

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- 0715
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- 0716
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- 0717
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- 0718

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**DEBT COST REBUTTAL TESTIMONY  
OF HOWARD COON**

February 12, 2010

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. Please state your name, business address and current position.

2 A. My name is Howard Coon. I have been with Iberdrola USA for six and a half  
3 years as the Director of Corporate Finance. My office is located at 52 Farm View  
4 Drive, New Gloucester, Maine 04260. I am responsible for the treasury and  
5 financing function for Iberdrola USA and all of its subsidiaries. My duties  
6 include raising long-term debt capital, arranging short-term credit facilities,  
7 maintaining relationships with our banks and rating agencies, overseeing the cash  
8 management function, managing interest rate derivatives, and supporting our  
9 Regulatory department in matters pertaining to financing and capital structure.  
10 Including my tenure at Iberdrola USA, I have 22 years of corporate finance  
11 experience. I have a Bachelor's Degree in Economics from Bowdoin College and  
12 a Masters Degree in Business Administration from the University of New  
13 Hampshire.

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

17 A. No.

18 Q. Mr. Coon, what is the overall purpose of your rebuttal testimony?

19 A. First, I will address the adjustments to the cost of floating rate debt recommended  
20 by the Staff Finance Panel. Second, I will address the Staff Finance Panel's  
21 adjustments to New York State Electric & Gas Corporation's ("NYSEG" or the  
22 "Company") new issuance rate. Third, I will address adjustments made by the

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1 Staff Finance Panel regarding the recovery of hedge losses incurred at Rochester  
2 Gas and Electric Corporation (“RG&E”).

3 Q. Are you sponsoring any exhibits in support of your rebuttal testimony?

4 A. Yes. I am sponsoring the following exhibits: Exhibit \_\_ (CD-1), Exhibit \_\_  
5 (CD-2), Exhibit \_\_ (CD-3), Exhibit \_\_ (CD-4), Exhibit \_\_ (CD-5), and  
6 Exhibit \_\_ (CD-6).

7 **COST OF DEBT**

8 Q. Are you familiar with the adjustments to the cost of debt that the Staff Finance  
9 Panel has recommended?

10 A. Yes, the Staff Finance Panel, at page 9 of its testimony, recommended a reduction  
11 in NYSEG’s cost of debt from 6.13% to 4.91%. This is the result of changes to  
12 interest rate assumptions on \$386 million of floating rate debt and \$100 million of  
13 debt to be issued during the rate year. The Staff Finance Panel recommended a  
14 reduction in RG&E’s cost of debt from 7.56% to 7.04%. This is the result of  
15 changes to interest rate assumptions on \$68 million of floating rate debt and the  
16 disallowance of the recovery of 25% of the hedge losses incurred by RG&E in  
17 connection with debt issuances completed in 2008 and 2009.

18 Q. What are the amounts in dollars of the adjustments in each case?

19 A. The NYSEG total adjustment is \$14.8 million, of which \$13.9 million is related to  
20 a change in rate assumptions on floating rate debt, and \$0.8 million is related to a  
21 change in the assumed rate on a new issuance forecasted to take place in the  
22 middle of the rate year. The RG&E total adjustment is \$4.2 million, of which

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1           \$2.7 million is related to a change in rate assumptions on floating rate debt, and  
2           \$1.5 million is related to disallowance of the recovery of 25% of the hedge losses.

3 Q.     Do you agree with Staff’s proposed adjustments to the cost of debt?

4 A.     The Companies would agree to accept the Staff Finance Panel’s adjustments to  
5           the rate assumptions on floating rate debt and to NYSEG’s new issuance costs if  
6           there are reconciliation mechanisms in place to protect the Companies and  
7           ratepayers. The Staff Panel’s disallowance of 25% of the hedge losses at RG&E  
8           is unsupportable and should be rejected by the Commission.

9           **Adjustments to Floating Rates**

10 Q.    How did the Companies address floating rate debt costs?

11 A.    The Companies used a forecasted rate of 5% for each of the 7 securities at  
12        NYSEG and the 2 securities at RG&E that currently bear floating rates of interest.  
13        The Companies’ assumptions were based on a combination of factors: 1) that  
14        short-term rates are likely to rise as an economic recovery takes hold; 2) that the  
15        cost of providing liquidity facilities on a certain number of the securities will  
16        increase due to the continuing shortage of capital in the banking sector; and  
17        3) that the Companies would likely elect to fix the rates on some of the securities  
18        prior to, or during, the rate year.

19 Q.    What changes did the Staff Finance Panel make at Schedule C, Exhibit \_\_  
20        (RRP-5) of the Revenue Requirements Panel’s testimony to the assumed floating  
21        rate debt costs presented by the Companies?

22 A.    The Staff Finance Panel elected to reflect the rates provided in Interrogatory  
23        Response NYRC-0355 (DPS-288) on each of the securities in question and

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1 requested that the Companies update these costs as the case proceeds. The rates  
2 from DPS-288 were in effect during the week of October 26, 2009. Because these  
3 rates float on a weekly or monthly basis, they are different, and as a whole,  
4 marginally higher at this time.

5 Q. Is the Staff Finance Panel's approach unreasonable?

6 A. Yes, but not because of the use of updated figures. The use of current rates is not,  
7 in and of itself, an unreasonable approach. However, the Staff Finance Panel did  
8 not support the adoption of a reconciliation mechanism for dealing with any  
9 differences between the actual and assumed costs of floating rate debt.

10 Q. Is a reconciliation mechanism necessary?

11 A. Yes. Without such a mechanism, the Companies will be exposed to significant  
12 interest rate risk. NYSEG has \$386 million of floating rate securities outstanding  
13 and would be exposed to \$3.86 million of increased interest expense for every 1%  
14 increase in rates. RG&E has \$68 million of floating rate securities outstanding  
15 and would be exposed to \$0.68 million of increased interest expense for every 1%  
16 increase in rates. The rates on the securities in question move with short-term  
17 interest rates, which are at historically low levels due in part to Federal Reserve  
18 policies aimed at addressing the economic situation – i.e., keeping short term  
19 interest rates low. These rates would be expected to increase quickly if the  
20 economy begins to recover and the Federal Reserve adjusts its policy in response.  
21 For example, 1-month Libor, to which the rates in question would be closely  
22 correlated, steadily rose over 400 basis points (4%) in the 36 month period from

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1 June 2003 through June 2006 as the Fed acted in response to economic  
2 conditions.

3 Q. What reasons did the Staff Finance Panel cite for not supporting the Companies'  
4 proposed reconciliation mechanism?

5 A. The Staff Finance Panel suggested that the Companies did not require  
6 reconciliation since they could refund the securities with fixed rate securities in  
7 order to remove the Companies' exposure to floating rates. The Staff Finance  
8 Panel also asserted at page 55 of its testimony that the Companies' exposure is  
9 "quite limited in the context of a one year case."

10 Q. Do you agree with the Staff Finance Panel's justifications?

11 A. No.

12 Q. Is it true that the Companies can eliminate their exposure to floating interest rates  
13 by fixing the rates on the securities in question?

14 A. Yes, although doing so would increase ratepayer debt costs. In the absence of a  
15 reconciliation mechanism, the Companies will take rapid action to fix the floating  
16 interest rates on these securities. Exhibit \_\_ (CD-1) shows indicative rates from  
17 Bank of America for fixing to maturity the rates on each of the securities in  
18 question. Exhibit \_\_ (CD-2) shows that NYSEG's cost of debt would increase  
19 from the Panel's assumed level of 4.91% to 6.34%, an increase of \$17.2 million,  
20 and that RG&E's cost of debt would increase from the Panel's assumed level of  
21 7.04% to 7.43%, an increase of \$3.2 million.

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1 Q. Rather than immediately fix rates, how do you recommend the Companies be  
2 allowed to proceed to benefit ratepayers?

3 A. The Companies believe that ratepayers will benefit if: 1) the securities remain in  
4 floating rate mode in the short term; 2) the Companies are given the flexibility to  
5 adjust the rate modes as market conditions change; and 3) there is a reconciliation  
6 mechanism to protect the Companies and customers from differences between  
7 assumed and actual debt costs.

8 Q. Can you please explain further why you disagree with the Staff Finance Panel's  
9 statement that the interest rate exposure is "quite limited in the context of a one  
10 year case"?

11 A. I have already indicated that the adjustments made by the Staff Finance Panel in  
12 connection with floating rate debt are \$13.9 million for NYSEG and \$2.7 million  
13 for RG&E. These significant adjustments are the result of differences between  
14 the variable interest rates recently being incurred and the future interest rates that  
15 are entirely within the realm of possibility for a rate year 6 to 18 months into the  
16 future. Given the amount of floating rate debt at the Companies, a 1% increase in  
17 interest rates would reduce NYSEG's return on equity ("ROE") by 19.3 basis  
18 points (0.193%) and RG&E's ROE by 5.4 basis points (0.054%). The Companies  
19 would not characterize this level of exposure as "quite limited" as did the Staff  
20 Finance Panel.

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1 Q. Are there other sound reasons that support adoption of a reconciliation  
2 mechanism?

3 A. The Staff Finance Panel extensively discusses on pages 31-32 of its testimony the  
4 various risk reducing policies it believes the Commission has adopted that make  
5 the authorization of below industry average ROE reasonable. Denial of an  
6 interest rate reconciliation mechanism in this case is inconsistent with those  
7 policies.

8 Q. What is a reasonable compromise between the Companies' position and the Staff  
9 Finance Panel's position on this issue?

10 A. It is reasonable to use current rates in establishing the cost of debt in combination  
11 with a reconciliation mechanism that captures any differences in cost (whether  
12 positive or negative) for inclusion in future rate adjustments. Such a symmetrical  
13 mechanism should also include any cost differences that are the result of  
14 refunding the bonds to fixed rate. The Companies would agree to keep Staff  
15 informed regarding the timing of any such refunding.

16 **Adjustments to NYSEG New Issuance Rate**

17 Q. How did the Staff Finance Panel change the assumed rate for a new issuance  
18 expected to take place at NYSEG during the rate year?

19 A. NYSEG had submitted an update to its cost of debt on December 4 in which the  
20 Company used an assumed interest rate of 7.15% on a 30-year bond. The Staff  
21 Finance Panel relied on an assumption from the Company's September filing in  
22 Schedule C of Exhibit \_\_ (RRP-5) of a 5-year bond bearing a 5.50% interest rate.  
23 The Staff Finance Panel also made an adjustment to the expense amortization

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1 associated with the proposed NYSEG issuance, zeroing it out, as if the issuance  
2 were taking place at the end of the rate year, rather than the middle. This  
3 adjustment to amortization had a \$17,000 impact on assumed interest cost.

4 Q. Are the two Staff Finance Panel adjustments reasonable?

5 A. No. First, the Staff Panel's adjustment to the amortization is clearly unreasonable  
6 because both the Company and the Staff Finance Panel assume in their  
7 preparation of Schedule C of Exhibit \_\_ (RRP-5) that the issuance will occur mid-  
8 year. Therefore, there will be amortization of expenses associated with the  
9 issuance.

10 Q. Can you please discuss why the Staff Finance Panel's second adjustment is also  
11 unreasonable?

12 A. I have provided, in Exhibit \_\_ (CD-3), indicative rates from the Bank of America  
13 that show that the Staff Panel's adjustment may be appropriate in today's current  
14 interest rate environment, if one assumes a 10-year maturity note since the all-in  
15 indicative rate is 5.262%. However, Staff's proposed adjusted rate is somewhat  
16 low if one assumes a 30-year bond (as NYSEG did in its amended RRP-5 filing),  
17 where the all-in indicative rate is 6.326%. The use of a 5.5% assumption by the  
18 Staff Finance Panel, therefore, results in Company exposure if treasury rates  
19 and/or credit spreads increase, which may limit the Company's maturity options if  
20 it wishes to avoid issuing at a cost higher than that assumed in rates.

21 Q. Is the risk to the Company significant?

22 A. I would characterize it as such. The difference, as stated above, is \$0.8 million.  
23 Moreover, the difference could be far larger if the coupon rate on the debt is

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1 higher than my assumption or if the issuance were to be necessary earlier in the  
2 rate year, since this adjustment reflects only a half-year effect. Further, given that  
3 yields on utility bonds are in a fairly low historical range, I feel that the possibility  
4 for increasing rates, and therefore, the downside risk for the Company, is  
5 significantly greater than for the opposite result.

6 Q. Would it be possible to establish a reasonable reconciliation mechanism for this  
7 instrument as well?

8 A. While the Company did not originally request one for this purpose, such a  
9 mechanism is possible and it would alleviate the Company's concern that the  
10 Staff Finance Panel's forecast leaves the Company exposed to an under-recovery  
11 of interest costs during the rate year. Since RG&E also has a forecasted new  
12 issuance during the rate year on which it would also be exposed to increasing  
13 rates, the Company requests a reconciliation mechanism for that transaction as  
14 well. Such a reconciliation mechanism will also protect ratepayers if rates remain  
15 low.

**HEDGE LOSSES**

17 Q. How did the Staff Finance Panel adjust the recovery of certain hedge losses  
18 incurred at RG&E?

19 A. The Staff Finance Panel adjusted downward, by 25% or \$1.526 million, the rate-  
20 year amortization of losses on interest rate hedges incurred by RG&E in  
21 connection with debt issuances that occurred in December 2008 and June 2009.

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1 Q. Did RG&E have authority from the Commission to enter into the hedges?

2 A. Yes. The Company entered into the hedges in 2006 under authority granted by  
3 the Commission in Case 03-M-0178.

4 Q. How does the Commission's Order in Case 03-M-0178 address hedges?

5 A. It grants RG&E authority to enter into hedges and states that "RG&E will  
6 demonstrate the reasonableness of any costs associated with these transactions in  
7 subsequent rate proceedings."

8 Q. Was the Company's hedging strategy reasonable?

9 A. The Company's hedging strategy was reasonable and the Staff Finance Panel's  
10 own conclusions support the reasonableness of the Company's hedging strategy.

11 Q. Can you please summarize the Company's hedging strategy at the time?

12 A. Yes. The Company's strategy was to hedge that portion of the interest rate risks  
13 faced by ratepayers for which hedging instruments were available to RG&E.  
14 Specifically, the Company entered into hedges in 2006 to protect ratepayers  
15 against the risk of rising treasury yields that could increase the cost of debt to  
16 ratepayers. Exhibit \_\_ (CD-4) shows the historical treasury yield context in  
17 which the Company's decision to engage in a hedge was taken. The Company  
18 entered into the hedges to manage the risk of rising interest rates (treasury yields)  
19 that were forecast as a result of the strong economy extant in 2006.

20 Q. How would rising treasury yields have impacted customer costs?

21 A. Treasury yields are a major component of utility bond rates. When treasury yields  
22 increase, the cost of debt passed on to customers also increases. On the \$250  
23 million of notional value hedges that are in question here, had treasury rates

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1 increased 100 basis points, absent the hedges, customers would have had to pay  
2 approximately \$30 million more after tax on a present value basis over the life of  
3 the issuances.

4 Q. What was the cost of the hedges?

5 A. At the inception of all four of the trades in question, the “forward premium,” or  
6 difference between the spot interest rate and the interest rate that was locked into,  
7 was 3-4 basis points in each case. So in dollar terms, the cost of the hedges was  
8 approximately \$1 million on an after-tax basis. This cost was reasonable to hedge  
9 the risk and associated costs to ratepayers of a significant interest rate increase,  
10 which was very possible at the time.

11 Q. Had RG&E ever employed this type of hedging strategy in the past?

12 A. Yes.

13 Q. When was this type of hedging strategy employed by the Company and what was  
14 the result?

15 A. The Company entered into a hedge on \$100 million notional in February 2005 in  
16 anticipation of a June 2007 financing need. That hedge was settled for a gain of  
17 \$8.4 million. The amortization of that hedge gain is currently reducing  
18 ratepayers’ debt cost by \$336,000 annually.

19 Q. Has the Staff Finance Panel questioned the reasonableness of the February 2005  
20 hedge that resulted in gains?

21 A. No.

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1 Q. Did Staff address the Company's hedging strategy?

2 A. Yes. First, the Staff Finance Panel states that the Company had "reasonable"  
3 guidelines and policies in place with respect to its hedging program (page 76,  
4 lines 2-3) and that these guidelines included "the prohibition of speculative  
5 transactions; the use of hedges confined to risk management activities; the use of  
6 hedges only to provide more certainty in the Company's cost structure; the use of  
7 derivatives only if the transactions qualified for hedge accounting under SFAS  
8 133; and the use of derivatives subject to internal control procedures defined in  
9 Company's Sarbanes-Oxley policies" (page 75, lines 17-25). Second, the Staff  
10 Finance Panel finds that the Company abided by its guidelines in that the hedges  
11 were not speculative (page 63, lines 11-19) and that the hedges qualified for  
12 hedge accounting under SFAS 133 (page 62, lines 12-16). Third, the Staff Panel  
13 agrees that "we believe there was no hedging alternative for RG&E's debt  
14 issuance that was clearly superior to the alternative the Company selected" (page  
15 74, lines 3-6). Fourth, the Staff Finance Panel determines that "[t]he hedge  
16 worked as it was intended and was successful in locking in the Treasury rate"  
17 (page 63, lines 3-4). Fifth, the Staff Finance Panel concludes that "[t]he losses  
18 were due to the historically low Treasury rates caused by the financial crisis"  
19 (page 67, lines 17-18). Sixth, the Staff Finance Panel comments that the  
20 Company could not have foreseen the scope and severity of the financial crisis  
21 (page 67, lines 21-25 to page 68, lines 1-6).

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1 Q. What is your reaction to each of these statements about the Company's hedging  
2 strategy?

3 A. Each of these conclusions by the Staff Finance Panel strongly point to the  
4 reasonableness of the hedges in question. Stated more directly, RG&E properly  
5 entered into these hedges for the legitimate purpose of protecting ratepayers  
6 against the possibility of future increases in treasury interest rates and, as Staff  
7 acknowledges, the hedge functioned exactly as intended.

8 Q. Despite Staff's statements, does Staff question the reasonableness of the  
9 Company's hedging strategy?

10 A. Yes, but Staff's questions regarding the hedge do not comport with its findings  
11 which I discussed above.

12 Q. Please explain further.

13 A. On page 68, lines 10-19 of the testimony, the Panel suggests what appears to be a  
14 new standard for evaluating hedging activities. In particular, Staff says, "[t]he  
15 standard for determining if recovery of the costs of the hedge is reasonable is to  
16 evaluate if the hedge instruments used by the Company were an effective means  
17 of hedging utility debt 'to obtain some level of savings with no risk of higher  
18 costs.' This standard should be viewed in the context of when the hedge was  
19 entered into or when it was renewed, not from the perfect after-the-fact  
20 knowledge now available today."

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1 Q. Where does the language contained in single quotes – ‘to obtain some level of  
2 savings with no risk of higher costs’ originate from?

3 A. The language comes from a Commission Order issued and effective several years  
4 after the Company entered into the hedges in question. As the Panel notes in its  
5 testimony at pages 56-57, that language comes from Case 07-M-1194, Rochester  
6 Gas & Electric Corporation, Order Authorizing Issuance of Securities, issued  
7 November 18, 2008 (“RG&E Financing Order”). The Staff Finance Panel jumps  
8 to the conclusion on page 57 that this language from the RG&E Financing Order  
9 means that “[w]hile all of the derivative contracts that produced the large losses at  
10 RG&E were already entered into at the time of this Order, it provides a useful  
11 view of the Commission’s expectations for the Companies’ hedging program at a  
12 time before the existence of hedging losses, and particularly their magnitude,  
13 were known by Staff or the Commission.”

14 Q. Is it the Staff Finance Panel’s position that the language of a Commission Order  
15 promulgated in November 2008 constitutes a standard applicable to actions taken  
16 by the Company in 2006?

17 A. Yes. In response to NYSEG-RGE-79 (DPS), the Staff Finance Panel contends  
18 that the standard applied to the hedges undertaken by the Company in 2006,  
19 because “[the Order] reflects the Commission’s thinking on derivatives had it  
20 been asked at a time before the hedging losses were realized and became known  
21 to Staff.”

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1 Q. Do you agree with this conclusion by the Staff Finance Panel?

2 A. No. It is clearly unreasonable to hold the Company to a standard that purportedly  
3 reflects “the Commission’s thinking” if such thoughts are not reflected in a  
4 contemporaneous Commission writing. The Staff Finance Panel’s conclusion as  
5 applied to the 2006 hedges at issue should not be adopted.

6 Q. Can you please explain further why the Staff Panel’s conclusion should be  
7 rejected?

8 A. Neither the Commission language nor Staff’s interpretation of that language as a  
9 “hedging standard” were in existence at the time the Company entered into the  
10 relevant hedges. The Company entered into the hedges in 2006, more than two  
11 years prior to the Commission’s decision in Case 07-M-1194. Accordingly, it is  
12 unreasonable to claim that language from Case 07-M-1194 sets forth the standard  
13 of reasonableness in connection with these hedges.

14 Q. Does the Staff Finance Panel attempt to define any other standard of  
15 “reasonableness” relating to the 2006 hedges?

16 A. The Staff Finance Panel attempts on page 69 of its testimony to define an  
17 alternative standard. The Staff Finance Panel states that, “[f]or the Companies to  
18 demonstrate that their derivatives were reasonable, it must be shown that the  
19 correlation of the Treasury bond rate to the issuance rate of utility debt is quite  
20 high. Also, the extraordinarily long period that the derivative remained open  
21 should be examined, as well as the availability of any alternative derivatives the  
22 Company could have used.”

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1 Q. How do you interpret this statement?

2 A. Staff appears to be attempting to establish for the first time, in 2010, a three part  
3 “hedging reasonableness” test. Part one is a “correlation” test. Part 2 is a “time”  
4 test, and Part 3 is an “alternatives” test. I note, again, that Staff’s proposed three  
5 part test did not exist even as a theoretical construct at the time the relevant  
6 hedges were entered into in 2006 and it should have no application in the current  
7 circumstances. Nevertheless, I review the Staff Finance Panel’s application of its  
8 tests below, starting with the “time” test first, continuing with the “alternatives”  
9 test and ending with the “correlation” test.

10 Q. What is the Company’s response to Staff’s alleged findings under the “time” test?

11 A. The Staff Finance Panel argues that the hedges were open for a “long period of  
12 time” and that this increased the exposure for “unexpected consequences to  
13 happen.” Notwithstanding the fact that hedges are intended to be used to protect  
14 against future unknown events, the Staff Finance Panel claims that it might be  
15 reasonable to allow all of the Company’s hedging losses if the hedges had been  
16 open for a “short period of time.” The Staff Panel’s testimony fails to specifically  
17 define what a “long period of time” or a “short period of time” is with respect to  
18 open hedges. The Staff Finance Panel simply concludes with no rationale that the  
19 two years RG&E’s 2006 hedges were open was a “long period of time.” As a  
20 result it finds that the relevant hedges were somehow implicated by this test.

21 Q. In your view is the timing test valid?

22 A. Not at all. Absent a preset standard of what is “too long” for a hedge to be open it  
23 has no meaning and Staff’s conclusion is subjective and result-oriented.

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1           Moreover, even if, for example, the hedges were established at the end of July  
2           2008 – less than 6 months from the December 2008 financing and less than 12  
3           months from the June 2009 financing – the losses on these hedges would have  
4           exceeded 80% of the level actually incurred. In fact, more than half of the total  
5           losses on the hedges were incurred within a 30-day period after the onset of the  
6           financial crisis. The losses occurred, not because the hedges were open for “a  
7           long period of time,” but because of the precipitous fall in rates that occurred as a  
8           result of the financial crisis in late 2008. Therefore, Staff’s proposed undefined  
9           “long period of time” versus “short period of time” test is of no value in  
10          determining reasonableness and does not support Staff’s proposed adjustment to  
11          hedging loss recovery.

12   Q.     Do you have any other concerns about the “time” test?

13   A.     I describe in detail later in this rebuttal testimony the circumstances surrounding  
14          our efforts to secure new financing authority in Case 07-M-1194 that began in  
15          October 2007 and were not finalized until days before we issued in December  
16          2008. As I discuss subsequently in my testimony, the extended delay in securing  
17          a Commission Order in Case 07-M-1194 led to three of the four hedges being  
18          open rather than settled after the financial crisis occurred, during which period  
19          treasury rates dropped precipitously and resulting in the majority of the hedge  
20          losses.

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1 Q. What were the results of and the Company's response to Staff's second prong, the  
2 "alternatives" test?

3 A. The Staff Finance Panel notes on pages 73-74 of its testimony that its review of  
4 alternatives with the Company indicates that there were no better hedging  
5 alternatives that were clearly superior to the alternative the Company selected.  
6 The Company agrees and this test is fully satisfied and provides no basis for  
7 Staff's adjustment to hedging loss recovery.

8 Q. Please describe the third prong or "correlation" test.

9 A. The Staff Finance Panel correlated the movements in "10-year Treasuries" and  
10 "long-term utility debt." According to the Staff Panel's testimony on page 70,  
11 lines 1-5, "If the correlation between treasury debt and utility debt was high  
12 during the period before the derivative was issued, it would be reasonable to  
13 assume that changes in treasury rates would roughly track utility debt costs."  
14 Using data from the period July 1997 through June 2008, the Staff Finance Panel  
15 found a coefficient of correlation of 0.75. The Staff Finance Panel concludes the  
16 following: "This means that 75% of the change in utility debt rate was explained  
17 by changes in the 10-Year Treasury Bond Rate." The Staff Finance Panel then  
18 goes on to say that they reviewed monthly data and in so doing noted that the  
19 "spread" between Treasuries and utility debt varied.

20 Q. Are there flaws in Staff's reasoning underlying the "correlation" prong?

21 A. Yes. First, the results of a correlation calculation such as the one described by the  
22 Staff Finance Panel are sensitive to the input data. The 75% result in the Panel's  
23 study is a result of the particular time period that it selected, which period

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1 includes input data from *after* the hedges were executed. Running the same test  
2 on the period from July 2003 through April 2006 (the month before the first hedge  
3 was executed) produced a correlation coefficient of 95%. Second, as a matter of  
4 fact, very few hedge instruments provide perfect correlation with the underlying  
5 risk they are meant to hedge. As the Staff Finance Panel has pointed out on page  
6 75, line 23 of its testimony, the Company’s hedges qualified for hedge accounting  
7 under SFAS 133. Third, the Staff Finance Panel presents its study findings as if  
8 the findings tell us something we may not have known in the absence of the study,  
9 which is that credit spreads move independently of treasury yields. Of course, the  
10 Company is, and was, well aware of that fact as its contemporaneously  
11 documented strategy was to hedge that portion of the interest rate risk for which  
12 there were tools available, a strategy which the Staff Finance Panel agrees was the  
13 “best alternative available” (page 73, line 15).

14 Q. Does the Company object to the use of the “correlation” prong?

15 A. Yes. The Company objects to the “correlation” prong and Staff’s application of  
16 the test because, like each of the other parts of Staff’s proposed test, it was first  
17 articulated in this proceeding which took place well after the actions taken by the  
18 Company, and because of the numerous flaws in the test itself. In addition, the  
19 correlation is highly dependent upon the time period selected and the test does not  
20 reveal anything except the well-known fact that credit spreads move  
21 independently of treasury yields.

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. Do you have any other concerns in relation to the Staff Finance Panel's  
2 recommendation to deny recovery of 25% of the hedge losses?

3 A. The hedge strategy RG&E utilized is widely used by a number of utilities and has  
4 been used by NYSEG and RG&E on previous occasions. For small, illiquid  
5 issuers like RG&E, no market exists to hedge credit spreads and the Staff Finance  
6 Panel has acknowledged this fact (page 73, lines 15-17). RG&E used the tools it  
7 had at hand to hedge a legitimate risk and is now being unfairly penalized  
8 because, in the midst of the deepest financial crisis since the depression, the worst  
9 possible combination of events occurred – treasury rates fell and spreads widened.  
10 I believe that the Commission should be concerned that the actions recommended  
11 here might be seen as punitive or at best arbitrary and capricious, which would  
12 stifle utility hedge-related activity that the Commission views as beneficial.

13 Q. What is your conclusion regarding recovery of the hedge losses?

14 A. First, the hedges were reasonable when they were entered into, given the market  
15 conditions that existed at the time. The actual cost of entering the hedges was  
16 reasonable given the protection against certain increases in interest rates provided  
17 by the hedges. Although the market ultimately moved against the hedges as a  
18 result of the historic financial crisis, the Company remains entitled to full  
19 recovery of the cost of these reasonable hedges.

20 Q. Do you agree with Staff's attempt to retroactively impose a new reasonableness  
21 standard on the hedges?

22 A. No. Staff's attempt to create, out of whole cloth, a new reasonableness standard  
23 for hedges and apply that standard retroactively should be rejected for the

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 following reasons: First, the hedges at issue were entered into to protect  
2 ratepayers from the risk of interest rate increases well before the RG&E Financing  
3 Order at the heart of Staff’s proposed new reasonableness standard. Second,  
4 Staff’s proposed new reasonableness standard is seriously flawed. Third, the  
5 Staff Finance Panel’s own testimony demonstrates no wrongdoing by the  
6 Company since it acknowledges that there were no superior hedging instruments  
7 available, the hedges were entered into for appropriate purposes in accordance  
8 with the Company’s hedging policy, the hedges worked as intended, and the  
9 losses were caused by the historically low treasury rates resulting from the  
10 financial crisis.

**Delay in Approval of RG&E’s 2007 Finance Petition**

11  
12 Q. Did RG&E submit a financing petition on October 4, 2007?

13 A. Yes. The Company submitted a financing petition (“Petition”) and Case 07-M-  
14 1194 was opened by the Commission.

15 Q. Why did the Company file the Petition?

16 A. The Company filed for additional financing authority in October 2007 because  
17 RG&E’s need for new financing in 2008 far exceeded the authority it had  
18 remaining under the authority granted by the Commission in Case 03-M-0178.  
19 Rather than do several separate, smaller transactions, it was our intention to use  
20 the new authority to execute a single larger transaction in April 2008. Larger  
21 transactions are more efficient for a number of reasons, including the elimination  
22 of redundant legal and accounting work and better capital markets execution.

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. When was the final decision in Case 07-M-1194 issued?

2 A. The original decision was issued on November 18, 2008, more than 13 months  
3 after the financing petition was submitted. The original decision, however,  
4 contained language which the Company needed to have clarified by the  
5 Commission before the Company could issue new debt. The final decision from  
6 the Commission which clarified the original decision was issued on December 10,  
7 2008, more than 14 months after the financing petition was submitted.

8 Q. Staff claims on pages 65-66 of its testimony that “the financing Petition was  
9 deficient and based on erroneous information.” Do you agree?

10 A. No. It is not unusual after filing a financing petition that Staff might seek  
11 clarification or to ask for additional information. To label the Company’s  
12 financing petition as “deficient” is incorrect. In any event, according to our  
13 records, we had addressed all of Staff’s questions and requests for clarification  
14 concerning the Petition by December 6, 2007. On January 7, 2008, the Company  
15 made an initial contact with Staff regarding the status of the Petition. We were  
16 informed that it would not be on the January session, but were given no reason.

17 Q. Does the Staff Finance Panel identify the alleged deficiency in the Company’s  
18 petition in its testimony?

19 A. No. However, in response to NSYEG-RGE-77 (DPS), which is included in  
20 Exhibit \_\_ (CD-5), Staff indicates that it disagreed with the Company’s  
21 calculation of the reimbursement margin based on an allegation that the  
22 calculation incorrectly reflected the effects of the sale of the Company’s Ginna  
23 nuclear facility.

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. Did the Company address Staff's concerns regarding the reimbursement margin  
2 calculation?

3 A. Yes. According to our records, we had addressed all of Staff's questions and  
4 requests for clarification about the Petition, which primarily concerned the  
5 calculation of the reimbursement margin, by December 6, 2007. None of the  
6 questions asked by Staff or responses provided by the Company after  
7 December 6, 2007 were on the subject of the reimbursement margin.

8 A. Staff says in response to NYSEG-RGE-77 (DPS) question 4, included in  
9 Exhibit \_\_ (CD-5), "[t]he deficiencies in the Company's filing were ultimately  
10 corrected by Staff, but the matter took almost seven months to resolve. For much  
11 of the period from the time the petition was filed until the end of April 2008, Staff  
12 was unable to justify the transaction because the reimbursement margin was  
13 insufficient. Only when the Company finally sent Staff its FERC Form 1 on  
14 April 24, 2008 was a basis established for resolving the reimbursement margin  
15 issue."

16 Q. Did Staff ever produce a reimbursement margin calculation?

17 A. Yes. Staff's calculation of the reimbursement margin is included as Attachment 3  
18 to the Order issued on November 18, 2008.

19 Q. Is there any information on Attachment 3 that was not available to Staff when the  
20 petition was initially filed in October, 2007?

21 A. Staff used December 31, 2007 balance sheet data, which would not have been  
22 available in October 2007 as a starting point for its analysis. However, the

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1 analysis could just as well have used the balance sheets submitted in the original  
2 Petition as the starting point.

3 Q. What is the reimbursement margin meant to indicate?

4 A. It is a calculation of the cumulative difference over time between the Company's  
5 capital expenditures and its sources of capital to pay for the expenditures. It is  
6 meant to be an indication of the Company's need for external financing.

7 Q. If the reimbursement margin were to indicate a need for financing that is lower  
8 than the amount requested in a petition, is Staff at liberty to authorize an amount  
9 lower than what that requested?

10 A. Yes. Staff does so routinely. In fact, in the Petition and March 12 supplement  
11 thereto, we requested authority to issue up to \$612.4 million of securities,  
12 including \$250 million to finance additions to utility plant and equipment. The  
13 Order issued in November, 2008 authorized \$495 million of securities, including  
14 up to \$157 million to finance additions to utility plant and equipment.

15 Q. Did you receive any inquiries pertaining to the financing petition after January  
16 2008?

17 A. Yes. On February 25, 2008, Staff requested information concerning the recent  
18 disruption in the auction rate securities market. We provided a response on  
19 February 26, 2008. On March 12, 2008 the Company submitted a letter  
20 supplementing the original financing petition, with a request to incorporate the  
21 potential need to refinance up to \$162.4 million of tax-exempt auction rate  
22 securities. This request was made in response to the disruption in the auction rate  
23 securities market. Since this request was to refinance, it would not have affected

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1 the Company's need for new long-term debt authority and therefore would not  
2 have had an impact on the calculation of the reimbursement margin. On March  
3 25, 2008 we received a number of interrogatories from Staff, including a request  
4 for our FERC Form 1 filing (financial statements) for 2007. We responded to all  
5 of the interrogatories by March 28, 2008 and provided a draft FERC Form 1 as  
6 soon as it was available on April 7, 2008. We were asked for additional pages  
7 from the FERC Form 1 on April 14, 2008. We provided these pages on the same  
8 day.

9 Q. Why did the Company believe Staff made the requests for additional information  
10 in February and March?

11 A. We thought that Staff's inquiries about the auction rate markets were in response  
12 to events that were occurring in those markets and that may have an impact on  
13 securities issued by the Company. We believed the inquiries in March 2008 were  
14 because sufficient time had passed since the financing petition was initially  
15 submitted that financial information related to the Company's third and fourth  
16 quarter results had become available and Staff wanted to utilize the most current  
17 information available in reviewing the Petition.

18 Q. Did Staff ever relay to you in February, March or April that they had concerns  
19 about the reimbursement margin and that these concerns were the source of the  
20 delay in having the Company's financing petition considered by the Commission?

21 A. No. The Staff Finance Panel's response to NYSEG-RGE-77 (DPS), which is  
22 included in Exhibit \_\_ (CD-5), is the first indication the Company received after

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 December 6, 2007 that specifically mentioned that Staff had a problem with the  
2 then-available reimbursement margin schedule.

3 Q. When was the next communication the Company had with Staff regarding the  
4 financing petition?

5 A. The Company inquired on May 7, 2008 and again on July 18, 2008 as to the status  
6 of the financing petition, only to be informed that it would not be on the  
7 Commission agenda. On September 24, 2008 the Company contacted Staff to  
8 express growing concern about the Company's liquidity position. Based on that  
9 call, the Company expected that the financing petition would be on the  
10 Commission's November agenda. On October 2, 2008 the Company inquired  
11 whether Staff had any further questions or information needs in relation to the  
12 financing petition. On October 7, 2008 we received additional interrogatories  
13 from Staff, which we answered on October 11, 2008. On October 17, 2008 the  
14 Company was notified by Staff that the financing petition would *not* be on the  
15 November agenda. On October 20, 2008, a further call with Staff reached the  
16 conclusion that the financing petition should be addressed at the Commission's  
17 next open session. Thereafter, the Company received and responded promptly to  
18 a series of additional interrogatories from Staff, none of which were related to the  
19 reimbursement margin. On November 7, 2008 the Petition appeared on the  
20 Commission's consent agenda.

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. Staff claims on page 65 of its testimony that “[t]he delay in the issuance of the  
2 November 2008 financing order is not solely the responsibility of Staff or the  
3 Commission.” Do you agree with this?

4 A. No. Once the Company had submitted the Petition and fully answered Staff’s  
5 interrogatories concerning the Petition, both of which had occurred by December  
6 6, 2007, the Company’s role was complete and the timing of the ultimate order  
7 was outside the Company’s control. At no point after December 6, 2007 was the  
8 Company informed that there were further deficiencies in the Petition. The few  
9 follow-on inquiries made by Staff were unrelated to the problems with calculating  
10 the reimbursement margin that Staff claims to have experienced and were  
11 immediately answered by the Company, creating no additional delay in the  
12 process.

13 Q. Staff states on page 66 of its testimony that “the Company was consumed by the  
14 Iberdrola proceeding that resulted in the Acquisition Orders and great amounts of  
15 Company and Staff resources were focused on that proceeding. Communications  
16 on the financing between Staff and the Company suffered.” Did the lack of  
17 Company resources impact the financing petition timing?

18 A. No. As I previously testified, all of Staff’s initial concerns about the filing and  
19 Staff’s normal interrogatories were addressed and answered by the Company  
20 within 63 days of the initial submission. Every inquiry from Staff was answered  
21 within four days and most within twenty-four hours.

22 Q. The Staff Finance Panel claims on page 67 that “it appears the Company  
23 misunderstood the financing authorization that remained available to it under the

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 previous financing Order issued in Case 03-M-0178.” What authority did the  
2 Company have remaining under the financing authority granted in Case 03-M-  
3 0178?

4 A. The Company’s records of compliance filings required under 03-M-0178 clearly  
5 show that the Company had \$52 million of financing authority. In the Petition  
6 filed on October 4, 2007 the Company stated at page 2: “[w]hile the Company’s  
7 financing authorization will expire on December 31, 2008, the Company requests  
8 that the Commission approve this Petition at or before the Session scheduled for  
9 December 12, 2007. This request is necessary for several reasons, including  
10 (1) that the Company has used \$150 million of the \$202 million in traditional  
11 utility purpose authority, of which the Company applied \$75 million to the  
12 establishment of a multi-year revolving credit facility.” On page 3 of the Petition,  
13 the Company listed each of the issuances it had completed under 03-M-0178,  
14 showing explicitly how it had reached its conclusion regarding the \$52 million of  
15 remaining authority.

16 Q. In response to NYSEG-RGE-76 (DPS), included in Exhibit \_\_ (CD-5), Staff notes  
17 that “[t]he correct amount of debt remaining on the Company’s authorization of  
18 \$202 million from Case 03-M-0178, in the Order Authorizing Issuance of  
19 Securities issued August 1, 2003, was \$127 million.” When did Staff first  
20 communicate to you its interpretation of the authority remaining under Case 03-  
21 M-0178?

22 A. Our records indicate that Staff’s first specific identification of its interpretation of  
23 our remaining authority from Case 03-M-0178 came in late October 2008

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 discussions with Staff. The Company has no record prior to late October 2008 of  
2 any communication that Staff disagreed with the Company's statements in its  
3 Petition in 07-M-1194 that the Company had \$52 million in remaining authority.  
4 Further, there is no record of Staff having requested an amendment of, or having  
5 questioned previous compliance filings under 03-M-0178 which clearly showed  
6 we had only \$52 million remaining.

7 Q. In response to NYSEG-RGE-76 (DPS), which is contained in Exhibit \_\_ (CD-5),  
8 Staff asserts that, "[a]t issue was whether a short-term revolving credit facility of  
9 \$75 million encumbered the Case 03-M-0178 financing authority. The Company  
10 acknowledged that Staff classified the \$75 million as short-term debt, in a letter  
11 dated October 12, 2007 from Joseph Syta, Vice President, Treasurer and  
12 Controller of RG&E to Richard Ansaldo of Staff." What does the letter Staff  
13 cite to address?

14 A. That letter, which Staff referenced in its response to NYSEG-RGE-76 (DPS) and  
15 which we provide as Exhibit \_\_ (CD-6), amends the Petition submitted on  
16 October 4, 2007 in 07-M-1194, "by withdrawing the request for Commission  
17 authorization for the 5-year credit facility found in Paragraph 11 of its Petition."  
18 It dealt prospectively with the issue of whether the Commission had jurisdiction  
19 over such credit facilities. The letter does not address the interpretation that the  
20 Company held in its filings pursuant to 03-M-0178. It clearly neither sought to  
21 amend any of its previous filings under 03-M-0178 as they related to such credit  
22 facilities nor to amend the October 4, 2007 Petition sections regarding the  
23 remaining authority under Case 03-M-0178.

**DEBT COST REBUTTAL TESTIMONY OF HOWARD COON**

1 Q. Is there any acknowledgment by the Company in the letter concerning Staff's  
2 classification of the \$75 million as short-term debt?

3 A. There is no reference whatsoever in the letter to the classification of the \$75  
4 million and it would not have been expected to reference it, since the letter dealt  
5 with the October 4, 2007 Petition, paragraph 11.

6 Q. Did Staff or the Commission acknowledge the October 12, 2007 letter and, if so,  
7 how?

8 A. Yes. The Commission in footnote 1 of its Order in Case 07-M-1194, identified  
9 that the Company had withdrawn its request originally made in Paragraph 11 of  
10 the Petition.

11 Q. Was there any response from Staff as to the credit facility jurisdiction or  
12 utilization issue related to your filings under 03-M-0178, specifically with respect  
13 to the \$75 million multi-year revolving credit facility?

14 A. No.

15 Q. Why did the Company not utilize that \$52 million in authority under Case 03-M-  
16 0178, thus closing part of the open hedges?

17 A. If the Company had a crystal ball and could have predicted the financial crisis it  
18 might have done so. However, absent knowledge that a historic financial crisis  
19 was looming and having completed and filed the financing petition in 2007, there  
20 was no reason to second-guess the strategy of utilizing new authority to more  
21 efficiently issue a larger debt issuance. The Company had no reason to expect  
22 that the financing petition would not be addressed by the Commission until over  
23 13 months had elapsed. In any case, once the financial crisis hit in September

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1           2008, BBB-level companies like the Company were effectively shut out of the  
2           market until early November 2008, at which point the financing petition was  
3           approved on the Commission’s Consent Agenda.

4   Q.   Staff claims at page 66 of its testimony that “the Company had no need to issue in  
5           April. In fact it had a cash surplus and no long-term debt was maturing until  
6           November.” Do you agree?

7   A.   No. Staff acknowledges in response to NYSEG-RGE-0178, included in  
8           Exhibit \_\_ (CD-5), that it used the Company’s June 30, 2008 balance sheet to  
9           assert that the Company had a cash surplus in April. In fact, RG&E did not have  
10          a “cash surplus” in April. In addition, the Company forecasts its financing needs,  
11          and does not wait until it runs out of funds before seeking to issue debt. By the  
12          end of September, the Company had borrowed \$139 million in short-term debt,  
13          which included \$42 million from Iberdrola USA (formerly Energy East), because  
14          it had used all of its available bank revolver capacity to cover various operating  
15          and capital costs being incurred. Further, the Company neither needs, nor has it  
16          been the historical practice of the Company, to refinance its maturities exactly on  
17          the date of those maturities. In fact, \$100 million of the Company’s \$150 million  
18          June 2009 financing was applied to an October 2009 note maturity. So, if for  
19          some reason the Company had not carried out its plan to issue in April 2008, it  
20          certainly would have done so before the end of September 2008, but for the fact  
21          that it lacked the authority it had been seeking since October 2007.

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1 Q. If you had issued in April 2008, what would the hedge losses have been?

2 A. The losses on the hedges that were eventually settled in December 2008 were  
3 \$100 million and they would have been \$15 million if settled in April 2008. The  
4 loss on the hedge eventually settled in June 2009 would have been the same, \$20  
5 million. In total, the losses would have been \$35 million, rather than \$120  
6 million.

7 Q. Has the Company subsequently submitted a petition for new financing authority?

8 A. Yes. On April 3, 2009, RG&E submitted another financing petition, designated  
9 Case 09-M-0309, seeking to increase our financing authority.

10 Q. Has an order been issued in the case and, if so, when was it issued?

11 A. The Commission issued an order in Case 09-M-0309 on June 23, 2009,  
12 approximately 12 weeks after the filing date.

13 Q. Staff claims at page 67, lines 2-6 and 12-14 of its testimony that “[w]e think that  
14 the deteriorating state of the hedges could have been conveyed to Staff and  
15 perhaps the petition could have been expedited if the dire circumstances had been  
16 made known to Staff... If communications between Staff and the Companies had  
17 been better, a good deal of the hedge losses could have been avoided.” Do you  
18 agree with this assessment?

19 A. No. As stated above, more than half the losses occurred in a very short period  
20 after the onset of the financial crisis. During the month of October and into mid-  
21 November, BBB-rated companies could not access the capital markets, so lack of  
22 authority was not the issue. In any event, Staff was made aware of the  
23 Company’s increasing sense of urgency surrounding its liquidity position in a

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1 conference call on September 24, 2008. As noted above, RG&E had by then  
2 taken the unprecedented step of borrowing over \$40 million from Iberdrola USA.  
3 The Order was not issued for another eight weeks after that call.

4 Q. In your opinion, does the Company bear the blame for the hedge losses that  
5 occurred in December 2008?

6 A. No. I reiterate that the losses were caused by the unprecedented fall in treasury  
7 rates that happened during the financial crisis.

8 **Summary**

9 Q. How would you summarize the appropriate adjustments and resolution to the cost  
10 of debt issue with respect to the rate assumptions for floating rate debt?

11 A. The Companies would agree to accept an adjustment to the rate assumptions to  
12 reflect a current floating rate of interest. Our amended RRP-5 schedules include  
13 floating rates in effect from the week of February 1 and we will update these at  
14 Staff's request as the case proceeds, if there is a reconciliation mechanism. This  
15 is a downward adjustment of \$13.7 million and \$3.0 million to the debt costs of  
16 NYSEG and RG&E, respectively. In the absence of a reconciliation mechanism,  
17 the Companies will fix the rates on the securities, the consequences of which are  
18 discussed above.

19 Q. Can you also briefly summarize how you think the adjustments to the cost of debt  
20 with respect to the new issuances forecast at NYSEG and RG&E should be  
21 resolved?

22 A. Yes. In the amended Exhibit \_\_ (RRP-5), NYSEG has used Staff's estimated  
23 interest rate, resulting in an \$0.8 million adjustment to the rate noted above. This

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1 schedule also adds back in the \$17,000 amortization noted above. Both NYSEG  
2 and RG&E request reconciliation treatment to protect both ratepayers and the  
3 Companies from their exposure to rates in relation to the new issues forecast.

4 Q. Can you summarize how the adjustments to the cost of debt with respect to the  
5 amortization of hedge losses at RG&E should be resolved?

6 A. I believe that RG&E is entitled to recover all of its hedge losses in accordance  
7 with its original submission and, accordingly, I have restored the disallowed  
8 \$1.5 million of amortizations to the cost of debt schedules.

9 Q. Does this conclude your rebuttal testimony at this time?

10 A. Yes, it does.

11

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