

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- |

**DIRECT TESTIMONY OF
THOMAS J. FLAHERTY**

September 17, 2009

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BY WHOM YOU ARE EMPLOYED.

A. My name is Thomas J. Flaherty, and I am a Senior Vice President in the Energy and Utilities practice of Booz & Company. My business address is 901 Main St., Suite 6500, Dallas, Texas 75202.

Q. WOULD YOU BRIEFLY SUMMARIZE YOUR ACADEMIC AND PROFESSIONAL BACKGROUND?

A. I graduated from the University of Oklahoma with a B.B.A. degree in Accounting and immediately joined Touche Ross & Co., where I began my career as a management consultant. Subsequently, I worked for Deloitte & Touche (formed by the merger of Touche Ross and Deloitte, Haskins & Sells in 1989) for more than 30 years until joining Booz & Company (N.A.) Inc. (“Booz & Company”) as a Senior Vice President. Over the course of my consulting career, I have specialized in the public utility industry and have performed a variety of assignments pertinent to that industry.

I have assisted managements from a number of electric and / or gas utilities in the identification, evaluation and integration of acquisitions, including: screening analysis; review of corporate restructuring alternatives; analysis of economic values; development of post-merger operating models; assessment of merger-related cost reduction opportunities; development of regulatory strategies; planning and execution of merger integration; and assignment and allocation of costs and benefits related to mergers and acquisitions. In addition to my

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 involvement in merger and acquisition consulting, I have participated in
2 numerous other utility consulting engagements in the areas of corporate growth,
3 diversification, restructuring, organizational analysis, business transformation,
4 performance management, strategic planning, market analysis, litigation
5 assistance, economic feasibility studies, regulatory planning and analysis, and
6 financial analysis.

7 I also have conducted or directed similar assignments for a variety of
8 industries, including construction, retailing, publishing, health care, real estate and
9 manufacturing, in addition to utilities. Exhibit __ (TJF-1) to this testimony
10 provides my curriculum vitae and details my previous experience with regulated
11 utilities.

12 **Q. PLEASE SUMMARIZE YOUR EXPERIENCE IN UTILITY MERGERS**
13 **AND ACQUISITIONS.**

14 A. I have evaluated more than 350 actual, proposed or potential transactions
15 involving electric, electric and gas combination, gas, or water utilities. I have
16 experience working for both buyers and sellers and have assisted client
17 managements in their assessment of a broad range of transactional issues,
18 including the following:

- 19 • Target analysis
- 20 • Asset quality analysis
- 21 • Customer analysis
- 22 • Competitor analysis
- 23 • Synergy assessment
- Financial analysis
- Transaction structuring
- Regulatory strategy
- Testimony
- Integration planning

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 The publicly announced transactions in which I have been significantly
2 involved, other than the one that is the subject of this proceeding are: Kansas
3 Power & Light and Kansas Gas and Electric, IPALCO Enterprises and PSI
4 Resources, Entergy and Gulf States Utilities, Southern Union and Western
5 Resources (Missouri properties), Washington Water Power and Sierra Pacific
6 Resources, Midwest Resources and Iowa-Illinois Gas & Electric, Northern States
7 Power Company and Wisconsin Energy Corporation, PECO Energy Company
8 and PPL Resources, Public Service Company of Colorado and Southwestern
9 Public Service Company, Baltimore Gas & Electric and Potomac Electric Power
10 Company, Delmarva Power and Atlantic Energy, WPL Holdings, IES Industries
11 and Interstate Power, Puget Sound Power & Light and Washington Energy, TU
12 Electric and ENSERCH, Western Resources and Kansas City Power & Light,
13 Western Resources and ONEOK, Inc. (Kansas, Oklahoma gas properties),
14 Houston Industries and NORAM Energy, Ohio Edison and Centerior, ENOVA
15 and Pacific Enterprises, Brooklyn Union Gas and Long Island Lighting,
16 Allegheny Energy and DQE, Inc., LG&E Energy and KU Energy, NIPSCO
17 Industries and Bay State Gas, American Electric Power and CSW, BEC Energy
18 and COM Energy, Northern States Power and New Century Energies, Dynegy
19 and Illinova, DTE Energy and MCN Energy, ConEdison and Northeast Utilities,
20 PECO Energy and Unicom, AGL Resources and Virginia Natural Gas, Energy
21 East and RGE Energy, FPL Group and Entergy, PNM Resources and TNM
22 Enterprises, Exelon and PSEG Enterprises, Duke Energy and Cinergy, FPL Group

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 and Constellation Energy, Black Hills Power and Northwestern Energy, WPS
2 Resources and Peoples Energy, Exelon and NRG Energy, and USPowerGen and
3 Boston Generating.

4 **Q. DO YOU HOLD ANY PROFESSIONAL CERTIFICATIONS?**

5 A. Yes. I am a Certified Management Consultant and a member of the Institute of
6 Management Consultants.

7 **II. PURPOSE OF DIRECT TESTIMONY**

8 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?**

9 A. I have been asked to appear for New York State Electric & Gas Corporation and
10 Rochester Gas and Electric Corporation (the Companies) to summarize an
11 independent review I conducted of selected aspects surrounding the recently
12 finalized acquisition of Energy East Corporation (Energy East) by Iberdrola, S.A.
13 (Iberdrola). Specifically, I was requested to assess whether combination
14 synergies would potentially be available from a transaction of the scope, nature
15 and structure as that completed by the two companies. This assessment was
16 intended to provide an independent third-party perspective on the comparability
17 of this transaction to those generally seen within the U.S. utilities industry and on
18 the likelihood that the unique facts and circumstances underlying this transaction
19 would lend themselves to the creation of typical merger synergies.

20 The scope of this assessment was structured around several key elements
21 related to the above transaction and issues previously raised by the New York
22 Public Service Commission (the Commission) regarding the potential for cost

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 savings, efficiency gains or the sharing of information regarding best practices
2 resulting from the Iberdrola – Energy East transaction.

3 The scope of this work: 1) addressed the typical parameters that give rise
4 to merger synergies; 2) compared those to the circumstances prevailing in the
5 current transaction; 3) identified the nature and outcomes of prior Energy East
6 transactions that would bear upon availability of potential synergies; 4) evaluated
7 how the governance model for Energy East has changed or is anticipated to
8 change, if at all; and 5) evaluated whether certain categories of synergies would
9 be likely to be realized. My assessment is intended to address whether the
10 conditions for typical utility merger synergies were present in this transaction as
11 they would relate to the Company and any of its operating subsidiaries.

12 **Q. HAVE YOU INCLUDED ANY EXHIBITS TO YOUR TESTIMONY?**

13 A. Yes. Exhibit __ (TJF-1) is my C.V. and a summary of my experience with
14 regulated utilities, and Exhibit __ (TJF-2) is a formal Booz & Company report
15 that provides the results of the assessment of the potential for merger synergies.

16 **III. SUMMARY OF ASSESSMENT**

17 **Q. PLEASE SUMMARIZE YOUR ASSESSMENT OF POTENTIAL**
18 **MERGER SYNERGIES AS SET FORTH IN YOUR REPORT.**

19 A. In their most simplistic form, merger synergies generally arise from the existence
20 of overlap or duplication in functions, such as human resources, or the capture of
21 economies of scale in areas like supply chain and services. These synergies
22 typically result from the ability to consolidate similar organizations and operating

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 functions of the companies involved. In this case, the parties to the transaction
2 are dissimilar in construct, different in asset composition in the U.S. and have
3 geographically distant utility operations that are not affected by the transaction.
4 This lack of geographic proximity between the utility operations of the
5 Companies and those of Iberdrola is a key obstacle that effectively prevents
6 operational synergies from occurring in those areas, which could ordinarily
7 provide a significant source of synergies in utility transactions.

8 Several analytical activities were undertaken to ascertain the potential for
9 synergies at the Companies based on the circumstances of the Iberdrola – Energy
10 East transaction. These activities were designed to provide perspective on: the
11 nature of the transaction completed; the relationship of business elements within
12 the companies; the operating model in effect; efforts within the companies to
13 integrate operations; and the availability of synergies in light of the above
14 assessments.

15 While numerous synergies sources may generally be available in many
16 utility transactions, fewer of these sources apply in the Iberdrola – Energy East
17 transaction. Many of the traditional sources of synergies, particularly those that
18 reflect the operating aspects of the business, will not be available absent certain
19 fundamental characteristics which are not present in this transaction.

20 The lack of comparability to these other transactions initially extends from
21 the structural dissimilarities of the companies. Iberdrola is an international
22 holding company that has operations throughout the world and an operating

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 model and profile that reflect that dispersion. While Energy East has a holding
2 company and corporate structure, it is more localized and simpler in design.
3 Moreover, Iberdrola’s other businesses in the U.S. are focused on renewables, gas
4 storage and energy marketing, none of which are similar to Energy East’s
5 transmission and distribution business profile.

6 In addition, differences in operations complicate the portability of
7 operating practices. For example, even though Iberdrola and Energy East
8 maintain certain similar business unit operations, such as electric distribution, the
9 businesses have certain elements of difference, *e.g.*, system voltage design, local
10 physical conditions, etc., that make operations less comparable than might be
11 imagined. Thus, opportunities for formal integration would be limited and hard to
12 accomplish.

13 Finally, a fundamental predicate for achieving operational synergies is not
14 present in this transaction, *i.e.*, geographic proximity. Where other transactions
15 have been able to capitalize on location to share and leverage resources across
16 similar work, no such opportunity exists in this transaction, as all of Energy East’s
17 distribution companies are located in the northeastern part of the United States,
18 and all of Iberdrola’s distribution companies are located in Spain, the United
19 Kingdom and certain other countries outside of North America.

20 From this assessment, initial conclusions were reached that synergies from
21 the operating areas, *i.e.*, field operations, facilities, fuel supply, and capital
22 expenditures, were not likely to be available given the dependencies identified.

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 More specifically, the lack of geographic presence of a comparable business
2 would be a limiting factor in any ability to create synergies opportunities.

3 However, several traditional synergies sources were identified as being
4 “possible” areas of applicability in the current transaction. These areas, *e.g.*,
5 corporate and related support, were then reviewed more closely to determine
6 whether they would potentially offer merger synergies with respect to Energy
7 East.

8 While selected synergies categories, such as in the areas of shareholder
9 services and insurance were determined to be available and have been identified
10 by Energy East for the Iberdrola transaction these categories only result in
11 synergy savings of approximately \$5.1 million. Moreover, it is my understanding
12 that most of these costs (*i.e.*, approximately \$3.6 million) have not previously
13 been allocated to Energy East’s operating subsidiaries (or included in rates) and,
14 therefore, would not impact customers. The potential for synergies that are
15 actually attributable to Energy East’s regulated operations reflects only *de*
16 *minimis* levels of approximately \$1.5 million across all of Energy East’s operating
17 companies, where realized. Finally, the value of these *de minimis* synergy
18 savings is further diluted once allocation is reflected across all the operating
19 subsidiaries within the Energy East system. The attached report sets forth these
20 conclusions and the basis for them.

21 The conclusions in my report are consistent with the outcome of the
22 jointly conducted integration process between Iberdrola and Energy East. The

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 integration process also did not identify the potential for obvious merger
2 synergies to be captured. Rather, an ongoing effort to share information regarding
3 best practices within and across the network operations of both Iberdrola and
4 Energy East was identified as a focus area for the future. However, the sharing of
5 information to improve operating performance does not directly translate into
6 tangible cost reduction, as these outcomes may simply reduce risk or enhance
7 operating reliability. Further, benefits obtained from the adoption of best
8 practices are generally not considered to be merger related, since they could
9 potentially be achieved through traditional management practices rather than
10 requiring the combination of two stand-alone entities.

11 Consequently, consistent with the findings in the attached report, I do not
12 believe that the Iberdrola – Energy East transaction can be viewed as a source for
13 meaningful merger synergies due to the operating limitations mentioned above.
14 Further, where selected synergies categories might be present, the combination of
15 prior regulatory treatment of related costs and the outcomes of the cost allocation
16 process would combine to minimize the level of synergies available to be shared
17 with New York customers.

IV. OVERVIEW OF REPORT

18 **Q. HOW IS YOUR REPORT ORGANIZED?**

19 A. My report is divided into eight sections. Section I provides a general introduction
20 to my analysis. Section II presents an executive summary of my findings and
21 conclusions. Section III describes the scope and nature of the activities that I
22

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 performed in connection with my assessment. Section IV provides a general
2 overview of the types of synergies that are typically available through utility
3 merger transactions. Section V provides a discussion of the details of the
4 Iberdrola – Energy East transaction. Section VI discusses integration efforts and
5 synergies savings that were achieved as a result of prior Energy East mergers, as
6 well as the integration efforts for this transaction. Section VII assesses the
7 availability of synergies resulting from the Iberdrola – Energy East transaction.
8 Finally, Section VIII provides a high level conclusion of my assessment.

9 **Q. PLEASE DESCRIBE THE SECTION OF YOUR REPORT THAT**
10 **DEFINES THE SCOPE AND NATURE OF ACTIVITIES PERFORMED**
11 **WITH RESPECT TO YOUR ASSESSMENT.**

12 A. The purpose of my assessment of the Iberdrola – Energy East transaction was to
13 review the situation as it exists today and to address whether the specific facts of
14 this transaction would give rise to the availability of typical merger synergies. As
15 described in more detail in Section III of my report, this approach incorporated
16 the consideration of the typical categories that normally comprise merger
17 synergies and compared the current transaction against the circumstances that
18 exist in other utility industry transactions. The assessment also identified under
19 what circumstances such merger synergies could be attributed to this transaction
20 and whether those conditions were likely to prevail.

21 **Q. HOW DOES YOUR REPORT DISCUSS THE TYPICAL SOURCES OF**
22 **SYNERGIES VALUE THAT ARISE FROM A UTILITY MERGER?**

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 A. As described in more detail in Section IV of my report, in a utility merger
2 transaction, synergies arise from the ability to combine similar corporate
3 functions, align certain operating functions, adopt common processes, and
4 integrate market facing functions where products and services are procured. In
5 my experience, the synergies that arise from electric utility mergers primarily
6 relate to three major sources; staffing, A&G costs and economies of scale, as
7 discussed below.

8 *Staffing* – These synergies arise from a reduction in workforce between the
9 merging entities, generally as a result of overlapping or duplicative functions. For
10 example, corporate center functions, such as shareholder services, will be largely
11 duplicative, while functions such as human resources, will be able to absorb
12 additional functions with fewer resources than the total of the two stand-alone
13 companies.

14 *A&G / O&M Costs* – These synergies relate to non-labor related corporate,
15 operating support or operations costs that reflect the ability to reduce the total
16 costs of performance or avoid fundamental incurrence. In essence, they arise
17 from the ability to integrate functions and then perform required activities at a
18 lower cost level than would exist if stand-alone companies’ costs were simply
19 combined. The lower cost of performance results from the ability to avoid
20 overlap, align underlying infrastructure, reduce the need for certain services, and
21 reshape programs that incur costs. These synergies sources are the most diverse
22 as they encompass a wide range of sources, including: professional services;

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 information technology; facilities; benefits; overheads; investor programs;
2 insurance; and credit facilities.

3 *Economies of Scale* – The ability to leverage the enhanced market position of the
4 combined companies typically results in supply chain benefits of various types.
5 For example, lower unit costs of materials and supplies may arise through
6 consolidated procurement across the vendor pool. In addition, costs of services
7 obtained from contractors can be reduced as the volume of potential work is
8 enhanced and the attractiveness of the combined company as a customer increases
9 to the supplier community. Economies of scale are also available in corporate
10 cost areas where programs, such as insurance and benefits as mentioned above,
11 can be aligned to achieve design and cost benefits.

12 It is important to note, however, that while merger synergies may
13 theoretically be available in most transactions, there are factors that limit the
14 ability of companies to realize synergies at perceived or expected levels.

15 **Q. WHAT ARE THE FACTORS THAT YOU IDENTIFY IN YOUR REPORT**
16 **THAT INFLUENCE THE NATURE AND LEVEL OF SYNERGIES**
17 **AVAILABLE?**

18 A. As my report describes in more detail, the realization of cost synergies will be
19 based on the extent to which the operations of the merging entities are similar and
20 overlapping. Cost synergies are predicated on some level of business or activity
21 duplication that can be eliminated through consolidation and integration, therefore
22 resulting in synergies. This duplication typically comes in the operating structure,

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 asset base, employee skill set or geographic territory. While the circumstances
2 described above that relate to traditional U.S. utility mergers are different in the
3 Iberdrola – Energy East transaction, each of the categories identified were
4 reviewed to determine applicability in the current transaction.

5 **Q. DOES YOUR REPORT ADDRESS WHETHER THIS TRANSACTION**
6 **GIVES RISE TO SYNERGIES AS TYPICALLY EXPECTED IN UTILITY**
7 **TRANSACTIONS?**

8 A. Yes, my report addresses this issue directly, and I conclude in the report that the
9 circumstances of this transaction do not lend themselves to meaningful synergy
10 creation. As previously mentioned, the Iberdrola – Energy East transaction is not
11 a typical utility merger or consolidation event. Its structural aspects, *e.g.*,
12 strategic underpinnings, geographies, business constructs, etc., are different than
13 those of the traditional transaction. Consequently, the companies did not focus on
14 synergies quantification as a necessary input to the valuation process or as an
15 expected outcome to support deal economics.

16 As described earlier, while Iberdrola has other U.S. based operating
17 entities, none of them have utility operations. Further, there is no U.S. holding
18 company that owns or oversees the assets presently owned and operated.
19 Consequently, the facts of this transaction are dissimilar from most utility
20 transactions that are normally completed in the U.S. These factors are all further
21 described in Exhibit __ (TJF-2).

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 **Q. HOW DID YOU ASSESS THE AVAILABILITY OF SYNERGIES FROM**
2 **THE IBERDROLA – ENERGY EAST TRANSACTION IN YOUR**
3 **REPORT?**

4 A. As discussed in more detail in Section VII of my report, I reviewed the potential
5 for cost reduction, cost avoidance, revenue enhancement, and sources of
6 synergies, *i.e.*, corporate, shared services, field operations, etc., and then assessed
7 their availability based upon the presence of certain factors in the transaction to
8 enable realization.

9 While numerous synergies sources may generally be available in many
10 transactions, fewer of these sources apply in the Iberdrola – Energy East
11 transaction. Many of the traditional sources of synergies, particularly those that
12 reflect the operating aspects of the business, are only available when the merging
13 companies share comparable businesses, similar operations and geographical
14 proximity (none of which are present in the Iberdrola – Energy East transaction).
15 Consequently, synergies sources such as local facilities, fuel supply, and capital
16 expenditures are not consistent with the nature of this transaction.

17 **Q. WERE ANY MEANINGFUL MERGER SYNERGIES IDENTIFIED AS A**
18 **RESULT OF THE TRANSACTIONS?**

19 A. Although I identified several traditional synergies sources as being “possible”
20 areas of applicability, the facts of the Iberdrola – Energy East merger did not
21 support a finding of any meaningful merger synergies. This finding is based on
22 the review of several traditional synergies sources, including corporate and related

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 support functions; administrative and general (“A&G”) expenses; certain non-
2 labor A&G cost areas; insurance costs; and Iberdrola’s planned governance model
3 with respect to Energy East.

4 I conclude that corporate and related support staffing and non-labor A&G
5 areas where available synergies were determined most likely to be “possible” do
6 not, in reality, lend themselves to any significant level of benefit. Iberdrola’s and
7 Energy East’s businesses differ such that they are precluded from the same level
8 of integration that is normally observed in U.S. utility transactions. In addition,
9 the operating model of Iberdrola has historically provided substantial operational
10 independence to operating subsidiaries. Finally, in those few areas where actual
11 cost eliminations have been realized, these benefits will not impact customers as
12 most related costs have not previously been allocated to Energy East’s operating
13 subsidiaries (or included in rates). Thus, the potential for merger synergies that
14 are actually attributable to Energy East’s regulated operations is both limited to a
15 modest number of areas and only reflects *de minimis* levels of approximately \$1.5
16 million across all of Energy East’s subsidiaries, before any individual company
17 allocations occur. This outcome of only *de minimis* synergies is consistent with
18 our experience with international utility transactions whether in-bound to, or out-
19 bound from, the U.S., as further detailed in Exhibit __ (TJF-2).

20 **Q. HAVE OTHER INTERNATIONAL UTILITY TRANSACTIONS**
21 **INVOLVING U.S. BASED COMPANIES YIELDED MERGER**
22 **SYNERGIES?**

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 A. Yes, but this transaction bears little resemblance to other transactions that have
2 occurred in the Northeast. Certainly other transactions involving foreign utilities
3 have given rise to potential synergies, but only in specific circumstances where
4 utility operations or costs are intended to be directly affected.

5 For example, National Grid has been a serial acquirer of companies in the
6 U.S., most recently KeySpan Energy and its operating companies. However, this
7 transaction markedly differs in several critical respects. First, while National Grid
8 is foreign-owned, the National Grid transactions involved similar distribution
9 company operations located in the U.S. Northeast that were merging with other
10 U.S. Northeast - based entities. Second, given these preceding circumstances, the
11 natural vehicle for synergies creation was already in place, *i.e.*, common,
12 proximate and addressable operations within the utilities. None of these
13 circumstances are present in the Iberdrola – Energy East transaction.

14 Even in other cases, such as Scottish Power’s acquisition of PacifiCorp or
15 E.ON’s subsequent ownership of LG&E Energy where utilities were owned by
16 the international acquirer, operations of the U.S. utility have not been integrated
17 as is the norm in U.S. transactions to provide the potential for traditional merger
18 synergies. In fact, this is one reason why foreign buyers have not more actively
19 pursued U.S. based companies. Even in these transactions, direct synergies have
20 been limited to the avoidance of limited future costs, such as shareholder services
21 and other investor related costs, versus broader governance or operating costs.

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 **Q. PLEASE SUMMARIZE THE OVERALL CONCLUSIONS IN YOUR**
2 **REPORT WITH RESPECT TO THE AVAILABILITY OF SYNERGIES**
3 **FROM THE IBERDROLA – ENERGY EAST TRANSACTION?**

4 A. My report concludes that the facts of this transaction do not support a positive
5 assertion regarding the availability of meaningful merger synergies for the
6 Companies. Iberdrola’s acquisition of Energy East does not create the potential
7 for the type of traditional synergies that arise in the typical U.S. utility merger
8 transaction. While there are two particular areas where synergies have been
9 identified to-date, the total level is small even before considering how these lower
10 costs would be allocated across jurisdictions and business segments. Further, it is
11 my understanding that prior regulatory practice in New York has been to treat
12 several of these synergies sources as non-recoverable from ratepayers, which
13 would further limit the availability of synergies to the New York operating
14 companies.

15 In my opinion, an expectation of synergies to flow from the Iberdrola –
16 Energy East transaction is inconsistent with the characteristics of the transaction.
17 Iberdrola is not affecting Energy East’s day-to-day operations and its integration
18 process focused on aligning corporate performance reporting rather than
19 integrating actual process execution. Consequently, the potential for traditional
20 synergies as might normally be expected from certain other utility mergers or
21 acquisitions would not apply in these circumstances.

DIRECT TESTIMONY OF THOMAS J. FLAHERTY

1 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

2 A. Yes, it does.