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

ANSWERING TESTIMONY OF THE COMPANY PANEL

James P. Laurito
Robert D. Kump
Steven R. Adams
Joseph J. Syta

February 23, 2009

ANSWERING TESTIMONY OF THE COMPANY PANEL

I. INTRODUCTION

Q. Please state the names of the members of this Company Panel for the record.

A. Our names are James P. Laurito, Robert D. Kump, Steven R. Adams, and Joseph J. Syta.

Q. Are you the same Mr. Laurito and Mr. Kump that submitted direct testimony for the Policy Panel on January 27, 2009?

A. Yes.

Q. Are you the same Mr. Adams and Mr. Syta that submitted direct testimony for the Revenue Requirements Panel on January 27, 2009?

A. Yes.

Q. What is the overall purpose of your testimony?

A. The Department of Public Service Staff ("Staff") submitted two pieces of testimony in conjunction with its Motion to Dismiss the Companies' January 27, 2009 rate filings in these proceedings. The principal piece of testimony was submitted by the Staff Financial Panel, which was made up of Mr. D'Ambrosia and Mr. Barry. Another piece of testimony was submitted by the Staff Service Quality and Reliability Panel ("SQRP"), which was made up of Ms. Barney, Mr. Rieder, Mr. Roenick, and Mr. Wheeler. Our testimony today is intended to respond to many of the factual errors and misstatements made by Staff in those pieces of testimony. Additionally, there are many points raised by Staff that are important to determine for purposes of a full rate case, but are not related to the central issues for this Motion to Dismiss. Therefore, while we disagree with the opinions stated by Staff on many issues, we do not provide detailed factual rebuttal where the determination of a particular issue is not relevant to determining the overall financial health of the Companies or ensuring that safe and reliable service are not jeopardized.

Q. Is this Panel sponsoring any exhibits?

A. Yes. Exhibit __ (CP-1) contains a copy of the interrogatory responses referenced in this Panel's testimony. Exhibit __ (CP-2) is a chart the Companies prepared that illustrates the value of the S&P 500 Index since January 2007. Exhibit __ (CP-3) is a chart the Companies prepared that illustrates the value of the Dow Jones Industrial Average since January 2007. Exhibit __ (CP-4) is a chart the Companies prepared that illustrates the value of both the Dow Jones Financial Services Index and the Philadelphia Exchange Utility Index since January 2007. Exhibit __ (CP-5) is a Morgan Stanley economic data bulletin from February 18, 2009 discussing the decline in industrial production. Exhibit __ (CP-6) describes the major differences between Staff's and the Companies' cash flow analyses. Exhibit __ (CP-7) provides a detailed description of the differences between Staff's and the Companies' Adjusted Return on Equity ("ROE") calculations.

II. SUMMARY

Q. Please summarize the Company Panel answering testimony.

A. The Companies' rate filing shows that the Companies' financial condition is deteriorating to a level that would jeopardize safe and reliable service in the future. The Companies are facing substantial cash obligations in 2009 and 2010 that approximate $850 million. While Staff takes issue with the amount of cash needed, even using Staff's $540 million of capital expenditures, the Companies would need $575 million in cash that the Companies do not currently have. The Companies' credit ratings are on credit watch or negative outlook, and therefore, if the Companies do not receive regulatory support in this proceeding and are forced to borrow money (in the capital markets or otherwise) to make up this cash shortfall, the Companies' already problematic credit rating metrics would be even more adversely impacted, which would likely trigger a downgrade, as indicated by S&P and Fitch in their most recent reports. Furthermore, contrary to Staff's suggestions that more aggressive cost-saving methods would cure this shortfall, this testimony explains that aggressive cost-savings are already being implemented on an interim basis at every level, but that cost savings alone cannot cure a cash shortfall of this magnitude. Finally, both NYSEG and RG&E have withheld dividends from their parent company since September 2008 in recognition of the financial distress of the Companies. However, this is not a sustainable situation. In order to attract capital, the Companies need to show investors and credit rating agencies that returns will be fair and adequate and that cost recovery will be timely and predictable, all of which the Companies are seeking to achieve in this filing. Unreasonable returns and the inability to recover costs would be confiscatory and would raise serious concerns with investors and credit rating agencies.

Q. Why are you focusing on the overall financial health of the Companies?

A. The Merger Order provides that rate cases can be filed outside of the New York Public Service Commission's ("Commission") stated "Target Period" if the Companies' "financial performance otherwise would fall to levels that would jeopardize [their] ability to provide safe and reliable service." The language in the Merger Order is clear that, if the overall financial health of the Companies is deteriorating, and if that deterioration jeopardizes our ability to provide safe and reliable service in the future, then rate cases should be filed. Webster's Dictionary defines "jeopardize" as "to expose to danger or risk."

Q. Does this standard mean that you have to wait to file rate cases until safe and reliable service is no longer being provided?

A. No. The plain meaning of this standard is whether the Companies' financial performance exposes the Companies to danger or risk of being unable to provide safe and reliable service. This is a prospective rather than a current or historical event. The SQRP focused on the fact that they did not see any failure to provide safe and reliable service. The

Companies are proud of their historically high levels of service quality, and view Staff's findings as a positive. But Staff misses the point when it suggests that since the Companies have provided historically good service they should not have filed their rate cases. The words in the Merger Order talk about whether the Companies' "financial condition" would put at risk the Companies' ability to provide safe and reliable service in the future. Rate relief in these proceedings will allow the Companies to continue to provide safe and reliable service to their customers. If service and reliability have to be compromised before rate relief is allowed, it would be too late to protect the Companies and their customers from the resulting consequences. That approach would not make sense for a regulated public utility company that has a continuous obligation to provide safe and reliable service.

III. RESPONSE TO STAFF TESTIMONY

Deteriorating Financial Condition

Q. Is there any truth to Staff's allegation that the Companies have manufactured their own liquidity crisis?

A. No. Companies all over the world are facing difficulties due to the global financial crisis, none of which could have been foreseen or prevented. The Companies' liquidity crisis is neither self-inflicted nor fabricated. As the Policy Panel testimony describes in detail, the global financial crisis has significantly impacted the Companies' financial performance and created serious cash flow and liquidity concerns. Both NYSEG and RG&E have fully utilized their available revolving credit facilities and have been forced to borrow money temporarily from their parent company. Additionally, both NYSEG and RG&E have withheld dividends from their parent company since September 2008 in order to retain necessary liquidity at the Companies for operations.

Q. Can the Companies improve their liquidity situation and overall financial health without rate relief from the Commission?

A. No. The Companies require expedited rate relief or they will be forced to issue and assume significant debt in order to improve their liquidity problems. A lack of Commission support in this proceeding, combined with a significant increase in debt would cause other major financial problems for the Companies, including likely credit rating downgrades.

Q. Staff argues that the Companies could have sought additional bank loans during late 2008 and that their failure to do so proves that no real liquidity crisis exists at the Companies. Is there any merit to this claim?

A. No. Given the significant capital destruction that banks experienced last year and the fact that NYSEG had already added a $190 million credit facility earlier that year, the bank lending market was difficult to access and was not a realistic way to remedy significant liquidity concerns for the Companies. *See* Exhibit __ (CP-1), Response to DPS-186. Moreover, Staff's suggestion that the Companies should have borrowed their way out of a liquidity problem is unrealistic, would only have exacerbated the

Companies' deteriorating financial condition, and would have forced customers to pay higher than necessary interest rates for many years.

Q. Why can't the Companies free up their short-term liquidity facilities by issuing more long-term debt as Staff suggests?

A. Staff's suggestion fails to take into account the impact of issuing additional long-term debt on the overall financial health of the Companies and its increased costs to customers. The Companies' credit metrics are already weak for their current ratings, as evidenced by the negative outlooks and watches at each agency. A lack of regulatory support in this proceeding, combined with the assumption of additional debt to fund the significant cash requirements needed over the next two years, would likely lead to credit rating downgrades and increased costs to ratepayers. In fact, the amount of cash required over the next two years may be greater than the amount that the Companies can reasonably borrow – under short-term or long-term debt. Even if the Companies could borrow at such levels, that would result in the Companies' credit metrics dropping significantly below the levels needed to sustain their current credit ratings. Credit rating downgrades would, in turn, impair access to capital and trigger higher debt costs. Adjusting rates today will avoid significantly higher interest costs that would ultimately be borne by ratepayers, as well as risks of service quality degradation that would impact customers.

Q. Is Staff correct that RG&E had $127 million of remaining authority under its existing financing order to issue debt in 2008?

A. No. As described in RG&E's petition for financing authority submitted to the Commission on October 4, 2007[1], RG&E had $52 million of "new money" and $15.5 million of "refinancing" authority under the Commission's financing order in Case 03-M-0178, rather than the $127 million that Staff contends. *See* Exhibit __ (CP-1), Response to DPS-23. Given that this small amount of remaining financing authority was insufficient to meet RG&E's financing needs, the Company requested new authority in October 2007 and was planning an issuance in April 2008.

Q. How do you respond to Staff's allegation that RG&E created its own liquidity crisis by choosing to enter, extend and hold a financial hedge, which ultimately resulted in a loss of approximately $100 million?

A. RG&E entered into the three trades that comprised this hedge position in 2006 in order to protect the Company and its ratepayers against future interest rate increases. The Companies have entered into these types of derivative transactions for many years to manage risk associated with interest rate fluctuations. At the time that the Companies entered into the hedge transaction in 2006, the average locked-in swap rate was 5.56%, which, based upon then current spreads, translated into an expected

[1] Case 07-M-1194 – Petition of Rochester Gas and Electric Corporation Under Section 69 of the Public Service Law for Authority to Issue Long-Term Indebtedness, Preferred Stock and Hybrid Securities, to Enter Into and borrow Under Revolving Credit Facilities and to Enter into Derivative Instruments Pursuant to a Global Financing Plan (submitted October 4, 2007) (stating "[t]his request is for several reasons, including (1) that the Company has used $150 million of the $202 million in traditional utility purpose authority . . .").

coupon rate of 6.4% over a 30-month term – an attractive rate in any market environment.

Q. If the financing order for RG&E had been issued earlier by the Commission, would that have impacted the amount of losses associated with the hedge?

A. Yes. If RG&E's financing order had been issued by April 2008, six months after the Company's filing, then RG&E would have refinanced its debt as planned, and the hedging losses only would have been approximately $15 million and the all-in average cost of financing would have been approximately 6.95% as opposed to the 10.76% because of the delayed issuance of the financing order.

Q. What is the Commission's practice with respect to the rate treatment for gains and losses from hedge transactions?

A. Both the gains and losses associated with hedge transactions are included in rates. This means that ratepayers benefit from any gain experienced by reducing the interest rate costs in a new financing, similar to the gain associated with RG&E's July 2007 financing. In this instance, however, historically low Treasury rates caused by the financial crisis, combined with the fourteen-month delay in the Commission's issuance of RG&E's financing order, increased the amount of the hedge loss to a level significantly greater than it otherwise would have been, which the Companies could neither have predicted nor prevented.

Q. Do you have anything else to add on this topic?

A. The Companies are required to enter into hedging transactions in connection with their supply service in order to insulate customers from energy price volatility.[2] The Companies have similarly used interest rate hedges for many years to insulate customers from interest rate volatility, and these kinds of transactions were permitted by the Commission. We agree with Chairman Brown's recent statements supporting the overall use of hedging practices, and his recognition that, by their nature, individual hedge positions do not always result in ratepayer savings, where he noted:

> But we, as regulators, just need to be very cognizant if we are going to encourage the utilities to do hedging, which is the proper thing to do, that we are completely fair with them when things don't go the direction that we had hoped, but it was still the right thing to do.[3]

Global Financial Crisis

Q. How do you respond to Staff's various allegations that the global financial crisis has not significantly affected the Companies?

A. Staff makes a number of remarkable statements that downplay the scope of the financial crisis and its impact on the Companies. Staff's statements to that end ignore the irrefutable evidence the Companies have presented

---

[2] See, e.g., Case 06-M-1017 - Proceeding on Motion of the Commission as to Policies, Practices and Procedures For Utility Commodity Supply Service to Residential and Small Commercial and Industrial Customers, Order Requiring Development of Utility Specific Guidelines For Electric Commodity Supply Portfolios and Instituting a Phase II Address Longer-term Issues (Apr. 18, 2007); 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 (Aug. 23, 2006).

[3] Informal Transcript, Regular Meeting of the Public Service Commission, at 15-16 (Oct. 15, 2008).

about their deteriorating financial condition. As the Policy Panel testifies, the financial crisis has had a direct and substantial impact on the Companies' financial problems. This should come as no surprise to anyone, given the breadth and depth of our global economic problems. In addition to the increased cost of debt, the crisis has contributed to the Companies' flat to declining sales, higher delinquencies and uncollectible expenses, higher pension costs, higher operations and maintenance costs, and higher property taxes.

Q. How do you respond to Staff's various arguments that the Companies knew or should have known about the impending global financial crisis?

A. It is hard to believe that Staff or any person would seriously suggest that Iberdrola, Energy East, or the Companies could be so clairvoyant as to be able to predict a financial crisis that took the United States Government, State Governments and most global businesses by surprise. Any assertion that Iberdrola and Energy East should have foreseen the severity of the economic decline would be naïve. For example, Staff argues that "stock markets had declined substantially over 2008" (Staff Financial Panel, at 15). While that may be true to a certain extent, it is impossible to ignore the objective evidence of the dramatic nosedive that the markets experienced in the immediate wake of the Lehman Brothers bankruptcy, which occurred one day before the merger closing. *See* Exhibit __ (CP-2) (tracking the S&P 500 Index since January 2007); Exhibit __ (CP-3) (same for the Dow Jones Industrial average); Exhibit __ (CP-4) (tracking the Dow Jones Financial Services Index and the Philadelphia Exchange Utility Index). Other indicators also confirm that the economic downturn escalated rapidly since the closing of the Companies' merger. Industrial production, for instance, bottomed out during the latter part of 2008. *See* Exhibit __ (CP-5). These charts all clearly illustrate the precipitous decline in the financial markets and other economic sectors that no one foresaw. Staff's contrary statements are simply wrong.

Q. What about other factors that the Companies knew existed, such as the Companies' large capital expenditure spending requirements, increases in O&M expenses, large and growing deferrals/reserves, and the implementation of positive benefit adjustments or "PBAs"?

A. These other factors are also important to consider because they increase financial pressures on the Companies and cannot be ignored – regardless of whether they were known before the financial crisis made matters worse. The Commission's standard for whether the Companies can file rate cases prior to the Target Period is whether the Companies' overall financial performance is deteriorating to a level that would jeopardize safe and reliable service – without regard to whether the factors leading to that performance were known or not. Thus, it is necessary to view the entire financial health of the Companies, and not simply the most recent adverse impacts that the Companies are facing.

Capital Markets

Q. Staff claims that the Companies and other utilities have had continued access to the capital markets and seems to suggest there are no concerns associated with long-term liquidity. Do you agree with Staff?

A. No. Staff's testimony pretends that the credit crisis does not exist, and that money is freely available at a moment's notice with little impact on credit quality. The Companies are not claiming that they cannot access the capital markets today at certain debt amounts and at "BBB" level credit ratings. That is not the point. Instead, the Companies have explained that their access to the credit market is not unlimited, comes at high cost and must be viewed in the broader context of the Companies' overall financial health. Moreover, as the Policy Panel testifies, while the Companies can access the markets at this moment, absent rate relief there is considerable doubt as to whether the Companies could fund their significant 2009 and 2010 cash requirements with debt, and whether the Companies' current ability to access the markets will continue.

Q. Do you agree with Staff's assessment that the increase in the Companies' cost of debt is not problematic?

A. No. While Staff agrees with the Companies that the cost of debt is significantly higher now, especially for "BBB" level utilities, Staff ignores the fact that, without rate relief, the Companies would be left with no choice but to assume significant amounts of new debt to fund the Companies' cash and capital expenditure requirements. As the Policy

Panel testimony describes in detail, the Companies do not have sufficient cash flow to meet their 2009-2010 cash needs. If the Companies did not receive rate relief and were forced to assume significant additional debt to fund those requirements, that would result in higher costs to customers and likely credit downgrades. *See* Exhibit __ (CP-1) Response to DPS-197 (stating that the Companies cannot even fund the $540 million in capital expenditures described in the Merger Order without rate relief). Moreover, as discussed above, Staff itself recommends that the Companies issue additional new long-term debt to free up their short-term liquidity facilities for emergency situations. This would put further pressure on the Companies' key credit metrics and result in increased cost to ratepayers.

Q. How do you respond to Staff's argument that credit rating downgrades would not have any immediate significant effect on ratepayers?

A. Credit rating downgrades will result in significantly increased capital costs to ratepayers, particularly in the current markets. Additionally, credit downgrades would result in a variety of other costs increases for ratepayers. For example, lower credit ratings would increase the Companies' insurance costs and increase the collateral and guarantee requirements associated with their power procurement arrangements, including the credit and collateral requirements to participate in the markets administered by The New York Independent System Operator, Inc. While Staff ignores the risk of further credit downgrades, the

Companies agree with Chairman Brown and Mr. Fetter that utilities do not want to be rated at the lower end of the "BBB" range because an unexpected shock could take them outside the investment grade range. *See* Exhibit __ (PP-3).

Q. How is the Companies' cost of debt affected by negative watches or outlooks from rating agencies?

A. As a result of S&P's recent action placing the Companies on CreditWatch with negative implications, once again NYSEG has a negative watch or outlook from all three major rating agencies, and RG&E has a negative watch or outlook from both S&P and Moody's. Companies with negative watches/outlooks from all or most rating agencies will generally have their debt issuances priced at spreads above those that would exist in the absence of such negative watch/outlook, particularly in the current financial environment. This results in even higher debt costs for NYSEG and RG&E than their current ratings would indicate.

Q. What other issues might the Companies face as a result of their "BBB" level credit ratings?

A. "BBB" level utilities (and the Companies, in particular, with their negative outlooks) have limited flexibility in the current markets. Given the current uncertainty in the financial markets, the Companies are concerned that access for "BBB" level utilities could be restricted again in the future, particularly if the Companies are downgraded, or if the economy experiences another dramatic drop.

ANSWERING TESTIMONY OF THE COMPANY PANEL

Q. You mentioned that you disagreed with some of Staff's statements, claims and implications with respect to capital markets access and pricing. Are there any that you think are worth addressing?

A. Staff claims that there have been no "failed offerings" since the Lehman bankruptcy. But this point ignores the realities about deals that never proceeded to market.

Q. Please explain this further.

A. Since the current financial turmoil began with the Lehman bankruptcy, financings are typically "pre-sounded" by investment banks to a small group of investors who are most apt to have interest in the potential securities offering. If there is a lack of interest, those deals are never launched. By using pre-sounding techniques, the banks are able to avoid the adverse consequences of a public failure of a deal. We understand from our discussions with banks that numerous deals were "pre-sounded" to the markets and never launched due to lack of interest. *See* Exhibit __ (CP-1), Response to DPS-185. Additionally, the Companies have provided undisputed evidence that "BBB" level issuances decreased after the Lehman bankruptcy, and that credit spread levels between "BBB" and "A" level utilities have increased dramatically since that time. *See* Exhibits __ (PP-2) and (PP-1).

Q. What other statements by Staff about access to the capital markets do you want to address?

A. Staff stated that the capital markets were open at all times since the Lehman bankruptcy, including the two-week period that the Companies stated were inaccessible. For evidence, Staff pointed to the debt issuance by Laclede Gas Company.

Q. Are you generally familiar with the Laclede financing Staff references?

A. Yes. There are two primary differences that make Laclede Gas Company's debt offering completely different than that of the Companies. First, the Laclede transaction was a retail offering that was marketed to individual investors, rather than a more traditional offering to institutional investors. It is also important to highlight that Laclede's First Mortgage Bonds were rated A/A3/A+ by S&P, Moody's and Fitch, respectively. Retail investor reaction to market turmoil tends to lag institutional reaction, so the ability of a high grade retail debt transaction to be completed within days of the Lehman bankruptcy is not surprising. It is likely that the combination of these unique factors allowed the company to have a successful issuance during this time period. The Companies also note that retail offerings comprise a very small portion of corporate debt offerings and the fact that the Laclede Gas deal was completed does not signal that corporate debt markets were "open" during the period immediately following the Lehman bankruptcy.

Q. Do you have any issue with the way Staff characterized the difficulties that RG&E experienced in its December 2008 issuance?

A. Yes. As the Policy Panel describes in detail, RG&E's offering took over two days to market, and may not have been successful at all without a one-third purchase by a single investor. This Company Panel cannot recall any other instance in which it took more than a day to market a securities issuance. These difficulties cannot simply be explained away by other factors such as the pre-holiday time period or the relatively small size of the offering. The Companies have not found the pre-holiday period to be an unfavorable time to issue securities. Moreover, the Companies were prepared to access the capital markets significantly earlier than this timeframe, but were left with no practical option because the Companies were awaiting the Commission's final order on rehearing of the RG&E financing petition.

Q. Are there any other points you want to raise about Staff's statements on access to capital?

A. Yes. Staff suggests that we believe the cost of debt will remain static.

Q. Is that what the Companies believe?

A. No, and this is a mischaracterization of the Companies' position. The Companies know that the cost of debt will change over time. The Policy Panel was commenting that many experts have opined that the cost of debt is more likely to return to the higher historical costs of debt over the long term, rather than the unusually low cost of debt levels we have seen in the past 3-5 years. The Policy Panel indicated that there is logic supporting those opinions. More recently, others in the industry have opined that the cost of debt for utilities may, in fact, be irrevocably altered. For example, Charles Wortman, a managing director at JPMorgan Chase, stated that "[t]he events of last year are going to lead to dramatic changes in the way utilities approach financing . . . . I think the world has changed dramatically as far as access to capital."[4] John Bohn, a member of the California Public Utilities Commission, agreed with these sentiments: "[W]e're not going to go back to what it was – it's just not going to happen."[5]

Credit Ratings

Q. How do you respond to Staff's argument that any increase in interest expense as a result of the increased capital costs for "BBB" level utilities will not materially impair the Companies' credit profile and can be recovered in the course of their next rate case (Staff Financial Panel, at 30)?

A. The Companies completely disagree with Staff. Both Companies are already on negative watch or outlook with both S&P and Moody's, and NYSEG is also on negative watch with Fitch. In the absence of rate relief, the Companies would be forced to fund (or attempt to fund) significant cash and capital expenditure requirements in 2009 and 2010 with debt,

[4] Jason Fordney, "NARUC panel mulls credit crunch effects," PLATTS ELECTRIC POWER DAILY, Feb. 20, 2009.

[5] *Id.*

which, in turn, will result in reduced credit metrics and likely credit downgrades. *See* Exhibit __ (PP-4) and Exhibit __ (CP-1), Response to DPS-197 (showing same effect on credit metrics based on $540 capital expenditure levels). As described above, credit rating downgrades would lead to a variety of increased costs for ratepayers, including significantly higher cost of capital.

Q. How do you respond to Staff's suggestion that the Companies' rate filings provoked S&P to put the ratings of Energy East and all of its subsidiaries on review for a downgrade?

A. Staff's suggestion makes no sense. Mr. Fetter is addressing this from a credit rating agency standpoint. Credit rating agencies focus on the facts with respect to the financial condition of a rated company. Moreover, the Companies did not have an option to withhold from the credit rating agencies material financial information about the Companies, as investors rely on rating agency opinions in making investment decisions. Ignoring the Companies' current financial situation and encouraging rating agencies to do the same would misrepresent the Companies' financial condition and be inconsistent with credit rating agency requirements and protocols. As Mr. Fetter explains, credit rating agencies look at the Companies' financials in a forward-looking manner, rather than as a snapshot in time. This means that credit rating agencies focus on how a company's financial situation looks on a forward-looking basis. Relevant to this analysis, of course, is the regulatory treatment that the Companies receive and are expected to receive in the future. Moreover, as noted in the Answering Testimony of Mr. Fetter, the Companies have been on negative watch for virtually the entire time period since the Commission issued NYSEG's electric rate order in 2006.

Q. Have you heard whether the credit rating agencies are monitoring these rate cases, including the Commission's response to Staff's Motion to Dismiss?

A. Yes, with keen interest. As described in the accompanying testimony of Mr. Fetter, both S&P and Fitch have indicated in recent releases that the outcome of this rate case will be a significant factor in their evaluation of the Companies' credit ratings. The outcome of both this Motion to Dismiss and the overall outcome of these rate cases will be important signals to the rating agencies on the amount of regulatory support that the Companies will receive from the Commission.

Q. What do you mean by regulatory support from the Commission?

A. It has been well-reported that credit rating agencies view New York as a difficult regulatory environment. Staff itself acknowledges that Moody's perception of the low returns allowed in New York was one of the factors that led the agency to affirm the Companies' review downgrade status. Credit rating agencies are closely monitoring whether the Commission is serious about maintaining the financial health of the utilities it regulates by providing timely and predictable cost recovery and fair and adequate returns on equity.

Parent Company Support

Q. Staff states that NYSEG's and RG&E's parent companies have refused to come to their aid during this financial crisis. Staff also claims that rating agencies have found that Iberdrola is not interested in helping NYSEG and RG&E. Is there any merit to Staff's claims?

A. No. NYSEG and RG&E have received extensive assistance from their parent companies since the closing of Iberdrola's acquisition of Energy East. To the extent that credit rating agencies have spoken on this issue, they have acknowledged the support that Iberdrola has provided thus far, and have indicated that without that support, NYSEG and RG&E would be in worse financial shape.

Q. What credit rating agency statements does Staff try to use to show that NYSEG's and RG&E's parent companies have not provided support to NYSEG and RG&E?

A. Staff points to a brief S&P press release from January 29, 2009, which S&P later clarified in its formal report on February 9, 2009. In the formal report, S&P explained that "[c]urrent ratings on Energy East and its utility subsidiaries incorporate a level of support from Iberdrola and would likely be lower if Standard & Poor's were to view Iberdrola's strategic and financial commitment to have weakened since acquiring Energy East in 2008. Iberdrola has demonstrated its support for Energy East by suspending dividends and extending liquidity to the company as it faced the difficult capital markets in 2008." *See* Exhibit __ (CP-1), Response to DPS-169.

Q. How have NYSEG's and RG&E's parent companies provided assistance to NYSEG and RG&E?

A. First, they have provided $110 million in loans to NYSEG and RG&E. RG&E borrowed $90 million and NYSEG has borrowed $20 million as of December 31, 2008. It is also important to note that interest rates on these inter-company loans are much lower than current interest rates in the current financial markets.

Q. Have the parent companies provided any other assistance?

A. Yes. NYSEG's and RG&E's parent companies have foregone dividends from NYSEG and RG&E since the closing of the merger.

Q. What is the total amount of dividends foregone by the parent companies since that time?

A. Approximately $55 million in dividends were foregone in 2008 by NYSEG's and RG&E's parent companies since the start of the financial crisis. Additionally, no dividends have been paid in 2009 so far (in contrast to the $30 million dividend paid by NYSEG in February 2008).

Q. Companies are seeing hard times in many industries during this financial crisis. Why is it significant that NYSEG and RG&E have not been paying dividends?

A. It is highly unusual for public utilities not to provide dividends to their shareholder(s). Investors consider utility dividends to be a critical component of their total return. Utilities that do not pay dividends are effectively signaling to the marketplace that investment in those utilities presents investors with high risks and low returns, which is not conducive to attracting capital.

Q. Have the Companies routinely paid dividends to shareholders?

A. Yes. Until the onset of the current financial crisis, the Companies have routinely paid dividends to shareholders.

Q. What other benefits have the Companies seen from being part of the Iberdrola Group?

A. When RG&E accessed the markets in December 2008 and financed $150 million in long-term bonds, those long-term bonds had terms and conditions that took into consideration the fact that RG&E was a wholly-owned indirect subsidiary of Iberdrola, which is an “A” level rated company. In the absence of being part of the Iberdrola Group, and given NYSEG’s and RG&E’s weak credit metrics for their current ratings, it is logical to assume that the pricing and other terms provided to RG&E would have been less favorable.

Q. What other statements have credit rating agencies made about the level of Iberdrola’s support?

A. As noted above, S&P’s February 9, 2009 report on Energy East and its utility subsidiaries views Iberdrola’s support positively: “[c]urrent ratings on Energy East and its utility subsidiaries incorporate a level of support from Iberdrola and would likely be lower if Standard & Poor’s were to view Iberdrola's strategic and financial commitment to have weakened since acquiring Energy East in 2008."

Q. What does this statement mean?

A. While Mr. Fetter can speak to this from a rating agency perspective, we interpret this statement to mean that, in the absence of Iberdrola and Energy East (and in the absence of the support thus far that parent companies have extended), NYSEG's and RG&E's credit ratings would be worse than they are today.

Q. Does that mean that that level of support should continue indefinitely or increase?

A. Investors need to earn a reasonable return to encourage further investment. Foregoing dividends over a sustained period of time is not a financial remedy or a means of attracting capital.

Q. Staff argues that Iberdrola committed to invest equity in NYSEG and RG&E in the merger proceeding, regardless of whether NYSEG and RG&E were given fair and adequate rate treatment. Is that correct?

A. No. All the statements that Staff quotes specifically say that Iberdrola would help put NYSEG and RG&E in a better position to attract investment under better terms and conditions. The Companies believe those statement were and remain true. In the absence of the acquisition, NYSEG and RG&E would be in significantly worse financial shape and likely have lower bond ratings, resulting in less favorable terms and conditions on long-term debt financing.

Q. Staff argues that it, the Commission and the State of New York had no idea that utilities in New York would have to compete to attract capital. Is that statement credible?

A. Absolutely not, and this is a critical point. All companies must compete to attract equity and debt investment. Utilities are no exception, whether investor-owned or otherwise. Investors in utilities look to return levels and risks of investment, as compared with other investment options in the marketplace. If risk is higher and/or returns lower for one utility as compared with another, all things being equal, investment dollars will flow to the utility investment opportunity with lower risk and/or higher returns. This concept is not unique to the Companies. As discussed in Dr. Makholm's testimony, it applies to wholly-owned subsidiaries as well as publicly traded entities, and was the case both before and after Iberdrola's acquisition of Energy East.

Q. What does that mean for NYSEG and RG&E, and the State of New York, when they are trying to attract equity investment?

A. There are two regulatory components to what NYSEG and RG&E need to set themselves on the right course, and to signal to investors and credit rating agencies that investment in NYSEG and RG&E is encouraged. The first is that investors must receive a fair and adequate return, as set forth in the legal requirements of *Hope* and *Bluefield* and discussed in more detail in the Direct Testimony of Dr. Makholm. Projections for the Companies in 2009 and 2010 are well below a fair and adequate return. Regulatory assistance is needed for the Companies to reach a fair and adequate return in 2009 and 2010, as reflected in our rate filings. The second is timely and predictable cost recovery. By granting appropriate rate relief, the Commission will send a strong signal to investors and rating agencies of its intention to encourage the flow of capital into New York State. With the requested rate relief, NYSEG and RG&E will be on a better footing, and should be able to stop the negative movement in their credit ratings. We also believe that the results of these rate cases should lead to greater investment in the Companies.

Cash Flows

Q. Staff alleges that the Companies will have approximately $100 million of free cash flow in the aggregate over the years 2009-2010. Do you agree with Staff's position?

A. No. Staff's cash flow analysis, which is summarized in Staff Exhibit __ (SFP-12) is inaccurate in many respects. As indicated in the Companies' initial testimony and as we further demonstrate, cash flows at the Companies will be inadequate by a wide margin for 2009 and 2010. The cash flow forecast variation between the Companies and Staff is dramatic, totaling approximately $550 million in 2009. In 2010, the cash flow difference is approximately $400 million. The combined difference of approximately $950 million is extraordinary, particularly since cash flow is one of the core reasons the Companies made the rate filings. The major differences, as shown on Exhibit __ (CP-6), between the cash flow analysis of Staff and the Companies can be grouped into four major categories:

1. Capital Expenditures	$276 million
2. Dividends	$209 million
3. Deferrals	$155 million
4. Non-Bypassable Charge	$141 million

Q. Please describe the capital expenditures difference.

A. The primary capital expenditures differential relates to costs that would be required to meet North American Electric Reliability Corporation ("NERC") Electric Reliability Organization ("ERO") Project costs currently before the Federal Energy Regulatory Commission ("FERC") in a pending proceeding. The Companies' Capital Expenditures, Reliability and Operations Panel fully describes the ERO Project and the potential requirements imposed on the Companies to comply with the FERC initiative to expand the NERC ERO Standards down to the 100kv level in the Northeast Power Coordinating Council compliance region. The purpose of introducing the ERO Project was to inform the Commission of the significant financial impact that the potential expansion of the NERC ERO Standards will have on the Companies. Staff's testimony criticizes the Companies for raising the issue of this potential reliability standard requirement. Staff apparently believes that the Companies should not even discuss the future cost of the ERO Project in its current filings. The Companies clearly state in their testimony that the final ERO Project requirements have not yet been adopted. However, the Companies would be remiss in not recognizing the potential costs of a mandatory ERO Project and ensuring that they are financially capable of meeting these standards if they are adopted by FERC. Staff's criticism and flat elimination of the potential impact the ERO Project would have on the Companies and their customers is near-sighted and inappropriate.

Q. How does Staff propose to handle the cost of the ERO Project if, as the Companies anticipate, FERC requires that the Project be developed?

A. Staff does not provide any proposal or idea of how the costs would be financed and recovered. If FERC requires that the ERO Project proceed, then the Companies must comply with that requirement. The Companies must have sufficient financial ability and resources to respond to unexpected events.

Q. Please describe the difference between Staff's and the Companies' positions on the payment of dividends.

A. Staff has proposed that no dividend payments be made by NYSEG and RG&E for all of 2009 and 2010.

Q. Do you agree that no dividends should be paid during this period?

A. No. As we testified previously in response to the question regarding parent company support, the fact that dividends have not been paid since the start of the global financial crisis by the Companies is a symptom of the financial distress of the Companies, rather than a cure. The Companies have been proactively foregoing dividends in recognition of the financial problems they are experiencing. However, this situation cannot be sustained and is not a viable solution, and as we testified previously, it is highly unusual for public utilities not to provide dividends to their shareholders. The Commission and the Companies should focus on working together to rectify this situation, rather than considering actions, which, if allowed, would chill further capital investment in the Companies. As discussed by the Companies' Policy Panel, it is unreasonable and confiscatory to assume that NYSEG's and RG&E's parent company must continue to forego all dividend payments. Mandating such an action would raise serious concerns with investors and rating agencies, which would exacerbate the financial difficulties faced by the Companies.

Q. Are dividend restrictions just one part of a package of similar measures proposed by Staff?

A. Yes. Staff has proposed numerous measures, including: 1) withholding payment to affiliated service companies; 2) withholding income taxes; and 3) workforce reductions such as reducing overtime, cutting the workweek, eliminating bonuses, and reducing workers or contractors. While 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.

Q. Does Staff propose that the Companies should stop paying for services rendered by vendors?

A. Yes, it appears that Staff suggests that the Companies simply stop paying certain vendors. Staff suggests that if the Companies simply breach their obligation to pay affiliated service companies, such as purchasing, accounting, and IT services, that could save $77 million.

Q. Are you sure that Staff is really proposing that the Companies simply refuse to pay these affiliated service companies?

A. Staff says "delay payments," but then also indicates that they are seeking savings of $77 million which is the total amount that the Companies paid these affiliated service companies in 2007. It appears that Staff is recommending no payments to affiliated service companies, or at the very least, an indefinite suspension of payments.

Q. When a vendor is typically not paid for services rendered, what can the defaulting customer receiving services typically expect?

A. Generally, if a vendor that is providing services is not paid in a timely fashion, a defaulting customer would have to expect that: (a) the service provider would declare the customer in default of its payment obligations; (b) the service provider would suspend or terminate service to the defaulting customer; and (c) the service provider would initiate a legal action against the defaulting customer for amounts owed. Because of the importance of the services provided by the affiliated service companies, such as purchasing, accounting, and IT, refusing to pay for those services is not a viable strategy – cash management or otherwise.

Q. Is Staff actually suggesting that the Companies withhold payment of federal income tax?

A. Yes, it appears so. Staff claims that the Companies could withhold approximately $70 million of federal stand alone income tax payments.

Q. Is there any basis Staff offers for withholding these tax payments?

A. Staff offers absolutely no factual evidence to support its proposal to withhold tax payments. Staff's sole basis for this position appears to be the same evidence that Staff attempted to introduce during the merger proceeding that the Commission declined to adopt in the Merger Order. Staff's attempt to resurrect its unsuccessful attempt to introduce this issue again here – particularly in a Motion to Dismiss process – is suspect and should be rejected.

Q. How do you respond to Staff's allegations that the Companies' stated austerity measures are "weak" and that the Companies should engage in more aggressive austerity measures?

A. Staff's criticisms of the Companies current measures are misplaced. The Companies have implemented numerous austerity measures that are consistent with maintaining safe and reliable service.

Q. What austerity measures have the Companies already implemented?

A. The Companies have implemented a number of the austerity measures, some of which are similar to Staff's proposals. For example, as described in the Policy Panel testimony, the Companies have implemented restricted hiring (including delaying line worker classes), travel restrictions, reductions in operating expenses, delay of vendor payments to the extent possible, limits on overtime, and other cash conservation measures. The Companies have not provided salary increases to any Company employees since the financial crisis began and have implemented a salary freeze for non-union management employees for 2009.

Q. Please respond to Staff's statement that the Companies' service quality performance remains good and has not declined since the merger.

A. The Companies are pleased with Staff's recognition that historically the Companies' have provided high quality service and continue to achieve high customer satisfaction ratings. The Companies are proud of their service quality record.

Q. Can you briefly comment on Staff's proposal that the Companies implement workforce reductions such as reducing overtime, cutting the workweek, eliminating bonuses, and reducing workers or contractors?

A. Staff would have the Companies cut their available workforce without any detailed analysis of the negative impact on service. Staff suggests that the Companies could implement a variety of workforce reduction measures, including reducing overtime, cutting the workweek, and offering unpaid vacations in order to improve earnings or cash flows. Other than certain reductions in overtime, which the Companies have implemented, workforce reductions cannot be implemented without running the risk of further jeopardizing the Companies' ability to provide safe and reliable service.

Q. Are the Companies staffed in a manner that allows for the type of reductions in available labor resources proposed by Staff?

A. No. The headcount of the Companies was already greatly reduced as a result of prior merger and integration efforts. In fact, the Companies' total headcount has gone from more than 5,100 to approximately 3,400 over the past eight years. The Companies are lean on available human resources, making the cuts proposed by Staff particularly harmful to service and reliability.

Q. What impact would Staff's proposed austerity measures have on the ability of the Companies to maintain this high service quality record?

A. Staff's various austerity proposals would strike at the heart of the Companies' ability to provide high quality service. For example, 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.

Q. Even if Staff's extreme austerity recommendations were realistic, would these measures cure the level of revenue shortfall that the Companies are facing over the next two years?

A. No. It would be impossible to cure the type of significant cash shortfall that the Companies are facing (*i.e.*, approximately $850 million in 2009 and 2010) through these types of cost saving measures. As a rule of thumb, for every 100 workers that could be eliminated (none of which are feasible) there would be a before-tax cost savings to the Companies of approximately $8-9 million of salaries and benefits (this conservatively does not count any severance costs that would be incurred to make these reductions happen, which would reduce the overall resulting savings). Putting aside the safety and reliability ramifications of such an action, Staff's proposed workforce reductions would not have a significant impact on the Companies' two-year cash needs.

Q. Please summarize the cash flow differences between Staff's and the Companies' positions associated with deferrals.

A. Staff completely ignores all cash flow implications associated with deferred costs, primarily those related to storms and environmental restoration costs. For example, over the last two years, NYSEG has collected approximately $15 million in rates for storm restoration costs and actually spent over $70 million to restore service due to storm events in that same period. Staff has ignored this under collection and the need to reset the storm reserve target in its cash flow analysis. Environmental restoration costs have similarly been under collected over the last two years at the Companies by approximately $48 million ($13 million collected in rates and $61 million spent). The annual reserve amount for environmental restoration costs needs to be reset at a higher level to avoid increasing deferral amounts. These two items (storms and environmental) show a cash shortfall over the last two years of over $100 million, and this figure does not include the numerous other smaller deferrals that are the result of new regulatory mandates (such as Stray Voltage testing and Pipeline Integrity), or items with agreed upon threshold levels (such as Property Taxes), which required current outlays of cash with only the promise of future recovery through deferrals. The three referenced items (Stray Voltage testing, Pipeline Integrity and Property Taxes) totaled over $10 million in net negative cash flow for the Companies in 2008.

Q. Do you anticipate that this trend will continue in 2009?

A. Yes. Absent the rate relief requested, this trend will continue. Assuming continuation of the types of costs that have been deferred over the last two years, the Companies could well experience an ongoing annual shortfall in cash collections of over $70 million for costs associated with storms, environmental testing, Stray Voltage, Pipeline Integrity and Property Taxes.

Q. What is the impact of deferrals on the Companies' available cash?

A. The impact is substantial. The amount of the Companies' rate request related to deferrals is over 25%. The Companies support deferral accounting; however, a more rapid recovery of growing deferred balances is crucial to improve liquidity. Staff appears to ignore the negative impact of excessively growing deferral balances on the Companies' cash position. The Companies' rate filing can help to reduce the deferral account balances, avoid future rate shock and improve the Companies' cash position.

Q. Are there also differences in the cash flow treatment associated with the Non-Bypassable Charge ("NBC")?

A. Yes, there are important differences in the treatment of the NBC. Staff's Exhibit __ (SFP-12), page 2, shows a working capital cash flow increase of $24.3 million in 2009 and $59.6 million in 2010. These amounts sharply differ from the $60 million cash flow decrease calculated by the Companies. The primary difference in the working capital cash flow calculations relates to the use of the RG&E Asset Sale Gain Account ("ASGA") to offset the Ginna Purchase Power payments. The cash flow impact is an outflow of $59 million in 2009 and neutral in 2010 (*i.e.*, cash inflow equals cash outflow). Staff, however, states that the cash impact of the NBC is an inflow of $81.7 million between 2009 and 2010. The difference between the Companies' and Staff's NBC calculations is approximately $141 million. Staff ignored the cash shortfall in 2009 when the customers' obligation to pay for the Ginna purchase power costs was offset by the ASGA amortization of approximately $57 million for Ginna purchased power costs. Staff then assumes that the Companies' request to cease the ASGA amortization, which requires Commission approval, will be granted in 2010 resulting in the Companies having a net cash inflow of $57 million. The Companies agree that if the ASGA is not utilized to offset Ginna purchased power in 2010, then they will receive an additional $57 million from customers. However, the net cash impact on the Companies is neutral in 2010 since the $57 million received from customers will be paid to suppliers for the cost of purchased power, which Staff also ignores. Staff's calculation, therefore, is incorrect and misleading.

Q. Do you have any additional comments regarding the NBC?

A. Yes. In its March 2009 Commodity Program Filing, the Companies will seek permission to implement a 2009 interim adjustment to the NBC to mitigate a potential large under collection that would otherwise be recovered in 2010. The Companies proposed interim NBC adjustment is designed to help improve the cash flow of the Company.

Q. Referring back to Staff's Exhibit __ (SFP-12), are there any mistaken and/or erroneous assumptions with "Net Income"?

A. Yes. On the "Net Income" line, Staff adds $17.5 million of after-tax commodity profits to each year (*i.e.*, 2009 and 2010). Since the filings by the Companies are delivery rate cases, inclusion of commodity business earnings or commodity cash flows is inappropriate.

Q. Can you explain further why Staff's adjustment to include $17.5 million of after tax commodity profits to 2009 and 2010 is inappropriate?

A. First, in accordance with the Commission's January 20, 2009 Order in Cases 07-E-0479 and 03-E-0765, the Companies will notify the Commission next month that they will no longer offer a Fixed Price Option ("FPO") after 2009. Consequently, there will be no commodity earnings in 2010. Second, Staff presumes annual commodity earnings at an extraordinary level given the sharing mechanisms in place at each

Company (85/15 ratepayer/Company sharing after a prescribed threshold of $9.6 million (after-tax) total between the Companies). The Companies would have to achieve an additional $100 million, pre-tax, of annual commodity earnings to generate the $17.5 million (after-tax) included in Staff's schedules. This is clearly unachievable, particularly given the current global economic crisis, flagging commodity prices, and reductions in sales. The after-tax commodity earnings for 2009 are forecast to be $7.5 million, $10 million less than Staff has projected for 2009.

Earnings

Q. Do the Companies agree with Staff's ROE calculation for 2009 as shown on Staff Exhibit __ (SFP-13)?

A. No. The Staff calculations include several mistakes and erroneous assumptions.

Q. Are you providing an Exhibit indicating the differences between Staff's and the Companies' calculations?

A. Yes. Exhibit __ (CP-7) provides a detailed description of the differences between Staff's and the Companies' calculations. The Exhibit illustrates the ROE impacts of the various Staff adjustments from Staff Exhibit __ (SFP-13).

Q. Do you agree with Staff that a 10.1% ROE is appropriate?

A. No. As shown by the Companies' witness Dr. Makholm, the fair and reasonable return on common equity for NYSEG and RG&E is 12.0% and 12.2%, respectively, and, therefore, the Companies have requested those returns. Staff asserts that a 10.1% ROE is appropriate. We believe that Staff's 10.1% ROE is significantly below the cost of equity capital. The Companies disagree with Staff's overall ROE level and Staff's calculation methodology. We defer to Dr. Makholm on these ROE issues.

Q. Putting aside for a moment your disagreement with Staff's view of the cost of equity capital and appropriate ROE level for the Companies, what are the problems with Staff's calculation of its proposed 10.1% ROE?

A. Aside from the Companies' disagreement with the appropriate cost of equity capital and appropriate ROE level, Staff's approach would result in earnings by the Companies significantly below even the 10.1% ROE level that Staff proposes for the Companies.

Q. Please explain.

A. Staff seeks to make a variety of requirements, modifications and other adjustments to the Companies' earnings. With proper calculations, rather than the erroneous approach employed by Staff, the Companies' actual earnings would be at 6.39 % ROE absent rate relief as shown on Exhibit __ (CP-7), rather than the 10.1% Staff claims its calculations yield. This exhibit sets forth the differences between the Companies' and Staff's ROE calculations.

Q. Please explain those differences.

A. The Companies have grouped the ROE differences between the Companies and Staff into four general categories: 1) Mathematical Calculation Error - 101 basis points on ROE; 2) Mistakes - 81 basis points on ROE; 3) Double Counting PBA - 62 basis points on ROE; and 4) Ratemaking Adjustment Disagreements - 128 basis points on ROE.

Q. Please discuss the Mathematical Calculation Error.

A. In Staff's Exhibit __ (SFP-13), Staff double-counted the effect of its rate base adjustments by reflecting the impact on rate base (through its equity ratio) and by calculating a pre-tax earnings impact. Staff also failed to reflect interest synchronization. The net impact of this "quick" approach taken by Staff is an overstatement of Staff's calculated ROE by 101 basis points. Thus, even if one assumes all other Staff adjustments are correct, which they are not, the mere mathematical exercise would produce an ROE of 9.10% instead of 10.1%.

Q. Please discuss your second category, Mistakes.

A. Staff made four adjustments that are simply incorrect or mistakes. These adjustments are not the result of disagreements as to whether or not the costs are appropriately borne by ratepayers, but rather reflect Staff's misunderstanding of the Companies' schedules or failure to recognize how certain of the Companies' costs are recovered or reconciled. In any event, we have classified these items as mistakes. The first mistake relates to Staff's decommissioning expense adjustment of $8.5 million (decommissioning expenses related to Beebee Station and Russell Station). Beebee Station decommissioning expenses are collected through delivery rates. Russell Station decommissioning expenses are collected through the NBC. Unless the Commission allows the Companies to cease accruing decommissioning expenses, while continuing to collect such expenses from customers, then there is no potential for earnings to increase. Since Russell Station decommissioning expenses ($6.5 million annually) are included in the NBC, and the NBC is designed to be fully reconciled, there is no opportunity for the Companies to increase their return. Any reduction in Russell Station decommissioning expenses would presumably be accompanied by a corresponding reduction in the NBC. Beebee Station decommissioning expenses ($2.0 million annually) are a component of base rates. Any reduction in those expenses would be reflected in a corresponding reduction in base rates.

Q. Please describe the other mistakes made by Staff.

A. One of the most obvious mistakes in the Staff schedule is its amortization adjustments associated with the NYSEG Gas Pension deferral and 2006 Flood. Staff's amortization adjustments for the NYSEG gas pension deferral and 2006 Flood are reconciled through the Transition Surcharge as explained in the Companies' testimony and presented on line 4 of Exhibit __ (NYSEG Gas RRP-2), Schedule B. If Staff proposes to eliminate the amortizations, then it must correspondingly eliminate the revenues, so that the net effect has no impact on ROE. Staff also ignored the fact that economic development costs are fully reconciled and have no impact on earnings. Finally, Staff removed inflation of non-rate case legal costs. The total impact of the mistake category is 81 basis points or a resulting ROE of 8.29%.

Q. Please describe the next category called "Double Counting PBAs."

A. This category relates to the PBA rate base deduction. The Merger Order required the Companies to accrue interest on the PBAs until rates are reset, rather than utilizing PBAs to reduce rate base. Despite this, Staff proposes to reduce rate base by the PBA amount, which artificially inflates the Companies' ROE. In essence, this reduction in rate base by Staff double counts the PBA benefits because customers are already getting the benefits ordered by the Commission via the accrual of interest. Staff cannot have it both ways. The ROE impact of Staff's PBA adjustment is 62 basis points, bringing the overall ROE down to 7.67%, even before addressing the disagreements associated with traditional ratemaking adjustments.

Q. Please describe the remaining category that you have entitled "Ratemaking Adjustment Disagreements"?

A. The Ratemaking Adjustment Disagreements category represents numerous disagreements about the ratemaking treatment of certain items. These disagreements include Staff's adjustments related to payroll (which ignores the contractually required union wage increases), rate case expense (which is a legitimate cost of doing business in New York and routinely allowed in rates), EBCAP, the hedge loss, and equity ratio. The Companies strongly disagree with Staff's conclusions and positions on these issues. Staff has not made any demonstration as to why it made these adjustments or whether any of them are appropriate. These matters should be addressed in the "Case in Chief" and should not form a basis for determining the Motion to Dismiss. As explained above, this Motion to Dismiss should be focusing upon the overall financial health of NYSEG and RG&E, which cannot be evaluated through after-the-fact regulatory adjustments. Simply removing costs on a sheet of paper will not eliminate those costs from being incurred and the impact they have on the financial condition of the Companies.

Q. Staff states in its testimony that in the latter part of 2008 there is unexplained sales margin erosion that could create future cash benefits to the Companies. Do the Companies agree with Staff's suggestion?

A. The Companies did see erosion in the electric margins in the latter part of 2008. This erosion was the result of declining commodity earnings compared to the same period in 2007, driven by a reduction in demand for the FPO and the increase in risk associated with market price volatility.

Capital Expenditure Levels

Q. How do you respond to Staff's assertion that the $540 million level of capital expenditures from the Merger Order is the appropriate level of capital expenditures needed to ensure safe and reliable service, and that no additional capital expenditure amounts are required in 2009 and 2010?

A. As we state above and in the Policy Panel testimony, the Companies do not have sufficient cash flow to fund the $540 million capital expenditure levels required under the Merger Order (let alone the other capital expenditure projects that were identified in the Companies' rate filing).

The Companies would have to rely on the long-term debt markets to raise these funds. Given the current state of the financial markets, however, there is no guarantee that the Companies can raise the amount needed for capital expenditures and other cash needs for the Companies that are required. But assuming they could, we have now calculated the resulting ratios for the two critical metrics that Moody's reviews when assessing a company's credit rating – Funds Flow Interest Coverage, and Funds from Operations to Total Debt. The resulting ratios for 2009 and 2010 for RG&E would be *below* the bottom of Moody's Baa range for a utility with medium business risk, and near or below the bottom of the same range for NYSEG. *See* Exhibit __ (CP-1), Response to DPS-197. As these statistics show, and as the Answering Testimony of Mr. Fetter explains in further detail, attempting to fund the Companies' significant cash requirements with debt will quickly lead to reduced credit metrics and likely credit ratings downgrades.

Q. How do the Companies respond to Staff's suggestion that other key capital expenditure projects identified by the Companies are part of a "massive spending binge"?"

A. The Companies disagree with Staff's suggestion. The Companies have identified other key infrastructure projects that may be needed, including anticipated FERC ERO requirements. The Companies believe that the merits of these capital expenditure projects should be evaluated in a full rate case process, as opposed to being decided along with Staff's Motion to Dismiss.

Merger Costs Excluded

Q. On page 83 of the Staff Financial Panel testimony, Staff states that "the Companies fail to address the removal of merger related integration and transaction costs." How do the Companies' intend to treat merger related costs in the proposed rates?

A. The Companies committed as part of the merger that transaction and integration costs related to the merger would not be included in rates. The Companies reaffirm that commitment.

Energy Efficiency/Uncollectibles

Q. Did Staff's testimony support in any detail those portions of the Motion to Dismiss (Point III) relating to appropriate treatment of energy efficiency and uncollectible issues?

A. No. These issues were only summarily addressed in the Motion itself, but not in the testimony.

Q. The Motion states that the costs associated with energy efficiency and uncollectibles are being addressed in other Commission proceedings and that they provide no basis here for new rate relief. Do the Companies wish to clarify their position regarding these items?

A. Yes. The Companies would like to reiterate their support for the Commission's energy efficiency goals. The Companies' energy efficiency proposal is to initiate well thought out plans utilizing funds currently being collected from customers to rapidly implement effective energy efficiency programs. As a result, the Companies' proposed Energy Efficiency initiatives would be both cash flow and earnings neutral. The Companies expressed in their rate filings a willingness to implement flexible energy efficiency programs at a rapid pace and potentially in a manner that differs from the programs filed many months ago by the Companies in the Commission's generic Energy Efficiency proceedings. Under any approach, the Companies' intent would be to match cash collections with cash expenditures to allow for sustainable support for enhanced energy efficiency programs. Turning to the uncollectible issue, the Companies are actively participating in the Commission's generic proceeding (Case 08-M-1312). However that case is designed to address the issue on a generic industry-wide basis and it remains pending. In this proceeding, the Revenue Requirements Panel is proposing that rate delivery uncollectible expenses be adjusted for the Companies to reflect the proposed additional low income program arrears forgiveness, which would be incremental to the 2008 actual uncollectible expense. These expenses are not generic in nature, but are specific to the Companies' rate proposal, and therefore are appropriately included for recovery in the rate case filings. As Staff acknowledges, in the generic proceeding it is anticipated that a final order will confirm procedures by which utilities may seek deferral treatment of uncollectibles. Additional deferrals will not assist the Companies in resolving liquidity concerns, which is why the Revenue Requirements

ANSWERING TESTIMONY OF THE COMPANY PANEL

Panel proposed a reconciliation of actual delivery uncollectible expense with the rate year allowance for the periods beyond the 2008-2009 heating season.

Q. Does this conclude the answering testimony of the Company Panel?

A. Yes, it does.