BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

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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-
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-
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-
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-

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DIRECT TESTIMONY OF THE POLICY PANEL

James P. Laurito
Robert D. Kump

January 27, 2009

DIRECT TESTIMONY OF THE POLICY PANEL

I. INTRODUCTION

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

A. Our names are James P. Laurito and Robert D. Kump.

Q. Mr. Laurito, please state your current position and business address.

A. My title is President and Chief Executive Officer ("CEO") of New York State Electric & Gas Corporation ("NYSEG"), President and Chief Executive Officer of Rochester Gas and Electric Corporation ("RG&E"). My business address is 89 East Avenue, Rochester, New York 14649.

Q. What are your current job responsibilities?

A. As President and CEO of NYSEG and RG&E, I am ultimately responsible for the overall day-to-day gas and electric operations of NYSEG and RG&E (together, the "Companies"). I am responsible, among other things, for maintaining the Companies' financial health and enhancing the operating efficiency and reliability of the Companies' electric and gas businesses. I am ultimately responsible for assuring that the Companies provide customers with safe and reliable electric and gas service.

Q. Please summarize your educational background.

A. I graduated from West Virginia University with a Bachelor of Science Degree in Civil Engineering and have completed executive programs in financial and manufacturing management at Columbia University.

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Q. Please describe your work experience.

A. I have been President and CEO of RG&E since June 2003 and President and CEO of NYSEG since May 2003. In addition, I served as NYSEG's Treasurer from May 2003 to July 2003; President and Chief Operating Officer of Connecticut Natural Gas Corporation and The Southern Connecticut Gas Company (two local distribution companies of Energy East Corporation ("Energy East") in Connecticut) from October 2000 to May 2003; President of TEN Companies, Inc. ("TEN") (a CTG Resources, Inc. affiliate) from January 1998 to October 2000; and Vice President of Business Development of TEN from September 1997 to January 1998.

Q. Have you previously testified in other proceedings before the New York State Public Service Commission ("Commission") or other state or federal regulatory agency or court?

A. Yes. I previously offered direct and rebuttal testimony before this Commission in Case 07-M-0906 regarding the indirect acquisition of NYSEG and RG&E by Iberdrola, S.A. ("Iberdrola").

Q. Mr. Kump, please state your current position and business address.

A. My title is Senior Vice President and Chief Financial Officer ("CFO") of Energy East. My business address is 52 Farm View Drive, New Gloucester, Maine 04260.

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Q. What are your current job responsibilities?

A. I am responsible for all aspects of accounting and finance for Energy East. In that capacity, I am responsible for ensuring that the utilities maintain adequate liquidity and oversee all financing activities of Energy East and its subsidiaries.

Q. Please summarize your educational background.

A. I graduated from Binghamton University Magna Cum Laude with a Bachelors of Science Degree in Accounting in May 1983 and became a Certified Public Accountant in New York State in October 1985. (This certification is currently inactive.)

Q. Have you previously testified in other proceedings before the Commission or any other state or federal regulatory agency or court?

A. I have not testified before this Commission in recent years.

Q. What is the overall purpose of your testimony?

A. The purpose of our testimony is to provide: (i) an explanation of why the Companies need rate relief on an expedited basis (by July 1st) so that safety and reliability are not jeopardized; (ii) an overview of the global financial crisis and its effect on all utilities and, in particular, on "BBB" level rated utilities such as the Companies; (iii) a description of the unique effect of the financial crisis on the Companies; and (iv) an overview of the rate filings, including a discussion of positive benefit adjustment (or "PBA") implementation, merger savings, capital structure and ring-fencing, and energy efficiency issues.

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Q. Is this Panel sponsoring any exhibits?

A. Yes. Exhibit __ (PP-1) is a table listing credit rating basis point spreads for 2007 and 2008. Exhibit __ (PP-2) is an excerpt from a presentation given by Anthony Ianno from Morgan Stanley at the Federal Energy Regulatory Commission's ("FERC") recent technical conference on credit and capital market issues. Exhibit __ (PP-3) is a statement given by Chairman Garry Brown at the recent FERC technical conference on credit and capital market issues. Exhibit __ (PP-4) shows NYSEG's and RG&E's projected funding requirements and key credit rating metrics in the absence of rate relief. Exhibit __ (PP-5) is a comparison of NYSEG's and RG&E's credit ratings to those of other major electric and gas utilities in New York State. Exhibit __ (PP-6) shows NYSEG's and RG&E's projected funding requirements and key credit rating metrics with rate relief.

II. EXECUTIVE SUMMARY

Q. Please summarize the testimony of this Policy Panel.

A. This testimony shows that, since the closing of the merger between Iberdrola and Energy East, the global financial meltdown and resulting economic recession have caused a severe liquidity and credit crisis at both NYSEG and RG&E. As a result, the Companies are requesting that the Commission adjust rates on an expedited basis by July 1, 2009 so that the Companies can continue to provide safe and reliable service to their customers. These rate increases will also put the Companies on a path to achieving an "A" level credit rating over the next few years, which will ultimately benefit ratepayers in the long term.

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Q. Why are the Companies seeking expedited rate relief?

A. As described below, the Companies are currently experiencing severe financial difficulties resulting from the global financial meltdown, which are compounded by their "BBB" level credit ratings, the lowest ratings of any major electric or gas utility in the state. The Companies require expedited relief to avoid the costly results of credit downgrades and to ensure that the Companies can continue to provide safe and reliable service to customers.

Q. What are the major reasons why rate increases are needed??

A. The vast majority of the rate increases are needed to recover costs related to: (a) recovery of previous deferrals and adjustments to reserve targets (recovery of these known cost increases will improve the Companies' poor liquidity situation); (b) operations and reliability (recovery of these costs will ensure that the Companies can continue to provide high quality service and build needed additional infrastructure); (c) pension expense (these costs reflect the severe stock market declines since the Lehman Brothers bankruptcy); and (d) low income assistance (recovery of these costs will allow the Companies to provide support to low income customers).

Q. Did the Companies address certain Positive Benefit Adjustments or "PBAs" in their rate requests?

A. In the Merger Order,[1] the Commission required that the Companies address certain PBAs in their next rate cases. Accordingly, the Companies have reduced their requested rate increases through the utilization of the PBAs, which is discussed in more detail in the testimony submitted by the Revenue Requirements Panel. This PBA proposal would result in a reduction of the Companies' proposed rate increase by over $95 million or 25%. When the Companies agreed to the PBAs in the merger proceeding, the financial crisis had not yet begun, and the Companies could not have predicted their difficult situation. The Companies' proposed utilization of PBAs, therefore, strikes a balance between the size of the Companies' rate request and need for improved liquidity given the Companies' financial situation.

Q. Please provide a broad overview of the Companies' rate case filings.

A. The Companies and their ratepayers need immediate action and assistance by the Commission by July 1, 2009. The Companies are currently experiencing severe financial difficulties as a result of the global capital markets meltdown and resulting recession. A "perfect storm" of negative events, driven in part by the financial crisis and NYSEG's and RG&E's "BBB" level credit ratings, have led to (i) immediate cash flow and liquidity issues, (ii) significantly higher costs of

[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., Abbreviated Order Authorizing Acquisition Subject to Conditions* (Sept. 9, 2008) and *Order Authorizing Acquisition Subject to Conditions* (Jan. 6, 2009) ("Merger Order").

capital, and (iii) higher costs and reduced sales. Based on this deteriorating overall financial performance, it is necessary for the Companies to submit this rate filing prior to the "target period" for rate filings set forth in the recent merger proceeding between Iberdrola and Energy East.

As described in further detail in this Policy Panel testimony, waiting eight months to file rate cases, and another eleven months until new rates become effective (*i.e.*, in August 2010), would jeopardize the Companies' ability to obtain capital needed to provide safe and reliable service. The immediate and acute financial pressures that the Companies are facing cannot be deferred until August 2010 without exacerbating the Companies' dire financial situation, which would, in turn, make any potential cure less certain and more costly for ratepayers.

The Companies are facing higher costs and deteriorating cash flows in part because of their "BBB" level credit ratings. Additionally, the Companies' currently allowed equity returns are substantially below today's cost of equity capital and are not reasonable or competitive, and the Companies' projected equity returns for 2009 now approximate the current after-tax cost of debt. Failing to permit returns at reasonable levels is confiscatory and would simply discourage future capital investment. Rate relief is needed to maintain the capital spending requirements in the Merger Order (let alone additional capital expenditures identified by the Companies in the Capital Expenditures, Reliability and Operations Panel (the "CRO Panel")) and to ensure that safe and reliable service is not jeopardized.

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To allow the Commission to address the Companies' acute financial pressures as quickly as possible, NYSEG and RG&E are seeking rate relief, and a Commission decision on all revenue requirement issues, so that rates can be implemented on an expedited basis by July 1, 2009. Expediting these rate proceedings in this manner will allow the Commission to address the Companies' immediate cash flow and liquidity needs, to ensure that the Companies can continue their normal operations, and to ensure that safe and reliable service is not jeopardized. We note that the New York Department of Public Service Staff ("Staff") sought an expedited rate process for the Companies during the merger proceeding.[2] Filing full rate cases in advance of the "target period" set out in the Merger Order will allow this Commission to evaluate fully the merits of the rate cases, as well as the Companies' dire financial situation.

In order to assist the Commission in addressing the Companies' immediate financial concerns, the Companies are seeking a Commission decision on an expedited basis on all revenue requirement related matters. All testimony, data and other information that is necessary to support a revenue requirement determination, is being filed contemporaneously with this Policy Panel testimony, including direct testimony sponsored by: (i) the Revenue Requirements Panel; (ii) the Delivery Rate Design Panel; (iii) the Electric and Natural Gas Deliveries and Revenue Panel; (iv) the Capital Expenditures, Reliability, and Operations

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[2] *See* 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., Staff Brief on Exceptions,* at 46-48 (filed June 26, 2008) ("Staff Brief on Exceptions") (recommending an expedited rate process for all four companies with streamlined filing requirements).

Panel; (v) the Electric and Natural Gas Supply Panel; (vi) the Retirement and Employee Benefits Panel; (vii) the Depreciation Panel; (viii) Jeff D. Makholm on rate of return issues; and (ix) Steven M. Fetter on credit rating issues. The Companies will address certain non-revenue requirements matters in a second, subsequent filing that the Companies intend to submit by May 29, 2009. At that time, testimony would be submitted on marginal and embedded cost of service studies, rate design, further unbundling of competitive services, revenue decoupling mechanisms, energy efficiency programs, and low income and economic development programs.[3]

III. REQUEST FOR EXPEDITED RATE RELIEF

Q. Why do the Companies need rate relief on an expedited basis by July 1st, which is before the expiration of the 11-month process?

A. The Companies are seeking rate relief on an expedited basis (by July 1st) because of the urgent financial crisis that the Companies are facing. The Companies are currently experiencing severe financial difficulties resulting from the global financial meltdown. The cost of capital for "BBB" level utilities like NYSEG and RG&E has risen dramatically, while at the same time the Companies' overall financial performance has deteriorated. The Companies require expedited relief to avoid the costly results of credit downgrades and to ensure that the Companies can continue to provide safe and reliable service to customers. In short, the

[3] The Companies' commodity programs are not addressed in this filing. The Companies will address such programs in a March 1, 2009 filing in compliance with the Commission's January 20, 2009 *Order Establishing Filing Requirements* in Cases 07-E-0479 and 03-E-0765.

Companies need the Commission's assistance to obtain rate relief in the timeframe required.

Q. Will ratepayers ultimately benefit from expedited relief?

A. Yes. Waiting the full 11-month process for rates to go into effect would simply exacerbate the Companies' dire financial situation and will make any potential cure less certain and more costly for ratepayers. As noted above, rate increases now are certainly preferable to the higher costs later that would result from future credit rating downgrades (if rate relief is not granted now), as well as the potential continued deterioration of the financial health of the Companies.

Q. Please describe the Companies' revenue requirements filing.

A. In order to assist the Commission in addressing the Companies' immediate financial concerns, the Company is seeking an expedited Commission decision with respect to the Companies' revenue requirement issues. All testimony, data and other information that is necessary to support a revenue requirement determination, is being filed contemporaneously with this Policy Panel testimony. As stated above, the Companies are requesting that the Commission address all revenue requirement issues on an expedited basis by July 1, 2009.

Q. Please describe the Companies' filing on non-revenue requirement matters?

A. The Companies will address certain additional matters that are not related to the Companies' revenue requirements in a subsequent filing that the Companies intend to submit by May 29, 2009. The Companies propose that the Commission address these subsequent issues in a separate order. Addressing the revenue requirements first on an expedited basis, and leaving non-revenue requirement issues for resolution in a subsequent order, is a logical approach that the Commission has used previously in adjudicating rate cases.[4] As noted above, Staff recommended an expedited review of the Companies' rates in the merger proceeding.

Q. How does the Companies' proposed schedule for these rate cases differ from what Staff recommended in the merger proceeding?

A. Not only did Staff advocate an expedited schedule, but Staff also recommended that the Commission establish streamlined filing requirements that would be "less rigorous than the requirements for a major rate filing."[5] Although the Companies are requesting an expedited decision of all revenue requirement issues, they are providing full revenue requirements data, and are not seeking to streamline or reduce revenue requirements issues or determinations.

IV. FINANCIAL CRISIS

A. Overview of the Global Financial Crisis

Q. Please describe the current state of the financial markets that you and the Companies have observed.

A. The financial markets are currently experiencing an historic, worldwide financial market melt-down with a resulting severe economic recession. The current financial situation has been described by President Barack Obama as "an

4 *See, e.g.*, Case 08-E-0539 - *Proceeding on Motion of the Commission as to Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Electric Service, Recommended Decision*, at 1, Appendix I, p. 4 (issued Jan. 7, 2009) ("ConEd RD") (noting that the Recommended Decision only addresses revenue requirement issues and that all other issues are deferred to a later date).

5 Staff Brief on Exceptions, at 47.

economic crisis of historic proportions,"[6] and by New York State Governor David Paterson as the "worst . . . in this country since the Great Depression."[7] As recently reported by the Wall Street Journal, the U.S. stock market experienced its "third-worst year in more than a century" in 2008, with the S&P 500 and the Dow Jones Industrial Average down 38.5% and 33.8%, respectively, for 2008.[8] No fewer than fifteen United States banks failed in 2008, including the well-publicized bankruptcy of Lehman Brothers filed on September 15, 2008, which is the largest bankruptcy in United States history. The collapse of Lehman Brothers marked a watershed to which the markets are still reacting and that precipitated the financial crisis we now find ourselves struggling to overcome. In fact, economists have pointed to the Lehman Brothers bankruptcy as the onset of the financial crisis. Immediately afterwards, the credit markets literally froze, and credit was unavailable for nearly a two-week period – particularly for "BBB" level rated companies. The changes we have seen on Wall Street, which appear to be permanent changes to the way that our financial markets operate, mean that remaining firms will have less capital available in both the debt and equity markets for companies seeking debt and equity investment.

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[6] Jeff Zeleny, *Obama and Bush Working to Calm Volatile Market*, N.Y. TIMES, Nov. 25, 2008, at A1.

[7] Danny Hakim, *Paterson Calls for $5.2 Billion in Budget Savings*, N.Y. TIMES, Nov. 13, 2008, at A1.

[8] E.S. Browning, *After the Collapse, Guarded Hope for '09*, WALL ST. J., Jan 2, 2009, at R1.

Q. How has the financial crisis affected the ability of utilities to access the credit markets?

A. The unprecedented turmoil in the financial markets has negatively affected the availability, terms and cost of capital for companies. Utilities are uniquely dependent upon the credit and capital markets due to their large capital spending programs and their need to access the credit markets on a regular basis. Many utilities, particularly those that are "BBB" level rated utilities, are experiencing significant difficulties in accessing the capital markets, and those utilities that are able to access the markets are incurring significantly higher costs and may also be forced to accept less favorable terms and conditions. As Moody's recently reported in a January 16, 2009 issuance, "[d]ramatic changes in the financial markets during 2008 have materially changed the banking environment for utilities going forward, which will make upcoming credit facility renewals significantly more challenging. . . . Those banks that do remain will be constrained in both their ability and inclination to provide traditional credit, especially at the relatively low pricing levels and on the liberal terms and conditions that prevailed prior to mid-2008."[9]

In light of the financial crisis, investors are more carefully evaluating and assessing risk, resulting in significantly increased costs of capital for utilities, particularly lower rated ones. Yields on bonds with default risk have been moving significantly higher, as opposed to the plummeting yields on U.S.

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9 Moody's, *Near-term Bank Credit Facility Renewals To Be More Challenging For U.S. Investor-Owned Electric And Gas Utilities*, at 2 (Jan. 2009).

Treasury bills.[10] The stark impact of this unprecedented situation on utilities is illustrated by a comparison of current and historic basis point spreads between utility bond yields and the yield levels for U.S. Treasury bonds. *See* Exhibit __ (PP-1).

Q. How has the upheaval in the financial markets affected the cost of capital for "BBB" level rated utilities?

A. Although the financial crisis has clearly had an adverse impact on all utilities, regardless of their credit ratings, the negative impact on "BBB" level rated utilities like NYSEG and RG&E has been dramatically worse than on "A" level rated utilities. Borrowers with anything less than "A" level ratings are finding it more difficult to raise capital in the current credit markets and are incurring significantly higher costs, which puts "BBB" level rated utilities at an even greater disadvantage in this financial atmosphere.

For example, during the FERC Technical Conference on Credit and Capital Issues Affecting the Electric Power Industry, regulators, industry representatives and banks all agreed the financial crisis is having a more dramatic impact on lower rated utilities. W. Paul Bowers, the Executive Vice President and Chief Financial Officer of Southern Company, noted that although the financial crisis has led to increases in debt and equity risk premiums for all utilities, these increases have been more consistently applied to utilities without high credit ratings, resulting in significantly higher cost of debt capital for "BBB"

[10] The value of non-treasury securities is the value of an identical treasury security plus a credit spread, also called a quality spread.

level rated utilities than "A" level rated utilities.[11] Mr. Bower's views were supported by data presented by Anthony Ianno, Managing Director and Head of Energy & Utilities Global Risk Capital Markets at Morgan Stanley, which showed that investment in "BBB" rated utilities dropped approximately 13% in the period after the Lehman Brothers bankruptcy, while investment in "A" rated utilities rose by the same margin.[12] *See* Exhibit __ (PP-2). These data clearly show that, in the wake of the financial crisis, investors are choosing to invest in less risky "A" rated utilities at the expense of "BBB" rated utilities. Finally, Commission Chairman Garry Brown noted that "there is a clear relationship between a utility's bond rating and its ability to borrow at a reasonable cost, particularly in times of economic distress as we are now facing." *See* Exhibit __ (PP-3).

Q. Can you further demonstrate the unique impact of the financial crisis on "BBB" level utilities?

A. The unique impact of the financial crisis on "BBB" level utilities is well illustrated by a comparison of current and historic basis point spreads between "A" and "Baa" rated Moody's utility bond indices and 30-year U.S. Treasury bonds, which have widened at an alarming rate since the beginning of the financial crisis. *See* Exhibit __ (PP-1). In December 2007, the amount over U.S. Treasuries for "A" rated utility bonds was 163 basis points, and the amount over U.S. Treasuries for "Baa" rated utility bonds was 198 basis points. Now, those

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[11] *Credit and Capital Issues Affecting the Electric Power Industry*, Statement of W. Paul Bowers, Docket No. AD09-2-000, at 4 (Jan. 13, 2009) ("Bowers Statement").

[12] *Credit and Capital Issues Affecting the Electric Power Industry*, Power Point Presentation of Anthony Ianno, Docket No. AD09-2-000, at 6 (Jan. 13, 2009).

basis point spreads have skyrocketed. As of December 2008, the amount over U.S. Treasuries for “A” rated utility bonds was 365 basis points, and the amount over U.S. Treasuries for “Baa” rated utility bonds was 524 basis points.[13] The difference between “A” and “Baa” rated utility bond yields is now 159 basis points (a growth of 124 basis points since December 2007). As described in the Direct Testimony of Jeff D. Makholm, these spreads are objective evidence that investors in this volatile market require a substantial premium to provide capital to utilities with lower ratings. The dramatically increased capital costs for “BBB” level utilities will be borne by ratepayers.

Additionally, the capital markets have been completely closed to “BBB” level rated utilities during certain periods in late 2008. This was particularly evident in late September and October of 2008 when there were virtually no utility issuances of “BBB” long-term debt. As shown on Exhibit __ (PP-2), “BBB” level rated utilities represented almost half of the 2008 utility debt issuances prior to the Lehman Brothers bankruptcy filing on September 15, 2008, but only 35% of the utility debt issuances during the remainder of the year. This clearly illustrates that the financial crisis is more severely impacting the ability of “BBB” level utilities to access the capital markets.

Q. Are increased capital costs of particular concern to the utility industry?

A. Yes. Utilities must provide efficient, safe and reliable service to their customers irrespective of increased capital costs or dysfunctions in the financial markets.

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[13] Sources: Treasury Yields from U.S. Treasury Dep’t; Moody's Utility Bond Indices Yields available from *Mergent Bond Record* through October 2008; Moody's Bond Indices Data from November and December 2008 from *Bloomberg*.

The utility sector is one of the most capital-intensive sectors in the country, and utilities must continue to make significant capital expenditures in good times and in bad to maintain reliability, replace aging infrastructure and meet load growth requirements. As recently noted by Chairman Brown, "[l]arge capital programs . . . make it very important that electric utilities continue to have access to the financial markets, and regulatory policies should support utilities' ability to raise capital." *See* Exhibit __ (PP-3). While many utilities are looking to reduce their near-term capital needs, this trend is not sustainable on a long-term basis. As a result, the ongoing economic and financial crisis presents unique challenges that the utility industry and its regulators have never before experienced.

Q. Is the financial crisis adversely impacting utilities in other ways?

A. Yes. The financial crisis and related recession are adversely impacting utilities because of stagnant revenues and increasing costs. In addition to increased capital costs, utilities are also experiencing increased costs in connection with delinquent or uncollectible expenses, pension costs and property taxes. Moreover, the Companies are also experiencing declining sales. Lower industrial usage during an economic downturn is normal, but the degree to which residential and commercial demand has weakened has been remarkable. For example, in 2008, RG&E electric sales were down 4% as compared to 2007, and 5% below expectations.

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Q. Have the Companies seen any indication that the current financial crisis is abating, or is likely to improve in the near future?

A. No. The Companies have seen no indication that the financial crisis is abating, or is likely to improve in the near future. In fact, the Companies have seen significant evidence to the contrary. As recently reported by Moody's, costs are expected to increase significantly over the next 12-18 months.[14] Moreover, as described in Section III.B below, the Companies' financial performance has been declining and, based on current economic trends, the Companies expect only further deterioration in their financial performance.

Q. Are there any indications that cost of capital will return to the low levels we have seen over the past three to five years?

A. No. The cost of capital in the past few years has been extraordinarily low. A longer term view shows that today's cost of capital more closely approximates historical levels. Investors over the past three to five years were not adequately assessing risk and pricing that risk into the cost of capital. In the wake of the financial crisis and the implosion of the banking sector, investors are now more appropriately assessing and pricing risk. Thus, the current cost of capital should not be seen as a short-term phenomenon, but rather as a permanent shift in the costs of capital to reflect the true risk of investment.[15]

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[14] Moody's, *U.S. Investor-Owned Electric Utilities* (Jan. 2009) (stating that "bad debt expense will increase significantly over the next 12 to 18 months").

[15] As discussed in the Direct Testimony of Dr. Makholm, *Fitch* Managing Director Ellen Lapson believes that the absolute cost of debt will remain high.

B. Negative Effects of the Financial Crisis on NYSEG and RG&E

Q. How has the global financial crisis affected NYSEG and RG&E specifically?

A. NYSEG and RG&E, like all utilities, have been severely and negatively impacted by the economic and financial crisis. Broadly speaking, the Companies are experiencing: (i) severely constrained short-term liquidity; (ii) significantly higher cost of capital and extremely volatile markets that have made it very difficult, and at times impossible, to raise long-term capital; and (iii) higher costs and reduced sales, which all lead to deteriorating overall financial performance. The Companies continue to experience these financial difficulties notwithstanding the implementation of cash conservation and austerity measures, and significant assistance from their parent companies.

Q. Could the scope and severity of the financial crisis have been foreseen?

A. No. The unprecedented chaos in the financial markets that has occurred since the closing of the Companies' merger with Iberdrola in September 2008, and the depth of the current economic recession, are events that were not, and could not realistically have been, foreseen or predicted by anyone. The financial crisis has taken both private and public interests completely by surprise, and Energy East and the Companies are no exception. When Iberdrola and Energy East closed the merger transaction on September 16, 2008, just one day after Lehman Brothers filed for bankruptcy, they could not have predicted the domino effect that would occur from that collapse, nor the scope or severity of the resulting upheaval in the financial markets. The Companies are now attempting to adjust to an entirely new economic environment.

Severely Constrained Short-Term Liquidity

Q. Please explain the Companies' current cash flow and liquidity concerns.

A. The Companies are severely cash constrained. Both NYSEG and RG&E have fully utilized their available revolving credit facilities. In addition to drawing down fully on their revolving credit facilities, as of December 31, 2008, RG&E and NYSEG were temporarily borrowing over $90 million and almost $20 million, respectively, from their parent company. Operating cash flows at the Companies are expected to be insufficient to meet prospective cash requirements through 2010 by approximately $500 million at RG&E and approximately $390 million at NYSEG. *See* Exhibit __ (PP-4). As a result of these cash flow and liquidity concerns, NYSEG and RG&E are without any "liquidity cushion" to ensure that they can respond properly to emergency situations such as major storms, as described in more detail in Section IV below.

Q. What events gave rise to these liquidity concerns at the Companies?

A. The liquidity shortfall at the Companies has numerous causes, which, together, have formed a "perfect storm" of negative events. First, the collapse of the auction rate markets caused the cost of auction rate tax exempt debt to skyrocket. As a result, the Companies utilized over $125 million of liquidity to minimize the cost of such debt. NYSEG also secured an additional $190 million credit facility from banks to support the restructuring of auction rate securities into an alternative floating rate instrument called variable rate demand notes.

Second, due to historically low interest rates, anomalies in the swaps markets caused by the financial market meltdown, and a delay in approval from the Commission on the authorization of a $495 million financing petition, RG&E incurred losses approximating $100 million on a hedge position for the bond financing completed in December 2008. RG&E was forced to hold this hedge position because it did not receive approval from this Commission to issue securities (which had expired in December 2007) until December 2008, fourteen months after the initial financing petition was filed. Third, the Companies' cash flows have been lower than expected due to deteriorating financial performance, as will be discussed in greater detail below, thereby further impacting liquidity. Fourth, NYSEG was required to put over $100 million into its post retirement medical plans and other post employment benefits ("OPEB") Rabbi Trust. Fifth, RG&E faces an impending $100 million debt maturity in October 2009.

Q. Are the Companies still paying dividends to their parent?

A. No. RG&E has not paid a dividend to its shareholder since April 2008, and NYSEG has not paid a dividend to its shareholder since August 2008, in order to retain cash at the Companies that is necessary to continue operations. In total, NYSEG's and RG&E's parent has not been paid $55 million in dividends. Moreover, no dividend has been paid since Iberdrola's acquisition of Energy East.

Difficulties in Accessing the Credit Markets and Significantly Increased Cost of Capital

Q. What are the credit ratings for NYSEG and RG&E, respectively?

A. NYSEG's corporate issuer credit ratings are BBB+ (Stable) from S&P, Baa1 (Negative Watch) from Moody's, and BBB (Negative Outlook) from Fitch.

RG&E's corporate issuer credit ratings are BBB+ (Stable) from S&P, Baa1 (Negative Watch) from Moody's, and BBB- (Stable) from Fitch.

Q. How do these ratings compare to those of other utilities in New York State?

A. As Exhibit __ (PP-5) illustrates, NYSEG and RG&E have the lowest credit ratings of any major utility in New York State. With these lower ratings, the Companies are experiencing considerably greater difficulties than other New York utilities as a result of the financial crisis.

Q. How has the global financial crisis affected NYSEG's and RG&E's access to credit markets, considering their status as utilities with "BBB" level credit ratings?

A. Since the Lehman Brothers bankruptcy, borrowers with anything less than "A" level ratings are currently finding it more difficult, expensive, and at times impossible, to raise capital. "BBB" level utilities that are able to access the markets must accept significantly higher costs and often have been forced to accept less favorable terms. These significantly higher capital costs will ultimately be borne by ratepayers.

Q. Did the Companies experience any difficulties in accessing the capital markets in 2008?

A. Yes. Upon receiving the Commission's clarification order on its request for financing authority,[16] RG&E quickly attempted to access the market on December

[16] 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, Order Granting Clarification* (Dec. 10, 2008).

18, 2008. Given the turmoil in the capital markets, RG&E's underwriters needed two full days of marketing before the Company was able to price $150 million of 25-year first mortgage bonds on December 19, 2008. This issuance was largely attributable to one investor's purchase of over one-third of the bonds. Absent that investor, RG&E likely would not have been able to close the transaction on comparable terms.

Q. How did the cost of RG&E's debt issuance compare to issuances by other New York utilities in 2008?

A. RG&E issued $150 million of 25-year first mortgage bonds at a coupon rate of 8%, a significant spread to U.S. Treasuries of approximately 550 basis points. On December 4, 2008, Consolidated Edison Company of New York, Inc. ("ConEd") issued $600 million of 10-year senior unsecured notes at a coupon rate of 7.125%, a spread of around 450 basis points above U.S. Treasuries. Therefore, just two weeks prior to RG&E's issuance, ConEd, which maintains an "A" level credit rating, was able to issue unsecured debt at a significantly lower cost than RG&E.[17] The 100 basis point spread between ConEd's and RG&E's issuances would have been even wider if ConEd had issued secured, first mortgage bonds like RG&E (rather than the unsecured bonds ConEd issued). This comparison clearly illustrates the comparative disadvantage that "BBB" level rated utilities like NYSEG and RG&E face in the current financial market.

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[17] As shown in Exhibit __ (PP-5), ConEd maintains "A" level ratings at S&P and Moody's. Consolidated Edison Company of New York, Inc. *Form 8-K*, Dec. 4, 2008.

Q. Did RG&E's debt issuance alleviate its liquidity concerns?

A. No. This issuance did little to improve the overall liquidity position of RG&E given the maturity of $50 million of first mortgage bonds in December 2009 and monies owed on the previously discussed hedge position.

Q. Can the Companies simply utilize short-term bank financing to solve their cash flow concerns?

A. No. The Companies' needs cannot realistically be met solely by additional short-term bank financing. Throughout 2008, and particularly since the historic bankruptcy of Lehman Brothers, the banking sector has undergone, and continues to experience, a radical transformation driven primarily by the tremendous capital losses incurred as a result of the financial crisis. As previously discussed, banks are extremely hesitant to lend additional funds at reasonable rates, including the Companies' existing relationship banks, which already have significant exposure to NYSEG and RG&E and Energy East as a whole. This was exacerbated by the need earlier this year to restructure auction rate tax exempt securities, which required an additional $190 million of bank letters of credit. As of the end of 2008, the Companies' banks had extended to NYSEG and RG&E over $540 million in credit, all of which is being utilized. As Mr. Bowers recently stated at FERC's technical conference on credit and capital issues, "[i]n addition to [] increased costs of debt, the availability and cost of credit from banks have been even more severely impacted due to their financial troubles."[18]

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[18] Bowers Statement, at 4.

Q. Please describe the Companies' current bank financing arrangements.

A. NYSEG and RG&E are parties to a Joint Revolving Credit Facility along with the other regulated affiliates of Energy East. This facility provides for short-term borrowing up to $475 million. Each borrower under the facility is subject to a maximum limit. In NYSEG's and RG&E's case, the limits are currently $160 million and $100 million, respectively. To help ameliorate some of the immediate liquidity pressures for NYSEG, the Joint Borrowers re-adjusted NYSEG's limit under the Joint Revolving Credit Facility from $125 million to $160 million on January 22, 2009. The facility is used primarily to fund working capital needs, temporarily fund capital investments prior to obtaining long-term financing in the debt capital markets, temporarily fund the redemption of long-term debt before refinancing in the debt capital markets and post letters of credit with business trade partners when necessary. As noted above, NYSEG and RG&E have essentially exhausted their current limits under this facility.

In addition, NYSEG has a $190 million liquidity facility that serves as a required liquidity backstop to five series of floating rate tax-exempt notes. RG&E also maintains a $125 million liability guarantee facility that serves as a bank guarantee of payment of a liability for the disposal costs of certain nuclear waste that was retained after the sale of the Ginna nuclear station, which runs to the party that purchased the Ginna facility.

DIRECT TESTIMONY OF THE POLICY PANEL

Q. Can you generally describe the cost and availability of short-term bank financing before the financial crisis?

A. In May 2007, when the Companies' Joint Revolving Credit Facility was last re-priced, bank credit pricing was at its lowest level in over a decade. Banks were anxious to lend and willing to make lending commitments with maturities as long as five years. Arranging loan commitments was relatively easy, in part due to the number of banks willing to lend and the amounts each bank was willing to lend. The costs of the Companies' short-term liquidity facilities currently range from 27 to 88 basis points over London Inter-Bank Offer Rate ("LIBOR").

Q. How have the cost and availability of bank financing changed during the financial crisis?

A. U.S. investment grade loan volume decreased by 52% in 2008 as compared to 2007 volume. In the second quarter of 2008, the 364-day facility market share surpassed 5-year facility market share for the first time since late 2003. This shift is occurring because banks must now commit more of their scarce capital to support longer-term commitments. Additionally, the cost of bank financing has increased dramatically. Facility fees for recent "BBB" level borrowers have ranged from 50-63 basis points and LIBOR margins have ranged from 200-400 basis points. As discussed above, there is no end in sight to these conditions, and we would expect that the cost of bank financing will remain high for "BBB" level companies for quite some time.

Q. What problems complicate the Companies' use of bank financing?

A. NYSEG's Liquidity facility must be renewed in August 2009. NYSEG expects a substantial increase in the cost of that facility—perhaps even as much as 200-300%. There is also a chance that the banks in that syndicate will withdraw or reduce their commitments, forcing NYSEG to engage in a costly restructuring of the floating rate securities that the facility supports.

Deteriorating Financial Performance

Q. Could you describe the Companies' recent financial performance?

A. NYSEG's and RG&E's financial performance has been steadily declining. Moreover, based on current economic trends, the Companies expect only further deterioration.

Q. What are the Companies' projected equity returns?

A. In the absence of rate relief, the Companies currently project that returns on equity for 2009 will be at or below 7% for the electric and gas distribution businesses. These low returns on equity are unreasonable, particularly given the higher cost of capital in today's markets. It would be confiscatory for the Commission to deny rate relief in light of these projected returns and the Companies' overall financial deterioration. These low equity returns also exacerbate the Companies' liquidity problems and increase the likelihood of credit downgrades. Remarkably, these projected equity returns now approximate the after-tax cost of debt available to "BBB" level utilities like NYSEG and RG&E in the current market.

DIRECT TESTIMONY OF THE POLICY PANEL

Q. Has the financial crisis impacted the cost of equity?

A. Yes. Since the onset of the financial crisis, equity investors, like bond investors, have become skittish and now require returns that are commensurate with today's risks. This means that investors that are willing to assume risks inherent in companies with "BBB" level ratings are now requiring significantly higher equity returns than for "A" rated companies.

Q. What factors are contributing to the Companies' poor financial performance?

A. The Companies' financial performance is crippled by a number of major factors, including flat to declining sales, higher delinquencies and uncollectible expenses, higher pension costs, higher interest costs, higher operations and maintenance costs and higher property taxes. Moreover, the Companies do not have the revenue decoupling mechanisms that are in effect at other New York utilities, which exposes them to the effects of declining sales.

Q. Are these factors contributing to the Companies' poor financial performance related to the financial crisis?

A. Yes. All of these significantly increased cost pressures are related to the current economic crisis and its negative impact on consumers, capital markets and state and local government finances.

Q. Can you describe how the financial crisis has impacted pension costs?

A. The Companies' pension plans have traditionally been over-funded, however, given the market turmoil since closing, the Companies' combined pension and OPEB plans are currently in a net under-funded position, amounting to approximately $130-140 million pre-tax (or approximately $100 million after tax) at both NYSEG and RG&E.

Q. What are the practical implications of this pension and OPEB under-funding?

A. As a practical matter, the Companies are experiencing increased expenses as a result of the pension and OPEB under-funding. Additionally, if further deterioration in funding levels occurs, the Companies run the risk of having to put more money in the pension and OPEB funds, which would further exacerbate the cash flow and liquidity issues described in this testimony.

Q. How will the rating agencies treat the under-funded plans?

A. The rating agencies will likely impute this deficiency, *i.e.*, the net of tax unfunded balance, as expected debt in determining the Companies' debt-to-equity ratios. This would result in added leverage of approximately 200 basis points at RG&E and 150 basis points at NYSEG. As discussed in more detail below and in the Direct Testimony of Steven M. Fetter, signs of the Companies' deteriorating financial condition such as this one increase the likelihood of rating agency downgrades.

Q. Are there other factors contributing to the Companies' deteriorating financial condition and concerns about ratings downgrades?

A. Yes. Pursuant to the Merger Order, the Companies have also recorded $275 million in positive benefit adjustments or "PBAs," which reduced equity as a percentage of total capital about 2.5% at both NYSEG and RG&E, while increasing interest costs. As a consequence, the Companies' balance sheets have been further weakened. In addition, further reductions in cash flows are expected as the PBAs are passed back through customer rates.

Austerity Measures

Q. What austerity measures have the Companies implemented in an attempt to alleviate liquidity concerns and improve financial performance?

A. The Companies are taking aggressive measures to help conserve liquidity in the current financial crisis, including restricting hiring (including delaying line worker classes), travel restrictions, reducing operating expenses, delay of vendor payments to the greatest extent possible and other cash conservation measures.

Q. Have these steps restored the Companies' financial performance to adequate levels?

A. No. These 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.

Assistance from Parent Companies

Q. In light of the financial crisis, what measures have the parent companies taken to assist the Companies?

A. Iberdrola and Energy East have provided significant financial support to the Companies in an attempt to ameliorate their immediate liquidity concerns and prevent a financial emergency. This financial assistance has included short-term loans to the Companies and cessation of dividends. As of December 31, 2008, RG&E was temporarily borrowing over $90 million, and NYSEG was temporarily borrowing almost $20 million, from their parent company. Energy

East has not received any dividends from RG&E since April 2008, or from NYSEG since August 2008, and Iberdrola has not been paid any dividend from Energy East since the closing of the merger transaction. In that sense, Iberdrola has not earned any return on its equity investment in the Companies since closing. This is not sustainable as Energy East and Iberdrola have their own liquidity needs, and investors in public utilities (both debt and equity) must receive a reasonable return on their investment to ensure the utilities have future access to capital for the provision of safe and reliable service.

C. <u>Rating Agency Implications</u>

Q. How is the financial crisis affecting NYSEG's and RG&E's credit ratings?

A. As described in further detail in the Direct Testimony of Steven M. Fetter, the combination of poor liquidity, deteriorating financial condition, limited access to capital and weakened balance sheets pose a risk of adverse rating decisions for NYSEG and RG&E. This is particularly true at Moody's and Fitch, both of which have already placed a negative outlook on NYSEG's and RG&E's ratings. Moody's also states in its most recent credit reports for both NYSEG and RG&E, "[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 historical position, placing it in the Ba [i.e., non-investment grade] category."[19] As Moody's stated in a recent issuance, "[t]here could be rating implications for those utilities whose liquidity position is significantly diminished

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19 Moody's, *Credit Opinion: Rochester Gas and Electric*, at 2 (Oct. 16, 2008). *See also* Moody's, *Credit Opinion: New York State Electric and Gas Corporation*, at 2 (Oct. 16, 2008).

as a result of these continued difficult credit market conditions."[20] Clearly, any degradation in credit metrics that is not offset by a demonstration of increased regulatory support from the Commission could result in a downgrade, which would only serve to exacerbate the current situation.

Q. What other factors contribute to the credit ratings pressure that NYSEG and RG&E are experiencing?

A. NYSEG and RG&E already receive additional rating agency scrutiny as a result of the perceived unfavorable regulatory environment in New York. All three rating agencies have expressed doubt that companies in unsupportive jurisdictions will be able to retain their current ratings in 2009. Fitch has noted 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."[21] Fitch has further noted its view that "[s]tates with challenging regulatory environments include . . . New York."[22] As the Direct Testimony of Jeff D. Makholm notes, New York's awarded returns on equity are the lowest of any state in the nation, which, he concludes, affect New York utilities' cost of borrowing. Dr. Makholm also states that other aspects of New York ratemaking regulation, which Department of Public Service Staff and this Commission often cite as utility-friendly (*e.g.*, using a forward-looking rate year, allowing full recovery of commodity-related costs, and permitting reconciliation for sales revenues and

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[20] Moody's, *Near-term Bank Credit Facility Renewals To Be More Challenging For U.S. Investor-Owned Electric And Gas Utilities*, at 2 (Jan. 2009).

[21] FitchRatings.com, *EEI 2008 Wrap-Up: Cost of Capital Rising*, at 5 (Nov. 17, 2008).

[22] *See id.*

some expenses),[23] do not counterbalance these low returns on equity adequately in the eyes of investors and rating agencies. As a result, NYSEG and RG&E face even greater credit risks because of the difficult regulatory regime in which they operate.

Q. In the merger proceeding, the Petitioners asserted, and the Commission found, that the merger would improve the financial condition of the Companies. Were the Petitioners and the Commission correct arriving at that conclusion?

A. Yes. In fact, on September 11, 2008, in response to the Commission's approval of the merger, S&P revised its rating outlook on NYSEG and RG&E from "Negative" to "Stable" as a result of Iberdrola's support. Unfortunately, however, the ensuing onslaught of the financial crisis has overshadowed the benefits of Iberdrola's superior financial strength.

Q. How would a potential credit rating downgrade affect NYSEG and RG&E?

A. A downgrade in the Companies' credit ratings would further exacerbate the financial issues that are already threatening the Companies' ability to provide safe and reliable service. If a downgrade occurs, the Companies would have even greater difficulty accessing the long-term debt markets, resulting in even a higher cost of debt for the Companies. This would, in turn, further reduce earnings for the Companies, resulting in even less favorable credit metrics. Without regulatory support, a spiral of reduced ratings and increased financial costs could occur that would negatively impact service, reliability and safety. As Chairman Brown has observed, utilities "do not want to be rated at the lower end of the

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[23] ConEd RD, at 231.

BBB range because an unexpected shock could move [a utility] outside the investment grade range."[24] Accordingly, a downgrade could mean dire consequences for NYSEG and RG&E.

Q. Are the Companies comfortable with their current "BBB" level credit ratings?

A. No. It is in ratepayers' best interests that the Companies achieve an "A" level credit rating within the next few years. This is consistent with the Commission's stated goals of supporting and maintaining "A" level credit ratings for New York utilities.[25] Particularly in the current economic environment, an "A" level credit rating is essential to ensure their long-term financial health and access to capital, which will be beneficial to ratepayers in the long term.

Q. How would achieving an "A" level credit rating be beneficial to ratepayers?

A. Achieving an "A" level rating would, among other things, lower the Companies' cost of capital, ultimately benefiting ratepayers over the long term. As discussed in greater detail in the Direct Testimony of Jeff D. Makholm, there is abundant evidence that the lack of an "A" level rating makes the cost of raising capital more expensive, particularly in the current environment. The Companies agree with Chairman Brown's recent statement that, "[g]iven current economic realities, 100-200 basis point premiums on the yield for BBB debt over A debt may indicate that A is cheaper to ratepayers now." *See* Exhibit __ (PP-3). Finally, as Exhibit __ (PP-5) illustrates, almost all other major utilities in New York State are

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[24] *Credit and Capital Issues Affecting the Electric Power Industry*, Statement of Garry Brown, Docket No. AD09-2-000, at 3 (Jan. 13, 2009).

[25] Case 27679 - *Proceeding on Motion of the Commission to Investigate the Financing Plans for Major New York Gas and Electric Companies, Opinion and Order Concerning Financial Policies* (Oct. 18, 1982).

"A" level rated. The Companies need an "A" level credit rating to compete on equal footing with other utilities for access to capital in this new financial environment with limited available capital.

Additionally, as discussed in Section III above, "BBB" level utilities were unable to access the credit markets during certain periods of 2008. Achieving an "A" level rating would ensure that the Companies have sustained and reliable access to the credit markets, particularly given the uncertainty as to whether and when the credit markets may again be unavailable to "BBB" level rated businesses.

Achieving an "A" level credit rating would also lower a wide variety of other costs to the Companies, which would ultimately inure to the benefit of ratepayers. For example, improved credit ratings would lower the Companies' insurance costs, and reduce 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. ("NYISO"). These reduced costs will be beneficial to both the Companies and ratepayers over the long term.

Q. How will ratepayers benefit from an "A" level credit rating as a result of NYISO credit requirements?

A. The Companies currently spend approximately $850 million annually purchasing electricity products from the NYISO administered markets. The NYISO has proposed more stringent credit requirements in reaction to the market crisis that could significantly increase costs for the Companies, and ultimately, ratepayers.

In particular, the NYISO has proposed eliminating unsecured credit in all markets. It has also discussed moving to a weekly (rather than monthly) settlement process. While the details of NYISO's credit requirement modification proposals are still being discussed, an "A" level rating would better position the Companies to meet any new requirements while minimizing the impact of any additional costs.

Q. Will the rate increases requested as part of this filing progress the Companies' toward achieving an "A" level credit rating?

A. Yes. The Companies believe that the rate increases requested in this filing will be a critical first step toward improving their credit ratings. As described in further detail in the Direct Testimony of Jeff D. Makholm, allowed returns on equity and the capital structure used to determine the overall cost of capital and fair rate of return have an important impact on the Companies' financial strength. Importantly, Dr. Makholm also opines that a supportive outcome in this case "will be absolutely essential" to avoiding future downgrades and working toward an "A" level rating, which is a goal he found reasonable. The Direct Testimony of Steven M. Fetter similarly concludes that rating agencies are scrutinizing "BBB" level utilities more closely in the current market environment. Mr. Fetter also describes what measures are needed in order to achieve an "A" level credit rating and, with respect to this proceeding, states that the proposed rate increases would be a critical step toward improving the Companies' credit rating.

V. RATE INCREASES ARE NECESSARY SO THAT SAFE AND RELIABLE SERVICE IS NOT PLACED IN JEOPARDY

Q. Why are the Companies filing these rate cases prior to the target period the Commission set forth in the Merger Order?

A. The Companies simply cannot wait that long. Waiting another eight months to file rate cases would jeopardize the Companies' ability to provide safe and reliable service. Under this scenario, the Companies' new rates would not become effective until August 2010 (*i.e.*, after the 11-month process has run). In the immediate interest of protecting both ratepayers and investors, the Companies are seeking the Commission's assistance at this time.

Q. How would waiting an additional eight months to file major rate cases (within the "target period") jeopardize the Companies' ability to provide safe and reliable service?

A. As explained above, the Companies' insufficient cash flows, and the credit and liquidity concerns in the marketplace, along with unusually high uncollectibles, increased operations and maintenance expenses and reduced sales, have pushed them to a dangerous point. The Companies need rate relief in order to perform their basic mandated functions (*i.e.*, to provide safe and reliable service to the public), while at the same time, not further deteriorating the financial condition of the Companies. Additionally, NYSEG and RG&E must have a "liquidity cushion" to allow them to respond properly to emergency situations such as major storms. Currently, this liquidity cushion is virtually non-existent.

Q. Why is a liquidity cushion necessary?

A. A liquidity cushion is critical in these uncertain times so that the Companies can respond to emergency situations, such as major storms or other natural disasters, in an immediate and decisive manner without concerns of how those costs will be funded. When large storms damage their transmission and distribution systems, utilities launch massive, around-the-clock restoration efforts to restore service as quickly as possible. In 2008, the Companies spent approximately $50 million in connection with their response efforts for major storms. These emergency situations by their very nature involve no opportunity to obtain third-party loans or financing, and utilities must be prepared to address these situations with their available liquidity. The Companies believe that a liquidity cushion equal to approximately 50% of their revolving credit facilities (*i.e.*, $80 million for NYSEG and $50 million for RG&E) is needed.

Q. Are the Companies required to make certain levels of capital expenditures under the Commission's Merger Order?

A. Yes. Pursuant to the Commission's Merger Order, NYSEG is required to make capital expenditures in 2009 and 2010 of no less than an average of $140 million per year for its electric system and no less than an average of $20 million per year for its gas system. Similarly, RG&E is required to make capital expenditures of no less than an average of $90 million per year for its electric system and no less than an average of $20 million per year for its gas system. In total, the Merger Order requires the Companies to make capital expenditures in the amount of $540 million in 2009 and 2010. For years after 2010, NYSEG and RG&E are required to make capital expenditures at no less than 90 percent of these levels.[26]

Q. Why do the Companies need rate relief in order to meet the capital expenditure levels from the Merger Order?

A. Extensive capital expenditures, by their very nature, require significant reliance on the capital markets and, as illustrated throughout this Policy Panel testimony, the cost of capital is significantly higher than it was during the merger proceeding. Moreover, the market for capital will only become more competitive, because other utilities (and other industries) around the nation have similar capital needs and the amount of available capital (and interested debt and equity investors) has decreased. Therefore, we expect capital costs to continue to rise. It becomes a severe challenge for utilities, particularly lower rated utilities, to make the same level of new infrastructure investments without rate increases that acknowledge the unprecedented and unpredictable increase in cost of capital that has placed utilities in such a difficult position.

Q. Have the Companies identified any other capital expenditure projects that would promote safe and reliable service?

A. Yes. As described in further detail in the Direct Testimony of the CRO Panel, the Companies have identified certain other key infrastructure investment projects that will require capital expenditures significantly in excess of the levels set forth in the Merger Order. The Companies would only be able to pursue these important investment projects with rate relief.

26 Merger Order, Appendix 2, ¶ 2.

Q. Have you analyzed the Companies' funding needs for 2009 and 2010?

A. Yes. In order to finance the $540 million of necessary capital expenditures called for in the Merger Order (let alone the additional capital expenditure projects that are identified in the CRO Panel), to pay off short-term borrowings from Energy East, to free up 50% of the Companies' lines of credit to provide financial flexibility for unexpected expenditures, to refinance expected maturities of long-term debt, and to resume dividend payments, RG&E and NYSEG face cumulative funding requirements of $500 and $390 million, respectively, in 2009 and 2010. These amounts are shown on Exhibit __ (PP-4).

Q. Absent rate relief, how would these funds be raised?

A. The Companies would have to rely on the long-term debt markets and likely pay interest rates of 8% or more, given the recent issuance at RG&E. This would result in significantly higher costs for ratepayers in the long term.

Q. Is it feasible to assume that the Companies could raise those amounts of capital solely from the debt markets?

A. No. As an initial matter, given the current state of the financial markets, it is less than clear whether the Companies can even raise those amounts. But assuming they could, we have calculated the resulting ratios for two of the critical metrics that Moody's reviews when assessing a company's credit rating – Funds Flow Interest Coverage, and Funds from Operations to Total Debt. As shown in Exhibit __ (PP-4), 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 (i.e., below investment grade), and near or below the bottom of the same range for NYSEG.

Q. Would your answer change if the Companies only spent the $540 million required by the Merger Order?

A. No. The credit metrics would not change measurably from those shown on Exhibit __ (PP- 4), and both Companies would be facing significant credit downgrade risk.

Q. Why don't the Companies simply have their parent companies finance incremental funding requirements with infusions of equity?

A. The Companies' parent companies have already provided extensive assistance to the Companies in the form of short-term borrowings and foregone dividends. NYSEG and RG&E are stronger than they would otherwise be with Iberdrola as their ultimate upstream parent, as reflected in S&P's improved outlook for the Companies from "Negative" to "Stable". However, being indirect subsidiaries of a strong parent company does not mean that the parent company can or should subsidize its operating utility subsidiaries, particularly when equity returns are below reasonable levels and approximating the after-tax cost of debt. Like any potential investor, decisions by a parent company to invest equity in its subsidiaries are based upon available capital and the merits of balancing risk and return. Absent the rate relief requested in this filing, the returns on equity permitted by this Commission are significantly less than today's equity cost of capital and returns that can be expected from other investments with a similar risk profile.

DIRECT TESTIMONY OF THE POLICY PANEL

Q. What do you conclude from this analysis?

A. In order to return to a position of sufficient financial flexibility for the provision of safe and reliable service, the Companies will require substantial funding requirements during 2009 and 2010. Absent rate relief, and if financed with debt, these requirements would threaten the Companies' already weak "BBB" level credit ratings. Conversely, if returns of and on capital are permitted that are reflective of risk and consistent with the cost of capital in the current market, then the Companies will have sufficient access to equity and debt investment at reasonable rates to fund needed spending, which will lower costs for ratepayers and ensure that the Companies can provide safe and reliable service to customers.

Q. Are there adequate incentives in place to encourage equity investors to invest capital into the Companies?

A. No. Just as the Companies face increased competition in the new marketplace to issue new debt, they face greater competition attracting equity investments since the onset of the financial crash. It is unrealistic to expect that equity investors will choose to place capital in entities that do not provide adequate returns. As noted above, the Companies have already stopped payment of dividends to their shareholder. This option is not a viable long-term solution to the Companies' deteriorating financial condition and certainly runs counter to the need to encourage further equity investment in the Companies.

DIRECT TESTIMONY OF THE POLICY PANEL

Q. How will the Companies' proposed rate increases promote safe and reliable service?

A. The proposed increases will assist the Companies' efforts to perform their basic operation and maintenance duties and fund capital expenditures. As Chairman Brown recently noted in his statements to the FERC, "it is important to recognize the economic realities of a recession and expect utilities to take a hard look at their capital programs with an eye toward prioritizing." *See* Exhibit __ (PP-3). In the absence of rate relief, the Companies would be forced to evaluate investment projects on a case-by-case basis, and some projects will likely be deferred so that the Companies have adequate liquidity to perform basic operation and maintenance of their transmission and distribution systems.

Q. Have you analyzed the impact of the requested rate relief on the Companies' funding requirements and resulting credit metrics?

A. Yes. Exhibit __ (PP-6) shows the impact of rate relief on the Companies' funding requirements. With such rate relief, the Companies are able to earn a reasonable rate of return on invested capital. The increased net income and cash flows help to improve Moody's two key credit ratios. Therefore, it is reasonable to assume that the rate relief requested will allow the Companies to maintain their credit ratings and finance the funding requirements consistent with the capital structure requested – 47% equity for RG&E and 48% for NYSEG – which will help the Companies set a course to move to an "A" level credit rating over the next few years.

VI. MERGER SAVINGS

Q. What obligations do the Companies have with respect to any costs or savings related to operational changes resulting from their merger with Iberdrola?

A. Pursuant to the Merger Order, the Companies must provide "all studies, analyses and related work papers prepared by Iberdrola, its subsidiaries, affiliates, or agents that identify or quantify the costs and savings related to merger synergies, efficiency gains, and the adoption of utility best practices that in any way affect the management, operation and underlying costs of NYSEG's and RG&E's utility business."[27]

Q. Have any merger savings been identified?

A. No. The merger was not intended to create any merger savings, and no such merger savings have been identified. In fact, because the Companies have determined that no such savings were likely, no studies or analyses were performed.

VII. IMPLEMENTATION OF POSITIVE BENEFIT ADJUSTMENTS

Q. Please explain how the Companies have implemented the PBAs required by the Merger Order.

A. Pursuant to the Merger Order, the Commission directed the Companies to defer the PBAs for disposition in NYSEG's and RG&E's future rate proceedings.[28] Per the Commission's instructions, NYSEG and RG&E have already recorded the

[27] Merger Order, at 140-41.

[28] Merger Order, at 138.

PBAs on their books effective as of the acquisition's closing date (*i.e.*, September 16, 2008) among the Companies' four departments in proportion to the departments' respective delivery revenues for calendar year 2007. Pending their disposition, the PBAs are accruing interest at the respective Companies' allowed pre-tax rates of return (even though projected equity returns for 2009 are substantially below those deferred interest rates).

Q. How are the Companies proposing to implement the PBAs in this rate proceeding?

A. The implementation of the PBAs in this rate proceeding should accomplish three important goals. First, the PBAs should be implemented in a manner that minimizes rate changes and fluctuations. Second, PBA implementation must ensure that ratepayers receive the full benefit of the PBAs. Third, in light of the financial crisis discussed at length above, the PBAs should be implemented in a manner that minimizes adverse effects on the Companies' financial situation. With these goals in mind, the Companies are proposing to amortize $95.3 million of the PBAs annually over the next 3-4 years to offset the proposed rate increases, as discussed in further detail in the Direct Testimony of the Revenue Requirement Panel.

VIII. CAPITAL STRUCTURE AND RING FENCING

Q. What type of capital structures are the Companies proposing for ratemaking purposes?

A. The Companies are proposing the use of the standalone capital structures of NYSEG and RG&E for ratemaking purposes, rather than a consolidated approach.

Q. Why is the use of a standalone capital structure appropriate?

A. The use of standalone capital structures is appropriate because NYSEG and RG&E are standalone corporate entities that operate independently from their holding companies. Additionally, as described below, the Companies implemented numerous bankruptcy protection and other "ring-fencing" measures in connection with their merger with Iberdrola. As discussed in more detail in the Direct Testimony of Steven M. Fetter, these measures are consistent with the Moody's ring-fencing guidelines. As a result, these ring-fencing provisions support the use of a standalone capital structure for NYSEG and RG&E.

Q. Please describe the corporate separation between NYSEG and RG&E and their holding companies.

A. NYSEG and RG&E are standalone corporate entities that operate independently from their holding companies. Each of NYSEG and RG&E holds its own assets, keeps its own independent books and records, and issues it own debt. Additionally, each of NYSEG and RG&E hold independent credit ratings from each of the major rating agencies, and their credit ratings are different from those of both Energy East and Iberdrola.

Q. What additional "ring-fencing" measures have the Companies implemented since their merger with Iberdrola?

A. Since the merger, NYSEG and RG&E have taken extensive and numerous measures to ensure financial separation from Energy East and Iberdrola, in compliance with Appendix 1 of the Commission's Merger Order. Those measures include bond rating covenants, restrictions on asset transfers and lending, money pool restrictions, and cross-default prohibitions.

In particular, the Merger Order includes the following ring-fencing requirements:

- **Separate Bond Ratings:** Iberdrola, Energy East, NYSEG and RG&E must maintain separate bond ratings with major nationally and internationally recognized bond rating agencies, such as Standard & Poor's, Moody's Investor Service, and Fitch Ratings.
- **Restrictions on Asset Transfers:** Ratings downgrades trigger a prohibition on the Companies' ability to transfer, lease or lend any money, assets, rights or other items of value to any affiliate without obtaining prior Commission approval.
- **Dividend Restrictions:** The Companies must refrain from paying common dividends if the bond rating on Iberdrola's, Energy East's or their own least secure forms of debt issued falls to the lowest investment grade rating and there is a negative watch or review downgrade notice, as determined by a nationally recognized rating agency or if the bond rating falls to non-investment grade with no notice. Additionally, dividends

from the Companies generally may not exceed 100% of their earnings in a given year.

- **<u>Code of Conduct</u>:** The Companies must operate pursuant to a Code of Conduct that governs affiliate transactions and prohibits the Companies from providing service to affiliates on preferential terms.
- **<u>Money Pool Restrictions</u>:** NYSEG and RG&E may only participate in a money pool if all other participants (with the exception of Iberdrola, Energy East and RGS) are regulated utilities operating within the United States, in which case NYSEG or RG&E may participate as either a borrower or lender. Furthermore, Iberdrola, Energy East, and RGS may only participate as lenders in money pools involving NYSEG or RG&E. This means that neither NYSEG nor RG&E may participate in a money pool in which there is a loan or transfer of funds to Iberdrola, Energy East or RGS.
- **<u>Cross Defaults</u>:** Neither Iberdrola nor Energy East is permitted to have any cross-default provisions that would affect NYSEG or RG&E in any manner.

Q. What bankruptcy protection measures have the Companies undertaken in addition to the “ring-fencing” described above?

A. NYSEG and RG&E are modifying their corporate by-laws to establish an independent consent right to prevent a bankruptcy, liquidation, receivership, or similar proceeding at either Company from being caused by the bankruptcy of Iberdrola, Energy East or any of their affiliates. This consent right will take the form of a class of preferred stock, whereby NYSEG or RG&E may only commence voluntary bankruptcy with the consent of such shareholder(s). NYSEG and RG&E have already filed petitions with the Commission seeking authority to establish this class of preferred stock. This bankruptcy protection measure, along with the other "ring-fencing" and corporate separation protections described above, support the use of a standalone capital structure for ratemaking purposes.

Q. Have you compared these ring-fencing provisions to those required by the rating agencies?

A. As described in detail in the Direct Testimony of Steven M. Fetter, these ring-fencing provisions are consistent with the Moody's ring-fencing guidelines. As a result, these ring-fencing provisions support the use of a standalone capital structure for NYSEG and RG&E.

Q. What is the significance of the conclusion that these ring-fencing provisions are sufficient to support the use of a standalone capital structure for NYSEG and RG&E?

A. Isolating RG&E and NYSEG through ring-fencing provisions makes it important and appropriate for the Companies to stand on their own with regard to cash flows, liquidity, and balance sheet strength because these standalone factors will form the basis for the rating agencies assessment of the creditworthiness of the Companies. As we have discussed, rating agency assessments and credit ratings will have a major impact on the Companies' ability to provide safe and reliable service, particularly in the current market environment.

DIRECT TESTIMONY OF THE POLICY PANEL

IX. ENERGY EFFICIENCY

Q. Please describe the Companies' proposal to expedite the implementation of energy efficiency programs in their service territories.

A. Governor Paterson announced this month his "45 by 15" plan and determined that energy efficiency measures will be an important goal for New York State. Since the acquisition of Energy East by Iberdrola, the Companies have shifted their focus and energy efficiency is now a top priority for them, notwithstanding the financial difficulties they currently face. Accordingly, the Companies have begun a management initiative to develop a new energy efficiency plan so that they can become a leader on energy efficiency matters in the State. The Companies acknowledge that significant work must be done in this regard, and want to develop a working dialogue with the Commission and with Staff on energy efficiency measures that can be implemented in the near and medium term. As an initial step, the Companies are seeking to expedite the implementation of energy efficiency programs in their service territories. In particular, as described in further detail in the Direct Testimony of the Delivery Rate Design Panel, the Companies will be proposing modifications to their 90-day energy efficiency plans to emphasize an "agile" rather than uniform state-wide standardized model. The Companies believe that this model will maximize savings, optimize emerging market and technological opportunities, and better accommodate changing customer demands for energy efficiency services and products. The Companies will be seeking to work with the Commission and Staff to test this model with the hopes that it will benefit both their customers and New York State generally. The Companies believe that these modifications will allow them to provide energy efficiency opportunities to their customers as quickly as possible.

X. CONCLUSION

Q. Does this complete the Policy Panel's direct testimony at this time?

A. Yes, it does.