

The requirements proposed at Staff Report Condition 26 ensure that the improvements to gas operations necessary to justify elimination of the additional gas executive have actually been made. Consequently, the Companies shall include in their 60-day compliance filing required here a demonstration that the GSPC has been created and that it meets on a regular basis, and provide the notes from GSPC meetings that have been held previously. They shall also file the notes taken at each GSPC meeting conducted after the compliance filing is made within 30 days the meeting.

B. Utility Consolidation

In the Audit Recommendations Order, it was decided that the consolidation of NYSEG and RG&E into one utility should be investigated further. The consolidation, however, necessarily raises rate impact and rate design questions beyond the scope of these proceedings. Therefore, as recommended at Staff Report Condition 27, further investigation of the consolidation issue is deferred to later time in a more appropriate proceeding, such as a major rate filing proceeding.

C. Implementation of the Merger Order SOX Requirement

As discussed in the Audit Recommendations Order, the interpretation of the Merger Order condition requiring NYSEG and RG&E to comply with SOX as if they were still bound directly by its provisions was not sufficiently addressed in the management audit. Through the Staff Report Conditions, however, requirements derived from SOX that are of significant benefit to ratepayers have been explicitly imposed on NYSEG and RG&E. Since it is disagreements over the application of those SOX provisions caused the issue of the interpretation of the Merger Order condition to arise in the first instance, with these explicit requirements in place, additional interpretation of the Merger Order requirement is not needed and this issue need not be pursued further.

Management Audit Compliance

The Companies' clarifications to the provisions regarding compliance with the management audit recommendations have some merit, beginning with Recommendation 2.6, on communications between IUSA management and IBE Spanish management. The Staff Report provides that demonstration of compliance with Recommendation 2.6 would begin anew, subject to an approach stated at Staff Report Appendix B. As the Companies contend, the language at Staff Report Appendix B is overly restrictive and would be difficult to implement. As a result, that requirement is reworded to facilitate its implementation, as set forth at Appendix II here. Moreover, as the Companies point out, compliance with Recommendation 14.5, on ethics Compliance Officer access to high level corporate officials, is primarily a continuing obligation instead of an obligation to provide specific additional documentation.

The Companies did not object to two other Management Audit Recommendations resolved in the Staff Report. At

Recommendation 2.5, no action was recommended on the theory that the gaps perceived in IBE and IUSA governance did not lend themselves to concrete recommendations for changes. In the Staff Report, the issues the Recommendation raised were resolved by pointing to the many reorganization Conditions that enhanced governance. So long as those conditions were adhered to, the issues raised by the Recommendation would be satisfactorily addressed. In addition, Recommendation 2.4, on conducting the performance review for the IUSA Chief Executive Officer, was resolved in the Staff Report by the addition of a condition that would prevent directors who report to an officer from participating in the evaluation, or deciding the compensation, for that officer. The resolutions in the Staff Report of these two Recommendations are appropriate.

The Companies shall file an Audit Implementation Plan within 60 days of the date of this Order addressing any modifications to existing audit compliance plans necessary to comply with the four Recommendations that were reconfigured in the Staff Report, as the Recommendations are clarified here. They also shall restate in the Plan the compliance efforts they have made regarding the remaining seven Recommendations that were remanded to these proceedings in the Audit Recommendations Order.

The Companies' Proposed Clarifications

Addressing the wording changes the Companies propose to various Staff Report Conditions begins with Appendix I, §8(c)(formerly Staff Report Condition 5), on the insulation of NYSEG and RG&E from adverse tax consequences attending the affiliations resulting from the reorganization. One of the most significant risks attending the reorganization is the movement of IRHI into closer proximity with NYSEG and RG&E when it becomes a subsidiary of IUSA, which will also be the indirect owner of NYSEG and RG&E. Once incorporated into that corporate structure, IRHI will join in the filing, by IUSA, of a consolidated tax return for all of its U.S. subsidiaries, including NYSEG and RG&E. Given the importance of fully protecting NYSEG and RG&E ratepayers from any adverse consequences that may result from that relationship, the protections written into Staff Report will not be weakened through the proposed revision, and it is rejected.[38]

The Companies would revise the definition, set forth at Appendix I, §7(b)(formerly Staff Report Condition 9), of the qualifications a Director must meet to be designated as independent. As discussed in the Staff Report, requirements are needed to ensure that Directors can exercise independent oversight over company operations and that they are familiar with issues affecting regulated New York operations. One of the requirements set in the Staff Report Condition, however, for showing that a Director is independent is demonstration that he or she has ten years of experience in the regulated utility or energy industries. Some additional flexibility in the wording of the definition is appropriate, in that the Companies should be able to determine when a Director has significant experience warranting the selection of him or her as independent, without requiring a showing that the experience runs over a period of at least ten years.

The Companies, however, also request the authority to rotate the Director that is designated as the lead independent Director at any time. This flexibility would undermine the purpose of identifying a lead independent Director, which is to bring to the Board's attention matters that might not be

[38] IRHI's obligation to provide all tax information relevant to protecting ratepayer interests is now explicitly stated at §8(a) as well.

considered otherwise. If the lead could be replaced at any time, he or she might be more reluctant to raise those matters. Consequently, some limitation on rotation is needed.[39] Allowing for rotation no more than annually, but no less than every three years, provides both flexibility and ensures that the lead independent Director can exercise the requisite responsibilities without concern that a rotation early in his or her tenure might be the consequence of that exercise. These revised requirements are set forth at Appendix I, §7(e).

The prohibition at Appendix I, §7(g)(formerly Staff Report Condition 11) prevents the same person from holding both the CEO and the Chair of the Board positions at IBE U.S. utility affiliates. The Companies object to the inclusion of IUSA on the list. Since the Companies agree that the requirement should remain in place at NYSEG, RG&E and Networks, its importance at the IUSA level is attenuated. Moreover, the Companies maintain that cost savings and enhanced flexibility enabling them to better manage their operations would attend elimination of the requirement at IUSA. As a result, the Condition is not imposed on IUSA, and Appendix I, §7(g) reflects this clarification.

Turning to Staff Report Appendix C at §1(a), now Appendix I, §1(a), the Companies correctly point to a scrivener’s error in the goodwill restriction stated there. As discussed above, however, that restriction on the push down of goodwill was premised upon the Merger Order requirement precluding the push down of goodwill. Since that requirement is now revised, Merger Order Appendix 1, §1(a) must also be revised

[39] While different Director independence requirements are noted in the Central Hudson Merger Order, there a holding company will own a U.S. regulated utility affiliate in only one state, New York, while IBE owns regulated utility affiliates in both New York and Maine, distinguishing the two circumstances.

accordingly, to accommodate the push down of the goodwill to NYSEG and RG&E. The necessary revisions to the Merger Order restriction are now set forth at Appendix I here.

As the Companies also point out, Networks is included in the subsidiaries that, under Staff Report Appendix C, §2(b)(i), must be credit-rated. Because Networks does not plan to incur debt independent of its subsidiaries, however, it need not be rated at this time. If Networks were to change its plans and announce it desires to incur such debt, a rating requirement could be implemented at the appropriate time. Appendix I §2(b)(i) here reflects the necessary clarification to the Staff Report proposal.

## CONCLUSION

The other clarifications proposed by the Companies have been reviewed and considered, and we have made minor and additional changes to the Staff Report Conditions and resolutions of management audit Recommendations to address those clarifications, or for other appropriate reasons, while declining to make requested clarifications that are unnecessary or inappropriate. Therefore, the Staff Report is modified and clarified to the extent discussed above, and is otherwise adopted, and the petitions for approval of the reorganization of Iberdrola, S.A. are granted, subject to the Staff Report Conditions as modified and clarified and as set forth in Appendix I.[40]

[40] As noted in the Staff Report, p. 43, fn. 34, approval of the reorganization for IBE's fully regulated subsidiaries would carry with it approval of the reorganization for its IRHI subsidiary in Case 12-E-0065, because that transaction is reviewed with less scrutiny under the lightened ratemaking regulation applicable to IRHI as a competitive market participant.

The Companies shall make the compliance filings required in the body of this Order, within 60 days of the date of this Order, including those necessary to demonstrate satisfaction of GSPC requirements, which are discussed above. A management audit compliance filing shall also be made as of that date that conforms to the discussion above.

Additional compliance matters must be addressed to implement the various new provisions set forth at Appendix I. To comply with Appendix I, §8(b), the Companies shall submit a tax sharing and indemnification agreement that properly protects ratepayers in conformance with the requirements of this Order, 60 days before IUSA files a consolidated U.S. income tax return that reflects the operations of subsidiaries which include NYSEG and RG&E and competitive market participants. The Companies shall also report on the implementation of the minimum common equity ratio provided for at Appendix I, §2(b)(ii)(including its commencement date, which shall be no later than December 31, 2013); plans for providing the quarterly report required at Appendix I, §5(h) commencing no later than December 31, 2013; updating Company Codes of Conduct, including revisions to the interlocking Director matrix to comport with the requirements of Appendix I, §6(c) and to reflect the identity of affiliates as they exist post-reorganization; and, implementing the provisions of §7(b) regarding independent Directors; §7(d) regarding eligible Directors; §7(e) regarding the lead independent Director; §7(f) regarding the Networks Audit and Compliance Committee; §7(h) regarding conflicts of interest prohibitions; and, §7(i) regarding conflicts of interest disclosures.

The Commission orders:

1. The petitions for approval of the reorganization of Iberdrola, S.A. are granted, the transactions described

therein are authorized, and the Staff Report on Reorganization and Related Management Audit Issues is adopted, subject to:

i) all the terms and conditions set forth in this Order and in the Appendices hereto, which are an integral part of this Order; and

ii) the filing of an Audit Implementation Plan within 60 days of this order addressing the recommendations described or restated in Appendix II hereto. The Companies shall confer with Staff regarding the implementation of these recommendations before their implementation actions are commenced.

2. The Petitioners must submit a written statement of complete and unconditional acceptance of this Order and its terms and conditions, signed and acknowledged by duly authorized officers, on behalf of themselves and their New York subsidiaries, within 15 days of the date of this Order or before any closing of the proposed reorganization. In the absence of such acceptance, our approval of the proposed reorganization is rescinded.

3. New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall file a compliance plan within 60 days of the date of this Order, and in conformance with the discussion in the body of this Order, implementing the new requirements adopted in Appendix I as listed and discussed in the body of this Order.

4. New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall submit a tax-sharing and indemnification agreement in conformance with the requirements stated in the body of this Order 60 days before the making of a consolidated U.S. income tax return by Iberdrola USA, Inc. or any other parent entity.

5. New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall make monthly payments for services to Iberdrola Engineering Projects, Inc.

consistent with the discussion in the body of this Order, beginning with the month of December 2013.

6. New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall, upon any future request for financing authority, provide for the issuance of debt in conformance with Securities & Exchange Commission Rule 144A.

7. New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall show, in the compliance filing due within 60 days of the date of this Order, that the Gas Strategic Planning Committee has been created and meets on a regular basis, and shall submit to the Secretary, copied to the Director of Electric, Gas and Water, the notes from each meeting of the Gas Strategic Planning Committee within 30 days of the meeting.

8. The consolidation of New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation shall be considered further in an appropriate proceeding.

9. The Secretary may extend the deadlines set forth in Ordering Clause Nos. 3, 4 and 7 and in the body of this Order for good cause shown, provided the request for such extension is in writing and filed on a timely basis, which should be on at least one day's notice.

10. Case 12-E-0065 is closed. Cases 12-M-0066 and 10-M-0551 are continued.

By the Commission,

Kathleen H. Burgess

Digitally Signed by Secretary
New York Public Service Commission

KATHLEEN H. BURGESS
Secretary

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 12-M-0066 - New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation, RGS Energy Group, Inc., Iberdrola USA Networks, Inc., Iberdrola USA, Inc., and Iberdrola Finance UK Limited - Petition of for Approval of an Internal Reorganization Pursuant to Public Service Law §70.

NOTICE OF DETERMINATION OF
NON-SIGNIFICANCE

NOTICE is hereby given that an Environmental Impact Statement will not be prepared in connection with the approval by the Public Service Commission of the reorganization of the holding company arrangements for the U.S. subsidiaries of Iberdrola, S.A. based on our determination, in accordance with Article VIII of the Environmental Conservation Law, that such action will not have a significant adverse affect on the environment. The exercise of this approval constitutes an "unlisted" action, as is defined in 6 NYCRR §617.2(ak).

Based on our review of the record, we find that the proposed action, which will lead to a corporate holding company reorganization, will not have a significant adverse environmental impact. A change in the configuration of corporate holding company arrangements will not otherwise cause any physical alterations to the operations of holding company subsidiaries or their surroundings.

The address of the Public Service Commission, the Lead Agency for the purposes of the environmental quality review of this project, is Three Empire State Plaza, Albany, New York 12223-1350. Questions may be directed to Leonard Van Ryn at (518) 473-7136 or at the address above.

KATHLEEN H. BURGESS
Secretary

FINANCIAL AND CORPORATE PROTECTION CONDITIONS

1. Goodwill and Acquisition Cost Conditions

(a) No goodwill, implementation or transaction costs associated with Iberdrola, S.A.'s (Iberdrola) corporate holding company reorganization approved in Case 12-M-0066 (the Reorganization) or Iberdrola's previous acquisition of Energy East Corporation (Energy East) approved in Case 07-M-0906 may be reflected on the books maintained by New York State Electric & Gas Corporation (NYSEG), Rochester Gas and Electric Corporation (RG&E), RGS Energy Group, Inc. (RGS), Iberdrola USA Networks, Inc. (Networks), or Iberdrola USA, Inc. (IUSA) after the closing of the Reorganization. To the extent that push down accounting of goodwill is required upon their registration with the Securities and Exchange Commission as provided for in §5(i) below, NYSEG and RG&E will be permitted to record goodwill on their books.

(b) All goodwill whenever incurred or recognized, as well as implementation and transaction costs, must be excluded from rate base, expenses, and capitalization in the determination of NYSEG's and RG&E's rates and earned returns for New York State regulatory reporting purposes.

(c) If at any time any analysis determines that goodwill on the books of Iberdrola, IUSA, Networks, RGS, RG&E or NYSEG from this Reorganization and prior transactions, including transactions prior to Iberdrola's acquisition of Energy East, is impaired to any extent, Petitioners must submit that analysis to the Commission within five business days after the determination has been made.

2. Credit Quality and Dividend Restriction Conditions

(a) Copies of all presentations made to credit rating agencies by Iberdrola or any of its affiliates that relate to NYSEG, RG&E, RGS, IUSA or Networks, together with supporting materials (work papers, assumptions, and underlying calculations), must be provided, within ten business days of the presentation, to Department of Public Service Staff on a continuing basis.

(b) i) Iberdrola, IUSA, Networks (to the extent Networks incurs debt from a third party or experiences a business need for a credit rating), NYSEG, and RG&E must register with the two major nationally and internationally recognized bond rating agencies, Standard & Poor's and Moody's Investor Service, and intend to maintain at least an investment grade credit rating at each entity.

ii) NYSEG and RG&E shall maintain a minimum common equity ratio (measured using a trailing 13-month average) at the same equity ratio used to set rates exclusive of goodwill. At each month-end, NYSEG and RG&E shall maintain a minimum equity ratio of no less than 300 basis points below the equity ratio used to set rates. If gas and electric equity ratios for ratemaking purposes differ within a particular Company (either NYSEG or RG&E) then, the Company shall use a weighted average of the equity ratios for purposes of this provision. In the event that NYSEG, RG&E, Networks (to the extent applicable), IUSA or Iberdrola ratings are downgraded to the lowest investment grade with a negative watch, or ratings are downgraded to noninvestment grade, NYSEG and RG&E shall be prohibited from issuing dividends that would result in a trailing 13-month average common equity less than the maximum equity ratio, exclusive of goodwill, utilized for the Companies' earnings sharing mechanism (e.g., currently 200 basis points above the equity ratio used to set rates). At each month-end, NYSEG and RG&E shall maintain a minimum equity ratio, exclusive of goodwill, of no less than the equity ratio used to set rates. Subject to this condition, NYSEG and RG&E, respectively, are permitted to pay dividends in any year up to an amount equal to the sum of: (i) income available for common dividends generated in that year; (ii) the cumulative amount of retained earnings accrued in prior years, starting with the closing date of this restructuring; and (iii) that portion of paid-in capital that was recorded on the books of NYSEG or RG&E, respectively, as unappropriated retained earnings, unappropriated undistributed earnings, and accumulated other comprehensive income immediately prior to the closing date of this restructuring, to the extent that those earnings have not already been paid out as dividends in years following the closing date of this acquisition.

(c) To the extent that NYSEG or RG&E desires, for the purposes of this provision, to exclude from the calculation of "income available for common dividends" non-cash charges to income resulting from accounting changes or charges to income or retained earnings resulting from significant, unanticipated events (including changes related to the push down of goodwill), NYSEG or RG&E, respectively, must first notify the Commission of its intent to do so and provide an explanation for that action. NYSEG or RG&E, respectively, may exclude the items identified in the notification if the Commission or its designee has not, within 30 days from the date of its receipt of notification, notified the company that additional review is necessary. Under no circumstances may the balance of retained earnings become negative as a result of a dividend payment.

(d) If: (i) a credit rating agency's bond rating on the least secure form of debt issued by NYSEG or RG&E falls as a result of action by or against and affiliate, the cost of debt for NYSEG and RG&E will be imputed based upon the lower cost of debt attributable to that entity with a rating equivalent to the Company's rating prior to the downgrade. This requirement applies to debt issuances made during any applicable downgrade period. The starting point for any comparison would be to the then current ratings of NYSEG and RG&E, unless a rating change occurs other than due to a rating action taken against an affiliate, in which case the starting point would be the credit rating in effect immediately prior to any rating change of NYSEG and RG&E. This imputation requirement applies to debt issuances made only during any applicable downgrade period; or, (ii) the bond rating on the least secure form of debt issued by Iberdrola, IUSA, or Networks (to the extent applicable) falls to the lowest investment grade rating and there is a negative watch or review downgrade notice for Iberdrola, IUSA, or Networks (to the extent applicable) as determined by any nationally recognized rating agency or, alternatively, if the bond rating for Iberdrola, IUSA, or Networks (to the extent applicable) immediately falls to non-investment grade without such a notice, see subparagraph (e).

(e) (e) If a ratings event described in clause (ii) of subparagraph (d) above occurs with respect to NYSEG, RG&E, Networks (to the extent applicable), IUSA or IBE, NYSEG and RG&E may not transfer, lease, or lend any moneys, assets, rights, or other items of value to any affiliate without first obtaining Commission approval. This provision excludes payments for goods, services, and assets related to reasonable commitments made 180 days or more before the triggering event, routine transactions required in the regular course of business pursuant to contracts or other arrangements in existence 180 days or more before the triggering event, corporate taxes, and payments, if not accelerated, of principal or interest on loans.

(f) If a ratings event described in subparagraph (d) above occurs, Iberdrola, IUSA, Networks, NYSEG, and RG&E must file a plan with the Secretary to the Commission within 60 days explaining the actions that are planned to address and rectify the situation. The dividend payment and value transfer provisions in subparagraph (d)-(e) above end when the relevant credit rating is restored, the negative watch or review notice is removed with no negative action taken, or the Commission or its designee specifically approves the payment of dividends or transfer of items of value.

3. Money Pooling Conditions

(a) NYSEG and RG&E may participate in a money pool only if all other participants, with the exception of Iberdrola, IUSA, Networks, and RGS, are regulated utilities operating within the U.S., in which case NYSEG or RG&E may participate as either a borrower or a lender. Iberdrola, IUSA, Networks and RGS may participate only as lenders in money pools involving NYSEG or RG&E. Neither NYSEG, nor RG&E may participate in any money pool in which any participant directly or indirectly loans or transfers funds to IUSA, Networks, or Iberdrola.

(b) Neither Iberdrola, IUSA, Networks, nor any of their affiliates may have any cross default provision at closing of the approved restructuring that affects NYSEG or RG&E in any manner. Neither Iberdrola, IUSA, Networks, nor any of their affiliates may enter into any cross default provision that affects NYSEG or RG&E in any manner. To the extent that any cross default provision that might affect NYSEG or RG&E already exists, Iberdrola, IUSA, and Networks must use their best efforts to eliminate that provision within six months of closing. If any cross default provision remains in effect at the end of that period, Iberdrola must obtain indemnification from an investment grade entity, at a cost not borne by ratepayers, that fully protects NYSEG and RG&E from the effects of any cross default provision.

4. Special Class of Preferred Stock Conditions

(a) The voting right, previously accepted by the Commission as preventing a bankruptcy, liquidation, receivership, or similar proceedings ("bankruptcy") of NYSEG or RG&E, respectively, from being caused by a bankruptcy of Iberdrola, applies to IUSA, Networks, or any other affiliate.

5. Financial Transparency and Reporting Conditions

(a) Networks, NYSEG, and RG&E must continue to use U.S. Generally Accepted Accounting Principles (GAAP) for all financial reporting purposes.

(b) NYSEG and RG&E must continue to satisfy all reporting requirements that currently apply to them.

(c) After the closing of the reorganization, Networks must continue to comply with the provisions of the Sarbanes-Oxley Act (SOX) as if it were still bound directly by the provisions of the SOX. Network's periodic statutory financial reports must continue to include certifications provided by its officers concerning compliance with SOX requirements as if still bound directly by the provisions of SOX.

(d) Networks, NYSEG, and RG&E shall remain subject to annual attestation audits by independent auditors.

(e) Staff will have full access, on reasonable notice, and subject to resolution of confidentiality and privilege issues to (i) the books and records, in English, of IBE and of its subsidiaries that own majority interests in NYSEG and RG&E directly or indirectly (currently, IUSA, Networks and RGS) where such books and records are relevant to the Public Service Commission's exercise of authority under the Public Service Law or any other applicable statute; and, (ii) the books and records of all other IBE subsidiaries or affiliates (currently, IEP and IRHI), in English, to the extent necessary to audit and monitor any transactions that have occurred between NYSEG and RG&E and such subsidiaries or affiliates subject to Public Service Law §110 or any other provision of law.

(f) i) Iberdrola must file annually with the Commission financial statements, including balance sheets, income statements, and cash flow statements for Iberdrola and its major regulated and unregulated energy company subsidiaries in the United States. Domestic business entities with annual revenues less than five percent of total domestic U.S. revenues may be aggregated, provided that each entity included is fully identified. Energy utility information must be fully consistent with former Securities and Exchange Commission (SEC) Form U-9C-3.

ii) Iberdrola must file annually with the Commission historical consolidating balance sheets, income statements, and cash flow statements in a format similar to former SEC Form U-5S. These statements must specifically show financial results for IUSA, Networks, RGS, NYSEG, and RG&E and must link the specific IUSA, Networks, RGS, NYSEG, and RG&E account balances to the overall consolidated results. Although individual statements for individual business entities other than IUSA, Networks, RGS, NYSEG, and RG&E are not required, Iberdrola's consolidating statements must show the aggregate results for both its unregulated and its regulated subsidiaries separately.

iii) To the extent that information required by clause (i) or clause (ii) of this subparagraph is presented in an IFRS format, Iberdrola must provide answers within 10 business days to any question raised by the Commission or Department of Public Service Staff concerning the format or the content of the financial statements.

iv) Following the initiation of the next rate case for NYSEG or RG&E, if Staff requests that NYSEG and RG&E provide information on the capital structure for Networks or IUSA, the Companies shall provide such information.

(g) All information required by the financial transparency and reporting requirements in subparagraphs (a) through (f) above must be provided in English and stated in U.S. dollars and shall be publicly available to the extent not protected from disclosure as confidential information pursuant to 16 NYCRR §6-1.3 - 2.4.

(h) NYSEG and RG&E shall provide to the Secretary a quarterly governance report to notify the Commission of the following: (i) a list of changes in directors, committee members, officers or executives at NYSEG, RG&E, RGS, Networks, and IUSA; (ii) a list of completed major transactions (i.e., at least 5% of IUSA net assets) that relate to or affect NYSEG, RG&E, RGS, Networks or IUSA; (iii) Significant changes in capitalization at NYSEG, RG&E, RGS, Networks, and IUSA;

and, (iv) meetings of the Boards of Directors of Networks, IUSA, IEP, IRHI, and IBE, which notifications shall be accompanied by the agendas for each of the Board meetings reported.

(i) NYSEG and RG&E shall fully register with the Securities and Exchange Commission for the purpose of issuing securities at a time to be specified.

6. Affiliate Transactions, Cost Allocations, and Code of Conduct

(a) Iberdrola shall be subject to the rules, practices, and procedures in the existing code of conduct, and as that code of conduct is revised, governing relations among Networks and its subsidiaries, including, but not limited to, NYSEG and RG&E, in the same manner as they apply to Networks.

(b) The Companies shall continue to comply with both the Standards of Conduct and PSL § 110 (which requires the filing of contracts with affiliates). The Companies shall file with the Secretary, copied to the Director of the Office of Accounting, Audits, and Finance, or its successor Office, all amendments and supplements to the Standards of Conduct and related guidelines, thirty (30) days prior to making such change(s). The Companies shall also notify in advance the Secretary, copied to the Director of the Office of Accounting, Audits, and Finance, of any services that Management Corp (as defined in the Standards of Conduct) provides to IRHI or companies that are not subsidiaries of Networks in excess of 5% of the respective net incomes of NYSEG or RG&E.

(c) Following the Reorganization, the Standards of Conduct will be updated to reflect the Reorganization entities.

(d) Staff may propose subsequent to the reorganization modifications to the Standards of Conduct, the related Cost Allocation Guidelines, and any other related guidelines, subject to the solicitation of comments on the proposal from interested parties.

7. Governance Provisions

(a) NYSEG and RG&E shall maintain their headquarters, and shall continue to locate their utility books and records, in their respective New York service territories. The majority of the NYSEG and RG&E executives (Officers and Vice-Presidents) shall have their work locations in the service territories. NYSEG and RG&E shall commit that, for local emergencies, channels of communication and field operations will be coordinated from local emergency command centers that would be centrally located in the respective NYSEG and RG&E service territories, and that, for emergencies of wider company impact, the system Area Command Planning Section located in the service territory (formerly referred to as the "Emergency Operations Center") may be activated, as appropriate.

(b) At least one-third of the directors at Networks shall be "independent directors," as defined in SEC Rule 4200(a)(15). At least half of the independent directors must either live or work in the service territories of NYSEG or RG&E or have significant relevant work experience in the regulated utility or energy industry, but in all cases, the Board must have at least one member who meets this residency or work experience requirement.

(c) Staff and Commissioners may submit written communications to the Secretary of the Networks Board of Directors, and receipt of a communication will be confirmed in writing. The Board Secretary shall then provide such written communications to the Networks Board of Directors.

(d) A majority of the Utility Board of Directors shall be Eligible Directors. An Eligible Director is any individual who is not: (i) an officer or director of HoldCo (other than Networks only); or (ii) an officer or director of any of Iberdrola's non-utility Affiliates; or (iii) an officer or director of any Competitive Energy Affiliate or Unregulated Affiliate.

(e) The Networks Board shall designate a lead independent director. The Board of Directors shall authorize an independent director, to request the chairman of the Board of directors to call a meeting of the Board of Directors whenever such independent Director deems appropriate, to request the inclusion of matters on the agenda for Board of Directors Meetings, and to act as a liaison and communicate any issues to the Chairman brought to the lead director if requested by the other independent directors. The lead independent director shall rotate periodically, with each rotation of at least one year and no more than three years in duration.

(f) At least two-thirds of the directors on the Networks Audit and Compliance Committee (ACC) will be independent directors, one of which shall be the Chair of the Networks ACC. All members of the Networks ACC will be "financially literate," as such term is used in NYSE Rule 303A.07 and explained in the commentary to NYSE Listed Company Manual Section 303A.07, and that at least one member of the Networks ACC must have "accounting or related financial management expertise", as such term is used in NYSE Rule 303A.07 and explained in the commentary to NYSE Listed Company Manual Section 303A.07.

(g) The same person shall not hold the CEO and the Chairman of the Board positions at NYSEG, RG&E, or Networks.

(h) NYSEG, RG&E and Networks shall prohibit the members of their Boards of Directors from having interests, financial or otherwise, in competitors to NYSEG, RG&E or Networks, or in Iberdrola affiliates or subsidiaries that are not subject to ratemaking regulation.

(i) NYSEG, RG&E and Networks shall requires disclosure if a member of the Board of Directors has an interest in an unaffiliated entity adverse to, or that conducts significant business with, NYSEG, RG&E or Networks.

8. Consolidated Tax Provisions

(a) After the Reorganization is completed, IUSA may file as the consolidated U.S. taxpayer for the U.S. subsidiaries. A Tax Sharing Agreement will be used to allocate tax benefits and obligations among the companies participating in the consolidated tax return. The agreement shall provide for full Staff access to all income tax records of IRHI.

(b) The Petitioners commit to have IUSA indemnify NYSEG and RG&E customers for tax obligations other than those that would have been incurred by NYSEG or RG&E on a stand-alone basis. The contractual mechanism for implementing the tax indemnification shall be set forth in the Tax Sharing Agreement referenced above.

(c) For ratemaking purposes, NYSEG and RG&E customers shall be held harmless from any adverse tax consequences that may occur though affiliated companies. Income tax expense charged to customers will be computed treated as if they were able to receive the benefits of any NYSEG or RG&E losses, credits or deductions that would have been attributable to NYSEG or RG&E on a stand-alone basis and, subject to the normalization rules applicable to NYSEG and RG&E. NYSEG and RG&E shall be treated on a stand-alone basis for rate purposes, including tax issues.

MANAGEMENT AUDIT COMPLIANCE

Recommendation 2.1 - Suspend Use of Iberdrola Engineering Projects, Inc. (IEP).
Resolution: Compliance shall be achieved through a Condition adopted in the body of this Order.

Recommendation 2.2 - Consolidate the gas business under a single executive reporting to the COO.
Resolution: Compliance shall be achieved through a Condition adopted in the body of this Order.

Recommendation 2.3 - Streamline executive communications and empower IUSA CEO.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 2.4 - Institute formal IUSA board evaluations of CEO performance and review of CEO evaluations of other top management incumbents.
Resolution: Compliance shall be subject to the filings made to date and a prohibition preventing Directors who report to the Officer being evaluated from participating in the evaluation or deciding the compensation for that officer.

Recommendation 2.5 - Governance gap — The gaps between IBE governance and what one would expect for a company with the breadth of operations of IUSA do not lend themselves to concrete, executable change recommendations.
Resolution: Compliance will be subject to implementation of the Reorganization Conditions adopted in the body of this Order.

Recommendation 2.6 - Make IUSA personnel a more central voice in communicating regulatory requirements, expectations, decisions, guidance and other matters to senior Spanish executives and the parent board and establish vehicles to make those audiences more aware of U.S. regulatory issues.
Resolution: To improve communication between U.S. Companies and Iberdrola, concrete mechanisms shall be created, ensuring that appropriate information concerning NYSEG and RG&E operations and regulation is provided to IBE managers or executives and the IBE Board, through procedures consistent with the reliable transmission of the information, with ensuring its receipt, and with IBE’s corporate protocols.

Recommendation 2.7 - Institute yearly self-assessments of board performance.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 10.3 - Enhance the IUSA Board's role in overseeing capital budget formation and monitoring.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 14.2 - Subject prior and future changes in SOX compliance structure, responsibilities, procedures, practices, and components (e.g., key controls) to a focused analysis of potential impacts on utility regulatory processes and proceedings.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 14.4 - Incorporate into the IUSA Code of Conduct specific statements of IUSA values and principles regarding affiliate relationships and transactions, and summarize and make references to applicable policies, procedures, and guidance.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 14.5 - Make the reporting of the IUSA chief ethics and compliance lead organizationally separate from the general counsel's organization, establish a direct reporting organizational relationship to the IUSA CEO, and provide for regular and confidential reporting to the IUSA board's audit committee.
Resolution: Compliance shall be subject to continued demonstrations that the means and provisions for direct and immediate access of the ethics Compliance Officer to the CEO and other high level officers are in place and are adequate to ensure the requisite access.

Recommendation 14.8 - Give the IUSA board the full power to design and determine the compensation of IUSA employees.
Resolution: The filings to date appear to meet the spirit of this Recommendation.

Recommendation 14.9 - Make the IUSA board the sole authority for establishing and measuring IUSA incentive compensation and assure the creation of all goals by the start of the period they address.
Resolution: The filings to date appear to meet the spirit of this Recommendation.