Dewey & LeBoeuf LLP
99 Washington Avenue
Suite 2020
Albany, NY 12210-2820

tel +1 518 626 9311
fax +1 518 626 9010
bfitzgerald@dl.com

DEWEY & LEBOEUF

March 13, 2009

**VIA E-MAIL AND HAND DELIVERY**

Honorable Elizabeth Liebschutz
Honorable William Bouteiller
Office of Hearings & Alternative Dispute Resolution
New York State Department of Public Service
Three Empire State Plaza
Albany, NY 12223-1350

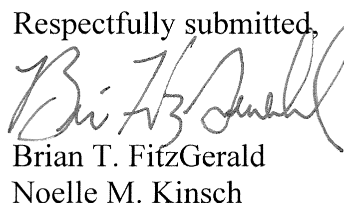
Re: Cases 09-E-0082, 09-G-0083, 09-E-0084 and 09-G-0085 – New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation's Post-Hearing Brief Concerning New York Department of Public Service Staff's Motion to Dismiss

Dear Judges Liebschutz and Bouteiller:

On behalf of New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation (together, the "Companies"), attached please find the Companies' Post-Hearing Brief in the above referenced proceeding. The Post-Hearing Brief is being filed in accordance with Your Honors' February 20, 2009 Ruling on Schedule to Address Preliminary Motion.

Should you have any questions, please contact us.

Respectfully submitted,



Brian T. FitzGerald
Noelle M. Kinsch

BTF:clc(101012)
Enclosure

cc: Active Party Service List (via e-mail)
Honorable Jaclyn A. Brilling (via e-mail and hand delivery)
Paul K. Connolly, Jr., Esq.
David L. Schwartz, Esq.

BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

| ----------------------------------------------------------------------x | |
|---|---|
| Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service | Case 09-E-0082 |
| Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Gas Service | Case 09-G-0083 |
| Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Electric Service | Case 09-E-0084 |
| Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Gas Service | Case 09-G-0085 |
| ----------------------------------------------------------------------x | |

**POST-HEARING BRIEF OF**
**NEW YORK STATE ELECTRIC & GAS CORPORATION AND**
**ROCHESTER GAS AND ELECTRIC CORPORATION**


Paul K. Connolly, Jr.
Vice President and General Counsel
Energy East Corporation
260 Franklin Street
Boston, MA 02110
Tel: (617) 748-6868
E-mail: paul.connolly@energyeast.com

Brian T. FitzGerald
Noelle M. Kinsch
Dewey & LeBoeuf LLP
99 Washington Avenue, Suite 2020
Albany, NY 12210
Tel: (518) 626-9000
E-mail: brian.fitzgerald@dl.com
nmkinsch@dl.com

David L. Schwartz
Rebecca L. Malcolm
Latham & Watkins LLP
555 Eleventh Street, NW, Suite 1000
Washington, DC 20004
Tel: (202) 637-2200
E-mail: david.schwartz@lw.com
rebecca.malcolm@lw.com


Dated: March 13, 2009

**TABLE OF CONTENTS**


I. INTRODUCTION AND EXECUTIVE SUMMARY ........ 1

A. The Companies Meet the Applicable Merger Order Standard ........ 1

B. The Global Financial Crisis Caused the Companies to File the Rate Cases ........ 2

C. The Financial Condition of the Companies Is Deteriorating ........ 2

D. The Evidentiary Process Corrected Misconceptions About the Rate Filings ........ 3

E. The Outcome of the Motion to Dismiss Is a Signal to Credit Rating Agencies and Investors ........ 4

F. Definitive Final Resolution of the Motion to Dismiss Is Necessary ........ 5

II. THE FINANCIAL HEALTH OF THE COMPANIES IS DETERIORATING ........ 6

A. The Companies' Cash Flow For 2009 and 2010 Is Inadequate By a Wide Margin ........ 8

1. Exhibit 43 – Cash Flow Comparison ........ 9

(a) Net Income ........ 9

(b) Depreciation ........ 12

(c) Other ........ 12

(d) Non-Bypassable Charge ("NBC") ........ 15

(e) Capital Expenditures ........ 17

(f) Long Term Debt Redemption ........ 18

(g) Free Up 50% of Existing Credit Facility/Repay Loan to EEC ........ 18

(h) Dividends ........ 19

2. Austerity Measures ........ 21

B. Absent Rate Relief, the Companies' Earnings Will Be Inadequate ........ 25

1. Mathematical Calculation Errors ........ 27

2. Mistakes ........ 27

3. Double Counting PBAs ....27

4. Ratemaking Adjustment Disagreements ....29

C. Avoiding Credit Ratings Downgrades and Ensuring Access to Capital Markets Benefits Ratepayers ....32

III. RELIABILITY AND SERVICE QUALITY WOULD BE IN JEOPARDY ABSENT THE REQUESTED RATE RELIEF ....36

IV. THE COMPANIES' RATE CASES ARE SUFFICIENT ....37

V. THE CROSS-MOTIONS TO INSTITUTE A NEW DIVIDEND PROCEEDING SHOULD BE DENIED ....39

VI. STAFF BEARS THE BURDEN OF PROOF ON THE MOTION TO DISMISS ....44

VII. CONCLUSION ....45

# I. INTRODUCTION AND EXECUTIVE SUMMARY

On January 27, 2009, New York State Electric & Gas Corporation ("NYSEG") and Rochester Gas and Electric Corporation ("RG&E") (together, the "Companies") submitted rate cases seeking rate increases from the New York State Public Service Commission ("Commission"). On February 13, 2009, the New York State Department of Public Service Staff ("Staff") submitted a Motion to Dismiss the Companies' January 27, 2009 rate filings, alleging that the Companies have not satisfied the standard in the Merger Order[1] that allows the Companies to file in advance of the "target period," and that the Companies' rate filings are deficient. The Companies responded to Staff's Motion to Dismiss on February 23, 2009 ("Answer to Staff's Motion to Dismiss"), and two days of evidentiary hearings were held on March 3, 2009 and March 4, 2009.

## A. The Companies Meet the Applicable Merger Order Standard

The Companies submitted their rate filings pursuant to the provision in the Commission's order approving the acquisition of Energy East Corporation ("Energy East") by Iberdrola, S.A. ("Iberdrola") in which the Commission allowed the Companies to submit rate filings prior to the "target period" whenever either Company's "financial performance otherwise would fall to levels that would jeopardize its ability to provide safe and reliable service."[2]

The express language of this standard is important. First, the initial focus is on the financial performance of the Companies, rather than their operational performance. Second, the Commission uses the conditional word "would" to signal that financial performance need not have been degraded currently, and that this is a conditional future event. Third, the Commission

---

1 Case 07-M-0906 - Joint Petition of Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A., Order Authorizing Acquisition Subject to Conditions (Jan. 6, 2009) (hereinafter "Merger Order").

2 Id. at 141.

uses another conditional phrase to describe the effects of the Companies' financial performance ("that would jeopardize its ability to provide safe and reliable service"), further showing that this is a prospective standard with respect to safe and reliable service. Fourth, the Commission chose the word "jeopardize" to signify a prospective risk or danger, rather than requiring that the Companies show that safe and reliable service will necessarily deteriorate. As explained below, other parties to this proceeding have purposefully ignored these carefully chosen conditional words and instead focused on historical rather than prospective performance.

**B. The Global Financial Crisis Caused the Companies to File the Rate Cases**

Iberdrola's acquisition of Energy East was consummated on September 16, 2008, just one day after the Lehman Brothers bankruptcy signaled the onset of the global financial crisis.[3] The effects of this financial crisis on the Companies have been unexpected and severe. While some of the causes of the Companies' financial pressures pre-dated this watershed event, the record demonstrates that the Companies would not have filed these rate cases but for the impacts of the financial crisis on the Companies (even though such a demonstration is not necessary under the applicable Merger Order standard discussed above).

**C. The Financial Condition of the Companies Is Deteriorating**

The Companies' rate filings and testimony in this case set forth extensive evidence about the nature and scope of the Companies' financial problems. The Companies have demonstrated the need for regulatory support and rate relief in 2009. In particular, the Companies have shown that, in the absence of rate relief, they do not have sufficient cash flow to

[3] Staff witness Henry acknowledged that the collapse of Lehman Brothers marked the "onset of…extreme financial distress." Tr. at 834.

satisfy their large cash needs ($575-850 million)[4] over the next two years. The Companies have further demonstrated that attempting to fund their large cash requirements with additional debt, which in and of itself would be an extraordinarily difficult task in the current market environment, would reduce the Companies' credit rating metrics to non-investment grade ratings, and would likely result in credit rating downgrades. Finally, the Companies have shown that this continued financial deterioration would threaten the Companies' ability to provide safe and reliable service.

### D. The Evidentiary Process Corrected Misconceptions About the Rate Filings

The evidentiary hearing and the record shed light on a variety of misconceptions about the Companies' rate filings:

- Dividends/Infusions of Equity – Contrary to the initial assertion of many parties that the Companies' rate cases were a pretext for paying $400 million in dividends to their parent companies, Exhibit 10 clearly projects that, over the next two years, if the requested rate relief is granted, $365 million out of the approximately $400 million in assumed dividends would be retained by, or re-invested in, the Companies to fund capital projects, which means that less than 10% of earnings would be paid to their shareholders as dividends on a net basis. Tr. at 409.

- Parent Company Support – Contrary to suggestions by certain parties who initially suggested that credit rating agencies may be concerned about the level of NYSEG's and RG&E's parent company support, the credit rating agencies and experts have stated clearly that the Companies' credit ratings would likely be lower in the absence of the extensive assistance that NYSEG and RG&E have already received from their parent companies, including approximately $110 million in temporary loans and at least $55 million in foregone dividends. Tr. at 528, 556-57; Exh. 11 at 7.

- PBAs – There was a misconception that the Companies' $278 million requested rate increase is an attempt to recover the $275 million in "positive benefit adjustments" or "PBAs" that were required in the Merger Order. The hearing and record show that the opposite is true – the amount of the PBAs reduced the proposed rate increase by $95 million, or approximately 25%. Tr. at 387-89.

[4] The Companies have demonstrated that their cash needs in 2009-2010 would be approximately $850 million based upon the Companies' identified capital expenditure projects, or $575 million if the $540 million capital expenditure level that Staff recommends is used. Tr. at 288, 358.

- Deferrals – The single largest driver of the requested rate increase is the recovery of reserves, deferrals and expense items that would otherwise continue to be deferred (contrary to Staff's approach, which excludes approximately $155 million of deferred costs from its projected cash flow analysis). Tr. at 824-25, 830-31; Exh. 43. If not remedied, these deferred costs will continue to grow and have even greater impacts on the Companies' liquidity position until they are reflected in rates. Tr. at 320-21.

- Rate of Return – At the hearing, the Companies clarified another misconception that the rate increase may be used solely to fund greater return on equity for the Companies and their shareholders. To the contrary, the hearing process and the record show that only a small portion of the requested rate increase (approximately 12% of the requested rate increase) was based upon updates to the Companies' cost of capital, which has increased as a result of the global financial crisis. Tr. at 416.

- Timing of the Filing – There was a misconception that there would be no harm to the Companies if they waited another six months to file rate cases (i.e., until the target period). This misconception ignores the fact that the rate case process could take up to a year and that the impact of a rate increase could take even longer. In other words, the Companies could see no relief until at least eighteen months from now.

The evidentiary hearing also brought the parties' positions together on the significant impact of the global financial crisis:

- Staff agreed that the Lehman Brothers bankruptcy marked the beginning of what could be the worst financial distress that our country has experienced since the Great Depression. Tr. at 834.

- Staff agreed that the return requirements of equity investors have likely increased as a result of the global financial crisis (Tr. at 843), and that riskier investments require higher yields. Tr. at 840.

- Staff acknowledged that a non-investment grade credit rating would be particularly challenging in the current market environment (Tr. at 842) and, as a result, that utilities do not want to be rated in the low "BBB" level range where an unexpected event could move them to non-investment grade. Tr. at 862.

### E. The Outcome of the Motion to Dismiss Is a Signal to Credit Rating Agencies and Investors

The Commission's decision on Staff's Motion to Dismiss will be an important signal to both investors and credit rating agencies about whether the Commission will maintain

the financial health of New York's utilities by providing timely and predictable cost recovery, as well as fair and adequate returns. The rating agencies have placed the Companies on negative watches or outlooks, and have indicated that they will be closely monitoring the outcome of this proceeding in their determination as to whether to downgrade the Companies. If the Companies' rate filings are dismissed and the Companies must re-file in September 2009, their rate cases may not be addressed or rate relief granted until August 2010. Under these circumstances, the Companies would expect that their credit ratings would be downgraded, their weak financial condition would continue to deteriorate, their costs of providing service (including debt service) would increase, and their ability to provide safe and reliable service would be jeopardized. On the other hand, if the Commission provides the requested rate relief in this proceeding, the Companies would be able to improve their liquidity situation, maintain their current credit ratings and fund capital projects through a combination of equity infusions and debt issuances.

### F. Definitive Final Resolution of the Motion to Dismiss Is Necessary

All parties agree that a prompt and final decision by the Commission on the issue of whether the Companies have satisfied the standard for filing in advance of the "target period" is in their best interests. Tr. at 928-30, 932-33. An expedited procedural schedule to address Staff's Motion to Dismiss was supported by all parties to this proceeding. After two rounds of testimony, substantial discovery, two days of evidentiary hearings that produced nearly 1,000 transcript pages, and a subsequent round of briefing, the evidentiary record is fully developed on the Motion to Dismiss and all parties have had an opportunity to be heard on this threshold issue. Accordingly, the Companies respectfully request that the Commission issue a ruling on Staff's Motion at the Commission's April 7, 2009 Open Session. Postponing a decision on this issue any further would leave all parties in a state of limbo and present significant inefficiencies for all parties and the Commission.

For the reasons set forth herein, the Commission should deny Staff's Motion to Dismiss with prejudice and allow the rate cases to proceed on an expedited schedule.

## II. THE FINANCIAL HEALTH OF THE COMPANIES IS DETERIORATING

While the parties disagree about a variety of issues in this proceeding, the evidentiary hearing clarified a number of matters relating to the global financial crisis and its impact on the financial condition of the Companies. For example, while Staff's pre-filed testimony initially challenged the timing of the start of the global financial crisis, Staff agreed during cross-examination that the Lehman Brothers bankruptcy, which occurred just one day prior to the closing of the merger transaction between Iberdrola and Energy East, marked the beginning of "extreme financial distress" that has the potential to be worse than anything this country has experienced since the Great Depression. Tr. at 834. Moreover, Staff agreed with the Companies that, in evaluating whether the Companies' financial performance would fall to levels that would jeopardize safe and reliable service, the Commission must look at the Companies' overall financial health. Tr. at 753.

Beyond these undisputed areas, the Companies have shown that the financial crisis, which occurred shortly after the closing of Iberdrola's acquisition of Energy East, was the proximate cause of the Companies' current financial situation. The Companies have also shown that, because of the financial crisis: the cost of capital has risen dramatically (Tr. at 243-44); sales during the fourth quarter of 2008 were materially lower than previously projected (Tr. at 245, 473); delinquencies and uncollectible expenses have increased significantly (Tr. at 256, 332); and pension costs have skyrocketed (Tr. at 256-57). In response to the Administrative Law Judge's ("ALJ") question as to whether the Companies would have filed the rate cases "but for" the global financial crisis, the Company Panel responded that the global financial crisis, starting with the Lehman Brothers bankruptcy filing, was the "tipping point" and that the Companies

would not have filed their rate cases in the absence of the financial crisis and its adverse impacts on the Companies. Tr. at 456-57.[5]

The Companies see no indication that the global financial crisis is improving or is likely to do so in the near future. As Mr. Fetter testified, there is no reason to believe that the worst impacts of the financial crisis have already occurred. Tr. at 552. The financial markets have continued to decline since the Companies submitted their rate case filings on January 27, 2009. On the first day of the evidentiary hearing regarding Staff's Motion to Dismiss, the equity markets hit a 12-year low, as evidenced by the Dow Jones Industrial Average reaching 1997 levels. Tr. at 836. Basis point spreads between "A" and "BBB" level utilities remain at historically high levels, and are likely to remain that way for the foreseeable future. Tr. at 303-04, 552. Just this week, the Wall Street Journal reported in a front page article "[a]fter what seemed like the beginning of a thawing of debt markets early in the year, sentiment has deteriorated" and "[t]he markets remain open only to the strongest companies."[6]

Consistent with the standard for filing a rate case outside of the Target Period, the Companies have shown that their financial condition "would fall to levels that would jeopardize [their] ability to provide safe and reliable service."[7] The evidence that the Companies meet this standard is as follows:

- First, the Companies show that, if the requested rate relief is not granted, the Companies will need to fund $575-850 million in cash requirements over the next two years with substantial amounts of debt. (Section II.A)

---

[5] The Companies note that the relevant standard in the Merger Order as to whether a rate proceeding could be filed at this time is whether financial performance otherwise would fall to levels that would jeopardize the ability to provide safe and reliable service – without regard to its cause. Thus, while the Companies have sought to explain the circumstances that are the direct cause of the need for their rate filings, it would be inappropriate for the Commission to add retroactively a causation element to the standard in the Merger Order, and the Commission should reject any efforts by the parties to do so in this proceeding.

[6] Liz Rappaport and Serena Ng, New Fears as Credit Markets Tighten Up, Wall St. J., Mar. 9, 2009 at A1.

[7] Merger Order at 141.

- Second, in addition to inadequate cash flow, the Companies show that their earnings will not be adequate to support such major new issuances of debt. (Sections II.A and II.B)
- Third, the Companies show that, even if they were able to secure this additional amount of debt, this increased debt would cause the Companies' credit rating metrics to more closely resemble below investment grade companies, and therefore, would likely result in credit rating downgrades. (Section II.C)
- Fourth, the Companies show that this level of financial deterioration would threaten the Companies' ability to provide safe and reliable service. (Section III)

The record demonstrates that the Companies need rate relief to ensure that the ongoing effects of this global financial crisis do not lead to financial performance levels that would jeopardize their ability to provide safe and reliable service.

### A. The Companies' Cash Flow For 2009 and 2010 Is Inadequate By a Wide Margin

Positive free cash flow is one indicator of a healthy business. Conversely, negative cash flow (i.e., a shortfall between internally generated cash and cash requirements) is reason for concern, particularly in a market where raising capital is costly. Negative cash flow impairs liquidity because internally generated funds are insufficient to meet basic operating needs. In this case, the Companies' current liquidity position, significantly negative cash flow, weak bond ratings and the existing market turmoil demonstrate that the Companies' financial performance would fall to levels that would jeopardize safe and reliable service.

The Companies have shown that they will experience negative cash flow of $850 million in the aggregate for 2009-2010. Tr. at 288; Exhs. 16, 43. In contrast, Staff alleges that the Companies' cash flow will be adequate and that the Companies will have free cash flow of $80 million in the aggregate for 2009 and 2010. Tr. at 764.

Given the enormous differences in projected cash flow for the Companies, the parties mutually agreed on the record that Staff and the Companies would create a single

combined cash flow schedule, Exhibit 43, to provide a common analytic framework for comparison purposes. Tr. at 802-03.

1. Exhibit 43 – Cash Flow Comparison

Exhibit 43 highlights the differences between Staff's and the Companies' cash flow analyses.[8] The differences are divided into nine subparts, including: 1) Net Income; 2) Depreciation; 3) Other; 4) Non-Bypassable Charge ("NBC"); 5) Capital Expenditures; 6) Long Term Debt Redemption; 7) Free Up 50% of Existing Credit Facility; 8) Repay Loan to EEC; and 9) Dividends. Each item is addressed below.

(a) Net Income

As demonstrated on Exhibit 43, the Companies and Staff agree on the "Delivery" component of Net Income, at least for cash flow forecasting purposes. The sole disagreement between the Companies and Staff relates to the treatment of Commodity Income. The Companies' and Staff's positions on Commodity Income differ by $27.5 million (a $10 million difference for 2009 and a $17.5 million difference for 2010). Exh. 43 at 1. As the Companies' witnesses testified, Staff's inclusion of $17.5 million of after-tax commodity profits for 2009 and 2010 is just plain wrong.[9]

Staff's presumed 2009 commodity earnings are unachievable given the sharing mechanisms in place at each Company and the Companies would need to earn an additional $100 million (pre-tax) to generate Staff's $17.5 million (after-tax), which is impossible in light of the decline in fixed price option ("FPO") election by customers, declining commodity prices and reductions in sales. Tr. at 323-24; see also Answer to Staff's Motion to Dismiss at 15. In

[8] The NBC and certain items in the "Other" category show pre-tax numbers. Tr. at 832-33.

[9] During cross-examination, Staff implied that its Commodity Income amount also includes gas commodity income. The inclusion of gas commodity is wrong since the Merger Order eliminated the Gas Cost Incentive Mechanism-2 effective December 31, 2008. Merger Order at Appendix 2, ¶ 1(g).

addition, Staff erroneously bases its "estimate" of commodity income on a five-year historical average. Tr. at 819. By definition, Staff's historical average cannot, and does not, take into account the significant changes made to the NYSEG and RG&E commodity programs for residential customers in 2007 and 2009, respectively, that were specifically designed to reduce the Companies' commodity income (i.e., change in the default commodity option, reduction in the risk premium, change in the earnings sharing mechanism). In fact, given current FPO load of roughly 2,000 gwh per year, the Companies would have to receive $50/mwh in margin to achieve the $17.5 million cited, more than eight times the $6/mwh provided for in the FPO rate.

Staff also ignores the fact that neither NYSEG nor RG&E will offer an FPO in 2010. Tr. at 323. RG&E is expressly prohibited by the Commission from offering the FPO after 2009.[10] While NYSEG is authorized to provide the FPO through 2010 pursuant to its Commission-approved Joint Proposal in the NYSEG Supply Service case,[11] the Commission recently revisited its decision and directed NYSEG to justify the offering of the FPO in 2010, unless NYSEG decided to cancel it.[12] In that event, the Commission required NYSEG to commit to any cancellation of the FPO by March 1, 2009.[13] The Commission also directed RG&E to file, by March 1, 2009, justification for the FPO if the Company intended to offer it in 2010.[14] On March 2, 2009,[15] the Companies formally notified the Commission that they will

---

[10] Case 03-E-0765 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Electric Service, Order Modifying Fixed Price Offer, at 7 (Aug. 28 2008) (stating "RG&E may not offer the FPO again after 2009 without our explicit approval").

[11] Case 07-E-0479 - Tariff Filing of New York State Electric & Gas Corporation to Offer Customers a Single Fixed Supply Service, Order Establishing Commodity Program, at 11 (Aug. 29, 2007).

[12] Case 07-E-0479 and Case 03-E-0765, Order Establishing Filing Requirements, at 3 (Jan. 20, 2009).

[13] Id.

[14] Id.

[15] The due date, March 1, 2009, was a Sunday.

discontinue the FPO and committed to end such offerings as of December 31, 2009.[16] Thus, Staff's inclusion of commodity income in 2010 is inappropriate.

Despite knowing about the Companies' commitment to end the FPO after 2009, Staff testified, on cross-examination, that the commodity income level should remain in Staff's cash flow forecast. Tr. at 807, 820. When asked whether Staff understood that the Companies "will no longer be pursuing the [FPO] in 2010," Staff's witness answered: "I don't believe the Commission has acted on that request. So the Commission could modify, eliminate, expand it. I don't know what the Commission might do." Tr. at 821. It is inappropriate to ignore the Companies' statement of intent that they will not be offering FPO service for 2010, particularly where: (a) the Companies have determined that the allowable pricing formula does not compensate the Companies for the risks of the program;[17] (b) RG&E has no authority to offer an FPO in 2010; and (c) NYSEG was directed by the Commission to justify the continuation of the FPO. Staff also ignores Commission precedent expressly discouraging utilities from offering FPOs.[18] In fact, as recently as January 20, 2009, the Commission identified a number of reasons

---

16 Cases 07-E-0479 and 03-E-0765, Petition of New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation Regarding Commodity Programs, at 1, 4 (Mar. 2, 2009).

17 Tr. at 821-24.

18 Since 2004, the Commission has repeatedly stated that the FPO is a transitional mechanism and, absent unique circumstances, energy service companies rather than utilities should offer such service. See, e.g., Case 00-M-0504 - Proceeding on Motion of the Commission Regarding Provider of Last Resort Responsibilities, the Role of Utilities in Competitive Energy Markets and Fostering Development of Retail Competitive Opportunities, Statement of Policy on Further Steps Towards Competition in Retail Energy Markets, at 30-32 (Aug. 25, 2004) (expressing an expectation that energy service companies will provide fixed priced options to those customers who desire it); Case 05-E-1222 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service, Order Adopting Recommended Decision with Modifications, at 4 (Aug. 23, 2006) (stating "[i]n the RD, the judges noted that utility provision of fixed-price service is expressly discouraged under the Commission's Retail Markets Competition Policy Statement"); Case 03-E-0765, Order Modifying Fixed Price Offer, at 6-7 (Aug. 28, 2008) (stating "the FPO was intended as a transitional mechanism in the movement towards a future state, envisioned in the Policy Statement on Retail Markets, in which fixed-price service would be obtained from the competitive market, rather than from the utility"); Cases 07-E-0479 and 03-E-0765, Order Establishing Filing Requirements, at 3 (Jan. 20, 2009) (stating "it is still our expectation that [competitive retail markets] could be expected to serve as the source of fixed price services").

why the Companies should not offer an FPO in 2010.[19] In light of the Commission's oft-stated position on FPOs and the Companies' notification and commitment that they will not offer such services in 2010, Staff's testimony regarding commodity income must be disregarded.[20]

(b) Depreciation

The subheading entitled "Depreciation" is not in dispute, and the Companies' and Staff's calculations of depreciation for cash flow purposes are identical. Exh. 43.

(c) Other

The sixth row in the Primary Differences Column of Exhibit 43 is labeled "Other," with subcategories including: a) Pension; b) Deferred Taxes; c) Amort ST Debt/ AFUDC/Other; d) Deferrals; and e) Amortizations in Other O&M. Each of the "Other" subcategories is addressed below. Of these subcategories, the most important are Pension and Deferrals.

(i) Pension

The Companies and Staff essentially agree that the cash flow for pensions is approximately negative $12 million in 2009. In 2010, the Companies continue to forecast a negative cash flow (approximately $11 million), while Staff inexplicably forecasts a positive pension cash flow of approximately $21 million. Exh. 43. Staff claims that pension expenses are reflected as a reduction in income but are not a cash flow item and, therefore, in 2010 Staff added pension expense back to cash flow. Tr. at 768. Staff appears to have incorrectly assumed that the delivery income shown on the first line on Exhibit 43 reflects the unadjusted pension expense from the Retirement and Employee Benefits Panel Testimony. Tr. at 480. It does not.

---

[19] Cases 07-E-0479 and 03-E-0765, Order Establishing Filing Requirements, at 3 (Jan. 20, 2009).

[20] This testimony is peculiar in light of the fact that the Staff witness stated that he was "extensively involved in the review of NYSEG's and RG&E's compliance filings establishing its [FPO]" (Tr. at 700) and, thus, could reasonably be expected to be familiar with Commission precedent on the topic.

Instead, the delivery income on Exhibit 43 reflects existing pension deferral provisions for NYSEG Gas, RG&E Electric and RG&E Gas.[21] Tr. at 460-67. Staff's difference of $33 million between 2009 and 2010 has no valid record support and is inconsistent with the Companies' testimony that the economic crisis has dramatically lowered the Companies' current and prospective pension income and funded status. Exh. 1, RG&E Revenue Requirements Panel Testimony at 19-20 and NYSEG Revenue Requirements Panel Testimony at 19-20. The Companies' forecast of approximately negative $11 million pension impact on cash flow in 2010 is consistent with the 2009 forecast and should be adopted by the Commission. Tr. at 467.

(ii) Deferred Taxes

The $9 million difference between Staff and the Companies on "Deferred Taxes" in the context of the examination of cash flow was not addressed by the parties on the record. Tr. at 339.

(iii) Amort ST Debt /AFUDC/Other

The difference between Staff and the Companies on "Amort ST Debt/AFUDC/ Other" in the context of the examination of cash flow was not addressed by the parties on the record. Tr. at 339.

(iv) Deferrals

One of the most important differences between Staff's and the Companies' cash flow forecasts relates to deferrals. A buildup of deferral accounts will have cash flow implications because the Companies are required to fund whatever expenses are being deferred. Tr. at 831. In fact, growing deferral balances represent the largest component of the Companies' requested rate relief. Tr. at 321. While Staff alleges that the current amount of expense recovery

[21] Staff apparently views actuarial pension expense as a source of cash in 2010 based on an assumption that rates were set based on the actuarial level of pension expense. However, the revenue requirements were set using the 2009-2010 actuarial average with deferrals to balance out the earnings results, and Staff is therefore wrong.

allowed in base rates is adequate to cover the cash expense, the Companies testified that it is insufficient. Tr. at 320-21, 824-25. The Companies support the use of deferral accounting, but in the context of the current global financial crisis, untimely recovery of deferrals creates a cash shortfall that the Companies can no longer tolerate. See Answer to Staff's Motion to Dismiss at 14. Accordingly, the Companies have included a negative $155 million on the cash flow schedule in the Deferral subcategory for 2009 and 2010. Tr. at 340-41; Exh. 43.[22] Staff has included zero impact of deferrals on cash flow. Tr. at 814.

As the Company Panel testified, the treatment of deferral buildup goes to the heart of the Companies' case regarding the quality of the Companies' earnings. Tr. at 340. Growing regulatory deferrals (the regulatory promise to pay in the future for cash paid out now) can materially impact cash flow. A company can have solid accounting earnings but poor quality cash earnings if deferrals build up and are not timely recovered. Staff resolutely ignores all cash flow implications associated with the Companies' deferred costs. Tr. at 320-21.

Staff's justification for excluding the negative impact of deferrals on the Companies' cash flow turns on the claim that recovery for these expenses is already included in the Companies' existing base rates. Tr. at 824-25, 830-31. However, Staff cannot dispute the underlying data that shows otherwise. In fact, in just two categories alone – Storm Costs and Environmental Remediation – costs over the last two years have far exceeded the amounts built into rates. For example, over the period 2007 and 2008, NYSEG collected $15 million in rates for Storm Costs and actually spent over $70 million to restore service. Tr. at 320. Over the same two-year period, the Companies have spent $61 million on environmental remediation costs and have collected only $13 million in rates. Tr. at 320-21. The amount of money built into base

[22] The Companies' deferrals are set forth in Exhibit 1, Revenue Requirements Panel Exh. RRP-2, Schedule C, page 2.

rates for these items is insufficient and that insufficiency is growing significantly over time. Absent the rate relief requested, the trend of increasing deferrals will continue. Tr. at 321.

Not only are such costs exceeding the levels set in rates established as far back as 2004, Staff conceded that for RG&E, Stray Voltage Testing was not included at all in RG&E's base rates, an approximately $4 million annual expense. Tr. at 825-26. Yet, Staff illogically maintains its position that there would be zero impact on cash flow from deferrals.[23]

The Companies have demonstrated that base rates do not include recovery for these costs and that the resulting deferrals will negatively impact cash flow. In their rate filing, the Companies seek to address this issue by increasing the amount allowed in rates for these expenses. Accordingly, the Commission should adopt the Companies' forecast and authorize a more expeditious recovery of growing deferral balances to improve liquidity. Tr. at 321.

(v) Amortizations in Other O&M

There is no dispute between the Companies and Staff regarding the subcategory "Amortizations in Other O&M." Tr. at 814; Exh. 43.

(d) Non-Bypassable Charge ("NBC")

The NBC was originally a $141 million dispute, with Staff alleging that there would be an inflow of $81.7 million between 2009 and 2010 (Tr. at 767), and the Companies testifying that in reality there will be a cash shortfall of approximately $60 million. Tr. at 322. After reviewing the Companies' Answer and Answering Testimony, Staff adopted, for the most part, the Companies' Ginna adjustment to the NBC. These adjustments relate to the treatment of

[23] Staff also suggests that deferral amounts are not included in its cash flow projections because they have not yet been audited or substantiated. Tr. at 827. However, ignoring the cash flow implications of an expense simply because Staff has not yet evaluated whether it thinks that expense is recoverable in rates misses the point. The question on cash flow is whether the Companies' cash situation is impacted by an expense.

certain working capital cash flow calculations surrounding the use of the RG&E Asset Sale Gain Account ("ASGA") to offset the Ginna Purchase Power payments. Tr. at 804.

The Companies and Staff are in agreement that the cash flow impact of the NBC will be zero for 2010. However, a discrepancy of approximately $27 million remains for 2009. Exh. 43. The Companies have forecast a negative amount of approximately $60 million for 2009, while Staff forecasts a negative $32 million. Exh. 43. The specific NBC calculation differences are set forth in detail on page 2 of Exhibit 43. First, the Companies included $15 million for the NYPA true-up, while Staff utilized $19 million.[24] Second, the Companies show zero cash flow for NBC commodity uncollectibles, while Staff shows a positive cash flow of approximately $6 million. Exh. 43 at 2. Staff's cash flow position on uncollectibles assumes that the Companies' actual uncollectible expenses will be approximately $6 million less than in 2008. Tr. at 332. However, the Companies under-collected uncollectible expenses in 2008 by that amount, and there is no net cash source in 2009 for commodity uncollectible expense. Tr. at 332; Exh. 1, Revenue Requirements Panel Testimony at 22.[25] Finally, the Companies utilized approximately $16 million for NBC 2008 Return of VPO Basis, while Staff utilized zero. This reflects an East/West basis differential, needed to further supplement the East customers. Exh. 43 at 2. During 2008, the Companies forecasted and placed in NBC rates an amount of dollars to compensate East customers for regionally higher costs of energy. The cost exceeded the forecast by $16 million. The Companies owe this money back to East customers during 2009. Staff did not include this item in their analysis.

---

[24] This difference is apparently caused by Staff's failure to account for a 2007 NYPA true-up.

[25] The Companies utilized $4 million for NBC '07/08 Lost Revenue Recovery true-up while Staff utilized zero. The Companies also utilized approximately $6 million for the NBC '07/08 base NBC true-up while Staff utilized zero. These amounts were simply ignored by Staff and, in essence, net each other out.

(e) Capital Expenditures

The Companies' cash flow forecast is based on a capital expenditure of approximately $375 million in 2009 and approximately $441 million in 2010. Exh. 43. The infrastructure projects identified by the Companies' Capital Expenditures, Reliability and Operations Panels ("CRO Panels") over the next two years are based upon the Companies' requested rate relief. Assuming rate relief, the capital expenditures would be funded by a combination of debt and equity. Staff, on the other hand, argues that the Companies should spend no more on capital expenditures in the next two years than the $540 million set forth in the Merger Order. Tr. at 888-90.

Capital expenditures at either the Companies' or Staff's proposed level would require cash flow that the Companies currently lack, and that would require substantial new debt. Even assuming Staff's $540 million level of capital expenditures, the Companies have testified that they would still need $575 million in cash they simply do not have. Tr. at 288, 358. Moreover, as discussed in Section II.C below, any attempt to fund these requirements with additional new debt will result in significantly higher debt costs for ratepayers, reduced credit metrics and likely credit downgrades. Tr. at 288, 509-10, 532.

Staff's witness admitted on cross-examination that Staff did not evaluate the merits of any specific projects when developing its cash flow projections for capital expenditures, but instead simply used the amount that the Commission imposed in the Merger Order. Tr. at 890.[26] Similarly, Staff testified that it did not have "an opinion as to the importance or priority" for the projects identified on the CRO Panels' exhibits. Tr. at 216. Thus, the record demonstrates significant uncertainty with respect to the appropriate level of capital

[26] Staff further acknowledged that the $540 million level in the Merger Order was not driven by a bottom-up project-by-project analysis, but was more of a "macro allowance." Tr. at 890.

expenditures over the next two years, and the Companies believe that the merits of these individual projects should be evaluated in a full rate case process.

(f) Long Term Debt Redemption

The subcategory "Long Term Debt Redemption" is not a matter of controversy between Staff and the Companies, with both forecasting a negative $100 million. Tr. at 342.

(g) Free Up 50% of Existing Credit Facility/Repay Loan to EEC

These two items appear separately on Exhibit 43 but are closely related and readily addressed together. First, with respect to the Companies' credit facilities, the Companies were fully drawn on their available short-term borrowing facilities as of December 31, 2008. Tr. at 359. As Mr. Kump testified, "[t]hat's not a sustainable position. We need to have liquidity available for unforeseen events." Tr. at 359. The Companies' cash flow projections for 2009 and 2010 assume that the Companies will reduce the amount of short-term debt under their revolving credit facilities to improve liquidity. The Companies have testified that they need to pay down approximately fifty percent of their short-term credit facilities to ensure that they can respond to emergency situations, such as major storms or other natural disasters. Tr. at 266, 343. This is smart business planning. Staff, however, refuses to include these costs in its cash flow projections for the Companies for 2009 and 2010, without explanation or justification. Staff's failure to recognize the need to have liquidity available for unforeseen events in its cash flow analysis is inconsistent with its testimony that the Companies can improve their liquidity situation by issuing long-term debt to reimburse their short-term borrowings.[27] Tr. at 786.

---

[27] Moreover, Staff's suggestion at the hearing that the Companies can simply increase the limit of their liquidity facility at any time is inaccurate. Tr. at 862. The Companies cannot increase the limit of their liquidity facility without the consent of their bank lenders. That consent would be uncertain at best in the current market environment.

Second, and similar to its position on short-term borrowings, Staff refuses to recognize that the Companies need to repay approximately $110 million in short-term loans extended by their parent company, Energy East. Energy East extended these loans to NYSEG and RG&E on a temporary basis during the third and fourth quarters of 2008 to provide the Companies with necessary liquidity for continued operations. Tr. at 365. As the Company Panel testified, these temporary loans are structured as demand notes on which Energy East can call for repayment at any time. Tr. at 448. This is the first time that Energy East has ever extended these types of temporary loans to its operating subsidiaries, and this "band-aid" solution is not sustainable over the long term. Tr. at 258-59. Continuing to tie up over one-third of Energy East's credit facility with temporary loans to NYSEG and RG&E would impair Energy East's ability to respond to its own liquidity needs, as well as the future liquidity needs of all its operating subsidiaries. See Exh. 25, Response to DPS-7. Staff offers absolutely no justification for its failure to recognize the repayment of temporary loans from Energy East in its cash flow analysis. Accordingly, the record demonstrates that leaving these loans outstanding for an indefinite period of time is not a sustainable long-term solution to the Companies' liquidity problems, and the Companies have properly included approximately $110 million for the repayment of the Energy East loans in their 2009 cash flow forecast.

(h) Dividends

Exhibit 43 includes an assumption that dividends are normally paid to utility shareholders, and therefore, that earnings are paid out as dividends. While Staff, the New York State Consumer Protection Board ("CPB") and Multiple Intervenors ("MI") take issue with the payment of dividends in the projected 2009 and 2010 cash flow projections, in an industry in which shareholders receive a large portion of their returns by means of a dividend payment, it makes little sense to assume, in advance, that dividends would not be paid. However, including

a payment of dividends in the cash flow projections for 2009 and 2010 does not mean that the Companies have made any specific determinations as to whether or at what level they will pay dividends in 2009-2010. Tr. at 344-46. Instead, Exhibit 43 reflects the fact that utilities, including the Companies, regularly pay dividends to their shareholders in the ordinary course of business. Tr. at 344-46.

Staff's suggestion that the Companies should remedy their cash flow problems by continuing to withhold dividends from their parent company is unreasonable, confiscatory and contrary to United States Supreme Court precedent. Although NYSEG's and RG&E's parent companies have foregone at least $55 million in dividends since September 2008 to ensure that the Companies retained necessary liquidity to continue operations, this is not a sustainable long-term solution to the Companies' cash flow problems. It is highly unusual for utilities to withhold dividends from their shareholders, regardless of whether an institutional investor or holding company parent is involved. Tr. at 308-09, 394, 454, 557.

Hope and Bluefield require that utilities and their equity owners earn a fair and adequate return.[28] As the Supreme Court noted in Hope and the Company Panel testified, dividends are one of the most important components of a utility shareholder's total return.[29] Tr. at 308-09, 394. The Supreme Court was clear when it held that "[f]rom the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock."[30] Requiring the Companies to withhold dividends would constitute an unlawful

---

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

[29] Hope, 320 U.S. at 603 (1944).

[30] Id. at 603 (emphasis added).

confiscation of capital.[31] Finally, assuming that dividends would continue to be foregone for an indefinite period of time as part of the Companies' cash flow analysis sends the wrong message to both investors and credit rating agencies, and would chill debt and equity investment in the Companies.[32] Accordingly, the record demonstrates that the Commission should reject Staff's assertion that the Companies should continue to withhold dividends as a cash conservation measure.

Finally, it is important to note that the Companies' dividend assumption in Exhibit 43 is based on cash flow projections in the absence of rate relief. Exhibit 10 projects that, if the Companies' request for rate relief is granted, then approximately $365 million in earnings would either be retained, or reinvested in the Companies through equity infusions, in order to fund capital projects. Tr. at 409; Exh. 10. This equates to over 90% of the earnings that would otherwise be available for dividends. Thus, if the Companies' request for rate relief is granted, then the Companies would pay out less than 10% of earnings as dividends on a net basis. Tr. at 410.

2. Austerity Measures

In its Motion to Dismiss, Staff claims that the Companies failed to implement austerity measures. The record in this proceeding demonstrates that the Companies have, in fact, implemented aggressive austerity measures at all levels on an interim basis. Additional means

---

[31] Bluefield, 262 U.S. 679, 690 (1923) ("Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.").

[32] Staff claims that competition for capital is a "new and undisclosed hurdle" to investment in the Companies. Tr. at 741. In doing so, Staff completely takes out of context a recent statement by Iberdrola Chairman Galan made with respect to nuclear investment in Europe and misapplies it here. Tr. at 741; Exh. 33. Chairman Galan's statement has absolutely no relevance to the Companies or these rate proceedings. Moreover, Staff's argument regarding "new" competition for capital ignores the fact that the standard for the return that investors are due has not changed in the U.S. since the Hope decision in 1944, which held that returns should be commensurate with returns on other enterprises having corresponding risks and sufficient to attract capital. Answer to Staff's Motion to Dismiss at 11-12.

proposed by Staff and other parties lack any legal or factual justification, would harm the Companies' ability to provide safe and reliable service, and must be rejected. Tr. at 317-20, 383, 401. Finally, even the most aggressive cost-saving measures cannot alleviate the Companies' significant cash shortfall over the next two years. Tr. at 319; Answer to Staff's Motion to Dismiss at 17.[33]

Staff's proposed austerity measures are not based on studies or supported by any record evidence. Tr. at 863. On cross-examination, Staff's witness acknowledged that he is not an expert on austerity measures. Tr. at 864. Staff's witness also admitted that he conducted no studies regarding the potential impact of Staff's proposed austerity measures (including whether the measures would work or whether they would jeopardize safe and reliable service) and that Staff's proposed measures appear to be based solely on a newspaper article. Tr. at 864. Staff's testimony on austerity measures has no probative value and should be rejected. Tr. at 864.

The austerity measures voluntarily imposed by the Companies are wide-ranging and appropriate given the circumstances. Specifically, the Companies have restricted hiring (including delaying line worker classes) and employee travel, implemented reductions in operating expenses, delayed payments to vendors to the extent possible, limited overtime, and imposed other cash conservation measures, including but not limited to a restriction on salary increases for Company employees since the beginning of the financial crisis and a salary freeze for non-union management employees for 2009. Tr. at 258, 317-20, 376-79, 382-84.

Staff's proposed austerity measures would strike at the heart of the Companies' ability to maintain safe and reliable service. Tr. at 319. For example, Staff's proposed austerity measures affecting the workforce (e.g., cutting the work week, furloughs, and reducing workers

[33] As the Companies testified, "austerity measures are necessary to ameliorate further complications from the Companies' financial crisis, but are simply temporary band-aid measures and the Companies' financial performance continues to deteriorate." Tr. at 258.

and contractors) were proposed without any analysis of the potential negative impact on service quality and reliability. Tr. at 864. Staff's witness testified that he "didn't do any studies…." Tr. at 864.

The Companies, on the other hand, were careful to implement only those austerity measures that are consistent with the provision of safe and reliable service. Tr. at 685. As the Companies' witnesses testified, Staff's proposed measures cannot be implemented without placing the provision of safe and reliable service at risk.[34] Tr. at 318-19. The Companies are not staffed in a manner that allows for the type of reductions proposed by Staff. Tr. at 319. Prior merger and integration efforts, as well as power plant retirements and transfers to affiliated service companies, have already greatly reduced the Companies' headcount from more than 5,100 employees to approximately 3,400. Tr. at 319, 376-78. Thus, Staff's proposed workforce reductions would impair the Companies' ability to react to customer needs and to respond rapidly and flexibly to unexpected events, such as storm damage and pole hits. Tr. at 319. As noted by the Companies, "[w]hile private industry companies can engage in short-term cash saving strategies that directly impact production and harm customer service, such actions would be antithetical to public utilities with their statutory obligation to provide safe and reliable service at all times." Tr. at 315. Ordering the Companies to implement austerity measures beyond those already employed is impractical, contrary to good business practice, and would potentially further jeopardize the Companies' ability to provide safe and reliable service. Tr. at 319.

---

[34] These types of austerity measures are inconsistent with the positions taken by Staff and other parties in the merger proceeding. See Case 07-M-0906, Prefiled Testimony of Policy Panel (DPS Staff), at 73 (Jan. 11, 2008); Case 07-M-0906, Initial Brief of Multiple Intervenors, at 34-35 (Apr. 11, 2008) (requesting that the Commission condition merger approval on the maintenance of existing manpower levels at NYSEG and RG&E "for some reasonable period (e.g., three years) following the transaction"). MI explicitly stated that a "reduction in manpower could have detrimental impacts on reliability, service quality and safety." Id. at 35.

Setting aside the fact that Staff's proposed austerity measures have no record support and, if implemented, would further jeopardize safe and reliable service, many of Staff's proposed cash conservation measures are not viable business strategies. For example, Staff proposes that the Companies indefinitely suspend payments to the Companies' affiliated service companies without taking into consideration the nature of the services those affiliated companies provide and the resultant effects that nonpayment would have on the Companies. Tr. at 770-71. The types of services provided by affiliated service companies include accounting, purchasing, and IT, and are essential to the Companies' operations. Tr. at 316. No company can expect to continue to receive contractually provided services (either by an affiliated service company or third-party vendor) absent payment for the services. Tr. at 316. Refusing to pay these essential vendors is not a viable option. Tr. at 316-17; Answer to Staff's Motion to Dismiss at 16.

The Commission should also reject Staff's suggestion that the Companies could conserve cash by withholding federal income taxes. Tr. at 766, 769, 770. Staff claims, without any factual or legal basis, that the Companies may be able to consolidate their tax returns with certain Iberdrola Renewables projects in the United States and therefore reduce their federal income tax liability. Tr. at 437. However, the Companies are not able to file consolidated federal income tax returns with Iberdrola Renewables projects under the Internal Revenue Service ("IRS") consolidation requirements, because Iberdrola Renewables and the Companies do not share a common United States parent company.[35] On cross-examination, Staff admitted that it did not review or consider the IRS consolidation rules to determine whether consolidation among the Companies and Iberdrola Renewables projects was even possible. Tr. at 900.

[35] I.R.C. §§ 1501, 1504.

In addition, the Staff witness's statements at the hearing with respect to the Merger Order provisions on Production Tax Credits ("PTCs") are incorrect. The Staff Panel suggested in pre-filed testimony and in the hearing that the Commission made a ruling on PTCs. Tr. at 769-71, 911-12. In fact, the Commission did not make <u>any</u> ruling or factual finding on PTCs in the Merger Order. The sentence that the Staff witness read into the record was an incomplete recitation from the Recommended Decision and was not a Commission finding. Staff's witness omitted the portion of that description of the Recommended Decision in which there was "uncertainty" about Staff's PTC analysis.[36] As such, the withholding of federal income tax payments has no legal basis. To compound its error, Staff would have the Companies delay payment of federal income taxes in any event:

> A: (D'Ambrosia) No, that's not what I said. I didn't say they shouldn't pay them. I said they should delay until the financial situation unwinds.
>
> Q: Is that irrespective of whether or not there are PTC credits available?
>
> A: (D'Ambrosia) Yes. (Tr. at 902.)

As such, the withholding of federal income tax payments has no legal or factual basis, and would be no more appropriate than withholding New York State income tax payments or annual Commission assessments, which Staff testified it does not recommend. Tr. at 902.

For the reasons discussed herein, the Commission should reject the cash conservation measures proposed by the parties. As the Companies have shown, such measures are infeasible and would further jeopardize safe and reliable service.

### B. Absent Rate Relief, the Companies' Earnings Will Be Inadequate

The Companies currently project that returns on equity for 2009 will be at or below 7% for the electric and gas distribution business. Tr. at 255. At this level, the returns

---

[36] Merger Order at 121.

have at times "approximated the after-tax cost of debt available to 'BBB' level utilities like NYSEG and RG&E in the current market." Tr. at 255. This level of return is far below the cost of equity capital of 12% to 12.2% for the Companies. Tr. 324-25. See also Exh. 1, Direct Testimony of Jeff D. Makholm at 8.[37] Staff has alleged that the Companies' 2009 pro-forma delivery ROE will meet or exceed 9%, without rate relief on a regulatory basis. Tr. at 756. Notably, even with Staff's myriad of adjustments and disallowances designed to artificially increase ROE, Staff's 9% level remains far below the fair and reasonable return on equity capital. Tr. 324-25. Even Staff has acknowledged that the return requirements of equity investors have likely increased as a result of the global financial crisis. Tr. at 843.

In calculating its inflated delivery earnings, Staff makes numerous unjustified assumptions and adjustments. Staff's original calculation of the Companies' forecast ROE is set forth in Exhibit 36. Staff subsequently revised various components of its calculations at the evidentiary hearings and those calculations are set forth in Exhibit 41.

The Companies identified various flaws in Staff's ROE calculation and illustrated each of those flaws in Exhibit 17. Tr. at 324-29; Answer to Staff's Motion to Dismiss at 18-20. The Answer to Staff's Motion to Dismiss and Exhibit 17 group Staff's erroneous ROE assumptions and calculations and into four main categories: 1) Mathematical Calculation Errors (Tr. at 326); 2) Mistakes (Tr. 326-27; 876-77); 3) Double Counting PBAs (Tr 328); and 4) Ratemaking Adjustment Disagreements (Tr. 328-29). See Tr. at 324-29; Answer to Staff's Motion to Dismiss at 18-20.

Staff's corrections at the hearing to its ROE calculations (modestly reducing the ROE shown by Staff) require the Companies to update the treatment of these issues provided in

[37] The Companies addressed in their Answer to Staff's Motion to Dismiss why Staff's assertion that the Companies "accepted" a 10.1% return on equity ("ROE") in the Merger Order is contrary to a plain reading of the Merger Order and must be rejected. Answer to Staff's Motion to Dismiss at 20.

the Answer to Staff's Motion to Dismiss. Below, the Companies address each of Staff's flawed calculations of ROE utilizing the same four groups identified above:

1. Mathematical Calculation Errors

As shown on Exhibit 41, Staff acknowledged that it made various calculation errors that double counted the effect of Staff's rate base adjustments. However, Staff still fails to synchronize interest. Tr. at 326; Compare Exh. 36 with Exh. 41.

In addition, Staff improperly utilizes an average of the RG&E and NYSEG post-rate relief pre-tax rate of returns of 13.0% to calculate the income impacts of Staff's rate base adjustments. This calculation is incorrect because it overstates the impacts of Staff's rate base adjustments. The 13.0% pre-tax rate of return is based on the Companies' requested returns on equity of 12.2% for RG&E and 12.0% for NYSEG. The purpose of Staff's Exhibit 41 is to calculate the Companies' 2009 ROE without rate relief. Thus, using the higher post rate relief return to determine a pre rate relief ROE is inappropriate and serves only to overstate the impacts of Staff's rate base adjustments.

2. Mistakes

Staff removed its Expense Adjustments for Economic Development and Decommissioning in response to the Answer to Staff's Motion to Dismiss. Tr. at 877; Exh. 41. Staff also corrected errors identified by the Companies regarding Amortizations for Pension Deferrals and the 2006 Flood. Tr. at 877-79; Exh. 41. Staff fails, however, to correct its error regarding the inflation impact on non-rate case legal costs. Tr. at 327.

3. Double Counting PBAs

Staff's calculation of return was not corrected with regard to PBAs. Staff double counts the impact of the PBAs on the Companies by including the PBAs in rate base, thus

reducing rate base (Tr. at 868) while still requiring the Companies to accrue interest on the PBAs.

Although Staff admitted at the evidentiary hearing that both accruals of interest and reductions of rate base should not happen simultaneously (Tr. at 880), that is precisely what Staff did in its earnings calculations.

The Merger Order required the Companies to accrue interest on the PBAs until rates are reset. The Merger Order states in relevant part:

> At this time, however, we will not require an immediate rate reduction as a precondition of the proposed transaction… Instead, to promote rate stability and preserve the scope of our discretion when applying the PBAs for the benefit of ratepayers, we will direct petitioners to defer the PBAs for disposition in NYSEG's and RG&E's future rate proceedings…. The PBAs should be recorded on the books of NYSEG and RG&E effective as of the acquisition's closing date, allocated among the companies' four departments (at NYSEG and RG&E respectively, electric and gas) in proportion to the departments' respective delivery revenues for calendar year 2007. Pending such disposition, the PBAs will accrue interest at the respective companies' allowed pre-tax rates of return.[38]

This language expressly directs the Companies to hold the PBAs out of rate base and requires the Companies to accrue interest on the PBAs below the line. Tr. at 868. Staff made two significant errors in its earnings calculations that are contrary to the Merger Order language.

First, while the question of whether PBAs should reduce rate base is a question for determination in the underlying rate case, Staff calculates this reduction in rate base <u>in the absence of</u> rates being reset, which is contrary to the Merger Order which requires the disposition

[38] Merger Order at 138.

of the PBAs "in NYSEG's and RG&E's future rate proceedings."[39] The Merger Order would certainly not allow any disposition of the PBAs (including through a reduction of rate base) now, prior to the resetting of rates.

Second, Staff fails to recommend the termination of the interest accruals in 2009 and 2010 absent rate relief, after reducing rate base by the amount of the PBAs. Staff acknowledged in the evidentiary hearing that once PBAs are pushed into rate base, at that point, the interest accrual should cease because "it wouldn't be fair." Tr. at 880. Failure to do so is a double-count that, in Staff's own view, is admittedly unfair.

4. Ratemaking Adjustment Disagreements

In their Answer to Staff's Motion to Dismiss, the Companies placed numerous items into a Ratemaking Adjustment Disagreement category. This category represents issues and disagreements surrounding the ratemaking treatment of certain items. These include Staff's O&M and rate base adjustments for payroll increase annualizations, rate case expenses, a positive Earnings Base Capitalization ("EBCAP"), Hedge Loss, and Common Equity Ratio. Staff inappropriately assumes that it will prevail on every one of these critical rate case items. Needless to say, the Companies disagree with Staff's conclusions and positions on these issues. Tr. 328-29; Answer to Staff's Motion to Dismiss at 20. The Companies have addressed in detail the necessary corrections to Staff's adjustments in Exhibit 17, page 2.

The payroll increases reflected in the Companies' rate filing are appropriate and reflect the annualization of the 2008 non-union salary increase and the 2009 union salary increase. There is no 2009 non-union salary increase. Rate case expenses are a legitimate cost of doing business and were conservatively estimated based on the 2005 NYSEG Electric rate

[39] Merger Order at 138 (emphasis added). Staff acknowledged on cross-examination that its ROE calculations in Exhibit 41 assume that rate relief is not granted in this proceeding. Tr. at 868.

case. That estimate did not contemplate the level of activity associated with this Motion to Dismiss.

NYSEG included EBCAP in rate base. Staff removes NYSEG EBCAP, asserting simply that all positive EBCAP should not be in rate base. Exh. 41. To the extent that actual capitalization exceeds the formulaic-calculated rate base, positive EBCAP should be included in rate base since it represents an amount of capitalization on which the Companies actually pay interest and for which they should be entitled to earn a return on equity.

Staff next removed the loss on the hedge from the Companies' rate base. The Companies included the hedge loss as a rate base item like any other asset that is not accruing interest. Staff seeks to confuse the hedge loss issue by claiming that the Companies "chose to enter, extend and hold its hedge which ultimately cost them $100 million." Tr. at 786. This argument is a red herring. Staff cannot deny that the Companies paid out the $100 million and in the past have recovered hedge losses or gains through rates.[40] The hedge loss is therefore properly included in rate base for purposes of calculating ROE. Staff's quote and criticism of the Companies' holding the hedge also reveals a basic misunderstanding of the very purpose of a hedge. Hedges ameliorate future interest rate risk and they necessarily do not always move in a favorable direction. The Companies acknowledge that, as a result of historically low interest rates, anomalies in the swaps market caused by the financial market meltdown, and a 14-month delay in approval from the Commission of RG&E's financing authority, RG&E incurred losses

[40] As Chairman Brown has stated, it is proper for utilities to engage in hedges and there must be recognition that those hedges do not always go in the direction the utilities would prefer. Tr. at 295. Any allegation that RG&E improperly entered into this hedge position back in 2006 and that it should therefore be excluded from rate base is without sufficient basis and must be rejected, particularly in a motion to dismiss context. Tr. at 293-94.

approximating $100 million on a hedge position for a bond financing completed in December 2008. Tr. at 248-49.[41]

Staff's challenge to inclusion of the hedge loss appears to be that the hedge loss has not yet been audited. Exh. 41. It is inappropriate to unilaterally remove the hedge loss from the rate base for ROE calculation purposes before this issue is determined in the underlying rate case.

Finally, instead of utilizing the actual equity ratio of the Companies in its calculations, Staff utilizes some type of consolidated equity ratio capped at 45%. Given the ring-fencing and other financial protections in place, the Companies believe that their higher stand-alone equity ratios should be utilized. Once again, this is an issue that is best determined as part of the full rate case, and Staff's calculations for purposes of this Motion to Dismiss inappropriately presume that Staff will prevail on this issue. Regardless of what equity ratio is ultimately used in determining new rates, the fact remains that the actual equity ratios of the Companies are currently higher than the imputed equity ratio used in Staff's calculation and, therefore, the actual return on equity is lower than the ROE calculated by Staff.

There is no basis on the record for the Commission to conclude that Staff's ratemaking adjustments are appropriate, particularly here in the motion to dismiss context, before the rate cases are actually heard. It would be inappropriate for the Commission to consider or decide these issues at this preliminary state of the proceeding.

For the foregoing reasons, the Companies have demonstrated that Staff's alleged delivery ROE is grossly overstated and is based on numerous flaws. Absent the requested rate

---

[41] Had there been no delay in approval, the hedging loss would have been approximately $15 million. Tr. at 294.

relief, the Companies' ROE for 2009 will be at or below 7%, even after the reduction in expense resulting from the Companies' commitment to remove incentive compensation from rates.

### C. Avoiding Credit Ratings Downgrades and Ensuring Access to Capital Markets Benefits Ratepayers

As described in Section II.A above, Staff's argument that the Companies will not need to issue significant debt during the 2009-2010 time frame is illogical and based upon flawed assumptions. To the contrary, the Companies have demonstrated that, in the absence of rate relief, they would be forced to fund significant cash requirements over the next two years with additional debt. Regardless of whether the Commission assumes the Companies' approximately $816 million or Staff's $540 million level of capital expenditures, taking on additional debt without the requested rate relief would reduce even further the Companies' credit metrics that are already inconsistent with Moody's criteria for "Baa" level utilities (i.e., below investment grade), which would likely cause credit downgrades and higher costs to customers. Tr. at 268-69, 330, 509-10, 531-37. Credit downgrades, in turn, would lead to even more difficult and expensive borrowings and significantly higher costs to customers. On the other hand, if the Commission provides rate relief to alleviate the Companies' current cash flow shortfall, the Companies would be able to maintain their current credit metrics, and perhaps gradually improve them. The record demonstrates that credit rating agencies are closely monitoring this proceeding, and have indicated that the Commission's decision will be a key factor in evaluating the Companies' current ratings, including the near-term resolution of S&P's negative watch. Tr. at 306, 405-06, 460-61, 529, 534; Exh. 11 at 6.

Mere access to the credit markets does not alleviate the Companies' significant credit rating concerns. While the Companies could assume greater levels of debt now (Tr. at 392), such additional debt comes at a high cost and is not unlimited. As the Policy Panel and Mr.

Fetter testified, basis point spreads between "A" and "Baa" category utilities skyrocketed in the fourth quarter of 2008 and remain at historically high levels. Tr. at 243-44, 552; Exh. 5. Staff itself acknowledged this increase and the "differentiation" that now exists between "A" and "BBB" category utilities. Tr. at 839-40. Moreover, contrary to Staff's testimony regarding the limited and inapposite examples of successful post-September 2008 debt (e.g., the offering by Laclede Gas Company), record evidence in this proceeding shows that the level of issuances of "BBB" level rated utility companies decreased markedly after the Lehman bankruptcy. Tr. at 254, 302; Exh. 6. The Company Panel testified as to the difficulties that RG&E experienced in its December 2008 issuance, and another regulated affiliate of the Companies could not successfully complete a recent debt issuance after "presounding" the transaction to potential investors. Tr. at 369-70. Thus, the Companies' access to the current financial markets comes with substantial difficulties and high costs to ratepayers.

The costs of large amounts of additional debt go beyond the high yields and the wide spreads between "BBB" and "A" category utilities. Even assuming that the Companies could access the capital markets to fund their $575 million cash requirements for 2009 and 2010 with debt, in the absence of rate relief, any attempt to do so likely would result in one or more credit downgrades, and associated higher borrowing costs. Tr. at 288. The credit rating agencies utilize certain established, objective financial ratios. Mr. Fetter testified that the most important ratios that the credit rating agencies employ to evaluate utility credit profiles are: (a) the funds flow to interest coverage ratio; and (b) the operating funds to total debt ratio. Mr. Fetter demonstrated that further borrowing to meet even the $540 million in capital expenditures (let alone the higher level identified in the Companies' rate filings) would cause both Companies to "have ratios that are no longer consistent with the key ratio guidelines established for 'Baa'-rated

utilities by Moody's" (i.e., below investment grade).[42] Tr. at 268-69, 509, 510, 532. Mr. Kump further confirmed at the hearing, based on either the Companies' or Staff's level of capital expenditures, that "[e]ither way, when you look at the resulting credit metrics that come out of that because the company is so weak…it's not a sustainable position and the company is going to get downgraded as a result." Tr. at 458. This matter should not be in dispute. Staff's witness further agreed that, in light of the fact that the Companies are already on the low end of Moody's financial ratios, he would "expect the matrix [of financial ratios] would likely go down" absent rate relief and absent any further parent infusion of equity. Tr. at 844.

The Companies already have the lowest credit ratings of any regulated utilities in New York State. S&P, Moody's and Fitch have placed the Companies on negative watch or outlook. Tr. at 304, 401-02, 534. The credit rating agencies have noted that the Companies' current ratings already incorporate a high level of parent company support, and would be even lower in the absence of that support. For example, S&P stated in its February 9, 2009 report on Energy East that its current ratings "incorporate a level of support from Iberdrola" and "would likely be lower if [S&P] were to view Iberdrola's strategic and financial commitment to have weakened…." Exh. 11 at 7. Mr. Fetter also testified that current ratings "would be lower if there were no support in place" from its parent companies. Tr. at 528, 545; see also Tr. at 401-02.

The Companies' deteriorating financial situation would be exacerbated if the Companies received a downgrade, possibly even below investment grade. Tr. at 391-92, 547. Such an event would result in significantly increased borrowing costs, lower availability of capital, and other harm to ratepayers. Tr. at 299. In addition to increasing the cost of new debt,

[42] The Companies' credit rating expert, Mr. Fetter, speaks from direct experience. From 1993 to 2002, Mr. Fetter was the Group Head and Managing Director of the Global Power Group within Fitch. Tr. at 502. His group's primary role at the Fitch ratings agency was to perform and assign electric and gas utility credit ratings. Tr. at 538. Prior to his position at Fitch, Mr. Fetter served both as Chairman and Commissioner of the Michigan Public Service Commission for six years.

any credit downgrade would also increase costs under the Companies' existing credit facilities. More critically, if a downgrade to non-investment grade were to occur, the Companies could be subject to borrowing costs of as much as a 1,353 (13.53%) basis point spread from U.S. Treasuries, as Staff has acknowledged. Tr. at 841-42. As Staff's witness succinctly stated, "now is not a good time to be a junk bond and issuing a junk bond." Tr. at 842. He also agreed with Chairman Brown's recent remarks to the Federal Energy Regulatory Commission that "you do not want to be rated at the lower end of the B range because an unexpected shock could move you outside investment grade range." Tr. at 861; Exh. 7.

All the rating agencies already view New York State as an unfavorable regulatory climate, a fact which Staff itself has acknowledged. Tr. at 850-51 (S&P), 846-48 (Moody's), 854 (Fitch).

- Moody's states in its October 16, 2008 report on both NYSEG and RG&E that "[w]e also give significant weighting under the rating methodology to the company's regulatory risk profile, which in our opinion has weakened from a more favorable position, placing it in the Ba [non-investment grade] category." Tr. at 529-30.

- Fitch states in a November 17, 2008 report that "the ratings of utilities operating in states with relatively low authorized ROEs and significant regulatory lag are more likely to suffer future credit deterioration in Fitch's view. States with challenging regulatory environments include Arizona, Missouri, New Mexico, New York, and Vermont."[43] Tr. at 854.

- S&P rates the credit supportiveness of all regulatory jurisdictions into five categories: (1) most credit supportive; (2) more credit supportive; (3) credit supportive; (4) less credit supportive; and (5) least credit supportive. New York is categorized as less credit supportive. Tr. at 850.

---

[43] In response to questions from the bench, Staff's witness stated that Fitch's low rating of New York is "befuddling." Tr. at 908. In this proceeding, Staff argues that the Companies' cash shortfalls should be ignored, and that Companies should, instead: (a) stop paying vendors; (b) withhold federal tax payments; (c) eliminate the payment of dividends for indefinite periods; (d) reduce workforces beyond their current lean levels; and (e) refuse to pay back short-term debt to parent companies and lenders in 2009 and 2010 to improve liquidity. It is no wonder that the credit rating agencies have a negative perception of the regulatory climate in New York.

Moreover, credit rating agencies are closely monitoring the outcome of this proceeding, including Staff's Motion to Dismiss. Tr. at 306, 405-06, 529. For example, S&P stated in its February 9, 2009 report that that the Companies' ability to improve their credit profile through increased rates "will be an important factor in resolving the CreditWatch listing," which is typically resolved within three to six months. Tr. at 460-61, 527; Exh. 11 at 6. Similarly, Fitch's recent RG&E report also notes the significance of the Companies' requested rate relief, without which "credit measures will continue to decline." Exh. 11 at 9. Moody's also stated in October 2008, that it would likely downgrade the Companies if the Commission's level of support for the Companies is compromised "in any material way" to jeopardize the Companies' financial support from regulators, which Mr. Fetter testified includes dismissal of the Companies' rate case. Tr. at 514-15, 530.

The rating agencies have indicated that the Commission's action with regard to Staff's Motion to Dismiss will provide an important signal to investors and rating agencies as to the level of regulatory support that will be extended to the Companies during this severe financial crisis. Denying the Companies the ability to move forward with their rate proceeding in the face of substantial evidence of the economic harm that would result in the absence of such rate relief would send a clearly unfavorable message to investors and rating agencies.

## III. RELIABILITY AND SERVICE QUALITY WOULD BE IN JEOPARDY ABSENT THE REQUESTED RATE RELIEF

On cross-examination, Staff's witness agreed that a utility should not wait until its service has deteriorated before it files a rate case. Tr. at 201-02. Despite this testimony, Staff claims that a rate increase should not be considered at this time because "performance measures show that neither NYSEG nor RG&E suffer from service-related problems." Tr. at 153. In particular, Staff argues that the Companies' System Average Interruption Frequency Index,

Customer Average Interruption Duration Index and other reliability and customer service metrics have been historically high and did not decline in 2008 (or have even increased in certain respects).

Although the Companies are proud of their historically high levels of service quality, Staff's position that the future provision of safe and reliable service is not in "jeopardy" because of current performance levels is illogical. Staff misses the point that, consistent with the Commission's standard in the Merger Order, absent rate relief, the Companies' current financial condition would reach levels that would jeopardize safe and reliable service. The Companies' CRO Panels testified that continued investment in and replacement of the Companies' aging infrastructure is necessary in order to continue to provide safe and reliable service. In fact, Staff concedes that increased aging of the infrastructure could negatively impact reliability. Tr. at 209.

The Commission should reject Staff's misplaced and formulistic reliance on historical performance results and conclude that the Companies' overall financial condition jeopardizes the Companies' ability to provide safe and reliable service.

## IV. THE COMPANIES' RATE CASES ARE SUFFICIENT

The Companies' rate cases comply with all applicable Commission rules and regulations. For brevity's sake, the Companies do not restate the sufficiency of the rate case arguments herein and, instead, rely upon the Answer to Staff's Motion to Dismiss and supporting testimony.[44] See Answer to Staff's Motion to Dismiss at 22-28. No additional facts were developed at the hearing to support Staff's allegations that the rate cases are deficient.

---

[44] Parties may argue that the Companies' rate cases are deficient because only revenue requirement matters were submitted at the time of filing. As the Companies have explained, the non-revenue requirement components of the cases will be filed by May 29, 2009. Such an approach is not prohibited by statute, regulation or any Commission order. While certain generic Commission orders may dictate that the Companies include various

In fact, the only alleged deficiency that was discussed at the evidentiary hearing related to merger synergies, efficiency gains, and the adoption of utility best practices. Staff and MI claim that the Companies have failed to comply with the Merger Order in this regard. During the hearing, the Company's witness testified that Iberdrola, Energy East, NYSEG, and RG&E have not identified merger synergy savings. Tr. at 436. The fact that synergy savings have not been identified is consistent with statements in the Iberdrola/Energy East merger proceeding that the transaction was not undertaken to take advantage of synergies and that none had been identified.

The Companies' witness also testified that no studies or analyses related to merger synergies, efficiency gains or best practices were included with the Companies' rate case filings, but explained that the merger did not require Iberdrola, Energy East, NYSEG, or RG&E to undertake any such studies or analyses. Tr. at 436-38. This testimony is supported by the language in the Merger Order, which states:

> NYSEG and RG&E each must provide, in prefiled testimony as part of its next general rate case filings (whether within or outside the target period), all studies, analyses and related workpapers <u>prepared</u> by Iberdrola, its subsidiaries, affiliates, or agents that identify or quantify the costs and savings related to merger synergies, efficiency gains, and the adoption of utility best practices that in any way affect the management, operation and underlying costs of NYSEG's and RG&E's utility business.

Merger Order at 140-41 (emphasis added).

Contrary to Staff's, CPB's and MI's assertions, this language does not require Iberdrola, its subsidiaries, affiliates or agents to conduct studies or analyses regarding merger synergies, efficiency gains, and the adoption of utility best practices. The language simply

---

non-revenue requirement matters in a rate case, the orders do not require that such materials be included at the time of the initial filing.

requires NYSEG and RG&E to include any such studies and analyses in their next general rate case filings if they were already prepared.

In contrast, the Merger Order imposes an explicit obligation on the Companies to conduct studies in other areas (e.g., economic deliverability study, bottled generation study). See Merger Order at Appendix 3, ¶¶ 9-10. In those instances, the Commission expressly used the words "shall perform" and "shall periodically conduct" studies. Id. If the Commission intended to require that the Companies undertake a study on merger savings, efficiency gains or best practices, the Commission would presumably have utilized the same language to require that the Companies engage in such studies. The Commission chose not to do so. Thus, the Companies' rate case filings cannot be deficient for failing to conduct synergy studies as Staff and MI contend because the Merger Order does not include any such requirement.

## V. THE CROSS-MOTIONS TO INSTITUTE A NEW DIVIDEND PROCEEDING SHOULD BE DENIED

On February 23, 2009, CPB filed as part of its response to Staff's Motion to Dismiss a cross-motion requesting that the Commission institute new proceedings to: 1) prevent the Companies from paying dividends; 2) conduct a management audit to address issues such as utility best practices and merger savings; and 3) examine the prudence of actions of the Companies and Energy East Corporation regarding the instant filings.[45] During the hearing on Staff's Motion to Dismiss, the ALJs ruled that the parties should only address the portion of CPB's cross-motion related to its request that the Commission institute a proceeding to consider whether dividend restrictions should be imposed on the Companies. Tr. at 953.[46]

---

[45] CPB's Response to Staff's Motion to Dismiss and Motion for Institution of Proceedings at 3.

[46] Chief Administrative Law Judge Elizabeth Liebschutz clarified in a March 9, 2009 e-mail to all parties that this ruling was independent of Staff's and MI's claims (in the absence of any cross-motions) that the Commission has the authority to impose dividend restrictions at any time, including as part of this proceeding. The Commission's substantive authority to impose dividend restrictions is discussed below.

As an initial matter, CPB fails to understand the Companies' schedule PP-6 (Exhibit 10) as it relates to dividends. In its cross motion, CPB alleges that the rate increase would provide $400 million in dividends to the parent of the Companies. To the contrary, as the Company Panel testified, should the Companies obtain the requested rate relief, the Companies project that $365 million out of the approximately $400 million in assumed dividends would be retained by, or reinvested in, the Companies to fund capital projects, which means that less than 10% of earnings would be paid to their shareholders as dividends on a net basis. Tr. at 409-10.

Nonetheless, there is no basis for the Commission to impose a mandatory dividend restriction on the Companies. Restricting a utility's ability to make dividend payments is extraordinary action and the Commission should not intrude into the managerial operations of a utility unless the public interest is unfavorably affected by a course of management that ignores the obligation to provide safe and reliable service, which is not the case here.[47]

The parties in this proceeding will likely cite to Jamaica Water Supply[48] as it is the only court case on this topic. In the underlying proceeding, the Commission imposed a mandatory dividend restriction on Jamaica Water Supply based on specific findings that the utility's management policies were so egregious as to compromise the utility's ability to carry out its public service obligations.[49] In the 1970s, Jamaica Water Supply had total accounts payable amounting to nearly $1 million, a substantial portion of which was overdue, and a negative working capital of over $1 million; all of its lines of credit were utilized; and it was operating at a net loss.[50] Moreover, the management policies of Jamaica Water Supply led to

---

[47] Case 29484 - Long Island Lighting Co., Opinion No. 89-8, 101 P.U.R.4th 81, 111 (Apr. 13, 1989) ("LILCO").

[48] Public Service Comm'n v. Jamaica Water Supply Co., 54 A.D.2d 10 (3d Dep't 1976), aff'd, 42 N.Y.2d 880 (1977).

[49] LILCO, 101 P.U.R.4th at 111 (citing Jamaica Water Supply).

[50] Jamaica Water Supply, 54 A.D.2d at 11.

volatile organic compound well contamination, an insecure source of supply, an inability to meet peak day water demands, rusty and corrosive water, insufficient water pressure in some zones, a serious leakage problem, lax billing and collection practices, and a very serious customer relations problem.[51] It was in the face of a finding of serious managerial and service deficiencies (that do not exist here) that the Commission imposed dividend restrictions on Jamaica Water Supply. Subsequent to Jamaica Water Supply, the Commission has emphasized its reluctance to impose dividend restrictions, absent egregious circumstances.[52]

The standard for the imposition of dividends is thus different than the standard for filing these rate cases. In the rate cases, although the Companies have argued that their financial performance would fall to levels that would jeopardize their ability to provide safe and reliable service under the prospective standard in the Merger Order, the Companies' service quality has not already deteriorated, as Staff has repeatedly noted. Tr. at 153-54, 162-63, 173-75, 187-88, 193-95, 201. In fact, Staff itself has praised the Companies' management, noting that both Companies have maintained strong service records in recent years. Id. The Companies' ability to maintain safe and reliable service up to this point is partially due to the fact that NYSEG's and RG&E's parent company has provided approximately $110 million in temporary loans to the Companies and has willingly forgone at least $55 million in dividends in order to ensure that the Companies maintain adequate liquidity for continued operations. However, voluntarily

---

51 Case 28563 - Jamaica Water Supply Company - Water Rates, Opinion No. 84-12, Opinion and Order Determining Revenue Requirement and Authorizing a Purchased Water Adjustment Mechanism, 24 NY PSC 1856, 2033 (Apr. 23, 1984).

52 LILCO, 101 P.U.R.4th at 111; see also Cases 96-W-1148, 96-W-1197, 97-W-1299 and 97-W-1300 - Re Orchard Hill Water Company, Monroe Hills Estates, and Scott Acres Water Company, Opinion No. 98-4, Opinion and Order Determining Revenue Requirements and Charges for Water Service (Feb. 6, 1998) (ordering dividend restrictions where improper payments were made to the company's manager without justification and to the detriment of service quality).

foregoing dividends is vastly different from a Commission-imposed restriction of the payment of dividends and does not justify the action requested by CPB and other parties.

Additionally, as discussed in Section II.A above, any imposition of mandatory dividend restrictions would also be unreasonable, confiscatory, and contrary to the legal requirements under Hope and Bluefield.[53] As the Supreme Court noted in Hope and the Company Panel testified, dividends are one of the most important components of a utility shareholder's total return,[54] and requiring the Companies to continue to withhold dividends in these circumstances would constitute an unlawful confiscation of capital.[55] Tr. at 308-09, 394.

Finally, sound public policy dictates that the Commission should reject any invitation to impose mandatory dividend restrictions on the Companies. Mandatory dividend restrictions would send the wrong signal to investors and credit rating agencies, and would chill debt and equity capital investment at the Companies. Tr. at 312, 315. As the Commission noted in LILCO, a "continuing failure to pay common stock dividends is inevitably perceived in the financial community as an indication of overall financial weakness."[56] The notion that the Commission should mandate dividend restrictions is contrary to Staff's own admission that the cost of equity has likely increased due to the greater risks that equity investors face in the current financial markets. Tr. at 843. In order to make investments in infrastructure and satisfy other cash requirements, all utilities, including the Companies, must be able to attract capital by

---

[53] See Hope, 320 U.S. 591; Bluefield, 262 U.S. at 690.

[54] Hope, 320 U.S. at 603 ("From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividend on the stock.") (emphasis added).

[55] Bluefield, 262 U.S. at 690 ("Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.").

[56] LILCO, 101 P.U.R.4th at 101.

offering investors an appropriate rate of return that adequately reflects investment risk in the current financial markets. Tr. at 464. Accordingly, the Commission should reject any request for the imposition of the extreme and extraordinary measure of imposing dividend restrictions on the Companies.

The Companies also note that the imposition of dividend restrictions as part of this proceeding would violate the Companies' due process rights. Due process requires that parties whose rights are to be affected be given reasonable notice and an opportunity to be heard.[57] Staff merely references a possible dividend restriction in a footnote in its Motion to Dismiss. Staff's Motion to Dismiss at 10, n.50. The reference is not supported in Staff's testimony. In fact, the only reference to a potential Commission-imposed dividend restriction in Staff's testimony was upon a condition precedent not a request for action in this case. Tr. at 765 (stating "should the Companies' credit ratings deteriorate as they suggest they will, the Commission could impose a dividend restriction"). It was not until the hearing on Staff's Motion to Dismiss that the Companies fully understood that Staff or any other party intended to request that the Commission impose a mandatory dividend restriction based on the record in this case.[58]

Similarly, MI's suggestion that the Commission should prohibit the Companies from paying dividends was first raised in its response to Staff's Motion to Dismiss, which was filed the same day as the Companies' response. MI did not sponsor a witness in these

---

[57] See e.g., Case 03-W-0952 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Reagans Mill Water Company for Water Service, Order Denying Petition for Rehearing (June 13, 2005) citing Baldwin v. Hale, 68 U.S. 223 (1864).

[58] The Commission's Notice of Hearing to Consider Staff's Motion to Dismiss Rate Filing provided no notice that the issue of mandatory dividend restrictions would be addressed at the hearing.

proceedings and, thus, did not file testimony to support its position. The same holds true for CPB.

The Companies, therefore, were not afforded an opportunity to file testimony or to cross-examine witnesses on this issue. For these reasons, Companies would be deprived adequate due process if the Commission were to prohibit the Companies from paying dividends based on the record in this proceeding.

## VI. STAFF BEARS THE BURDEN OF PROOF ON THE MOTION TO DISMISS

The Companies fully briefed the burden of proof issue in the Answer to Staff's Motion to Dismiss. For brevity purposes, the Companies incorporate those arguments by reference and do not repeat them here. See Answer to Staff's Motion to Dismiss at 32-33.

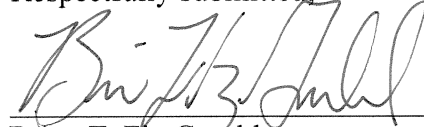
Regardless of which party bears the burden of proof for the purposes of Staff's Motion to Dismiss, there is substantial evidence in the record demonstrating that, in the absence of rate relief, the Companies' financial condition would reach levels that would jeopardize safe and reliable service. A dismissal of the rate cases poses serious risk to the Companies and ultimately ratepayers. Given these risks, the Commission should not accept that Staff's extreme and impractical austerity measures, such as indefinitely suspending dividend payments, withholding federal tax payments, delaying payments of affiliates' inter-company payables, and further reducing the Companies' workforce (none of which were based on expert studies or have evidentiary support), will cure the Companies' significant cash shortfall over the next two years. While the Companies appreciate that a rate increase is unpopular, especially in these difficult economic times, dismissal of the rate cases would have an even greater impact on the Companies' ratepayers in light of the fact that the Companies' deteriorating financial situation would jeopardize safe and reliable service.

## VII. CONCLUSION

For the reasons set forth herein and in the Companies' Answer to Staff's Motion to Dismiss, the Commission should definitively conclude that the rate cases should proceed and deny Staff's Motion to Dismiss with prejudice.

Dated: March 13, 2009

Respectfully submitted,



Brian T. FitzGerald
Noelle M. Kinsch
Dewey & LeBoeuf LLP
99 Washington Avenue, Suite 2020
Albany, NY 12210
Tel: (518) 626-9000
E-mail: brian.fitzgerald@dl.com
nmkinsch@dl.com

David L. Schwartz
Rebecca L. Malcolm
Latham & Watkins LLP
555 Eleventh Street, NW, Suite 1000
Washington, DC 20004
Tel: (202) 637-2200
E-mail: david.schwartz@lw.com
rebecca.malcolm@lw.com

Paul K. Connolly, Jr.
Vice President and General Counsel
Energy East Corporation
260 Franklin Street
Boston, MA 02110
Tel: (617) 748-6868
E-mail: paul.connolly@energyeast.com

*Attorneys for New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation*