

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
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Case 09-G-

**DIRECT TESTIMONY OF
THE POLICY PANEL**

**Steven R. Adams
Michael H. Conroy
Joseph J. Syta**

September 17, 2009

DIRECT TESTIMONY OF THE POLICY PANEL

1

I. INTRODUCTION

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

3 A. Our names are Steven R. Adams, Michael H. Conroy, and Joseph J. Syta.

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

5 A. My title is Vice President – Regulatory Policy of Energy East Management

6 Corporation. My business address is 52 Farm View Drive, New Gloucester,

7 Maine 04260.

8 Q. Please summarize your educational background and work experience.

9 A. I have a Bachelor of Science Degree in Business Administration from James

10 Madison University and I am a Certified Public Accountant in Virginia. In 1995,

11 I joined New York State Electric & Gas Corporation (“NYSEG”) in its Gas Rate

12 Department. In 2001, I became Director – Rates and Regulatory Economics for

13 Energy East Management Corporation. In 2005, I assumed my current position.

14 From 1987 to 1995, I was employed at the Virginia State Corporation

15 Commission where I worked on utility rate applications with primary

16 responsibilities associated with accounting and tax issues for electric, gas and

17 water utility filings.

18 Q. Have you previously testified in other proceedings before the New York State

19 Public Service Commission (“Commission”) or another state or federal regulatory

20 agency or court?

21 A. Yes. I have testified in Connecticut, Maine, New York and Virginia. I previously

22 offered testimony before this Commission in support of NYSEG’s and Rochester

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1 Gas and Electric Corporation’s (“RG&E” and together, the “Companies”) January
2 2009 rate filings in Case 09-E-0082 *et al.* and in Case 07-M-0906 regarding the
3 indirect acquisition of NYSEG and RG&E by Iberdrola, S.A. (“Iberdrola”).

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

5 A. My title is Senior Vice President and Chief Operating Officer. My business
6 address is 89 East Avenue, Rochester, New York 14649.

7 Q. Please summarize your educational background and work experience.

8 A. I received a B.S. degree in Electrical Engineering from Cornell University, and
9 M.B.A. from the University of Southern Maine. I was employed by Central
10 Maine Power Company (“CMP”) from 1979 through 2002, serving in a variety of
11 technical, supervisory and managerial positions. I left CMP as Vice President of
12 Marketing and Economic Development to join NYSEG and RG&E in January
13 2003 as Vice President – Electric Technical Services. In September 2003, I was
14 assigned the added responsibility of Gas Technical Services. I assumed the
15 position of Vice President, Operations, in 2004. I assumed my current position of
16 Senior Vice President and Chief Operating Officer in August 2009.

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

19 A. Yes. I have previously testified in New York and Maine. I previously offered
20 testimony before this Commission in support of the Companies’ January 2009
21 rate filings in Case 09-E-0082 *et al.* and in Case 07-M-0906 regarding the indirect
22 acquisition of NYSEG and RG&E by Iberdrola. I also testified in Cases 03-E-
23 0765, 03-G-0766 and 05-E-1222.

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

2 A. My name is Joseph J. Syta, and I am Vice President, Controller and Treasurer of
3 NYSEG and RG&E. My business address is 89 East Avenue Rochester, New
4 York 14649.

5 Q. Please summarize your educational background and work experience.

6 A. I have an undergraduate degree in management from Rensselaer Polytechnic
7 Institute. I am also a graduate of the William E. Simon School of Business,
8 University of Rochester, with an M.B.A. degree in Accounting. I have been
9 employed by RG&E for over 24 years. I assumed my present position in 2004
10 with the responsibility for financial accounting and reporting, as well as other
11 accounting functions. Before then, I held the position of Controller and Treasurer
12 for RG&E and NYSEG.

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

15 A. I have testified before the Commission in numerous cases dating back to 1989.
16 Most recently, I testified in support of the Companies' January 2009 rate filings in
17 Case 09-E-0082 *et al.* and in Case 07-M-0906 regarding the indirect acquisition
18 of NYSEG and RG&E by Iberdrola.

19 Q. What is the overall purpose of your testimony?

20 A. The purpose of our testimony is to: (i) provide a general overview of the
21 Companies' rate filings and the requested rate increases; (ii) explain how the
22 Companies' requested rate increase is consistent with the draft State Energy Plan;
23 (iii) discuss the importance of improving the Companies' financial condition,

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1 including working toward an “A” level credit rating over the next few years; (iv)
2 set forth the need for sustained regulatory support from the Commission to allow
3 the Companies to achieve timely, predictable and sufficient cost recovery, as well
4 as fair and reasonable return on investment; (v) discuss and recognize the
5 extensive parent company support the Companies have received (and continue to
6 receive) and the cost savings measures the Companies have implemented (which
7 do not resolve the Companies’ financial issues); (vi) explain the Companies’
8 proposal to apply positive benefit adjustments (or “PBAs”) to rates in a manner
9 that balances ratepayer benefits with the Companies’ need to improve their
10 financial health; (vii) review the results of Booz & Company’s merger savings
11 report, which identified no material synergy savings resulting from the merger
12 with Iberdrola; (viii) discuss the Companies’ request for a limited modification of
13 their capital expenditure requirements set forth in the Commission’s January 9,
14 2009 Order Authorizing Acquisition Subject to Conditions in Case 07-M-0906
15 (the “Merger Order”), in that the Companies would continue to be obligated to
16 satisfy all cumulative capital spending required by 2011, without any independent
17 interim capital spending requirement prior to 2011; and (ix) discuss the
18 Companies’ willingness to enter into a multi-year rate plan through a settlement
19 process with the Department of Public Service (“DPS”) Staff and other interested
20 parties. Additionally, this testimony will explain how the Companies’ delivery
21 rates have remained essentially flat since the mid-1990’s.

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1 Q. Is this Panel sponsoring any exhibits?

2 A. Yes. Exhibit __ (PP-1) sets forth the Companies' projected capital expenditures
3 for 2009-2011. Exhibit __ (PP-2) shows the Companies' annual dividend
4 payments from 2002 to 2009.

5 **II. RATE CASE OVERVIEW**

6 Q. Please provide a general overview of the Companies' rate filings and their
7 requests for rate relief.

8 A. As described herein, the Companies are requesting rate relief to help ensure the
9 provision of safe and adequate service, to avoid further financial degradation and
10 begin to improve their overall financial health. RG&E's electric delivery rates
11 have not increased since 1996, and NYSEG's delivery rates have been reduced
12 twice since 2001. Both Companies' natural gas delivery rates have been
13 essentially flat since 1994. Moreover, as the Direct Testimony of Susan Abbott
14 discusses, rate increases will put the Companies on a path to achieve "A" level
15 credit ratings, which will benefit both the Companies and their customers. Rate
16 increases are also necessary to reflect the increased cost of equity capital in the
17 current financial markets, as discussed in the Direct Testimony of Dr. Jeff D.
18 Makholm.

19 Q. What do the Companies' rate filings specifically entail?

20 A. The Companies' proposed delivery rate increases are designed to produce a total
21 annual revenue increase of approximately \$383.4 million collectively for the
22 Companies, which represents an additional \$169.7 million for NYSEG Electric,

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1 \$63.4 million for NYSEG Gas, \$87.4 million for RG&E Electric, and \$62.9 for
2 RG&E Gas. The increases are necessitated by a reduction in sales, increased cost
3 pressures (such as rising property taxes and pension expenses) and the need for
4 more timely cost recovery. The increases also support major capital transmission
5 and distribution system investment to address growth and serve customers, meet
6 regulatory requirements, support renewable generation and provide systematic
7 infrastructure improvements. The infrastructure investments feature the
8 introduction of a substantial Grid Modernization Initiative (“GMI”) designed to
9 replace aging infrastructure while injecting newer technology to support the
10 improved operation and reliability of the electric system. The GMI supports the
11 draft State Energy Plan because it provides for systematic investment in the
12 replacement and modernization of the Company’s infrastructure. The Companies
13 propose additional maintenance for reliability, most notably through a full-cycle
14 distribution line clearance program. The Companies also propose a new,
15 enhanced low income program for its electric and gas businesses, consisting of
16 bill reductions, arrears forgiveness and referrals for energy efficiency measures.
17 The Companies’ filings also include proposals related to the implementation of
18 revenue decoupling mechanisms, modifications to service quality measures, a
19 symmetrical true-up of delivery and supply uncollectible expense, additional
20 customer deposits, credit card payment option, revenue allocations and rate
21 design, and various tariff modifications.

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1 Q. How are the Companies’ rate filings consistent with the draft State Energy Plan
2 (“Plan”)?

3 A. The Plan released for review and comment in August 2009 includes a number of
4 policy objectives and recommendations aimed at improving energy efficiency,
5 system reliability, and the development of renewable energy resources. The Plan
6 highlights the dependence of New York’s businesses and residents on reliable
7 energy and a robust delivery infrastructure, and recognizes that substantial
8 investments must be made to modernize aging infrastructure. NYSEG and RG&E
9 support the policy recommendations contained in the Plan, and the Companies
10 will do their part to help New York State achieve the goals and objectives laid out
11 in the Plan. As discussed in the Direct Testimony of the Capital Expenditures,
12 Reliability and Operations Panel, the Companies’ proposed capital expenditures
13 support renewable generation through hydroelectric projects and farm digester
14 collection systems, provide substantial investment in grid modernization, and
15 improve reliability through multiple “state of good repair” projects and programs,
16 which will avoid larger and more expensive investments in the future. All of
17 these proposed investments are consistent with the goals of Plan.

18 Q. How does the Companies’ overall financial health compare to how it was in
19 January 2009?

20 A. While the liquidity crisis that the Companies faced last January has subsided
21 somewhat, their overall financial condition continues to deteriorate. Both
22 NYSEG’s and RG&E’s credit ratings were downgraded following the issuance of
23 the Commission’s April 8, 2009 Order Dismissing the January 2009 Rate Filings

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1 in Case 09-E-0082, *et al.* (the “April 2009 Order”). Moody’s downgraded both
2 NYSEG and RG&E from “Baa1” to “Baa2” on April 8, 2009, and S&P
3 downgraded RG&E from “BBB+” to “BBB” on April 9, 2009. Finally, the
4 Companies’ earned equity returns for the test year were approximately 5% for all
5 businesses (excluding the impact of the September 2008 PBA expense).

6 Q. Are the Companies facing any new financial pressures since the April 2009 Order
7 was issued?

8 A. Yes. The Companies’ unit sales have continued to decrease throughout 2009,
9 while deferral balances, pension expense, property taxes and uncollectible
10 expense have continued to increase. The Companies are also facing new financial
11 pressures such as the recent increase in the Temporary State Assessment
12 Surcharge on utilities, which will add an estimated \$37 million to the Companies’
13 expected 2009 cash shortfalls, absent Commission action on the Companies’ to be
14 filed petition to accelerate the recovery of the temporary assessment amount. The
15 Companies were also facing dramatic 2009 under-collection of commodity costs
16 until the Commission authorized the Companies to make interim adjustments to
17 their non-bypassable charges (“NBC”) to improve these under-collections in its
18 May 18, 2009 Order Authorizing Interim Adjustments to Non-Bypassable Wires
19 Charges in Cases 09-E-0228, *et al.* (the “NBC Order”). The Commission
20 acknowledged in the NBC Order that the Companies “would confront
21 unanticipated difficulties in executing their responsibilities to manage their cash
22 flows” without “adjustments to enhance recovery of these costs.” The Companies
23 appreciate the Commission’s assistance on this issue.

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1 Q. How would the Companies’ request for rate relief impact customers’ overall
2 energy bills?

3 A. As described in the Direct Testimony of the Revenue Allocation and Rate Design
4 Panel, the Companies’ requested rate increase will result in an average 15-19%
5 impact on a customer’s total bill. In fact, when comparing the average residential
6 customer’s total bill to the average total bill paid during 2008, after applying the
7 requested delivery rate increases and using currently projected market prices,
8 many customers may see lower average total bills than in 2008.

9 **III. NYSEG, RG&E AND THEIR PARENT COMPANIES HAVE TAKEN**
10 **AGGRESSIVE MEASURES TO IMPROVE THE COMPANIES’ FINANCIAL**
11 **HEALTH**

12 Q. What steps have the Companies taken to improve their financial health and work
13 towards “A” level credit ratings?

14 A. Consistent with the Commission’s directive in the April 2009 Order, the
15 Companies have been working to improve their financial condition through a
16 combination of retaining all earnings, implementing austerity measures, and
17 minimizing uses of cash to avoid additional long-term debt issuances. The
18 Companies’ aggressive cash and cost management measures, most of which can
19 only be temporary in nature, are described in Section III.A below. As part of
20 these temporary cash management measures, NYSEG and RG&E have not made
21 any dividend payments to their parent company since the merger closing. In fact,
22 the Companies are not currently projecting any dividend payments to their parent
23 company while these rate cases are pending. Additionally, as discussed in more

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1 detail in Section III.B below, NYSEG’s and RG&E’s parent companies have
2 provided strong support to the Companies, including the aforementioned cessation
3 of dividends, temporary loans, and Iberdrola’s assumption of Energy East’s debt
4 and related equity infusion into Energy East. Additionally, Energy East will also
5 make a \$25 million equity infusion into RG&E in the fourth quarter of 2009. It is
6 important to note that while these steps are significant, Iberdrola and Energy East
7 cannot bring financial stability to the Companies on their own. As Susan Abbott
8 testifies, the Companies are viewed by the rating agencies on a standalone basis,
9 and the Companies need regulatory support in the form of adequate rate relief
10 from the Commission in order to improve their financial health and work together
11 toward “A” level credit ratings.

12 **A. Cost Savings Measures**

13 Q. What cost savings measures have the Companies implemented in an attempt to
14 alleviate liquidity concerns and avoid further financial decline?

15 A. Consistent with the Commission’s directive in its May 15, 2009 Notice Requiring
16 the Filing of Utility Austerity Plans in Case 09-M-0435 (the “Austerity Notice”)
17 that each utility “closely examine . . . expense areas over which it has discretion to
18 identify costs that may be reduced”, the Companies have implemented aggressive
19 cash and cost management measures across the Companies, many of which are
20 temporary in nature. As described in the Companies’ June 12, 2009 report in
21 response to the Commission’s Austerity Notice, the cash conservation measures
22 that the Companies have implemented include delayed payments to vendors
23 whenever possible and consistent with their contractual obligations, tax deferral

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1 strategies, and aggressive measures to reduce costs, which include the following
2 actions: pay and hiring freezes, reduced overtime, reduced employee travel,
3 reduced employee benefits, inter-company borrowing (as opposed to external debt
4 issuances) to mitigate increases to their overall cost of debt, reduced charitable
5 contributions and sponsorships, reduced association memberships, and reduced
6 external services. The Companies have also taken further measures to reduce the
7 costs associated with advertising, membership dues, insurance and postage.
8 Moreover, the Companies continue to scrutinize every aspect of their businesses
9 to identify possible cost reductions that would not adversely impact their ability to
10 provide safe and adequate service.

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

13 A. No. These cost-cutting measures have helped the Companies to avoid even more
14 severe financial degradation. However, even the most aggressive cost reduction
15 measures cannot restore the Companies' overall financial health. Only rate relief
16 can begin to address the fundamental issues confronting the Companies.

17 Q. What cash management measures have the Companies implemented with respect
18 to capital expenditures?

19 A. In an effort to reduce costs during the financial crisis, the Companies have
20 reduced and deferred certain capital expenditures while maintaining their ability
21 to provide safe and adequate service. As a result, the Companies are seeking a
22 modest modification of the Merger Order's capital expenditure requirements as
23 part of this proceeding. The Commission has required \$540 million of capital

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1 expenditures through 2010 and an additional \$243 million for 2011. The
2 Companies are not seeking to reduce these capital expenditure requirements, but
3 instead are seeking to meet them in the aggregate by the end of 2011. The
4 Companies are currently projecting capital expenditures of approximately \$193
5 million in 2009, and with appropriate rate relief, approximately \$277 million in
6 2010, and approximately \$556 million in 2011, for a total of approximately \$1
7 billion in cumulative spending for the three year period. See Exhibit __ (PP-1).
8 Thus, with the requested rate relief, the Companies project that they will satisfy
9 (and likely exceed) the \$783 million in capital expenditure requirements in the
10 Merger Order, on a cumulative basis, by the end of 2011.

11 Q. Is this modest modification of the capital expenditure requirements from the
12 Merger Order consistent with Commission policy?

13 A. Yes. The Companies' request is consistent the Commission's directive in its
14 Austerity Notice that each New York utility "closely examine its capital
15 expenditures, operation and maintenance expenses and any other expense areas
16 over which it has discretion to identify costs that may be reduced without
17 impairing the ability to provide safe and adequate service." This request is also
18 consistent with Chairman Brown's January 13, 2009 comments in the Federal
19 Energy Regulatory Commission's Technical Conference on Credit and Capital
20 Issues Affecting the Electric Power Industry, Docket No. AD09-2-000, that
21 utilities should "take a hard look at their capital programs with an eye toward
22 prioritizing" in light of the financial crisis, and that projects "that are discretionary
23 and can be deferred should be evaluated on a case by case basis as to whether

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1 customers are best served by going forward with the projects at this time.”

2 Finally, this modest modification of the capital expenditure requirements from the
3 Merger Order will not have any negative impact on customers. In fact, smart
4 management of capital expenditures benefits customers by minimizing the level
5 of necessary expenditures and corresponding rate increases for the rate year
6 without compromising safe and adequate service.

7 **B. Strong Parent Company Support**

8 Q. What measures have NYSEG’s and RG&E’s parent companies taken to assist the
9 Companies during the ongoing financial crisis?

10 A. Iberdrola and Energy East have provided strong parent company support to
11 NYSEG and RG&E throughout the financial crisis. Most importantly, NYSEG
12 and RG&E have not made any dividend payments to their parent company since
13 the merger closing. In fact, Energy East will be making a \$25 million equity
14 infusion into RG&E in the fourth quarter of 2009, and NYSEG and RG&E are not
15 currently projecting any dividend payments to their parent company while these
16 rate cases are pending. Moreover, as Exhibit __ (PP-2) illustrates, while NYSEG
17 made an average annual dividend payment of approximately \$109 million from
18 2002-2007, NYSEG’s average annual dividend payment during the 2008-2009
19 period will be only \$30 million. Similarly, Exhibit __ (PP-2) shows that while
20 RG&E made an average annual dividend payment of approximately \$68 million
21 from 2002-2007, RG&E’s average net dividend payment for the 2008-2009
22 period will be \$0.

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1 Q. What other types of support have NYSEG’s and RG&E’s parent companies
2 provided?

3 A. NYSEG’s and RG&E’s parent companies also have provided in excess of \$100
4 million in temporary loans to NYSEG and RG&E to support them during certain
5 months of the financial crisis. Parent company support did not end there. In
6 April 2009, Iberdrola assumed \$1.3 billion of Energy East’s debt, which included
7 a \$250 million equity contribution to Energy East.

8 Q. How did the credit rating agencies view Iberdrola’s equity contribution to Energy
9 East and assumption of Energy East debt?

10 A. All three rating agencies viewed Iberdrola’s equity contribution and assumption
11 of this debt favorably, reflecting strong parent company support. In its April 8,
12 2009 rating action, Moody’s upgraded certain Energy East debt securities “given
13 the added support of an Iberdrola S.A. guarantee,” which it viewed as a “strong
14 credit positive.” The next day, S&P noted “in our view, [Iberdrola] has
15 unequivocally expressed its full support for its U.S. subsidiary,” and upgraded
16 Energy East’s credit rating from “BBB+” to “A-”. On July 9, 2009, Fitch
17 upgraded Energy East from “BBB” to “BBB+”, citing this assumption of debt as
18 an indicator of Iberdrola’s “tangible support” and noting that the rating agency
19 “considers the inter-company loan to be ‘equity like’ in nature.” Both Iberdrola
20 and Energy East now have higher credit ratings from S&P and Fitch than the
21 Companies.

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1 Q. Can these examples of strong parent company support replace the Companies’
2 need for rate relief?

3 A. No. While strong parent company support has allowed the Companies to mitigate
4 partially the negative impacts of the financial crisis thus far, continuing to
5 withhold dividends and relying upon such extensive parent company support is
6 not an appropriate long-term solution to the Companies’ financial problems. As
7 the Commission noted in the April 2009 Order, foregoing/withholding dividends
8 “does not represent a sustainable long-term solution to any cash flow problems”
9 since “[h]olders of utility stocks typically expect dividend payments and price
10 utility stocks with that expectation in mind.” As explained in the testimony of
11 Susan Abbott, improving the Companies’ credit ratings and overall financial
12 health requires strong support not only from parent companies, but more
13 importantly from regulators. Iberdrola and Energy East cannot bring financial
14 stability to the Companies on their own, particularly since, as Susan Abbott
15 testifies, the rating agencies evaluate the Companies on a standalone basis.
16 Therefore, regulatory support in the form of adequate rate relief from the
17 Commission will allow the Companies to begin to restore their overall financial
18 health and place them on a path to achieve “A” level credit ratings.

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1 **IV. THE COMPANIES NEED RATE RELIEF TO BEGIN TO RESTORE**
2 **THEIR FINANCIAL HEALTH**

3 **A. Credit Rating Improvement**

4 Q. Did the Commission's April 2009 Order dismissing the Companies' rate filings
5 affect the Companies' credit ratings?

6 A. Yes. Moody's reacted by immediately downgrading both Companies one notch
7 (from "Baa1" to "Baa2"). S&P also immediately downgraded RG&E one notch
8 (from "BBB+" to "BBB"), while maintaining NYSEG's "BBB+" rating.

9 Q. Have the rating agencies responded to other recent ratemaking orders issued by
10 the Commission?

11 A. Yes. Moody's downgraded Consolidated Edison Company of New York, Inc.
12 ("Con Ed") two notches (from "A1" to "A3") following the Commission's recent
13 rate order awarding Con Ed a 10% return on equity using a 48% equity capital
14 structure. Moody's reaction also provides further evidence that the rating
15 agencies do not view New York as a favorable regulatory environment. As both
16 Susan Abbott and Dr. Jeff Makholm explain in their testimony, Regulatory
17 Research Associates and all the rating agencies maintain a generally unfavorable
18 view of the New York regulatory environment for these same reasons. In fact,
19 Moody's recently stated in its April 21, 2009 report that a "key rating concern"
20 for both Companies is their "regulatory relationship in New York, where the
21 NYSPSC has been unsympathetic to the [Companies'] views about the need for
22 rate relief and has been demonstrating a tendency to rely upon much lower
23 allowed returns on equity when setting base revenue requirements for utilities

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1 under its jurisdiction.” As the Commission itself recently noted in a June 30,
2 2009 letter to Assemblyman Kevin Cahill in Cases 08-E-0887 and 08-G-0888 (the
3 “Cahill Letter”), the Commission’s allowed returns on equity are “among the
4 lowest equity returns in the country.”

5 Q. Please describe the benefits of working toward achieving “A” level credit ratings
6 at the Companies.

7 A. As the Commission acknowledged in the April 2009 Order, “there is no reason
8 why the State’s utilities should not strive for ratings in the ‘A/A’ category.” The
9 Companies agree. Working toward achieving “A” level credit ratings will benefit
10 the Companies and their customers in both the short and long term. As Susan
11 Abbott testifies, “A” level credit ratings would provide the Companies with
12 increased access to capital on preferable terms and conditions, as well as a lower
13 overall cost of capital. Susan Abbott similarly agrees with the Commission’s
14 statements that working to achieve an “A” level credit rating is even more
15 important in light of the recent turmoil in the financial markets that has occurred
16 over the past year. As the Commission acknowledged in the April 2009 Order,
17 “an ‘A/A’ rating has a much lower interest rate cost than a ‘BBB/Baa’ rating in
18 times of uncertain economic conditions, such as the present.”

19 Q. How will rate relief in this proceeding help the Companies to move toward an
20 “A” level credit rating?

21 A. Sustained regulatory support from the Commission in the form of timely cost
22 recovery and fair and adequate returns will allow the Companies to avoid further
23 credit downgrades and to improve their credit metrics, which are primarily based

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1 upon cash flows. As Susan Abbott testifies, credit rating agencies view regulatory
2 risk as it affects cash flow as the most important element of their business risk
3 analysis. The Commission also recognized the importance of cash flow in the
4 April 2009 Order, when it stated that cash flow “most directly impacts upon the
5 ability of the Companies to provide safe and reliable service through day-to-day
6 funding of payroll and other operations and maintenance expense and through
7 timely investments in physical plant.” Granting the Companies their requested
8 rate relief would allow them to begin to improve their cash flow position and
9 credit metrics, and would also improve the rating agencies’ assessment of the
10 Companies’ regulatory risk, which will be an important first step toward
11 improving the Companies’ credit ratings.

12 **B. Deferred Cost Recovery and PBA Implementation**

13 Q. Have the Companies taken any steps to address the mounting deferral balances
14 they were facing at the time of their January rate filings?

15 A. Yes. The Commission acknowledged in the April 2009 Order that growing
16 deferral balances were creating a “net cash imbalance” for the Companies, and
17 that DPS Staff also agreed that the Companies had recently spent more on items
18 such as environmental remediation, storm damage and stray voltage than was
19 included in their existing delivery rates. The Companies’ deferral balances have
20 continued to increase since the April 2009 Order. As a result, on August 28,
21 2009, the Companies filed a verified petition in Case 09-M-0642 with the
22 Commission to seek to utilize certain amounts of the PBAs required by the
23 Merger Order to offset certain deferral balances (the “PBA Petition”).

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1 Specifically, the Companies requested authority to utilize \$173.6 million of the
2 PBAs to offset an equal amount of their respective deferral balances for: 1)
3 environmental remediation costs; 2) storm costs; 3) pension costs; 4) property
4 taxes; 5) variable rate debt costs; and 6) pipeline integrity costs. As described in
5 the PBA Petition, the Companies are proposing to offset only “deferred regulatory
6 assets whose balances are currently accruing interest with the PBAs that are also
7 accruing interest at similar rates.”

8 Q. What factors should be considered in the implementation of the remaining PBAs?

9 A. The implementation of the remaining PBAs in this rate proceeding should
10 accomplish two important goals. First, PBA implementation should ensure that
11 customers receive the full benefit of the PBAs in a timely manner. Second, the
12 PBAs should be implemented in a manner that minimizes adverse effects on the
13 Companies’ financial situation and allows them to begin to improve their
14 financial health.

15 Q. In light of these considerations, how are the Companies planning to utilize the
16 remaining PBAs?

17 A. The Companies are proposing to offset remaining PBA balances with other
18 regulatory assets at the start of the rate year. The Companies’ proposals on this
19 issue are discussed in further detail in the Direct Testimony of the Revenue
20 Requirements Panel.

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1 Q. Assuming the Commission grants the Companies’ petition with respect to those
2 existing deferrals, will the Companies still have concerns about deferrals going
3 forward?

4 A. Yes. Many of these deferred cost items are expected to create additional cash
5 flow pressures for the Companies due to their seasonal nature. For example, the
6 Companies generally experience the most significant storm costs during the
7 winter. These costs will continue to create cash flow concerns for the Companies,
8 since the Companies also need to make significant gas purchases for the winter
9 heating season during this period. While the Companies fully support the concept
10 of deferred cost accounting, the Companies are seeking to implement new deferral
11 recovery mechanisms as part of their rate requests in order to provide more timely
12 recovery of deferred costs and to help to alleviate the cash flow pressures of
13 future deferrals.

14 Q. Please explain the Companies’ proposal to establish new deferral recovery
15 mechanisms.

16 A. Growing deferral balances force the Companies to act like banks and lend money
17 to customers. This becomes particularly problematic given the Companies’ weak
18 financial condition and credit ratings. As described in the Direct Testimony of the
19 Revenue Requirements Panel, the Companies are now seeking to establish new
20 deferral recovery mechanisms that will allow more timely recovery of certain
21 future deferred costs. These deferral recovery mechanisms will ensure that future
22 deferred costs do not create cash flow problems for the Companies or
23 unnecessarily delay the benefits of favorable deferrals in customers’ bills.

DIRECT TESTIMONY OF THE POLICY PANEL

1 Q. How will the Companies’ new deferral recovery mechanism benefit customers?

2 A. These new deferral recovery mechanisms will benefit customers over the long
3 term by avoiding future rate shock and potentially significant carrying charges
4 through more timely recovery of deferred costs, just as the Companies’ interim
5 adjustments to their NBC charges are intended to do. In the NBC Order, the
6 Commission determined that recovery of a small portion of under-collections now
7 would help to avoid future rate shock. The Commission should apply the same
8 reasoning in approving the Companies’ proposals for new deferral recovery
9 mechanisms. For example, if one of the Companies incurs significantly high
10 storm costs during a given year due to unusual weather activity, then those costs
11 can be recovered through these deferral recovery mechanisms, rather than having
12 to wait for a lump-sum implementation of those costs in a future rate case that
13 addresses other increased operating costs.

14 C. **Cost of Capital and Capital Structure**

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

16 A. Yes. As Dr. Makhholm testifies, it stands to reason that investors would demand
17 higher equity returns to compensate for the increased risks they face in the
18 marketplace as a result of the financial crisis. As DPS Staff admitted on the
19 record in Case 09-E-0882, *et al.*, the cost of equity capital has likely increased
20 since the financial crisis began. The Commission similarly acknowledged in the
21 Cahill Letter that “[r]ecent market volatility and uncertainty has lead to higher
22 return requirements in order to provide capital.”

DIRECT TESTIMONY OF THE POLICY PANEL

1 Q. How has the financial crisis impacted the cost of equity for “BBB” level rated
2 companies like NYSEG and RG&E?

3 A. While risk and corresponding returns have increased for all investors as a result of
4 the financial crisis, investors are requiring a greater premium to invest in weaker
5 rated utilities like NYSEG and RG&E. As Susan Abbott testifies, the Companies
6 are the lowest rated electric and gas utilities in New York State, which places
7 them at a significant disadvantage in competing for capital.

8 Q. How have the Companies’ equity returns been impacted by the financial crisis?

9 A. The Companies’ earned equity returns for the test year were approximately 5%
10 for all businesses. As the Commission recently noted in the Cahill Letter, debt
11 investors in May 2009 were requiring 7.76% returns “to invest in ‘BBB’-rated
12 bonds, which are safer than equity investments.” The Companies agree with the
13 Commission’s observation that “in this market, equity investors require a return
14 greater than these debt instruments.” Moreover, these projected returns are
15 significantly below the Companies’ previously authorized returns on equity, as
16 well as the increased cost of equity capital in the current financial markets. As the
17 Commission acknowledged in the April 2009 Order, “investors are entitled to a
18 reasonable return on their investment” and the Commission should be “guided in
19 rate setting to provide a reasonable opportunity for investors to earn such a
20 return.” Consistent with this principle, the Companies need rate relief to achieve
21 reasonable returns that reflect the increased cost of equity capital.

DIRECT TESTIMONY OF THE POLICY PANEL

1 Q. How has the global financial crisis impacted the Companies’ rate of return on
2 equity proposal?

3 A. As described in the Direct Testimony of Jeff D. Makhholm, the Companies’ rate of
4 return on equity proposal contains certain important adjustments to the
5 Commission’s traditional ratemaking approach that are necessary in light of the
6 current economic crisis. Consistent with Commission precedent in Case 09-E-
7 0428, Dr. Makhholm’s testimony sets forth his limited adjustments to the
8 Commission’s traditional ratemaking methodology in his testimony, as well as the
9 reasoning behind them. These adjustments are based upon the specific
10 circumstances of the Companies and in light of the changed circumstances
11 resulting from the recent global economic crisis. We urge the Commission and
12 DPS Staff to examine each of these proposed adjustments closely and with an
13 open mind.

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

16 A. The Companies are using their own standalone capital structures for ratemaking
17 purposes. The Commission has stated that it would be appropriate for the
18 Companies to use standalone capital structures once they implemented the
19 bankruptcy preferred shares required by the Merger Order. For example, the
20 Commission stated in the April 2009 Order that it would be “improper to employ
21 a stand-alone equity ratio for the Companies” since they had “not completed the
22 step of creating and designating a holder of the special voting share of preferred
23 stock.” Similarly, at the Commission’s June 18, 2009 Regular Session, in which

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1 the Commission approved the Companies' issuance of bankruptcy preferred
2 shares, Chairman Brown indicated that this issuance represented "the final
3 components necessary for [NYSEG and RG&E] to meet the ring fencing
4 requirements we established when approving the Iberdrola acquisition of Energy
5 East last September."

6 Q. Do the rating agencies view the Companies on a standalone basis?

7 A. Yes. Pursuant to the Commission's June 24, 2009 Order Authorizing Issuance of
8 Preferred Stock, which approved NYSEG's and RG&E's bankruptcy preferred
9 shares in Case 07-M-0906, Susan Abbott is including in her testimony the
10 "written evidence, from at least two independent major credit rating agencies, that
11 support evaluating the ratings of NYSEG and RG&E, and treating their capital
12 structures, as standalone companies." As Susan Abbott testifies, not just two, but
13 all three of the major credit rating agencies view the Companies on a standalone
14 basis.

15 Q. Please describe the Companies' proposed standalone capital structure for
16 NYSEG.

17 A. The Companies are proposing to use NYSEG's rate year capital structure for
18 ratemaking purposes. This proposal results in a 48% equity ratio for NYSEG.

19 Q. Please describe the Companies' proposed standalone capital structure for RG&E.

20 A. The Companies are proposing a similar approach for RG&E. RG&E's rate year
21 capital structure also includes the impact of an equity infusion that Energy East
22 will make into RG&E within the next three months (*i.e.*, during the fourth quarter
23 of 2009). Including this equity infusion results in a 48% equity ratio for RG&E.

DIRECT TESTIMONY OF THE POLICY PANEL

1 Q. How has the financial crisis impacted the cost of debt for “BBB” level rated
2 entities?

3 A. As described in further detail in the Direct Testimony of Susan Abbott, the cost of
4 debt has increased significantly for “BBB” level rated entities like NYSEG and
5 RG&E as a result of the financial crisis.

6 Q. How did the cost of RG&E’s two recent debt issuances compare to its historical
7 debt costs?

8 A. The coupon rate for RG&E’s December 2008 first mortgage bond issuance was
9 8%, a significant spread (*i.e.*, 550 basis points) above U.S. Treasuries, and a level
10 that was materially higher than RG&E’s historical debt costs. The coupon rate for
11 RG&E’s first mortgage bond issuance was also significantly higher than Con Ed’s
12 7.125% unsecured debt issuance during the same time period. The fact that Con
13 Ed had an “A” level credit rating was likely the primary reason for this
14 differential. The coupon rate for RG&E’s July 2009 first mortgage bond issuance
15 (5.9%) was still approximately 225 basis points above U.S. Treasuries. As
16 discussed above, if RG&E were an “A” rated utility, the cost of these debt
17 issuances would have been significantly lower, saving customers millions of
18 dollars in interest costs over the full term of the bonds. As the Commission
19 recently noted in the Cahill Letter, the wide basis point spreads between “BBB”
20 and higher rated issuers throughout the financial crisis have led investors to
21 require “a large premium to invest in [‘BBB’-rated] instruments.”

DIRECT TESTIMONY OF THE POLICY PANEL

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V. MERGER SAVINGS REPORT

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. The Merger Order provides “To ensure that the ratemaking process accounts for savings and costs related to operational changes resulting from the transaction, NYSEG and RG&E must provide, in prefiled testimony as part of its next general rate case filings (whether within or outside the target period), all studies, analyses and related workpapers prepared by Iberdrola, its subsidiaries, affiliates, or agents that identify or quantify the costs and savings related to merger synergies, efficiency gains, and the adoption of utility best practices that in any way affect the management, operation and underlying costs of NYSEG’s and RG&E’s utility business.”

Q. How are the Companies complying with that requirement?

A. Although the merger between Iberdrola and Energy East was not driven by synergy savings, and most efficiency gains were already achieved following previous Energy East acquisitions, the Companies hired Booz & Company to perform an independent analysis of the costs and savings resulting from the merger transaction and to submit testimony explaining their findings to satisfy the Commission’s requirement in the Merger Order. No synergy savings were expected given the nature of the merger transaction and, as described in more detail in the Direct Testimony of Thomas J. Flaherty, no material synergy savings to the Companies were identified resulting from Energy East’s merger with

DIRECT TESTIMONY OF THE POLICY PANEL

1 Iberdrola. Moreover, to the extent that the Companies ever experience synergy
2 savings resulting from the merger, those savings would be shared with customers
3 when new rate cases are filed, or, in the event of a multi-year settlement, through
4 an agreed upon earnings sharing mechanism.

5 **VI. MULTI-YEAR RATE PLAN**

6 Q. Are the Companies open to pursuing a multi-year rate plan?

7 A. Yes. The Companies are open to pursuing a multi-year rate plan through a
8 settlement process with DPS Staff and other interested parties and working with
9 the parties to move the settlement process efficiently and expeditiously.

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

11 A. Yes, it does.