STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on April 7, 2009

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman
Patricia L. Acampora
Maureen F. Harris
Robert E. Curry, Jr.
James L. Larocca

CASE 09-E-0082 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service.

CASE 09-G-0083 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Gas Service.

CASE 09-E-0084 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Electric Service.

CASE 09-G-0085 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Gas Service.

ORDER DISMISSING THE JANUARY 2009 RATE FILINGS

(Issued and Effective April 8, 2009)

BY THE COMMISSION:

INTRODUCTION AND SUMMARY

On September 9, 2008, the Commission granted Iberdrola, S.A. authority to acquire the Energy East Corporation subject to certain conditions.[1] Those conditions included the following:

> The $275 million PBA (positive benefit adjustment) amount we are adopting is not intended to reflect synergy and efficiency savings attributable to the transaction. To provide ratepayers a share of any such savings, an additional condition of our approval is that NYSEG and RG&E file electric and gas rate applications during a “target period” which is the 30 days immediately following the first anniversary of the acquisition’s closing date…. Notwithstanding the target period, either company may file a general rate application at any time upon a showing that its financial performance otherwise would fall to levels that would jeopardize its ability to provide safe and reliable service.
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> To ensure that the ratemaking process accounts for savings and costs related to operational changes resulting from the transaction, NYSEG and RG&E each must provide, in prefiled testimony as part of its next general rate case filings (whether within or outside the target period), all studies, analyses and related workpapers prepared by Iberdrola, its subsidiaries, affiliates, or agents that identify or quantify the costs and savings related to merger synergies, efficiency gains, and the adoption of utility best practices that in any way affect the management, operation and underlying costs of NYSEG’s and RG&E’s utility business.[2]

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[1] Case 07-M-0906, Joint Petition for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A., Abbreviated Order Authorizing Acquisition Subject to Conditions (issued September 9, 2008). Energy East is the parent company of New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E)(collectively referred to as the Companies).

[2] Ibid., pp. 12-14. The same conditions are stated in the Commission's final order. See, Order Authorizing Acquisition Subject to Conditions (issued January 6, 2009), pp. 140-41.

On September 10, 2008, Iberdrola, Energy East, NYSEG and RG&E, and the other petitioners, provided their unconditional acceptance of the terms and conditions of the September 9, 2008 Order and, on September 16, 2008, Iberdrola completed its acquisition of Energy East. This occurred just one day following the Lehman Brothers bankruptcy that marked an intensification of the downturn in the financial markets.[3] NYSEG and RG&E assert that the situation in the financial markets has had serious negative financial consequences for them. For this reason, on January 27, 2009, they filed to increase electric and natural gas delivery rates by a total of $278 million, starting July 1, 2009.[4]

On February 13, 2009, Department of Public Service Staff filed a motion to have the NYSEG and RG&E rate filings dismissed. Staff asserts that the rate filings do not satisfy the conditions and requirements of the September 9 Order. Staff maintains that a sufficiently poor financial performance has not been shown nor have the Companies presented the merger synergy analyses, efficiency studies and other rate case materials that should have been provided to complete a rate case filing.

On February 23, 2009, the State Consumer Protection Board (CPB) stated its support for the Staff motion and presented three motions of its own. CPB believes there should be a prudence investigation of the rate case filings to determine whether there is a basis for disallowing the filing costs and to impose other sanctions. CPB also proposes a management audit to consider the best practices for the

[3] From May 2, 2008 to September 16, 2008 the stock market, as measured by the Dow Jones Industrial Average, dropped by 1999 points or about 15%.

[4] By orders issued February 12, 2009, the Commission suspended the rate increase filings to conduct its review in these proceedings.

Companies and to provide customers savings and operating efficiencies. Further, CPB believes a proceeding is needed to consider whether restrictions should be imposed on NYSEG and RG&E to preclude the payment of dividends to the parent companies.

Multiple Intervenors (MI) also supports Staff's motion to dismiss the rate filings.[5] Further, MI objects to NYSEG and RG&E omitting from their rate case filings the cost-of-service studies, rate design proposals and other non-revenue requirement matters that are typically addressed in a complete rate filing. While the Companies have proposed to provide their non-revenue requirement materials by May 29, 2009, MI believes that the numerous omissions in the rate filings support their dismissal.

A hearing on the Staff motion and the parties' responses was held on March 3 and 4, 2009. In addition to the Companies, Staff, CPB and MI, the hearing was attended by Nucor Steel Auburn, who shares MI's concern about the lack of an embedded cost-of-service study and related rate design proposals.

At the March hearing, Staff presented testimony in support of its motion from an accountant, a financial expert and a panel of witnesses who addressed service reliability, service quality and customer service. The Companies provided answering testimony from a panel of witnesses that included their chief executive officer, chief financial officer, their controller and treasurer, and a regulatory policy expert. A financial analyst

[5] MI is an unincorporated association of about 50 large industrial, commercial and institutional energy consumers located throughout New York, including the NYSEG and RG&E service areas.

who specializes in public utility matters also testified for NYSEG and RG&E.[6]

The Commission has received numerous letters, electronic comments and telephone messages from customers who oppose the proposed rate increases. Many customers are aware of the commitments made when Iberdrola acquired Energy East to avoid and postpone any rate increase filings. The Commission has received many post cards requesting that the rate filings be rejected.

On March 13, 2009, NYSEG and RG&E, Staff, CPB and MI filed post-hearing briefs addressing the motion to dismiss the rate filings. The parties' positions are summarized below, followed by a fuller discussion of our reasons for granting Staff's motion and for dismissing the NYSEG and RG&E rate filings.

In this order, we grant Staff's motion to dismiss. We find the Companies' financial performance, assuming exercise of prudent management, will not fall to levels that would jeopardize their ability to provide safe and reliable service in the absence of rate relief prior to the time new rates would be available under the Merger Order. We base our decision primarily on our analysis of the Companies' cash flow, which reveals that the Companies will, at the very most, have cash needs of $260 million in 2009 and $120 million in 2010. Such needs can be met through a combination of long-term debt, equity infusions, reasonable dividend payments and cost-cutting if necessary. Thus, we find that, notwithstanding the current global financial crisis, the Companies will be able to access the capital markets to the extent necessary. We also find the

[6] NYSEG and RG&E prefiled their answering testimony on February 23, 2008. The testimony was accompanied by their formal answer to Staff's motion.

Companies' earnings going forward, until rates may be re-set, to be at a level that similarly does not jeopardize their ability to provide safe and reliable service. We conclude that the Companies' financial health depends on reasonable financial management by the Companies and their corporate parents, not on emergency rate relief.

Because we find the Companies are not in the dire financial straits they have alleged and because of various commitments made by Iberdrola, Energy East, and the Companies as part of their acceptance of our order approving the merger, we find no basis for granting the cross-motion of the Consumer Protection Board to consider the imposition of mandatory dividend restrictions on the Companies.

In dismissing these filings, we note substantial deficiencies that should be remedied before the Companies refile during or after the target period consistent with our Iberdrola Merger Orders.

THE PARTIES' POSITIONS

According to Staff, NYSEG and RG&E have sufficient capital to fund their critical infrastructure and necessary operations in 2009 and 2010 without receiving any rate relief before August 2010. To the extent that the Companies' internal cash flows are inadequate to cover the cash requirements, Staff states that NYSEG and RG&E can access external capital to provide liquidity and cover any cash flow shortfall. Thus, Staff believes the Companies can continue to provide safe and reliable service until the time that any rate increases would be available pursuant to a filing made during the target period.

Staff has reviewed the financial information provided by NYSEG and RG&E and does not foresee a significant cash flow shortfall in 2009 or during the first half of 2010. While NYSEG and RG&E have projected a $571 million shortfall in 2009 and $277 million for 2010, Staff believes that these shortfalls can be avoided or be addressed by proper management actions without resort to higher delivery rates. According to Staff, the loans that NYSEG and RG&E received from their corporate parents can continue and they need not be paid off in 2009-10. Also, NYSEG and RG&E can increase their lines of credit and access bank financing to provide cash to operate in 2009-10. Staff also points out that the Companies can issue more long-term debt or obtain equity infusions from their parent companies. Staff states that there are no regulatory or financial barriers to prevent the Companies from covering their 2009-10 cash flow requirements with any combination of these means.

NYSEG and RG&E insist, however, that they do not have sufficient cash and higher rates are needed in July 2009. They estimate total cash flow requirements for 2009-10 of $575 million or $850 million depending on the capital project expenditures projected respectively by Staff and the Companies. The Companies are reluctant to attempt either level of debt financing which could be difficult to obtain in the current financial market conditions. The additional debt would reduce their credit rating metrics to below the levels expected for investment grade offerings; consequently, the Companies fear their credit ratings could be downgraded.

Stated another way, if the Commission grants Staff's motion and dismisses the rate increase filings, NYSEG and RG&E assert that such action could signal to investors and the credit rating agencies an unwillingness to maintain the Companies' financial health and a reluctance to provide timely cost recovery to sustain adequate returns. The Companies point out that they have been placed on negative watches or outlooks by rating agencies, which are closely monitoring this proceeding.

NYSEG and RG&E believe a dismissal of the rate increase filings will perpetuate their relatively weak financial condition and allow their finances to deteriorate before any new rate filings are made in September 2009 and rate relief is obtained in August 2010.

Cash Flow Analysis Differences

The Companies and Staff differ substantially on the cash flow requirements for 2009-10. NYSEG and RG&E foresee a possible $850 million negative cash flow; Staff has calculated the potential for $80 million of positive cash flow in 2010 before the target date for new delivery rates. The first difference between the parties concerns the expected amount of commodity earnings given a recent NYSEG and RG&E proposal to end the “fixed-price option” that is currently available to customers. According to the Companies, changes in the commodity programs should not be ignored. According to Staff, until the Commission accepts the proposal, the “fixed-price option” revenues should be assumed to continue.

Secondly, the Companies and Staff disagree on the amount of pension costs to include in cash flow for 2009-10. NYSEG and RG&E assert that their pension income has fallen and the pension funds require contributions. On the other hand, Staff states that it reviewed the pension information provided by the Companies’ actuaries in the January 2009 rate filings. Staff maintains that the testimony states that no payments will be made into the pension funds in 2010. Further, Staff insists that pension expense and income do not affect cash flow and they should not be considered cash items. The Companies disagree with Staff’s understanding of the prefiled testimony; the parties also disagree on the amount of deferred taxes to include in this portion of the cash flow analysis.

Next, there is a $76 million cash flow difference for the items for which deferral accounting is provided: environmental remediation expenses; storm damage; stray voltage testing and inspections; and other items. Staff doubts that a large increase in the deferred costs is likely and claims that the Companies' projections are aggressive and speculative.

NYSEG and RG&E differ and believe that the build-ups in the deferral accounts require current cash funding. They note that the largest amount included in the January 2009 rate increase filings is sought to cover the projected deferral balances. In support of their position, NYSEG and RG&E point to large amounts of storm damage costs and environmental remediation expenses incurred in 2007 and 2008 that exceeded the current rate allowances. Addressing stray voltage testing and inspections, RG&E states that these costs are not included in its rates.

As to the amount of environmental remediation expenses experienced in recent years, Staff states that this "up tick" is unusual; the incurrence and timing of these costs is discretionary; and, the most recent amounts do not evidence a trend. As to storm damage costs, Staff also considers the amount built into rates to be reasonable and asserts that the Companies should bear the risk of storms and adverse weather. Staff acknowledges that RG&E's stray voltage costs are not included in rates; however, it believes this expense, by itself, is insufficient to support rate increases in advance of the target period.

Continuing with the cash flow analyses, they differ in 2009 by $27 million for items related to the non-bypassable charge (NBC). About $4 million relates to a New York Power Authority (NYPA) true-up item; about $6 million concerns NBC commodity uncollectibles; and $16 million pertains to a "NBC

2008 Return of VPO Basis." Overall, Staff asserts that the $27 million has not been adequately explained by the Companies, having only recently appeared in their February 23, 2009 testimony. Staff believes that the $27 million should be excluded from the cash flow analysis.

The capital expenditures included in the cash flow analyses also differ. Staff relies on the capital expenditures provided at the time of the Energy East acquisition. The Companies have included $276 million of additional capital expenditures in the January 2009 rate filings. The Companies show $375 million of capital expenditures for 2009 and $441 million for 2010. Staff only recognizes $540 million for 2009-10 as established at the time of the September 9 Order. It doubts, in the span of only five months, the previously determined amounts became inadequate.

Pointing to the electric capital expenditures NYSEG made since 2006 and the previous projections for 2009 and 2010,[7] Staff states that much of the recent increase ($76.8 million) is attributable to the Electric Reliability Organization (ERO) standards that could be required by the Federal Energy Regulatory Commission (FERC).[8] However, FERC has yet to make its determination and it has only requested a list of the transmission and distribution facilities over 100 kV that might, in the future, become subject to the ERO standards. Staff observes that hundreds of facilities have yet to be studied for upgrades and a transition to the new standards would take substantial time and require detailed plans.

[7] 2006 - $125.1 million; 2007 - $92.3 million; 2008 - $130.4 million; 2009 - $140 million; 2010 - $140 million.

[8] RG&E included in its rate filing $47.8 million for Electric Reliability Organization construction expenditures.

Staff also questions the recent increase in NYSEG's natural gas capital construction budget and asks whether it is being properly managed in these times of financial distress. Staff believes the Company should establish priorities, postpone projects and save costs before it seeks to obtain higher rates.

Turning to RG&E's capital expenditures, Staff states that insufficient justification was provided for the new projects since the September 9 Order. Staff considers the RG&E electric system to be in sound condition and doubts that the newest proposed expenditures are needed very soon. Staff also notes that the RG&E natural gas capital budget exceeds the amount provided at the time of the September 9 Order and claims it should be more austere in this period of financial distress.

According to the Companies, at either its or Staff's level of capital spending, it will be difficult to issue new debt. NYSEG and RG&E state that a new debt issuance would produce higher costs for ratepayers; would reduce the Companies' credit metrics; and could produce a credit downgrade.[9]

NYSEG and RG&E add to the cash flow requirements by including one-half the balance of an existing credit facility and the repayment of an inter-company loan made from Energy East. They state that the credit facility is fully drawn and a portion of it should be re-established to create liquidity for unforeseen events. They object to Staff's refusal to include this item in the cash flow analysis. They also object to Staff's suggestion to increase their line of short-term credit (as an alternative to issuing long-term debt), as this would require the lenders' consent which may not be forthcoming in the current market conditions.

Addressing the Energy East loan, the Companies state it was only provided temporarily (during the second half of

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[9] NYSEG's and RG&E's Post-Hearing Brief, p. 17.

2008) to maintain liquidity. Continuing the loan, they state, would impair Energy East's ability to support other subsidiary companies. They do not believe the loan should be left unpaid indefinitely. However, according to Staff, the credit facility and the inter-company loan are not currently due and cash should be preserved for higher priorities.

Staff is also opposed to dividends being paid when the Companies' liquidity is strained. It objects to as much as $209 million being paid out in 2009-10. According to Staff, prudent management of the Companies' financial resources does not permit dividends if there is insufficient cash flow.

NYSEG and RG&E state that they have not decided whether or not to pay dividends in 2009-10. The Companies point out that they did not remit $55 million in dividends in 2008 to have the liquidity they needed to operate. However, they do not consider dividend omissions to be a proper long-term solution to their cash flow problems. They state that it is highly unusual for public utility companies to withhold dividends from shareholders and it would be unreasonable, confiscatory and contrary to the standards established by the United States Supreme Court for a regulatory commission to require any such long-term solution.[10] In any event, assuming rate relief in July 2009, NYSEG and RG&E would expect to earn about $365 million (90% of the indicated earnings) that would either be retained or reinvested in the Companies and would not be paid out as dividends.[11]

Finally, Staff believes that NYSEG and RG&E can improve cash flow by implementing austerity measures. In

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[10] Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944); Bluefield Improvement Co. v. Public Service Comm'n of the State of West Virginia, 262 U.S. 679 (1923).

[11] NYSEG's and RG&E's Post-Hearing Brief, p. 21.

addition to the $6 million of austerity savings that the Companies achieved during the latter half of 2008, Staff believes that they should freeze executive and management compensation levels; eliminate bonuses; reduce registration and filing fees; and impose employee travel restrictions. Staff estimates that more than $25 million can be had annually by implementing such measures.

On an interim basis, NYSEG and RG&E are not opposed to implementing austerity measures as they did in 2008. However, over the next two years, they doubt that even the most aggressive cost-savings measures can provide sufficient liquidity and alleviate a significant cash shortfall. They point out that Staff has neither provided a study nor any expert evidence to support its assertion that austerity measures alone can resolve their 2009-10 finances. Further, they believe the austerity measures Staff favors would adversely affect the workforce and compromise safe and reliable service. According to the Companies, it would not be wise to suspend payments to affiliated service companies or essential vendors. Nor do they think it would be correct to withhold federal income tax payments that are due and payable.[12]

Earnings Expectations

Absent any higher rates in July 2009, the Companies show projected equity returns at or below 7% for 2009 which they consider to be too low. They point out that the cost of debt

[12] In this case Staff has asserted a belief that cash flow could be improved by $70 million if the Companies retained their federal income tax payments otherwise due to Iberdrola. Staff believes that Iberdrola can offset its 2008 federal income taxes by using Production Tax Credits. NYSEG and RG&E state that they are not able to consolidated their income tax returns in the manner that Staff suggests to reduce Iberdrola’s federal income taxes.

for “BBB” rated utility companies is close to this figure, and these equity returns are far less than the 12% to 12.2% equity allowances they would expect the Commission to establish. The Companies disagree with Staff’s claim that their earnings in 2009 can be expected to meet or exceed 9% without any higher delivery rates in July 2009. They believe that Staff’s calculations contain unjustified assumptions and incorrect adjustments. In any event, the Companies do not consider a 9% return on equity to be sufficient.

In the category they label “mathematical calculation errors,” NYSEG and RG&E take issue with Staff’s use of a pre-tax rate of return of 13% to calculate the income impact of Staff’s rate base adjustments. The Companies state that the 13% should only be used if their requests for 12% and 12.2% equity return allowances are granted; without rate relief, they state that the 13% pre-tax return is incorrect. The Companies also believe that Staff is mistaken in its treatment of inflation impacts on non-rate case legal costs. They also claim that Staff has double counted the impact of the PBAs (positive benefit adjustments) by using them to reduce rate base and by showing them as accruing interest. NYSEG and RG&E state that the interest accruals are proper but the rate base deduction is not.

The Companies and Staff also differ on numerous other matters affecting earnings that would be addressed during the course of a ratemaking proceeding. Were Staff to succeed on the merits of various ratemaking issues, NYSEG’s and RG&E’s cash flow for 2009-10 would be improved to the extent the Companies exclude from their operations such items as payroll increases, rate case expenses and various other ratemaking disallowances. In total, Staff believes that Commission adoption of its ratemaking adjustments could yield up to $53 million of additional cash flow and earnings improvements for the Companies.

The Global Financial Crisis

According to NYSEG and RG&E, the global financial crisis, beginning with the Lehman Brothers bankruptcy, is the proximate cause for the July 2009 rate increase filings. If it were not for this, the Companies would not have filed before the target period specified by the September 9 Order. They claim that the Lehman Brothers bankruptcy was the "tipping point" that created the need for rate increases.[13] The Companies point specifically to low sales, high capital costs, delinquent accounts and higher uncollectibles as the direct consequences of the current downturn in the economy.

From its examination of NYSEG's and RG&E's financial statements, Staff does not see a connection between the poor economy and the Companies' performance.[14] Staff notes that there have been other recessions and utility companies are accustomed to operating during periods of inflation, unemployment, high debt costs and poor stock market performances. Staff asserts that the current recessionary trend began in early 2008 and Iberdrola, Energy East, NYSEG and RG&E were all aware of its potential effects when they acted, in September 2008, and unconditionally accept the conditions for the Energy East acquisition. According to Staff, the recession's effects are embedded in NYSEG's and RG&E's 2008 operating results and the Companies were able to achieve earnings on their operations in excess of 10%. Given these results, Staff states that NYSEG and RG&E can weather the current recession.

[13] NYSEG's and RG&E's Post-Hearing Brief, p. 6.

[14] Staff's Post-Hearing Brief, pp. 4-6.

Staff also states that NYSEG's and RG&E's capital and operating expenditures for 2009-10 are not related to current economic conditions or any changes following the Lehman Brothers bankruptcy. Addressing the specific items the Companies listed, Staff states that changes in NYSEG's and RG&E's sales, uncollectibles and property taxes do not affect their overall financial condition significantly. Staff also states that the incremental impact of the Companies' higher cost of debt in today's capital markets is negligible and it does not threaten financial stability. Consequently, Staff does not believe the financial market and economic conditions provide any reason to allow rate increases in advance of the target period.

NYSEG and RG&E observe that worse financial impacts may still occur. With the financial markets at or near their lowest levels in recent times, and a large gap in financing costs for "A" and "BBB" rated firms, the Companies consider it important to maintain their ratings so they can obtain financing on favorable terms.

Credit Ratings and Capital Markets

The July 2009 rate increases sought by NYSEG and RG&E are intended by them to provide cash flow and earnings to support the issuance of long-term debt for the 2009-10 operations. Without rate relief, the Companies would expect their credit metrics to deteriorate below the levels needed to sustain a "Baa" rating. With a credit downgrading, higher financing costs would ensue. To avoid this, the Companies urge the Commission to provide them rate relief. NYSEG and RG&E note that the credit rating agencies are monitoring this proceeding and the Commission's decision could be a key factor in the resolution of a pending, negative credit watch.

The Companies assert that they have experienced difficulties in the financial markets since the time of the Lehman Brothers bankruptcy. They believe that “BBB” rated utility companies, like them, have limited access to capital and are exposed to a historically high cost spread between “A” and “BBB” rated debt. NYSEG and RG&E also point out that theirs are the lowest credit ratings of the regulated utilities in New York and they are concerned about their ratings deteriorating. For this reason, they urge the Commission to provide sufficient regulatory support in times of a financial crisis to avoid sending an unfavorable message to investors and the rating agencies.[15]

Staff states that NYSEG and RG&E are not in a financial emergency given that they expect equity earnings in 2009 at or just below 7%. Staff also asserts that an increase in the Companies’ debt costs does not create any crisis and notes that a debt issuance in 2009-10 can be avoided. Without a debt financing, Staff believes that any concern about the currently high cost for “BBB” rated debt is alleviated. However, even if RG&E were to proceed with the $100 million debt issuance it has scheduled, Staff states that the applicable interest rate and costs would not seriously impact its 2009 income and cash flow. Thus, Staff does not view a debt issuance as creating any financial crisis.

Staff also states that utility companies had access to capital following the Lehman Brothers bankruptcy and they continue to have access to capital on reasonable terms. Pointing to a series of utility company debt issuances in late 2008, Staff states that it has discovered no instance of a failed utility company debt offering. Staff has also determined that about $15.7 billion of capital was raised by utility

[15] NYSEG’s and RG&E’s Post-Hearing Brief, p. 36.

companies in 50 public and private offerings. Thus, it concludes that the capital market for long-term debt remains available to investment-grade utility companies. Staff points specifically to an RG&E debt issuance on December 19, 2008 and asserts that it (and another in December 2008 for an affiliated company in Connecticut) demonstrates that the Companies have continued access to capital.

Staff states that the proposed July 2009 rate increases would not improve the Companies' liquidity if they were used primarily for dividend payments and to pay off short-term loans. Instead of pursuing an untimely rate increase, Staff urges the Companies to increase their equity ratios with retained earnings and equity infusions. Staff recommends that the Companies become completely ring-fenced and obtain an independent holder for their "golden shares." This action, Staff states, would permit NYSEG and RG&E to obtain stand-alone capital structures. Staff also favors the implementation of revenue decoupling mechanisms for NYSEG and RG&E that would incidentally protect them from downside sales risk.

Staff does not believe that the dismissal of July 2009 rate requests need result in any downgradings nor does it believe that the resolution of the pending credit watches would result in the Companies' credit ratings falling below investment grade. The Standard and Poor's and Moody's credit watches, Staff states, are concerned primarily with Iberdrola's support for the Energy East companies. If Iberdrola, Energy East and the Companies announce an equity infusion, the creation of golden shares and the implementation of revenue decoupling mechanisms, Staff believes that the Companies' credit outlook would strengthen.

Addressing the perception of a challenging regulatory environment in New York, Staff states that the utility companies in the State have earned, and sometimes exceed, their authorized returns in contrast to utility companies located elsewhere. As to the Companies' desire to achieve an "A" rating in the next few years, Staff believes this it is a reasonable goal but states that it cannot be achieved overnight or by the July 2009 rate increases the Companies have sought.

The Consumer Protection Board

CPB supports the dismissal of the NYSEG and RG&E rate increase filings as a proper action to maintain just and reasonable rates, and to properly serve the public interest. Like Staff, CPB asserts that the rate filings are contrary to the terms and conditions of the September 9 Order. From its review of the Companies' financial information, CPB concludes that there is neither a liquidity crisis nor any indication that safe and reliable service is in jeopardy.

CPB also considers the rate filings to be deficient for lacking merger synergy studies, efficiency gain analyses and the best practices that the Commission sought to have included in the first rate filings following the Energy East acquisition. Because they also lack the embedded cost-of-service studies that typically accompany major rate filings, CPB considers the rate filings to be inadequate.[16] According to CPB, no amount of updating and supplementation can perfect the rate filings and

[16] CPB also notes other deficiencies including: the omission of a plan for the use of local gas production connected directly to distribution facilities as upstream capacity and to serve as replacement for capacity provided by local distribution companies; revenue decoupling mechanism proposals; revenue class allocations and rate designs; and sufficient tracking, backup and workpapers for the assumptions, escalation factors, contingencies and changes in activity levels contained in the rate filings.

provide interested parties a proper process and opportunity to participate in the rate proceedings.

CPB also recalls that Iberdrola stated that it has good access to capital markets on favorable terms, and knowledge of utility company best practices, that can be used to NYSEG's and RG&E's advantage. CPB therefore believes that Iberdrola should act in the interests of the upstate communities in the NYSEG and RG&E service areas by avoiding rate increases that exacerbate financial distress and contribute to the hardships of local residents during the current economic downturn.

CPB questions whether the January 2009 rate filings are primarily intended to cover deferred costs, pension expenses and current operations; to provide system reliability; and to offer low-income customer assistance programs as the Companies have stated. Instead, CPB believes that the rate filings are designed to obtain corporate dividends; to receive payment for the inter-company loan; to reduce outstanding credit lines; to increase NYSEG's and RG&E's allowed rate of return.

Addressing NYSEG's and RG&E's scenario for a potential financial rating downgrade, CPB states that the critical question is not whether the Companies need rate increases to borrow funds on reasonable terms. Instead, it asserts that the foremost question is whether there is any true need to provide NYSEG and RG&E additional funds. In the current economic recession, CPB believes it is not wise to increase rates for any discretionary projects or non-essential activity.

Addressing the issue of dividends, CPB states that the Commission has ample authority to restrict dividend payments and it supports the use of dividend restrictions to prevent the Companies' financial decline.

Multiple Intervenors

MI also supports a dismissal of the rate filings. It considers the filings, for all practical purposes, to be the same as emergency rate requests because they seek new rates on an expedited basis. MI insists that the Companies have not shown any sufficiently extraordinary circumstances to warrant rate relief before the target date. It also asserts that NYSEG's and RG&E's requests for emergency rate relief are at odds with the commitments and representations Iberdrola made in the Energy East acquisition proceeding.

MI states that any disappointment NYSEG and RG&E may have in their current performances, and their expected earnings, are insufficient and do not entitle them to emergency rate relief. The possibility of a credit rating downgrade; the inability to pay dividends at a desired level; or projected equity returns in the range of 6% to 8%, according to MI, do not jeopardize the Companies' ability to provide safe and reliable service. Any claimed threat to service, MI states, must be imminent; otherwise, the Companies can wait and file in accordance with the September 9 Order. Having failed to make the necessary showing, MI insists that the Companies have not met their burden of proof and the filings should be dismissed.

Like Staff, MI suggests that Iberdrola provide NYSEG and RG&E financial assistance to remedy a cash flow shortage. Absent such support, MI states, the Companies should access the capital markets and borrow the funds they need. It believes that the Companies can avoid discretionary cost items, implement aggressive austerity measures and limit their capital expenditures. According to MI, no dividends should be paid if the Companies cannot afford them and no rate increases should be granted for this purpose.

MI has reviewed NYSEG's and RG&E's earnings from 1999 to 2007 (including profits on commodity sales) and states that the earnings have been healthy. This demonstrates a favorable regulatory climate in New York according to MI. It also believes that the Companies have good earnings prospects for 2009 without any rate increases. It is opposed to the Commission changing the Companies' allowed equity returns in advance of the target date for new rates.

MI also considers the possibility of a credit rating downgrade to be speculative. It does it believe the Commission should anticipate the credit rating agencies' actions. Instead, it urges the Commission to act in the public interest. Like Staff, MI does not believe that a downgrade would preclude access to capital markets or jeopardize service.

Addressing the deficiencies in the NYSEG and RG&E rate filings, MI notes that the filings omit proposals to unbundle competitive services, energy efficiency proposals, low income and economic development proposals. MI states that the Companies' plan to provide missing information by May 29, 2009 presents analytical, logistical and resource problems for it and others. MI is also concerned about the lack of any merger synergy studies, efficiency gain analyses and best practices in the January 2009 rate filings in contravention of the September 9 Order.

Finally, MI believes the scope of the existing dividend restrictions applicable to NYSEG and RG&E should be expanded to protect customers from capital being drained away. It states that the restrictions should include a prohibition on any upstream dividends until the Companies demonstrate that dividend payments would not threaten safe and reliable service.[17]

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[17] Multiple Intervenors' Post-Hearing Brief, p. 45.

DISCUSSION

Under the Merger Order, the Companies are generally not entitled to file for a rate increase until September of 2009, seeking new rates that would take effect in August of 2010. The essence of the Companies' instant filing is that they cannot wait that long. Based on our analysis of the cash flow and earnings information on this record, we disagree. We conclude that the Companies do have sufficient cash flow, access to capital and earnings such that their ability to provide safe and reliable service is not jeopardized here. Therefore, we grant Staff's motion to dismiss. For the same reason, we deny the requests of CPB and MI that we begin a proceeding to consider dividend restrictions or that we impose such restrictions now. Finally, although Staff's deficiency arguments do not form the basis for our dismissal here, we note the serious problems with the Companies' rate filings that require substantial revision or supplementation before the Companies refile during or after the target period. We discuss each of these conclusions below.

Cash Flow

We begin with an analysis of the Companies' cash flow. We regard cash flow to be the most critical factor to be considered here. It most directly impacts upon the ability of the Companies to provide safe and reliable service through day-to-day funding of payroll and other operations and maintenance expense and through timely investments in physical plant. This focus is consistent with the parties' presentation in this case, which primarily addresses the Companies' need for cash in the short term.[18]

The Companies and Staff helpfully provided a joint exhibit[19] in this proceeding that sets forth the differences between Staff and the Companies regarding the Companies' need for cash in 2009 and 2010 under a scenario in which no rate increase is granted. The Companies assert that they must raise $572 million through external sources for 2009, while Staff projects a $35 million need. For 2010, the Companies project a cash flow need of $278 million, while Staff forecasts a $117 million need. While we have accepted some of the Staff arguments that reduce the Companies' forecasted cash flow needs, for the most part we have simply accepted or slightly modified the Companies' positions regarding their projected expenses and capital investments for purposes of this cash flow analysis. We conclude that, even at the Companies' higher numbers, their cash needs can be met without the need for an expedited rate increase. Based on our analysis of the record, we conclude that NYSEG and RG&E have total external cash requirements of no more than $260 million in 2009 and $120 million in 2010.

The following is a summary of our adjustments to the Companies' projection:

[18] We note that a cash flow analysis has been the primary focus of our more recent decisions considering utilities' requests for temporary rate increases, pending the determination of permanent rates, under PSL §113. See Cases 96-E-0134, et al., Niagara Mohawk Power Corp. – Electric and Gas Rates, Opinion 96-14 (issued May 31, 1996)(evaluating the "jeopardy" to utility service from the absence of §113 relief). While the Companies have not sought temporary rates in this proceeding, and we are not acting here pursuant to that statute, we find the standards and analysis applicable to a PSL §113 request to be highly relevant and analogous to our consideration of the Companies' request for early, expedited relief here.

[19] Exhibit 43.

1) The level of capital expenditures: We reduce the Companies' anticipated capital additions by about $52 in 2009 and by $73 million in 2010, to eliminate expenditures earmarked for compliance with hypothetical Electric Reliability Organization (ERO) standards. There remain $53 million and $98 million of capital expenditures in 2009 and 2010, respectively, that exceed the amounts reflected in our Merger Orders for each year. While additional analysis may show that these remaining forecasted increases are unjustified, we include them for purposes of our analysis in this Order. Elimination of only the ERO expenditures reduces the Companies' external financing requirements from $572 million to $520 million in 2009 and from $278 million to $205 million in 2010.

2) The payment of loans from Energy East: NYSEG and RG&E assume that, in 2009, they will completely pay off moneys that Energy East has loaned them. We reject this $110 million item in the Companies' cash flow projection because repayments are not required on this debt in 2009. This improves cash flow and further reduces the Companies' external financing requirements from $520 million to $410 million in 2009.

3) The level of dividends paid to Iberdrola: NYSEG and RG&E assume in their projections that 100% of net income is paid out as dividends. Given the Companies' concerns about cash flow, a more reasonable divided payout of 50% is assumed. This improves cash flow by $60M in 2009 and $45 million in 2010. It thus reduces the Companies' external cash need from $410 million to $350 million in 2009 and from $205 million to $160 million in 2010.

4) Various expenses afforded deferred ratemaking treatment: Overall, it is reasonable to expect about $10 million more in cash flow in 2009 and 2010 relating to these expenses than was reflected by the Companies. This improves cash flow and further reduces the Companies' external financing requirements from $350 million to $340 million in 2009 and from $160 million to $150 million in 2010.

5) Deferred taxes: NYSEG and RG&E did not reflect any deferred taxes associated with the various ratemaking deferrals. In addition, the recently-enacted federal economic stimulus package will provide the Companies the ability to take 50% bonus tax depreciation on certain assets that go in service in 2009 and 2010. It is estimated that these two items will improve cash flow by

about $70 million in 2009 and $20 million in 2010. This further reduces the Companies' external financing requirements in 2009 from $340 million to $270 million and in 2010 from $150 million to $130 million.

6) Other Adjustments: Staff proposes a variety of other ratemaking adjustments which could have cash flow effects. It is reasonable to conclude that there will be about $10 million of added cash from some of these items, further reducing the Companies' external financing requirements in 2009 from $270 million to $260 million and in 2010 from $130 million to $120 million.

We describe each of these changes, as well as other elements of our cash flow analysis, as follows:

a) Capital Expenditures

The Companies' filings show a greatly expanded outlay for capital investment in the transmission and distribution systems of both Companies in 2009 and 2010, beyond the forecasted expenditures we just recently considered in the merger proceeding or in connection with RG&E's recent financing petition. Staff asserts that the Companies have inflated their capital expenditure forecast in an attempt to justify the present rate filings. Staff would forecast cash flow on the basis of the $540 million investment for the two-year 2009-2010 period required in our Merger Order, whereas the Companies' position presumes an additional $276 million, for a total investment of $816 million over the two years. We agree generally with the Companies' assertion that the merits of any particular incremental expense require a more thorough examination than was available in considering Staff's motion. Therefore, solely for the purposes of evaluating the Companies' cash flow, we assume the Companies' higher figures, with one significant adjustment.

A large portion of the incremental expense is attributable to the forecasted costs to comply with a possible directive from FERC that does not currently exist and may never materialize. These are the capital expenditures to comply with a possible change in Electric Reliability Organization (ERO) reliability standards. We agree with Staff that these costs are far too speculative to warrant a finding that they may jeopardize the Companies' ability to provide safe and reliable service. At the hearing, the Companies' witnesses seemed to acknowledge as much, explaining that they included the ERO expenditures as an appropriate potential forecast cost to be included in an ordinary general rate proceeding but not because such expenses are driving their asserted need for expedited relief here. Instead, the Companies assert that, even based on the capital expenditures that were described in our Merger Orders, the Companies' alleged need for cash flow and improved financial ratios justify the commencement of the rate cases. While we are analyzing the Companies' filing based on their higher level of capital expenditures, minus the ERO costs, we recognize that the cash outlay may be $151 million less for the two years, consistent with the level assumed in our Merger Order.

b) Loans and Credit Facility

The Companies assume that they will repay a $110.5 million demand note from Energy East and pay off 50% ($84 million) of what they owe on their existing credit facilities. There is no record evidence that either of these amounts must be paid in 2009. Therefore, these payments are discretionary. We conclude that, under the present circumstances, there is no need to support repayment of the loan to Energy East in 2009. With regard to the credit facility, there is record evidence indicating that it is possible for NYSEG and RG&E to increase their borrowing capacity under the existing credit facility with bank approval, although such expansion could very well entail added costs. Moreover, the Companies make a valid point by stating that it is reasonable to pay down a portion of the credit facility in order to assure short-term liquidity to respond to unforeseen events. As a result, we have eliminated the $110.5 million repayment to Energy East from the cash flow forecast, but we have included the Companies' projection of $84 million to pay off 50% of the credit facility.

c) Dividend Payments

Exhibit 43 computes the Companies' cash flow needs by showing 100% of the Companies' net income paid out as a dividend in 2009 and 2010 to either Energy East or Iberdrola. However, NYSEG and RG&E note that no specific determination has been made "as to whether or at what level they will pay dividends." By contrast, the Staff's position is based on the Companies' paying no dividends in 2009 or 2010.

We do not agree with Staff that withholding dividends is a reasonable scenario on which to base a cash flow forecast here. While withholding dividends might be valid if the Companies were indeed in a financial crisis, the record does not indicate such a crisis actually exists at either NYSEG or RG&E. Moreover, the Companies are correct that Staff's position does not represent a sustainable long-term solution to any cash flow problems. Holders of utility stocks typically expect dividend payments and price utility stocks with that expectation in mind.

We reject the Companies' suggestion, however, that the Hope and Bluefield cases, holding generally that utilities and their equity owners should earn a fair and adequate return, create any rigid short-term dividend payment requirement. Net income generated by NYSEG and RG&E represents a return on Iberdrola's investment in these companies regardless of whether the net income is paid to a holding company parent as a dividend or reinvested in the Companies' business as retained earnings.

Under either approach, it is reported as net income on the consolidated books of the parent.

The appropriate inquiry here concerns the reasonable level of dividends, given the issues, facts and circumstances currently facing NYSEG and RG&E, to use in forecasting the Companies' cash flow needs for the next two years.[20] Because we have determined that the Companies are not in financial crisis, it is reasonable to assume that a dividend will be paid. However, the payment of all net income as dividends to owners, implied by the Companies' presentation, is as unsustainable in the long run as is the payment of no dividends, because over time it would likely produce large equity ratio reductions. For the purposes of this analysis we believe a payment equal to 50% of net income is reasonable given the present circumstances.[21] Therefore, our cash flow analysis assumes a dividend payment of approximately $60 million in 2009 and $45 million in 2010.[22]

d) Deferrals

Staff challenges the Companies' assertion that their cash flow will be adversely affected by the use of deferral accounting to address outlays for items such as environmental remediation, storm damage and stray voltage. Staff's position implies that the Companies will not spend more on these items than amounts already in rates. Staff concedes, however, that the Companies have recently spent more than their rate allowance

[20] We are not ordering the Companies to take any particular action here with respect to dividends but are merely explaining our calculations.

[21] The estimate is conservative given the Companies' projection that, in the event rate relief were granted, they would effectively retain 90% of earnings that would otherwise be available for dividends. Companies' Post-Hearing Brief at 21.

[22] We did not update net income or the dividend payment to reflect our expectations that the Companies' earnings will exceed their current projections.

for these categories of expense. Therefore, it is appropriate to assume some level of net cash imbalance, and we will generally accept the Companies' cash forecast for these issues, with one exception. The $44.3 million annual amount estimated by the Companies for 2009 and 2010 environmental remediation is excessive, given their statement that, over two recent years, they incurred $24 million more of annual costs in this area over the rate allowance. We have therefore reduced the environmental remediation deferral amount by $20 million from $44 million to $24 million for 2009 and 2010. This results in a $12 million improvement in cash flow for each of these years.

e) Deferred Taxes

There is a $4.6 million difference between Staff and the Companies related to deferred taxes for 2009 and 2010 reflected on Exhibit 43. Because the difference between the precise dollar amounts was not well explained on the record, we do not adopt Staff's figure. However, we do agree with Staff's assertion that the Companies failed to consider the tax impacts of deferral accounting for certain costs. We adopt Staff's rationale and find it supports a much larger upward adjustment to the Companies' deferred tax estimate. Staff is correct that any deferrals generated during 2009 and 2010 should also generate a partially offsetting deferred tax cash flow benefit. The added deferred tax generated by about $56 million of deferrals is approximately $20 million for both years.

In addition, following the hearing, the federal stimulus package was enacted, providing for 50% bonus tax depreciation for certain property constructed in 2008-2009 and placed in service in 2008-2010. More specifically, spending on projects in 2008 and 2009 that go into service in 2009 and 2010 will qualify for this treatment. While it is not possible to make a precise estimate of the cash flow value of this item based upon the record, it is worth noting that this is likely a substantial source of cash. For example, at the $270 million level of annual capital expenditures established in our Merger Order, if 50% of the Companies' capital spending in 2008 and 2009 were eligible for bonus depreciation as a result of a 2009 in-service date, the added cash flow provided by deferred taxes would be about $50 million. We have therefore assumed that level of cash for 2009; we have not included an estimate of bonus depreciation effects for 2010.

f) Other Adjustments

Staff takes issue with one aspect of net income shown on the parties' joint Exhibit 43, namely the level of commodity earnings that should be assumed in 2009 and 2010. Staff relies upon historic trends of commodity earnings to forecast a number that is $10 million higher than the Companies' forecast for 2009. These trends will likely not continue in 2009, however because we recently altered the formula for commodity earnings sharing for RG&E. Staff projects continued commodity earnings at the same level in 2010. We agree with the Companies that it is not reasonable to assume there will be commodity earnings in 2010, because the Companies have formally announced their intent to discontinue their fixed-price commodity programs, the source of the earnings, in 2010. Consequently, and consistent with our conservative analysis of cash flow here, we have assumed the Companies' forecasted numbers.

Staff and the Companies differ by $27 million relating to components of the Non-Bypassable Charge in their cash flow projections. We are unable to resolve this difference on this record. For purposes of deciding this motion, we have simply accepted the Companies' numbers as correct. We have also accepted, solely for purposes of this analysis, the Companies' forecast of pension expense, without the reduction proposed by Staff.

Staff suggested a number of adjustments to expenses as part of its estimate of the Companies' earned return on equity for 2009, several of which have cash flow implications. Here again, giving the Companies the benefit of the doubt, we focus primarily on the effect of adopting Staff's adjustment, to which the Companies concede, to eliminate approximately $17 million of bonuses and payroll expenses that the Companies will not pay in 2009. This correction produces an after-tax increase of $10 million in net income and cash flow.[23]

* * *

Our consideration of these cash flow issues leads us to conclude that the Companies' cash flow needs are not likely to exceed $260 million in 2009 or $120 million in 2010, even accepting most of the Companies' positions. As discussed further below, such a level of cash needs can be met by long-term debt issuances and/or equity infusions in the ordinary course of business. We therefore find insufficient justification for the extraordinary relief sought here.

Earnings

As noted, we view cash flow as the primary factor on which we base our decision here. The earned return on equity (ROE), in contrast, reflects a mix of cash and non-cash items affecting income, and as such does not provide sufficient information to understand whether the Companies' ability to

[23] Staff, on brief, apparently abandoned several proposed austerity measures that would impact cash flow, such as delaying payments to affiliated companies and retaining the benefit of Iberdrola tax credits. These proposals are not part of our calculation here. Nevertheless, it is reasonable to assume some savings attributable to austerity measures.

provide safe and reliable service is in jeopardy. However, while earnings are a less important consideration in deciding the present motion, we have considered and address here the parties' differing projections of the earnings the Companies are likely to realize. The Companies assert that their earnings are likely to fall to approximately a 7% return on equity, whereas Staff asserts the actual earnings are likely to be about 9%. The record developed to date does not afford an opportunity to conduct an exhaustive or definitive analysis of this issue, but a definitive analysis is not required here. It suffices for present purposes that we conclude that, absent some unexpected event, earnings will almost certainly exceed the Companies' estimate and will not fall to a level that would jeopardize the Companies' ability to provide safe and reliable service.

At the outset, we note that the Companies' calculation was based upon an average stand-alone common equity ratio for the two companies of almost 48%. Because all of the ring fencing provisions required by our Merger Order are not yet in place for NYSEG and RG&E, the rating agencies are unlikely to view the Companies on the basis of their stand-alone credit metrics. As a result, it is improper to employ a stand-alone equity ratio for the Companies. We use Staff's 45% consolidated equity ratio in place of the stand-alone ratio, increasing the Companies' rate year ROE by about 40 basis points.[24]

[24] We note that Staff's 45% Energy East consolidated equity ratio is not only significantly higher than the 41.6% ratio we employed in Case 05-E-1222, New York State Electric & Gas Corp. – Electric Rates, Order Adopting Recommended Decision with Modifications (issued August 23, 2006), the last rate case we decided for either of these companies, but also the 41% consolidated equity ratio reported in Energy East's Consolidated Financial Statements for the Years Ended December 31, 2007 and 2008. The use of either one of the ratios would result in at least an additional 40 basis point increase in the earned return on equity.

Staff also asserts earnings will be higher in 2009 due to the elimination of $17.3 million of bonuses and incentive pay as well as $4.5 million of payroll increases. While the Companies concede that the adjustment to eliminate bonuses is proper, they dispute the $4.5 million payroll adjustment, arguing the expense is unavoidable because it is related to existing union contracts. We accept the Companies’ argument and therefore assume a reasonable savings estimate of $17.3 million attributable solely to the bonus adjustment. This increases expected 2009 earnings by about 60 basis points.

Staff eliminates $8.4 million of rate case expenses from the earnings forecast, arguing that the case should not have been filed until September and, had the case been filed at that time, only about 25% of the expense, or $2 million, would have been incurred in 2009. Staff's argument ignores the reality of the timing of the filing; it is a rate-making type adjustment inapplicable to the inquiry on this motion to dismiss. Nevertheless, we do not regard this expense to be an appropriate component of the Companies’ earnings forecast here. The amount itself seems unreasonably high given the limited scope of this proceeding. To the extent these are legitimate business expenses, we fully expect that the Companies would seek appropriate treatment in rates in the future. For now, it is proper to increase the Companies’ earned return on equity to reflect the elimination of the rate case expense estimate from earnings. This increases expected 2009 earnings by about 30 basis points.

Staff also reduced the Companies’ overall rate base for three items. First, the Companies estimated that capitalization exceeded earnings base and as a result increased rate base by $95.9 million. Staff reversed this adjustment based upon our adoption in NYSEG’s last rate case of a similar adjustment primarily related to the presence of other comprehensive income temporarily overstating common equity.[25] Such an adjustment would be equally appropriate here. The net effect of this adjustment is to increase the Companies' ROE by about 40 basis points.

Staff's second rate base adjustment reflects the impact PBAs would have on earnings if they were included in rate base. The Companies object to this treatment because they are currently required to accrue interest on the PBAs and believe it is a double count to include them as part of rate case given the interest accrual requirement. The Companies' position is correct. Consequently we have not assumed any earnings adjustment for this issue.

Staff's final rate base adjustment is the elimination of a hedging loss incurred by RG&E in late 2008. The record in this proceeding is not developed sufficiently to make an informed decision regarding the appropriate regulatory treatment of the loss at this time. Therefore, it is not properly included in rate base at this time, but should instead be considered in a future rate filing. Removing this item from rate base increases earnings by about 40 basis points.

Based upon this analysis, it appears that the Companies are likely to earn on average about 9% on common equity for 2009. An earned return at this level is not indicative of a financial emergency. We emphasize that we are not determining rates in ruling upon Staff's Motion to Dismiss. In the rate setting context, we would not, in the present market, set an authorized return for the Companies at a level of 7 or 8% or, likely, even at 9% ROE. That issue is not before us

[25] Case 05-E-1222, supra, Recommended Decision (issued June 9, 2006), p. 59; approved by Order Adopting Recommended Decision With Modifications (issued August 23, 2006), p. 128.

here, however. Instead, as noted earlier, our sole inquiry is whether the Companies' financial situation is so dire that waiting to obtain new rates in compliance with the schedule required by our Merger Order would jeopardize the provision of safe and reliable service. Earnings in the range at issue here do not, in and of themselves, suggest an inability to provide such service.

We note also that a reduced earned return for the Companies in the period following the Iberdrola merger is consistent with our expectations. It is reasonable to assume that the Companies have incurred a number of one-time expenses that would suppress earnings in the short term. Ordinarily, we consider such short-term expenses as costs to achieve synergy savings from such transactions, and we capture the net effect in a rate plan accompanying the merger. In the Iberdrola merger proceeding, because there was no viable rate plan developed, we required a "stay out" provision. The stay out provision of our Merger Order, restricting rate filings until the target period, was designed to ensure that the Companies experienced a period of transition costs following the merger before they could seek rates, so that such costs would not be passed on to ratepayers without the benefit of corresponding savings.[26]

While we thus expect earnings to be suppressed during this period, we do not believe they will be as low as forecast by the Companies. As we discuss elsewhere in this Order, the poor quality of the Companies' filings renders the validity of the income statement suspect here. This deficiency provides yet another basis for us to conclude that the Companies have understated their estimated returns here.

[26] Of course, the stay out provision also provides consumers with the significant benefit of rate stability for 23 months following the merger's closing.

Access to Capital

The primary argument made by the Companies to justify their early, expedited rate filing is that, if they were to wait to file a rate case until the target period specified in our Merger Order, the Companies would be unable to raise sufficient debt and/or equity to fund their necessary operational expenses and capital expenditures. The Companies acknowledge that, in the short term, they do have access to the debt markets and therefore could borrow cash for immediate needs. However, the Companies argue that such borrowing comes at an unacceptably high price. Specifically, further borrowing would, they allege, worsen two key financial ratios: the funds flow to interest coverage ratio and the operating funds to total debt ratio.

Evidence on the record suggests that if the Companies' projections of no rate relief and significant debt issues were actually to occur, the ratios for both Companies would no longer be fully consistent with the key ratio guidelines established for "Baa" rated utilities by Moody's. Given the Companies' cash flow assumptions and without a significant change in their reliance on debt financing, no equity infusions and a 100% dividend payout ratio, a downgrade is possible. However, as we discuss below, such a downgrade is far from inevitable.

First, based upon our cash flow analysis, above, we find the Companies' need to borrow is significantly less than presented. Indeed, the record indicates that if it were necessary, the Companies could develop an austere budget for 2009 with, at most, a minimal need to raise funds in the market.[27]

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[27] This would include capital additions equal to what we required when we approved the merger in September, a smaller reduction in the Companies' outstanding short-term debt, a more conservative dividend payout ratio, and additional cost reductions.

Second, the deterioration of the Companies' financial ratios assumes that there will be no infusion of equity in the Companies from their corporate parents. That is not a reasonable assumption to make in the present circumstances. Instead, we expect that, in the circumstances alleged by the Companies in this filing, equity investment is an entirely appropriate way for Iberdrola to manifest support to its subsidiaries. With an equity infusion, and the signal it would send to the financial community of parental support, the downgrade alleged by the Companies is not inevitable or even likely.

The Companies assert in this proceeding that their parent stockholder should be regarded as no different from the stockholders of a publicly traded company. We agree with the general proposition that investors are entitled to a reasonable return on their investment, and we are guided in rate setting to provide a reasonable opportunity for investors to earn such a return. This general philosophy does not, however, compel rate relief on an expedited or emergency basis whenever investors do not, in actuality, realize the authorized return. Moreover, the earnings expectations of the Companies and their corporate parents also appear to be inconsistent with their agreement as a condition of the merger that the Companies would not seek rate increases during the initial and unsettled twelve-month period after consummation.

An equity infusion from the Companies' parent is appropriate in the short term where the Companies have not completed the process of ring fencing required by our Merger Order. While the Companies have put in place most of the ring fencing provisions, they have not completed the step of creating and designating a holder of the special voting share of preferred stock. Until that critical step is completed, it is not possible to view the Companies as independent from their corporate parents. Consequently, were we now to be setting new rates for the Companies today, we would continue to rely upon a consolidated capital structure for purposes of calculating the return on rate base.

Ultimately, the financial results desired by the Companies' parent stockholder are likely achievable through the use of a stand alone capital structure when setting rates. The key to such a capital structure, however, lies not with emergency rate relief, but rather with the completion by the Companies of the ring fencing requirements in conjunction with the execution of financial policies by the Companies and their parent that assure a reasonable stand-alone capital structure over an extended time period. While we recognize that this process may take some time, it is the path that must be pursued to achieve the long-term financial health and credit ratings that will benefit shareholders and ratepayers alike.

Following this logic, equity infusions from Iberdrola are equally appropriate once ring fencing is complete. The need of capital-intensive utilities to access the market poses some unique challenges for ring-fenced utilities that are part of larger holding companies. Rating agencies will view their credit quality based, to a large extent, on their stand-alone financial parameters. While the utility subsidiaries may directly issue debt, they do not typically have the ability to directly issue common equity in order to balance their capital structure in order to preserve a particular equity ratio and credit profile. As a result, holding company parents may have to require lower dividend payments and make equity infusions to accomplish this objective.

As previously noted, the Companies' ring fencing is almost complete. However, despite statements of strong financial support for NYSEG and RG&E made by Iberdrola throughout the merger proceeding, Iberdrola appears unwilling to make an equity infusion in NYSEG and RG&E or, for that matter, to loan moneys to NYSEG and RG&E that it has already raised in the financial markets. Given Iberdrola's liquidity position, its statements before us less than a year ago, and the general need for holding companies to help their ring-fenced subsidiaries maintain reasonable capital structures, we see no reason why Iberdrola should not extend its financial resources to NYSEG and RG&E during this time.

Because the actions of Iberdrola and the Companies are uncertain, it is possible that a bond rating downgrade may occur. The evidence before us suggests that Iberdrola's willingness to provide financial support to the Companies has in fact impacted their credit quality. However, even if a downgrade occurs in the short term, the evidence indicates that the immediate impact of such an event is not as significant as the Companies have stated.

In the Companies' presentation, much of the alleged harm to ratepayers is based upon the extreme scenario of a downgrade to "junk bond" status. However, the record supports a finding that, if either or both Companies were to be downgraded in the short term, they would likely not be downgraded to junk status. Instead, a downgrade of one notch would leave both Companies in the investment-grade range, albeit at a lower rating. The consequence would indeed be some increased cost to issue debt, but the magnitude of such costs to ratepayers is far less than the cost of the rate increases proposed by the Companies here. Therefore, we do not accept the Companies' assertions that ratepayers would be better off paying substantially higher rates in the short term than they might be in funding a higher cost of any debt issuance that may be required. Moreover, given our finding that the Companies have much lower external financing requirements than they allege in their filing, an equity infusion from Iberdrola in combination with a more conservative dividend policy largely avoids this problem by reducing the need to issue debt.

That is not to suggest that we are indifferent to the Companies' bond ratings. We appreciate the Companies' evidence regarding the difficulties experienced by non-investment grade utilities in accessing the markets. We understand there are significant cost, service quality and regulatory flexibility benefits associated with investment grade bond ratings. We also share the Companies' view that we are in the midst of a global financial crisis and, contrary to Staff's position, we do not believe its magnitude could or should have been fully foreseen by the Companies. The current market downturn makes bond ratings all the more important.

The evidence provided here demonstrates that an "A/A" rating has a much lower interest rate cost than a "BBB/Baa" rating in times of uncertain economic conditions, such as the present. Moreover, the overall cost to ratepayers, based on the pre-tax return, of an "A/A" rating is likely to be lower in this situation as well. However, this may not always be the case if interest rate spreads between "A/A" and "BBB/Baa" debt are narrow. Overall, across a wide variety of economic conditions, there is not likely a major difference in the cost to ratepayers of the two ratings categories. The one major advantage of a rating in the "A/A" category over a "BBB/Baa" rating is that it provides a greater buffer against falling outside the investment grade category in the event that an unforeseen event creates a financial shock that causes an unexpected bond rating decline. Thus, absent a clear showing that it would be inconsistent with ratepayer interests, there is no reason why the State's utilities should not strive for ratings in the “A/A” category. We see the use of ring fencing in combination with corporate policies that maintain reasonable capital structures as a sound way for the Companies to move toward this objective.

We do not credit the Companies’ testimony that our action in dismissing these rate cases will, in and of itself, trigger a downgrade. That self-serving testimony is effectively rebutted by the analysis by Standard and Poor’s, introduced by Staff, which suggests the rating agencies base many of their concerns on a lack of support by the parent companies.[28] Effective utility regulation may create an environment which makes it possible to obtain and maintain an “A/A” rating. However, the responsibility for actually obtaining and maintaining this objective rests squarely with utility management. Bond rating improvements are best obtained through a more permanent approach of a steady build up in the utility’s common equity position.

Service Reliability

The record here reflects the parties’ agreement that both NYSEG and RG&E are currently providing safe and reliable service. Moreover, there is no imminent danger that they will fail to continue to do so in the near future. Rather, the Companies allege here a secondary threat to service reliability that is derived from their arguments regarding access to capital. We do not find any such threat to the Companies’ ability to provide safe and reliable service. Therefore, the Companies have not made a case to justify the expedited relief they seek here.

Part of the Companies’ presentation regarding cash flow in this case is the desire to retire some of the borrowing

[28] Exhibit 31.

under their short-term credit facilities, in order to free up cash that could be available to address a sudden event, such as a storm. We agree it is appropriate for the Companies to have such short-term credit available to address emergency situations. However, as discussed above, the Companies can readily issue long-term debt to replace some of their current short-term obligations. Such long-term financing, combined with an equity infusion, should be adequate to cover any emergency service needs for the foreseeable future.

In addition to a short-term cash flow problem, which we find to be non-existent here, the Companies raise a further argument that reliability will ultimately be impacted by an inability to raise capital in the future, due to low earnings and poor financial ratios that might lead to a downgrade. This argument is too speculative and too long-term in nature to warrant early rate relief here. The Companies' concerns are not ones that will be materially altered by regulatory action now versus 16 months from now. Moreover, as discussed above, the remedy for the Companies' long-term financial improvement begins with better support from its corporate parent and the short-term management of its cash flow through a combination of long-term debt and equity, together with, if necessary, an appropriately-timed rate case that can be considered in an orderly fashion by this Commission. In the meantime, we find no evidence that the Companies cannot continue their *status quo* provision of safe and reliable service to their customers.

Cross-Motion Regarding Dividend Restrictions

We deny CPB's cross-motion to institute a proceeding to consider the imposition of dividend restrictions upon either NYSEG or RG&E. We further decline to order such restrictions at the present time, as advocated by Multiple Intervenors. Rather, as the discussion in this order indicates, we do not regard the Companies' financial condition to be nearly so dire as the Companies allege. Instead, we believe the Companies have ample resources at their disposal to manage their business and their capital structure as necessary to provide safe and reliable service and to work towards a fair return to investors. The Companies have heretofore exhibited sufficient skill and expertise to do so without the interference of this Commission that dividend restrictions would represent.

We also note that Appendix 1 (Financial and Corporate Protection Conditions) of our Merger Order obligates the Companies, Iberdrola and Energy East to "intend to maintain at least an investment grade credit rating." That Appendix also prohibits the payment of dividends if this credit rating is lost or in danger of being lost. These provisions require that Iberdrola, Energy East and the Companies manage the dividend payment policy of NYSEG and RG&E in a manner that is consistent with an investment grade credit rating. The execution of a dividend payment policy that would clearly lead to a downgrade to non-investment grade credit quality would be a violation of these conditions.

We will continue to monitor the financial health of the Companies, and a proceeding to consider dividend restrictions can be instituted if warranted due to changed circumstances in the future. To assist that monitoring effort, we will require the Companies to notify us within 24 hours after either of them declares a dividend between now and the date new rates go into effect for either Company.

Adequacy of Rate Case Filing

Given our determination here that these cases should not go forward on the present schedule, but should instead be considered during or after the target period established in our Merger Order, we need not base our decision on Staff's alternative ground relating to the sufficiency of the filing. However, we find that the filings are deficient and would justify a decision to dismiss the filings outright for the reasons alleged in the second prong of Staff's motion and supported by CPB and MI. The presentation filed by the Companies would require substantial revision and supplementation before we would be able to consider rate relief in an orderly rate case process.

First, and most important, the filings did not provide any information regarding merger costs or merger savings. In our Merger Order, we required the Companies, in any future rate case filing, to include testimony regarding "All studies, analyses and related work papers prepared by Iberdrola, it subsidiaries, affiliates, or agents that identify or quantify the costs and savings related to merger synergies, efficiency gains and the adoption of utility best practices that in any way affect the management, operation and underlying costs of NYSEG and RG&E's utility business."[29] The Companies filed no such studies or analyses, alleging simply that there are no merger savings. We would expect, at a minimum, some further detail regarding the process by which the Companies and their corporate parents reached that conclusion. We would also expect, at a minimum, testimony relating to analyses of costs of the merger, as required by our prior Order. If there have been absolutely no changes in the business of NYSEG and RG&E as a consequence of their acquisition, we would, at a minimum, expect there to be some testimony as to the decision-making processes of all the relevant entities in the corporate family that led to a conclusion to make no changes whatsoever.

[29] September Merger Order, pg. 14.

Second, the Companies failed to comply with the directive in our Merger Order that they file information equivalent to the former U5-S and U-9 Reports previously filed with the U.S. Securities and Exchange Commission. Instead of providing this information, the Companies noted an intent to comply with our order, and they did indeed provide at least some of the information over one month later in the form of a discovery response. The delay in meeting this filing requirement is now a moot issue, but the Companies are advised that, if and when they do file rate cases in the future, our requirement must be met in the initial filing, so that Staff and other parties can begin analyses of the Companies' presentation beginning on the date it is filed.

The same timing issues plague the Companies' proposal, in this rate filing, to submit information only on those issues deemed relevant by the Companies to a revenue requirement filing, while omitting key aspects of a traditional rate filing, such as an embedded cost of service study and proposed inter-class revenue allocation and rate design, as well as other key issues such as a revenue decoupling mechanism, from the rate filing. The Companies have proposed to address these other issues in a subsequent filing to be made at the end of May of this year, and to have the Commission take those issues up in a second phase, after an initial granting of a rate increase. Such a procedure is highly problematic, at best. As MI and CPB both pointed out in their briefs, it is extremely difficult for Staff and intervener parties to address such a piece-meal filing without a full understanding of the ultimate rate implications for any particular class of customer. Moreover, issues such as the creation of a revenue decoupling mechanism do have revenue requirement implications, because they impact the risk profile and therefore the determination of an appropriate return on equity for the Company. Therefore, we do not regard the Companies' filing and their proposed second stage supplemental filing to offer a workable means for setting rates appropriately for these Companies in the future.[30]

Consequently, under the circumstances presented by these rate filings, the best, most workable result here is to dismiss the filings outright. At the time the Companies re-file their rate cases, if they choose to do so, the Companies will have an opportunity to collect the various pieces — testimony analyzing costs and savings of the merger or of adoption of best practices; U5-S and U-9 equivalent reports; treatment of issues such as cost of service, revenue allocation, rate design, and a revenue decoupling mechanism — and to provide all this information, including accompanying work papers, in a single filing with an up-to-date historic test year and forecast rate year, consistent with the requirements of our regulations and with our Policy Statement on Test Periods. In that way, we will have a single, coherent case for each Company in which we can proceed, in proper deliberative fashion, to consider a rate request.

[30] We acknowledge that, in the past, this Commission has bifurcated the consideration of revenue requirements from final revenue allocations and rate design decisions in rate cases. Recently, the Administrative Law Judges in the Consolidated Edison case proposed such a bifurcation of Commission consideration in that case. Such a splitting of the issues at the <u>end</u> of a case that has been litigated through discovery, hearings, and briefing on a complete, consolidated record, in which all parties understood the full consequences of the utility's proposal and in which all parties and this Commission were working with a single historic test period and forecast rate year, is a very different scenario from separating the issues at the <u>beginning</u> of a case and having relevant information dribble in over time.

CONCLUSION

When we approved the acquisition of Energy East, the parent of NYSEG and RG&E, by Iberdrola in September of 2008, we did so on the condition that NYSEG and RG&E would not file for rate increases before September of 2009. We allowed one exception to that general condition, namely, that if the financial performance of either Company “otherwise would fall to levels that would jeopardize its ability to provide safe and reliable service,” the Company could make an earlier filing for rate relief. Both NYSEG and RG&E have submitted such early rate filings, alleging that they fall within this exception. As discussed herein, we conclude that they do not. We do not believe that the Companies’ financial performance has fallen or will fall, during the relevant period, to levels that will jeopardize their ability to provide safe and reliable service. Instead, the Companies have the tools and resources to manage their affairs adequately during the upcoming months prior to the target period when they are permitted, under our Merger Order, to file for rate relief.

If the Companies desire to file rate cases at that time, they should make new rate filings, thoroughly documenting and supporting their request for rate relief consistent with 16 NYCRR Part 61 with the Commission’s Policy Statement on Test Periods, and with the additional requirements for the rate filings detailed in our Merger Orders. The present rate filings by both Companies are dismissed, without prejudice to the ability of the Companies to file again during the designated target period.

The Commission orders:

1. The rate filings of NYSEG and RG&E seeking expedited rates for electric and gas service are dismissed.

2. NYSEG and RG&E are directed to file supplements cancelling the tariff leaves listed on Appendix A to this order. The supplements will be effective on one day's notice on April 5, 2009.

3. NYSEG and RG&E are directed to notify the Commission within 24 hours after declaring dividends to their shareholder.

4. This proceeding is closed pending compliance with ordering clause 2, above.

(SIGNED) By the Commission,

JACLYN A. BRILLING
Secretary

Attachment

SUBJECT: Filings by NEW YORK STATE ELECTRIC & GAS CORPORATION

Amendments to Schedule P.S.C. No. 120 – Electricity

Second Revised Leaf No. 272.1
Fourth Revised Leaves Nos. 208.1, 215.1
Fifth Revised Leaves Nos. 198.2, 288.2
Sixth Revised Leaves Nos. 207, 260, 271, 287.1, 299
Seventh Revised Leaves Nos. 122, 149, 156, 176, 185, 195, 203, 213, 252, 257, 268, 296
Eighth Revised Leaves Nos. 119, 130, 147, 155, 173, 193.4, 201.1, 212, 214, 247
Ninth Revised Leaves Nos. 129, 202
Tenth Revised Leaves Nos. 184, 194
Eleventh Revised Leaves Nos. 187, 188
Thirteenth Revised Leaves Nos. 135, 288.1
Fifteenth Revised Leaves Nos. 206, 270, 298
Sixteenth Revised Leaves Nos. 121, 124, 131, 148, 157, 158, 174, 175, 215, 216, 248, 249, 250, 251, 259, 262
Seventeenth Revised Leaves Nos. 198, 201
Twentieth Revised Leaves Nos. 287, 288

Amendments to Schedule P.S.C. No. 121 – Electricity (Street Lighting)

Fourth Revised Leaf No. 36
Fifth Revised Leaf No. 58
Sixth Revised Leaf No. 54.6
Eighth Revised Leaves Nos. 17, 22.2, 27, 40
Ninth Revised Leaves Nos. 42, 43, 48, 57
Tenth Revised Leaves Nos. 20, 28, 34.3, 35, 41, 47, 56
Eleventh Revised Leaves Nos. 46, 55
Twelfth Revised Leaves Nos. 19, 30, 31, 45

Amendments to Schedule P.S.C. No. 87 – Gas

Third Revised Leaf No. 15.1
Fourth Revised Leaf No. 12.1
Eighth Revised Leaves Nos. 15, 47
Ninth Revised Leaves Nos. 16, 34
Eleventh Revised Leaf No. 12
Twelfth Revised Leaf No. 13

SUBJECT: Filings by NEW YORK STATE ELECTRIC & GAS CORPORATION

Amendments to Schedule P.S.C. No. 88 – Gas (Transportation)

Fourth Revised Leaves Nos. 68.1, 68.2
Sixth Revised Leaves Nos. 52.1, 52.2
Ninth Revised Leaves Nos. 52, 96.1
Tenth Revised Leaves Nos. 51, 68, 69.1
Eleventh Revised Leaves Nos. 96, 102.1
Twelfth Revised Leaves Nos. 53, 102, 103, 104
Thirteenth Revised Leaf No. 101
Fourteenth Revised Leaf No. 69

SUBJECT: Filings by ROCHESTER GAS AND ELECTRIC CORPORATION

Amendments to Schedule P.S.C. No. 18 – Electricity

First Revised Leaves Nos. 37.1.1, 45.1.1
Second Revised Leaf No. 26.4
Third Revised Leaves Nos. 37.3, 38
Fourth Revised Leaf No. 45.3
Fifth Revised Leaf No. 28
Sixth Revised Leaves Nos. 27, 29
Eighth Revised Leaf No. 37
Tenth Revised Leaf No. 45

Amendments to Schedule P.S.C. No. 19 – Electricity

First Revised Leaves Nos. 164.1.1, 166.1.1, 190.1.1, 210.3.1
Third Revised Leaves Nos. 187.4, 188, 195.1
Sixth Revised Leaves Nos. 164.3, 174.2, 174.3, 190.3, 195, 210.2
Seventh Revised Leaves Nos. 161.1, 161.2, 161.3, 166.3
Ninth Revised Leaf No. 210
Tenth Revised Leaves Nos. 164, 166, 190, 242
Eleventh Revised Leaf No. 174
Twelfth Revised Leaf No. 243

Amendments to Schedule P.S.C. No. 16 – Gas

First Revised Leaf No. 147.8
Second Revised Leaves Nos. 133.5.1, 145, 146, 147.1
Third Revised Leaves Nos. 129.1, 133.6, 134
Fifth Revised Leaf No. 130.6
Sixth Revised Leaf No. 134.1
Tenth Revised Leaf No. 128