STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a Session of the Public Service Commission held in the City of Albany on August 16, 2012

COMMISSIONERS PRESENT:

Garry A. Brown, Chairman
Patricia L. Acampora
Maureen F. Harris
James L. Larocca
Gregg C. Sayre

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

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

# ORDER DIRECTING THE SUBMISSION OF A MANAGEMENT AUDIT IMPLEMENTATION PLAN AND ESTABLISHING FURTHER PROCEDURES ON CORPORATE STRUCTURE AND GOVERNANCE ISSUES

(Issued and Effective August 28, 2012)

BY THE COMMISSION:

## INTRODUCTION

On December 10, 2010, we authorized, pursuant to Public Service Law (PSL) §66(19), the issuance of a Request for Proposal (RFP) for an independent third-party consultant to conduct a comprehensive management and operations audit of Iberdrola USA, Inc. (IUSA) and its New York operating utilities, New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E), focusing on construction program planning and operational efficiency. In addition, the consultant was asked to examine certain aspects of IUSA operations, and the operations of its parent, Iberdrola, S.A. (ISA), and to evaluate the resulting impact on New York State ratepayers. On March 17, 2012, after reviewing various consultants' proposals, we approved the selection of The Liberty Consulting Group (Liberty or Consultant) to conduct the audit and directed IUSA to enter into a three-party contract with Liberty and Department of Public Service (DPS). Liberty has completed the audit titled "Final Report - Management Audit of Iberdrola S.A., Iberdrola USA, New York State Electric and Gas, and Rochester Gas and Electric" (the Final Audit Report) dated June 4, 2012, and submitted it to the DPS.

The primary goal of the audit was to identify opportunities to improve NYSEG and RG&E's (the Companies') construction program planning processes and operational efficiency. The approach of the audit was to examine existing functions, processes, systems, organizations, and staffing, as well as past performance, for the purpose of defining prospective changes that will improve future performance. This forward-looking approach was intended to evaluate root causes of problems and to point the way for the Companies to move to a more effective level of construction program planning and spending levels, consistent with their responsibility to provide safe, adequate and reliable service.

Scope of the Audit

The scope of the audit was established in a Letter Order issued December 16, 2010 in this proceeding, and was articulated in the RFP attached to that Letter Order. With input from Department of Public Service Staff (Staff), Liberty prepared a draft work plan that incorporated the scope requirements in its proposal, and further refined the scope in a more detailed work plan after a number of documents were reviewed and initial company interviews were completed. The Final Report addresses the eight scope elements identified in the RFP:

1) Corporate Mission, Goals, Objectives, and Planning
2) Load Forecasting
3) Supply Procurement
4) System Planning
5) Capital and Operations and Maintenance Budgeting
6) Program and Project Planning and Management
7) Work Management
8) Performance and Results Management

Additionally, Liberty was directed in the RFP to explore and analyze specific issues pertaining to the following areas:

- Corporate Governance
- Common Service Costs (arising from affiliations and a common service company)
- Consolidation of New York Operations and Rates
- Wholesale Market Issues
- Vegetation Management

These issues are also covered in the report.

Audit Process

Before and during the audit field work, Liberty met with Staff to obtain input on specific audit areas of concern. During the audit field work, Liberty interviewed company representatives and analyzed responses to its document requests. Liberty issued nearly 1,200 document requests and conducted over 275 interviews of key ISA, IUSA, NYSEG and RG&E personnel.

Liberty’s initial Draft Audit Report was provided to Staff on February 14, 2012. On May 25, 2012, Liberty provided an overview of its audit results to the Chairman and his senior advisors. Additional overview briefings for the other Commissioners were conducted on June 11 and 13, 2012.

The Draft Audit Report was provided to the Companies for review of factual accuracy and comment on April 17, 2012. Liberty provided the Final Report on June 4, 2012, and the Companies and IUSA provided written comments to the report on June 18, 2012.[1]

Liberty's findings, conclusions, and recommendations fell into two distinct categories: operational, which mirror the type of report we would expect to see in a management audit, and corporate structure and governance, which arose primarily from the Consultant's view of the influence of ownership by an international entity with limited knowledge of the regulatory expectations in the United States (U.S.). Chapter 2 of the Draft Audit Report devotes itself to Corporate Structure and Governance topics; however, the operational chapters also include facets of these same topics.

## AUDIT FINDINGS AND RECOMMENDATIONS

### Operational Findings and Recommendations

The majority of this audit focused on operations at NYSEG and RG&E, and followed traditional management audit practices. The findings, conclusions, and recommendations pertaining to operational areas are included in Chapters 3 – 14 of the Final Audit Report. These recommendations are similar to those that have been produced in other New York State audits. Liberty's Final Audit Report contains 222 conclusions, resulting in 75 recommendations[2] identifying opportunities for improvement. On the operational side, Liberty found some areas of strength at the Companies and IUSA:

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[1] The Companies' comments, which were confidential only up to the time of this decision on the matter, are attached as Appendix B.

[2] Liberty's 75 recommendations are attached as Appendix A.

1. Liberty determined that the overall structure in the U.S. is utility focused, and that the U.S. management is fully "utility-engaged." The Consultant felt that IUSA was properly addressing the issue of consolidating NYSEG and RG&E, with no prejudice or predetermination.
2. The Consultant found that the financial systems in place can trace transaction flow at a detailed level, and that annual budgeting and billing processes engage the Companies' attention. They found that the operations and maintenance budgeting processes are effective.
3. Liberty believes the Companies actively and appropriately participate in New York Independent System Operator Operators (NYISO) venues, and that their programs for Smart Grid, renewables, and Demand Side Management review and support are properly structured and implemented. The Consultant also pointed out that the Companies have a sound plan for dealing with the aging gas infrastructure.
4. Liberty stated that NYSEG and RG&E have a well-defined supply risk management approach, but opined that they should eliminate ISA's roles, such as credit evaluation, in the process. The Consultant stated that the Companies have a diverse gas supply asset portfolio, but that it would require re-evaluation of the Heating Degree Day calculation. Liberty also stated that the Companies perform effective, unbiased administration of retail choice.
5. Liberty lauded the Companies' effective worker training, and their reasonable flexibility in using workers under labor contracts.
6. Liberty found that IUSA uses appropriate, well-structured, cascading goals and targets to measure performance. The Consultant stated that there is a sound ethics and compliance program, but that the IUSA Code of Conduct needs

to address affiliates more specifically. They found sound linkage among goals, performance measures, and incentive compensation, but stated that the goals exhibit the extremely common overemphasis on "outputs."

The management audit process, however, focuses on improvement opportunities. Liberty found many areas where it felt the Companies could increase efficiency and effectiveness. The complete list of Liberty's recommendations is attached as Appendix A. Some of Liberty's more significant operational findings and recommendations include:

1. Liberty believes that what it describes as embedding the Spanish engineering and construction affiliate Iberdrola Energy Projects (IEP) into the Companies' operational functions is preventing the optimization of internal resources, and that the benefits presented to the Commission to justify the affiliate's use were compared to the wrong baseline by using external contractor costs as the base instead of in-house personnel costs. Liberty thinks a drastic reduction in internal personnel, which already manifests itself in delays in getting projects engineered, estimated, and "into the pipeline," was a major contributor to the Companies' catch-up expenditures in capital spending in 2010 and 2011, and could continue if less work is performed by internal utility resources, and more by the IEP resources, which will be less familiar with the Companies' service territories. Liberty says that IUSA's claims that loyalty, familiarity, and performance benefits would better accrue from using contractors rather than from employees are counterintuitive. Liberty recommended that the Commission immediately modify the conclusion of its recent order finding that the utility Companies were authorized to contract with IEP for engineering and construction services at the lesser of

fully loaded costs or market prices,[3] and that the Companies be directed to suspend use of construction services indefinitely.[4]

2. Liberty recommends that the Companies conduct market solicitations for electric energy resources through an RFP process and implement any alternatives identified as superior to the existing plan of energy and hedging instrument purchases. Similarly, Liberty suggests that the Companies conduct market solicitations for electric capacity resources through RFP processes and implement any alternatives identified as superior to the existing plan of capacity purchases. Liberty estimates that there would be significant savings if this were adopted.
3. Liberty recommends that the Companies move to a five-year distribution vegetation trim cycle for all distribution circuits. Liberty estimates that there would be significant savings if this cycle was adopted.
4. The Companies, Liberty states, have had difficulty meeting capital spending targets effectively. This was demonstrated by the fact that they fell well behind the pace of spending expected in 2010 and 2011, and had to engage in significant catch-up spending in year-ending months to meet their spending goal. The Companies

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[3] Case 07-M-0906, Iberdrola, S.A., Order Denying Petition (issued April 21, 2011).

[4] This finding is found in Chapter 2 Corporate Structure and Governance as well as throughout the operations chapters. For this reason, while this finding is articulated in this section, it will be addressed in the Reorganization Petition case, which is Case 12-M-0066, Petition of New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation, RGS Energy Group, Inc., Iberdrola USA Networks, Iberdrola USA, Inc., and Iberdrola Finance UK Limited for Approval of an Internal Reorganization Pursuant to Public Service Law §70 (Reorganization Petition), and which is discussed below.

acknowledge difficulty in keeping “pipeline full” of work due to problems with design, estimating, and work planning. The Companies added an ISA executive to increase the pace of capital spending.

5. Liberty sees IUSA Board engagement as weak. Liberty states that there is a lack of Board focus on examining, monitoring, and driving corrective actions.
6. Liberty found no consistent capital project prioritization approach or methodology. An example is a lack of effective review of capital projects, which makes expenditure efficiency questionable. Liberty states that there are significant warning signs of potential problems in this area, and that the current processes clearly provide a poor basis for moving forward.
7. Liberty found many problems in the area of work management. The Consultant states that IUSA focuses on monitoring, not improving work management. There is a lack of trained cost estimators and an absence of estimation processes, with a small and inexpert cost support staff. Cost analytical and cost control skills and mission are deficient, and the systems do not support dynamic, real-time cost analysis or provide reliable installation rates. There is a lack of focus on productivity measurement, which is problematic, given past problems the capital expenditure program. There is no strong plan for replacing the Companies’ aging work force, and no long-term resource numbers or capability modeling, a concern that was posed in the consumer services area of the RFP. In this area, the cuts made to the NYSEG call center were done for fiscal purposes only, without a real staffing model to determine optimal staffing.
8. According to Liberty, the Companies lack project management skills. The project manager role is not clearly defined or executed, and there is no structured plan or approach to

managing project costs. Contractors are performing the role the Companies should take, without controls. There is no workable Quality Assurance/Quality Control organization; again, contractors are taking most of the responsibility. However, the Consultant states that the Companies have good vegetation contracting processes, but there are delays in getting work started seasonally on the distribution system sector. Finally, Liberty states that the Companies lack a sufficiently defined VM cycle approach to the distribution system.

9. Liberty states that the Spanish parent is strongly interested in IUSA staffing levels. This was acknowledged as a principal concern when ISA's ownership began, and remains a major focus of the ISA leadership. Liberty states that this focus is driven by European benchmarking, and IUSA officials acknowledged ISA's lack of appreciation of U.S. environmental differences such as climate, vegetation, and labor agreements. Liberty believes the New York Companies operate with very low internal resources while overusing contractors, indicating there are opportunities for increasing the efficiency and effectiveness of capital program spending, which will ultimately benefit New York State ratepayers. Liberty finds that the overuse of contractors threatens cost performance in both the short- and long-term. Furthermore, IUSA cannot demonstrate the cost effectiveness of its high contractor use. Contractor productivity is not monitored, leaving the Companies vulnerable to overcharges, overtime, and work sequence deficiencies, which threaten achievement of cost performance targets generally, and increase the risk of incurring unnecessary additional costs to expedite projects. In addition, comparisons of in-house unit costs

to contractor resource costs have not been adequately justified.[5]

10. Liberty feels that not having a consolidated natural gas business unit is a weakness in the organizational structure, causing the Companies to lose focus on this vital aspect of their businesses.[6] The Consultant recommends that the gas business be consolidated under a single executive reporting to the Chief Operating Officer.

Corporate Structure and Governance Findings

When Liberty studied the corporate structure and governance of ISA, it found certain aspects of ISA's operations that were profoundly different from traditional utility practices in the U.S., and these became the focus of intense scrutiny. Liberty concluded that the structure and scope of parent board organization and activities differ significantly from what is generally accepted in the case of U.S.-based utility companies.

Liberty came to the following conclusions:[7]

*1.* ISA does not strongly emphasize board member diversity of business and operating skills and experience, which contrasts with what has been observed at major U.S. utility enterprises.

*2.* The parent board does not provide a substantial level of independent oversight over New York utility operations.

*3.* The IUSA and the IUSA subsidiary boards provide a more detailed level of oversight, but they are dominated by Spanish executives, which continue to leave an

[5] For the reasons discussed above, this finding will be addressed in the case on the Reorganization Petition.

[6] For the reasons discussed above, this finding will be addressed in the case on the Reorganization Petition.

[7] Final Audit Report, Chapter 2, *Corporate Structure and Governance*, pp. 44 – 51.

"independence" gap by comparison with U.S. utility holding companies.

4. Senior Spanish executives and directors do not take a direct interest in or have more than very general knowledge of the details of U.S. regulatory requirements.
5. Routine information sources available to European directors (and any senior managers with significant actual or potential influence over New York operations should be of a scope, level of detail, and frequency to provide them with sufficient information to carry out their responsibilities as they affect those New York operations.
6. Outside consultants have reviewed board performance relative to peers, but there had been no self-assessments at the time of the audit work.
7. Management takes what is, as compared to Liberty's experience with many other utilities, an unusual perspective on regulatory transparency.
8. The IUSA board committee which is responsible for audit matters operates under a typical and appropriate charter and list of functions, is active in defining and exercising committee activities, and has financial expertise, but its membership is concentrated in ISA executive management members.

Where matters were concrete and implementable, the Consultant made the following recommendations:[8]

1. Make IUSA personnel a more central voice in communicating regulatory requirements, expectations, decisions, guidance and other matters to senior Spanish executives and the parent board and establish vehicles to make those audiences more aware of U.S. regulatory issues.
2. Institute yearly self-assessments of board performance.

[8] Final Audit Report Chapter 2, pp. 53-54.

The Consultant discussed the disconnect between the Spanish model of Board composition and U.S. involvement, and concluded that the Spanish model does not result in significant leadership or oversight of the U.S. utilities. ISA wants to standardize practices worldwide, but does not appear to recognize the vast differences in the service territories and regulatory and governance environments in which its many subsidiaries operate. One resulting outcome is a significant emphasis by ISA on “cost-cutting” at the U.S. utilities, using the Spanish utility as a model. This cost-cutting model has resulted in severe staffing cuts, which the Consultant perceives as a problem that will manifest itself in the future.

The IUSA Board is composed primarily of ISA executives, whose operations experience is rooted in a culture, regulatory environment, and operating and climatic zone that does not provide commonality of understanding. Senior Spanish officials and board members acknowledged their lack of detailed knowledge of U.S. operations.[9] The conclusion is that ISA has no one in a position of authority who understands the operating needs of a U.S. utility and is concerned with responsibilities to New York ratepayers. Liberty also questioned the autonomy of the U.S. executive team, as they all had counterparts from the parent company, and the U.S. Chief Executive Officer reports directly to an ISA executive who is also the Chairman of the IUSA Board.

Liberty’s summary governance recommendation states “the gaps between ISA governance and what one would expect for a company with the breadth of operations of IUSA do not lend themselves to concrete, executable change recommendations.”[10] Liberty concluded that the differences in culture, management

[9] Final Audit Report Chapter 2, p. 10.

[10] Conclusions #13 through #16 and #18.

style, and interests are too vast for any one, two, or three discrete recommendations to make a difference. A small number of specific recommendations would achieve only a "cosmetic change," perhaps promising on the surface, but which would not bridge the gap between Spain practices and U.S. expectations. Liberty stated: [11]

> Across time, the Commission will have many opportunities to observe successes and failures (even the best operating utilities with the most finely tuned regulatory ear experience both, given long enough). ISA will therefore have opportunities to experience: (a) the rewards and penalties that come with them, and (b) whatever connections the Commission makes between those successes and failures and any underlying governance issues of concern to it.

Given its statement, the Consultant asserted that many of the systemic shortcomings in the governance of the Companies (including ISA and IUSA) could not be addressed in the standard management audit implementation process. Instead, the Consultant opined, the Commission would necessarily have to review other avenues to effecting changes in the governance model that would benefit New York ratepayers.

On February 27, 2012, during the conduct of the management audit, NYSEG, RG&E, IUSA, RGS Energy Group, Inc., Iberdrola USA Networks, Inc. (IUSA Networks), and Iberdrola Finance UK Limited filed a petition for approval of an internal reorganization pursuant to Public Service Law §70, instituting Case 12-M-0066, which is the Reorganization Petition, discussed, supra. Iberdrola USA proposes to create a new holding company, IUSA Networks, upstream from the New York utilities, and place IUSA Networks below the IUSA holding company. The IUSA holding company would then own both IUSA Networks and ISA's and Iberdrola's renewables holding company, which holds ISA's U.S. renewables businesses. Iberdrola USA states: "the Internal

[11] Final Audit Report, Chapter 2, p. 54-55.

Reorganization is part of a global effort by Iberdrola to reorganize its operating companies on a country-specific basis. In the United States, this reorganization will allow for the consolidation of the subsidiaries currently owned by IBUSA and its affiliate, Iberdrola Renewables Holdings, Inc. ("IRHI"), into a unified country-specific holding company structure, thus creating a more centralized presence in the United States."[12] The Reorganization Petition highlights a number of issues related to the Governance areas of the Management Audit, since, as Liberty noted, the February Reorganization Petition is "a significant reorganization [and] would change the structure under which the New York utility businesses are owned and operated."[13]

## DISCUSSION

### The Reorganization

Liberty raises significant concerns about the Companies' (including ISA and IUSA) organization , but does not offer meaningful solutions. The corporate governance issues are arguably the most important ones raised by the audit, and we are concerned that these issues be analyzed fully and vetted carefully. The reorganization proposed in Case 12-M-0066, the Reorganization Petition case, further complicates our resolution inasmuch as Liberty did not have the time to analyze the issues posed by the new structure. Clearly, the proposed reorganization and the questions raised by Liberty are closely related, and it makes sense for us to evaluate the reorganization in light of the problems found by Liberty. A means to address those matters, and resolution of other issues, are discussed below.

[12] Reorganization Petition, p. 3.

[13] Final Audit Report, Chapter 2, p. 1.

Cost Benefit Analyses

This is the second audit where DPS asked the independent consultant to evaluate costs and benefits associated with recommendation implementation. Prior Management Audits only required cost benefit analysis (CBA) at the time the utility filed its implementation plan.

Liberty developed a formal CBA process in collaboration with Staff and the Companies prior to execution. The process included preparation of a guide document that laid out the requirements and procedures for the CBA process, to ensure the process would be as collaborative, comprehensive, fair and accurate as possible, while giving the Companies the opportunity to fully participate in the definition and quantification of costs and benefits. While disagreeing with the calculations arising from the CBAs, the Companies were supportive of the process itself.

Wherever possible, the Consultant was required to quantify both costs and potential benefits. For some recommendations, it is difficult to identify firm dollar values, since the quantifications are based on professional judgment and a projection of improvement opportunities unique to that utility. Other recommendations do not lend themselves to CBA, inasmuch as these other recommendations focus more on good management practices, which are less tangible, and cannot always be measured or quantified.

The proposed costs and benefits are to be used as a reference during the implementation phase of the audit. Staff's Subject Matter Experts (SMEs) will work with the Companies during the implementation phase to track incremental costs and attainment of benefits and ensure that those results are reported in future rate cases.

A total of 75 CBAs were issued, one for each of the identified recommendations in the Final Audit Report. A table summarizing the costs and benefits for each recommendation is included at the end of Chapter 1 of the Final Audit Report. If all recommendations are implemented as recommended, Liberty estimates that it would cost the Companies from $1.8 to $2.3 million in increased annual costs and approximately $103.7 million in one-time costs. Additionally, Liberty estimates the Companies could save from $153.8 to $253.3 million in reduced annual operating expenses, energy supply costs, and capital costs over a hypothetical five to fifteen year time horizon.[14]

A significant portion of the estimated benefits calculated by Liberty result from energy supply cost savings. These supply cost savings estimates, however, were not based on any factual analysis, as Liberty concedes by stating, under Recommendations 8.2 and 8.3., “The savings benefit cannot be calculated currently.”[15] The “example” benefits were calculated assuming energy and capacity could be purchased at various price reductions. Those price reductions are unrealistic. Because these calculated example savings lack support, they should not have been included in the summary of estimated benefits.[16]

The next recommendation with the most significant benefits would come from Program and Project Planning and Management (Chapter 11) in the area of distribution vegetation management. Liberty believes NYSEG could reap from $17 to $83 million in net present value (NPV) savings over 15 years if the Companies were to move to a five-year distribution vegetation trim cycle for all distribution circuits. In order to achieve

[14] Both Staff and the Companies take issue with the manner in which Liberty has quantified costs and benefits.

[15] Recommendations 8.2 and 8.3 recommend that the Companies conduct market solicitations for energy and capacity resources through an RFP process.

[16] Any savings that result from implementing these two recommendations will automatically benefit customers through the Companies’ supply mechanisms.

these future savings, Liberty estimates NYSEG would be required to spend an incremental $90.5 million upfront (or $18.1 million annually over the next five years).

The aforementioned estimated savings pertain to only 3 of the 75 audit recommendations. Liberty was not able to provide costs and benefits for all of its recommendations, nor was Liberty expected to do so. Even though unable to identify tangible costs and benefits for all 75 recommendations, Liberty has asserted that the audit benefits far outweigh the costs.

Inherently, costs are more suitable to prediction than savings. The quantified costs and benefits summary table Liberty provided has a number of limitations. First, it commingles recommendations with high quality quantifiable support with recommendations offering little or no quantifiable support. Next, it combines savings in capital, supply, and operating costs rather than segregating each. Finally, it mixes nominal savings with NPV savings over different time horizons. All of these limitations make it difficult to conclude with absolute certainty the timing, amount, and probability of net savings.[17]

Analysis of the Companies' (including IUSA) Comments

The Companies and IUSA submitted comments in response to the Final Audit Report on June 18, 2012. The Companies and IUSA have agreed that they will consider all the recommendations made by the Consultant, but they primarily take issue with recommendations concerning: 1) the suspension of IEP services to New York utilities, and 2) Liberty's estimation of savings on long-term electric supply, which the Companies and IUSA characterize as "speculative trading." The Companies' and IUSA's comments are attached as Appendix B.

[17] The Companies have proposed corrections to many of Liberty's calculations.

The Companies and IUSA disagree with Liberty’s assertions about IEP, and state that use of IEP services is in the best interest of NYSEG and RG&E customers.  They state that Liberty’s asserted linkage between its workforce reductions and use of IEP is unsupported and claims that they use an optimal mix of internal and external resources.  They assert that use of IEP offsets the use of higher priced contractors and allows for the sharing of worldwide best practices.  Finally, the Companies and IUSA state that the immediate suspension of IEP would disrupt their capital programs.  They request the opportunity to present their resource plans which will demonstrate that they are utilizing the optimal mix of internal and external resources.

In their comments, the Companies and IUSA refine Liberty’s CBA summary table and its quantifications by segregating the amounts into the capital, supply, and operating costs categories.  Further, the Companies and IUSA attempt to organize the timing of the costs and benefits into one and five year horizons and provide corrections to Liberty’s values.  The Companies and IUSA do not further segregate or discount the CBAs based upon the quality of Liberty’s quantification (i.e., for purposes of presenting their table, the Companies and IUSA accept the amounts provided by Liberty even though they reserve the right to ultimately disagree with many of these amounts).

The Companies and IUSA have responded to the cost benefit analysis, not always agreeing with the calculations, but expressing its willingness to engage in dialogue about the recommendations.  Using Liberty’s estimates, the Companies and IUSA provided the following summary of costs and benefits associated with Liberty’s recommendations:

| | Costs | Benefits | Net |
|---|---|---|---|
| | (Millions of Dollars) | | |
| Expenses | $ 123.0 | $ (21.1) | $ 101.9 |
| Capital | 3.6 | (28.6) | (25.0) |
| One-Time | 9.0 | - | 9.0 |
| Subtotal | $ 135.6 | $ (49.7) | $ 85.9 |
| Supply | - | (155.3) | (155.3) |
| Total | $ 135.6 | $ (205.0) | $ (69.4) |

If the Companies' and IUSA's presentation is correct, there would be a significant gap between non-supply related costs and benefits. In other words, should the supply-related cost savings fail to materialize, there would be significant cost increases to the utilities, of approximately $85.9 million over the next five years. Should such a gap actually materialize during implementation, it could put upward pressure on delivery rates in the near term. As a result, we direct the Companies to work with Staff during the implementation phase to further refine the costs and benefit estimates for the recommendations that result in near term cost increases. After such refinement, we would expect the Companies to take such cost increases into account in its implementation decisions so that short-term impacts on delivery rates are considered and mitigated to the extent possible.

Concerns Regarding Certain Liberty Recommendations

Some of Liberty's recommendations may be contrary to our policies, or may raise rather than lower costs. The following Liberty recommendations require additional clarification or study and support during the implementation process:

1. As mentioned previously in this Order, Liberty recommends that the Companies conduct market solicitations for electric energy resources through an RFP process and implement any alternatives identified as superior to the existing plan of energy and hedging instrument purchases.

Similarly, Liberty suggests that the Companies conduct market solicitations for electric capacity resources through RFP processes and implement any alternatives identified as superior to the existing plan of capacity purchases. Liberty estimates that there would be significant savings if this were adopted. However, these supply cost savings estimates were not of high quality, were not based on any factual analysis and were not realistic. The Companies should continue to meet periodically with Staff to discuss the composition of their electric supply portfolios.

2. A holistic cost management program, similar to that at Consolidated Edison Company of New York, Inc. (Con Edison), should be implemented by the Companies. Liberty states that the savings will be in the tens of millions. However, while these sizable costs are well defined, the benefits are not. This places some risks on consumers. We are aware of the sizable savings reported as achieved by Con Edison; therefore, we will require the Companies, in their Implementation Plan discussed below, to provide a more thorough quantification of the benefits of the holistic cost management program before it commits to spending the amounts proposed.

3. Liberty recommends that NYSEG be required to spend an incremental \$90.5 million upfront (or \$18.1 million annually over the next five years) to implement the distribution vegetation management (VM) program recommendation. As noted in NYSEG’s most recent rate case, however, there were concerns about NYSEG’s ability to manage such a large increase in scope of its VM program. Furthermore, the nature of Liberty’s recommendations requires a large up-front cost to achieve a five-year cycle followed by benefits in future years. This large up-front

cost has adverse rate consequences and, as a result, NYSEG must take into account short-term impacts on delivery rates and must mitigate these impacts to the extent possible. Finally, as noted earlier, these costs and benefits should not be taken as facts, but rather shall be treated as starting points for further examination.

4. Liberty accepted the Companies' finding that consolidation of RG&E and NYSEG would not produce appreciable savings. This finding is based on insufficient data and was premature.

5. Liberty recommends that we modify our Order which concluded that IUSA was authorized to procure services from IEP on behalf of NYSEG and RG&E, at the lesser of fully loaded costs or market price. However, further study of the staffing issues, in conjunction with the costs and benefits, is a more prudent step to take at this time. This review will take place in the Corporate Structure and Governance review conducted in Case 12-M-0066, as discussed below.

6. Liberty reviewed IUSA's compliance with the Sarbanes-Oxley Act (SOX), but may have overlooked one aspect of a condition imposed in the Merger Order,[18] that obligates IUSA to comply with SOX as if it were a publicly traded U.S. company. Those issues will be addressed in the Corporate Structure and Governance collaborative discussed below.

We order the Companies to confer with Staff regarding recommendations, including those which the Companies feel are inappropriate, contrary to Commission directives, or not cost-effective, before they commence implementation action. Staff

[18] Case 07-M-0906, supra, Order Authorizing Acquisition Subject to Conditions (issued January 6, 2009); see also Case 07-M-0906, supra, Abbreviated Order Authorizing Acquisition Subject to Conditions (issued September 9, 2009).

will review the validity of the costs and benefits of the recommendations during implementation, and these will be further tested in the rate case process.

## FINDINGS

### Operations

We direct the Companies to develop an implementation plan that carefully considers the Final Audit Report's recommendations in Chapters 3 - 14 and the additional findings in this Order. We expect the Companies to make the necessary changes that will improve their performance, and to demonstrate executive-level commitment to this process.

In the event that the Companies propose (as part of or in connection with their Audit Implementation Plan) alternatives to the Final Audit Report's specific recommendations, the Companies must provide appropriate justification. Any justification must demonstrate, as appropriate, how the alternative: 1) more effectively addresses the root causes of the relevant problems and findings; 2) produces a favorable risk/cost/benefit result; 3) is more technically feasible; and 4) is more desirable, based on other compelling analyses. The Companies shall advise Staff of any intentions to pursue alternative solutions. Staff will discuss such alternatives with the Companies; if modification of a recommendation is needed, the issue will be presented to us for resolution.

In the past, we recognized the need for flexibility in how utilities implemented audit recommendations, and that flexibility will also be applicable here. After receiving and reviewing management audit reports, we generally directed utilities to evaluate the recommendation, submit implementation plans, and work closely with Staff. Clearly, there was an understanding of the need for flexibility and cooperation between Staff and the utility.

Our decision to provide utilities with flexibility is guided by previous experience with the Management Audit program and by the dynamics of how organizations can achieve successful and sustainable changes that yield performance improvements. Specifically, we previously concluded, “audit recommendations are best carried out in a spirit of cooperation among the company, the auditor, and staff...” [19] We encourage this spirit of cooperation to continue throughout the implementation process.

We direct the Companies to file an Implementation Plan within 60 days of the date of this Order, and that standard implementation procedures be followed. The Companies should confer with Staff regarding recommendations, including those which the Companies believe are inappropriate, contrary to Commission directives, or not cost-effective, before they commence implementation actions. Staff will review the validity of the costs and benefits of the recommendations during implementation, and these will be further tested in the rate case process.

Corporate Structure and Governance

To facilitate further consideration of Liberty’s Corporate Structure and Governance findings,[20] and in particular the impact of the corporate restructuring proposals in Case 12-E-0066 on those findings, the petitioners shall supplement their Petition in that proceeding to show how the reorganization can be configured to address the problems Liberty identifies. After the supplement is filed, Staff will enter into collaborative discussions with the Companies, IUSA, and any interested

[19] Cases 28053, et al., Rochester Gas and Electric Corporation, Opinion No. 82-16, Opinion and Order Determining Revenue Requirement and Rate Design (issued July 12, 1982).

[20] These include any that may appear in Chapters 3 – 14 that are related to corporate structure and governance.

parties to further refine the issues. Upon conclusion of the collaborative, a report shall be prepared and presented to us on those issues, and we will take whatever action is appropriate to resolve the issues.

## CONCLUSION

Iberdrola, S.A., Iberdrola USA, Inc., New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation shall develop an Audit Implementation Plan (the Plan) for the areas covered in Chapters 3 through 14 of the Final Audit Report and file that Plan within 60 days of the date of this Order. The Plan will include an overall characterization of the relative priorities for each of the recommendations, implementation action steps, schedules with specific interim milestones, risk/cost/benefit analyses, and a designation of executive officer accountability for this implementation. The Companies shall consult with Staff during the development of this Plan.

As part of the Audit Implementation Plan, the Companies shall meet with Staff within 20 days after the issuance of this Order to discuss the development of the Audit Implementation Plan, to confer regarding recommendations, including those which the Companies feel are inappropriate, contrary to our directives, or not cost-effective, before they commence implementation actions. Periodic meetings with Staff will continue until the Plan is fully implemented. Specific focus should be placed on the areas highlighted as concerns in this Order.

As another part of the Plan, the Companies will provide written progress updates every four months. Additional interim updates will be necessary if the Companies experience schedule slippage or other significant deviations from the Implementation Plan.

The petitioners shall supplement the Reorganization Petition in Case 12-M-006 within 30 days of the date of this order, to explain how they will address Liberty's Corporate Structure and Governance findings. Following the supplemental filing, the Companies and IUSA shall meet with the Staff of the Department of Public Service, and any other interested parties, to begin a collaborative process to discuss the findings, conclusions, and recommendations from Chapter 2, "Corporate Structure and Governance," from the Liberty Consulting Final Audit Report. A report shall be prepared on the results of the collaborative discussions, proposing any further actions necessary to resolve the corporate structure and governance concerns as well as the issues raised in the Reorganization Petition.

<u>The Commission orders</u>:

1. Iberdrola, S.A., Iberdrola USA, Inc., New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation shall supplement their petition in Case 12-M-0066, as discussed in the body of this Order, within 30 days of this Order, and shall enter into the collaboration discussed in the body of this Order.

2. Iberdrola, S.A., Iberdrola USA, Inc., New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation shall file their Audit Implementation Plan on Chapters 3-14 within 60 days of the issuance of this Order. Iberdrola, S.A., Iberdrola USA, Inc., New York State Electric and Gas Corporation, and Rochester Gas and Electric Corporation shall confer with Staff regarding recommendations, including those which the Companies feel are inappropriate, contrary to Commission directives, or not cost-effective, before they commence implementation actions.

3. The Secretary in her sole discretion may extend the deadlines set forth in this Order.

4. This proceeding is continued.

By the Commission,

Jaclyn A. Brilling
Digitally Signed by Secretary
New York Public Service Commission

(SIGNED) JACLYN A. BRILLING
Secretary

# RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
|---|---|
| 2.1 | Suspend indefinitely the provision of services by affiliate IEP to the New York Utilities. |
| 2.2 | Consolidate the gas business under a single executive reporting to the COO. |
| 2.3 | Streamline executive communications links and focus IUSA leadership under a more fully empowered CEO, emphasizing U.S. operation's needs. |
| 2.4 | Institute formal IUSA board evaluations of CEO performance and review of CEO evaluations of other top management incumbents. |
| 2.5 | The gaps between ISA governance and what one would expect for a company with the breadth of operations of IUSA do not lend themselves to concrete, executable change recommendations. |
| 2.6 | Make IUSA personnel a more central voice in communicating regulatory requirements, expectations, decisions, guidance and other matters to senior Spanish executives and the parent board and establish vehicles to make those audiences more aware of U.S. regulatory issues. |
| 2.7 | Institute yearly self-assessments of board performance. |
| 3.1 | Change the identification of transactions as convenience payments to distinguish pass-through payments from expenses incurred in providing inter-affiliate services. |
| 3.2 | Review and update the language of the inter-affiliate service agreements to reflect the current practice for affiliate transactions. |
| 3.3 | Tighten the controls that should prevent inter-affiliate billing without a service agreement. |
| 3.4 | Improve the timeliness of inter-affiliate bill payments. |
| 3.5 | Improve employee training and develop more complete policy documents to encourage more direct and cost-causative charging of service company costs. |
| 4.1 | Assign responsibility to the Rates and Regulatory Economics group for supervision and coordination of electric energy and peak load forecasting. |
| 4.2 | Enhance the intermediate and long-term energy and load forecasting methods. |
| 4.3 | Enhance the economic and forecasting capabilities and competencies. |

# RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
|---|---|
| 4.4 | Perform a comprehensive electric load research program. |
| 4.5 | Assess alternative forecasting methods. |
| 4.6 | Designate an oversight committee to address the management and organization issues. |
| 5.1 | The Companies should prepare a strategic assessment focused on wholesale market goals and objectives. |
| 5.2 | The Companies should create a formal matrix management team to oversee and manage the Companies' participation in NYISO, FERC, NERC, NPCC, etc. proceedings and issue assessments. |
| 6.1 | Modify transmission planning process to include an assessment of risk and uncertainty. |
| 6.2 | Prepare a comprehensive distribution planning procedures manual. |
| 6.3 | Perform a reevaluation of transmission planning prioritization criteria. |
| 6.4 | Retain a power systems engineering firm to perform an independent needs assessment of its transmission planning models and methods. |
| 6.5 | Hire an additional experienced transmission planner. |
| 6.6 | Participate in one or more transmission and distribution benchmarking (best practices) programs. |
| 7.1 | Develop a gas system vision, master plan and associated implementation strategy, including designation of the responsible individual(s) and organizational unit(s). |
| 8.1 | Develop a comprehensive long-term portfolio management plan with quantified goals and objectives to optimize the electric resource portfolio and related hedging plans. |
| 8.2 | Conduct market solicitations for electric energy resources through RFP processes and implement any alternatives identified as superior to the existing plan of energy and hedging instrument purchases. |
| 8.3 | Conduct market solicitations for electric capacity resources through RFP processes and implement any alternatives identified as superior to the existing plan of capacity purchases. |

# RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
| --- | --- |
| 8.4 | Document processes, procedures, and guidelines for electric supply and scheduling. |
| 8.5 | An executive risk management committee should be formed at IUSA that oversees the risk functions and the RMOC and has executive responsibility for risk management. |
| 8.6 | Internal Auditing should schedule audits of electric procurement decisions, documentation for entering into capacity supply contracts, and daily purchase decisions. |
| 9.1 | Upgrade the Gas Control Center personnel numbers and qualifications. |
| 9.2 | Upgrade the Gas Control Center physical facilities. |
| 9.3 | Perform a weather study to determine the proper design day and design winter HDD targets. |
| 9.4 | Improve the short-term (one-to-five day) forecasting process. |
| 10.1 | Complete a major overhaul of capital budgeting processes and activities, in order to produce a more structured, realistic, and supported approach to capital budget development and monitoring. |
| 10.2 | Develop five-year and ten-year IUSA strategic plans and strongly link with rate plan forecasts and annual budgets. |
| 10.3 | Enhance the IUSA Board's role in overseeing capital budget formation and monitoring. |
| 11.1 | Determine the best balance of the number of internal project personnel for the demands for Project Managers, Project Engineers and Schedulers. |
| 11.2 | Improve the project management functions of the SAP system. |
| 11.3 | Issue written project management procedures. |
| 11.4 | Separate the design function from the delivery function. |
| 11.5 | Adopt a systematic process in place for updating SAP monthly cash flows during the budget year. |
| 11.6 | Put vegetation management contracts in place by January 1 of the contract year. |
| 11.7 | Move to a five year trim cycle on all circuits. |

## RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
|---|---|
| 11.8 | Achieve the benefits of using herbicides in the distribution vegetation management program. |
| 11.9 | Add in-house technical expertise rather than use contractors. |
| 12.1 | Formalize Gas Project Management Organization & Process by staffing a Gas project management group with experienced individuals to manage all of the capital program projects, even the small main and service replacements. Additionally, the Companies should formally document project management procedures in a Project Management manual. |
| 12.2 | Review manpower requirements to meet the capital and program requirements within the gas organization and make changes accordingly. |
| 12.3 | Staff QA/QC to support an effective and functioning QA/QC program for all Gas projects and programs. |
| 13.1 | Implement a holistic cost-management program. |
| 13.2 | Begin monitoring Actual Job-hour expenditures versus Planned Job-hours for Electric and Gas Operations; provide “Planned Job-hours” for all work packages issued to the field. |
| 13.3 | Enhance the cost estimating capability by establishing a structured cost estimating program. |
| 13.4 | Establish a structured approach, policies and supporting guidelines for the balancing of in-house and contractor resources in physical work assignments. |
| 13.5 | Conduct a root-cause analysis on the continuous high trend in OSHA injury rate in Gas Operations and implement a corrective action program. |
| 13.6 | Establish a structured corporate approach, policies and supporting guidelines to provide managers and supervisors with a framework to manage non-exempt employee overtime. |
| 13.7 | Prepare an analysis of overtime expenditures on Electric Operations and Stores, including root causes of the high trends and strategies for attaining a predetermined target. |
| 13.8 | Develop the capability to continuously assess and monitor the productivity and cost impact of the expected retirement of linemen. |

# RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
| --- | --- |
| 13.9 | Include in future contracts a requirement that contractors performing physical work report expended job-hours and quantities installed or completed (at a property unit level). |
| 13.10 | Evaluate the most cost-effective size of the overall internal work force, including the Mobile Work Force, taking into account such factors as future planned workload, worker versus contractor efficiency and productivity, and work rules; strive to achieve a balanced and cost-effective workforce level. |
| 13.11 | Promote the ability of NYSEG and RG&E workforces to perform cost-effective work in each other's territories. |
| 13.12 | Establish a Quality Assurance Organization to maintain the integrity of all the electric work performed. |
| 14.1 | Study and apply the ConEd experience in long-term infrastructure planning in forming a concrete plan for long-range infrastructure planning. |
| 14.2 | Subject prior and future changes in SOX compliance structure, structure, responsibilities, procedures, practices, and components (e.g., key controls) to a focused analysis of potential impacts on utility regulatory processes and proceedings. |
| 14.3 | Make examination of affiliate relationships and transactions a recurring element of Internal Audit's plans and provide for clear, timely documentation and reporting of progress in implementing recommendations. |
| 14.4 | Incorporate into the IUSA Code of Conduct specific statements of IUSA values and principles regarding affiliate relationships and transactions, and summarize and make references to applicable policies, procedures, and guidance. |
| 14.5 | Make the reporting of the IUSA chief ethics and compliance lead organizationally separate from the general counsel's organization, establish a direct reporting organizational relationship to the IUSA CEO, and provide for regular and confidential reporting to the IUSA board's audit committee. |
| 14.6 | Develop a series input-based metrics that will permit more robust assessment of cost performance by measuring it against work units accomplished and the productivity achieved in accomplishing those units. |
| 14.7 | Establish a formal program applying a robust mix of external and internal benchmarks. |

# RECOMMENDATION SUMMARY BY CHAPTER

| Chapter | Recommendation Description |
| --- | --- |
| 14.8 | Give the IUSA board the full power to design and determine the compensation of IUSA employees. |
| 14.9 | Make the IUSA board the sole authority for establishing and measuring IUSA incentive compensation and assure the creation of all goals by the start of the period they address. |
| 14.10 | Re-evaluate and reconstitute the peer groups used to benchmark IUSA compensation. |
| 14.11 | Delink IUSA incentive compensation from ISA Global performance, incorporate more stretch in targets, and incorporate input measures. |

75 Total Recommendations

# Cover Page for Iberdrola USA, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation's Comments to The Liberty Consulting Group's Final Management Audit Report dated June 4, 2012

**Case 10-M-0551: In the Matter of a Comprehensive Management Audit of Iberdrola, S . A . , Iberdrola, USA, New York State Electric & Gas, and Rochester Gas and Electric**

# Response to the Final Management Audit Report

## June 18, 2012

Iberdrola USA, Inc

New York State Electric & Gas Corporation

Rochester Gas and Electric Corporation

## I. Summary

Iberdrola USA and its affiliates (collectively the "Company") appreciate the opportunity to respond to Liberty's Final Management Audit Report ("Report"). The Company agrees with certain parts of the Report, including the overarching governance finding that "the Iberdrola USA organization and executive structure appropriately focuses on New York utility needs and promotes efficiency." The Report finds, among many positive observations, the following:

- clear and appropriate mission, vision, objectives,
- goals and objectives balance needs of customers, shareholders, employees, and regulators,
- appropriate affiliate cost allocation processes,
- effective OPEX budgeting,
- benefits of implementing a five-year cycle trim at NYSEG,
- electric transmission and distribution networks maintained to provide reliability and support competitive suppliers,
- analytically sound and structured process to examine network improvements, and
- work management processes for all physical work are pertinent, logical, comprehensive.

The Report contains 75 recommendations, most of which the Company agrees with and has already begun to implement as part of its continuous improvement efforts. Some recommendations require further evaluation to determine whether their implementation would be cost beneficial, and the Company will address them in its implementation plan. There are a few Report Recommendations that are unsupported and will not result in customer benefits.[1] The Company has specific comments on the following Liberty Findings and Recommendations:

[1] The Company considers the management audit as another opportunity to identify best practices that will bring customer benefits. Where the Company and the auditor did not share the same conclusion and opinions, the Company has tried to understand and appreciate the differences, and, conversely has provided a full documentation of its position. This response will not dwell on that process, but there is a complete record of the Report's factual errors and unsupported recommendations in the Company's data responses, comments submitted as part of the Cost Benefit Analysis process during late 2011 and early 2012, and response to the Draft Audit Report submitted 11 May 2012.

- Liberty's opinion that a governance structure without majority independence (at Iberdrola USA) fails to ensure a convergence of shareholder and customer interests is unsupported. Despite explicit and binding IBERDROLA internal regulations and evidence of improving operational and regulatory results, faced with a different board composition, Liberty elevates independence above experience and performance. While Liberty had no recommendation, their opinion is unsupported and contradicted by major findings in the Report.

- Liberty's recommendation to indefinitely suspend the use of Iberdrola Energy Projects (IEP) is not warranted or advisable and would cause significant disruption to the Company's capital program. The Company believes the Report misunderstands the relationship and purpose of utilizing IEP. The Company is conducting a comprehensive resource study, including engineering and construction management, to evaluate the most effective balance between employees, affiliates, and contractors to optimize efficiency and customer benefits.

- Liberty's recommendation to consolidate the NY gas businesses under a single executive is not needed and undermines the matrix management structure in place throughout the organization. While the Company agrees that the importance of gas safety and the opportunity to expand gas service deserve committed resources and executive champions, the Company believes these are being effectively achieved within the current organization design and resource planning initiatives already underway.

- Liberty's staffing recommendations to significantly increase employee staffing levels at NYSEG and RG&E lacks the necessary rigorous analysis to act immediately. The Company recognizes the delicate balance between optimizing efficiency and providing safe and adequate service. The Company will continue to focus on the proper balance of internal and external resources.

- Liberty's recommendation to increase supply hedging duration makes significant unsupported energy and capacity supply savings assumptions. If the Commission approves an energy price hedge strategy as recommended by Liberty, the Companies will certainly participate and work closely with Commission Staff in the process. However, the Companies are very concerned with reversing the Commission's policy and with Liberty's lofty expectations regarding savings.

This audit scope was extensive, providing an assessment of two New York utilities, a regional network parent, and the multinational energy group parent. The Company devoted significant effort and attention to this audit, including the active participation of the Iberdrola USA Board of Directors, Iberdrola USA executive management, IBERDROLA S.A. executive management, and the IBERDROLA S.A. Board of Directors.[2] The organizational structure and business practices of Iberdrola USA have been in transition since Energy East acquired RG&E in 2002. The audit largely reviewed activities during 2009 and 2010 and represents a snapshot

[2] This Audit was unprecedented in the access for Liberty and Staff to all Iberdrola USA Board members, all Iberdrola USA and IBERDROLA S.A. executive management, and a majority of the IBERDROLA S.A. Board members, over 1,200 information requests (approximately 90% answered within 10 days), more than 250 interviews, and the collaborative engagement on most of the Report recommendations.

of a dynamic enterprise in the midst of critical regulatory, financial and operational improvements.[3] In looking back at Iberdrola USA's recent history, the audit necessarily deals with key threads, such as the importance of the Company joining a much stronger enterprise, weathering the 2008-2009 financial crisis, reaching agreement on multiple New York rate plans, undertaking of a comprehensive business transformation, including the sharing of best practices within IBERDROLA. With the support of the IBERDROLA Group, NYSEG and RG&E have begun a return to financial health, embarked on a major reliability investment initiative, and continued to achieve all key customer service, reliability, and safety goals. These results are the evidence of the Company's commitment to a convergence of customer and shareholder interests, the key for the Company's long-term success as acknowledged by Liberty and the Company's vision and mission statement.

## II. Cost Benefit Analysis

### A. Process

The Company credits the Commission's Cost Benefit Analysis (CBA) process for making this Audit more productive. Over the course of the CBA process, the Company, Staff, and Liberty as the Recommendation Review Committee (RRC) worked to identify and improve recommendations that would produce customer benefits.[4] However, a number of

[3] The Report identifies a "significant reorganization" of IBERDROLA USA announced February 22, 2012 as having "the potential to moot broad and important portions of the report" (Report Chapter II, p. 1). As more fully described in the Companies' filing with the Commission (Case No. 12-M-0066, filed February 23, 2012), this is straightforward and routine holding company restructuring.

[4] The Company does not understand Liberty's assertion that the Company's "simple strategy" in regard to CBAs "was seriously damaging to the process" (Report Volume Two, p. 4). The Company brought preliminary thoughts to the RRC meetings and shared that information within the RRC. The Company understands that Staff was supportive of the process and indicated it was useful. Both the Company's and Staff's suggestions were discussed during the RRC meetings. In many instances, Liberty further modified the CBAs to take into account Staff's or the Company's suggestions, or both. Liberty gave every evidence of finding that the information was useful; certainly, Liberty never told the Company that they were not useful, or asked the Company to stop the practice. It is not clear how providing feedback to RRC participants (and only RRC participants) prevented the RRC from arriving at consensus or why Liberty failed to identify these concerns during the CBA/RRC process.

recommendations only appeared in summary format at the end of the process and were not afforded the full benefit of this process.[5]

### B. Savings

The Report's presentation of potential savings is confusing and methodologically incorrect. The Company has redone the presentation and, while using Liberty's underlying numbers, has corrected the methodological errors and put it in a summary format for easier understanding (Attachment 1).

While based on Liberty's estimates the overall net Year One savings to customers would be $5 million dollars, those net savings evaporate if Liberty's energy supply recommendations are not adopted by the Commission or if the significant savings assumed by Liberty do not materialize.[6] Liberty's remaining recommendations (if all were adopted), would result in an increase in net Year One costs of over $25 million (again, using Liberty's cost and savings estimates).

## III. Comments on Specific Areas of Liberty's Report

In addition to Liberty's estimated Savings, the Company has comments on four other specific areas: Governance, IEP, Staffing, and Gas Strategy.

### A. Governance

The Report makes many positive findings regarding governance and executive management. Nevertheless, the Governance section of the Report makes a number of findings

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[5] Liberty notes that the CBAs produced budgetary overruns that aggravated other similar overruns from other causes, and together these overruns led to a number of actions, including an unplanned cut-off for the CBA process. Liberty's loss of interest in completing the straw man process was consistent with Liberty's position that it "felt compelled to mitigate the overruns as practical within the obligations of their contract" (Report Volume Two, p.3.). These were more fully addressed by the Company in its 11 May 2012 comments on the Draft Report to Liberty (and Staff).

[6] The Companies believe that the Report's recommendation on hedging electric supply would amount to speculation on future supply prices. The Commission's supply policy is the result of careful analysis and design, and, as the recent JP Morgan hedging loss demonstrates, customers are better served in the long run by a conservative approach that focuses on mitigating volatility.

that are fundamentally incorrect and unsupported.[7] The Company has previously noted their disagreement in its comments on the Draft Report. The Company will not repeat them but rather focuses on one aspect of the Report's overarching governance findings.

Liberty asserts that a convergence of customer and shareholder interests can only arise when there is an independent Board of Directors directing the Company. Liberty concludes that neither Iberdrola USA nor IBERDROLA S.A.'s Board of Directors provides that independent review. However, Liberty makes no governance recommendations, and leaves it to the Commission, "after observing the Companies successes and failures, as to whether any changes are needed." None are.

IBERDROLA has been recognized for the transparency of its governance system (for example, IBERDROLA has been selected as the Spanish company with the best corporate governance practices, according to the publication World Finance) and maintains a continuously updated Corporate Governance System, which is the set of documents made up of the *By-Laws*, the *Corporate Policies*, the Internal Corporate Governance Rules and the other internal Codes and Procedures.[8] Such System has been developed taking into account the good governance recommendations generally recognized in international markets and reflects the IBERDROLA S.A.'s vision, which applies in full to the IBERDROLA Group:

> *"We aspire to be the preferred Global Energy Company because of our commitment to the creation of value, quality of life, the safety of people and of supply, the protection of the environment and customer focus".*

Naturally, the Company agrees that there should be a convergence of interests, a long-standing belief and a principle enshrined in the IBERDROLA S.A. governance model and

[7] In addition to the information provided during the audit, the Company submitted detailed comments and supporting references and material after receiving the Draft Report to correct this unsupported position. While Liberty accepted scores of technical corrections, they ignored all of the more substantive issues.

[8] In addition to providing complete access to all governance documents, (always available on-line at https://www.iberdrola.es/webibd/corporativa/iberdrola?IDPAG=ENWEBACCGOBCOR) the Company provided presentations and made experts available to discuss the design and operation of the IBERDROLA governance model. See, for example, Attachment 2, IBERDROLA Corporate Governance System, November 30, 2011.

documents. Liberty's notion of an "Independent" review of management, however, is not required to achieve convergence. First, IBERDROLA S.A.'s Governance Model establishes a framework that supports the consideration of customer interests. Second, as confirmed by the audit, Iberdrola USA has a fiduciary board that includes well qualified and engaged independent Directors. Third, these independents are joined by IBERDROLA executives that have exceptional operational and customer experience. Fourth, the Board is compelled by internal regulations to safeguard and promote customer interests.[9] Fifth, the corporate governance model in practice ensures the strategic guidance of the Company, the effective monitoring of management by the Board, and the Board's accountability to customer long-term interests.[10]

The IBERDROLA governance model is confirmed by a number of Liberty's important findings that the management of Iberdrola USA is appropriately focused on New York customers' needs and expectations. As Liberty found:

- Iberdrola USA's structure provides the "ability to focus strongly on New York needs" and the structure "promotes effective operation for both New York and Maine utility needs,"
- The organization and executive structure "appropriately focuses on New York needs and promotes efficiency through a notable level of consolidation of functions," and
- Iberdrola USA's "executives are fully engaged on and aware of New York conditions, needs, priorities, resources, customer needs, and public requirements and expectations."

These findings go to the very heart of what any Commission could want from the management and Board of Directors of a Public Utility and confirm that no governance changes are required.

[9] Many examples were provided in the Audit and in comments on the Draft Report, but to name one, a basic IBERDROLA organizing document, the General Corporate Governance Policy, requires consideration of the public interest, and, in particular, the convergence with the public interest of the local service areas in which the Company operates.

[10] An external and independent assessment conducted by PwC of the Iberdrola USA Board in 2011 found that the Iberdrola USA Board had a 95% compliance record, concluding the effective performance of the Group's governance system, a high compliance with policies and internal rules of the company and a high degree of alignment with the trends in Corporate Governance. This detailed assessment was provided to the Commission Staff and Liberty when issued in January 2012, before the Draft Report was completed.

### B. Iberdrola Energy Projects ("IEP")

The Audit recommends an indefinite suspension of work with IEP, a Company construction services affiliate. The Company objects to this recommendation and request that it be allowed to demonstrate to the Commission why utilizing IEP along with its own internal resources and other outside experts is in the best interest of New York customers. NYSEG and RG&E's use of IEP was the subject of a separate filing before this Commission where the Company demonstrated that IEPs costs were less than those of other external contractors providing similar services, while also comparing favorably to internal resources.

NYSEG and RG&E have historically relied on external resources to augment and support capital project work. Pursuant to the Companies rate plans, capital investment has elevated to higher levels and it is imperative that the Company follow a sound approach to managing such investment. The Company believes a balanced mix of internal and external resources, including utilizing its affiliate providing services at costs, is consistent with good utility practice and provides the best value for New York consumers. The Company can deliver the best value to customers because it uses the appropriate experts and resource levels for varying and unique projects. Joining the IBERDROLA Group, the Company now has access to affiliates that can supplement needed external resources at a cost below other external contractors and comparable to in-house employees, while providing greater qualitative value, such as:

- The effective sharing and implementing of best practices from a world-wide engineering firm and transferring that knowledge to the Company as a service provider/partner. For example, the Company gets access and experience on network standards, automation, and technology not previously experienced in New York State.
- The customer benefit that accrues over time as the Company standardizes asset management and capital delivery that is best accomplished within a family of companies as opposed to multiple project management contractors.
- The immediate ability to ramp up to deliver the substantially increased infrastructure investment for New York customers using an experienced affiliate.

An indefinite suspension of the use of IEP is not appropriate and not warranted, and would have significant adverse impacts on NYSEG and RG&E's construction programs[11]. As noted in the Staffing section, the Company is developing a resource plan which will evaluate the optimal mix of internal and external resources. The resource plan is underway and will be completed by the fourth quarter of 2012. The Company requests that it be allowed to complete its analysis and present its results to the Commission prior to any decision regarding the use of IEP. Attachment 3 provides an overview on this issue.

### C. Staffing

A number of recommendations in the Report relate to increased staffing levels for NYSEG and RG&E. The Company and its subsidiaries are committed to efficiency, excellent customer service, safety, and reliability. It was in this context that the Company initiated and has continued its operations assessments and shared best practices to identify opportunities for accelerating improvement. With this background as a context, as noted above, the Company is committed to examine the proper mix of internal and external resources and to identify areas, if any, where an increase in internal staff could improve efficiencies or performance.

### D. Gas Strategy

The Company agrees that given the growth opportunities that now exist with the expansion of shale gas, the Gas business deserves support and strategic focus and believes that the matrix management approach, as opposed to a silo approach recommended in the Report, is most effective. The Company is in the midst of reviewing resources dedicated to various gas functions within the matrix organization. The Company does not believe that an additional gas executive is necessary, but has added a resource from a strategic perspective to work closely with the Vice President, Gas Operations on growth opportunities.

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[11] NYSEG and RG&E currently have a mix of about 30 internal FTE's and 85 external FTE's providing capital project delivery. IEP provides about half of the external resources. Suspending IEP or transitioning resources would seriously disrupt the planned capital delivery. As set forth in Attachment 3, the use of IEP should be continued while a resource plan is completed and evaluated.

The Company has taken steps to strengthen various work groups within the gas matrix organization. Examples of this include the creation and staffing of a new position (Director of Gas Operations in the Gas Operations organization) and the realignment of the field portion of the gas corrosion program from engineering and asset management to gas operations. These Director positions report directly to Vice Presidents, and these Vice Presidents report directly to the Iberdrola USA COO, who reports directly to the Iberdrola USA CEO, and also have functional reporting responsibilities to the President of NYSEG and RG&E.

All of the major gas functions and support functions (Gas Supply, Gas Control, Gas Operations, Gas Engineering and Asset Management, Human Resources, Safety and Training and General Services) are headed and/or staffed with Managers, Directors or Vice Presidents or a combination of the three that have extensive gas experience and expertise. Furthermore, the Gas functions receive the same amount of focus, planning and scrutiny as do the other major business areas throughout the Company. Iberdrola USA holds weekly staff meetings, team calls and quarterly face-to-face meetings with the senior team continually reviewing and adjusting priorities and strategic initiatives. The results of the senior team meetings are then implemented throughout the organization. All of the Vice Presidents participate in these meetings.

The matrix organization performs well at standardizing procedures and processes throughout the Company. The matrix organization requires diverse workgroups to communicate frequently. Many ideas are shared and implemented as a result of best practices that would have never occurred in the prior conventional organization structure. The matrix organization has helped improve communications and efficiency by requiring standardization, while functional oversight and strategic vision is provided for all workgroups from the Iberdrola USA CEO, Iberdrola USA COO and the NYSEG/RG&E President.

**Conclusion**

The Company has made a substantial commitment in this Management Audit. Working with Liberty and the Staff, particular effort was made to identify areas of potential improvement that can deliver customer benefits. In many ways the Final Report accomplishes this objective. Unfortunately, at least as to several key areas, the Draft and subsequent Final Report reaches erroneous conclusions based on unsupported one-sided opinion where the Company either had no opportunity to respond or where our response was ignored. The Company has, therefore, focused these comments on those areas where the Commission should have the benefit of a more complete picture. The Company commits to further develop appropriate responses to these areas during the implementation planning phase of this audit.

## Attachment 1. Costs and Savings[12]

In preparing these tables, the Company has used the estimates of costs and savings that Liberty included in its Report. Throughout the audit process, the Company has repeatedly discussed these figures and has made clear that it does not agree with the Liberty estimates. However, we have included the Liberty figures in this Attachment as a means to show that even on the basis of estimates made by Liberty, it is clear that the net benefits Liberty predicted are derived primarily from the recommendations relating to Market Solicitations (recommendations 8.2 and 8.3) and the rest of Recommendations would net more costs than savings over the five year period following the audit.

| Rec # | Recommendation | Year 1 - Cost/Benefit | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | *One-Time Cost - O&M and Capital* | *Increased Annual Operating Cost* | *Increased Annual Capital Costs* | *Annual Supply Savings (Pass-through)* | *Reduced Annual Capital Cost* | *Reduced Annual Operating Cost* | *Total Net Savings / (Costs)* |
| 2.1 | Suspend use of IEP | - | - | - | - | 2,000,000 | - | 2,000,000 |
| 2.2 | Consolidate its gas activities under a senior officer | - | (300,000) | - | - | - | - | (300,000) |
| 2.3 | Streamline communications; fully empowered CEO | - | - | - | - | - | - | 0 |
| 2.7 | Yearly self-assessments of board performance | (25,000) | (25,000) | - | - | - | - | (50,000) |
| 4.2 | Enhance intermediate & LT energy & load forecasting | (80,000) | (100,000) | - | - | - | - | (180,000) |
| 4.3 | Enhance econ/forecasting capabilities/competencies | - | (125,000) | - | - | - | - | (125,000) |
| 4.4 | Comprehensive electric load research program | - | (25,000)* | - | - | - | - | (25,000)* |
| 4.5 | Assess alternative forecasting methods | - | (25,000) | - | - | - | - | (25,000) |
| 5.1 | Strategic assessment of wholesale market goals/obj | (400,000)* | - | - | - | - | - | (400,000)* |
| 6.1 | Modify trans plng to include risk assessment | (59,000)* | - | - | - | - | - | (59,000)* |
| 6.2 | Distribution planning procedures manual. | - | (8,000) | - | - | - | - | (8,000) |
| 6.3 | Revaluation transmission planning prioritization criteria | (4,000) | - | - | - | - | - | (4,000) |
| 6.4 | Needs assessment trans plng models and methods | (85,000) | - | - | - | - | - | (85,000) |
| 6.5 | Hire an additional experienced transmission planner | - | (150,000) | - | - | - | - | (150,000) |
| 6.6 | Participate in 1+ T&D benchmarking programs | - | (80,000) | - | - | - | - | (80,000) |
| 8.1 | Comprehensive long-term portfolio management plan | - | (150,000)* | - | - | - | - | (150,000)* |
| 8.2 | Market solicitations for electric energy resources | - | (20,000) | - | 23,000,000 * | - | - | 22,980,000* |
| 8.3 | Market solicitations for electric capacity resources | - | (20,000) | - | 5,400,000 * | - | - | 5,380,000* |

[12] The Company used Liberty's cost and savings information for individual recommendations throughout this table. For analytical simplicity, all one-time costs are assumed to occur, and all annual costs are assumed to begin, during Year 1. The Company does not speculate here on the actual expected timing of the one-time costs, or when the annual costs will first be incurred. The asterisk (*) indicates that the high end of any range amount specified by Liberty was used for costs, savings, and/or net present value (NPV) benefits.

| Rec # | Recommendation | Year 1 - Cost/Benefit | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | ***One-Time Cost - O&M and Capital*** | ***Increased Annual Operating Cost*** | ***Increased Annual Capital Costs*** | ***Annual Supply Savings (Pass-through)*** | ***Reduced Annual Capital Cost*** | ***Reduced Annual Operating Cost*** | ***Total Net Savings / (Costs)*** |
| 8.4 | Document processes for electric supply/scheduling | (10,000) | - | - | - | - | - | (10,000) |
| 8.5 | Form IUSA executive risk management committee | (50,000) | - | - | - | - | - | (50,000) |
| 8.6 | Internal Auditing of electric procurement | - | (50,000) | - | - | - | - | (50,000) |
| 9.1 | Upgrade the Gas Control Center personnel | - | (146,000) | - | - | - | - | (146,000) |
| 9.2 | Upgrade the Gas Control Center physical facilities | (500,000) | - | - | - | - | - | (500,000) |
| 9.3 | Weather study of design day & design HDD targets | | (44,000) | - | 2,600,000* | - | - | 2,556,000* |
| 9.4 | Improve short-term (1-5 day) forecasting process. | | (44,000) | - | 67,000 | - | - | 23,000 |
| 10.2 | Develop strategic plans/link w/ rate plan & annual fcst | (200,000) | - | - | - | - | - | (200,000) |
| 11.1 | Int v Extl personnel (PM's, Engineers, Schedulers) | - | - | - | - | 637,500 | 637,500 | 1,275,000 |
| 11.3 | Issue written project management procedures. | (45,000)* | - | - | - | - | - | (45,000)* |
| 11.7 | Move to five year trim cycle on all circuits (NYSEG) | - | (18,100,000) | - | - | - | - | (18,100,000) |
| 11.8 | Achieve benefits using herbicides for dist Veg Mgt | (3,000,000) | (2,100,000) | - | - | - | - | (5,100,000) |
| 11.9 | Add in-house EEPS expertise vs contractors | (40,000) | - | - | - | - | 134,000 | 94,000 |
| 12.1 | Formalize Gas PM Org, process, & procedures | - | - | (248,000) | - | - | - | (248,000) |
| 12.3 | Staff QA/QC for Gas projects and programs. | - | (225,000) | - | - | - | - | (225,000) |
| 13.1 | Implement a holistic cost-management program. | (3,860,000) | (1,150,000) | - | - | - | - | (5,010,000) |
| 13.2 | Monitor/Communicate Actual vs Planned Job-hours | (20,000) | - | - | - | 750,000 | 750,000 | 1,480,000 |
| 13.3 | Establishing a structured cost estimating program | (150,000) | - | - | - | - | - | (150,000) |
| 13.8 | Assess productivity/cost impact of linemen retirement | (100,000) | - | - | - | - | - | (100,000) |
| 13.10 | Cost-effective # internal work force, including MWF | - | (2,104,000) | (496,000) | - | 2,658,000 | 1,772,000 | 1,830,000 |
| 13.12 | Establish an electric Quality Assurance Organization | - | (500,000) | - | - | - | - | (500,000) |
| 14.2 | SOX changes - analyze potential regulatory impacts | (50,000) | - | - | - | - | - | (50,000) |
| 14.5 | Modify IUSA chief ethics/compliance organization | - | (100,000) | - | - | - | - | (100,000) |
| 14.7 | Apply robust mix of external/internal benchmarks | (250,000) | - | - | - | - | - | (250,000) |
| 14.10 | Reconstitute peer groups for IUSA compensation | (50,000) | - | - | - | - | - | (50,000) |
| | **Grand Total** | **(8,978,000)*** | **(25,591,000) *** | **(744,000)** | **31,067,000 *** | **6,045,500** | **3,293,500** | **5,093,000 *** |
| | **Total without Supply Savings** | **(8,978,000)*** | **(25,591,000) *** | **(744,000)** | | **6,045,500** | **3,293,500** | **(25,974,000) *** |

| Rec # | Recommendation | Years 1-5 Cumulative | | | | | | | Year 6+ |
|---|---|---|---|---|---|---|---|---|---|
| | | ***One-Time Cost - O&M and Capital*** | ***Increased 5-Year Operating Cost*** | ***Increased 5-Year Capital Costs*** | ***5-Year Supply Savings (Pass-through)*** | ***Reduced 5-Year Capital Cost*** | ***Reduced 5-Year Operating Cost*** | ***Total 5-Year Net Savings / (Costs)*** | ***Net Present Value - Savings After Year 5*** |
| 2.1 | Suspend use of IEP | - | - | - | - | 10,000,000 | - | 10,000,000 | |
| 2.2 | Consolidate its gas activities under a senior officer | - | (1,500,000) | - | - | - | - | (1,500,000) | |
| 2.3 | Streamline communications; fully empowered CEO | - | - | - | - | - | 3,000,000 | 3,000,000 | |
| 2.7 | Yearly self-assessments of board performance | (25,000) | (125,000) | - | - | - | - | (150,000) | |
| 4.2 | Enhance intermediate & LT energy & load forecasting | (80,000) | (500,000) | - | - | - | - | (580,000) | |
| 4.3 | Enhance econ/forecasting capabilities/competencies | - | (625,000) | - | - | - | - | (625,000) | |
| 4.4 | Comprehensive electric load research program | - | (125,000)* | - | - | - | - | (125,000)* | |
| 4.5 | Assess alternative forecasting methods | - | (125,000) | - | - | - | - | (125,000) | |
| 5.1 | Strategic assessment of wholesale market goals/obj | (400,000)* | - | - | - | - | - | (400,000)* | |
| 6.1 | Modify trans plng to include risk assessment | (59,000)* | - | - | - | - | - | (59,000)* | |
| 6.2 | Distribution planning procedures manual. | - | (40,000) | - | - | - | - | (40,000) | |
| 6.3 | Revaluation transmission planning prioritization criteria | (4,000) | - | - | - | - | - | (4,000) | |
| 6.4 | Needs assessment trans plng models and methods | (85,000) | - | - | - | - | - | (85,000) | |
| 6.5 | Hire an additional experienced transmission planner | - | (750,000) | - | - | - | - | (750,000) | |
| 6.6 | Participate in 1+ T&D benchmarking programs | - | (400,000) | - | - | - | - | (400,000) | |
| 8.1 | Comprehensive long-term portfolio management plan | - | (750,000)* | - | - | - | - | (750,000)* | |
| 8.2 | Market solicitations for electric energy resources | - | (100,000) | - | 115,000,000 * | - | - | 114,900,000 * | |
| 8.3 | Market solicitations for electric capacity resources | - | (100,000) | - | 27,000,000* | - | - | 26,900,000* | |
| 8.4 | Document processes for electric supply/scheduling | (10,000) | - | - | - | - | - | (10,000) | |
| 8.5 | Form IUSA executive risk management committee | (50,000) | - | - | - | - | - | (50,000) | |
| 8.6 | Internal Auditing of electric procurement | - | (250,000) | - | - | - | - | (250,000) | |
| 9.1 | Upgrade the Gas Control Center personnel | - | (730,000) | - | - | - | - | (730,000) | |
| 9.2 | Upgrade the Gas Control Center physical facilities | (500,000) | - | - | - | - | - | (500,000) | |
| 9.3 | Weather study of design day & design HDD targets | | (220,000) | - | 13,000,000 * | - | - | 12,780,000* | |
| 9.4 | Improve short-term (1-5 day) forecasting process. | | (220,000) | - | 335,000 | - | - | 115,000 | |
| 10.2 | Develop strategic plans/link w/ rate plan & annual fcst | (200,000) | - | - | - | - | - | (200,000) | |
| 11.1 | Int v Extl personnel (PM's, Engineers, Schedulers) | - | - | - | - | 3,187,500 | 3,187,500 | 6,375,000 | |
| 11.3 | Issue written project management procedures. | (45,000)* | - | - | - | - | - | (45,000)* | |

| Rec # | Recommendation | Years 1-5 Cumulative | | | | | | | Year 6+ |
|---|---|---|---|---|---|---|---|---|---|
| | | *One-Time Cost - O&M and Capital* | *Increased 5-Year Operating Cost* | *Increased 5-Year Capital Costs* | *5-Year Supply Savings (Pass-through)* | *Reduced 5-Year Capital Cost* | *Reduced 5-Year Operating Cost* | *Total 5-Year Net Savings / (Costs)* | *Net Present Value - Savings After Year 5* |
| 11.7 | Move to five year trim cycle on all circuits (NYSEG) | - | (90,500,000) | - | - | - | - | (90,500,000) | 83,000,000 * |
| 11.8 | Achieve benefits using herbicides for dist Veg Mgt | (3,000,000) | (10,500,000) | - | - | - | - | (13,500,000) | 6,700,000* |
| 11.9 | Add in-house EEPS expertise vs contractors | (40,000) | - | - | - | - | 670,000 | 630,000 | |
| 12.1 | Formalize Gas PM Org, process, & procedures | - | - | (1,240,000) | - | - | - | (1,240,000) | |
| 12.3 | Staff QA/QC for Gas projects and programs. | - | (1,125,000) | - | - | - | - | (1,125,000) | |
| 13.1 | Implement a holistic cost-management program. | (3,860,000) | (5,750,000) | - | - | - | - | (9,610,000) | |
| 13.2 | Monitor/Communicate Actual vs Planned Job-hours | (20,000) | - | - | - | 3,750,000 | 3,750,000 | 7,480,000 | |
| 13.3 | Establishing a structured cost estimating program | (150,000) | - | - | - | - | - | (150,000) | |
| 13.8 | Assess productivity/cost impact of linemen retirement | (100,000) | - | - | - | - | - | (100,000) | |
| 13.10 | Cost-effective # internal work force, including MWF | - | (5,600,000) | (2,400,000) | - | 13,290,000 | 8,860,000 | 14,150,000 | |
| 13.12 | Establish an electric Quality Assurance Organization | - | (2,500,000) | - | - | - | - | (2,500,000) | |
| 14.2 | SOX changes - analyze potential regulatory impacts | (50,000) | - | - | - | - | - | (50,000) | |
| 14.5 | Modify IUSA chief ethics/compliance organization | - | (500,000) | - | - | - | - | (500,000) | |
| 14.7 | Apply robust mix of external/internal benchmarks | (250,000) | - | - | - | - | - | (250,000) | |
| 14.10 | Reconstitute peer groups for IUSA compensation | (50,000) | - | - | - | - | - | (50,000) | |
| | **Grand Total** | **(8,978,000)*** | **(123,035,000) *** | **(3,640,000)** | **155,335,000 *** | **30,227,500** | **19,467,500** | **69,377,000 *** | **89,700,000*** |
| | **Total without Supply Savings** | **(8,978,000)*** | **(123,035,000) *** | **(3,640,000)** | | **30,227,500** | **19,467,500** | **(85,958,000) *** | |

# Iberdrola Corporate Governance System

IBERDROLA

**Albany, November 30th**

# Index



Note.- All of the Corporate Governance Documents are available on the Internet in Spanish and English in a digital version (eBook)

# Iberdrola Corporate Governance: Iberdrola's view

**The Iberdrola Group understands good corporate governance as key to value creation:**

✓*Only a Group with solid and* ***adequate corporate governance principles*** *and rules can create value in a sustained manner over time*

✓*This strategy is based on* ***developing, revising and continually improving*** *its corporate governance rules*

**The governance principles and rules of Iberdrola and its Group are structured into the Corporate Governance System**

# Iberdrola Corporate Governance System

The Corporate Governance System of Iberdrola **is integrated by**:

- **the By-Laws**
- **the Corporate Policies**
- **the internal rules on Corporate Governance and**
- **Codes and Proceedings approved by the competent bodies of Iberdrola**

Projected on the different companies of the Iberdrola's Group in accordance with the Company Governance Structure **approved by the Board of Directors of Iberdrola on the 16th December of 2008.**

# Iberdrola Corporate Governance System: content

1. **By-Laws of Iberdrola, S.A.**

2. **Corporate Policies of Iberdrola, S.A.**

    **2.1. Corporate Governance and Regulatory Compliance Policies**

    **2.2. Risk Policies**

    **2.3. Social Responsibility Policies**

3. **Internal Corporate Governance Rules** (Rules and Regulations for the General Shareholders' Meeting, the Board of Directors and its Committees)

4. **Other Internal Codes and Procedures** (Conduct in the Securities Markets, Code of Ethics, Separation of Activities, Conflicts of Interest , Management of News and Rumors, Processing of Non-Public Information, Electronic Shareholders' Forum, Operating Committee, Iberdrola, S.A. director's Code of Ethics.)

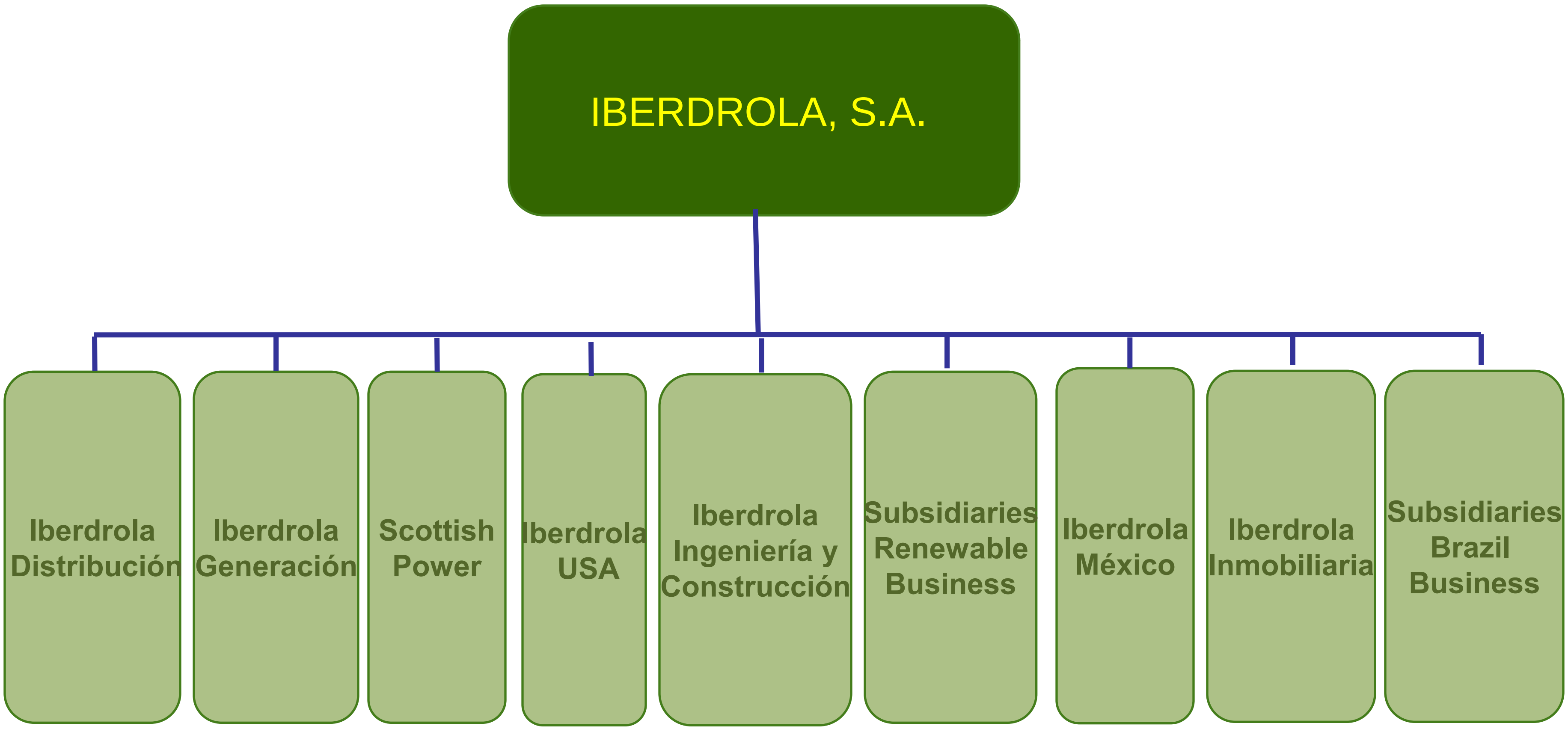
# The Corporate Policies

| Corporate Governance and Regulatory Compliance | Risk | Social Responsibility |
|---|---|---|
| **1.** General Corporate Governance | **1.**General Risk Control and Management | **1.**General Corporate Social Responsibility |
| **2.** Dividend | **2.**Corporate Risk | **2.**Innovation |
| **3.** Shareholder Relations | **3.**Specific Risk Policies for the Various Group Businesses | **3.**Quality |
| **4.** Provision of Information to Shareholders and to the Markets | | **4.**Knowledge Management |
| **5.** Definition and Cooperation of the Iberdrola Group and Foundations of Corporate Organization | | **5.**Environmental |
| **6.** Directors Compensation | | **6.**Policy Against Climate Change |
| **7.**Senior Management Compensation | | **7.**Biodiversity |
| **8.**Auditor Hiring | | **8.**Recruitment and Selection |
| **9.**Crime Prevention and Anti-fraud | | **9.**Reconciliation of Personal and Working Life and Equal Opportunity |
| **10.** Good Tax practices | | **10.**Occupational Risk Prevention |
| | | **11.**Contracting and Relationship with Suppliers |

# Principles:

- ✓**Local decisions** taken locally with the interest of customers in mind
- ✓**Independent Directors** in the Subholding companies
- ✓Coordinated approach to **efficiencies** in the best interest of the customers, of the Group and of its different companies
- ✓Safeguard of the **economic integrity** of the Group and its long-term success
- ✓Full respect to the **separation between regulated and liberalized activities**

# CHART OF THE STRUCTURE OF THE GROUP:



# Corporate Governance System and Business Model

**The Corporate Governance System:** **decentralization** of the decision processes.

a) The Board of Directors of Iberdrola, S.A.:

- defines the **general strategy** of the Group and its policies
- **supervises** the fulfillment of these strategies and policies
- Defines the **organization** of the Group

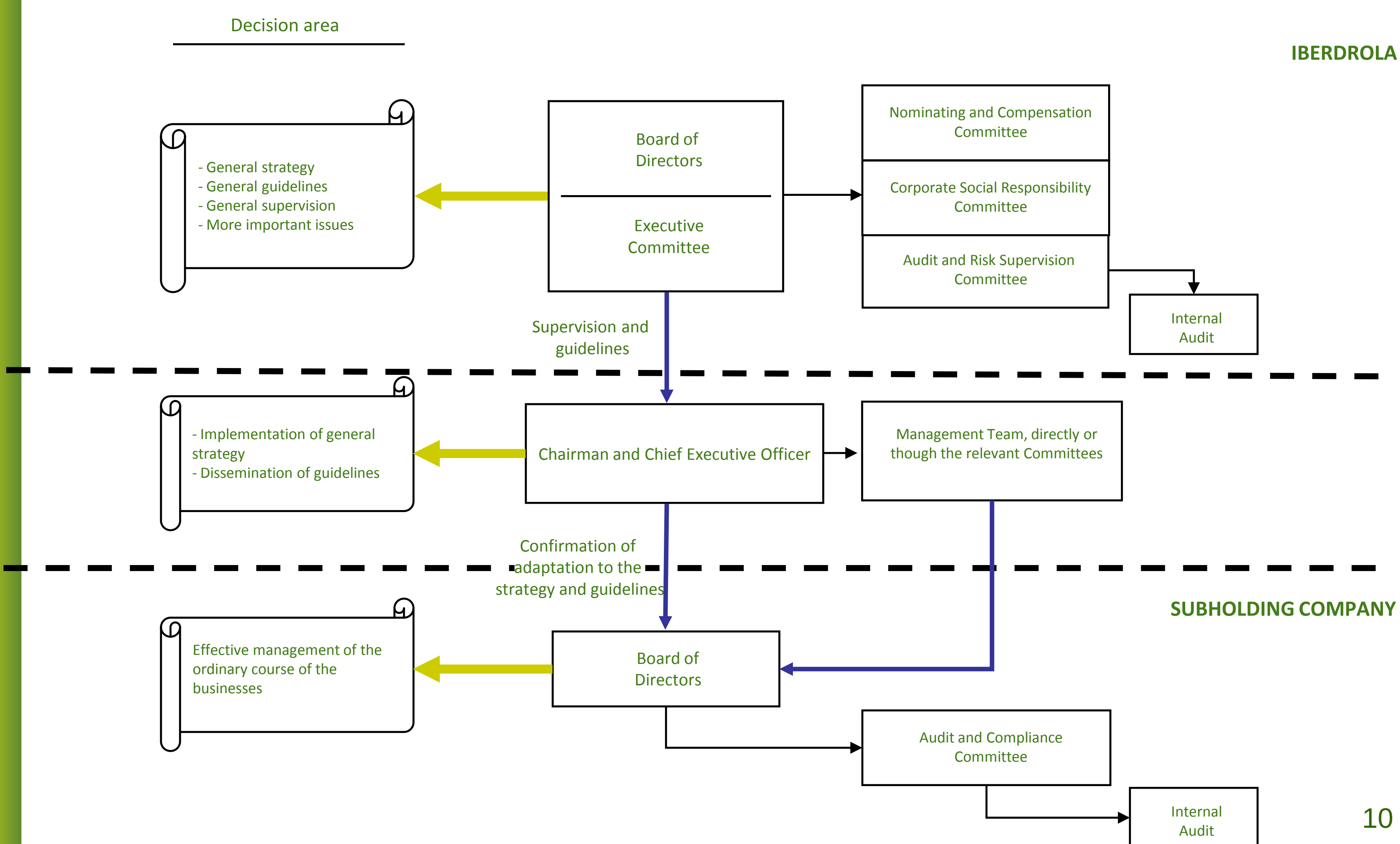
b) The Board of Directors of IUSA **ultimately responsible for the direction and management of its business** => IUSA managed by its management team and its Board of Directors. Only them have <u>decision making legal power</u> regarding the management of IUSA.

The Iberdrola **Business Model** implies the global integration of the businesses (Networks, Liberalized and Renewable) and:

✓**Coexists with the decentralized decision process structure**,

✓Pursues the **optimization** of the management and performance of the businesses trough the exchange of <u>best practices</u>

# Decision flow diagram



# The Governance System and the Group Strategy (I)

**Reaffirming our presence in the Atlantic Area…**

### United States

- Wind generation
- Networks

### United Kingdom

- Wind generation
- Networks
- Opportunities in W&R

**Focused on business and corporation efficiency**

**New organization**

### Latam

- Increased focus on networks: Elektro
- Large hydro projects
- Operational excellence in CCGTs

### Spain & Portugal

- Hydro and wind generation
- Networks

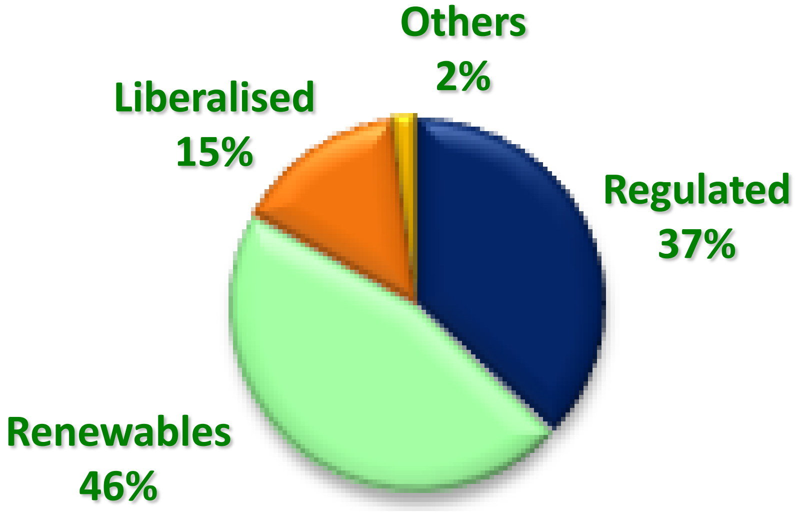
### Continental Europe

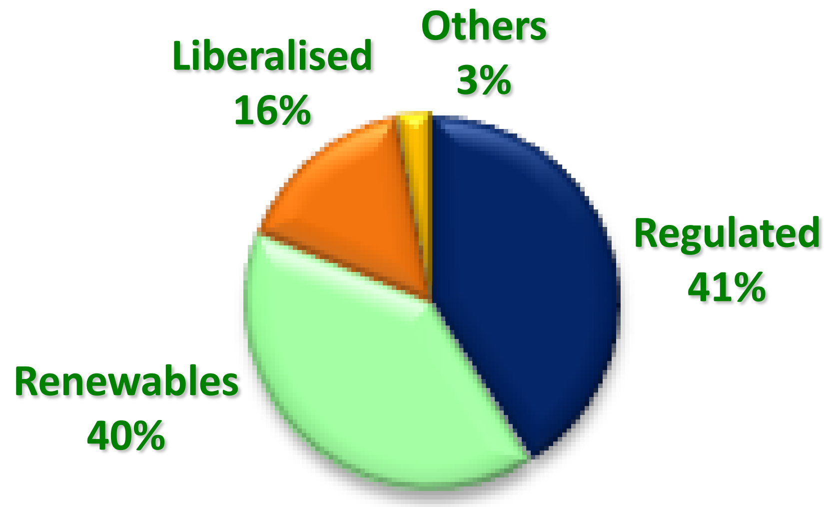
- Wind generation

# The Governance System and the Group Strategy (II)

**Investment mix confirms the strategic foundations of the Group**

| Previous organic investments 2007-2009 | New organic investments 2010-2012 |
| --- | --- |




Renewables + Regulated exceed 80% of total investment

# The Governance System and the Group Strategy (III)

**2010-2012 total investments will still total circa Eur 16 bn ...**

*Eur MM*

| | ORGANIC | ELEKTRO | TOTAL |
|---|---|---|---|
| Liberalised Businesses | 2,200 | --- | 2,200 |
| Regulated Businesses | 5,600 | +2,400 | 8,000 |
| Iberdrola Renovables | 5,300 | --- | 5,300 |
| Others | 300 | --- | 300 |
| Total | 13,400 | +2,400 | 15,800 |
| Divestments | 3,000 | --- | 3,000 |

# The Governance System and the Group Strategy (IV)

| 2010 Main Figures | Spain | UK | USA | Total |
|---|---|---|---|---|
| Electricity Energy Distributed GWh | 102,071 | 36,452 | 31,214 | 169,737 |
| Gas Energy Distributed GWh | - | - | 29,698 (1) | 29,698 |
| Workforce | 4,317 | 2,750 | 4,122 | 11,189 |
| EBITDA* Eur MM | 1,390 | 799 | 711 | 2,900 |
| Investments Eur MM | 356 | 339 | 400 | 1,095 |

**Networks Business represents 39% of Group EBITDA and 25% of its investments**

(1) Excluding Connecticut gas companies sold during 2010

(*) Euros - IRFS

# The Governance System & the focus on costumers interest

- **GENERAL CORPORATE GOVERNANCE POLICY** *(... the long-term success taking into account the legitimate public or private interests to converge in the conduct of all business activities, particularly those of the various* ***stakeholders and the communities and territories*** *in which the company and its employees act)*
- **POLICY FOR THE DEFINITION AND COORDINATION OF THE IBERDROLA GROUP AND FOUNDATIONS OF CORPORATE ORGANISATION** *(sets the different roles of the Iberdrola, S.A Board of Directors and the sub holding companies Boards of Directors, the Group Business Model and the general principle of coordination for the achievement of* ***synergies and benefits****).*
- **IUSA RISK POLICY** *(**long term** investments vs. speculation)*
- **QUALITY POLICY** *(**creating value for...customers**...can be achieved trough excellent management of all the Company's processes and resources*
- **CONTRACTING AND RELATIONSHIPS WITH SUPPLIERS POLICY** *(recognises as a strategic objective the importance of* ***minimizing the overall costs*** *of equipment and materials procurement and contracts for works and services)*
- **CODE OF ETHICS** *(Vision and values: we aspire to be the preferred global energy company because of our commitment to the creation of value,* ***quality of life, the safety of people and of supply****, the protection of environment and* ***customer focus****)*

# The model & the efficiency:

✓**Best Practices within Group's Networks businesses:**

- Increase the **quality and reliability** of NY customers supply
- Optimize **operating expenses**
- Leverage the transformation based on **technology**
- Identify business growth **opportunities**

✓**Optimization of CAPEX:**

- Iberdrola Engineering working **at costs** (same project, less money for customers)
- Group **purchasing power.** Procurement Rules. Allow the different sub holding companies to benefit of the purchasing power of the Iberdrola Group, to optimize resources, achieve synergies and a bigger efficiency. Example, 10% under budget.
- **Investment Policy.** Standard for Investments/Disinvestments. Example, MPRP transmission investment.

✓**Financial benefits:**

- **Ratings** improved => less debt costs
- Only the Group financial strength allows such as big **investments**: 1.4 billion USD in NY

# Strategy & Commitment:

**Iberdrola believes that it is possible to keep a profitable long term business and at the same time to improve the service to the customers**

**GLOBAL MATCH**

**INTEREST OF CUSTOMERS**

**INTEREST OF REGULATORS**

**INTEREST OF IBERDROLA**

Attachment 3. Iberdrola Corporate Energy Projects

# Iberdrola Energy Projects

IBERDROLA

June 15, 2012

# Background

- ➢Liberty's recommendation to indefinitely suspend the use of IEP does not recognize either the benefits that IEP provides or the risks of immediate suspension
  - ✓These issues were addressed in the company's response to the draft DAR, but ignored by Liberty
  - ✓The Company will further elaborate on these issues during the implementation phase
- ➢The Companies are in the midst of a detailed resource planning effort that will determine:
  - ✓Appropriate internal resources
  - ✓Mix of affiliate and external resources to supplement internal staff

# Risks of IEP suspension

➢Continued use of IEP while the resource plan is under development and being completed is **appropriate, reasonable, and in the best interests** of customers

- ✓Changing project management on current capital projects will significantly delay (minimum of months, possible year based on construction windows) their completion
- ✓Changing project management will introduce new and different methods, controls, and delivery mechanisms

➢The loss of knowledge and innovation provided to NYSEG and RG&E without restriction from IEP as an affiliate

# Risks of Immediate IEP suspension

- Incremental internal resources are **not a viable short-term option**
  - ✓Different management and delivery strategy than past practice and best practices
  - ✓Different skill sets
  - ✓Requires significant time and expense to staff up (recruit, hire, train, and assign) in a tight labor market for engineers
- Changing project management from IEP to external resources results in **immediate and significant increase in project costs**

# Current Snapshot of Resources

## Current snapshot of resource loading
## (IUSA, IEP, other external resources used for project delivery)

| | IUSA (Internal) | IEP (Affiliate) | SNC-Lavalin* (Contractor) |
|---|---|---|---|
| Project Management | 9 | 10 | 11 |
| Technical Services | 14 | 25 | 24 |
| Construction Management | 1 | 8 | 1 |
| Other | 5 | 2 | 4 |
| Subtotal | 29 | 45 | 40 |
| **Total** | -------------- 114 -------------- | | |

*SNC-Lavalin is an external contractor utilized for these services by NYSEG and RG&E

# Electric CAPEX

**Current snapshot of CAPEX planned to be spent consistent with 5-year plan filed at Commission (without common/generation plant)**

| | Annual | | | | | | | | | Annual Average |
|---|---|---|---|---|---|---|---|---|---|---|
| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | |
| Electric CAPEX NY ($ Million) | 155 | 137 | 221 | 272 | 282 | 228 | 381 | 336 | 334 | 293 |

# Resource Planning Initiative

- How: Determine type, responsibilities and number of resources required internally and externally (affiliate and contractor)

  1. Define internal and external roles and responsibilities
  2. Estimate individual project hours by category and assign internal/external
  3. Develop and analyze future scenarios
  4. Develop internal and external resource plan to perform expected work cost-effectively and on schedule

- When: Complete 4Q12