STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 07-M-0906 - Joint Petition of Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A.

ORDER AUTHORIZING ACQUISITION SUBJECT TO CONDITIONS

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on September 3, 2008

COMMISSIONERS PRESENT:

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

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(Issued and Effective January 6, 2009)

I. INTRODUCTION

A. Background and Summary

We initiated this case to consider a joint petition filed on August 1, 2007 under Public Service Law (PSL) §70 by petitioners Iberdrola, S.A. (Iberdrola), New York State Electric & Gas Corporation (NYSEG), Rochester Gas and Electric Corporation (RG&E), Energy East Corporation (Energy East), RGS Energy Group, Inc., and Green Acquisition Capital, Inc.[1] in which

[1] NYSEG and RG&E both are wholly-owned subsidiaries of RGS, which in turn is a wholly-owned subsidiary of Energy East. Green Acquisition Capital is a wholly-owned subsidiary of Iberdrola formed for the purpose of this proposed acquisition. Following the transaction, Green Acquisition Capital is being merged into Energy East.

they seek approval of Iberdrola's acquisition of Energy East.[2] We granted the petition subject to conditions, in an abbreviated order which stated our conclusions and, in the accompanying Appendices 1 through 3 (included here as well), set forth the conditions that are part of our decision.[3]

As the abbreviated order explains, the conditions on which we have approved the proposed transaction include, most notably, that petitioners must commit $200 million to new wind generation in New York over the next two years or, failing that, allocate up to $25 million of shareholder funds to economic development projects in their New York service territories; divest their fossil fueled generating facilities; implement protective measures related to financial structure, corporate governance, and regulatory monitoring; accept additional regulatory oversight over the level of capital expenditures, and a strengthened incentive program, to prevent degradation in reliability, safety, and service quality; and set aside for customers $275 million of positive benefit adjustments (PBAs).[4]

Pursuant to Ordering Clause 2 of the abbreviated order, petitioners unconditionally accepted the order's terms by two letters dated September 10, 2008, one on behalf of Iberdrola and the other on behalf of Energy East, NYSEG, and RG&E. This

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[2] PSL §70 provides, inter alia, that no gas or electric corporation may transfer its franchise, works or system, or acquire the stock or bonds of a similar business, without our consent; and that no more than 10% of a gas or electric corporation's voting capital stock may be transferred without our consent, which we may grant subject to conditions and only if "it shall have been shown that such acquisition is in the public interest."

[3] Case 07-M-0906, Abbreviated Order Authorizing Acquisition Subject to Conditions (issued September 9, 2009).

[4] This is a short summary of the conditions we adopted. The accompanying appendices set forth a complete statement of those terms.

order states in more detail the reasons for our conclusions and the conditions we adopted.

B. Procedural History

Following the filing of the petition with supporting testimony and exhibits on August 1, 2007, the parties initiated settlement discussions on September 20, 2007 pursuant to a duly issued notice of impending negotiation issued by petitioners and approved by the Administrative Law Judge in accordance with 16 NYCRR 3.9.

Petitioners filed a short-form Environmental Assessment Form (EAF) with the petition, and supplemented it with a long-form EAF filed February 12, 2008. On reviewing the EAFs, we determined that the proposed transfer of ownership is an "unlisted" action for purposes of the State Environmental Quality Review Act and that it would not significantly affect the environment.[5]

On October 22, 2007, the proceeding to consider an electric and gas revenue decoupling mechanism (RDM) for NYSEG was consolidated into this case.[6]

A November 28, 2007 deadline was established for reaching an agreement in principle in the settlement discussions, or proceeding to litigation. On that date, the parties announced that they would proceed to litigation, and petitioners filed supplemental testimony regarding vertical integration and market power issues. Responsive testimony and exhibits were filed January 11, 2008 by staff of the Department

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[5] Case 07-M-0906, Order Adopting Negative Declaration, and Notice of Determination of Non-Significance (issued April 28, 2008).

[6] Case 07-M-0906 and Case 07-M-0996, N.Y.S. Elec. & Gas Corp. - Revenue Decoupling Mechanism (originally docketed as Case 07-E-0996), Notice Consolidating Proceedings (issued October 22, 2008).

of Public Service (Staff), City of Rochester, Greater Rochester Enterprise (GRE), Independent Power Producers of New York, Inc. (IPPNY), System Council U-7 and Local 36 of International Brotherhood of Electrical Workers, Natural Resources Defense Council (NRDC), New York Association of Public Power and N.Y.S. Rural Electric Cooperative Association (NYAPP/NYSRECA or the rural cooperatives), N.Y.S. Department of Environmental Conservation (DEC), N.Y.S. Department of Economic Development (DED), and Nucor Steel Auburn, Inc. (Nucor). Petitioners filed rebuttal testimony and exhibits on January 31, 2008.

On February 5, 2008, Staff moved to suspend the scheduled February 26 hearing date in order to perform additional discovery regarding possible takeover attempts directed at Iberdrola. Petitioners responded in opposition on February 7. On February 14, before the motion had been ruled upon, Staff was allowed to withdraw the motion without prejudice to its reinstatement, and petitioners and Staff moved to postpone the hearings to allow time for resumption of settlement negotiations. A March 12, 2008 target date was established for either an agreement in principle or resumption of litigation. On that date, the parties reported to the Administrative Law Judge that no agreement had been reached; and that they intended to proceed to evidentiary hearings, without seeking further postponement on the basis of Staff’s February 5 motion.

On March 14, 2008, petitioners filed a Partial Acceptance document[7] identifying a set of unilateral concessions regarding certain issues that had been raised by Staff and intervenors, in an effort to narrow the scope of contested issues at the evidentiary hearings. The hearings began on March 17 and continued through March 20. Staff responded to the Partial Acceptance document through supplemental direct

[7] Exhibit (Exh.) 50.

testimony given orally on the record at the hearing. Additional intervenor parties, in addition to those filing direct testimony, participated in the hearings. The hearing record comprises 1,908 pages of testimony and 136 exhibits.

We granted, in part, Staff's interlocutory appeal from a discovery ruling, and denied a pro se intervenor's appeal from another discovery ruling, March 19 and July 17, 2008, respectively.[8]

Eleven parties filed initial post-hearing briefs on April 11, and eleven parties submitted reply briefs on April 25, 2008.[9] The Administrative Law Judge's Recommended Decision issued June 16, 2008 concluded that we should deny the petition and, as an alternative, that we should approve it upon conditions including principally that we bar petitioners from owning generating facilities connected with the NYSEG and RG&E grid and that we implement $646 million in PBAs. Briefs on exceptions and briefs opposing exceptions were filed June 26 and July 3, 2008, respectively.[10]

We considered the petition, the Recommended Decision and exceptions, and the record as a whole, at our regularly

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[8] Case 07-M-0906, Order Denying in Part and Granting in Part Staff Interlocutory Appeal (issued March 19, 2008); Order Denying Interlocutory Appeal (issued July 17, 2008).

[9] Initial briefs were filed by petitioners, Staff, IPPNY, Multiple Intervenors (MI, representing large industrial customers), NYAPP/NYSRECA, N.Y.S. Consumer Protection Board (CPB), DED, DEC, NRDC, Nucor, and Strategic Power Management (SPM, an energy services corporation). Reply briefs were filed by all those parties except DEC, and by GRE.

[10] Briefs on exceptions were filed by petitioners, Staff, GRE, IPPNY, MI, NYAPP/NYSRECA, CPB, DEC, Nucor, and SPM. Briefs opposing exceptions were filed by petitioners, Staff, MI, CPB, DEC, Nucor, and SPM. The deadline for briefs opposing exceptions, originally July 1, was extended to July 3 at the request of Staff and MI. (Case 07-M-0906, Notice of Revised Briefing Schedule (issued June 18, 2008).)

scheduled public session on August 20 and at special public sessions on August 27 and September 3, 2008.

C. Public Comments After the Recommended Decision

Although we did not solicit public comments after the Recommended Decision was issued, many have subsequently been filed in addition to those described in the Recommended Decision, by mail or through our Web site. Of these more recent comments, about 124 oppose the merger, many of which specifically urge adoption of the Recommended Decision. About 221 comments, including an organized mailing from 208 union members or officers, support the transaction.

Generally, as described in more detail below, the comments opposing the transaction were submitted primarily by New York residents whose stated concerns include the allegedly dubious or illusory nature of Iberdrola's proposed $2 billion investment in wind energy in New York and the creation of jobs; the risks said to be associated with foreign ownership of New York's infrastructure; and the adverse consequences of allowing petitioners to own or control generation in addition to transmission and distribution (T&D). They also question whether wind generation is reliable, economical, or appropriate for New York, and whether Iberdrola is a sufficiently reputable, responsive, and service-oriented firm.

Some comments in opposition to the merger are unusually partisan. They applaud the Recommended Decision as well-reasoned and courageous, while questioning the integrity—intellectually or generally—of the elected officials, businesses, and other parties that favor the proposed transaction. They question whether officials that support the merger, particularly U.S. Senator Charles E. Schumer in his reported meeting with the Chairman of the Commission, are adequately informed and are putting New Yorkers' interests first. Such commenters tend to define the issue as whether we will yield to political pressure.

More specifically, some comments argue that the supposed $2 billion wind generation investment would be a vehicle for substantial tax avoidance and public subsidies, thus shifting the tax burden and other costs to New York customers and taxpayers while sending New York customers' revenue contributions abroad. Commenters also assert that these tax advantages and subsidies are costs of wind energy that typically go unrecognized. These factors, together with negative impacts on property values and on communities' health and safety, are said to be hidden components of the true cost of wind energy.

Other commenters say the economic development benefits of wind farms have been exaggerated, arguing that wind farm construction jobs are temporary and may be filled by non-local workers; materials and supplies may not be locally produced; and the rental payments to landowners will likely be minuscule relative to the incremental costs that wind farms impose on the general public.

Some argue that the need for reliably dispatchable generation means that wind cannot effectively displace fossil fueled generation, since generation additions to meet load growth or replace plant retirements will have to include fossil plants for backup even if wind farms are built. Others assert that wind generation enjoys a benign image unjustifiably, countering that it causes bird and bat kills, habitat destruction, and noise, and degrades the landscape and scenic views.

According to some commenters, large-scale wind development in New York makes no sense, as a scientific or practical matter, because the State's wind patterns are suboptimal and because experience in California and Texas demonstrates the difficulty of integrating wind generation's intermittent output into a transmission grid. A few commenters challenge whether Iberdrola's proposed wind investment even would produce "new" generating capacity, as the prospective investment already is accounted for in the New York Independent System Operator (NYISO) queue.

Several commenters express serious misgivings about allowing foreign ownership of domestic infrastructure. Some contend that such ownership raises issues of homeland security. Others question whether a foreign-owned corporation can be effectively regulated. A few suggest that the New York infrastructure transferred to Iberdrola, which they describe as a Spanish company with Middle Eastern funding, might subsequently become acquired and/or controlled by an Iranian company or by an Abu Dubai affiliate of Iberdrola.

Some claim that Iberdrola has been cited and fined in the European Union for exercising market power and has a record of antitrust violations. Another contends that Iberdrola is "condescending" and "aloof" and will "not appear in public programs where there are opposing positions presented." A few claim that, after the National Grid merger was approved, the acquired utility's service deteriorated and the utility became less responsive; they fear that the Iberdrola acquisition would have similar effects. Some predict that the acquisition would lead to rate increases. One commenter expresses concern that the proposed buyout of Energy East stock would harm NYSEG retirees who depend on their Energy East dividend income for living expenses.

Some comments claim that the lack of comprehensive state regulation of large-scale wind energy projects allows developers, including affiliates of Energy East and Iberdrola, to be excessively aggressive, prevailing upon rural town officials to adopt local standards that fail to achieve even minimal health and environmental protections. Letters from Otsego 2000 and the Preservation League of New York State cite the Jordanville wind project as evidence that Iberdrola or its affiliates do not behave as good corporate citizens with due respect for the public interest.

Some commenters express concern that, if the transaction is approved, Iberdrola will have incentives and opportunities to exercise market power. At least one commenter adds that if we preclude Iberdrola from owning generation and if wind energy is economically sound, no harm will ensue, because other investors will enter the market and develop wind generation without demanding, as Iberdrola does, ownership of T&D.

Comments in favor of the merger include, among others, a letter from the Laborers' International Union of North America (LIU); form letters individually written by about 208 current or retired members of various labor unions; letters from 19 Assembly Members, including one from the Chair and 12 members of the Assembly Energy Committee; and a letter from nine of the 29 members of the Monroe County Legislature.

LIU, on behalf of its 40,000 New York members, contends that the "main opposition [to the acquisition] comes from one party, government bureaucrats." The union argues that the State needs Iberdrola's investment and asks that we approve the proposed acquisition in a way that encourages jobs and investment. Numerous union members echo LIU's sentiments.

In the Assembly Members' letter, Energy Committee Chairman Kevin Cahill and his colleagues argue that "[i]f New York is to reach its goals for renewable electric generation, then the State . . . needs all the renewable power that can be generated," and excluding Iberdrola from the renewables market would be "shortsighted." They urge us to make every effort to work with Iberdrola to find an appropriate compromise that would allow Iberdrola to own wind generation. The Monroe County Legislators, backing Senator Schumer's efforts on behalf of the proposed transaction, urge us to adopt four of his proposals.

Finally, a few individual commenters advocate approval on the ground that Iberdrola's commitment to wind energy would benefit the environment and the State, especially insofar as Iberdrola may have superior access to technical research which could be applied in New York.

We have taken these comments into account, as well as those reported in the Recommended Decision. Our decisions in the abbreviated order, as stated in more detail here, are intended as a reasonable response to the public's expressed concerns.

II. PUBLIC INTEREST STANDARD

A. Recommended Decision and Exceptions

The Recommended Decision interpreted the PSL §70 "public interest" standard to mean that the proposed transaction's identifiable benefits must outweigh the detriments. It noted petitioners' position that, because Iberdrola has no pre-existing presence as a regulated utility in North America, there would be no opportunity to consolidate its operations with those of Energy East's New York subsidiaries, and thus no synergies to be captured for the benefit of the subsidiaries' customers. The Recommended Decision found that, in the absence of synergies, petitioners must demonstrate there are other, real and definite positive benefits to the transaction that outweigh its detriments or risks. The

Recommended Decision acknowledged that the transaction's benefits may be relevant for purposes of §70 even if they are not tangible and quantified. Nevertheless, it found that the benefits asserted by petitioners in this instance would be too insubstantial to satisfy the §70 standard. Its primary recommendation, accordingly, was that we find petitioners had not met their burden of proof that the proposed merger would provide positive net benefits, i.e., identifiable tangible and intangible benefits causally related to the transaction and outweighing its detriments.

On exceptions, petitioners accept that definition of their evidentiary burden under PSL §70. However, they argue that the Recommended Decision applied the §70 standard improperly. First, petitioners contend that the Recommended Decision found the proposed transaction unacceptable not because it fails to offer net benefits; but only because the Recommended Decision demanded a particular level of benefits greater than the transaction happened to offer, regardless of whether we adopted measures to mitigate the supposed risks or detriments. Petitioners maintain that the Recommended Decision erred by mandating a preordained level of benefits consistent with Staff's targeted level, thus establishing an arbitrary "entry fee" for Iberdrola to invest in New York.

Petitioners, supported by SPM, take the position that the PSL §70 public interest standard may be met through a variety of benefits, including those which are intangible or unquantifiable, without requiring any specific level of benefits or any immediate rate reductions. Petitioners deny that our precedents require a specific level of net benefits, as long as a weighing of expected transaction-specific benefits and risks portends at least some net benefits. Petitioners and SPM point to petitioners' offer (in the Partial Acceptance document) of

$201.6 million in PBAs; they cite this PBA amount, and the resulting opportunity for rate reductions, as a tangible and material customer benefit that meets and probably exceeds the requirements of §70.[11]

Second, petitioners and SPM except to the Recommended Decision on the ground that it gave little or no weight to intangible and unquantifiable benefits of the proposed transaction. They assert that such benefits resemble those on which we have relied when approving water company mergers that offered no synergistic benefits or immediate savings for customers.[12] They say that the PSL §70 public interest standard for energy company mergers is the same as the standard for water company mergers under PSL §89(h), and that the Recommended Decision's stated distinctions between the water company precedents and this case do not withstand scrutiny.[13]

Third, petitioners and SPM argue that the Recommended Decision evaluated benefits and risks inconsistently and unfairly in arriving at its assessment of positive net benefits. Specifically, they say that it discounted or ignored tangible, quantifiable benefits of the transaction only because they fell short of those proposed by Staff and that it similarly failed to acknowledge the significance of intangible benefits. Conversely, they claim, the Recommended Decision credited allegations of purported risks uncritically, even if speculative or unquantifiable, and without regard to the availability of safeguards to mitigate those risks. Petitioners argue that the Recommended Decision improperly required them to overcome other

[11] Petitioners' Brief on Exceptions, pp. 9-13; SPM's Brief Opposing Exceptions, pp. 15-16.

[12] Petitioners cite, e.g., Case 01-W-1949, Long Island Water Co., et al., Order Adopting Terms of a Joint Proposal (issued November 27, 2002).

[13] Petitioners' Brief on Exceptions, pp. 13-17.

parties' allegations of risks even when the degree of risk could not be objectively identified or quantified. Petitioners and SPM maintain that, under our precedents, one must first assess the plausibility and likelihood of an asserted risk before imposing remedial conditions or including it as a factor in the positive net benefit determination.[14] Petitioners believe that, in any event, the Recommended Decision removed potential risks from the calculation of "net" benefits by recommending mitigation measures, so that the transaction's risks would be neutralized and any benefits therefore should be viewed axiomatically as positive net benefits. Therefore, petitioners contend, even if we consider only their proposed PBAs and rate decrease and their commitment to invest $100 million in renewable resource development, these constitute sufficient net benefits to satisfy PSL §70 when weighed against risks that petitioners consider speculative and neutralized.[15]

Staff supports the Recommended Decision's analysis of the risks, benefits, and criteria for approval under PSL §70. Staff says the water company cases on which petitioners and SPM rely are at best only marginally relevant to the proposed transaction here, and are contrary to controlling precedent from energy company merger cases. Staff argues that the positive net benefits test is not always applicable in water company mergers, because of the capital intensive nature of the water business; our policy favoring consolidation among water utilities; and water utilities' typically negligible cash reserves, their difficulty attracting capital, and the severe challenges they therefore face in attempting to comply with costly health and

[14] Petitioners cite Case 01-M-0075, Niagara Mohawk Holdings, Inc. and National Grid Group plc, Opinion 01-6 (issued December 3, 2001)(Niagara Mohawk-Grid Order).

[15] Petitioners' Brief on Exceptions, pp. 17-19.

safety regulations.[16] Unlike water companies, Staff says, NYSEG, RG&E, and Energy East already are financially healthy entities with sufficient access to capital markets, so that acquisition by Iberdrola would not provide benefits analogous to those achievable through water company consolidations. Moreover, Staff adds, even in water company cases we require positive monetary benefits for customers when feasible.

Staff maintains that although PSL §70 is worded similarly to §89(h) regarding water company mergers, we may reasonably adopt a continuum of criteria in applying the positive net benefits test to energy company mergers as distinguished from water company mergers. Staff argues that while smaller monetary benefits may satisfy the public interest standard as part of the acquisition of a financially troubled small water utility, greater net benefits are needed to justify the acquisition of a more financially stable company, including the "highest level of monetary benefit when a strong, self-sufficient utility is acquired."[17] Staff says this approach balances the higher risk that acquisition of a more healthy utility company may affect the acquired company's financial standing adversely rather than favorably. Staff says a requirement of greater monetary benefits in the acquisition of a stable company also promotes financial stability, because the acquiring company's ability to provide monetary benefits demonstrates its own financial strength and increases its incentive to commit to long-term ownership of the utility acquired.

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[16] Staff cites Case 06-W-1367, Gaz de France, S.A. and Suez, S.A., Order Authorizing Reorganization and Associated Transactions (issued June 25, 2008)(Suez Order), pp. 6-7; Case 93-W-0962, Acquisition and Merger of Small Water Utilities, Statement of Policy (issued August 8, 1994).

[17] Staff's Brief Opposing Exceptions, p. 17.

Staff also argues that, in a positive net benefits inquiry, the intangible non-monetary benefits Iberdrola proffers are no substitute for monetary benefits. All of the asserted non-monetary benefits are operational and managerial skills expected of any utility, Staff maintains, and Energy East is already reasonably competent without Iberdrola ownership. Staff concludes that improvements from an Iberdrola acquisition would be insubstantial, as well as achievable by existing management, and thus would not contribute toward satisfying the positive net benefits test.[18]

B. Discussion

The Recommended Decision's method of applying PSL §70 is unsuitable for our purposes because its recommendations flow from an initial finding that, upon examination, all the transaction's purported benefits are insubstantial. Once the Recommended Decision had adopted that conclusion, there was no logical necessity that it gauge the magnitude of the risks or detriments, because the transaction inevitably would appear devoid of positive net benefits regardless of whether the detriments were negligible or substantial. Ultimately, this line of reasoning also led the Recommended Decision to conclude that, if we approved the transaction, we should adopt all the proposed risk mitigation measures—including PBAs at the level proposed by Staff—except for measures shown to be burdensome or, in the case of the PBAs, shown to be excessive when compared with the customer benefits in other mergers. The mitigation and PBA recommendations, like the finding that the transaction offers no benefits, again rendered immaterial the question whether the risks and detriments were substantial.

[18] Ibid., pp. 15-17.

Thus, while the Recommended Decision's analysis was rationally derived from its initial premise that the transaction offers no benefits, we find that premise to be an oversimplification. As we shall explain in more detail, our own review of the record at the exceptions stage leads us to conclude, as a first step, that some of the benefits completely discounted by the Recommended Decision in fact deserve some weight. It therefore becomes necessary, as a second step, to consider the magnitude of the transaction's residual risks or detriments that remain after applying whatever mitigation measures may be identified as reasonable and practical (instead of merely concluding, as the Recommended Decision did, that the detriments would be substantial in the absence of mitigation).[19] The third step is to compare the benefits with the residual, unmitigated detriments, and thus arrive at an assessment of the transaction's positive net benefits for purposes of the PSL §70 analysis. This approach leads us to require a level of PBAs designed to overcome a lack of positive net benefits in the transaction prior to PBAs.

The exceptions regarding the application of PSL §70 can be resolved by reference to the differences just noted between the Recommended Decision and this order. First, to the extent that petitioners object to the PBAs as an entry fee irrationally demanded by the Recommended Decision a priori, the exception is misguided because PBAs are warranted if the transaction otherwise would not provide positive net benefits. As discussed elsewhere in this order, we are determining a reasonable PBA amount using a methodology different from the Recommended Decision's, but that does not alter the general

[19] As should be evident from the accompanying text, we are using the term "mitigation" to mean partial amelioration, rather than complete neutralization, of the risks under consideration.

principle both here and in the Recommended Decision that an assessment of the transaction's benefits and detriments may mandate some level of PBAs.

Second, we find no indication that the Recommended Decision was biased against recognition of intangible benefits as distinguished from tangible ones, and indeed it expressly acknowledged that both deserve consideration. The weighing of asserted benefits is necessarily judgmental and therefore leaves room for reasonable disagreement, but petitioners and SPM have not shown that the weighing in the Recommended Decision was systematically flawed. Moreover, as discussed elsewhere in this order, we do not accept petitioners' and SPM's premise that intangible benefits sufficient to achieve positive net benefits in a water company merger must, ipso facto, suffice for that purpose in this transaction where the acquired energy utilities would be capable of continuing to operate adequately without the merger.

Finally, as noted, the exceptions to the Recommended Decision's evaluation of detriments and mitigation measures are well taken if one first rejects the Recommended Decision's finding that the transaction offers no substantive benefits. Again, because we find initially that the transaction does provide benefits, it follows that we must weigh the alleged detriments remaining after the application of mitigation measures, and to that extent the exceptions are granted.

III. FINANCIAL AND CORPORATE STRUCTURE ISSUES

A. Asserted Financial and Corporate Benefits

Petitioners maintain that Iberdrola's acquisition of Energy East would provide financial and corporate benefits based on Iberdrola's financial strength and credit rating; its managerial expertise; and its willingness to continue, and consider enhancing, NYSEG's and RG&E's existing economic development initiatives. The Recommended Decision gave little weight to these claimed benefits, finding them variously speculative; insubstantial; or merely of a "hold harmless" nature, maintaining the status quo. Parties have excepted regarding three of those issues.

1. Financial Strength and Credit Rating

The Recommended Decision rejected petitioners' contention that Iberdrola's status as a multinational, diversified firm with an "A" rating would confer financial advantages on Energy East and its subsidiaries. It found these claimed benefits impermanent and speculative. It noted that Iberdrola's climb from the 19th to the fourth largest utility company in the world over six years coincided with similar firms' precipitous declines, demonstrating that a company like Iberdrola can abruptly lose its dominance. It also stated that any number of developments might change the current credit rating differentials among Iberdrola and Energy East, NYSEG, and RG&E. The Recommended Decision observed that petitioners conceded the economic value of the credit rating differential cannot be quantified. It found the uncertainty of that value is exacerbated by the inability to factor in the unknown probability of a ratings change.

Petitioners and MI except, stating that the expectation remains undisputed that Iberdrola's superior credit rating will give NYSEG and RG&E greater access to capital at lower cost than as stand-alone subsidiaries of Energy East, whose ratings are one to three notches lower. MI argues that the Recommended Decision's reasons for discounting Iberdrola's greater financial strength are themselves purely speculative, non-specific, and hypothetical. MI counters that just as unknown factors might in the future lower Iberdrola's financial strength relative to Energy East's, they might have the opposite effect. Petitioners argue that in other merger cases, such as the Grid-KeySpan merger,[20] we have evaluated financial strength or weakness not on the basis of the broad range of future events that might occur, realistic or otherwise, but on consideration of an acquirer's prevailing credit rating. Iberdrola's financial strength and stability are well recognized by the market, they say, evidenced by capitalization of more than $67 billion and successful issuance of $4.5 billion of equity to fund the proposed merger.

Petitioners claim that considering Iberdrola's current credit rating to be impermanent is inconsistent with our customary reliance on comparative credit ratings to justify allowing a utility a lower return on equity than a proxy group in rate cases. They cite our Suez Order as establishing that access to capital markets on reasonable terms—even though unquantified and in the absence of significant synergy savings—constitutes a benefit sufficient to support approval of an acquisition as in the public interest. Petitioners urge us to find that Iberdrola's financial strength and superior credit rating are tangible benefits weighing in favor of the proposed merger's approval. MI takes the position that Iberdrola's financial strength, while itself insufficient to justify the proposed transaction, does constitute a benefit to be weighed.[21]

Staff maintains that petitioners admit NYSEG, RG&E, and Energy East are already financially healthy, with sufficient access to capital markets to support their operations. It

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[20] See Case 06-M-0878, National Grid PLC and KeySpan Corp., Order Authorizing Acquisition Subject to Conditions and Making Some Revenue Requirement Determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued September 17, 2007)(Grid-KeySpan Order).

[21] Briefs on Exceptions of Petitioners, pp. 27-31, and MI, pp. 10-13.

contends that the differential between Iberdrola's financial strength and the strength of Energy East and its New York utility subsidiaries is insubstantial compared to the financial benefits created upon the consolidation of water companies into larger entities. Thus, Staff says, the water company cases provide no support for viewing Iberdrola's financial condition as a benefit of the proposed transaction.[22]

The Suez Order on which petitioners rely is not apposite. In the Suez case, we stressed the capital intensive nature of the water industry and our general desire to see greater consolidation of ownership of the State's many small water companies,[23] factors absent from this proceeding. As Staff notes, moreover, the Energy East companies currently are financially sound and have adequate access to capital markets. Iberdrola's credit quality is only slightly better than the ratings for the Energy East companies. Iberdrola's bond rating was downgraded one notch after the announcement of its proposed acquisition of Energy East, but it has stabilized the rating by pre-funding the transaction with equity. At this point Iberdrola's bond ratings (Moody's A3, Standard and Poors (S&P) A-) are just one step higher than NYSEG's and RG&E's bond ratings (each rated as Moody's Baa1, S&P BBB+) and one to two steps higher than Energy East's (Moody's Baa2, S&P BBB+).

As MI and petitioners point out, it would be speculative to assume that this minor differential between the credit ratings of Iberdrola and those of the Energy East companies would increase, rather than decrease or remain constant, all else equal. We have substantial concerns, however, about Iberdrola's capital structure and its ability to sustain its current status, particularly in light of its

[22] Staff's Brief Opposing Exceptions, pp. 21-24.

[23] Suez Order, pp. 6-7.

continuing pace of acquisitions over recent years and the part that goodwill plays in the transactions. Our apprehension about its consolidated equity ratio, the amount of existing and post-acquisition goodwill it will carry, and the risks to its credit rating and to its utility subsidiaries are discussed in greater detail below. In light of those concerns, we conclude that the small differential between Iberdrola's current credit ratings and those of NYSEG and RG&E are outweighed by the risks of the international holding company structure, its goodwill, and financial complexity and transparency issues discussed below.

2. Managerial Expertise

Petitioners object that the Recommended Decision failed to acknowledge Iberdrola's extensive global utility expertise and sharing of best practices with its affiliates as a benefit of the proposed acquisition. The Recommended Decision endorsed Staff's and CPB's position that the promised benefits are not identifiable, much less enforceable. It found that petitioners' testimony established that Iberdrola follows a laissez faire policy toward management at its operating subsidiaries. Notwithstanding that Iberdrola might share information on best practices with those subsidiaries, the Recommended Decision found that the benefit of Iberdrola's expertise would be insubstantial because of the asserted local managerial autonomy for subsidiaries, the geographic remoteness of supervision by Iberdrola, and the probability that local management could effectively identify and follow best practices on its own without access to Iberdrola's expertise.

Rather, the Recommended Decision accepted CPB's position that Iberdrola's expertise simply answers the threshold question whether Iberdrola is qualified to manage Energy East, and it would be untenable to infer that the proposed transaction therefore offers an affirmative benefit for purposes of a PSL §70 analysis. The Recommended Decision also questioned whether Iberdrola's asserted commitment to customer service quality and reliability would provide any benefit over that of Energy East and its subsidiaries, given that Iberdrola has no relevant experience in a North American climatic, cultural, and legal environment. It stated that petitioners conceded NYSEG and RG&E already seek out every opportunity to improve service and could not show that Iberdrola's objectives would differ in that respect. It added that we have ample authority to impose service and reliability standards in rate cases regardless of whether we approve the proposed merger.

Petitioners say the Recommended Decision overlooked record evidence that Iberdrola has a history of implementing best practices in subsidiaries outside its home country of Spain, despite retaining local management; and, in its 100 years of diversified global utility experience, has demonstrated superior levels of performance in service quality. They say the Recommended Decision ignored our precedents in water company merger cases giving weight to global utility expertise as a relevant, albeit unquantifiable, benefit. Petitioners point specifically to record evidence that Iberdrola has shared best practices that have positively influenced operations in its distant utility subsidiaries in Brazil and Guatemala. They note that Iberdrola, over the last three years, has delivered results that would rank in the first or second quartile of U.S. utilities. They also say that NYSEG's and RG&E's current pursuit of opportunities to improve service, and our authority to impose service quality standards, do not undercut the tangible benefit that Iberdrola's strong service quality performance will bring to NYSEG, RG&E, and their customers.[24]

[24] Petitioners' Brief on Exceptions, pp. 31-34.

Staff counters that any best practices and service reliability benefits Iberdrola could provide are operational skills expected of any competent utility operator. It argues that NYSEG and RG&E are already reasonably competent. Any improvements Iberdrola could offer could be achieved by existing management, according to Staff. Thus, Staff asserts that the claimed benefits are insubstantial, and inadequate for purposes of meeting the positive benefits test.[25]

Petitioners are correct that we have taken managerial expertise into account as a relevant benefit in other merger cases. Here, though, the record remains unclear whether Iberdrola's experience and expertise are likely to provide significant improvement in utility operations to benefit NYSEG and RG&E customers. For one thing, NYSEG, RG&E, and Energy East are much larger and more capable than the relatively small water companies involved in the cases that petitioners cite as precedent. In addition, we find convincing the Recommended Decision's determination that claims of benefit from Iberdrola's expertise are substantially negated by petitioners' assertions of Iberdrola's hands-off policy toward local utility management, Iberdrola's lack of experience in the North American utility environment, and petitioners' concession that NYSEG and RG&E are no less committed to service quality than Iberdrola.

We find little reassurance in petitioners' contention that Iberdrola's collaboration with local management has led to recent results that would rank its subsidiaries in the top one or two quartiles among U.S. utilities. It amounts merely to a claim that Iberdrola's utility subsidiaries' performance compared to U.S. utilities' would not be below average. In addition, petitioners' continuing insistence that there will be no short-run synergy savings from the proposed merger supports

[25] Staff's Brief Opposing Exceptions, pp. 17-18.

the inference that the impact of Iberdrola's management expertise on NYSEG and RG&E is too elusive to be considered a significant benefit.

For these reasons, we conclude that the benefits of Iberdrola's managerial expertise are either too insubstantial or too speculative to be counted as positive benefits for purposes of the PSL §70 analysis. To that extent, we adopt the Recommended Decision's findings and deny petitioners' exception.

3. Parties' Proposed Economic Development Initiatives

Nucor advocated that we direct NYSEG and RG&E to propose enhancements to their existing economic development plans after consulting with interested stakeholders. In its brief on exceptions, Nucor notes Iberdrola's agreement now to continue the operating utilities' existing economic development programs, including negotiating flex rate contracts. Nucor also points out that Iberdrola has undertaken to enhance the economic development initiatives, "if possible," in subsequent rate cases. Nucor considers these commitments responsive to its request for merger conditions directing the utilities to work with stakeholders. The Recommended Decision found that continuation of economic development programs would merely maintain the status quo, and thus could not be considered a benefit of the proposed transaction. It did not address the significance of the possibility that Iberdrola would enhance these economic development initiatives in future rate proceedings. That possibility is inherently speculative, however, and entitled to no weight. No party has taken exception to the Recommended Decision's conclusion, which we accept, that economic development initiatives should not be counted as a benefit of the proposed merger.

Nucor, however, takes exception to the Recommended Decision's lack of any condition, in the event we approve the proposed merger, addressing economic development initiatives. Nucor urges us to fashion a merger condition that effectuates petitioners' commitment, by establishing a specific process to address expanded utility economic development initiatives. No party has responded to Nucor's exception.[26]

Since NYSEG's and RG&E's current economic development initiatives will continue pursuant to their tariffs, we are not addressing these rate issues here. We encourage NYSEG and RG&E to meet with Nucor and any other interested entities to discuss possible enhancement of those initiatives. Nucor and other interested parties will have the opportunity to pursue proposals for additional or enhanced economic development initiatives in future rate cases. We therefore deny Nucor's exception.[27]

B. Asserted Financial and Corporate Risks

Staff, MI, and other parties have raised a number of concerns about financial and business risks to NYSEG, RG&E, and their customers if the proposed merger occurs. The financial and business risks the transaction poses could, in turn, adversely affect the ability of NYSEG and RG&E to provide safe and adequate service at just and reasonable rates. Any financial and business risks of the transaction must be weighed against benefits in determining whether the proposal will provide net benefits and serve the public interest under PSL §70.

[26] Nucor's Brief on Exceptions, pp. 1-4.

[27] We are, however, adopting economic development requirements as part of a contingency plan should Iberdrola fail to carry out its commitments regarding investment in wind generation in New York, as discussed elsewhere in this order.

The Recommended Decision concluded that we should accept as credible and persuasive Staff's characterizations of the proposed transaction's risks. It stated that petitioners bear the burden of showing that the transaction would satisfy the public interest requirement of PSL §70, but had failed to overcome the other parties' demonstration that the risks are realistic concerns. It noted, however, that the magnitude of such risks cannot be quantified. Thus, the Recommended Decision did not weigh these risks against asserted benefits. Instead, it treated them only as subjects for protective or mitigative measures.

As discussed above, petitioners and SPM challenge the Recommended Decision as uncritically accepting purported risks without addressing how speculative or unquantifiable those risks might be or the conditions available to mitigate them. Petitioners maintain that, under our precedents, an asserted risk must first be assessed to determine its reasonableness and likelihood, before we may impose remedial conditions or include the risk as an element of the positive net benefits determination. Petitioners believe that, in any event, the Recommended Decision removed potential risks from the calculation of positive net benefits by imposing mitigating conditions, so that any benefits of the transaction would then by definition become "net" benefits.[28]

1. Goodwill Risk

In its presentation at hearings, Staff contended that, although petitioners agreed not to add goodwill to NYSEG's and RG&E's books, the amount of existing goodwill on Energy East's

[28] Petitioners' Brief on Exceptions, pp. 49-50; SPM's Brief Opposing Exceptions, p. 17; see also Point II (Public Interest Standard), above.

and Iberdrola's books posed a significant risk itself.[29] Staff asserted that a write-down or write-off of Iberdrola's goodwill is likely in the long term and could adversely affect its access to capital. If petitioners' claim about a lack of synergy savings is true, Staff said, goodwill would be unsupported by earnings, a condition that could be exacerbated by future transactions increasing the amount of goodwill and financial risk in Iberdrola's capital structure. Petitioners generally countered that goodwill is common at the holding company level; that no goodwill would be added to the books of Energy East, NYSEG, or RG&E; and that various conditions would adequately protect customers' interests.

We estimated at the time of the abbreviated order, based upon an update of Exhibit 100 through June 2008 and an exchange rate of $1.50 per euro, that Iberdrola would have about $12.2 billion of goodwill (28% of its equity) on its books prior to the proposed transaction. Energy East would have $1.5 billion of goodwill (45% of its equity) on its books and the merger would create another $1.2 billion in goodwill. Thus, Iberdrola would have $14.9 billion of goodwill (34% of its equity) on its books after the proposed merger. Goodwill is of particular concern for regulated utilities because the regulatory process limits their revenue allowance by applying a pre-tax return allowance to an original cost rate base, and thus limits their ability to generate cash flow. To support goodwill, utilities therefore must consistently earn above-normal profits on their tangible earning assets. If an annual

[29] In the context of utility accounting in the U.S., "goodwill" generally represents the amount that the acquirer pays over and above the book value of the common equity of the acquired utility. Regulators typically set rates that will provide a return only on the historical cost of utility assets, and goodwill is not an asset that is typically recovered in rates.

goodwill impairment test shows earnings and cash flows from tangible assets do not support goodwill, it must be written off. Iberdrola’s sizeable goodwill balance puts financial pressure on it to produce supporting cash flows or face significant write-offs that could have a serious impact on the company. That pressure could cause utility operating companies’ management to cut costs and reduce future investment in plant, property, and equipment, threatening the utilities’ ability to provide safe and adequate service.

2. Credit Quality Risk

Staff contended at hearings that Iberdrola’s finances present significant risk for NYSEG and RG&E and their customers. Staff pointed out that Iberdrola would take on $3.7 billion in debt on Energy East’s books and also claimed that the approximately $3 billion in goodwill related to the proposed merger and prior Energy East transactions would eliminate the benefit of the equity Iberdrola used to fund it. Staff said that Iberdrola’s capital structure would include 42% equity, almost half of which would be goodwill, and that impairment of the goodwill could increase its debt ratio to as high as two-thirds. In that case, Staff argued, the holding company’s credit rating could fall to junk status. It noted a six-year slide in Iberdrola’s bond rating, a strategic plan to grow investments by up to $38 billion, and a dividend payment policy that puts pressure on the company’s financial position. Staff asserted that Iberdrola’s capital structure is more consistent with a BBB-rated utility; and that holding companies like Iberdrola that focus more on competitive businesses than regulated utility operations score only as “satisfactory” on business risk evaluations, compared with the “excellent” or “strong” grades typical for companies concentrating on regulated business. In addition, Staff argued that the holding company's cash flow characteristics fit with a lower rating range.

Petitioners argued at the hearing stage that the best, most relevant evidence of Iberdrola's financial strength or risk is its credit ratings, which are forward looking and take into account future events to the extent they can be anticipated. They contended that Iberdrola's credit ratings are stable and higher than those of Energy East. Thus, they maintained the judgment of the market is that Iberdrola poses less credit risk than Energy East. They also argued that any pressure on Iberdrola's credit rating will more likely be caused by adverse regulatory action, such as approval conditioned on excessive rate concessions, than by the proposed transaction itself.

As noted, Iberdrola currently has slightly higher credit quality than the Energy East companies. Its bond ratings are one notch higher than NYSEG's and RG&E's bond ratings and one to two notches above Energy East's. Iberdrola's consolidated equity ratio after acquisition of Energy East would be about 53%, which is sufficient to support its current "A-" rating if it can sustain its cash flow. Although that equity ratio is acceptable, it could change with Iberdrola's next acquisition or if any portion of its equity relating to goodwill becomes impaired and is written off. Write-off of all the goodwill would reduce the holding company's equity ratio to 43%. Moreover, a major acquisition financed with debt, such as Iberdrola's 2007 acquisition of ScottishPower, could significantly alter Iberdrola's financial profile.

Such changes could result in downward pressure on the bond ratings of Iberdrola and its affiliates. Thus, Iberdrola's acquisition of Energy East will expose NYSEG and RG&E to greater credit quality risk compared to what prevails under Energy East alone. An additional transaction financed in the same manner as

ScottishPower could, absent effective financial protections for NYSEG and RG&E, result in customers being asked to bear higher financing costs, a reduction in NYSEG's and RG&E's ability to access the market on reasonable terms, and excessive cash being drained out of these operating utilities rather than being applied toward the provision of service.

3. Holding Company Risk

At the hearing stage, Staff contended that Iberdrola's vast, complex corporate structure, spanning three continents and numerous regulated and unregulated businesses, presents much greater risk to NYSEG and RG&E and their customers than does Energy East's role as a holding company. Staff argued that our ability to exercise regulatory oversight would be strained in an environment in which Iberdrola frequently acquires and divests firms; and that communications with its headquarters in Spain are difficult, especially given petitioners' inconsistency in providing prompt translations of Spanish documents needed for regulatory purposes. Staff noted Iberdrola has been the subject of fines and sanctions for poor regulatory performance and market power abuse, which would increase risk over that posed by Energy East ownership. Staff maintained that Iberdrola's extensive holdings and size increased the risk of cross-subsidization and cost-shifting from competitive to regulated companies and that the holding company's debt structure is sufficiently complex to make monitoring problematic. Finally, Staff noted its concerns about the additional risks posed by Iberdrola's claims of confidentiality and secrecy for business information, including corporate structure and credit quality metrics. This kind of information is considered public in the

United States, Staff states, and Iberdrola's claim of secrecy could interfere with public scrutiny of regulated operations.[30]

Petitioners contended that traditional principles of regulation, our regulatory tools, and conditions to which petitioners are willing to agree would adequately protect customers of NYSEG and RG&E. They maintained that Iberdrola's organizational structure is not overly complex, and that sanctions and fines incurred by Iberdrola and its affiliates provide little basis for claiming an overall regulatory compliance problem. They said that confidential business information has been and will continue to be provided to Staff as needed in future proceedings.

There is compelling evidence to support Staff's contention, endorsed by the Recommended Decision, that Iberdrola as a holding company creates significant additional risk to NYSEG, RG&E, and their customers compared with the risk they face with Energy East alone as a holding company. Staff highlighted the unusually complex nature of Iberdrola's structure and scope of operations. Its corporate organizational chart alone runs to 15 pages, compared to Energy East's one page, with a broad range of regulated and unregulated subsidiaries in many countries, including more than 100 affiliates in the United States alone.

Petitioners claim that we have sufficient regulatory tools to oversee Iberdrola's corporate empire. While it is true that we have a broad array of regulatory tools to protect customers, we have substantial concerns about the limit of DPS

[30] MI and CPB shared Staff's concerns about holding company and other financial and business risks associated with Iberdrola's acquisition of Energy East, although they felt those risks could be mitigated to a sufficient extent by various protective conditions. With appropriate conditions, they believed the remaining overall risk of the transaction would be outweighed by its benefits.

staff's ability to monitor effectively the ever-shifting, complicated interrelationships among Iberdrola's affiliates, particularly amidst its frequent acquisitions and divestitures in multiple countries, with several languages, on several continents. The difficulty of regulatory oversight of this enormous corporate web is exacerbated by the company's use of financial statements based on International Financial Reporting Standards (IFRS) instead of U.S. Generally Accepted Accounting Principles (GAAP). All of these factors adversely affect financial transparency, increase risk to NYSEG and RG&E customers, and constitute detriments we must take into account in assessing whether the proposed transaction provides positive net benefits to New York customers.

4. Hostile Takeover Risk

At the hearing stage, Staff raised the possibility of Iberdrola becoming the target of a hostile takeover. Staff warned that the cost of anti-takeover defenses by Iberdrola could impair its financial health, harming NYSEG's and RG&E's ability to provide safe and adequate service. NYSEG, RG&E, and their customers could also be hurt, Staff said, if the acquiring company succeeded and broke up Iberdrola and spun off its assets. Petitioners responded that any entity attempting to acquire Iberdrola would still be subject to our authority under PSL §70 to review the proposed corporate transfer. Any possibility of a hostile takeover or of an Energy East spin-off or sale after an upstream transfer is entirely speculative, they argued. They further maintained that takeover and regulatory compliance issues are implicit in any upstream ownership of a utility and are adequately controlled by our regulatory powers.

No one argues that the probability of a hostile takeover is any greater under Iberdrola's ownership than under

Energy East's. Moreover, under either circumstance, PSL §70 would require our approval as a precondition for transfer or lease of all or part of a gas or electric corporation's franchise, works or system, or a contract for the operation of its works or system, or certain transfers of more than 10% of its stock. However, if a hostile takeover of Iberdrola occurred after the proposed merger, it could aggravate some of the goodwill and credit quality risks this transaction already poses. For example, a hostile takeover could generate even greater amounts of goodwill than would prevail in a friendly takeover.

C. Financial and Corporate Mitigation Measures

Although Staff opposes the proposed transaction, it offers a set of conditions intended to protect NYSEG and RG&E and their customers if the merger is approved. Staff's proposed protective conditions fall within several categories: goodwill and acquisition costs; credit quality and dividend restrictions; money pooling arrangements; bankruptcy protection; financial transparency and reporting requirements; and a code of conduct related to affiliate transactions.[31] MI supported the Staff conditions, but proposed two additional conditions to guard against potential adverse effects it believed might flow from a hostile takeover of Iberdrola by a foreign corporation.

As explained earlier, the Recommended Decision found the posited risks sufficiently realistic to add weight to its recommendation that the proposed acquisition be disapproved. In addition, however, it addressed which of the proposed protective measures should be imposed if the merger is approved. In that analysis, the Recommended Decision first examined whether a particular proposal would be burdensome, and only if burdensome

[31] Staff's Initial Brief, pp. 135-70.

did it consider whether the burden would be commensurate with the risk at issue. It also invited comments on exceptions as to whether a particular protective condition might be burdensome. If a mitigation measure is not burdensome, it opined, we should adopt the measure as a prudently conservative step without weighing the degree of risk. The Recommended Decision supported adoption of all but two of the measures Staff put forward, as well as one of the two MI alone offered.

Petitioners take exception to a number of the protective conditions the Recommended Decision favored, offering their own alternatives in some instances. Staff excepts to the Recommended Decision's rejection of its proposal for a revised and expanded code of conduct and restrictions on affiliate relationships. Staff and MI also except to the Recommended Decision's rejection of Staff's proposal to require that Iberdrola hold NYSEG and RG&E customers harmless from increased capital costs resulting from any decline in credit rating.

As previously noted, the record here establishes that Iberdrola's acquisition of Energy East will create significant risks and uncertainties for NYSEG, RG&E, and their customers, discussed in detail above. To lessen the impact of these risks associated with the proposed transaction, we consider what protective conditions may reasonably be imposed.

1. Goodwill and Acquisition Costs

The Recommended Decision endorsed all three conditions Staff proposed involving goodwill and acquisition costs: that the acquisition premium and costs for not only this proposed merger, but also all past transactions among petitioners, not be recorded on Energy East's, NYSEG's, or RG&E's books; that the acquisition premium and related costs associated with this transaction not affect rates; and that Iberdrola annually provide the results of any goodwill impairment test.[32] Petitioners have agreed that the acquisition and premium costs of the proposed merger will not be added to goodwill on the books of Energy East, RGS, NYSEG, or RG&E; and that they will not seek recovery, in NYSEG or RG&E rates, of the acquisition premium and costs of this proposed transaction or the merger in which Energy East acquired RGS Energy Group and RG&E.[33] However, they except to any requirement that goodwill from past transactions be removed from the books of RGS and transferred upward to Iberdrola. They maintain that such a requirement would violate GAAP and exceed our authority. Petitioners observe that we did not include any similar requirement in approving National Grid's acquisition of Niagara Mohawk Power Corporation.[34] Petitioners also challenge the recommendation to provide the results of goodwill impairment tests. They maintain the requirement would be burdensome and unrelated to regulatory concerns about NYSEG or RG&E, because goodwill is typical at the utility holding company level and the operating utilities' customers will be protected adequately by other conditions.[35]

Staff replies that petitioners' GAAP argument should be rejected because they cite no particular GAAP provision and their contention is beyond the record.[36] In addition, Staff

[32] Utilities, like other entities, are required to confirm through a third party review that the asset values on their financial statements are reasonably stated. If the review determines that cash flow and the overall valuation are insufficient for the amount of the firm's goodwill, the goodwill is deemed to be impaired.

[33] Case 01-E-0359 and Case 01-M-0404, Energy East Corp., RGS Energy Group, Inc. et. al., Order Adopting Provisions of Joint Proposal with Modifications (issued February 27, 2002)(Energy East-RGS Order).

[34] Petitioners' Brief on Exceptions, pp. 50-52.

[35] Ibid., pp. 52-53.

[36] Staff's Brief Opposing Exceptions, p. 32.

asserts that the impairment test condition is necessary because Iberdrola poses substantially more risk than a typical holding company, due to its size and the extensive scope of its unregulated operations. Staff states that the provision would not be burdensome or unreasonable since Iberdrola should be performing the test annually in any event; and the test could signal potential problems before a crisis arises and help us prevent adverse impacts on customers.[37]

We can understand petitioners' objection to the requirement that existing goodwill related to earlier transactions be removed from the books of Energy East and RGS. We did not include such a requirement for National Grid's acquisition of Niagara Mohawk or the more recent Grid-KeySpan merger in similar circumstances. The other conditions to which petitioners have agreed, in addition to those we are imposing, will provide sufficient protection to customers. We will not, therefore, adopt Staff's recommendation on goodwill from past transactions.

We also did not impose a requirement for annual goodwill impairment tests in the Grid-KeySpan proceeding, which serves as a useful guide in this case,[38] and we find it unnecessary in the context of the other constraints we will impose on goodwill here. Goodwill impairment remains a risk associated with this transaction, however, and it is reasonable to require Iberdrola to file any analysis that establishes

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[37] Ibid., pp. 32-33.

[38] The circumstances of the transaction participants in the Grid-KeySpan merger do not establish a threshold that must be met before conditions similar to those in the Grid-KeySpan Order will be imposed. Regardless of the comparative degrees of risk, the types of risks in terms of goodwill, credit quality, and financial transparency for a complex holding company are similar in the two cases and warrant similar protective measures.

impairment, to any extent, of the goodwill associated with this merger or the goodwill already on the books of Energy East or RGS.[39] Accordingly, we are imposing the conditions set forth in paragraph 1 of Appendix 1 in lieu of Staff's Conditions 1 through 3.

2. Credit Quality and Dividend Restrictions

The Recommended Decision adopted all but one of Staff's ten conditions on credit quality and dividend restrictions, plus one of MI's proposals as the Recommended Decision interpreted it. Petitioners accept Staff's proposed conditions that NYSEG, RG&E, and Iberdrola must maintain S&P and Moody's credit ratings on their securities and must have a stated goal of maintaining investment grade ratings of their securities. They also accede to conditions limiting the amount of dividends NYSEG and RG&E each may pay Iberdrola in any year; prohibiting NYSEG or RG&E from paying a dividend if its respective bond rating is immediately downgraded to non-investment grade; and precluding NYSEG or RG&E respectively from transferring, lending, or leasing any item of value to any affiliate without our approval when under a dividend restriction.

Petitioners do not challenge the Recommended Decision's endorsement of Staff's proposal that we require them to file copies of presentations to credit agencies concerning NYSEG or RG&E. They object, however, insofar as the condition would include back-up information, and presentations (with back-

[39] The condition we are imposing requires the petitioners to supply whatever impairment test was employed for their financial statements, if there is a write-off of either existing goodwill on Energy East's or its RGS subsidiary's books or goodwill that Iberdrola recognizes as a result of this transaction.

up) that do not involve NYSEG or RG&E. They call these requirements overly broad and irrelevant, exceeding what is needed for reviewing NYSEG's or RG&E's financial health and maintaining effective regulation over the operating utilities.[40] Staff denies that the provision of information on presentations involving holding company matters would be burdensome, since the information has already been prepared. Staff believes information on Iberdrola's broader holdings would help us gain advance notice of matters that might adversely affect NYSEG and RG&E.[41]

We agree with petitioners that presentations on matters not involving NYSEG, RG&E, RGS, or Energy East would be unnecessary. However, the demand for presentations related to those companies that are provided to rating agencies, together with supporting materials, is fully justified. The full context of the presentations cannot be understood unless all materials used in connection with the presentation are available for review. Accordingly, we will grant the exception in part and modify Staff's proposed Condition 6 to read as set forth in subparagraph 2(a) of Appendix 1.

Petitioners next except to the Recommended Decision's conclusion that whenever NYSEG's or RG&E's credit is downgraded, a remedial plan must be filed with us. They note that the language of the condition applies to all bond downgrades and contend that it should be modified to cover only those situations when one of the companies is in danger of having its bond rating fall below investment grade. They say we recently adopted a similar provision in the Suez Order.[42] Staff maintains that no modification is warranted, because both companies are

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[40] Petitioners' Brief on Exceptions, pp. 53-54.

[41] Staff's Brief Opposing Exceptions, p. 33.

[42] Petitioners' Brief on Exceptions, pp. 53-54.

already near the bottom of the investment grade category and any downgrading will be costly to customers. MI continues to support Staff's condition as useful for protecting customers, but offers the alternative of imposing it for only four years after the merger.[43] We see no sufficient reason for a remedial plan unless an investment grade rating is threatened and so will grant petitioners' exception and make their requested modification.

Petitioners also take exception to the Recommended Decision's adoption of two other Staff conditions related to credit ratings. The first would prohibit NYSEG or RG&E from paying a dividend whenever the bond rating on its least secure form of debt is at the lowest investment grade and a rating agency has issued a negative watch or review downgrade notice. The second would bar dividend payments by either NYSEG or RG&E if Iberdrola's least secure form of debt sinks below investment grade with any rating agency. Petitioners object that these provisions restrict dividends while NYSEG or RG&E still has an investment grade rating. They argue that these restrictions are the same as those we imposed on the 2007 Grid-KeySpan merger, yet the proposed transaction here does not pose the same risk; and that Iberdrola's past practices, combined with our regulatory powers and other conditions, would ensure that cash would not be drained from NYSEG or RG&E in the circumstances in question.[44] Staff and MI continue to insist that the conditions are needed to guard and conserve cash for the benefit of customers in difficult times, preserve the operating companies'

[43] Briefs Opposing Exceptions of Staff, p. 33, and MI, pp. 29-31.

[44] Petitioners' Brief on Exceptions, pp. 55-57.

ability to provide safe and adequate service, and protect customers from financial harm.[45]

We reject petitioners' exceptions for two reasons. First, dividend restrictions are a key mechanism for ensuring that utilities are not stripped of cash when events negatively affect either the holding company parent or the utility itself. These mechanisms are required to ensure the utility's continuing financial viability, and thus its provision of safe and adequate service, as well as to provide insulation from events adversely affecting the holding company. Second, petitioners overlook the fact that the dividend restrictions we applied to National Grid are not rigid. National Grid has the opportunity to explain why dividends should be resumed even if the bond rating decline has not been rectified. We will apply the same provision to Iberdrola. If a ratings trigger occurs but Iberdrola can reasonably demonstrate in the circumstances then prevailing that dividend payments would not drain excessive cash from NYSEG and RG&E to the point of putting necessary and appropriate capital or operating expenditures at risk and threatening the utility's ability to provide safe and adequate service, we could lift the dividend restriction.

Staff and MI except to the Recommended Decision's rejection of Staff's proposed condition designed to hold NYSEG and RG&E customers harmless from the effects of any downgrading from their present debt ratings. Staff says we should follow the principle that customers should not suffer as a result of a rating downgrade, whatever its cause, applying the practical remedy that assigns the parent holding company the onus of maintaining the companies' fiscal health. MI says that we imposed similar conditions in the Grid-KeySpan merger to protect

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[45] Briefs Opposing Exceptions of Staff, p. 33-34, and MI, pp. 31-34.

Niagara Mohawk and KeySpan customers and that NYSEG and RG&E customers should be accorded similar protection.[46] Petitioners respond that Staff's proposal would place responsibility on the parent company for matters beyond its control which might well be the result of such factors as regulatory actions, general market conditions, or macroeconomic changes in future credit markets.[47] SPM adds that the "hold harmless" provision could actually harm customers by depriving the companies of cash flow to support borrowings needed for capital improvements.[48]

We find that the other financial protections we are imposing, including those discussed below, will provide sufficient protection for customers. In the event of any future downgrading of NYSEG or RG&E credit ratings, the parties may address the causes, responsibility, and consequences to customers in future rate proceedings for our resolution. Consequently, we deny Staff's and MI's exception regarding Staff's "hold harmless" provision.

MI proposes that we include conditions barring any dividend payments if any agreement become public whereby a foreign company would acquire Iberdrola, and requiring a 25% reduction in NYSEG's and RG&E's delivery rates if the acquiring company ignored or contested our jurisdiction over the acquisition. The Recommended Decision rejected MI's proposed condition on rate reduction, but, as a modification of the dividend restriction proposal, recommended that we reserve the right to enjoin dividend payments to Iberdrola if another firm acquired Iberdrola and its New York subsidiaries without our prior approval under PSL §70. MI does not except to the Recommended Decision's denial of the rate reduction condition or

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[46] Briefs on Exceptions of Staff, pp. 32-33, and MI, pp. 30-33.

[47] Petitioners' Brief Opposing Exceptions, pp. 38-39.

[48] SPM's Brief Opposing Exceptions, pp. 18-19.

modification of the dividend restriction proposal. Petitioners, however, except to the dividend restriction condition. They say the condition is based on pure speculation and the assumption that a future transaction might occur in violation of the PSL. They add that the condition is unnecessary because we retain our full complement of compliance and enforcement powers.[49] MI responds that we might have only limited ability to react effectively to a European transaction, and the proposed restriction would give a potential acquirer an incentive not to proceed without our approval.[50]

We have sufficient measures available under the PSL to act effectively to protect the interests of customers in the unlikely event of a foreign acquisition without our approval. We therefore will not adopt the dividend restriction condition, either as proposed originally by MI or as modified by the Recommended Decision. Thus, in addition to our earlier modification of the condition on submission of presentations to rating agencies, we adopt the conditions in subparagraphs (b) through (f) of paragraph 2 in Appendix 1, in lieu of Staff Conditions 3 through 5, 7, and 9 through 13.

3. Money Pooling Arrangements

The Recommended Decision accepted five Staff proposed conditions on money pooling arrangements, cross-default provisions, and indirect loans. Petitioners take no exception

[49] Petitioners' Brief on Exceptions, p. 57.

[50] MI's Brief Opposing Exceptions, pp. 34-36.

to four of those conditions,[51] but object to one that would preclude Iberdrola from participating in money pools except as a lender. Petitioners maintain the provision is overly broad and should be aimed only at money pools in which NYSEG or RG&E participate.[52] Staff's reply accepts petitioners' modification,[53] which we find reasonable. We also are modifying the cross-default conditions to provide greater clarity and to address in greater detail the possibility of existing cross-default provisions. In lieu of Staff's five conditions, we adopt the conditions in paragraph 3 of Appendix 1.

4. Special Class of Preferred Stock and Limited Purpose Entity

The Recommended Decision favored adoption of a Staff ring-fencing condition for establishment of a "golden share" that would prevent a bankruptcy of Iberdrola or any of its affiliates from triggering a voluntary bankruptcy of NYSEG or

[51] Staff Condition 18 would prohibit indirect loans from NYSEG or RG&E to any affiliate. In response to the Recommended Decision's observation that Staff had not made clear what it meant by the term "indirect loan," Staff's brief on exceptions explains that an indirect loan "occurs when a subsidiary makes loans to a parent, and the parent then loans that debt to another subsidiary participating in the money pool." Petitioners have not taken exception to Condition 18. In their brief opposing exceptions (at pp. 39-40), they state that they do not take issue with Staff's definition, but see no need for the provision because Iberdrola has committed not to borrow from any money pool in which NYSEG and RG&E are participants.

[52] Petitioners' Brief on Exceptions, p. 58.

[53] Staff's Brief Opposing Exceptions, p. 34.

RG&E.[54] Petitioners believe the “golden share” proposal is unnecessary and lacks sufficient detail on the process for implementing it. They agree, however, to a modified condition that would establish a more detailed process for what they characterize as an “independent bankruptcy consent right.” Petitioners’ revised condition would require that NYSEG and RG&E each modify its bylaws and file a petition, within six weeks after closing of the transaction, for authority to establish a preferred stock class with one share with the requisite voting right and for approval of a proposed holder of the share. If either utility could not do so despite good faith efforts, it would have to petition for relief, explaining why the requirement could not be met and how it proposed to meet the underlying need for bankruptcy protection.[55]

Staff responds that petitioners’ proposed modification would be acceptable, with a further modification that we could substitute a shareholder of our own choosing if NYSEG or RG&E failed to propose an acceptable candidate within six months after closing of the acquisition.[56] MI objects to the proposed modification as gutting the provision for a “golden share.” It argues there are no circumstances or difficulties identified that might prevent the companies from fulfilling the bylaw and acceptable independent shareholder requirements. MI thinks the

[54] “Ring-fencing” encompasses the range of techniques or mechanisms to insulate the credit of an issuer from the risks associated with affiliates within a corporate structure. A “golden share” is a ring-fencing measure in which a company issues a share of preferred stock to an independent holder with a voting right that precludes the company from voluntarily filing for bankruptcy without the holder’s consent.

[55] Petitioners’ Brief on Exceptions, pp. 58-59.

[56] Staff’s Brief Opposing Exceptions, pp. 34-35.

petitioners' modification serves only to provide a means for escaping a condition they have repeatedly opposed.[57]

Petitioners' proposed modified condition is substantially similar to a condition we imposed in the Grid-KeySpan merger, except for the provision here that the companies could propose shareholders for our approval instead of our selecting the shareholders. The provision to which MI objects is the same as the one we included in the Grid-KeySpan Order.[58] We therefore deny MI's exception and find petitioners' proposed modification generally reasonable and acceptable. However, as a compromise between that proposal and the condition adopted in the Grid-KeySpan merger, we will adopt Staff's suggestion that we select the shareholder in the event a company fails to propose an acceptable shareholder within six months after closing of the transaction. Staff's suggestion is a reasonable means of balancing the petitioners' interest in having an opportunity to select the shareholders, against the risk that the process could be extended unduly by a succession of unacceptable candidates. Accordingly, we adopt the conditions set forth in paragraph 4 of Appendix 1.

The Recommended Decision also supported Staff's proposal to require a "limited purpose entity" (LPE) that would ensure compliance with dividend and money pooling restrictions. Petitioners did not take exception. The LPE was discussed on the record primarily in connection with the proposal for a "golden share." Although the record includes basic generic information describing the general structure and function of an LPE, it provides essentially no information on the likely costs of establishing and maintaining an LPE in relation to the value it would add to the conditions on dividend restrictions and

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[57] MI's Brief Opposing Exceptions, pp. 36-37.

[58] Grid-KeySpan Order, pp. 126-27.

money pooling. We find the proposal for an LPE lacks sufficient specificity here to assess reliably its advantages and disadvantages and net benefit for the interests of customers. Given the lack of information, we decline to require an LPE as a condition of the approved acquisition.

5. Financial Transparency and Reporting Requirements

Staff proposed eight conditions on financial transparency and reporting requirements, all of which the Recommended Decision accepted. Petitioners take no exception to four conditions, which, with minor clarifying revisions, we find reasonable and adopt as set forth in subparagraphs (a) through (d) of paragraph 5 of Appendix 1.

Petitioners except to the four remaining financial transparency and reporting requirements that the Recommended Decision supported, one concerning access to books and records, the others addressing the nature and format of various statements Staff would have NYSEG and RG&E file regularly or in rate cases. First, petitioners object to the recommended condition that would require access to all books and records of Iberdrola and its majority-owned affiliates, in English, in New York. Petitioners call the requirement burdensome and overly broad because it would mandate DPS staff access to books and records of entities unrelated to NYSEG and RG&E and assertedly would have no relevance to our responsibilities.[59] Staff responds that it must bear most of the burden of monitoring Iberdrola's complex organization with limited financial transparency, and that providing documentation in English will not be as burdensome as petitioners claim.[60]

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[59] Petitioners' Brief on Exceptions, pp. 59-60.

[60] Staff's Brief Opposing Exceptions, p. 35.

Although Staff's proposal is somewhat more demanding than necessary, DPS staff's legitimate need for access to books is broad and not easily defined. Staff might well need access to information on a number of matters relating to the parent company and other affiliates bearing on NYSEG's or RG&E's responsibility to provide safe and adequate service at just and reasonable rates. Among other things, access to books and records of Iberdrola and other affiliates would be important to assure us an opportunity to assess whether income taxes and other affiliate costs are allocated properly to NYSEG or RG&E, and whether intercompany transactions involving NYSEG or RG&E are priced reasonably. More specifically, in the case of cost allocations from Iberdrola to NYSEG or RG&E, DPS staff would need access to all information supporting the underlying costs and the basis for allocating them.

Petitioners also except to three recommended conditions specifying the form in which they would have to present financial information in regular filings and in rate cases. They particularly object to requirements that they submit financial information about regulated and unregulated energy companies in the United States (other than NYSEG and RG&E) on an audited GAAP basis. They argue that, instead of GAAP, Iberdrola complies with IFRS, which the Securities and Exchange Commission (SEC) has now found acceptable for its purposes as IFRS and GAAP have become more convergent. Petitioners also disagree with having to file consolidating financial statements in the same format as SEC Form U-5S and energy company information in the same format as SEC Form U-9C-3 (both of which were required under the Public Utility Holding Company Act of 1935, now repealed) to the extent the condition would apply to all Iberdrola affiliates. Last, petitioners challenge the condition that they file projections of consolidating financial statements for Energy East and its utility affiliates based on GAAP in future rate cases.

Petitioners contend that these requirements are burdensome, unnecessary, and overbroad. They point to alternatives they have offered, which they believe would meet DPS staff’s needs in a way that is not unduly burdensome or costly. They say they are willing to work with DPS staff to ensure that the information provided is mutually agreeable and they offer to file certain traditional GAAP financial statements for Energy East, NYSEG, and RG&E.[61] Staff counters that if, as petitioners say, IFRS and GAAP have become more consistent, it should not be burdensome for them to translate from IFRS into GAAP; and, more generally, that petitioners have overstated the burdens associated with the requirement in question.[62] MI supports Staff’s position, adding that petitioners should bear the burden of conforming with our standard accounting requirements, rather than DPS staff having the burden of adjusting to an unfamiliar accounting system to accommodate Iberdrola alone.[63] Staff also maintains that information in the format of former SEC Forms U-5S and U-9C-3 is essential to regulatory oversight of the accounting books of New York utility subsidiaries of a holding company, particularly to evaluate equity ratios, a major driver of regulated rates.[64]

We endorse a reasonable middle ground between petitioners’ and Staff’s positions. In general, we find it excessive to require Iberdrola to report results for its own operations and those of its affiliates on an audited GAAP basis when those entities have not had to do so in the past. Some of

[61] Petitioners’ Brief on Exceptions, pp. 60-64.

[62] Staff’s Brief Opposing Exceptions, pp. 35-37.

[63] MI’s Brief Opposing Exceptions, pp. 37-41.

[64] Staff’s Brief Opposing Exceptions, p. 36.

the information Staff seeks through the proposed conditions is necessary, however, to evaluate whether NYSEG and RG&E rates are just and reasonable. We have employed the consolidating financial statements that were part of SEC Form U-5S on a number of occasions in recent years. True, as petitioners note, we did not require Grid or KeySpan to provide projected financial statements in the Form U-5S format as a condition of their merger. But we specifically required historical Form U-5S information, as well as Form U-9C-3 information, to be filed and to be available publicly.[65] We have also required NYSEG to provide such information in future rate cases.[66] Additionally, we will require that all necessary information be submitted in English and in U.S. dollars, as we categorically reject petitioners' claim that such a requirement would be burdensome and unreasonable.

Instead of the four Staff conditions in issue, or the alternatives petitioners have offered, we will adopt the conditions on financial transparency and reporting appearing as subparagraphs (e) through (g) of paragraph 5 in Appendix 1. The key to making these requirements work successfully, however, will remain Iberdrola's willingness to cooperate with our staff and us to address any format or informational questions, as it has committed to do.

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

Staff proposed to adapt the code of conduct currently applicable to transactions among NYSEG, RG&E, and Energy East

[65] Grid-KeySpan Order, p. 126.

[66] Case 05-E-1222, New York State Electric & Gas Corp. – Rates, Order Adopting Recommended Decision with Modifications (issued August 23, 2006), p. 90.

and its other subsidiaries,[67] applying it to Iberdrola with various revisions and four additional conditions. Among other things, parties expressed concern about potential conduct involving NYSEG or RG&E and Iberdrola's affiliates, including Community Energy, Inc., which has the advantage of an exclusive green power marketing arrangement with NYSEG and RG&E. Petitioners agreed to have Iberdrola "step into the shoes" of Energy East under the terms of the existing code of conduct, but opposed Staff's revisions and additions. The Recommended Decision declined to adopt Staff's revisions and additions, because of concerns that some might be overly broad, coupled with instances of ambiguities and inconsistencies. It did recommend requiring that Iberdrola step into Energy East's shoes under the existing code. Staff takes exception, arguing that the revisions and additions are necessary to address Iberdrola's much larger size, complexity, and diversity of activities compared to Energy East.[68] Petitioners echo the Recommended Decision's concerns.[69]

The record is not sufficiently clear on these issues to enable us to resolve the various disputes over affiliate transactions, cost allocations, and the code of conduct. For now, we have decided to require only that Iberdrola step into the shoes of Energy East under the existing rules and to establish a process to resolve the remaining disputes. Accordingly, the abbreviated order required that the parties consult over the 60 days following issuance of that order and attempt to negotiate an agreement on these matters. At the end of that period, they were to submit a report either advising us

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[67] Set forth in Appendix B of the Joint Proposal in the Energy East-RGS Order.

[68] Staff's Brief on Exceptions, pp. 28-32.

[69] Petitioners' Brief Opposing Exceptions, pp. 28-38.

that they have reached agreement, with an accompanying joint proposal incorporating the agreement's terms, or that they require an additional 30 days for further negotiations. We required that the parties submit the final results of their negotiations, specifying all points of agreement and disagreement, no later than 90 days after the abbreviated order. In either event, we will then consider and act upon the parties' submission, including any additional process we then deem necessary. These conditions appear in paragraph 6 of Appendix 1.

7. Follow-On Merger Savings

In approving National Grid's acquisition of Niagara Mohawk, the customer benefits on which we relied included a condition designed to capture savings for Niagara Mohawk customers resulting from future mergers or acquisitions by National Grid during the rate plan.[70] To provide a comparable level of benefits here, we have included a similar clause in Paragraph 7 of Appendix 1 which will capture for NYSEG and RG&E customers the follow-on merger savings from future Iberdrola mergers or acquisitions in the United States until new rates are set.

D. Summary of Financial and Corporate Risks and Mitigation Measures

We conclude that the proposed merger poses substantial financial and corporate risks, which in turn could adversely affect the ability of NYSEG and RG&E to provide safe and adequate service at just and reasonable rates.

The financial and corporate risks of the proposed merger can be mitigated to some extent by the protective

[70] Niagara Mohawk-Grid Order, Joint Proposal §§1.2.4.19 and 1.6.1.3.

conditions we are prescribing. Contrary to petitioners' contention, however, we are convinced that, although conditions on the merger can help reduce the actual or potential harm from the transaction, we cannot rely on them to eliminate or neutralize the risks. We conclude that, even mitigated by protective measures, the financial and corporate risks entailed in the proposed acquisition outweigh any minor financial and corporate benefits. We must therefore look to other sources of benefits to overcome that detriment and generate positive net benefits from the transaction.

We find that the proposed merger would substantially increase financial and corporate risks to NYSEG, RG&E, and their customers over the risks currently prevailing under Energy East alone. We base this finding on the identified risks of Iberdrola's international holding company structure, including problems associated with reporting and financial transparency; the potential for cross-subsidization and related affiliate abuses; Iberdrola's complexity; the level and nature of Iberdrola's post-merger goodwill and its credit quality implications; and the potential for exacerbation of risks in the event of either a major Iberdrola acquisition of another entity or the acquisition of Iberdrola or a part of Iberdrola by another entity. Overall, we conclude that Iberdrola's financial profile and corporate structure constitute a net detriment, not a benefit, of the proposed acquisition compared with the status quo.

IV. SAFETY, RELIABILITY, AND SERVICE QUALITY MITIGATION MEASURES

Staff proposed a number of conditions intended to protect safety, reliability, and service quality. The Recommended Decision concluded that we should postpone consideration of all such proposals until future NYSEG and RG&E

cases, rather than adopt any here. (Meanwhile, petitioners reached agreement with NYAPP/NYSRECA and with the City of Rochester on certain conditions related to reliability, service quality, and safety issues those parties had raised.) Staff and MI, in exceptions opposed by petitioners and SPM, oppose any delay in adopting these measures. We are granting the exceptions to the extent described below, because it is vitally important to ensure that the transaction does not become an obstacle to the provision of safe and adequate service.

A. Generally Applicable Conditions Related to Safety, Reliability, and Service Quality

With respect to electric reliability performance by NYSEG and RG&E, Staff proposed at the hearing stage that we double the currently applicable negative revenue adjustments for substandard performance. Moreover, for each consecutive year that a target was missed, the level that applied in the prior year would double. Staff also proposed that each utility be required to file, within 90 days after our approval of the transaction, an assessment of all elements of the company's electric system; and, annually, a five-year forecast of planned electric system upgrades.

Staff advocated more exacting metrics to improve gas safety performance, including higher standards for replacing leak-prone gas mains and service lines. Staff proposed negative adjustments, modeled on the Grid-KeySpan Order, for failure to meet the metrics. Thus, the companies would incur a negative adjustment of 60 basis points of return on equity for failure to meet a particular standard; up to 90 basis points for failure to meet the standard in a year when a dividend restriction occurred; and up to 120 basis points for failure to meet the standard in three out of five consecutive years.

As a separate matter related to gas performance, Staff recommended elimination of NYSEG's and RG&E's current gas commodity incentive mechanism (GCIM-2). This mechanism enables shareholders to retain a portion of gas cost savings attained through joint optimization of the Energy East local distribution companies' gas supply portfolios. Staff said the mechanism rewards the companies unnecessarily, because PSL §66(e) and (f) and our regulations already require that the companies procure and manage gas supplies prudently or risk denial of cost recovery.

In the area of customer service quality, Staff proposed several upgraded metrics, and proposed to double the rate adjustments currently applicable for failure to satisfy the service quality metrics. Citing our Grid-KeySpan merger decision, Staff said we should increase the adjustments applicable in the event of failure to meet a target in multiple years. Staff also proposed that we impose additional reporting requirements regarding customer service performance.

On exceptions, Staff and MI support Staff's electric, gas, and customer service performance proposals primarily on the same grounds that we applied in the Grid-KeySpan merger case. According to Staff, NYSEG's and RG&E's performance has already slipped in several respects between 2006 and 2007. Staff says the proposed acquisition poses financial and corporate risks, which in turn can create strong incentives to allow degradation of service quality as the expenditures needed to maintain or improve service at the operating company level are diverted for the benefit of the parent company. In a few instances, Staff also justifies its proposals as providing additional tangible benefits for customers.[71]

[71] Briefs on Exceptions of Staff, pp. 50-61, 76-78, 78-85, and MI, pp. 13-19.

Petitioners criticize Staff's proposed conditions as unnecessary and inappropriate, on the ground that NYSEG's and RG&E's performance allegedly has surpassed National Grid's and KeySpan's and thus does not warrant the same level of concern or revenue adjustments comparable to those in the Grid-KeySpan merger case. Petitioners argue that any deterioration in performance from 2006 to 2007 was negligible and in almost all instances NYSEG and RG&E have met target levels. Petitioners also argue for continuation of the GCIM-2 mechanism, claiming that it encourages a level of performance exceeding the requirements of mere prudence.[72]

Petitioners' arguments against more stringent conditions for electric reliability, gas safety, and customer service performance are inconsistent with our more general conclusions about the proposed transaction's risks and potential detriments. As discussed above, we have concluded that the transaction produces serious financial and corporate risks. These in turn create a risk that resources will be diverted to meet unforeseen financial needs of the parent holding company, thus depriving the operating utilities of the funds they require to provide safe and adequate service. This type of risk is precisely the concern that led us to impose similar conditions on the Grid-KeySpan merger, notwithstanding petitioners' attempt to distinguish that decision. Regardless of past performance, the risk of harm to New York customers, as a result of the parent company's inherent incentive to address its own financial imperatives first at the operating companies' expense, should be mitigated to the extent possible by means of strengthened reliability, safety, and customer service conditions. Here as in the Grid-KeySpan case, regardless of whether the cases differ

[72] Petitioners' Brief Opposing Exceptions, pp. 70-71, 72-73, 78-84.

in the degree of potential risk for customers, similar mitigation measures are needed because the proposed transaction entails the same type of risk: that the safety and reliability of service may be degraded for reasons related to the goodwill, credit quality, and financial transparency issues of a complex international holding company.

In addition to drawing comparisons with the circumstances of the Grid-KeySpan case, petitioners insist that the potential negative adjustments for NYSEG's and RG&E's failure to meet reliability, safety, and customer service quality targets should remain unchanged because these companies already are meeting their targets and performing better than various other New York utilities. This reasoning likewise is unavailing. For the most part, we are adopting only Staff's proposals to strengthen the potential adjustments, and thus the incentives to maintain satisfactory performance, as distinguished from Staff's proposals to alter the performance targets. Thus, if petitioners are correct that NYSEG and RG&E are performing well and will continue to do so, their argument against larger potential adjustments is moot because the adjustments at issue will not be triggered. To the extent that we are adopting more stringent performance targets, the new targets will impose no unreasonable new burden or risk on the companies, because the targets are designed only to perpetuate the companies' historically achieved performance levels in the critically important area of gas safety including replacement of leak-prone pipelines.

Based on these considerations, we find that most of Staff's proposals for protecting electric reliability, gas safety, and customer service quality are reasonable means of mitigating the risks of the proposed transaction. In some instances we are modifying Staff's proposals in response to petitioners' concerns, and in some instances we are imposing conditions slightly more stringent than those Staff proposed. For customer service quality conditions, again, we will increase adjustment levels as proposed, but not revise the metrics that can trigger an adjustment; nor will we require reports other than those currently required. These matters can be revisited if necessary in future rate cases. We are adopting Staff's recommendation to eliminate GCIM-2, because the companies should not continue to be rewarded for performing their duties at a level that merely complies with the requirements of prudence and the applicable statute and regulations.

Accordingly, our approval of Iberdrola's acquisition of Energy East is subject to the conditions set forth in paragraph 1 of Appendix 2.

B. Capital Expenditures

Staff proposed that we establish, as part of an expedited rate process after the conclusion of this case, a requirement that NYSEG's and RG&E's capital expenditures for the next two years conform to the capital expenditure levels that the companies currently are planning for that period. The planned levels would be subject to Staff-sponsored adjustments so that the comparison between actual and projected expenditures would disregard NYSEG's and RG&E's expenditures for advanced metering infrastructure (AMI) and software, and RG&E's expenditures for the Russell Station repowering. If, after these adjustments, actual expenditures fell short of the projections, a credit equal to carrying charges on the shortfall would be deferred for the benefit of customers. Staff also advocated that each utility be required to file annual reports detailing capital budgets by project, actual expenditures, and variances from previously forecast levels of expenditures.

Petitioners generally opposed Staff's proposals on the ground that the proposals were, by their terms, intended for consideration in a rate case rather than here. They also argued that, as a matter of symmetry, customers not only should be credited with carrying charges on expenditure shortfalls but also should be liable for carrying charges on a portion of any overspending.

We disagree with the parties' premise, which the Recommended Decision accepted, that consideration of capital expenditure requirements should be postponed to a future rate case. Instead, we must address the matter now to mitigate the risk, discussed above, that the proposed transaction will create incentives to degrade service by cutting costs. Previously budgeted levels of capital expenditures (adjusted as necessary to exclude unjustified or abnormal items) represent the parties' best judgment as to the expenditure level needed to maintain safe and adequate service. For that reason, we have used established budgets as benchmarks in capital expenditure accountability mechanisms in rate plans for NYSEG, RG&E, and other utilities, even in the absence of merger proposals. In this case, such mechanisms are all the more necessary as a risk mitigation measure accompanying our approval of the proposed transaction, particularly because (contrary to the assumption underlying Staff's proposals) we are not initiating a rate case now in which parties would have an immediate opportunity to examine the reasonableness of capital expenditures.

We will adopt a capital target expenditure requirement of $140 million annually for NYSEG's electric department, based on Staff's testimony that the budgeted expenditures for 2009 and 2010 amount to about $285 million (an annual expenditure level about $50 million more than reflected in current rates). Similarly, we will adopt a $90 million annual requirement for

RG&E's electric department, based on budgeted expenditures of about $182 million for the same two years ($41 million more than in current rates). For each of the two companies' gas departments, the prescribed expenditure level will be set at $20 million annually, based on Staff's testimony that this represents the minimum needed to maintain safe and adequate service. After 2010, subject to further review of these expenditure levels in rate cases, we are requiring that the companies either spend 90% of these levels or clearly demonstrate in full detail that an expenditure of less than 90% will suffice to maintain safe and adequate service.

In applying these expenditure requirements for accountability purposes, we will adopt Staff's proposed measurements of capital expenditures. Thus, we will disregard software expenditures when comparing actual and projected budgets for purposes of the accountability mechanism, unless the utilities can make an affirmative showing in this proceeding that the software expenditures should be capitalized.[73]

We are not adopting Staff's proposal that the companies credit customers with the carrying charges on any shortfall in actual expenditures relative to the targets, because we will assume for now that the companies will comply with our directives to maintain the prescribed expenditure levels without the need for negative adjustments as an incentive. Thus, the companies' objection to asymmetric treatment for overexpenditures and underexpenditures is moot. However, we retain our discretion to reconsider this matter

[73] The record indicates that the actual cost of the Rochester Transmission Project (RTP) exceeded the original estimate by about 60%. Moreover, publicly available information suggests that the RTP may not provide sufficient transmission reliability in the Rochester area. We expect RG&E to address both these subjects in its next rate case filing.

should an incentive prove necessary because a company is not making the required expenditures.

Finally, we will impose a requirement, proposed by Staff and accepted by petitioners, that NYSEG and RG&E file an annual five-year forecast of their planned electric and gas system upgrades, including the expected costs of each project or program and a report of variances and reconciliation between actual and forecast expenditures for the most recently completed year. Accordingly, within 30 days of this order, DPS staff should confer with petitioners regarding the content and format of the reports, including information showing the extent to which expenditure changes are caused by schedule changes. The annual reports will enable DPS staff to monitor the companies' planning, budgeting, and construction processes, and monitor the accountability mechanisms' effectiveness in ensuring that the companies' budgeting and expenditures serve the objective of maintaining safe and adequate service to meet the requirements of current customers and future growth.

Accordingly, our approval of Iberdrola's acquisition of Energy East is subject to the conditions set forth in paragraph 2 of Appendix 2.

C. Conditions Responsive to the Rural Cooperatives' Concerns

NYAPP/NYSRECA are participating in this proceeding on behalf of four rural electric cooperatives and the Village of Sherburne, all of which are dissatisfied with NYSEG's past responses to their concerns over service quality and reliability. During the proceeding, petitioners proposed to remedy the claimed shortcomings through measures such as a task force, a NYSEG transmission study, and adoption or consideration of new protocols for service restoration priorities, communications, and enforcement. In response to those concessions, NYAPP/NYSRECA withdrew their opposition to the proposed transaction and have endorsed it.

The Recommended Decision concluded that the public benefit of petitioners' commitment to address the reliability problems is insubstantial because the proposed remedies might not materialize if the parties fail in their effort to solve the alleged problems, and because the remedial measures fall within the range of litigated outcomes possible if the cooperatives and the village filed a formal complaint with us. The Recommended Decision also found that any benefit of the proposed concessions would not be attributable to the proposed transaction because, as petitioners themselves acknowledged, the cooperatives' and the village's underlying reliability complaints involve matters unrelated to the transaction.

NYAPP/NYSRECA except, urging that we consider the reliability concessions as a benefit for purposes of the PSL §70 analysis. They say they represent small electric cooperatives and municipal electric utilities of limited means, which lack the resources to support filing a complaint and perhaps a multi-year effort to make an unwilling company comply with the decision. They concede that, if petitioners' commitments prove inadequate, NYAPP/NYSRECA may have to resort to filing complaints with us and with the Federal Energy Regulatory Commission (FERC). But they believe that petitioners' written commitments constitute a step in the right direction. They also contend that their reliability complaints are at least arguably related to the proposed merger, because reliability in rural areas and NYSEG's response times to outages allegedly have been adversely affected by NYSEG's cost-cutting measures in recent years. They hope Iberdrola's infusion of capital and its reliability commitment will improve the situation.[74] No party has replied to NYAPP/NYSRECA's exception.

We agree with the Recommended Decision that the benefit of petitioners' commitments to NYAPP/NYSRECA is minor for purposes of the public interest analysis under PSL §70. Nonetheless, we have taken it into account in our weighing of benefits and detriments. In addition, we conclude that petitioners' commitments to NYAPP/NYSRECA should be made enforceable, to ensure that the financial and corporate risks associated with the transaction do not interfere with fulfillment of the commitments so as to leave NYAPP/NYSRECA's concerns unresolved or further compromise service reliability. We therefore adopt the conditions in paragraph 3 of Appendix 2, which reflect the concerned parties' agreement.

D. Conditions Responsive to the City of Rochester's Concerns

The City of Rochester raised several concerns, including most significantly the remediation of potential safety and environmental problems at certain RG&E facilities. During the proceeding, petitioners reached agreement with the City on conditions to address these matters. Petitioners cited these commitments to the City as a benefit of the proposed transaction. The Recommended Decision found that such benefit was insubstantial because the concessions were hedged with qualifications, were within the range of litigated outcomes if the City's issues were litigated, and were unrelated to the proposed transaction. No party takes exception.

We find that petitioners' concessions to the City of Rochester do have a real, albeit attenuated, nexus to the proposed transaction, and should be considered a minor benefit

[74] NYAPP/NYSRECA's Brief on Exceptions, generally.

associated with the transaction. The most significant of the City's issues do relate to safety, and we have explained our concern that the merger's financial and corporate risks include its potential adverse effects insofar as the transaction creates incentives to avoid expenditures needed for safety purposes. As in the case of NYAPP/NYSRECA's concerns, we will make petitioners' commitments to the City enforceable to ensure that these risks do not interfere with fulfillment of the commitments or lead to compromise of safety requirements. Thus, we adopt the conditions in paragraph 4 of Appendix 2, which reflect the concessions to the City.

V. VERTICAL MARKET POWER CONCERNS RELATING TO WIND OWNERSHIP

A. Background

1. Existence of Vertical Market Power

The Recommended Decision relied upon our Statement of Policy Regarding Vertical Market Power[75] to conclude that Iberdrola's ownership of both transmission and distribution companies and wind generators would provide it with incentives to exercise vertical market power, to the detriment of both the wind generation market and consumers. The Recommended Decision found that Iberdrola's ownership of wind generation in the NYSEG and RG&E territories would interfere with the provision of economically priced wind energy and would "encumber upstate economic growth with the dead weight of excessive energy prices."[76] It therefore recommended that if we were to approve this transaction, we should impose a condition that petitioners and their affiliates may not own or operate, and must divest, any generation interconnected with NYSEG's or RG&E's

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[75] Cases 96-E-0900, et al., Orange & Rockland Utilities, Inc. – Rate Restructuring, (issued July 17, 1998), Appendix I, pp. 1-2 (VMP Policy Statement).

[76] Recommended Decision, p. 61.

transmission or distribution facilities. It further recommended that the divestiture of wind and hydropower generating facilities should follow the same schedule as the divestiture of RG&E's fossil-fueled facilities. Petitioners, Staff, GRE, MI, CPB, DEC, IPPNY, and SPM except.[77] Petitioners, GRE, CPB, DEC, and SPM challenge the Recommended Decision's finding with respect to vertical market power. MI, CPB, and DEC take exception to the proposed remedy of divestiture of wind, hydro and fossil generation, offering alternatives for consideration. Staff takes exception to requiring divestiture only of facilities located in the NYSEG and RG&E service territories, arguing for a statewide prohibition on generation ownership.

Petitioners challenge any finding that ownership of wind generation would create the ability to exercise vertical market power. They note that the VMP Policy Statement establishes only a rebuttable presumption against a transmission owner owning an affiliated generation interest in New York, not an absolute prohibition. They assert that the presumption is rebutted here by the nature of wind power, the upstate market, and FERC and NYISO oversight.

Petitioners argue that the intermittent and unpredictable nature of wind generation, with its rapidly variable input levels, makes wind powered generating facilities ill-suited to be used in the exercise of vertical market power. If a transmission owner were to attempt to create or maintain a transmission constraint to increase prices for its affiliated wind generation, they say, there would be no assurance that the wind generator would be able to run when requested. As a result of this factor, combined with wind generators' zero fuel costs,

[77] Briefs on Exceptions, of petitioners, pp. 35-47; Staff, pp. 7-8, 20-26; GRE, generally; IPPNY, pp. 2-7; MI, pp. 19-27; CPB, pp. 3-9; DEC, pp. 10-12; and SPM, pp. 7-22.

wind generators are typically bid into the energy market as price takers. Thus, petitioners continue, if a wind generator were to sell in the day-ahead energy market, it would have to assume the risk of paying the unpredictable real-time price in the event that it could not produce the committed energy. Because of this, wind generators must participate in the NYISO's much smaller real-time market. Therefore, petitioners assert, even if NYSEG and RG&E were able to create or maintain transmission constraints to increase prices for their affiliated generation, such actions would have no impact on prices in the larger day-ahead market.

Petitioners also point to record evidence that wind facilities typically have a maximum capacity factor of only about 30%. As a result, the say, any incentive that theoretically may encourage NYSEG and RG&E to manipulate transmission to increase prices for their affiliated wind generation would be far less than suggested by the nameplate capacity of such generation. Further, petitioners dispute the Recommended Decision's contention that the NYSEG and RG&E territories are on the high-cost side of a transmission constraint. As a practical matter, petitioners assert, NYSEG and RG&E would not be in a position to use their transmission to create or maintain congestion that would raise prices on the low-cost side of New York's Central East constraint.

Petitioners contend that the record is replete with evidence as to the extensive market rules and other oversight and mitigation mechanisms that have been adopted by the FERC and the NYISO since the issuance of the VMP Policy Statement. These mechanisms directly address any vertical market power concerns that could potentially arise from Iberdrola's affiliated wind development activities in New York, they assert. According to petitioners, the NYISO effectively controls all of the functions giving rise to market power concerns including transmission system dispatch and generation re-dispatch, transmission planning, and generation interconnection procedures. Thus, they conclude that any hypothetically possible discriminatory actions by NYSEG or RG&E could easily be addressed through increased transmission measures rather than divestiture.

Petitioners, GRE, and DEC point to the FERC's approval of the proposed transaction as evidence of the lack of vertical market power concerns here. Petitioners insist that the FERC concluded that the transaction would raise no such concerns, given the comprehensive nature of the existing regulatory framework. Staff notes, however, that the FERC has declined to decide issues raised in the VMP Policy Statement, conceding that compliance with the Statement is the province of this Commission. Staff adds that the U.S. Government Accountability Office has called for the FERC to exercise greater vigilance in reviewing merger transactions.

Petitioners also assert the Recommended Decision's reliance on the Grid-KeySpan Order is misplaced as a basis for supporting a restriction on Iberdrola's affiliated wind activities. In the Grid-KeySpan case, the 2,400 megawatt (MW) gas-fired Ravenswood Generating Station serving the New York City load pocket presented issues significantly different from those presented by Iberdrola's affiliated wind projects. Any wind generators interconnected to the NYSEG or RG&E systems would represent only a small share of the NYISO western market, which has excess supply and is connected to other regional transmission operators that provide additional supply elasticity in the energy and capacity markets. Petitioners argue that the Grid-KeySpan Order therefore does not provide support for the Recommended Decision's proposed prohibition on the ownership or operation by Iberdrola's affiliates of wind generators interconnected to the NYSEG and RG&E systems.

GRE argues that requiring Iberdrola to divest its current wind generation projects and precluding it from developing additional wind capacity in New York is counter-productive to the revitalization of the region's economy. It states that Iberdrola's willingness to publicly commit $2 billion in support of renewable energy initiatives in New York State is bold and speaks volumes of petitioners' willingness to assist in finding a solution to the State's long-term energy needs.

Both CPB and SPM argue that the Recommended Decision's treatment of Iberdrola's interconnected wind generation is inconsistent with the PSL. They suggest that the size of the three Iberdrola renewable wind farms proposed to be connected with NYSEG's transmission facilities, each less than 80 MW, may exempt them from the VMP Policy Statement. In any event, they cite the PSL as encouraging the participation of utilities in alternate energy production facilities either directly or through subsidiaries. SPM argues that, if direct and indirect ownership by utilities is encouraged, then application of the VMP Policy Statement should take that into account. SPM urges us to find that ownership by Iberdrola Renovables ("Renewables") of interconnected wind generation at the levels currently in the NYISO queue is factually insufficient to create vertical market power, or, alternately, that the VMP Policy Statement's rebuttable presumption has been met.

Staff argues that the potential for the exercise of vertical market power is demonstrated by the example of the Ginna Nuclear Power Plant, which has been forced to substantially reduce its output because of actions that RG&E took to maintain the company's transmission system. Staff contends that, as a result, prices increased to levels 55% higher than when Ginna was feeding its generation into the system.[78] Staff continues that such a price premium can be created even though wind generation is weather dependent. As the ability to monitor and predict wind flows grows in the future, Staff predicts, it will be even easier to take a competitor off line at the time when the potential for producing wind generation reaches its optimum. According to Staff, preventing competitor deliveries for periods as short as a few hours might be financially beneficial when the breeze is strong. Staff adds that high winds, a well-known cause of outages, will also serve as a convenient excuse for delivery outages that affect competitors' generation.

Staff disputes the claims that the NYISO and FERC supervision of the transmission system will prevent this exercise of vertical market power. Staff first notes that the NYISO and the FERC were unable to prevent Ginna from losing delivery service even though Ginna could rely upon and collect contractual rights as well as appeal to those entities. Staff also notes that the personnel that actually operate the NYSEG and RG&E T&D systems are not NYISO or FERC personnel, but employees subject to retention or dismissal by NYSEG and RG&E who assertedly will act on petitioners' behalf. Staff thus concludes that both the incentive and avenue for exercising vertical market power exists when Iberdrola controls both T&D operations and wind generators.

In response to claims that the NYISO and the FERC would ensure that Iberdrola's wind developer competitors are treated fairly when seeking to interconnect with the RG&E and NYSEG delivery systems, Staff counters that such competitors

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[78] Staff's Brief Opposing Exceptions, p. 7, citing Transcript pp. (Tr.) 1272-73.

might reasonably shrink from filing complaints and taking other actions necessary to preserving their NYISO and FERC rates because the process is too expensive and time-consuming. Again, Staff cites the example of Ginna, stating that its operators filed a complaint on June 25, 2007 which is still not resolved.[79]

IPPNY asserts that granting petitioners an outright exemption from the VMP Policy Statement would reverse more than a decade of consistent Commission policy favoring competitive electric generation markets. We consistently have favored divestiture as the surest way to address market power abuses, IPPNY states, and we reaffirmed our policy favoring divestiture in the KeySpan-Grid decision.

IPPNY discounts the claims that NYISO and FERC market rules can sufficiently address petitioners' ability to exercise market power in their own service territories. Petitioners' arguments address only one potential way to exercise vertical market power, IPPNY states, and wholly ignore the intense competition in New York to secure Renewable Portfolio Standard (RPS) dollars for certain projects. According to IPPNY, petitioners could exploit the NYISO planning process to give favored treatment to their own proposed generation development. IPPNY observes that the NYISO has no control over the maintenance projects that transmission owners either propose in the first instance or actually perform. Additionally, there are significant amounts of lower voltage transmission or sub-transmission over which the NYISO does not exercise control, IPPNY asserts. IPPNY concludes that there is an existing incentive for transmission owners to use transmission outages to harm competitors financially or to delay competitors' projects while benefiting their own facilities.

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[79] Ibid., p. 9, citing Tr. 1266.

IPPNY also raises concerns about the current NYISO process. According to IPPNY, the possibility that generation could be curtailed due to insufficient transmission capacity creates yet another opportunity for NYSEG and RG&E to favor affiliated projects by moving quickly to resolve transmission constraints that affect their affiliated projects but not those which affect competitors.

IPPNY concludes that a blanket, rather than a case-by-case, prohibition on the ownership of generation interconnected to NYSEG or RG&E is the best means to ensure that there are no incentives to exercise vertical market power. It states that regulatory oversight is extremely difficult, costly, and inefficient to apply on a case-by-case basis. IPPNY adds that, contrary to the petitioners' and others' suggestions, the threat of NYISO or FERC-imposed sanctions may not be adequate to prevent future market power abuse. In any event, such sanctions would not cure the effects of the market power abuse, IPPNY says.

2. Mitigation Measures as an Alternative to Wind Divestiture

Because the Recommended Decision favored divestiture of wind projects within the Energy East service territories, it did not discuss at any length the imposition of mitigation measures that might be appropriate were we to allow continued ownership of wind generation. It did note three alternative proposals raised by SPM on brief: (1) long-term contracts between each wind project and NYSEG or RG&E; (2) long-term contracts between the wind projects and a third party, and (3) divestiture of the NYSEG and RG&E transmission systems. On exceptions, IPPNY argues the SPM proposals should have been dismissed as untimely and without record support because they were not offered in testimony, could not have been addressed on rebuttal, and were not offered on the record so they could be subject to discovery and cross-examination. IPPNY adds that raising new proposals in reply briefs runs contrary to the customary practice that reply briefs should be limited to addressing arguments raised by other parties, and that we therefore should dismiss SPM's proposals on procedural grounds.

SPM responds that IPPNY's request to have the SPM proposals dismissed should itself be dismissed as time barred. SPM argues that the proper time to join this dispute was before the Recommended Decision. SPM states that the fact that its proposals were not offered in testimony is of no consequence because they were completely conceptual.

On exceptions, Staff proposes alternatives to divestiture. While Staff cautions that only separation of T&D and generation functions will adequately protect ratepayers from the exercise of vertical market power, Staff notes that we could instead provide for various procedural and contractual protections if we decide to approve the transaction. Staff suggests that we consider (a) subjecting all further Iberdrola generation projects to Commission review; (b) requiring independent transmission studies; and (c) requiring contracts for differences. Staff states these protections still would not fully eliminate the risk that Iberdrola might exercise market power and would require our vigilant and active supervision.

According to Staff, these additional procedures could include review of vertical market power issues in proceedings to evaluate Iberdrola's proposals to build specific generation facilities. Staff notes that under PSL §68, we must approve any wind generation facility sized in excess of 80 MW. Staff states that, for facilities sized at 80 MW or less, Iberdrola must obtain permission under PSL §66-c(3) to create a subsidiary that will own the wind generation facility.

Staff recommends that we consider requiring Iberdrola to fund independently conducted studies, at least once every three years, of the T&D system reinforcements and upgrades needed within the NYSEG and RG&E service territories to accommodate new wind projects and avoid exercises of vertical market power. Staff claims these studies would enable Iberdrola's competitors to plan their wind projects and bring to light circumstances where Iberdrola and a competitor pursue projects that would use some of the same T&D facilities. Staff continues that such studies would also encompass transmission additions that would increase transfer capacity between adjoining states and regions, to prevent the "line that is not built" from escaping detection and thus benefiting petitioners' generators at customers' expense.

Staff adds that Iberdrola could be required to enter into contracts for the output from its wind generation facilities that disconnect its revenues from the NYISO's market prices. It continues that these contracts could be structured as contracts for differences. Staff says the term of any such contract should be at least ten years, and Iberdrola's affiliates should be excluded as counter-parties. According to Staff, such contracts would dampen the incentive for Iberdrola to use its monopoly T&D powers to raise prices for all generation in upstate New York. Staff argues that Iberdrola's incentive to exercise vertical market power exists even if Iberdrola owns generation facilities only outside the NYSEG and RG&E service territories, because Iberdrola can use the T&D assets to raise the prices paid for generation across New York. Staff adds that the Recommended Decision, in limiting its recommendation to the T&D service territories of NYSEG and RG&E, misinterpreted the VMP Policy Statement. According to Staff, nothing in that statement indicates that utilities are permitted to own generation outside their T&D service territories.

Petitioners argue that each of Staff's suggested alternative mitigation measures should be rejected as without evidentiary or precedental basis, stating there is no discussion on the record of the three "eleventh-hour" alternatives identified by Staff.[80] Petitioners argue that, since the record evidence supposedly shows that the proposed transaction raises no vertical market power concerns, it would be inappropriate to impose any restrictions other than those applicable to wind developers in the State generally. They add that the adoption of one or more of Staff's alternative proposals would have the same result as the statewide prohibition in that it would reduce, if not terminate, Iberdrola's investment in wind generation in New York.

According to petitioners, nothing in the statutory language supports Staff's view that PSL §66-c(3) could be used to override the express terms in PSL §§2(4) and 2(13) exempting alternate energy production facilities from Commission jurisdiction. Petitioners continue that Staff's proposal to justify such an extension of our jurisdiction is contrary to the express language of PSL §66-c(3) which expressly provides that "any such subsidiary corporation shall be exempt from any regulation by the Commission under this chapter."

Petitioners concede that PSL §68 will apply to the construction of generation facilities by Iberdrola's affiliates that are not otherwise exempt. However, they request clarification that any Iberdrola affiliate that submits a §68 petition will be subject to the same standards that apply to any wind developer in the State generally.

[80] Petitioners' Brief Opposing Exceptions, p. 19.

Petitioners also find untenable CPB's statement that, with respect to projects exceeding 80 MW, petitioners would have the burden of proof that their ownership of generation in Energy East's service territory would create no realistic opportunity to interfere with competitive markets. If Iberdrola affiliates are exposed to the possibility of a mandatory divestiture of their wind projects on the basis of vertical market power concerns raised in PSL §68 proceedings, petitioners assert, the resulting uncertainty would have a chilling effect on wind development. For this reason, they say, we should specifically find that Iberdrola's affiliated wind projects do not raise vertical market power concerns in New York State.

In response to Staff's proposal that Iberdrola be required to establish an independent transmission planning process, including funding an independent transmission study every three years, petitioners argue that the NYISO already performs, oversees, or reviews all interconnection studies needed to accommodate new generation to ensure they are fair and not discriminatory.

Petitioners state that Staff's reference to our recent Commission order granting a PSL §68 certificate to Marble River[81] provides no support for Staff's proposal to impose a transmission study obligation on Iberdrola. Instead, petitioners argue that the Marble River order recites a litany of the substantive functions performed by the NYISO in the interconnection process. Petitioners say the order thereby supports their position that, given the independent role of the NYISO in interconnection study matters, NYSEG or RG&E could not

[81] Case 07-G-1343, Marble River LLC, Order Granting Certificate (issued June 19, 2008), cited in Staff's Brief on Exceptions, p. 23.

manipulate the interconnection process even if they were so inclined.

In response to Staff’s proposed contracts for differences alternative, petitioners state that mandating such contracts would increase costs for Iberdrola’s affiliated wind projects as compared to other facilities, so that Iberdrola’s affiliates would be less likely to invest in wind development in New York.

DEC commends Staff for providing possible alternatives to divestiture and argues that, in doing so, Staff is furthering the short- and long-term energy goals that have been set by both the Governor and the Commission. DEC adds that between Staff’s suggestions and the record established to date, we have ample justification to allow Iberdrola to proceed without divestiture on the basis that the importance of generating wind power in New York State outweighs whatever opportunities may exist for imposition of vertical market power.

SPM applauds Staff’s approach to provide alternatives that would satisfy the public interest and meet Iberdrola’s goal of investing in renewable generation assets in New York. SPM does not oppose the independent transmission planning function proposed by Staff; but SPM suggests that the NYISO’s Transmission Planning Advisory Subcommittee, a long-established adjunct to its Operating Committee, should be consulted first. SPM says the Subcommittee may be undertaking the studies that Staff believes are needed and, if not, it could so because this group of experienced transmission planners have worked on such issues since the NYISO’s inception in 1999. SPM argues that this institutional knowledge and background should not be ignored in favor of an approach that would basically “re-invent the wheel.”

With respect to Staff's proposed contractual conditions, SPM argues that Staff has not explained how projects bidding in at zero will increase rather than decrease market prices. SPM reiterates that Staff's vertical market power concerns are more theoretical than real and, as a result, Staff's proposed contractual conditions are unnecessary under all the facts and circumstances present in this case. SPM continues that we need not impose any conditions now, because it would be better to review the specific facts on a case-by-case basis so any mitigation measures can be tailored to the specific concerns surrounding each project.

In response to the Staff and SPM proposals for alternatives to mitigate vertical market power if we approve the transaction, IPPNY contends that their proposals fail to adequately address the potential exercise of vertical market power and, in fact, demonstrate the problems inherent in trying to piece together remedies when the only complete solution is full divestiture. Specifically, IPPNY reiterates its previous observations that both proposals came very late in the process. It adds that they are vague and ill-defined measures that raise numerous substantive problems. For example, IPPNY contends that Staff's proposed project-by-project review will not be able to identify impediments that Iberdrola may be erecting against entry by its competitors. IPPNY claims that both the SPM and Staff proposals to require Iberdrola's unregulated affiliates to enter into long-term contracts may have adverse consequences on the competitive wholesale markets, and on the competitive solicitations conducted by the New York State Energy and Research Development Authority (NYSERDA) to implement the RPS.

IPPNY contends, for example, that SPM's first alternative (requiring long term contracts with NYSEG and RG&E) may effectively provide cost of service based recovery for all wind developers that interconnect with NYSEG and RG&E's transmission system. Alternatively, IPPNY says, SPM's proposal could be interpreted to require NYSEG and RG&E to execute standard offered contracts with all developers that propose wind projects. Under either alternative, IPPNY says, NYSEG and RG&E ratepayers could be required to bear above-market costs of renewable generation. IPPNY claims that this would radically alter our RPS policy and would reduce competition in the process.

With respect to Staff's proposed use of contracts for differences or, for that matter, any long-term fixed price contract, IPPNY claims that reliability might be adversely affected. For example, it claims that since the payments under the contracts would be unrelated to the value of energy at the time it is produced, the contracts would create an incentive for the project to continue operating even at times when additional generation from the projects threatens to overload the transmission system. IPPNY adds that if contracts are to be used as a method of ameliorating the potential exercise of vertical market power, then they must provide penalties for generating more energy than the transmission system can handle. Moreover, such penalties would need to be sufficiently high to override the payment that the project receives through the contract.

IPPNY continues that both Staff's and SPM's remedies by definition can only address the exercise of market power intended by petitioners to increase market power prices. It states the proposals would do nothing to remove the incentive for NYSEG and RG&E to enter into favorable agreements with their affiliates and then pass those costs through regulated rates to their customers. IPPNY further adds that none of the contract proposals address concerns that market power will be used to hamper competitors from obtaining RPS dollars in getting their projects built.

B. Discussion

1. Existence of Vertical Market Power

In 1998, we established our policy on the ownership of generation by T&D company affiliates. Our VMP Policy Statement stated that "[t]o guard against undesirable incentives, a rebutta[ble] presumption will exist for purposes of the [PSL §70] review of the transfer of generation assets, that ownership of generation by a T&D company affiliate would unacceptably exacerbate the potential for vertical market power."[82]

The VMP Policy Statement describes two ways that the presumption of unacceptability can be overcome. The first exception to the presumption of unacceptable vertical market power is a showing that vertical market power cannot be exercised, either because circumstances do not give the T&D company an opportunity to exercise market power or because vertical market power can be completely mitigated. The second would be for the T&D company to demonstrate that substantial ratepayer benefits, together with mitigation measures, warrant overcoming the presumption.

We do not accept the contention of petitioners and others that a combined T&D and wind generating company would have no opportunity to exercise vertical market power, nor do we find that vertical market power can be completely mitigated. In the absence of these factors, the first prong of the test put forth in our VMP Policy Statement is not met.

We emphasize that the vertical market power risk at issue here is a risk that the T&D company will engage in anticompetitive activity. As the operator of monopoly

[82] VMP Policy Statement, pp. 1-2.

bottleneck services, the T&D company (in this case NYSEG or RG&E) has market power. When the T&D company becomes affiliated with a generation company, such that their common shareholders will benefit from profits of the generation company, the T&D company gains the incentive to wield its market power for the benefit of its generation affiliate. Consequently, all petitioners' arguments about the behavior of wind generators miss the real concern, namely that the behavior of T&D companies can raise wholesale prices and thus harm consumers.

Petitioners' point that the intermittent nature of wind generation typically makes wind generators "price takers" may be true, but even a price taker benefits if the overall market clearing price of power in its region is high. Moreover, such generators have an interest in ensuring that other wind generators are excluded from the market, suffer from increased costs and/or delay in entering the market, and are otherwise disadvantaged by actions that the T&D company could take in making interconnection difficult or slow. These incentives exist whether the wind generator is participating in the day-ahead market or the real-time market.

Petitioners are also correct that wind generators' lower capacity factors mean that a T&D company's incentive to increase prices for its affiliated wind generation is less than would exist if the generator operated at its nameplate capacity. However, this does not rebut the presumption raised by the VMP Policy Statement. If anything, it serves as an admission by petitioners that vertical market power incentives exist and that they increase as the amount of generation produced by the generation affiliate of the T&D company increases.

There are at least three ways that petitioners could exercise vertical market power here. First, the Central-East interface within New York is not the only relevant transmission constraint. As Staff alleged in its testimony, the T&D companies (NYSEG and RG&E) will have an incentive to refrain from making transmission investments to overcome any constraints that may be causing a price differential between the upstate New York wholesale electric markets and lower-priced markets in Canada and in the Pennsylvania-New Jersey-Maryland (PJM) interconnection region. Making such connections would lower wholesale prices in upstate New York, thereby impairing the profits of the Iberdrola-owned wind generators. Of course, we recognize that upstate New York is on the lower-priced side of an intrastate constraint that prevents generation from reaching the higher-priced New York City market, a condition that provides NYSEG and RG&E an incentive to build their T&D systems to link to the New York City market. In practice, therefore, the incentives here make the probability of harm, for New York customers overall, lower than it otherwise would be.

Second, the T&D companies would have an incentive to create difficulties for competing wind generators in the interconnection process. The interconnection queuing process, as administered independently by the NYISO, is fairly transparent and is subject to FERC-approved tariffs. However, NYSEG or RG&E theoretically could discriminate in the interconnection planning and design processes in the timeliness of studies and design; in the appropriateness, cost and difficulty of the required design; and in alternatives considered, offered, or withheld. Such behavior makes the interconnection process more difficult and more costly to rival generators in the hope that such generators can be kept out of the market altogether or, at a minimum, will experience higher costs. Such higher costs will affect the overall market and therefore harm consumers.

Third, the T&D companies will have an incentive to reinforce their transmission systems in ways that favor Iberdrola's wind generation, to the detriment of competitors' generation. The need for transmission reinforcement relates to the ability of a wind generator to move all of its wind power to the upstate wholesale market. Wind developers' eligibility to sell installed capacity because the capacity is deemed deliverable does not necessarily mean that the wind-generated output is also economically deliverable. Moreover, a new generator may be interconnected in such a way that it potentially replaces other renewable generation in certain hours. In such a situation, new transmission, if cost-effective, should be installed to address the problem and thereby enable more renewable power to be sited in the area and moved to market. In this case, the T&D companies will have the incentive to spend ratepayer monies to add transmission to alleviate any bottled generation problems experienced by their affiliated generators, whereas they will have a disincentive to add transmission to alleviate similar problems of competing generators. In this circumstance, the resulting harm affects not only consumer prices but also the pursuit of the State's renewables goal.

Petitioners' focus on the characteristics of wind generation misses the point that the market power would be exercised by the T&D companies. Both Staff and IPPNY list several "real world" examples of potential bad behavior that petitioners would be motivated to engage in by virtue of their combined T&D and wind generation interests. These examples have not been rebutted on the record, and we are persuaded that they represent a real risk that cannot be completely mitigated.

We note that both the motivation and the means for the Energy East T&D companies to take actions that advantage their affiliated generators and/or disadvantage competing generators exist, in most instances, without regard to whether the affiliated generators are directly connected to the Energy East transmission system. For example, so long as the affiliated generator is located in the upstate wholesale market, there is an incentive for an Energy East T&D company to delay or otherwise hinder the interconnection arrangements or transmission upgrades necessary to accommodate a competing generator in one of the Energy East service territories, since such behavior raises the upstate New York market price. Indeed, it is arguably easier for the Energy East companies to "go slow" on all such arrangements with competing wind generators if the Energy East-affiliated generators are located outside their service territories, so that the Energy East delay tactics appear to occur on a completely nondiscriminatory basis. These and other scenarios point out the weakness of the distinction drawn in the Recommended Decision between generation within the Energy East service territories and generation located elsewhere in upstate New York. For this reason our VMP Policy Statement makes no such distinction but instead raises a general presumption against a T&D company in New York State owning generation in the State, whether or not it is in the T&D company's service territory.

We are well aware of the market rules and oversight provided by the FERC and the NYISO intended to prevent the exercise of vertical market power. Again, these measures are indicative of the extent to which vertical market power is a concern and requires intervention to be curbed. We are not persuaded, however, that regulatory oversight and market rules render impossible the exercise of vertical market power by a combined T&D and generating company. Our own regulatory experience teaches us that regulatory oversight never can detect every instance of behavior that is contrary to regulatory interests, where incentives are in place that encourage contrary behavior.[83]

The only effective way to completely eliminate the incentive and opportunity of a combined Iberdrola/Energy East to exercise vertical market power would be to require Iberdrola to divest its wind assets and forbid it from developing new ones. Such a condition, however, is not a realistic option in this case. Iberdrola has made clear that a prohibition on wind generation ownership would be an absolute "deal breaker" from its point of view, so that it would decline to move forward with the acquisition in that circumstance. Moreover, Iberdrola has suggested that its expertise as a wind developer is a great benefit associated with this transaction, which could be lost if Iberdrola withdrew from wind development in New York as a consequence of our failure to approve this acquisition.

As discussed in Point VI, below, we assign relatively little weight to the claim that the transaction will benefit wind generation, nor does that claim determine our decision here. Rather, we approve the transaction based on the PBA requirements we are adopting, which will provide real and concrete net benefits to Energy East ratepayers. We recognize that such approval necessarily means that Iberdrola will be allowed to continue to develop and own wind generation in upstate New York. In reaching our decision, we have analyzed the matter in accordance with the second prong of the test prescribed in the VMP Policy Statement.

That second test in the VMP Policy Statement provides that we can allow ownership of generation assets by a T&D

[83] We also conclude that the FERC's approval of this transaction does not bear on our analysis of this issue, which the FERC expressly declined to address.

company provided we impose mitigating conditions (which will reduce, although not entirely eliminate, the vertical market power risks) if we also find that the transaction produces substantial benefits for ratepayers. Our decision here on the vertical market power issue thus depends ultimately on the creation of the substantial benefits conferred by the PBAs, as discussed in Point VIII, below. Our approval is also based on our assessment that the mitigation measures we impose are likely to be relatively effective, given the nature and magnitude of the generation at issue here.

We assume here that only a relatively small amount of total generation assets are at issue. As discussed below, the development of wind resources worth $200 million corresponds approximately to 100 MW of completed wind construction. Similarly, Iberdrola's hopes for investment of up to $2 billion in the State translates roughly into a capacity of 1,000 MW, a level of capacity that is still relatively small compared to the total capacity statewide of over 40,000 MW. Moreover, as previously noted, such plants tend to operate at a relatively low capacity factor, further reducing the magnitude of the output as a profit-making factor affecting Iberdrola's incentives.

We also note that the vertical market power concerns presented in this case are less severe than those in the National Grid-KeySpan case, where vertical market power problems prompted us to require the divesture of the Ravenswood Generating Station in New York City as a condition of the acquisition. For example, New York City is a clear-cut load pocket that unquestionably has substantially higher prices than its neighboring markets, whereas the western upstate New York market is a load pocket only some of the time, and its prices are only slightly higher than those in the neighboring regions of PJM and Canada. Also, the Ravenswood plant’s 2,400 MW was a much larger amount of generation than the level we expect Iberdrola to ultimately own, which may be approximately 1,000 MW based on the $2 billion investment plan. Finally, a prominent potential new source of supply for New York City would be construction of a new transmission line to increase the amount of low-cost power that can be moved into the City. In contrast, for upstate New York, the main source of new supply will be generators that locate directly within that upstate market.

Therefore, National Grid’s ability to influence transmission into New York was of greater importance in our vertical market power analysis in the Grid-KeySpan merger than is the corresponding role of RG&E or NYSEG in influencing transmission investment in this case. Here, the probability of harm is much less certain than the risk presented by a combined National Grid and KeySpan company continuing to own Ravenswood.

Our decision in this case does not change our policy on vertical market power. Any future PSL §70 filing that seeks our approval of the ownership of generation by a T&D company affiliate will need to demonstrate either that vertical market power cannot be exercised or that substantial ratepayer benefits, together with mitigation measures, overcome the presumption that would otherwise bar a T&D company from owning generation.

2. Mitigation Measures

Because we have decided to let Iberdrola continue to build and operate wind generation in the State, we have given serious consideration to the mitigation measures proposed or discussed by the parties at the briefing stages of this case. Although this issue arose late in the proceeding, it involves legal and policy arguments that can adequately be addressed in reliance on briefs and our considerable experience with these issues.

IPPNY's criticism of some of the mitigation measures proposed by the parties is that they did not address the full range of harms identified by IPPNY and Staff related to the ownership of wind generation by a T&D affiliate. The need to closely tailor mitigation measures to the perceived harms flowing from such combined ownership is paramount. Consequently, we have considered mitigation measures in light of the potential problems identified in this record as resulting from the ownership of wind generation.

While both Staff and SPM urged us to consider various forms of long-term contracts or contracts for differences for the output of Iberdrola's affiliated wind generation, we decline to adopt such proposals. We agree with objections raised by various parties that these alternatives raise significant problems of their own in terms of their effect on the costs of Iberdrola's wind projects or their uncertain effects on competitive markets generally and specifically on the competitive solicitations conducted by NYSERDA to implement the RPS. Indeed, we condition this transaction on the requirements, as described in Appendix 3, that any investments in wind facilities shall be carried out through Iberdrola subsidiaries other than NYSEG or RG&E and that NYSEG and RG&E shall not enter into power purchase contracts with any affiliate or subsidiary.

a. Alleviating Transmission Constraints

One of the concerns raised in this case is whether petitioners would forgo investing in needed economic transmission projects such as those improving connections to PJM or Canada, in order to raise upstate New York wholesale prices and thus advantage their own generators. The NYISO's FERC-approved proposed economic planning process, once implemented in 2009, is intended to provide information that would potentially identify economic transmission opportunities. Given that electric markets are regional in nature, a NYISO regional economic planning process for addressing this issue is appropriate. In addition, New York transmission owners collectively are engaged in a study to address potential new transmission investments needed in the state both for reliability and economic purposes, over a 20-year horizon. These two studies suffice, at this time, to inform us of potential economic transmission investment opportunities that transmission owners or other developers can pursue. Therefore, we will not adopt Staff’s recommendation that we require the Energy East companies to perform similar studies of their own. Should we determine that identified opportunities are not being pursued by transmission owners or developers, we can take appropriate action to facilitate those investments.

b. Generator Interconnection Process

The ability to ascertain if a T&D company has discriminated against a generator in the interconnection process is somewhat complicated by the fact that: (a) engineering judgment is involved; (b) interconnection requirements and criteria are not necessarily uniform across utilities; and (c) interconnection requirements will vary depending upon specific locations and circumstances. Consequently, the measures set forth in Appendix 3 regarding the generator interconnection process address the need to protect competing non-affiliated generators from discrimination while allowing petitioners to protect their own legitimate interests and those of their ratepayers.

c. Generator Energy Deliverability

We have considered two types of generator deliverability. The first is a reliability or capacity version of generator deliverability which pertains to the ability of a new generator to be eligible to participate in the NYISO installed capacity market. The NYISO has developed a process, a set of requirements and cost responsibility, and testing requirements that have been filed with the FERC for implementation. Given the NYISO's actions and oversight, we will not impose any additional mitigation measures relating to this type of deliverability.

For the second type of generator deliverability, "economic" or energy deliverability, no process or set of requirements has yet been formally adopted. Recently, while approving the certificate of public convenience and necessity for the Marble River wind project, we expressed concern about the energy deliverability of wind projects located in "bottled" generation pockets. We requested that future applications include an analysis of energy deliverability, which would provide information on whether transmission is sufficient under most conditions to allow a generator's available energy to be delivered to load (even under minimum load conditions).[84]

Here, we will impose mitigation measures that help provide more transparency regarding economic deliverability and a more standard approach to incorporating economic deliverability into interconnection designs and system upgrades. These are set forth in Appendix 3. The Appendix also contains conditions regarding notification and resolution of disputes that may arise with respect to either interconnection or energy deliverability.

[84] Case 07-E-1843, supra, Order Granting Certificate (issued June 19, 2008), pp. 13-14.

d. Monitoring Future Investment

Iberdrola's stated goal is to invest up to $2 billion in the development of wind energy in the State. We anticipate that many of Iberdrola's wind development projects will be of a sufficient size to come before us in the context of an application pursuant to PSL §68 for a certificate of public convenience and necessity. It is also possible, in the future, that Iberdrola may choose to acquire outright or invest in a partial interest in wind generation projects that have been or are being developed by others. Again, to the extent the generating projects are of sufficient size or the level of investment is sufficient to require our approval under PSL §70, we will pass upon the public interest considerations of such transactions when they come before us. At that time, we will take into consideration the vertical market power effects of these transactions, based upon our understanding of the level of Iberdrola's wind generating interests in the State at that time. Consequently, we will require Iberdrola to keep us informed as to the level of its wind interests in the State, as reflected in the final condition of Appendix 3.

VI. IBERDROLA'S OWNERSHIP AND DEVELOPMENT OF WIND GENERATING FACILITIES

Given our decision here to approve the transaction while allowing Iberdrola to retain wind generation assets, we now look to Iberdrola's wind assets and expertise to evaluate how they might affect the pursuit of our wind development goals.

A. Background

During the proceeding, petitioners stressed Iberdrola's corporate commitment to, and expertise and experience in, renewable energy development. Iberdrola also made what it terms a “legally enforceable” commitment to support the investment of $100 million through its affiliate, Iberdrola Renewables, in development of wind generation facilities in New York over the next three years, if the merger is approved.[85] The Recommended Decision concluded that Iberdrola’s status as a potential wind energy developer in New York should not be considered a benefit of the proposed merger. As noted above, it recommended that if the merger is approved, Iberdrola should be barred from developing or owning wind generation in the NYSEG and RG&E service territories, to prevent vertical market power risks. The Recommended Decision observed that Iberdrola’s acquisition of T&D utilities could make its development of wind generation a public detriment, rather than a benefit, because its vertical market power could impair potential economic

[85] Petitioners qualify this commitment by stating that it stands only so long as there is “no material adverse change to the existing fundamental economics of wind generation development in New York State.” (Petitioners’ Brief Opposing Exceptions, p. 6, quoting from Partial Acceptance, Exh. 50, p. 2.) According to petitioners, Iberdrola would thus be relieved of its commitment should the federal production tax credit or New York’s RPS subsidies be eliminated or reduced, or should there be material changes in the market price for power in the market maintained by the NYISO. (Ibid., p. 6.) However, this qualification does not extend to the economics of any individual wind project, such as land rights acquisition, financing, construction, interconnection, or operation and maintenance. (Ibid., pp. 6-7.)

After the conclusion of the evidentiary hearings, Iberdrola made various press announcements referring to its investment of $2 billion in wind generation in New York if the proposed merger is approved. Following the Recommended Decision’s request for clarification of the level of Iberdrola’s investment commitment, petitioners have clarified that Iberdrola’s commitment is limited to $100 million, while the $2 billion represents merely its “hope.” (Ibid., p. 10.) Staff notes that $2 billion would be the cost to develop approximately 1,000 MW and that Iberdrola had stated on the record an intention of developing that quantity of wind capacity.

advantages of wind generation and deter potential competitors from developing wind generation.

The Recommended Decision also found it dubious to consider Iberdrola's renewables philosophy, resources, and expertise a benefit linked to the proposed merger. It endorsed Staff's position that Iberdrola's pursuit of wind generation development is unrelated to its ownership of transmission and distribution utilities because, among other things, a lack of T&D utility subsidiaries has not deterred Iberdrola from investing in wind projects in Pennsylvania, Oregon, or Texas, nor has acquisition of a regulated utility induced it to plan for wind projects in Maine. The Recommended Decision rejected petitioners' suggestion that our approval of the acquisition would influence Iberdrola's wind investment decision by convincing Iberdrola that New York's regulatory climate is receptive to that investment. It found that a large, sophisticated firm like Iberdrola would base major investment decisions primarily on financial considerations, and that the economic climate for wind generation is even more favorable in New York than in other states where Iberdrola already has invested in wind facilities. It concluded that our disapproval of the proposed merger probably would not lead Iberdrola to act against its own interests by forgoing economically viable wind investment in New York.

The Recommended Decision found that, in any event, Iberdrola's commitment to develop wind projects in New York depends on factors such as market conditions, availability of RPS subsidies and federal production tax credits (PTCs), regulatory approvals of the projects, and availability of financing. It noted that, because these factors affect all potential wind developers, the record does not establish that Iberdrola is any more likely to bring renewable generation to fruition than are other large developers. It concluded that if Iberdrola withdrew from the market because the merger was disapproved, the public interest would not suffer, because other developers would likely make wind investments in its stead to the extent economically viable.

Petitioners except to the finding that Iberdrola's renewable resources expertise and its commitment to support investment of $100 million in wind generation will not provide positive benefits resulting from the proposed merger. Petitioners suggest that Iberdrola can deploy its finite investment resources in other economically attractive locations if it concludes New York is unattractive from a regulatory standpoint because we have not approved the proposed merger on conditions Iberdrola views as reasonable. Petitioners, supported by GRE, CPB, and DEC, also argue that the Recommended Decision gave too little weight to the record evidence that Iberdrola's corporate renewables leadership, expertise, experience, and demonstrated capability to complete wind generation projects make it particularly well positioned to help meet New York's goals in developing renewable energy resources. Petitioners emphasize that the $100 million commitment to develop wind generation unquestionably falls in the category of tangible and material benefits for the State that will not be realized if the proposed merger does not occur.[86]

Staff, MI, and CPB all either reject or discount the value of the $100 million wind generation commitment as hedged by significant contingencies that would allow Iberdrola to escape the commitment or render it unenforceable. MI points specifically to Iberdrola's commitment only to "support and encourage" such investment by Iberdrola's subsidiary,

[86] Briefs on Exceptions, of Petitioners, pp. 23-27; GRE, generally; CPB, pp. 9-11; and DEC, pp. 5-10.

Renewables, which could be avoided if: (1) we impose any limitations on Renewables' future development of wind energy as a result of this case; (2) Renewables, as an entity distinct from Iberdrola, does not or cannot make the investment; or (3) Renewables is unable to obtain all necessary development approvals. Petitioners claim that the qualifications on their commitment are standard conditions necessary to address matters beyond their control. Petitioners also argue that the commitment can readily be made enforceable by incorporating it as a Commission condition of approval of the proposed merger.

Staff and MI consider Iberdrola's claimed commitment, besides being subject to caveats, to be of relatively little significance. MI says that Iberdrola's commitment not only is heavily hedged but equates to no more than about 50 MW of wind generation, or about five percent of the projects already "on the planning board" or under development in New York. Both Staff and MI believe that such a small level of investment in wind development will likely be made, whether by Iberdrola or others, regardless of the outcome of this proceeding.

Staff and MI also support the Recommended Decision's finding of no substantial relationship between Iberdrola's commitment to develop wind generation in New York and approval of the proposed merger. Both believe the lack of any correlation between Iberdrola's ownership of operating utilities and development of wind generation in other states demonstrates that economic considerations, rather than opinions about regulatory receptivity, will drive its wind investment in New York. MI argues that petitioners' "efforts to hold the possibility of future wind development 'hostage' to merger approval should be met with skepticism and accorded little or no weight."[87] MI does believe the commitment should be construed as

[87] MI's Brief Opposing Exceptions, p. 9.

a limited benefit of the proposed merger, but that it does not obviate monetary benefits for customers well in excess of petitioners' proposed $202 million in PBAs; more exacting reliability, service quality, and safety performance standards and rate adjustments; comprehensive customer financial protections; and stringent reporting requirements.

While Staff opposes recognizing potential Iberdrola investment in wind generation in New York as a public benefit, it insists that, if we do treat wind project development as a benefit, that potential development should be made concrete through a binding obligation. Staff suggests tying the level of wind generation investment to a "PBA account" that would benefit customers if the investment does not occur. As an example, Staff explains that we could discount the value of Iberdrola's $2 billion investment plan to $200 million, to be placed in a PBA account. For each MW of wind generation Iberdrola built in New York, it could draw the account down on a pro rata basis by $200,000. If all 1,000 MW were built, Iberdrola would recover the entire $200 million from the PBA account, but if there were any investment shortfall, the amount left in the account would inure to ratepayers.

DEC and SPM find Staff's proposal helpful and endorse it. CPB, although not explicitly supporting Staff's proposal, suggests that shortfalls of actual New York wind investment by Iberdrola from the $2 billion level be linked to additional required rate decreases or avoided rate increases.

Petitioners object to Staff's linkage proposal as outside the record and non-responsive to any proposal in the recommended decision. They also state that the proposed wind investment amount they wish considered as a benefit is the $100 million level, not the $2 billion level. In addition, petitioners argue that there is no need to make the $100 million commitment more binding because we can incorporate it as a binding and enforceable condition of our approval, making it subject to our enforcement authority. Petitioners further argue that it is inappropriate to tie the $100 million investment to PBAs because the investment is a benefit offered to the State as a whole to help meet its renewables goals and is unrelated to rate benefits inuring to NYSEG and RG&E customers only. Petitioners also claim Staff's proposal lacks Commission precedent insofar as it is unrelated to any synergy or other efficiency savings.

MI also attacks Staff's proposed linkage between wind investment and PBAs, albeit from a viewpoint opposite that of petitioners. MI criticizes Staff's proposal as reducing the PBAs intended to compensate NYSEG and RG&E customers for their exposure to the costs and risks of the acquisition, by diverting funds to guarantee investments that would occur in any event. MI objects that, under Staff's proposal, NYSEG and RG&E customers would in effect pay for Iberdrola to make profitable investments that will benefit shareholders of the unregulated Renewables subsidiary. MI considers this situation all the more inequitable because the investment in wind facilities could occur in parts of New York outside the NYSEG and RG&E service territories.

B. Discussion

As discussed elsewhere in this order, we conclude the acquisition should be approved because, with the inclusion of the PBAs we require, it provides customers significant net benefits sufficient to satisfy the PSL §70 positive net benefits test and to rebut the presumption against combined ownership of generation and T&D assets by the same firm. We reach that conclusion primarily without regard to any alleged benefit to be conferred by Iberdrola's status as a wind developer, but with the recognition that continued development and ownership of wind generation by Iberdrola is an inextricable part of the proposed transaction. We are left then with the question of how to address Iberdrola's interest in wind development and particularly its commitment to support the investment of at least $100 million in renewable infrastructure development in New York within the next three years.

Nine wind projects currently operate in the State, totaling 706 MW of installed capacity.[88] In addition to the projects in operation, DPS staff tracking the construction of the wind development projects we have approved reported at the time of the abbreviated order that there are six additional projects under construction, expected to be in operation by the end of calendar year 2008, totaling an additional 567 MW.[89] Thus, by the end of 2008, 1,267 MW of wind generation would be on line. In addition, we take notice of the fact that developers have placed more than 8,000 MW of wind development projects in the NYISO interconnection queue. Of these, wind projects totaling more than 3,000 MW have made considerable progress through the planning and interconnection phases of development, as documented by the NYISO.[90] Certainly there is no guarantee that a project merely listed in the NYISO queue or even one that has met planning milestones will ultimately be built. Nevertheless, the market for development of wind

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[88] These projects are Maple Ridge, Noble Clinton, Noble Bliss, Noble Ellenburg, Munnsville, Steel Winds, Fenner Wind, Madison Wind, and Weathersfield Wind.

[89] Those projects are Noble Altona, Noble Chateaugay, Noble Belmont, Noble Weathersfield, CPP 1 and 2, and Prattsburgh.

[90] These projects have received a ranking of "7" (of 14) on the NYISO's scale regarding their development status, meaning they have met key planning milestones, such as the submission of a System Reliability Impact Study.

generation in New York has been robust enough to suggest that good progress is being made toward the realization of our renewables goal.[91]

The projects currently in operation and proposed are sponsored by a variety of companies, including large national or international corporations with significant development portfolios and resources. While Iberdrola has made investments in wind facilities that were developed by others, none of its own projects in New York have advanced to the point of starting construction. As noted, however, Iberdrola has identified projects and placed them in the NYISO queue sufficient to provide New York an incremental 1,000 MW worth approximately $2 billion.[92]

Based on our analysis of the market and our familiarity with how the RPS program is structured, we cannot say that Iberdrola’s participation in the New York State wind market is necessary for the realization of our renewables goal. Rather, it is likely that desirable levels of wind generation will be developed in New York with or without Iberdrola’s participation. This is so because factors such as the RPS, the federal PTC, and the market for energy at wholesale will be far more significant in determining which projects and how many MW of capacity are built than will our approval of this

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[91] The RPS goal of incremental renewable development, 6 million megawatt-hours per year, could be reached by 3,000 MW of wind generation operating at a 23% capacity factor.

[92] We use a rough estimate of $2,000 per kilowatt (kW) of capacity for the all-in cost of development of a wind project through construction. This figure is derived from the U.S. Department of Energy’s Annual Report on U.S. Wind Power Installation, Cost, and Performance Trends: 2007, U.S. Department of Energy, May 2008, p. 21. That report indicated an average cost of $1,710 per kW for a sample of projects built in 2007, but noted there was reason to believe that increases in turbine costs would result in higher installed costs in the near future.

acquisition. Disruptions in the financial markets since issuance of the abbreviated order obviously have increased the inherent uncertainties of wind generation projections, but we have no evidence that new economic conditions will affect Iberdrola less than other potential wind developers.

It is therefore possible, and perhaps likely, that if Iberdrola did not make the investment reflected by its $100 million commitment, another wind developer would. However, we have no such assurance, and it would be irresponsible for us to claim with certainty that Iberdrola's participation is entirely irrelevant. Moreover, Iberdrola's investment in any given wind project brings at a minimum local economic development benefits at a time when all areas of the State are in need of economic stimulus. There is therefore some economic development benefit to Iberdrola's proffered wind development investment commitment.

Consequently, not only do we accept Iberdrola's commitment to invest in renewables in New York, but we also strengthen it by conditioning our approval of the transaction upon a requirement that Iberdrola commit to make wind-related capital investments in New York worth $200 million.[93] This requirement will be subject to the same contingency Iberdrola placed on its original $100 million commitment, namely, that there be "no material adverse change to the existing fundamental economics of wind generation development in New York State."[94]

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[93] We note an ambiguity in both petitioners' Partial Acceptance document (Exh. 50) and their Brief Opposing Exceptions. In those documents, Iberdrola commits "to support" an investment of $100 million in renewable generation. Given Iberdrola's 80% ownership interest in Iberdrola Renewables and its capacity to create other means to make such an investment, we resolve this ambiguity by requiring Iberdrola to make, rather than merely support, such an investment, and we increase the required investment from $100 million to $200 million.

[94] See note 85, supra.

In our view, Iberdrola's investment is beneficial only if it results in the creation of additional wind generation resources in the State, as opposed to the mere changing of hands of existing facilities. Therefore, this capital investment requirement applies to incremental investment in construction of new wind projects, as distinguished from investment in or acquisition of existing wind resources or sums already spent on projects underway. This requirement may be satisfied by new investments in wind projects within New York State that are made during the initial two years following the acquisition's closing date. We are willing to consider, however, upon a petition from Iberdrola, a modest extension of the two-year period.

Given the uncertainties of bringing wind projects to fruition, it is reasonable to ensure that, notwithstanding the qualification on petitioners' investment commitment, some value of a commitment to the State's economic vitality is realized. Therefore, we will require that, if, for whatever reason, Iberdrola is unable to reach the total of a $200 million investment in the development of wind generation in the State in the initial two years following the acquisition's closing (subject to extension by the Commission, as noted above), it must contribute up to $25 million toward economic development projects in the NYSEG and RG&E service territories. Such economic development funding will come from shareholders, not ratepayers, and will be incremental to any ratepayer-funded economic development programs included in the Energy East companies' current rates. Depending on the extent of the shortfall in wind investment, Iberdrola will be required to set aside prorated amounts in an economic development fund equal to 25% of the difference between the $200 million and the amount actually expended, which, for purposes of this calculation only, shall be assumed to be not less than $100 million.

Thus, if for whatever reason, Iberdrola invests under $100 million in new wind projects, the amount of economic development funds set aside would be $25 million. If it invests $200 million or more, the shareholder contribution to the economic development fund would be zero. For investments between $100 million and $200 million, contribution to the economic development fund would be prorated. For example, if Iberdrola achieves an investment of $150 million in wind projects, the amount of the economic development fund set aside would be $12.5 million. Iberdrola is required to file, at the end of the two years following the acquisition's closing, details of the wind investments made and any contributions required to be made to the economic development fund pursuant to this order; and, within 60 days thereafter, work with stakeholders to develop and submit a proposal for Commission approval detailing the application of the economic development fund.

We acknowledge that, as discussed above, Iberdrola's ownership of wind facilities raises vertical market power concerns. That issue has been resolved to our satisfaction through extensive mitigation measures and the significant benefits conferred by the PBAs. Given that decision, we conclude that the wind commitment required here provides some economic development benefits while, in terms of vertical market power, the marginal negative impact of such a level of development is small. Consequently, we conclude that directing such investment is in the public interest in this instance.

VII. NON-WIND GENERATION ISSUES

A. Fossil Fueled Generation

1. Recommended Decision and Exceptions

The Recommended Decision's discussion of Iberdrola's acquisition of fossil-fueled generation through the proposed merger took note of petitioners' Partial Acceptance offer to divest all fossil generation owned by Energy East and merchant generator Cayuga Energy, consisting of the 257 MW Russell Station and four other units with a total capacity of 158 MW. It noted that GRE, MI, CPB, and SPM all endorse the Partial Acceptance provisions as a remedy for vertical market power concerns. The Recommended Decision assumed that this divestiture, to which no party objects, would take place as a condition of the transaction, and it then proceeded to discuss the details of the auction process by which divestiture will occur. Because the Recommended Decision found that, if the proposed merger is approved, petitioners should be precluded from owning any generation connected to the NYSEG or RG&E systems, it concluded that the offer to divest only fossil-fueled generation could not legitimately be viewed as a "benefit" when it represents only a more limited alternative to a necessary condition of the acquisition's approval.

The Recommended Decision noted that, in their post-hearing reply brief, petitioners further proposed to share the above-book proceeds of the sale of their fossil generation by allocating 90% of the proceeds to ratepayers and 10% to shareholders. Because the parties had not had an opportunity to comment specifically on this sharing proposal, the Recommended Decision invited further comments in the exceptions process. It noted, however, that the best solution would be to initiate an auction collaborative at the conclusion of this case during which the parties would have an opportunity to arrive at protocols, deadlines, and any incentive sharing proposals, rather than litigate such issues at the exceptions stage. The Recommended Decision concluded that the offer to share above-book auction proceeds was not a benefit contingent on the transaction, because sharing is simply an outcome we would have the authority to impose regardless of whether petitioners proposed it.

Petitioners take exception to the Recommended Decision’s finding that divestiture is not a benefit. Petitioners argue that the test for whether the offer of divestiture creates a benefit is whether it would occur in the absence of the transaction. They state that most of the fossil divestitures would not occur at all without the merger, or, in the case of Russell Station, on a schedule such as proposed here. In addition, they argue, eliminating the alleged concerns in this proceeding about vertical market power with respect to the fossil-fueled generation should be seen as a benefit.[95]

MI challenges petitioners’ exception. It argues that the fossil-fueled plant divestiture commitment itself is not a benefit attributable to the proposed transaction, because divestiture is necessary to mitigate the vertical market power risks posed by the merger. CPB adds that the purported benefit in any event is overstated, because RG&E had previously committed to sell the Russell Station to an unaffiliated entity.

In general, the parties do not except to the recommendation for a collaborative process immediately following this case, in which they would resolve the details of an auction for the divestiture of all fossil generation in New York State to be acquired by Iberdrola through the merger. MI does take exception to the recommendation that the sharing of any above-book proceeds be determined in that collaborative process. Rather, MI asserts there are compelling reasons why we should resolve the allocation issue now, as a condition of merger approval, rather than in a subsequent phase of this proceeding. MI advocates that 100% of the above-book auction proceeds be allocated to ratepayers. Currently, MI states, the above-market

[95] Petitioners’ Brief on Exceptions, pp. 22-23.

value of net energy produced by these fossil-fueled facilities is allocated to RG&E customers. MI says that if such customers are to lose this benefit, they should receive the auction proceeds in return. Secondly, MI notes, ratepayers paid for the construction, operation, and maintenance of such facilities through their rates. Third, MI argues, allocation of all above-book auction proceeds to customers could be characterized in some sense as a benefit of the proposed transaction.

IPPNY does not object to establishing auction protocols through a collaborative process. However, it argues that we must impose a firm deadline on petitioners' divestiture of NYSEG's and RG&E's generation so that they cannot attempt to evade their commitments. In support of its advocacy of a firm deadline, IPPNY notes the recent behavior of RG&E with respect to Russell Station, stating that this example highlights the reasons why we should closely scrutinize RG&E's and NYSEG's generation divestiture. IPPNY proposes a nine-month deadline, arguing that, on cross-examination, petitioners' witnesses admitted nine months would not be an unreasonable period.

Petitioners agree with Staff's proposal to defer auction issues to a collaborative. They add as clarification, however, that the collaborative should occur (possibly as a separate proceeding) immediately after the closing and the submittal of their draft auction protocols, so that resources are not wasted. They say the collaborative can resolve the allocation of above-book revenues, the development of auction protocols and other related matters. They note that the allocation of above-book revenues will be an important input to any subsequent rate proceeding.

Petitioners assert on exceptions that the 90:10 sharing offer made in their reply brief should be considered a benefit of the transaction. Petitioners argue that a customers' share of above-book proceeds would not materialize in the absence of the proposed transaction and therefore should properly be viewed as a tangible, material benefit of the merger.

MI, however, argues that customers already receive the benefit of above-market sales made by RG&E's fossil-fueled generation, so that whether proceeds of sale of the facilities, accompanied by loss of above-market sales revenues, would constitute a net benefit for customers cannot be determined until after the terms of divestiture are known. Both MI and CPB contend that petitioners' 90:10 sharing offer is untenable because it would allocate a greater percentage of sale proceeds to shareholders and a lesser percentage to ratepayers than would be required under established Commission precedent.

Staff notes that past auction incentives have widely varied. It cites, for example, NYSEG's auction of its fossil-fueled generation in 1998, where NYSEG received no incentive at all. It contrasts this with the decision to allow Con Edison to retain the first $50 million of gain above book value. Staff states that given this disparity, the Recommended Decision was correct that the level of incentives and other auction issues should be deferred to an auction plan collaborative conducted after a decision is reached on the transaction itself.

2. Discussion

First, we clarify that Iberdrola's offer to divest any and all fossil-fueled generating assets in New York State that it acquires through this transaction is accepted and is made a condition of our approval. Moreover, Iberdrola, Energy East, and all their affiliates and subsidiaries are prohibited from owning any fossil-fueled generation within New York State in the future and thus are prohibited from constructing or acquiring any interest in such generation.

We agree with the Recommended Decision that all the details of the process for divesting fossil-fueled generation should be made the subject of a further phase of this proceeding. Given the interrelated issues that could affect the auction outcome, such as the timetable and methodology, we agree with Staff and petitioners that it is wise to allow the parties to address the issue of the disposition of above-book proceeds, including any sharing arrangement between shareholders and ratepayers, as part of this second phase of the proceeding. Therefore, we will not prejudge the sharing issue at this time.

In the abbreviated order, we have directed petitioners to collaborate with all interested parties to develop auction protocols, a timetable for divestiture, and the disposition of above-book proceeds from the sale, including any sharing between ratepayers and shareholders. We have directed that, within 90 days of the closing of the transaction approved in that order, the parties shall file with the Secretary to the Commission a divestiture plan that is the result of the collaborative process. We have directed that, in the event the parties are unable to agree upon all the details of such plan, the petitioners shall indicate which elements have and have not been agreed to by other parties in the collaborative process and shall justify the petitioners’ position as reflected in the filing. Other parties shall thereafter have 20 days in which to comment and to propose and justify alternative plans. We thereafter will issue a decision on the divestiture plan.

Even if this latter phase of the proceeding results in an arrangement where ratepayers receive 100% or some smaller percentage of the above-book proceeds from the fossil generation auction, we do not view that possible disposition as a benefit properly attributable to Iberdrola’s acquisition of Energy East. Rather, as several parties point out, the disposition of above-book proceeds from the sale of a utility asset is a matter that would come before us in any event, without regard to this merger transaction. In such a case, we would have full authority to require that all above-book proceeds be allocated for the benefit of ratepayers. Consequently, we cannot regard petitioners' offer to retain only 10% of such proceeds as a benefit flowing from this transaction.

Similarly, we do not regard the divestiture of fossil generation itself to be a benefit of the transaction. As the parties have noted, such divestiture is designed to mitigate a problem that would otherwise not exist. It is true that the problem of vertical market power resulting from the combined ownership of T&D and generation facilities is not, in the case of fossil-fueled generation, a consequence of the Iberdrola acquisition. Rather, these assets are currently owned by Energy East affiliates and thus the vertical market power problem exists even in the absence of the transaction. Iberdrola's proposed acquisition has focused attention on the situation and provided a forum within which the parties could raise all of the vertical market power concerns for our consideration. The fact remains, however, that we could have created an alternative forum for consideration of the issue with the result that Energy East would be required to divest its remaining fossil-fueled generation. Iberdrola's proposed acquisition has thus created, at most, a procedural benefit rather than a substantive one. As such, it is too insignificant to be considered a benefit of the transaction. This is particularly true where RG&E is already under orders to divest Russell Station, which constitutes the bulk of the fossil-fueled generation to be addressed in the divestiture plan required here.

B. Hydropower Generation

1. Recommended Decision and Exceptions

As noted, the Recommended Decision concluded that we should require divestiture of NYSEG's and RG&E's hydropower generation as a condition of the proposed transaction. The Recommended Decision rejected petitioners' arguments, made generically with respect to all types of generation, that vertical market power concerns were overstated and did not mandate divestiture here. It also considered arguments raised specifically with respect to hydropower. It found that retention of the hydropower units was not clearly more beneficial for customers than divestiture, although it invited further discussion on exceptions. The Recommended Decision concluded that, given the opportunity the merger afforded to examine this vertical market power issue, it might be appropriate to require hydropower divestiture at this time in conjunction with this transaction. On exceptions, petitioners, SPM, and MI all take issue with the Recommended Decision's treatment of hydropower divestiture.

Petitioners argue that the extensive market rules, oversight and mitigation mechanisms adopted by the FERC and the NYISO since the issuance of the VMP Policy Statement directly address any vertical market power concerns that could potentially arise from NYSEG's and RG&E's continued ownership of this <u>de</u> <u>minimis</u> amount of hydroelectric generation. They assert that run-of-the-river hydroelectric generation is ill-suited to the exercise of vertical market power, assertedly a critical fact that the Recommended Decision failed to recognize. Petitioners and MI note that despite previous opportunities to have raised vertical market power concerns with respect to Energy East's existing hydroelectric facilities, we have not done so, and vertical market power issues with respect to Energy

East hydropower facilities do not appear to have been a problem until now.

Petitioners also note that the only parties encouraging the divestiture of such facilities are Staff and IPPNY. They suggest that since IPPNY's members are incumbent New York producers, their commercial interests are averse to utilities competing in the generation market and they may be interested in bidding on such facilities upon divestiture. Petitioners say IPPNY's arguments therefore should be viewed with skepticism.

Petitioners argue that, while ratepayers may receive a short-term gain from the sale of hydroelectric facilities, the cost to replace power in the market may ultimately result in increased power costs to customers. Based on current market prices and expected output production, petitioners estimate that NYSEG and RG&E customers would have to pay on average $49 million to $55 million more annually for replacement power if these facilities are divested. SPM similarly argues that the proposed divestiture of a fully depreciated hydroelectric generating facility is decidedly not in the public interest because it would raise rates by over $50 million on average per year.

MI urges us to refrain from conditioning the merger approval upon the divestiture of the hydro facilities absent a demonstration that it is truly in the public interest. MI asserts that the record is devoid of any evidence that divestiture would be economically more beneficial for customers than retention; for this reason, it says, additional analysis should be undertaken, rather than blindly mandating divestiture of such facilities now. MI also adds that Energy East's existing hydropower facilities represent substantial assets which MI believes generate electricity well below current and projected future market prices; produce financial benefits for customers of NYSEG and RG&E; are environmentally benign; and presumably participate in competitive markets as price-takers, thus raising less of a vertical market power issue than other forms of generation.

Staff reiterates its claim that the best long-term approach to the efficient operation of the hydro facilities is subjecting them to competitive market forces. It claims that at least two utilities in New York have divested all of their hydro facilities without ill effect.[96] Staff adds that the Energy East utilities' exit from the hydro business will also end disputes over the prudence of rate-based investment. Staff supports a proposal made by CPB to preserve hydro benefits for ratepayers through long-term contracts with new owners. Staff therefore concludes that NYSEG and RG&E should be required to auction their hydro facilities and enter into supply contracts with new owners, at the same time as they sell their fossil units.

IPPNY agrees that petitioners should be directed to divest NYSEG and RG&E's hydro facilities but could maintain the benefits to customers by executing a long-term contract with the new owner of the facilities. IPPNY argues that petitioners have not demonstrated that their continued ownership of the hydro facilities will produce the substantial benefits required to rebut the VMP Policy Statement's presumption against generation ownership.

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[96] Staff's Brief Opposing Exceptions, p. 13, citing Case 96-E-00, Orange and Rockland Utilities, Inc., Order Approving Transfer of Generating Facilities (issued June 24, 1999) and Case 94-E-0098, Niagara Mohawk Power Corp., Order Approving Transfer of Hydroelectric Generation Facilities (issued May 27, 1999).

2. Discussion

We are persuaded that there is a greater economic benefit to ratepayers in allowing NYSEG and RG&E to retain their hydro facilities than in requiring divestiture here. Currently, these assets are included in rate base and subject to traditional ratemaking. If these assets were sold and the utilities had to purchase the corresponding output in the market, petitioners estimate that replacement power costs would be on the order of $50 million annually for 2009-11. We note that, in their most recent rate filings for the years 2007-2008, NYSEG and RG&E estimated the market value of the output of these facilities to be around $28 million annually. While petitioners did not provide an estimate of the amount of the current revenue requirement for these rate-based facilities in their briefs on exceptions, we believe, based upon a review of FERC Form 1 data, that the annual revenue requirement amounts are less than even the lower $28 million estimate. Consequently, inclusion of the assets in rate base offers customers an assured source of inexpensive power for part of their supply needs, even as market prices continue to escalate. Thus, they represent an excellent supply hedge for the benefit of Energy East customers.

If these facilities were sold, clearly the market value obtained from the sale of the assets would benefit customers now. However, the utilities would then have to purchase equivalent supplies on the market. If market prices in coming years escalate beyond the current forecast prices (built into asset valuation now), the asset sale gains now could be dwarfed by increased power purchase costs in the future.

Staff and IPPNY argue that new owners in a competitive market would likely operate these facilities more efficiently. However, those benefits of improved operations would accrue partially to the new owner. We conclude that it is highly unlikely the change in operation of these facilities would have a significant impact on market price by lowering it for the benefit of all customers.

In coming years, the utilities will have to make some capital expenditures in upgrading or refurbishing the facilities. It is true that, if NYSEG and RG&E sold these assets, the risk of those investments would reside with the new owner. In general, we have supported such transfers of risk to competitive entities, who may be better at making investments commensurate with the underlying risk. Nevertheless, given the other economic benefits under current circumstances, we can safely rely on our traditional regulatory powers to require that utility capital expenditures are prudent.

Finally, the impact on vertical market power of continued ownership of these facilities is quite small. First, as long as the plants remain under rate of return regulation, there would be no direct gain to shareholders from an increase in the wholesale market price. As a result, the regulated company has little incentive to raise wholesale prices for these units. Second, the approximately 118 MW at issue is not a large amount. Given these factors, the advantages to ratepayers of keeping the units outweigh the need to divest them.

VIII. PUBLIC BENEFIT ADJUSTMENTS (PBAs) AND RATE MECHANISMS

No party challenges the proposition that, under the PSL §70 “public interest” criterion applicable to this proposed transaction, petitioners must show that the transaction would provide customers positive net benefits after considering the expected benefits offset by any risks or detriments that would remain after applying reasonable mitigation measures.

In the preceding discussion, we have considered the benefits asserted by petitioners and other parties on exceptions. The foregoing analysis of the issues related to wind development, vertical market power, financial and corporate structure, and the utilities' operating performance all lead to the conclusion that the transaction itself, without more, does not offer positive net benefits sufficient to satisfy PSL §70. Consequently, the only real and significant public benefit to be derived from the transaction is the possibility of providing customers PBAs as a monetized benefit. Moreover, as discussed above, PBAs represent the substantial customer benefits required to rebut the presumption in our VMP Statement of Policy against ownership of generation by a T&D company.

For these reasons, our approval of this transaction is conditioned on the requirement that it include a monetized benefit to customers in the form of PBAs. For reasons explained below, we will set the amount of PBAs at $275 million.

The $275 million PBA amount offsets the risks and detriments of the transaction (net of the transaction's benefits and mitigation measures) and, in addition, ensures positive benefits for New York customers as a result of the transaction. However, this PBA amount is not intended to reflect synergy and efficiency savings attributable to the transaction. Therefore, 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, or become subject to the earnings sharing mechanism (ESM) described below. Moreover, neither company will be allowed to file a rate application before the target period except upon a showing that its financial performance otherwise would fall to levels that would jeopardize its ability to provide safe and reliable service. We discuss these scenarios in more detail below.

A. Recommended Decision and Exceptions

The Recommended Decision concluded that, to meet the "public interest" standard of PSL §70, we should impose PBAs as a precondition of the proposed transaction. Staff proposed $646.4 million in PBAs, which it calculated would provide an 8.1% reduction in overall NYSEG and RG&E delivery rates. Petitioners' Partial Acceptance countered with an offer of PBAs totaling $201.6 million, designed to reduce delivery rates by 4.4%.[97] The Recommended Decision endorsed Staff's $646.4 million proposal.[98]

1. Rationale for PBAs

The Recommended Decision characterized Staff's proposal as resting on two possible rationales. First, rejecting petitioners' insistence that the proposed transaction would provide no synergy savings, Staff maintained that PBAs are necessary as a proxy to preserve customers' interests in their share of synergy savings that have yet to be quantified. Second, Staff contended that the PSL §70 public interest standard requires identifiable, positive benefits to customers regardless of whether the transaction produces synergies.

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[97] The calculated rate impacts vary indirectly with the PBA amounts under the two scenarios because the $646.4 million includes a greater proportion of expense items, as compared with rate base items, than the $201.6 million.

[98] In their fourth exception, petitioners argue that the Recommended Decision attached insufficient weight to their proposed $201.6 million PBA level, merely because it was less than Staff's proposed level (Petitioners' Brief on Exceptions, pp. 20-21; similarly, Briefs on Exceptions of GRE, p. 2, and SPM, pp. 3-6). In fact, however, the Recommended Decision explained (at p. 54) that its conclusion was based on a comparison with other cases; and, in any event, we agree with the Recommended Decision that the $201.6 million is inadequate for reasons discussed in this order. Accordingly, the above exceptions are denied.

a. Proxy for Synergies

Staff argued that synergy savings can be expected despite petitioners' claims to the contrary, pointing to petitioners' admission that they did not analyze the possibility of synergy savings; the likelihood of savings from sources such as scale economies and sharing of information technology; and Iberdrola's significant underestimate of synergy savings realized when it acquired ScottishPower. Staff also argued that Iberdrola's substantial existing North American operations, even if currently devoid of regulated distribution utilities, can lead to potential synergies, as would best practices imparted to NYSEG and RG&E as a result of the merger. In addition, Staff posited potential synergies from Energy East subsidiaries' provision of services to Iberdrola and its other affiliates.

The Recommended Decision itself called petitioners' offer of $201.6 million in PBAs the practical equivalent of acknowledging that synergy savings will occur. In any event, the Recommended Decision found that Staff's presentation of potential sources of synergy savings was reasonable, and that petitioners' complete denial of any synergies was not. Accordingly, the Recommended Decision said the record compels a conclusion that the transaction will produce synergy savings, but in an amount that cannot yet be determined. Therefore, while the Recommended Decision concluded that the proxy theory justifies some amount of PBAs, it also recognized that a weakness in the proxy theory was its failure to provide guidance as to the appropriate level of PBAs to serve as a proxy for synergy savings.

Petitioners endorse the finding that the proxy theory is deficient in providing no guide to a proper level of PBAs, but they take exception to the Recommended Decision's failure to discard the theory entirely.[99] They contend that rate concessions should not be mandated except on the basis of careful studies that demonstrate cost reductions from utility operational savings, comparing the utility's costs after a merger to the costs it would have experienced but for the merger. (Petitioners do not address the Recommended Decision's theory that Staff, by advancing a reasonable claim of synergy savings, had given petitioners the burden of rebutting Staff's analysis or presenting an alternative.)

SPM maintains the Recommended Decision erred in characterizing petitioners' offer of $201.6 million in PBAs as an acknowledgment that there will be some synergy savings. SPM believes the offer more likely constitutes merely a pragmatic concession to provide tangible customer benefits to meet other parties' concerns and address our requirement of tangible net benefits.[100]

Staff attacks petitioners' contention that, under Commission precedent, benefits to customers are required only to the extent that synergy savings are identified. Instead, Staff supports the Recommended Decision's proposition that PBAs may serve as a substitute for synergy savings currently unidentified or unquantifiable. Staff believes that position is bolstered by the Niagara Mohawk-Grid Order and the Grid-KeySpan Order, as well as its argument that we have required rate concessions beyond the level warranted by identified synergy savings.[101]

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[99] Petitioners' Brief on Exceptions, pp. 64-69.

[100] SPM's Brief on Exceptions, pp. 22-24. Petitioners say their offer of $201.6 million in PBAs is purely voluntary because, again, they claim that customer benefits are unnecessary except to the extent that they can be supported by identifiable synergies.

[101] Staff's Brief Opposing Exceptions, pp. 22-25.

b. Positive Benefits to Customers

The Recommended Decision concluded that a PBA requirement is implicit in the net benefits test under Commission precedent;[102] and that the absence of synergies would itself necessitate PBAs as an alternative source of benefits. It said that “PBAs are intended to satisfy §70 by providing customers net benefits which may have to be underwritten by shareholders precisely because the transaction itself may not produce sufficient real benefits available for sharing.”[103]

Petitioners stress their agreement that the PSL §70 public interest standard requires a demonstration of positive net benefits. Notwithstanding their own offer of $201.6 million in PBAs, however, petitioners take exception to the Recommended Decision, continuing to maintain that §70 “does not mandate any *. . .* rate reductions for customers” (emphasis in original) in the absence of synergies.[104] In any event, they reject the Recommended Decision’s finding that the $201.6 million in PBAs they have offered fails to constitute a benefit “when offered as an alternative to [Staff’s] $646.4 million.”[105] Petitioners state that the Recommended Decision failed to provide any discussion of why their proposal—which would produce an immediate, permanent 4.4% reduction in annual delivery rates—is not a benefit to customers comporting with the Recommended Decision’s rationale for PBAs under §70.[106]

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[102] The Recommended Decision expressly declined to rest a PBA requirement on any equitable theory that would inject subjective notions of fairness into the PSL §70 public interest standard.

[103] Recommended Decision, p. 123.

[104] Petitioners’ Brief on Exceptions, p. 67.

[105] Recommended Decision, p. 55.

[106] Petitioners’ Brief on Exceptions, pp. 64-69.

Staff responds that our precedents in energy utility cases show that rate reduction benefits are not constrained by the level of identified synergy savings.[107] Staff claims that petitioners' proposed $201.6 million monetary benefit for customers is unsupported by any specific rationale and is inadequate. Staff observes that petitioners estimate only a 4.4% rate reduction from the PBAs they offered, comparing it unfavorably to a 9% rate reduction that customers in Maine will receive from Iberdrola's acquisition of Energy East. Staff maintains that the Recommended Decision properly rejected petitioners' $201.6 million in PBAs in favor of Staff's proposed $646.4 million, which Staff maintains is supported by several benchmarks and by analogies to other mergers.[108]

2. Level of PBAs

Having concluded that the amount of PBAs need not be limited to quantifiable, synergistic benefits generated by the proposed acquisition itself, the Recommended Decision turned to determining an appropriate level of PBAs. It observed that Staff's case in support of its proposed $646.4 million in PBAs provided the only reasoned methodology available on the record. Staff's analysis used three indicia of reasonableness. First, Staff compared the proposed PBAs to estimated benefits of the transaction to parties other than customers. Second, it analogized the transaction to a sale of assets and used our treatment of the proceeds of RG&E's sale of the Ginna plant as an example for testing its PBA proposal. Third, it compared the estimated benefits allocated to customers as a percentage of utility delivery revenues in three benchmark transactions:

[107] Staff's Brief on Exceptions, pp. 24-25, citing the Niagara Mohawk-Grid Order and the Grid-KeySpan Order.

[108] Arguments relating to Staff's proposed level of PBAs at the exceptions stage are discussed below.

Energy East’s acquisition of RGS Energy Group, whereby Energy East acquired RG&E; the Grid-KeySpan merger; and Iberdrola’s acquisition of Energy East and its subsidiary, Central Maine Power Company (CMP), as part of the transaction under review here.

The Recommended Decision found Staff’s analysis of the Maine acquisition substantially miscalculated. It nevertheless concluded that Staff’s comparisons, insofar as valid, established a range of reasonableness supporting Staff’s proposed $646.4 million in PBAs. The Recommended Decision acknowledged the imprecision in Staff’s analysis, but concluded that it must be relied upon for two reasons. First, it said, if Staff were correct that petitioners should have sustained the evidentiary burden of quantifying hidden synergies, then Staff’s analysis must prevail by default. Second, it said, if petitioners were correct in expecting no synergies, then the positive net benefits criterion as we have previously applied it would require PBAs on a scale comparable to the level indicated by Staff’s analysis.

In addition to the objections described above concerning the Recommended Decision’s interpretation of the positive net benefits requirement under PSL §70, petitioners challenge the Recommended Decision’s position on all three Staff benchmarks and contend that, properly analyzed, Staff’s comparisons better support petitioners’ own proposed $201.6 million in PBAs.

a. Benefits to Non-Customers

Staff calculated that the transaction will generate more than $1.6 billion in benefits to non-customer participants, comprising a $930 million acquisition premium payable to Energy East shareholders; about $124 million payable to underwriters, advisors, and attorneys facilitating the transaction; $150 million in production tax credits (PTCs) that Staff deemed available to petitioners for renewable generation projects; and $476 million in tax benefits available under Spanish law in connection with the transaction.

The Recommended Decision agreed with petitioners that the $930 million acquisition premium and the $124 million of transaction expenditures are costs, rather than benefits, to Iberdrola; but it nevertheless dismissed petitioners' objections to Staff's estimate, on the theory that customers should receive benefits via PBAs commensurate with the transaction's benefits to other parties generally. It considered immaterial petitioners' complaints that a particular item might be a cost rather than a benefit to Iberdrola itself, or might represent assets to which customers have no claim, or might be tax benefits intended for specific non-customer parties or particular public policy purposes. The Recommended Decision said petitioners' arguments, insofar as valid, proved only that the necessary level of PBAs would have to be funded from some other source.

Petitioners generally protest the Recommended Decision's endorsement of the $1.6 billion of non-customer benefits as guidance in setting a PBA level, as well as its dismissal of all their arguments regarding the individual elements of the $1.6 billion. They find the Recommended Decision unsatisfactory insofar as it says PBAs must be funded from other sources which it allegedly failed to identify.

Staff defends the Recommended Decision's point that PBAs should be funded from sources other than synergies or the elements of the $1.6 billion that actually are costs rather than benefits to petitioners. Staff says it first calculated the amount of benefits Iberdrola and other parties would realize from the acquisition; then determined that $646.4 million, when compared with those gross benefits, would suffice as a monetary benefit for customers; and finally identified the source of funding for PBAs, viz., adjustments to specific NYSEG and RG&E accounts that would amount to a $646.4 million rate benefit.

(i) Energy East Acquisition Premium; Transaction Facilitator Payments

Petitioners say the Recommended Decision is internally inconsistent in endorsing the $1.6 billion of non-customer benefits as a gauge for PBAs even after acknowledging that over $1 billion of that amount (namely, the $930 million acquisition premium and the $124 million of acquisition costs) includes no benefits to petitioners.[109]

(ii) Production Tax Credits (PTCs)

The Recommended Decision found the record unclear on whether Staff's estimate of $150 million in PTCs was overstated by including $50 million related to pre-existing projects. It tentatively assumed Staff's total had correctly excluded the disputed amount, subject to discussion on exceptions. It observed however that, even if Staff's estimate were overstated by $50 million, correcting that error would not materially affect Staff's argument that the non-customer benefits of about $1.6 billion would substantially outweigh $646.4 million in PBAs. The Recommended Decision found an inconsistency between

[109] Petitioners' Brief on Exceptions, pp. 70-73.

petitioners' argument that the availability of PTCs would depend on decisions by Iberdrola Renewables' management, and their representations in other contexts that Iberdrola exercises sufficient control over Renewables to cause it to invest specific amounts in wind projects in New York. The Recommended Decision said that uncertainty over whether PTCs would remain statutorily available beyond 2008 was offset by Staff's conservatism in recognizing only one year's worth of PTCs.

Petitioners take exception to recognition of any of the $150 million in PTCs for purposes of comparison with a PBA level. The availability of PTCs from Renewables' wind projects, they say, is highly speculative and unrelated to the proposed acquisition. (The Recommended Decision rejected these contentions, noting that petitioners previously cited as a merger benefit the opportunity to use PTCs and that they presented no reason why Renewables or petitioners would forgo that opportunity.) Staff, on the other hand, argues that its estimate of PTC benefits to Iberdrola is understated because its $150 million estimate included PTCs for 2008 only, while PTCs will remain available for ten years for each project Iberdrola develops. Even if the level for 2008 were only $100 million, Staff observes, the continuing benefits over the full ten-year period would amount to $1 billion.[110] Petitioners counter that Staff's estimate remains fundamentally flawed because: (1) as common practice, Renewables takes on tax equity partners who gain the right to use the PTCs, which makes the credits unavailable to offset other tax liability; (2) the PTCs depend on completion of wind projects, which is subject to uncertainty; and (3) the continued availability of PTCs is uncertain because (at the time of the exceptions briefs) the relevant statutory

[110] Staff's Brief On Exceptions, pp. 42-43, and Brief Opposing Exceptions, pp. 26-27.

provisions were due to expire at the end of 2008. Petitioners also assert that diverting the PTCs would be contrary to public policy supporting renewable energy sources.[111]

(iii) Spanish Tax Credits

The Recommended Decision accepted Staff's inclusion, in the $1.6 billion estimate of non-customer benefits, of $476 million in tax benefits under Spanish law. The tax benefits are associated with amortization of goodwill resulting from a premium paid by a Spanish company to acquire a qualifying non-Spanish subsidiary. The Recommended Decision rejected petitioners' claim that the tax benefit is uncertain, finding no substantial basis for doubt. It also found petitioners were inconsistent in arguing that Iberdrola might lose the tax benefit by divesting Energy East, when petitioners' entire case presumes that Iberdrola should acquire Energy East.

Petitioners continue to claim that the tax benefit remains speculative. In any event, they argue, the tax benefit is unrelated to rates paid by NYSEG and RG&E customers because they would bear no costs of the goodwill on which the benefit is based. Petitioners say the Spanish government intends the tax benefit to increase Spanish companies' incentive for foreign investment. Using the tax benefit to justify Staff's proposed PBAs would be contrary to its purpose, they believe.[112]

b. Comparison of the Proposed Merger to a Sale of Assets

Staff contended that, because Energy East is, in essence, proposing to sell all of its assets to Iberdrola, the proposed transaction is analogous to RG&E's sale of a major

[111] Petitioners' Brief Opposing Exceptions, pp. 47-49.

[112] Petitioners' Brief on Exceptions, pp. 70-73.

asset, its Ginna nuclear generating station. In that case, Staff argued, we allocated to customers more than 95% of the gain on the transaction. That decision provides guidance for determining an appropriate level of PBAs in this case, according to Staff. On exceptions, petitioners complain that the Recommended Decision seems to accept this analogy although we (and Staff) have previously rejected it.[113] SPM agrees with petitioners. SPM says that although customers have a legitimate claim on proceeds from an asset sale because they have been paying a return on the assets over the years, customers have no claim on shareholder gains, just as they have no role in indemnifying shareholder losses.[114]

c. Ratio of Customer Benefits to Distribution Company Revenues

Staff took the position that the ratios of customer benefits to distribution company revenues in three other mergers provide useful benchmarks for Staff's proposed PBAs. Staff maintained that its PBAs would produce a benefits-to-revenues ratio of 11% here, which Staff deemed reasonable when compared with the ratios it calculated of 10% for the Grid-KeySpan merger, 6% for the Energy East acquisition of RGS Energy Group, and 34% for Iberdrola's acquisition of CMP as approved by the Maine Public Service Commission in the transaction under review here. The Recommended Decision accepted Staff's calculated ratios for the Grid-KeySpan and Energy East-RGS mergers, but not

[113] Ibid., pp. 73-74, citing Case 98-M-0961, Consolidated Edison, Inc., et al., Order Authorizing Merger (issued April 2, 1999), p. 21.

[114] SPM's Brief on Exceptions, pp. 24-26.

the CMP merger. Petitioners except regarding the first two mergers, and Staff excepts regarding the third.[115]

SPM does not address each of these three benchmarks, but generally agrees with petitioners' criticism of the Recommended Decision. SPM argues that the benefits-to-revenues ratio is an extremely crude measure of comparability. SPM claims, however, that the average benefit ratio of Staff's three comparative examples is 8%, far less than the 11% ratio implicit in Staff's proposed PBA level here. SPM suggests that an 8% ratio would indicate $470 million as an appropriate level of PBAs for this transaction.

(i) Grid-KeySpan Merger

After reviewing the analysis in the Grid-KeySpan Order, the Recommended Decision concluded that the numerator of the benefits-to-revenues ratio in the Grid-KeySpan transaction would be $686.5 million (net present value or NPV) over the initial ten years following the merger. The Recommended Decision declined to subtract synergy savings from that total, because the PBAs in this case are based on the presumption of a lack of synergy savings and are intended as an alternative source of benefits to customers. Removing synergy savings, the Recommended Decision said, would simply represent an arbitrary a priori judgment that this proposed acquisition does not warrant as high a level of customer benefits as did the Grid-KeySpan merger.

For the denominator of the benefits-to-revenues ratio, the Recommended Decision followed Staff's method, including only KeySpan revenues but not those of Niagara Mohawk or the Long Island Power Authority (LIPA). It reasoned that the purpose of

[115] Petitioners' Brief on Exceptions, pp. 74-79, 83-84; SPM's Brief on Exceptions, pp. 26-28.

the ratio is to compare the magnitude of customer benefits to the relative revenues of the utilities that benefit, in various mergers on a consistent basis. In the case of the Grid-KeySpan merger, it accepted Staff's position that the benefits flowed primarily to KeySpan customers. In response to petitioners' claim that customer benefits in a merger are supported by revenues of all the firms involved, the Recommended Decision said that would mean that the revenue denominator in this case should include Iberdrola's revenues, as well as NYSEG's and RG&E's. It noted that such an approach would strengthen Staff's position because the ratio of Staff's proposed PBAs to overall Iberdrola revenues would appear infinitesimal as compared with the analogous ratios in the three other benchmark mergers. Overall, the Recommended Decision concluded that Staff's calculation of a 10% benefits-to-revenues ratio for the Grid-KeySpan merger was not overstated, but, if anything, understated.

Petitioners assert that the Recommended Decision's analysis of our actions in the Grid-KeySpan case erred in several ways. First, they say it ignored our own finding of a 1.9% benefits-to-revenues ratio in the Grid-KeySpan merger. In addition, they state that the Recommended Decision modified Staff's five-year nominal basis analysis to an unspecified type of ten-year analysis, while our own analysis used a ten-year NPV calculation. They believe the Recommended Decision also erred by including LIPA and Niagara Mohawk customer benefits of that merger (nearly 40% of the total customer benefits) in the ratio's numerator, while excluding LIPA and Niagara Mohawk delivery revenues from the denominator. They consider such an approach contrary to our own analysis, which they say included LIPA and Niagara Mohawk figures in both elements of the ratio.

Petitioners also attack the Recommended Decision's conclusion that including Niagara Mohawk and LIPA revenues in the denominator of the ratio for that case would require including Iberdrola's global revenues in the denominator in this case for comparative purposes. They maintain that we did not include National Grid's global revenues in determining the benefits-to-revenues ratio for the Grid-KeySpan merger. Petitioners suggest that the reason for excluding those global revenues in each instance is that neither acquiring company's global operations provide synergy savings in New York. For these reasons, petitioners argue that the 10% benefits-to-revenues ratio asserted by Staff and the Recommended Decision as the Grid-KeySpan benchmark is greatly overstated. They believe the $201.6 million PBAs they have offered would produce a 3.1% benefits-to-revenues ratio over a five-year period in this case, which compares favorably to the 1.9% ratio we calculated for the Grid-KeySpan merger.[116]

As an attachment to its brief on exceptions, Staff offers an analysis of benefits-to-revenues ratios over a ten-year term which purportedly shows that Staff's proposed PBAs in this case produce a ratio of 5.6%, compared with 5.9% for the Grid-KeySpan merger.[117] Petitioners protest that Staff's ten-year analysis was not introduced at hearings, and they reiterate their other criticisms of Staff's Grid-KeySpan calculation.[118]

Staff likewise accuses petitioners of apples-to-oranges comparisons. Staff contends that the Commission-determined 1.9% ratio for the Grid-KeySpan merger was a ten-year NPV calculation, while here petitioners' 3.1% ratio is based on nominal dollars over five years. Staff maintains that the Grid-

[116] Petitioners' Brief on Exceptions, pp. 74-79, 83-84.

[117] Staff's Brief on Exceptions, p. 41 and Appendix A.

[118] Petitioners' Brief Opposing Exceptions, pp. 44-45.

KeySpan merger entailed a combination of two owners of regulated T&D utilities into a new holding company, which is not proposed here. Accordingly, Staff says the Recommended Decision was correct in comparing Energy East customer benefits and revenues in this proceeding with the benefits and revenues associated only with KeySpan affiliates in the Grid-KeySpan merger. Staff also argues that petitioners further skewed their analysis by recognizing, in the Grid-KeySpan ratio, LIPA and Niagara Mohawk customer benefits but not LIPA and Niagara Mohawk revenues. Here, Staff maintains, there is no counter-party analogous to LIPA or Niagara Mohawk, and thus petitioners understate the true benefits-to-revenues ratio implicit in the Grid-KeySpan merger when adjusted to a basis comparable to the transaction proposed here.

(ii) Energy East-RGS Merger

The Recommended Decision accepted Staff's contention that the Energy East acquisition of RGS Energy Group, in which RG&E became a second operating subsidiary of Energy East in addition to NYSEG, had a benefits-to-revenues ratio of 6%. Here, as in its analysis of the Grid-KeySpan benefits-to-revenues ratio, the Recommended Decision rejected petitioners' argument that Staff's benchmark was distorted by failing to discount synergy savings and by using a ten-year rather than five-year period in calculating the ratio.

Petitioners except on the grounds that the Recommended Decision, unlike our decision approving the Energy East-RGS merger, failed to adjust the Energy East-RGS benchmark to reflect sharing of synergies in that case; we considered benefits only over a five-year period in approving that merger; and the Recommended Decision characterized the benefit estimate for the first five years after the Energy East-RGS merger as "atypical" without explanation, then artificially overstated the benefits of that transaction by simply multiplying the fifth-year benefits by ten. Petitioners maintain that the actual benefits-to-revenues ratio reflected in the Energy East-RGS order is less than 1.3%. Backing out the Recommended Decision's adjustment to the first five years' benefits, petitioners claim that even using a ten-year nominal value analysis and Staff's benefit values for the sixth through tenth years produces a ratio of 3.6%. They cite that figure as evidence that the 3.1% ratio implied by their $201.6 million in proposed PBAs in this case falls within the range of reasonableness.[119]

Staff contends that, contrary to petitioners' characterization, we actually viewed benefits in the Energy East-RGS merger over a period of ten years, but truncated the period to five years as part of our decision allocating to customers all synergy savings after the first five years. Staff says it recognized all the proposed transaction's benefits over ten years, multiplying the fifth-year customer share of savings times five to calculate the savings for the sixth through tenth years, as did the Recommended Decision.[120] In addition to their other complaints about Staff's methodology, petitioners criticize Staff for failing to exclude the benefits allocated to shareholders in the first five years, and for increasing its calculated estimate of sixth- through tenth-year benefits by 20%.[121] Staff counters the latter point by arguing that actual savings realized by NYSEG and RG&E proved to be higher than had been forecast for the first five years after the Energy East-RGS merger.[122]

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[119] Ibid., pp. 79-83.

[120] Staff's Brief Opposing Exceptions, pp. 29-31.

[121] Petitioners' Brief on Exceptions, pp. 79-83.

[122] Staff's Brief Opposing Exceptions, pp. 29-31.

(iii) Iberdrola-Energy East Merger in Maine

Examining the Maine Public Utilities Commission's approval of Iberdrola's acquisition of Energy East and its CMP subsidiary, the Recommended Decision agreed with petitioners' analysis that the benefits-to-revenues ratio there was only 3.3%, not the 34% that Staff claimed. It agreed with petitioners that the customer benefits calculation should exclude $306 million of an unrecovered acquisition premium, which petitioners say was not even sought. The Recommended Decision also rejected Staff's figure of $86 million in total forgone carrying charges on deferred costs of an Advanced Metering Infrastructure (AMI) initiative. Instead, it accepted petitioners' argument that the only properly cognizable evidence of this benefit shows it to be worth no more than $1.6 million annually.

The Recommended Decision ultimately concluded, however, that the 34% benefit-to-revenues ratio Staff advocated was only a qualitative makeweight argument. According to the Recommended Decision, reducing the ratio to 3.3% did not provide a basis for reducing the PBAs here, but eliminated just one among several arguments Staff made in support of the reasonableness of its proposed level of PBAs.

On exceptions, Staff insists that Iberdrola acquiesced to regulatory denial of $306 million, and recovery of only $8.8 million, of the acquisition premium. Because Iberdrola contested other rejected arguments in the Maine proceeding, but not that one, Staff argues that surrender of the $306 million balance of the acquisition premium should be included as a customer benefit of the transaction. Furthermore, Staff says the total AMI benefit of $86 million is established on the record. In contrast, Staff claims, petitioners declined the opportunity to quantify the annual AMI benefit on the record and failed to support their figure of $1.6 million per year. Staff now argues that the actual annualized benefit amount for Maine customers is $12.5 million, compared with CMP annual delivery revenues of $223 million, for a benefits-to-revenues ratio of 5.6%.[123]

In opposing Staff's exception, petitioners maintain that Staff fails to understand the Maine regulatory process and facts. They state that the acquisition premium arose in connection with Energy East's acquisition of CMP; and that CMP requested only $8.8 million annually in a rate filing that pre-dated the merger agreement between Energy East and Iberdrola. Therefore, petitioners argue, it was impossible for the $306 million to have been forgone to gain approval of the Energy East-Iberdrola merger in Maine. Concerning the AMI benefit, petitioners reiterate that the $1.6 million figure is fully supported on the record, asserting that it is derivable mathematically from the Maine Merger Stipulation. Moreover, they say Staff has inflated its calculation of the benefits-to-revenues ratio by including in the denominator only CMP's annual distribution revenues, while excluding annual transmission and demand-side management revenue requirements. Petitioners contend the true revenue figure therefore should be $311 million, not the $233 million Staff put forward. Using the $311 million revenue denominator and the correct $10.4 million benefits numerator adopted by the Recommended Decision, they aver, results in a ratio of 3.3%, as the Recommended Decision concluded.[124]

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[123] Staff's Brief on Exceptions, pp. 39-40.

[124] Petitioners' Brief Opposing Exceptions, pp. 40-44.

B. Discussion and Conclusions on PBA Justifications and Amounts

1. Rationale: Positive Benefits Requirement

To begin, we agree with the Recommended Decision that PBAs are an unsatisfactory proxy for savings from merger synergies because the amount of such savings is highly speculative in this case. Moreover, we will not even go so far as to accept the Recommended Decision's suggestion that the possibility of synergy savings yet to be quantified represents a supplementary rationale for PBAs, as an alternative to a rationale based on the net positive benefits requirement under PSL §70. Nor do we agree with the Recommended Decision that the $201.6 million of PBAs proposed by petitioners can be interpreted as their own estimate of synergy savings, in view of their continued insistence that the proposal is in the nature of a voluntary offer in settlement and that the absence of synergies makes any amount of PBAs inappropriate.

Accordingly, we adopt the Recommended Decision's general rationales for PBAs only insofar as the Recommended Decision found that (a) PBAs are necessary if the transaction's risks and benefits, considered together, fall short of satisfying the PSL §70 positive benefits test; and (b) the validity of a PBA requirement therefore does not depend on whether the PBAs can be funded from available synergy savings. Indeed, as this case illustrates, the very absence of identified synergies can aggravate the lack of net positive benefits, thus strengthening rather than weakening the justification for monetized benefits such as PBAs.

As the Recommended Decision correctly observed, the cases petitioners cite, as examples of merger approvals requiring neither synergy savings nor PBAs, are distinguishable because they involved water company acquisitions. In those cases, the transaction intrinsically provided a positive net benefit as compared with the costs and risks of continuing to operate a comparatively small water utility without the support of a large parent company. Moreover, despite petitioners' claims to the contrary, the water company case on which they primarily rely did reflect monetary benefits to the public, in that a rate plan was extended even though the utility was not earning its allowed return.[125] In contrast, as we have discussed, the absorption of NYSEG's and RG&E's parent into a larger international holding company will not significantly enhance the two New York utilities' ability to provide safe and adequate service at reasonable rates.

Accordingly, we deny petitioners' exceptions insofar as they fault the Recommended Decision for recommending PBAs regardless of whether the transaction will generate synergy savings. We grant petitioners' and SPM's exceptions insofar as they challenge the use of PBAs as a proxy for synergy savings.

2. PBA Quantification

Having concluded that some level of monetized benefits would be appropriate not because they can be funded from synergy savings but because the transaction's detriments or unmitigated risks would otherwise outweigh its benefits, the next step is to determine what PBA amount would suffice to provide positive net benefits. As the Recommended Decision observed, the determination requires an exercise of informed judgment rather than a purely mathematical calculation, but there are benchmarks we can apply to avoid basing a decision solely on subjective notions of equity.

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[125] Case 99-W-1542, United Water Resources, Inc. and Lyonnaise American Holding, Inc., Order Approving Stock Acquisition (issued July 27, 2000, Errata Notice issued August 1, 2000), p. 9.

To establish a reasonable PBA amount in this proceeding, we will adapt, with significant modifications, Staff’s and the Recommended Decision’s comparative analysis of customer benefits identifiable in other merger approvals. As noted, petitioners’ and Staff’s exceptions concern the Recommended Decision’s adoption of Staff’s proposed $646.6 million PBA amount on the basis of benefits-to-revenues ratios inferred from cases involving (a) Energy East’s acquisition of RG&E and (b) National Grid’s acquisition of KeySpan, notwithstanding the Recommended Decision’s rejection of the ratio calculated by Staff for (c) Energy East’s acquisition of Central Maine Power (CMP).

We agree with petitioners that the Energy East-CMP transaction should have been excluded from the comparative analysis of identifiable customer benefits. The circumstances and history of that transaction involve regulatory matters unrelated to the issues posed by the transaction proposed here. We therefore deny Staff’s exception to the Recommended Decision’s analysis of the Energy East-CMP merger. Of the two other transactions in the comparative analysis, we conclude that the National Grid acquisition of KeySpan resembles the proposed transaction much more closely than does Energy East’s acquisition of RG&E through RGS. This is because, unlike the Energy East-RGS transaction, the Grid-KeySpan transaction specifically included issues related to synergy savings, other positive benefits, vertical market power, and the risks and challenges associated with ownership by a large multinational utility corporation. Accordingly, we deny petitioners’ exception with regard to the Grid-KeySpan analysis and grant it with respect to the Energy East-RGS analysis.

Thus, only the Grid-KeySpan acquisition remains for purposes of a comparative analysis. Staff calculates a customer benefit of $603 million in that case. However, it is necessary to adjust that amount to put it on a comparable basis with the proposed transaction. First, as the Recommended Decision found, petitioners are correct that the $603 million initially should be reduced to $408 million by removing $195 million of benefits that customers would have realized even if the transaction had not occurred.

Second, we agree with petitioners that, because we are imputing no synergy savings from the proposed transaction, Staff's estimate of the customer benefits in the Grid-KeySpan transaction should be further reduced by $90 million to eliminate the synergy savings expected in that case. Although petitioners' testimony ultimately acknowledged an expectation of synergy savings and efficiency gains in the transaction proposed here,[126] there is no reliable record evidence as to the amount and source of such savings. We therefore will exclude synergy savings from our PBA determination in this proceeding, and rely instead on rate filing requirements and earnings sharing mechanisms (ESMs) to capture future synergy savings and efficiency gains for customers. This exclusion reduces the Grid-KeySpan customer benefits to $318 million, and petitioners' exception to the use of the initial $603 million benefits estimate is granted to that extent. The adjusted figure of $318 million equates to $350 million when scaled up in

[126] Tr. 943 ("[F]uture potential savings may be realized over time. These benefits may accrue over time as NYSEG and RG&E are able to consult with Iberdrola on management, share information regarding best practices and gain from Iberdrola's experience as a large, global leader. . . . That this possibility might be achievable is suggested by Energy East's current best practices ranking. . . .").

proportion to the size of the transaction proposed here, all else equal.[127]

However, three differences between the Grid-KeySpan case and this case affect our final determination of the appropriate PBA balance in this proceeding and therefore require further adjustment of the $350 million Grid-KeySpan benefit. First, the possibility that the firms in the Grid-KeySpan transaction could exercise vertical market power was highly attenuated, because we required divestiture of the Ravenswood generating facility and because the generation owned by KEDLI was subject to long-term cost-based contracts. In this case, although we are adopting measures to mitigate the transaction's vertical market power risks, they cannot be mitigated to the same degree as in the Grid-KeySpan case. Thus, the $350 million derived from the Grid-KeySpan decision understates the comparable net benefit that would be reasonable here.

Second, the Grid-KeySpan proceeding included a full analysis of synergy and efficiency savings for the merger participants, and rate case quality information about substantial elements of the operating companies' revenue requirements. Thus, we approved the Grid-KeySpan transaction with a high degree of confidence that rates going forward would be set at a proper level, and that excess earnings would be captured in a reasonable manner, in rate plans to be adopted shortly after the merger decision. In this case, however, the lack of a similar record means there is a greater risk that the current rates left in place after the merger will be excessive.

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[127] We multiply the $318 million by 1.1, representing the ratio of (a) the combined delivery revenues of NYSEG and RG&E to (b) the combined delivery revenues of KeySpan Energy Delivery New York (KEDNY) and KeySpan Energy Delivery Long Island (KEDLI).

While our adoption of rate case filing and ESM requirements tempers this risk, these measures do not eliminate it entirely. Thus, the present circumstances support an additional increase in the PBA amount appropriate to this transaction as compared with the Grid-KeySpan merger.

Third, the Grid-KeySpan merger differed from the proposed transaction in that the customer benefit requirement there was based partly on the supposition that customers might have fared better in an alternative transaction which KeySpan was considering at the time it accepted National Grid’s purchase offer. Since there is no similar evidence in the present case that Energy East obtained competing bids as an alternative to Iberdrola’s offer or that it should have done so, the PBA amount in this case should be decreased accordingly. We estimate that this component reduces the PBA otherwise applicable by about $135 million.

Based on the foregoing considerations, and recognizing that some of these factors inherently are not amenable to precise mathematical quantification, we find that the record considered as a whole provides a sufficient evidentiary basis to support the reasonableness of a PBA determination within the range of $250 million to $300 million. A PBA amount in this range will address the transaction’s unmitigated vertical market power, corporate structure, and financial and ratemaking risks, while also providing customers enough positive net benefits to satisfy the PSL §70 public interest standard.

Then the final step in quantification is to establish a specific PBA amount, necessarily as an exercise of informed judgment because there is no mathematical formula on which to base such a decision. Within the $250 million to $300 million range of reasonableness, the PBA amount needed to assure customers a positive net benefit should depend on our assessment of the transaction's benefits, its risks or detriments, and the effectiveness of available mitigation measures.

With those upper and lower constraints in mind, we will base the decision on our view, summarized above, that the transaction's benefits are not as compelling as its proponents allege; and that the transaction offers serious risks and detriments, which cannot be fully mitigated and therefore require PBAs to satisfy PSL §70. Furthermore, as explained above, the rebuttable presumption of unacceptable vertical market power necessitates customer benefits. Consequently, we conclude that these purposes can be served by adopting a PBA amount at the middle of the range of reasonableness. Accordingly, we will require PBAs in the amount of $275 million.[128]

C. Rate Proceedings

1. Ratemaking: Disposition of PBAs

On exceptions, petitioners and Staff both propose that we apply PBAs immediately to offset certain regulatory assets held for the benefit of customers, and to increase certain reserve accounts in order to offset specifically anticipated future cost increases. Other parties, similarly, advocate implementation of PBAs expeditiously if not immediately.[129] These proposals would lead to decreases in NYSEG and RG&E

[128] Having arrived at that figure, our analysis renders petitioners' exceptions somewhat academic insofar as they dispute the relevance of the $1.6 billion of non-customer benefits cited by Staff and the Recommended Decision as an equitable justification for PBAs.

[129] See Petitioners' Brief on Exceptions, pp. 84-86, and Brief Opposing Exceptions, pp. 50-57; Staff's Brief on Exceptions, pp. 43-49, and Brief Opposing Exceptions, pp. 38-40; MI's Brief Opposing Exceptions, pp. 41-44; CPB's Brief Opposing Exceptions, pp. 8-12; Nucor's Brief Opposing Exceptions, pp. 1-2; and SPM's Brief Opposing Exceptions, p. 18.

delivery rates, to a greater or lesser extent depending on the amount of PBAs the party advocates. In theory, the $275 million of PBAs adopted here make it possible to reduce delivery rates by 4.8% as compared with what the rates otherwise would be, assuming for illustrative purposes that the PBAs are amortized over five years.

At this time, however, we will not require an immediate rate reduction as a precondition of the proposed transaction. The financial information that petitioners have provided on this record is far less comprehensive than the rate case quality presentation that would be expected in a formal rate proceeding. Moreover, we are particularly concerned about the possibility that an initial rate reduction might cause unnecessary rate volatility because it would likely trigger an immediate need for a rate increase that otherwise could have been avoided.

Instead, to promote rate stability and preserve the scope of our discretion when applying the PBAs for the benefit of ratepayers, we will direct petitioners to defer the PBAs for disposition in NYSEG’s and RG&E’s future rate proceedings. The timing of those proceedings is discussed below. The PBAs should be recorded on the books of NYSEG and RG&E effective as of the acquisition’s closing date, allocated among the companies’ four departments (at NYSEG and RG&E respectively, electric and gas) in proportion to the departments’ respective delivery revenues for calendar year 2007. Pending such disposition, the PBAs will accrue interest at the respective companies’ allowed pre-tax rates of return.

2. Ratemaking: General Rate Cases

This transaction will involve a period of adjustment during which there will likely be a number of changes in the way

NYSEG and RG&E conduct their operations. Typically, the costs of actions taken to successfully integrate companies and obtain synergy savings and efficiencies ("costs to achieve") are incurred in the first few years after a merger, whereas the benefits of integration are realized over a longer horizon. Thus, if NYSEG and RG&E were to file rate applications today, the filings might reflect historical and projected costs exceeding normal levels due to the cost of integration activities, and they might not accurately reflect prospective synergy savings and efficiency gains. Rates set on the basis of such costs would be excessive.

For that reason, we are not adopting the Recommended Decision's proposal that we immediately institute full-scale rate cases for NYSEG and RG&E; Staff's proposal for immediate, expedited rate cases; or petitioners' proposal for a full-scale NYSEG rate case starting within 150 days after the fourth quarter of 2008. Conversely, we are not adopting petitioners' proposal to postpone a full-scale RG&E rate case until 150 days following the first complete calendar quarter after RG&E divests Russell Station, because a rate adjustment to reflect the realities of the companies' post-acquisition operations should not be contingent on an event that has yet to be scheduled. The parties' exceptions are denied insofar as they seek those results.[130]

The parties have extensively debated whether synergy savings and efficiency gains are possible as a result of the transaction. We view this as a fundamental issue in any utility merger proceeding because we ordinarily would allocate such savings to customers based upon information provided on the

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[130] Petitioners' Brief on Exceptions, pp. 84-86; Staff's Brief on Exceptions, pp. 43-49. See also Briefs Opposing Exceptions, of Staff, pp. 38-40; petitioners, pp. 50-57; MI, pp. 41-44; CPB, pp. 8-12; Nucor, pp. 1-2; and SPM, p. 18.

record. However, while Staff testified that such savings are likely and petitioners ultimately conceded on rebuttal that savings are possible, the record provides no direct estimate that we could use to impute a specific amount of synergy savings and efficiencies subject to sharing with customers. Therefore, as explained above, our method of determining the amount of PBAs is designed specifically to provide customers a positive net benefit sufficient to outweigh the transaction's risks or detriments (after mitigation) before synergy savings are taken into consideration. As a result, the $275 million PBA we are adopting is not intended to reflect synergy savings and efficiency gains attributable to the transaction.

To minimize the potential for inaccuracies and uncertainties associated with the underlying data that would accompany an immediate rate case filing by either NYSEG or RG&E, we will prohibit them from filing rate applications sooner than 12 months after the acquisition closes. We will instead require 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, or become subject to the earnings sharing mechanism described below. The scope and quality of evidence filed in support of any such application must conform with our rules and policies applicable to an application for a major rate change. If a rate filing is made, any earnings sharing mechanisms in force at the time of the filing will remain in place until disposition of the filing.

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.

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.

As an alternative means of capturing a share of synergy and efficiency savings for ratepayers, should either company elect to forgo an electric or gas rate filing as described above during the target period, that company must implement an earnings sharing mechanism (ESM) for each department that is not the subject of a rate filing during the target period. Any such ESM will take effect no later than the beginning of the first calendar month after the target period.

Under this ESM, shareholders will retain 20% of any earnings in excess of the cost of equity, which we have updated to 10.1%, and the remaining 80% will be preserved for ratepayers. The 10.1% sharing threshold reflects financial conditions as of the date of the abbreviated order, and the duration of the period in which NYSEG and RG&E will not be permitted to increase their electric and gas delivery rates. Earnings under this ESM will be calculated on the basis of financial results for delivery operations commencing at the beginning of the first calendar month after the target period. The 10.1% cost of equity will apply to NYSEG’s electric department and will supersede any pre-existing sharing thresholds in NYSEG’s gas rate plan and RG&E’s electric and gas rate plans, but will not affect ESMs applicable to commodity earnings associated with NYSEG’s or RG&E’s fixed price options. If an ESM is required for NYSEG’s electric department, which currently has none, the company will file, within 30 days after the expiration of the target period, an ESM proposal for Commission approval, designed to be effective as of the beginning of the first calendar month following the target period.

To ensure that the ratepayers’ share of excess earnings is not understated, the earnings calculation for purposes of the ESM will use an equity ratio based on Iberdrola’s consolidated capital structure or a 45% equity ratio, whichever is less. However, we will consider using a stand-alone equity ratio greater than 45% upon a showing that the rating agencies consider the utility operating subsidiary in question to be adequately insulated from the risks of Iberdrola’s other operations.

3. Other Potential Rate Case Issues

a. Non-PBA Rate Adjustments

Staff excepts to the Recommended Decision’s conclusion that various ratemaking adjustments proposed by Staff (other than PBAs) should be decided in future rate cases rather than in this proceeding.[131] However, our review of the record reveals ambiguities as to whether all parties considered these issues to have been joined; and, in any event, the issues cannot be examined here as effectively as in a rate case where the primary objective is to review rates rather than review a corporate restructuring. We agree with petitioners that Staff’s exception should be denied because the rate adjustments, other than PBAs and the merger-related provisions adopted here regarding

[131] Staff’s Brief on Exceptions, pp. 49-88.

performance incentives and capital expenditures, are best considered in separate rate proceedings.[132]

b. ESCOs and RDMs

For similar reasons, we agree with the Recommended Decision that Staff's proposed requirements for NYSEG and RG&E energy services company (ESCO) referral programs and for electric and gas revenue decoupling mechanisms (RDMs) are best considered in other proceedings. The Recommended Decision said the ESCO proposals could be presented in one of the current cases dealing with such matters, or the ESCO and RDM proposals all could be presented in NYSEG and RG&E rate cases. On exceptions, petitioners oppose any further consideration of these proposals, but add that they should be considered, if at all, in rate cases.[133] Staff (and SPM, with respect to RDM issues) support that alternative.[134] On this issue, we deny all exceptions and adopt the Recommended Decision, without determining whether the ESCO proposals should be considered in an ESCO proceeding rather than a rate case.

The Commission orders:

1. The Abbreviated Order Authorizing Acquisition Subject to Conditions (issued in this proceeding September 9, 2008), subject to the discussion in the body of this order, is adopted in its entirety and is incorporated as part of this order.

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[132] Petitioners' Brief Opposing Exceptions, pp. 57-59; see also SPM's Brief Opposing Exceptions, pp. 11-12.

[133] Petitioners' Brief on Exceptions, p. 87, and Brief Opposing Exceptions, pp. 74-75.

[134] Staff's Brief on Exceptions, pp. 78-79, 88-90; SPM's Brief Opposing Exceptions, p. 12.

2. This proceeding is continued.

By the Commission,

JACLYN A. BRILLING
Secretary

APPENDIX 1

FINANCIAL AND CORPORATE PROTECTION CONDITIONS

1. Goodwill and Acquisition Cost Conditions

(a) No goodwill or transaction costs associated with this acquisition 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), or Energy East Corporation (Energy East) after the closing of the acquisition of Energy East by Iberdrola, S.A. (Iberdrola).

(b) Goodwill 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 after the closing of this acquisition any analysis determines that goodwill on Iberdrola's books from this acquisition, or goodwill already on the books of Energy East or RGS from prior transactions, 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, or Energy East, together with supporting materials (workpapers, 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) Iberdrola, Energy East, NYSEG, and RG&E must register with major nationally and internationally recognized bond rating agencies, such as Standard & Poor's, Moody's Investor Service, and Fitch Ratings, and intend to maintain at least an investment grade credit rating. As long as each company maintains its investment grade rating, and subject to the other conditions of this order, 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 acquisition; 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 acquisition, 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 resulting from significant, unanticipated events, 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) Unless specifically authorized by the Commission, NYSEG and RG&E each is prohibited from paying common dividends if: (i) the bond rating on the least secure form of debt issued by it falls to the lowest investment grade rating and there is a negative watch or review downgrade notice for the company as determined by any nationally recognized rating agency or, alternatively, if the bond rating for the company in question immediately falls to non-investment grade without such a notice; or (ii) the bond rating on the least secure form of debt issued by Iberdrola or Energy East falls to the lowest investment grade rating and there is a negative watch or review downgrade notice for Iberdrola or Energy East as determined by any nationally recognized rating agency or, alternatively, if the bond rating for Iberdrola or Energy East immediately falls to non-investment grade without such a notice.

(e) If a ratings event described in clause (i) of subparagraph (d) above occurs with respect to NYSEG or RG&E, the company affected by that ratings event may not transfer, lease, or lend any moneys, assets, rights, or other items of value to any affiliate without first obtaining Commission approval. If a ratings event described in clause (ii) of subparagraph (d) occurs, neither NYSEG nor RG&E may transfer, lease, or lend any moneys, assets, rights, or other items of value to any affiliate without first obtaining Commission approval. These provisions exclude 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, Energy East, 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) 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, Energy East, and RGS, are regulated utilities operating within the United States, in which case NYSEG or RG&E may participate as either a borrower or a lender. Iberdrola, Energy East, 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 RGS, Energy East, or Iberdrola.

(b) Neither Iberdrola, Energy East, nor any of their affiliates may have any cross default provision at closing of the approved acquisition that affects NYSEG or RG&E in any manner. Neither Iberdrola, Energy East, nor any of their affiliates may enter into any cross default provision in the future 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 and Energy East 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. <u>Special Class of Preferred Stock Conditions</u>

(a) NYSEG and RG&E each must modify its corporate by-laws as necessary to establish a voting right in order to prevent a bankruptcy, liquidation, receivership, or similar proceedings ("bankruptcy") of NYSEG or RG&E, respectively, from being caused by a bankruptcy of Iberdrola, Energy East, or any other affiliate.

(b) Within six weeks after closing of this acquisition, NYSEG and RG&E each must file a petition with the Commission seeking authority to establish a class of preferred stock having one share, subordinate to any existing preferred stock, and to issue that share of stock to a party, to be proposed by NYSEG or RG&E, respectively, and approved by the Commission, who shall protect the interests of New York and be independent of the parent company and its subsidiaries. Each share of stock shall have voting rights only with respect to NYSEG's or RG&E's, respectively, right to commence any voluntary bankruptcy without the consent of the holder of that share of stock. If either NYSEG or RG&E, respectively, has failed to propose a shareholder approved by the Commission within six months after the closing of the acquisition, the Commission will appoint a shareholder of its own selection.

(c) In the event that NYSEG or RG&E is unable to meet this condition despite good faith efforts to do so, it must petition for relief from this condition, explaining why the condition is impossible to meet and how it proposes to meet an underlying requirement that a bankruptcy involving Iberdrola, Energy East, or any other affiliate does not result in its voluntary inclusion in such a bankruptcy.

5. Financial Transparency and Reporting Conditions

(a) Energy East, 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 this acquisition Energy East 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. Energy East’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) Energy East, NYSEG, and RG&E shall remain subject to annual attestation audits by independent auditors.

(e) Iberdrola, Energy East, NYSEG, and RG&E must provide Staff access to the books and records, including, but not limited to, consolidated tax returns, of Iberdrola and all of its affiliates to the extent necessary for Staff to determine whether the rates and charges of NYSEG and RG&E are just and reasonable. Among other things, such access must be sufficient to provide Department of Public Service Staff the opportunity to ensure that costs are allocated equitably among affiliates and that intercompany transactions involving either NYSEG or RG&E are priced reasonably compared to transactions involving similarly situated Iberdrola affiliates. That access must include, but not be limited to, all information supporting the underlying costs and the basis for any factor that determines the allocation of those costs.

(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 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 Energy East, RGS Energy Group, NYSEG, and RG&E and must link the specific Energy East, RGS Energy Group, NYSEG, and RG&E account balances to the overall consolidated results. Although individual statements for individual business entities other than Energy East, RGS Energy Group, 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.

(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.

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 governing relations among Energy East and its subsidiaries,[1] including, but not limited to, NYSEG and RG&E, in the same manner as they apply to Energy East.

(b) Staff, Petitioners, and other interested parties shall consult and use their best efforts to resolve their differences over all issues raised in this proceeding concerning the code of conduct and affiliate transaction and cost allocation rules to apply among Iberdrola and its subsidiaries, including, but not limited to, Energy East, NYSEG, RG&E, and Community Energy, Inc. Within 60 days from the date of this order, the parties must submit a report on the status of their negotiations, either advising us that they have reached agreement, with an accompanying joint proposal incorporating the terms of agreement for Commission approval, or that they require an additional 30 days for further negotiations. If the parties have failed to reach agreement within that 60-day period, then within 90 days from the date of this order they must submit a report on the final results of their negotiations, either advising us that they have reached agreement, with an accompanying joint proposal incorporating the terms of agreement for Commission approval, or specifying the matters on which there is agreement, the extent of any remaining differences, and the bases for remaining differences. The Commission will then consider and act upon the parties' submission, including establishing any additional

[1] Set forth in Appendix B to the Joint Proposal approved in Case 01-M-0404, Energy East Corporation, et al. – Merger and Stock Acquisition, Order Adopting Provisions of Joint Proposal with Modifications (issued February 27, 2002).

process it deems necessary at that time. Pending further action by the Commission, all existing provisions of the code of conduct shall continue to apply without modification, subject to subparagraph (a) above.

7. Follow-On Merger Savings

In the event that Iberdrola completes any additional mergers or acquisitions within the United States before the Commission adopts an order approving new rates for NYSEG or RG&E, Iberdrola must share the follow-on merger savings between shareholders and ratepayers. NYSEG and RG&E must submit, within 90 days of the follow-on merger closing, a comprehensive and detailed proposal to share the follow-on merger savings, to begin on the closing date of the follow-on merger. The proposal must provide for a minimum 50 percent ratepayer share of synergy savings and efficiency gains, net of costs to achieve. In addition, the proposal must include an allocation method for sharing the synergy savings and efficiency gains among corporate entities. NYSEG and RG&E must share such savings and gains with their ratepayers until the Commission approves new rates in response to a request for a rate change. The ratepayer share shall be set aside in a deferral account for future Commission disposition.

APPENDIX 2

SAFETY, RELIABILITY, AND CUSTOMER SERVICE PROTECTION CONDITIONS

1. General Performance and Reporting Conditions

(a) Negative electric system reliability revenue adjustments for New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E) shall apply beginning in calendar year 2009 in accordance with this table[1]:

	Performance Target	Base Revenue Adjustment
Frequency (SAIFI)		
NYSEG		
Minimum Threshold	1.20	$1,750,000
Maximum Threshold	1.26	$3,500,000
RG&E	0.90	$2,500,000
Duration (CAIDI)		
NYSEG		
Minimum Threshold	2.08	$1,750,000
Maximum Threshold	2.18	$3,500,000
RG&E	1.90	$2,500,000

(b) For each consecutive calendar year that a performance target in the table in subparagraph (a) is missed, the revenue adjustment shall be twice the adjustment applicable for the prior year.

(c) Within 90 days from the date of this order, NYSEG and RG&E each shall file with the Commission a report that includes: an assessment of the physical conditions of all elements of its electric system; and repair plans, remedial actions, and

[1] "SAIFI" is System Average Interruption Frequency Index. "CAIDI" is Customer Average Interruption Duration Index.

monitoring programs for correcting problems with facilities found deficient.

(d) Effective beginning in calendar year 2009, NYSEG shall be subject to the following gas safety performance measures and base negative adjustment levels, totaling up to 60 basis points, for failure to meet those measures:

(i) Leak prone pipe:

(a) Replace a minimum of 20 miles of leak-prone main. Base adjustment level: eight basis points.

(b) Replace a minimum of 2,000 leak-prone services. Base adjustment level: eight basis points.

(ii) Leak management: achieve a year-end backlog of total leaks no greater than 100. Base adjustment level: 12 basis points.

(iii) Prevention of excavation damages:

(a) Overall damages: maintain a level equal to or below 2.0 excavation damages per 1,000 One-Call Tickets. Base adjustment level: four basis points.

(b) Damages due to mismarks: maintain a level equal to or below 0.50 excavation damages due to mismarks per 1,000 One-Call Tickets. Base adjustment level: 10 basis points.

(c) Damages caused by company crews and company contractors: maintain a level equal to or below 0.20 excavation damages attributable to company and company contractor personnel per 1,000 One-Call Tickets. Base adjustment level: four basis points.

(iv) Emergency response:

(a) Respond to 75 percent of all gas leak and odor calls within 30 minutes. Base adjustment level: eight basis points.

(b) Respond to 90 percent of all gas leak and odor calls within 45 minutes. Base adjustment level: four basis points.

(c) Respond to 95 percent of all gas leak and odor calls within 60 minutes. Base adjustment level: two basis points.

(e) Effective beginning in calendar year 2009, RG&E shall be subject to the following gas safety performance measures and base negative adjustment levels, totaling up to 60 basis points, for failure to meet those measures:

(i) Leak prone pipe:

(a) Replace a minimum of 20 miles of leak-prone main. Base adjustment level: eight basis points.

(b) Replace a minimum of 2,000 leak-prone services. Base adjustment level: eight basis points.

(ii) Leak management: achieve a year-end backlog of total leaks no greater than 200. Base adjustment level: 12 basis points.

(iii) Prevention of excavation damages:

(a) Overall damages: maintain a level equal to or below 2.0 excavation damages per 1,000 One-Call Tickets. Base adjustment level: four basis points.

(b) Damages due to mismarks: maintain a level equal to or below 0.50 excavation damages due to mismarks per 1,000 One-Call Tickets. Base adjustment level: 10 basis points.

(c) Damages caused by company crews and company contractors: maintain a level equal to or below 0.20 excavation damages attributable to company and company contractor personnel per 1,000 One-Call Tickets. Base adjustment level: four basis points.

(iv) Emergency response:

(a) Respond to 75 percent of all gas leak and odor calls within 30 minutes. Base adjustment level: eight basis points.

(b) Respond to 90 percent of all gas leak and odor calls within 45 minutes. Base adjustment level: four basis points.

(c) Respond to 95 percent of all gas leak and odor calls within 60 minutes. Base adjustment level: two basis points.

(f) If NYSEG or RG&E, respectively, misses a target level set forth in subparagraph (d) or (e) above in three out of five consecutive calendar years, the negative adjustment applicable for that year and each subsequent year shall be twice the base adjustment level. For any calendar year in which NYSEG or RG&E, respectively, is under a dividend restriction at any time and misses a target level set forth in subparagraph(d) or (e) above, the negative adjustment applicable shall be 150 percent of the adjustment level otherwise applicable.

(g) The Gas Cost Incentive Mechanism-2 for NYSEG and RG&E is terminated effective December 31, 2008.

(h) Negative customer service revenue adjustments for NYSEG and RG&E shall apply beginning in calendar year 2009 in accordance with this table:

Performance Target	Base Revenue Adjustment	
	Electric	Gas
NYSEG		
PSC Complaint Rate	$3,000,000	$333,333
Overall Customer Satis.	$2,000,000	$333,333
Contact Satisfaction	$2,000,000	$333,333
Total	**$7,000,000**	**$1,000,000**
RG&E		
PSC Complaint Rate	$833,333	$233,333
Cust. Service Index	$833,333	$233,333
Appointments Kept	$833,333	$233,333
Calls Answered	$833,333	$233,333
Billing Accuracy	$833,333	$233,333
Estd. Meter Reads	$833,333	$233,333
Total	**$5,000,000**	**$1,400,000**

(i) For each consecutive calendar year that a performance target in the table in subparagraph (h) is missed, the revenue adjustment shall be twice the adjustment applicable for the prior year.

(j) The impact of any negative adjustment under subparagraphs (a), (b), (d), (e), (f), (h), or (i) above shall be excluded from all regulatory measurements, such as, calculations to implement an excess earnings or a revenue decoupling mechanism. Negative adjustments shall not be recovered directly or indirectly from ratepayers.

(k) Within 60 days from the end of each calendar year, NYSEG and RG&E shall file their annual reports with the Commission showing how they performed for each of the applicable electric reliability, gas safety, and customer service performance measures in subparagraphs (a), (d), (e), and (h) above.

2. Capital Expenditure Conditions

(a) For the years 2009 and 2010, NYSEG shall make capital expenditures of no less than an average of $140 million per year for its electric system and no less than an average of $20 million per year for its gas system.

(b) For the years 2009 and 2010, RG&E shall make capital expenditures of no less than an average of $90 million per year for its electric system and no less than an average of $20 million per year for its gas system.

(c) For years after 2010, NYSEG and RG&E, respectively, shall make capital expenditures at levels no less than 90 percent of the levels set forth in subparagraphs (a) and (b) above. In the event that either company proposes to spend at a level less than 90 percent of a level set forth in subparagraph (a) or (b), it shall submit its proposal to the Commission for approval, together with a full justification of how its proposal will provide for continued safe and adequate service.

(d) NYSEG and RG&E shall each file annually, within 30 days from the close of its annual planning cycle, a five-year forecast of its planned electric system and gas system upgrades, including the expected cost of each project or program. The annual filing shall also include a reconciliation (*i.e.*, variance report) of the past year's construction activity compared to its budget for that year.

3. Conditions Specific to Concerns of NYAPP/NYSRECA

(a) NYSEG shall establish a “task force” that includes representatives from Delaware County Electric Cooperative, Oneida-Madison Electric Cooperative, Otsego Electric Cooperative Steuben Rural Electric Cooperative (“cooperatives”), the Village of Sherburne, and NYSEG personnel. The task force shall hold meetings no less than quarterly and establish milestones to achieve numerous objectives. The objectives of the task force include:

(i) Capital investments: includes identifying capital improvements that could be made to enhance system reliability with respect to the system used to serve the cooperatives and the Village of Sherburne and agreeing on an overall schedule for implementation of certain capital improvements, which would be submitted for consideration in subsequent rate proceedings.

(ii) Transmission study: NYSEG shall conduct a transmission study, to be completed no later than 90 days after the closing of the Iberdrola acquisition of Energy East, to determine the age and capacity of all facilities providing service to the substations owned and controlled by the cooperatives and the Village of Sherburne. The study shall be provided to the cooperatives and Sherburne for review and comment.

(iii) Within 30 days after completion of the transmission study, NYSEG planning and engineering personnel shall hold a meeting with representatives of the cooperatives and the Village of Sherburne, and invite Department of Public Service Staff to attend, to discuss specific implementation measures.

(iv) Review of history, repair, and maintenance activities: The task force shall review outage history and line performance, as well as specific plans and schedules associated with the maintenance of transmission and sub-transmission facilities that service the cooperatives and the Village of Sherburne.

(v) Actions taken consistent with the process described above shall be implemented utilizing best efforts on a mutually agreed upon schedule and NYSEG commits to take additional corrective actions to the extent required.

(vi) Storm response: NYSEG shall provide the cooperatives and the Village of Sherburne with data related to the response to storm conditions that affect the cooperatives' and the Village of Sherburne's customers. This data shall be compared to data on NYSEG's overall storm response.

(vii) Notifications: NYSEG shall prioritize responses for any outage affecting the cooperatives' customers and customers of the Village of Sherburne as it would for an outage affecting a similar number of its own retail customers. Proper prioritization and response shall require continued communication and coordination among the parties. Review of outages, communications, and response shall be topics for the ongoing task force. A specific communications protocol shall be jointly developed that is not merely an automated outage report line, but shall include, and not be limited to, senior NYSEG personnel and other appropriate persons. Protocols shall be jointly established no later than 90 days after the closing of the Iberdrola acquisition of Energy East.

(viii) Reliability: NYSEG acknowledges the concerns expressed by the cooperatives and the Village of Sherburne regarding present and future electric reliability, without making any admissions. For the future, the parties shall develop guidelines that are intended to lead to the development of a penalty and enforcement protocol for failure of NYSEG to satisfy such guidelines, including, but not limited to: (*a*) minimum employment levels for NYSEG personnel dedicated to reliability requirements and operation and maintenance on transmission and sub-transmission facilities; and (*b*) maximum response times for outages.

(b) Reservation of rights: the conditions set forth in subparagraph (a) are subject to the reserved rights of the cooperatives and the Village of Sherburne to challenge NYSEG's implementation of its obligations in any and all forums.

4. Conditions Specific to Concerns of the City of Rochester

(a) Petitioners shall promptly begin comprehensive collaborative discussions with the City of Rochester, Department of Public Service Staff, and representatives of the Department of Environmental Conservation (DEC) to review the plans and schedules for the remediation of the Beebee Station and Andrews Street sites of RG&E, with the understanding that both of these sites are already in the DEC remediation "queue." RG&E shall share schedules and milestone data, along with periodic progress reports, with the City of Rochester.

(b) If the City of Rochester continues its interest in public access to RG&E's 81 South Avenue facility, RG&E shall work with the City on a schedule to review the facility's structural condition expeditiously and to make any necessary safety enhancements required for public access.

APPENDIX 3

VERTICAL MARKET POWER CONDITIONS

Divestiture of Fossil Generation; Corporate Separation of Non-hydro Generation Affiliates

1. Petitioners shall file with the Secretary to the Commission, within 90 days of the closing of this acquisition, a plan for divestiture of any fossil generation owned by any Iberdrola affiliate in New York State.

2. Iberdrola and Energy East and any of their affiliates are prohibited from owning any interest in fossil generation within New York State.

3. Any investments in wind facilities shall be carried out through Iberdrola subsidiaries other than NYSEG or RG&E.

4. NYSEG and RG&E shall not engage or enter into bilateral power purchase contracts with any affiliate or subsidiary.

Generator Interconnection Process

5. NYSEG and RG&E shall file with the Secretary to the Commission, within 60 days from the date of issuance of this Order, documents clearly defining interconnection criteria and the process and procedures that would provide assurance of transparency of decisions to provide interconnections to generators, and shall file promptly any subsequent changes to the documents.

6. NYSEG and RG&E shall report to the Secretary to the Commission on the first of each month, beginning October 1, 2008, any request for interconnection from any generator in the previous month, including affiliated and non-affiliated generators.

7. NYSEG and RG&E shall document, maintain, and make available to the Department of Public Service Staff, upon request, any communication with developers of generation in a timely fashion.

8. NYSEG and RG&E shall respond within five business days to any request relating to interconnection from a generator or other entity directly involved in the interconnection process, such as the New York Independent System Operator (NYISO), or provide an estimated date for delivery of the response with an explanation for the delay.

Generator Energy Deliverability

9. Generator-Specific Economic Deliverability Studies:

(a) Within 60 days from the date of the issuance of this Order, NYSEG and RG&E shall file with the Secretary to the Commission documents that clearly define their methods for performing economic deliverability studies for interconnecting generators, including affiliated and non-affiliated generators. The documents shall include, at a minimum, procedures for generic study methodologies, a process for working with generators in performance of the studies, remedies for potential congestion situations, a generic methodology for evaluating solutions and generic cost allocation procedures for the solutions, and a process for working with each generator regarding solutions.

(b) NYSEG or RG&E, as applicable, shall perform economic deliverability studies for each generator applying for interconnection to its system to determine if the generator is subject to potential restrictions in energy delivery and provide to the generator a detailed explanation of the economic deliverability study test.

(c) NYSEG or RG&E, as applicable, shall provide to the generator a statement of the costs of system upgrades required to remove or substantially reduce expected economic delivery restrictions and the share of the costs for which the generator is responsible, per the cost allocation procedures submitted to the Secretary to the Commission.

(d) NYSEG and RG&E shall file any such economic deliverability studies with the Secretary to the Commission within 15 days of the study's completion.

10. Bottled Generation Study: NYSEG and RG&E shall periodically conduct a study to identify potential congestion pockets in their service territories where generation could be bottled. The study shall identify the transmission measures required to alleviate the congestion and assess the cost effectiveness of implementing such measures. The study shall also determine the existing generation resources that will potentially be forced to curtail energy output and estimate the amount due to the new wind facilities. The study shall be conducted by an independent third party using shareholder funding. NYSEG and RG&E shall work with Department of Public Service Staff in developing the precise scope of the study. In

the event that NYSEG and RG&E and Department of Public Service Staff cannot resolve a dispute, the Staff shall request the Public Service Commission to provide a resolution of the dispute. NYSEG and RG&E shall provide a detailed and comprehensive scope of the study and associated timeline with milestones to the Secretary to the Commission within 30 days of the date of the issuance of this Order. The study shall, at a minimum, include planning for the next ten years, and model any wind projects in the New York Independent System Operator interconnection queue and projects of which NYSEG and RG&E are aware with an in-service date through the end of 2013. The scope of the study shall include base case assumptions and describe sensitivity and scenario cases included in the study. NYSEG and RG&E shall file the final results of the first study with the Secretary to the Commission no later than June 30, 2009. The study shall be repeated once every three years.

Other Conditions Relating to Generators

11. New York State Electric and Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E) shall notify the Secretary to the Commission of any disagreement with a developer of generation relating to the performance of interconnection or energy deliverability studies that they cannot resolve in good faith.

12. NYSEG and RG&E shall attempt to resolve in good faith any contested issues with generators. NYSEG, RG&E, or a generator may file a request with the Department of Public Service for mediation or arbitration of the dispute.

Monitoring Extent of Generation Holdings

13. Iberdrola and any of its subsidiaries that begin construction or acquire any direct or indirect interest in co-generation, hydro, or alternate energy production facilities, including wind generation, with a capacity of 80 megawatts or less are required to notify the Secretary to the Commission, within 60 days of such construction, investment, or acquisition.

MAUREEN F. HARRIS, concurring

I concur in the result the Commission reached, in allowing Iberdrola to acquire Energy East, NYSEG and RG&E. Iberdrola's experience in providing utility T&D service elsewhere should enable it to capably own and manage utilities providing T&D service in New York. Approval of the transaction benefits ratepayers, because Iberdrola will fund the $275 million in PBAs that will reduce future rates, and for other reasons. Without approval, those benefits might be lost, and that risk leads me to concur in the result here.

I am concerned, however, that the Commission did not properly apply the Vertical Market Power Policy Statement to these facts and circumstances. I also believe a better balance could have been achieved between the risks the acquisition poses and the benefits directed to ratepayers as compensation for shouldering those risks.

The Vertical Market Power Policy Statement

The Commission finds that Iberdrola has satisfied the Vertical Market Power Policy Statement because it has provided substantial ratepayer benefits that, together with mitigation measures, overcome the Policy Statement's presumption against T&D company involvement in the ownership of generation. I would apply the Vertical Market Power Policy Statement differently than the Commission. Rather than finding that Iberdrola has overcome the presumption against ownership of both generation and T&D facilities, Iberdrola's involvement in wind generation should be treated as an exception from application of the Policy Statement. Among other things, unlike any other T&D company, Iberdrola brings to the development of wind generation in New York its extensive experience in constructing and operating wind generation elsewhere, and the value of that expertise should not be lost.

Iberdrola's plans also do not present the market power threats that would be associated with the development or ownership of large-scale fossil-fueled facilities. The relatively small size of the wind generation plant Iberdrola must promise to build under the Commission's decision, at about 200 MW, and the limit on what it has announced it might build, at about 1000 MW, reduces somewhat the market power risk. That Iberdrola's generation is dependent upon wind limits the locations where it can be built and the hours when it can operate, further limiting the market power impact.

Consequently, I would allow Iberdrola to proceed with its wind development plans as an exception to the Vertical Market Power Policy Statement, although additional market power mitigation measures could have been required. I believe the totality of these unusual circumstances justifies that exception. Reliance on an exception would be as satisfactory as a finding on the presumption in securing for ratepayers the benefits that will accrue only if Iberdrola agrees to proceed with the transaction.

Creating an exception for Iberdrola from the Vertical Market Power Policy Statement would emphasize that its plans are not precedent for any other utility or T&D company affiliate to embark upon entry into the generation business. The Commission, by finding that Iberdrola has satisfied the Vertical Market Power Policy Statement, potentially opens the door to other utilities that might desire to pursue opportunities to develop generation. This does not sufficiently protect the competitive electric markets that the Commission has been trying so hard to promote from the exercise of vertical market power. Granting an exception rather than finding the presumption was satisfied also would have emphasized that approving Iberdrola's acquisition is not an invitation to other utilities to re-enter the generation market, because an exception is based on unusual circumstances rather than a finding that benefits outweigh risks, a problematic finding under these circumstances. I would better protect our discretion to make that sort of finding by awaiting a case when more compelling facts than those presented here are at issue.

For these reasons, finding that the Policy Statement’s presumption is satisfied is not the proper approach, in my view. Rather than attempting to apply the presumption, I would merely provide that Iberdrola will be allowed to build and own wind generation as an exception to the Policy Statement, based on the unusual circumstances present here.

The Balancing of Risks and Benefits

Although I concur in the result the Commission reached, because I was concerned that the $275 million in PBAs might be lost otherwise, I also believe a better balance between benefits and risks could have been achieved. This would have ameliorated another shortcoming of making a finding that the Policy Statement’s presumption was satisfied, because that finding is premised upon the assumption that the benefits obtained from Iberdrola offset the risks the transaction creates.

A. The Risks Attending the Transaction

The risks attending Iberdrola’s acquisition of the New York T&D companies are substantial. Iberdrola’s entry into the New York wind generation market might potentially discourage other wind generation developers from coming to New York if they perceive Iberdrola can leverage its control of T&D companies to their disadvantage. Through affiliation with those companies, Iberdrola might be able to manipulate the interconnection process for adding new generators to the grid in its favor. Competing developers that cannot as readily obtain interconnections again will be discouraged. Then there is the bottleneck problem, whereby Iberdrola might attempt to impede adding interconnection capability with other states, so that cheaper generation cannot flow into New York and reduce the market prices it will receive for its wind generation. Allowing Iberdrola to build wind generation could also distort the RPS process, because its presence as a participant might discourage other developers from competing for funding.

These potential harms to competitive electric markets could work to the disadvantage of New York utility ratepayers. The result could be less overall wind generation built in New York because of Iberdrola, rather than more, as the Commission assumes.

If Iberdrola discourages new entry into New York generation markets and market prices rise as a result, ratepayers in utility service territories other than those of NYSEG and RG&E will be harmed. Under the Commission's decision, no benefits are extended to those other ratepayers, like those of National Grid and Central Hudson, to compensate them for that risk, which they face as a result of the transaction.

The mitigation measures the Commission imposes, while important checks against the exercise of vertical market power, may not fully ameliorate the risks attending Iberdrola's ownership of both generation and T&D facilities. The mitigation measures consist mostly of reporting and monitoring requirements. Compliance with those requirements might not prevent Iberdrola from evading detection of exercises of vertical market power. Because the mitigation measures are not fully adequate, substantial benefits would be needed to offset the risks this transaction poses.

B. The PBA Benefit

The Commission relies upon the $275 million in PBAs Iberdrola will fund as adequate compensation to offset vertical market power risks. While substantial, and an important factor in my decision to concur with the Commission, the $275 million in benefits is intended to compensate for all of the risks of the transaction, which include financial and subsidiary affiliation risks as well as vertical market power risks. In addition, the $275 million in PBAs is the source of the positive benefit to ratepayers required to meet the standard for obtaining approval of this transfer under the Public Service Law. Consequently, only a portion of that fund can be attributed to the offset of vertical market power risks. The Commission does not allocate specific portions of the $275 million fund against specific risks, or to the positive benefit due ratepayers.

I would have identified the amount of the fund directed to offsetting vertical market power risk. An allocation would have allowed the Commission to establish a baseline that could be used to evaluate any future harms Iberdrola might cause through the exercise of vertical market power against the benefits that were obtained. Performing the allocation might also have demonstrated that the $275 million fund does not completely cover all of the risks this transaction raises, with a remainder for positive benefits, once the amount dedicated to each risk was ascertained and compared to the costs that might attend that risk. In my view, the remainder of the $275 million in PBAs that would be available to offset vertical market power risk after other demands on the PBA fund are satisfied does not fully compensate NYSEG and RG&E ratepayers for bearing the substantial risk that Iberdrola might be able to exercise vertical market power.

C. The Other Benefits

There are benefits to this transaction, including the market power mitigation measures that have been imposed to protect ratepayers, that persuaded me to concur in the result the Commission reached. Iberdrola does promise to build 200 MW of wind generation, and, if it does not, to fund economic development measures. These concessions have value.

Moreover, the Commission has adopted extensive financial and corporate protection conditions that should insulate the New York operating companies from poor performance by the holding company. These measures include credit quality and dividend restriction conditions; provisions for developing a code of conduct; and, the creation of the limited voting right to be exercised on behalf of ratepayers in the event of a bankruptcy or similar proceeding. The stricter service quality standards the Commission directed are an improvement over the previous standards. Even though the Commission cannot be certain these measures will always be adequate to mitigate the risks they address, I believe that these benefits and measures are sufficient to narrowly justify approval of the transfer.

On the other hand, public perception of the extent of the benefits Iberdrola offered might have been influenced by Iberdrola’s statement to the media that it would invest $2.0 billion in New York wind plant when, in the proceeding itself, it promised to invest only $100 million, and the Commission requires it to invest only $200 million. At that level, the promised wind generation will amount to 200 MW. That contribution towards assisting New York in achieving its wind generation development goals, while of some benefit, does not completely offset the PBAs’ shortcomings.

In addition, some of the benefits Iberdrola promised are ephemeral. Its assertions that jobs will be saved and company headquarters will remain in New York are at best of only temporary duration because they are difficult to enforce over the long run. I also agree with the Commission that Iberdrola's promise to sell RG&E's Russell Station site is not a benefit, because that sale was already required as a result of our prior decisions.

Iberdrola's claim that wind generation and its ownership of T&D companies are a benefit because they are connected to each other is unpersuasive. Iberdrola never adequately explained that link, which appears to amount to nothing more than its desire to be active in the two separate fields of wind generation ownership and T&D company ownership.

The absence of any identified synergy savings as a benefit raises a separate concern. Without savings created through synergies, the incentive for Iberdrola to extract a profit from this transaction through squeezing unwarranted profits from the operation of the T&D companies is increased, which could adversely affect the reliability and adequacy of the service the T&D companies provide. The stricter service quality standards may not be sufficient to offset the incentive to extract profits in the absence of synergy savings, and the financial consequences for service quality failures would be imposed only after the degradation of service is felt by customers.

D. Additional Remedies

The overall balance of benefits and detriments is less for ratepayers than could have been accomplished. A better balancing of the benefits and detriments could have been achieved in several areas. First, PBAs in excess of the $275 million fund Iberdrola offered could have been required. Those additional PBAs would have more fully offset the risks of this transaction, including both financial and subsidiary affiliation risk, while enhancing the positive benefits due ratepayers.

Second, earnings sharing could have been imposed effective immediately, instead of delayed for at least a year as the Commission does. That way, if Iberdrola extracted excessive profits from the T&D companies, or was able to find synergy savings in their operation, ratepayers would have at least seen some of those benefits returned to them promptly.

Third, vertical market power could have been further mitigated. Iberdrola could have been required to undergo a case-by-case review each time it proposed a new wind project. Permission to proceed with wind development would be contingent upon a showing it had not exercised vertical market power. The potential for the denial of that permission would have been a substantial deterrent against the exercise of vertical market power.

Conclusion

In conclusion, although I am disappointed that additional benefits for ratepayers were not realized from this transaction, I concur in the result. The benefits that were obtained are sufficient to justify approval of the transfer, even if too narrowly, and without approval, those benefits might have been lost to ratepayers. As to vertical market power, I would more carefully limit the scope of the decision the Commission reached, to restrict its use as a precedent for allowing other affiliates of T&D companies to attempt to enter generation markets in the future.