STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE
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July 3, 2008

Hon. Jaclyn A. Brilling
Secretary
Department of Public Service
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case 07-M-0906 – Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Greene Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation – Joint Petition For Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A.

Dear Secretary Brilling:

Enclosed please find Staff's Reply Brief on Exceptions in the captioned proceeding. A copy has been served on all active parties via e-mail, and regular mail to parties so requesting.

Very truly yours,

Leonard Van Ryn
Sean Mullany
Staff Counsel

Enclosure
cc: All Active Parties

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 07-M-0906 - Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Greene Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation – Joint Petition For Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A.

STAFF REPLY BRIEF ON EXCEPTIONS

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Dated: July 3, 2008
Albany, New York

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PRELIMINARY STATEMENT

In response to a Recommended Decision (RD) issued June 16, 2008 in this proceeding by Administrative Law Judge (ALJ) Rafael A. Epstein, Briefs on Exceptions (BOE) were filed on June 26, 2008. Staff received briefs from the Consumer Protection Board (CPB), the Department of Environmental Conservation (DEC), Greater Rochester Enterprise (GRE), Iberdrola, S.A. (Iberdrola) and Energy East Corporation (Energy East), Multiple Intervenors (MI), Nucor Steel Auburn, Inc. (Nucor), the Rural Electric Cooperative Association (RECA), and Strategic Power Management LLC (SPM). Staff replies to those arguments not adequately addressed in the RD or its Brief on Exceptions (SBOE).

SUMMARY OF POSITION

According to Iberdrola's BOE (IBOE), it is a "unique" entrant into New York, unlike any owner of electric and gas transmission and distribution (T&D) utility that has preceded it (IBOE 2). What is "unique" about Iberdrola, however, is not the "technical competency," the "management skills," or the “financial strength” it alleges it brings to New York (IBOE 2-4). While it appears that Iberdrola is a reasonably competent and skilled T&D utility holding company, Energy East, the current owner of the NYSEG and RG&E T&D utilities, is also reasonably competent and skilled. As to financial strength, Iberdrola can access capital markets on reasonable terms -- but so can Energy East. Consequently, as an acquisition transaction, Iberdrola’s proposal can be viewed as another in a series of utility holding company business decisions to expand the scope of their operations in New York. Iberdrola is “unique” only in the risks that would be posed to NYSEG and RG&E ratepayers through affiliation with Iberdrola’s far-flung and exceedingly complex corporate interests, which are opaque to regulatory scrutiny.

A complicating factor, however, affects this transaction. Besides engaging in T&D utility holding company activities, another of Iberdrola’s many business lines is development of wind generation projects. By all accounts, Iberdrola has been successful in that business. And Iberdrola is correct in pointing out that growth in renewable generation resources is important to New York. The policies New York and the Commission have undertaken to promote renewable resources are on the record here, as are the many actions Staff has taken in full support of those policies.

Taken separately, neither foreign utility holding company operations nor wind generation development efforts are unfamiliar to New York. Other foreign utility holding companies, such as National Grid, operate in New York, and many wind developers have entered the state in response to its renewable portfolio standard (RPS) incentives.[1] What is different about Iberdrola is the combination of T&D holding company operations and wind development efforts in one entity.

These two aspects of Iberdrola's corporate strategy come into conflict in New York because it is the only state in which Iberdrola plans to both own T&D utilities and to develop wind projects. Iberdrola pursues T&D utility investment opportunities throughout Europe and the Americas, and Energy East is an appealing asset to acquire in furtherance of such a strategy. Iberdrola also develops wind generation projects in Europe and North America, and New York is friendly to wind power developers. Iberdrola's two separate efforts cross in an unfortunate conjunction in New York.

Despite the efforts of Iberdrola and its allies, they have not resolved the disconnect between the acquisition of T&D utilities and the pursuit of the development of wind projects.

[1] See, e.g., Case 03-E-0188, Retail Renewable Portfolio Standard, Order Approving Implementation Plan, Adopting Clarifications and Modifying Environmental Disclosure Program (issued April 14, 2005).

The only connection that has been drawn between the two efforts is Staff's SBOE proposal to tie the level of monetary benefits Iberdrola must offer NYSEG and RG&E ratepayers in order to justify approval of the T&D acquisition to the level of investment it proposes to make in wind projects.

Otherwise, the link between Iberdrola's two separate lines of business is the "unique" feature of this proceeding that makes its resolution difficult, because, as established in the VMP Policy Statement, that link creates vertical market power (VMP).[2] Preventing the exercise of VMP to the detriment not only of NYSEG and RG&E ratepayers, but also to the development of renewable resources sufficient to meet New York's goals, must be a primary goal in this proceeding.

If this were just another holding company acquisition of T&D utilities, the remedy would be simple and straightforward –- Iberdrola would merely exit the generation business in New York and pursue generation projects elsewhere. Instead, Iberdrola desires to become a major participant in wind development in New York. At $2.0 billion, the level of investment CPB, DEC, and SPM proclaim for Iberdrola -- but Iberdrola itself does not so much as mention in its BOE -- is enticing. An investment, however, benefits New York only if it

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[2] Case 96-E-0900, et al., Orange and Rockland Utilities, Inc., et al., Statement of Policy Regarding Vertical Market Power (issued July 17, 1998).

is actually made, instead of just proclaimed. Iberdrola's only promise on the record is the $100 million commitment actually discussed in its BOE, and that commitment is unenforceable. The proclaimed $2.0 billion investment is, at present, no more than wishful thinking.

If, against Staff's recommendations, the Commission decides that Iberdrola should be allowed to pursue its two separate lines of business in New York, the Staff BOE outlines a means for doing so. An exception to the VMP Policy Statement can be created, upon conditions that will mitigate Iberdrola's exercise of VMP both to the detriment of NYSEG, RG&E and other upstate ratepayers and to achievement of the State's renewable generation goals. If VMP is not mitigated, those ratepayers could pay too much for generation. Iberdrola's competitors, who are at least as necessary as Iberdrola to achieving New York's renewable generation goals, could be discouraged from doing business in New York, because Iberdrola can obtain favorable treatment.

If the VMP issue can be addressed, the more mundane matter of the Commission's policies, established in the KeySpan/Grid Order and elsewhere,[3] for electric T&D utility

[3] Case 06-M-0878, National Grid PLC and KeySpan Corporation, Order Authorizing Acquisition Subject to Conditions and Making Some Revenue Requirement Determinations For KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued September 17, 2007).

acquisitions will remain. Iberdrola must still show that it meets all of the tests for acquiring NYSEG and RG&E. The wind generation development issue should not distract attention from those policies, or Iberdrola's failure to date to satisfy them.

ARGUMENT

Because the exercise of VMP is the central issue to this proceeding, given Iberdrola's interest in pursuing the separate T&D utility ownership and wind generation development business lines, the Commission should first address VMP before it proceeds to analyzing the acquisition transaction itself. Once VMP is dealt with, the issue of compliance with the positive benefits test for approval of an acquisition transaction, as most recently explicated in the KeySpan/Grid Order, should be decided, through analysis of the benefits and risks attending the transaction. Finally, if this transaction is approved, financial and structural conditions should be adopted to protect ratepayers from the risks affiliation with Iberdrola poses, again in conformance with the KeySpan/Grid Order.

A. Vertical Market Power

Iberdrola and its allies proclaim that ownership of wind generation is unlikely to raise vertical market power issues (DEC BOE 18-19). That claim, however, is unsustainable, because conjoined ownership of T&D utility operations and wind generation makes possible, and creates an incentive for, the classic exercise of VMP -- using control over T&D assets to raise the price paid for generation. Another adverse impact of VMP present here is Iberdrola's ability to exercise control over T&D assets in order to discourage its competitors, which would prevent them from assisting New York in meeting its renewable generation goals. Besides these issues, parties raise questions concerning the effects on VMP of the divestiture of the NYSEG and RG&E hydro facilities, and the role qualifying facilities (QF), which are exempt from Commission regulation, play in a VMP analysis.

1. Raising the Price of Generation

Contrary to the arguments of Iberdrola and its allies, VMP can be exercised to the benefit of wind generation Iberdrola would own in upstate New York. One example of the means for doing so already exists. The Ginna Nuclear Power Plant (Ginna), an independently-owned generator located in RG&E's service territory, has been required to substantially reduce its output because of actions RG&E took to maintain its transmission system (SM 1265-66). Preventing Ginna from delivering its generation to market increased some New York Independent System Operator (NYISO) prices to levels 55% higher than they were when Ginna was feeding its generation into the system (SM 1272-73). Any Iberdrola wind generation facility that had been on-line when the actions of Iberdrola’s would-be affiliates prevented that competitor from delivering its generation would have received that 55% price premium.

Such a price premium can be created even though wind generation is weather-dependent. Predicting and monitoring wind flows is already an important feature of wind project development and will only grow more so in the future. As the means for forecasting wind speed at a particular generation site, and monitoring actual production, grow more sophisticated, it will become ever easier to take a competitor off line at the time when the potential for producing wind generation reaches its optimum. Preventing competitor deliveries for periods as short as a few hours might be financially beneficial, when the breeze is strong. High winds, which are a well-known cause of outages, will also serve as a convenient excuse for delivery outages that affect competitors’ generation.

Iberdrola and its allies maintain that the New York Independent System Operator (NYISO) and Federal Energy Regulatory Commission (FERC) supervision of the transmission system will prevent this sort of exercise of vertical market power. First, NYISO and FERC were unable to prevent Ginna from losing delivery service, even though Ginna could rely upon contractual rights as well as its appeal to those entities. Second, it is not NYISO or FERC personnel that actually operate the NYSEG and RG&E T&D systems -- those personnel are hired, paid, and fired by NYSEG and RG&E, who will in the future, act on Iberdrola's behalf. As a result, both the incentive and the avenue for exercising VMP exists when Iberdrola controls both T&D operations and wind generators.

2. Discouraging Competitors

The exercise of VMP might also prevent New York from achieving its renewable generation goals, if Iberdrola's competitors are thereby discouraged because they encounter obstacles in delivering generation from their wind projects. Again, Iberdrola and its allies would rely upon NYISO and FERC to ensure that Iberdrola's wind developer competitors are treated fairly when seeking to interconnect with and use the NYSEG and RG&E delivery systems.

Iberdrola's competitors, however, might reasonably shrink from filing complaints and taking other actions necessary to preserving NYISO and FERC rights, because the process is too expensive and time-consuming. Indeed, Ginna filed its complaint on June 25, 2007 (SM 1266), and it is still not resolved. Consequently, if Iberdrola's competitors come to believe that Iberdrola will be favored in the use of delivery system resources in the NYSEG and RG&E service territories, they will not pursue the development of projects there. If New York becomes overly dependent upon Iberdrola as a result, its goals for renewable generation might not be reached.

3. DEC's Arguments

DEC finds it relevant that FERC decided to approval Iberdrola's acquisition of Energy East, on the hardly-surprising grounds that FERC believes its regulatory controls can prevent the exercise of VMP.[4] Nonetheless, FERC has conceded that compliance with the VMP Policy Statement is the province of this Commission, and FERC has declined to decide issues raised in that Policy Statement.[5] Moreover, the reasons justifying Staff's skepticism that FERC can adequately prevent the exercise of VMP are on the record at Exhibit 98 -- which rebuts DEC's contention that flaws in the Commission's approach to market regulation are at the root of Iberdrola's VMP failures instead of Iberdrola's choices (DEC BOE 11). In addition, the U.S. Government Accountability Office has called for FERC to exercise greater vigilance in reviewing merger transactions.[6]

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[4] Docket No. EC07-122-000, Energy East Corporation, 121 FERC ¶61,236 (2007).

[5] Docket No. EC06-125-000, National Grid plc, 117 FERC ¶61,080 (2006), ¶61,419.

[6] GAO-08-286 (issued February 2008).

DEC's VMP analysis is otherwise flawed. It dismisses both the VMP Policy Statement, and Opinion No. 96-12,[7] because their formats as statements of general policy are not binding in this proceeding (DEC BOE 11-12). The enormous effort the Commission has expended upon the development of the competitive markets that substantially benefit ratepayers, as embodied in the VMP Policy Statement and Opinion No. 96-12, should not be disregarded because DEC is uncomfortable with their format.

DEC also cites the Jordanville Certification Order as contradicting Staff's position here,[8] because that Order did not raise the VMP issue when Iberdrola's development of a wind generation facility was considered. Silence on an issue, however, is not precedent, and VMP issues could hardly have been considered in the Jordanville Certification Order because it was, as DEC concedes, issued only 23 days after Iberdrola filed its petition in this proceeding. That is well before the issues the petition raised could have been analyzed or predicted. As a result, DEC's analysis of VMP issues is deficient and unpersuasive.

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[7] Case 96-E-0952, Competitive Opportunities Regarding Electric Service, Opinion No. 96-12 (issued May 20, 1996).

[8] Case 06-E-1424, Jordanville Wind LLC, Order Granting Certificate of Public Convenience and Necessity and Providing For Lightened Regulation (issued August 23, 2007).

4. The Remedies

If, despite Staff's misgivings, the Commission decides to approve Iberdrola's acquisition of Energy East, Staff proposes, at SBOE 20-27, an exception to the VMP for Iberdrola's wind generation facilities, upon conditions. Procedural and process conditions would reduce the risk that Iberdrola's competitors would be discouraged from pursuing their wind projects. Contractual conditions would reduce the risk ratepayers would overpay for generation purchased for them on wholesale markets. Staff continues to caution, however, that those remedies are inferior to the divestiture Staff recommends.

5. The Hydro Facilities

Several parties oppose divestiture of the NYSEG and RG&E hydroelectric facilities. CPB maintains that continued utility ownership of those facilities reduces the delivery rates customers must pay (CPB BOE 8-9), while Iberdrola calculates the replacement power for the lost generation could cost $50 million (IBOE 46). As CPB notes, however, the hydro benefit could be preserved through a long-term contract with a new owner. Iberdrola's calculation is incomplete and misleading. It does not recognize substantial offsetting cost reductions, to rate base, operating expense and the like, that follow divestiture, or gains realized from the sales price.

Over the long term, the best approach to efficient operation of these hydro facilities is to subject them to competitive market forces. Moreover, at least two utilities in New York have divested all of their hydro facilities, without ill effect.[9] Exiting the hydro business will also end disputes over the prudence of rate-based investments, such as RG&E proposes, in the hydro facilities.

Therefore, appropriate remedy is divestiture, premised upon a long-term transition contract. While the longer the term of the transition contract, the lower the sales price that can be achieved, the value of these facilities for ratepayers is best realized through an appropriate transition contract. NYSEG and RG&E should be required to auction those facilities, and propose the contract, at the same time they sell their fossil units.

6. QF Issues

CPB and SPM identify some confusion in this proceeding on the regulation of the wind generation facilities that Iberdrola will develop as QFs. As they point out, and as Staff discussed in its April 25, 2008 Reply Brief (SRB) in this

[9] Case 96-E-0900, Orange and Rockland Utilities, Inc., Order Approving Transfer of Generating Facilities and Making Other Findings (issued June 24, 1999); Case 94-E-0098, Niagara Mohawk Power Corporation, Order Approving Transfer of Hydroelectric Generation Facilities and Making Other Findings (issued May 27, 1999).

proceeding, QFs are not regulated under the PSL (CPB BOE 6, SPM BOE 19-21, SRB 33-34). As SPM notes, PSL §66-c also provides that the development of wind power QFs is in the public interest. At SBOE 21-22, however, PSL §66-c is further interpreted as providing that electric utilities can develop new QFs only through subsidiaries whose formation is approved by the Commission. This method for creating an approval process, not raised in this proceeding prior to Staff's RBOE, can form the basis for a review of VMP concerns for Iberdrola's QFs, at the time Iberdrola creates them.

B. Benefits and Risks of the Transaction

Under the positive benefits test, as defined in the KeySpan/Grid Order, tangible monetary benefits to ratepayers are a necessary pre-condition for obtaining approval of an energy utility acquisition. These benefits must also offset any risks related to the transaction. Iberdrola disputes Staff's interpretation of the positive benefits test; maintains that non-monetary benefits are sufficient to satisfy the test; contends that investment in wind facilities is a benefit of this transaction; and, denies that significant risks attend this transaction. None of these contentions is sustainable.

Iberdrola reiterates arguments on the analysis of monetary benefits that the ALJ rejected. It also compares the $201 million in monetary benefits it offers to the monetary benefits achieved in other acquisition transactions. Those arguments and comparisons are flawed.

1. The Standard of Review

Iberdrola contends that its acquisition of Energy East is analogous to the acquisitions of water utilities that have been approved by the Commission. SPM adds a contention that, in a recent acquisition of a water utility, no monetary benefits were required (SPM BOE 4-5).[10] SPM also questions the development of one standard for water utilities and another for electric and gas utilities when the applicable PSL provisions, PSL §70 and PSL §89-h, are virtually identical in wording.

In making these arguments, the parties seek to apply to Iberdrola water company precedents that are at best marginally relevant, while simultaneously disregarding the energy company precedents, like the KeySpan/Grid Order, which are controlling here. As the Suez Order establishes, the positive benefits test is not always required where water company mergers are at issue because of the “capital intensive nature of the water utility business and [the Commission’s] general desire to see a greater consolidation of ownership for the State’s many water utilities.”[11] These water companies

[10] Case 06-W-1367, Gaz de France, S.A. and Suez, S.A., Order Authorizing Reorganization and Associated Transactions (issued June 25, 2008)(Suez Order).

[11] Suez Order, pp. 6-7.

"typically cannot attract capital and often have small cash reserves, or none at all,"[12] and so face acute challenges in funding compliance with costly health and safety regulations, including the Federal Safe Drinking Water Act. Even Iberdrola admits that water utilities find it more difficult to raise capital than energy utilities (SM 970).

Moreover, where positive benefits can be realized, they are required. For example, in the UWR Order, a rate plan was extended even though the utility was not earning its regulated rate of return, thereby creating monetary benefits for ratepayers.[13]

In contrast, as Iberdrola admits, NYSEG, RG&E and Energy East are financially healthy entities without Iberdrola's help, and have sufficient access to capital market to support their operations. Iberdrola cannot claim that it is providing a benefit upon their acquisition similar to the benefits created upon the consolidation of water companies into larger entities.

As a result, the positive benefits test may be applied here, and a higher level of monetary benefits may be required in energy utility mergers than are required in water company

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[12] Case 93-W-0962, Acquisition and Merger of Small Water Utilities, Statement of Policy (issued August 8, 1994).

[13] Case 99-W-1542, United Water Resources, Inc. and Lyonnaise American Holding, Inc., Order Approving Stock Acquisition (issued July 27, 2007).

consolidations. Notwithstanding that §70 and §89-h are worded similarly, it is reasonable for the Commission to establish a continuum, in requiring the smaller monetary benefits when a troubled water utility is acquired, to requiring greater benefits the more financially sufficient a utility becomes, and to requiring the highest level of monetary benefit when a strong, self-sufficient utility is acquired.

This approach will ensure that the acquisition of already-healthy financial entities is not cause for deterioration in their financial condition, as the ability of the acquiring entity to furnish the benefits demonstrates its financial strength. Moreover, an acquiring entity that must furnish monetary benefits is more likely to commit to long-term ownership of the regulated utility. Given the turmoil affecting corporate and financial institutions in recent years, as evidenced by the collapse of entities like Enron and Bear Stearns, pursuing stability in energy utility operations is a worthwhile goal.

2. Non-Monetary Benefits

The non-monetary benefits Iberdrola proffers are not a substitute for monetary benefits in satisfying of the positive benefits test. The intangible benefits Iberdrola presents, such as instituting best practices, maintaining adequate employment levels, and preserving reliability of service, are operational and managerial skills expected of any competent utility operator. Energy East is already a reasonably-competent operator, without Iberdrola's assistance. Whatever improvements Iberdrola could offer are both insubstantial and could be achieved by existing management. They are not adequate for the purposes of meeting the positive benefits test.

3. The Wind Investment Benefit

The alleged benefit that has attracted the most attention in this proceeding is Iberdrola's promise, at Exhibit 50, to invest in the development of wind projects. DEC eagerly reports that Iberdrola has "expressed a willingness to invest $2 billion in New York" (DEC BOE 6). Iberdrola, however, does not so much as mention the $2.0 billion figure in its Brief on Exceptions (even though invited, at RD 35, to comment on that figure), and makes no commitment of any kind on this record to actually invest that amount. The only commitment it does make, for $100 million (Exh. 50), is a meager 5% of the figure that drives DEC's hopes, and even that commitment is so hedged with conditions that it is unenforceable.

Whether $100 million or $2.0 billion, Iberdrola's investment in wind generation is unrelated to the transaction under review here, which is the acquisition of the NYSEG and RG&E T&D utilities. T&D operations and the development of wind projects are two separate lines of business that are not connected to each other. Iberdrola's own actions demonstrate the truth of that proposition -- it proposes to develop wind power facilities in Pennsylvania, Oregon and Texas, where it will not own T&D utilities, but will not develop wind power projects in Massachusetts, Connecticut or Maine, where it will own T&D utilities. The only intersection between its T&D ownership and wind generation development businesses occurs in New York.

DEC rashly alleges that Staff's and the ALJ's analysis on this point is "without proof or evidence on the record" (DEC BOE 8). But the facts supporting the analysis are easily found on the record (Exh. 41, Att. 19; Exh. 88, Resp. IBER-01315, IBER-0155), and were fully laid out at pages 22-23 of Staff's April 11, 2008 Initial Brief in this proceeding (SIB). DEC has not explained away those facts.

DEC accuses the ALJ of replacing reasoning with "supposition" (DEC BOE 8), but it is DEC that substitutes wishful thinking for reasoned analysis. DEC succumbs to Iberdrola's blandishments that "receptivity," "confidence" and its self-proclaimed "environmental ethos" will trump economic considerations and profit motives in driving wind investment decisions (DEC BOE 7-8). Nothing DEC mentions translates into a binding commitment to invest anything, much less $2.0 billion, in the development of wind projects in New York. Instead, DEC's clumsy restatement of Iberdrola's positions exposes that Iberdrola's arguments are dependent on clever rhetoric instead of substantive merit.

DEC's other arguments are similarly unconvincing. It attempts to weave together separate discussions at RD 36 and 41, on Iberdrola's alleged intangible benefits and the development of wind projects, into a contention that "all parties" are opposed to Staff and the ALJ (DEC BOE 6). Consumer advocates like MI and CPB, however, support many of the monetary benefit and other conditions Staff proposes, if the Commission decides to approve the transaction.

DEC proclaims that "development of wind energy resources is a desirable State policy" (DEC BOE 6), but its reiteration of those policies, at DEC BOE 9-10, adds nothing to the record here. Contrary to DEC's implication, the record in this proceeding demonstrates that Staff is a strong supporter of the State's renewable development policies (SM 1613-14, Exh. 112). Indeed, Staff has vigorously implemented the RPS incentives that have successfully attracted many wind developers to New York. But the existence of those policies does not prove that the plans of any one wind developer, whether Iberdrola or some other entity, are in the public interest, as DEC would have it.

DEC has misread the RD and the record. Its argument that Iberdrola's wind generation proposals are a benefit of the transaction under review here should be rejected. Only Staff's proposal to link Iberdrola's wind investment to monetary benefits for ratepayers ties the wind investment to this proceeding.

4. Risks of Iberdrola Ownership

Under the positive benefits test, the monetary benefits supplied must also be sufficient to offset the risks the transaction poses. Iberdrola has repeatedly denied that its ownership of Energy East will create any risks. The record demonstrates otherwise.

a. Business and Organizational Risk

Contrary to Iberdrola's claim that it is not a risky entity, the scope and complexity of its operations are particularly extensive and intricate. Iberdrola's entire corporate organizational chart takes 15 pages to lay out (Exh. 20, RESP IBER-0295).[14] The wide array of subsidiaries and intricate ownership relationships laid out in the chart is a vivid presentation of the vast reach and extent of Iberdrola's operations, and the scope and variety of its businesses. Indeed, Iberdrola insists upon keeping the details of the

[14] In contrast, Energy East's organizational chart consists of one page. See www.energyeast.com/ourcompanies.

organizational structure confidential, perhaps to prevent any searching analysis into its tangled web of business arrangements and affiliates.

Even Iberdrola's U.S. business operations, standing alone, are too complex to admit of easy analysis. After its 2007 acquisition of Scottish Power and its U.S. subsidiaries, Iberdrola operates over 100 affiliates in this country (Exh. 42, Resp. IBER-0060). Staff was unable to determine the risks of cross-subsidization among this vast web of affiliates, and even Iberdrola may be unable to monitor all of its subsidiaries' activities.

The risks of such complex structures is now well-known. The collapse of prominent corporations and financial institutions attributable to financial complexity has become a staple of business news reports. That complexity is a risk of this transaction, and the ratepayers of NYSEG and RG&E must be insulated against that risk.

b. Goodwill Risk

Another risk is goodwill impairment. Iberdrola's post-acquisition capital structure will reflect approximately $13.4 billion in goodwill, masking its true credit quality and creating credit quality risks for NYSEG and RG&E. A write-down or write-off of Iberdrola's goodwill is likely in the long-term (SM 1322), because the parent entity must carry the goodwill without relying upon cash flow from the regulated utilities. It can do so only if it realizes synergy savings -- but Iberdrola denies it will realize any synergies here. While, in the short-run a write-down of Iberdrola's goodwill may seem unlikely because it has performed capably (SM 500, 1324), the risk of impairment to goodwill increases with the passage of time as the holding company struggles to support its goodwill without the support of synergy savings.

The experience of American Water Works (AWW) demonstrates the ill effects goodwill can have over time. AWW's holding company parent has been compelled to write off goodwill in the amounts of nearly $400 million in 2005, over $225 million in 2006, and over $500 million in 2007 (Exh. 81, p. 23 of 222). The parent admits that "further recognition of impairment of a significant portion of goodwill would negatively affect our results of operation and total capitalization, the effect of which could be material and could make it more difficult for us to secure financing on attractive terms" (Exh. 81, p. 24 of 222). These write-offs of goodwill delayed an initial public offering as the parent attempted to spin off AWW into an independent entity.

The eventual outcome was an independent AWW that, on June 19, 2008, was downgraded by Standard & Poor's, because significant goodwill impairments resulted in a deterioration of

AWW's financial profile.[15] Goodwill impairment could lead to a similar downgrading at Iberdrola, and could have similar adverse effects on NYSEG and RG&E. As a result, goodwill is another risk of this transaction.[16]

The ALJ's conclusion that Iberdrola creates risks for NYSEG and RG&E ratepayers is justified. To offset those risks, a substantial monetary benefit is needed and structural and financial protections should be made conditions of approval, if this transaction is not rejected as Staff recommends.

5. Benefit Comparisons

In complaining that the $646 million in monetary benefits Staff seeks, through its Positive Benefit Adjustments (PBA), are overstated, Iberdrola lacks support from the record in this proceeding. Staff has justified the level of PBAs it selected, and has compared their impact to the monetary benefits achieved in other merger proceedings.

a. Iberdrola's Monetary Benefit

Iberdrola's monetary benefit, of $201 million, is inadequate and is not supported by any specific rationale (SM 611-12). That monetary benefit, by Iberdrola's own calculation, amounts to a 4.4% rate reduction for NYSEG and RG&E ratepayers.

[15] The Standard & Poor's analysis is set forth at Attachment A.

[16] Case 06-W-0490, American Water Works, Inc. and Thames Water Aqua Holdings GMBH, Order Authorizing Reorganization and Associated Transactions (issued July 26, 2007).

In comparison, following approval of the Energy East acquisition in Maine, ratepayers there received an approximately 9% rate reduction.[17]

b. The Synergy Arguments

Iberdrola claims that benefits must be tied to the level of synergy savings achieved in a merger, or have some other nexus to the merger transaction. This is simply incorrect. When National Grid acquired Niagara Mohawk Power Corporation, it wrote down stranded costs in the amount of $850 million, in addition to the synergy savings created. In the KeySpan/Grid Order, as Iberdrola itself concedes, monetary benefits attributable to items other than synergy savings were recognized (Exh. 79).[18]

Similar flaws in reasoning affect Iberdrola’s mistaken analysis of synergy savings by disputing that Staff’s PBAs can serve as a proxy for synergy savings that are hidden or are not readily calculated. Again, the National Grid and KeySpan/Grid precedents undermine Iberdrola’s arguments. As concluded in the RD, PBAs can serve as a substitute for synergy savings currently hidden from view, even if the amount of those synergy savings cannot be adequately determined at this time.

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[17] Maine Docket 2007-215, Stipulation (June 6, 2008).

[18] Case 01-M-0075, Niagara Mohawk Power Corporation and National Grid Group plc, Opinion No. 01-6 (issued December 3, 2001).

c. Staff's Benchmark

Iberdrola criticizes Staff's $1.6 billion benchmark against which calculation of the PBAs was measured. The ALJ correctly determined that Iberdrola's "arguments do not effectively discredit Staff's estimate of the transaction benefit" (RD 127), which is the benchmark Staff used. The ALJ questioned only one element of the benchmark -- the production tax credits (PTC) available for revenues earned on wind generation. That point is addressed at SBOE 42-43. Iberdrola's claim that additional components should be eliminated from the $1.6 billion benchmark calculation lacks merit.

Iberdrola disputes the ALJ's decision to include in the $1.6 billion benefit calculation Spanish tax benefits Iberdrola will realize if the transaction is consummated. Iberdrola argues that the tax benefit is speculative, and no party has demonstrated otherwise. The record contradicts Iberdrola's assertion. As Staff pointed out in SRB 12, the Spanish tax benefits have not been repealed or struck down and so remain available even if Iberdrola must vigorously pursue their realization (SM 512-14, 536, 603-04; Exh. 58).

The ALJ does point out that the PBAs will be funded from "some source other than the items" used to calculate the benchmark (RD 128). That is a correct interpretation of Staff's method; Staff first calculated the amount of benefits Iberdrola and others will realize from the transaction, at the $1.6 billion amount. It then determined that $646.4 million was a proportion of that benchmark amount sufficient to serve as a monetary benefit for ratepayers that could justify approval of the transaction. Finally, Staff identifies the PBAs, which are the adjustments to NYSEG and RG&E accounts needed to implement the $646.4 million benefit in rates. This reasonable approach to calculating and implementing the monetary benefits required to meet the positive benefits test should be adopted.

d. Comparisons to KeySpan/Grid

Iberdrola claims that Staff has miscalculated the comparison of its $646.4 million PBA adjustment to the amount of benefits achieved in other merger proceedings. It is Iberdrola's comparisons, however, that are mistaken. Indeed, Iberdrola begins with a glaring error, in asserting that the 1.89% ratio of merger benefits to utility revenues stated in the KeySpan/Grid Order is substantially less than the 3.1% ratio its offer of $201.4 million in monetary benefits will achieve (IBOE 75, 79). The 1.89% figure, however, is a net present value (NPV) calculation; Iberdrola's 3.1% figure is a nominal number. Since NPV and nominal figures are calculated on an entirely different basis, there is no comparison between the two.

Moreover, the NPV value in the KeySpan/Grid Order is measured over a 10-year term, while Iberdrola insists upon using

5-year terms for other measures of benefits it performs. As a result, it is Iberdrola's calculations that are flawed, not the ALJ's or Staff's, and Table A at IBOE 75 should be disregarded. Instead, the accurate calculation of benefit to revenue ratios is set forth at SBOE Att. A.

Further criticizing Staff's analysis of the KeySpan/Grid Order, Iberdrola claims the ratio of benefits achieved there over a five-year term is only 1.72% on a nominal basis (IBOE 76-79). That Order, however, addresses, in addition to required benefits for the ratepayers of the acquired KeySpan affiliate T&D companies, tangential benefits for Niagara Mohawk Power Corporation (Niagara Mohawk) and Long Island Power Authority (LIPA) ratepayers. While, in KeySpan/Grid, the merger joined two owners of regulated T&D entities into a new holding company, as Iberdrola repeatedly points out, it is not conjoining NYSEG and RG&E with any other T&D utility here. As a result, the correct comparison from the KeySpan/Grid Order to this transaction is a comparison of the benefits realized by the ratepayers of the KeySpan affiliate T&D entities that were acquired to the benefits the ratepayers of NYSEG and RG&E should realize if those T&D entities are acquired.

To perform that comparison is a simple matter of taking the KeySpan affiliate benefits and dividing them by the KeySpan affiliate revenues. This places the calculation on an equal basis with the calculation of benefits to NYSEG and RG&E ratepayers. In calculating its 1.72% ratio, however, Iberdrola did not use just the KeySpan affiliate revenues. Instead, it used the sum of those revenues and the LIPA and Niagara Mohawk revenues. Further distorting the calculation, it nonetheless used only the KeySpan affiliate benefits and not the sum of all benefits, including those allocated to LIPA and Niagara Mohawk.

Iberdrola would prefer a calculation that recognizes LIPA and Niagara Mohawk revenues, because that calculation produces a lower ratio. But, in this transaction, there is no counter-party analogous to either Niagara Mohawk or LIPA. As the ALJ points out, creation of such a fictitious counter-party could only occur if Iberdrola's overall holding company revenues were included in a calculation. Iberdrola fiercely resists that notion (RD 135, IBOE 78-79), but it is Iberdrola's own logic that compels the ALJ's conclusion. Iberdrola's efforts to understate the value of the KeySpan/Grid merger benefits should be rejected.

e. Comparisons to the Formation of Energy East

Iberdrola also misstates the benefits obtained when NYSEG and RG&E were merged into Energy East (IBOE 81). Unlike its comparison to KeySpan/Grid, where it overstates revenues to arrive at a ratio which furthers its cause, here Iberdrola, in contriving an argument that supports its position on this issue, attempt to understate benefits.

In approving the formation of Energy East,[19] the Commission viewed benefits over a 10-year period. While, as Iberdrola points out, the merger savings set forth in Appendix A to the January 15, 2002 Merger Joint Proposal in that proceeding showed five years of merger savings imputed in rates, that Appendix A was developed by taking amounts from Appendix E, page 7, to the March 23, 2001 Petition in the proceeding. There, $533 million in benefits were set forth, over a 10-year period. That benefit was truncated to a five-year period, which was adopted in part because Energy East was allowed to retain a share of synergy savings only for the first five years following the merger. Afterwards, all synergy savings were allocated to ratepayers.

As a result, it is proper to view the overall benefits of the Energy East transaction over a 10-year period. In arriving at the 10-year savings to ratepayers from the Energy East merger, for use in comparisons here, Staff needed to find the value of that merger over the 10-year term. It did so by assuming that the ratepayer share of savings in the fifth year of the merger would continue during each of the five following

[19] Cases 01-E-0359 and 01-M-0404, New York State Electric & Gas Corporation, et al., Order Adopting Provisions of Joint Proposal With Modifications (issued February 27, 2002).

years. Multiplying the resulting annual figure by five to arrive at a 5-year figure, for the last five years of the ten year term, is simple math. Iberdrola's criticisms of this approach are unavailing.

Finally, Staff's calculation was based on estimates of the value of the Energy East merger to ratepayers at the time the transaction was approved, in 2002. Subsequent events demonstrate that the forecast of benefits was understated. Instead of realizing the $82.16 million per year forecast for the 5-year rate plan, NYSEG and RG&E actually retained $85.0 million (Exh. 63).[20]

f. Conclusion

Therefore, Staff's analysis of benefits should be accepted. The Commission should reject Iberdrola's contention that the $201 million in monetary benefits it offers is sufficient to meet the positive benefits test.

C. Structural and Financial Protections

As discussed at SBOE Exception 7, all of the financial and structural protections adopted in the KeySpan/Grid Order are applicable to Iberdrola. Even the credit rating agencies view Iberdrola as at least as risky as National Grid (SM 1158). More importantly, when viewed from a regulatory perspective,

[20] At Attachment B, Staff compares, in nominal terms, ratios of benefits to revenues achieved in various transactions.

Iberdrola, as discussed above, poses substantially more risk to ratepayers than a typical holding company, because the size and scope of its unregulated operation are so extensive. Therefore, Iberdrola's contention, at IBOE Exception 12, that Staff's conditions are burdensome should be rejected.

At IBOE Exception 13, Iberdrola objects to transferring the goodwill on Energy East's books to Iberdrola's books, as Condition 2 provides (the Conditions are listed at Attachment 1 to the IBOE). As discussed above, the threat goodwill poses in this proceeding is more substantial than in other recent energy utility acquisitions, because the goodwill is not supported by synergy savings. In rebuttal, Iberdrola claims that generally-accepted accounting principles (GAAP) prevent this upward transfer. But Iberdrola's contention is nowhere supported on this record, and Iberdrola also fails to cite to the GAAP provision upon which it relies (IBOE 51). As a result, its exception should be denied, and existing goodwill should be transferred to Iberdrola's books, which will protect NYSEG and RG&E customers to some extent from the impact of the goodwill write-offs that Staff expects will eventually occur.

Iberdrola also objects, at IBOE Exception 14, to Condition 3, on reporting the results of impairment tests performed at the holding company level. Since Iberdrola should perform the impairment test annually in any event (SM 1314), requiring submission of something it already prepares is not burdensome. Viewing the results of the impairment test may signal problems Iberdrola might be experiencing well in advance of a crisis, which should assist the Commission in preventing those problems from adversely impacting NYSEG and RG&E ratepayers.

Condition 6 is addressed at Iberdrola's Exception 15. There, Iberdrola claims that it should not be required to submit the presentations it makes to credit agencies regarding holding company matters. Again, this requirement is not burdensome, because the presentation has already been prepared. The information supplied will assist the Commission in obtaining advance warning of problems elsewhere in the vast Iberdrola business empire, preventing their spread to NYSEG to RG&E.

At Exception 16, Iberdrola seeks to modify Condition 7, which requires the filing of a plan for remedying any credit downgrade at NYSEG and RG&E. No modification is needed. NYSEG and RG&E are already rated BBB+, near the bottom of the investment grade category, and any further degradation in their ratings will be costly to ratepayers. This condition was adopted both in the KeySpan/Grid Order and the Suez Order, and should be imposed here without modification.

Conditions 10 and 11 restrict payment of dividends, upon occurrence of bond rating triggers; Iberdrola opposes them at IBOE Exception 17. These conditions were imposed in the KeySpan/Grid Order, and are necessary to prevent Iberdrola from draining capital from NYSEG and RG&E if financial difficulties are encountered. Dividend restrictions ensure that cash is conserved for the benefit of ratepayers during difficult times, and are essential to preserving safe and adequate service. There is no reason to allow Iberdrola to evade these restrictions.

At IBOE Exception 19,[21] Iberdrola proposes to create an independent bankruptcy consulting right (IBCR), which would perform the same function as the “golden share” Staff proposes at its Condition 19. It appears that Iberdrola’s proposal fulfills Staff’s objectives, by inserting into the corporate structure an independent party with the authority to prevent a bankruptcy filing. The IBCR mechanism, however, must be properly drafted, so that credit rating agencies are satisfied that the independent right exists and can be exercised. If credit rating agencies find fault with Iberdrola’s drafting, it should be required to correct any drafting deficiencies to the satisfaction of the agencies.

Moreover, Iberdrola proposes to select the independent party that would exercise the IBCR, subject to Commission

[21] At IBOE Exception 18, Iberdrola proposes a modification to Condition 15, which Staff accepts.

approval. That approach is acceptable, so long as the Commission can substitute an independent party of its own choosing if Iberdrola fails to identify an acceptable candidate within six months of the closing of the transaction.

At IBOE Exception 20, Iberdrola protests that the ALJ erred in adopting Conditions 22, 26, 27 and 28, which establish the reporting requirements Iberdrola should satisfy if the transaction is approved. Staff opposes Iberdrola's Exception.

Condition 22 requires Iberdrola to make available books and records of the holding company and majority-owned affiliates in English. While Iberdrola maintains the requirement is burdensome, the burden will fall mainly on Staff, which must bear responsibility for detecting and regulating the many risks inherent in this transaction because of Iberdrola's organizational complexity and lack of financial transparency. Affording access to documentation, in English, upon Staff's request will not be as burdensome as Iberdrola envisions.

Condition 26 would require GAAP reporting of Iberdrola financial information, instead of International Financial Reporting Standards (IFRS), in a SEC Form 10-K format. Iberdrola maintains that GAAP accounting is burdensome because it prepares its statements under IFRS, and is also unnecessary, because GAAP and IFRS are converging. If so, the convergence relieves the burden, as it should be relatively simple for

Iberdrola to prepare Form 10-K type information from the IFRS data. This would relieve Staff of the difficulty of translating IFRS into GAAP, which Staff uses in regulatory accounting. It is Iberdrola's responsibility to furnish that translation, if it desires to operate in an arena where IFRS is not commonly used.

As to Condition 27, it requires Iberdrola to file equivalents of SEC Forms U-5S and U-9C-3. The information from those forms is necessary to analyzing the equity ratio of utility subsidiaries of holding companies (SM 1344-45). Preparation of these forms has been performed for years, and should continue even though Iberdrola will not be legally required to prepare them, as Energy East was. The information is still essential to regulatory accounting in New York and to establishing the appropriate equity ratio, which is a major driver of regulated rates. Substituting, for the formerly-applicable federal law requirement, a regulatory requirement that preparation of the forms continue is reasonable under these circumstances. Moreover, preparation of SEC forms is a cost that was recognized in regulated rates, and Iberdrola should not be allowed to escape the obligation to prepare the forms while still charging rates that include the costs of producing the forms.

Condition 28, which is not set forth at IBOE Attachment 2, requires the filing of consolidated balance sheets, income statements and cash flow statements for Energy East, and its direct subsidiaries, in English using GAAP. Notwithstanding Iberdrola's objections, filing information in the form requested ensures that the information needed to set regulatory rates is readily available. Besides all of its other responsibilities in analyzing a utility rate filing, Staff should not encounter difficulties because Iberdrola chooses to cloak information in a foreign format.

Iberdrola claims that the requirement goes beyond the 1977 Statement of Policy on Test Periods in Major Rate Proceedings, but, in 1977, global holding company ownership of New York utilities was not anticipated. As a result, requiring this informational format in addition to that established in the Test Period Policy Statement is reasonable.

Finally, Iberdrola's position on the financial conditions at issue in this proceeding is clouded by confusion. At Attachment 2 to its IBOE, Iberdrola lists 27 Conditions it will accept, either as set forth in the RD or with modifications. In its April 25, 2008 Reply Brief (IRB) in this proceeding, however, Iberdrola furnished an Attachment 1 that listed 31 Conditions. The relationship between the two Attachments is unclear. The IBOE Attachment 2 appears to omit the Conditions 17, 21, 22, 26, and 28 through 31 that were listed in the IRB Attachment 1.

It is important that several conditions on the record here be adopted, notwithstanding their absence from IBOE Attachment 2 or IRB Attachment 1. Iberdrola should be required to provide Staff with all tax returns, domestic and foreign, that reflect acquisition-related impacts, or RG&E, NYSEG, or Energy East taxable income, tax deductions, or tax credits (Exh. 52, p. 3). Impairment tests should be performed on the goodwill on the books of RGS, Energy East, and the results should be provided to Staff within 30 days of the date of the analysis (SM 1403). The Commission's Statement of Policy on Pensions and Other Post Employment Benefits (OPEB) should be adhered to, as currently implemented in NYSEG and RG&E rate plans, with the exception that deferral of NYSEG gas pension amounts will cease effective January 1, 2008. To the extent that the merger has a favorable impact on pension and OPEB expense, cost savings should be preserved for customers. To the extent that the merger has an unfavorable impact, ratepayers should be insulated from any cost increases (SM 1736).

D. Subsequent Rate Proceedings

Iberdrola objects to the ALJ's decision to make rates at NYSEG and RG&E temporary upon approval of the transaction. Iberdrola errs, for the reasons described at SBOE Exceptions 9 and 10.

In particular, RG&E's electric rates are overstated. At the 15.54% ROE Staff calculates, at SBOE Exception 10, RG&E is over-collecting revenues by approximately $45 million, or about 10% per year -- an amount in excess of the 4.4% rate reduction Iberdrola proposes. Temporary rates are necessary to address those excessive charges.

At the very least, RG&E's request for extension of its current rate plan beyond its expiration on December 31, 2008 should be rejected, and rates should be made temporary as of January 1, 2009. RG&E's rates are stale, and do not reflect its sale of the Ginna Nuclear Plant, the retirement of the Russell Station, and the completion of the Rochester Transmission Project. Also, the treatment of a transition contract for the purchase of electricity from the new owners of Ginna raises rate issues that must be addressed.

Iberdrola proposes that subsequent rate proceedings be conducted on a staggered schedule, because conducting rate proceedings at the same time for four operations -- NYSEG gas and electric and RG&E gas and electric -- would be burdensome. Pursuing gas and electric rates for one utility at one time, however, is efficient, because of common expenses and the many issues that affect both.

Iberdrola maintains that a review of RG&E rates should be delayed, to reflect the results of the auctioning of its gas-fired facilities. Any benefits realized by ratepayers for such an auction, however, can be easily deposited in a deferral account and addressed at a later time. Iberdrola should not be allowed to postpone a review of RG&E's excessive rates upon such a flimsy excuse.

The better alternative is presented at Exception SBOE 10. The Commission should decide the issues Staff has presented on the record here, thereby facilitating expedited consideration of rate plans upon reduced filing requirements. In such proceedings, issues like revenue decoupling mechanisms (RDM) could be addressed; under Iberdrola's approach, consideration of RDM is put off indefinitely.

Finally, Nucor joins Iberdrola in its effort to postpone the consideration of new rates (Nucor BOE 2). But NYSEG gas, and RG&E electric and gas, rates have not been reviewed in five years. The more stale those rates become, the more difficult it may be to correct any hidden problems, which may grow more intractable the longer they are not addressed. When such a problem must be corrected, and a substantial impact results, Nucor is sure to be among the first to object to the correction. Notwithstanding Nucor's arguments, hidden problems should not grow to unmanageable proportions because of delay in conducting a rate review.

CONCLUSION

Staff's Exceptions to the Recommended Decision should be adopted, and if they are not, Staff's alternatives should be adopted. In all other respects, the Recommended Decision should be adopted, or modified, for the reasons stated above.

Respectfully submitted,

Leonard Van Ryn
Sean Mullany
Staff Counsel

Dated: July 3, 2008
Albany, New York

ATTACHMENT A

STANDARD
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RATINGSDIRECT®

June 19, 2008

Research Update:

American Water Works, Capital Corp Downgraded To 'BBB+', Off CreditWatch; Outlook Stable

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Research Update:

American Water Works, Capital Corp Downgraded To 'BBB+', Off CreditWatch; Outlook Stable

Rationale

On June 19, 2008, Standard & Poor's Ratings Services lowered its corporate credit ratings on American Water Works Co. Inc. (AWW) and its funding subsidiary American Water Capital Corp. (AWCC) to 'BBB+' from 'A-'. At the same time, we removed the ratings from CreditWatch with negative implications. The outlook is stable.

The downgrade primarily reflects our concern that the pace and extent of cash flow improvement will be considerably slower than we previously expected. Despite an 8% increase in revenues in the first quarter of 2008, key credit metrics, including adjusted funds from operations (FFO) to total debt of around 9%, FFO interest coverage under 3x, and adjusted debt to total capital of 60%, were unchanged from the prior quarter and are weak for the 'A-' rating. Over the intermediate term, the company will be engaged in a greater number of rate proceedings than we expected, as AWW seeks to phase in rate increases incrementally to avoid rate shock while prudently financing capital spending of up to $1 billion per year over the next several years. This is likely to result in sizable back-to-back rate filings in a number of states and make achieving financial metrics appropriate for the 'A' category a longer term proposition. Funding from the secondary equity market could be more challenging as RWE AG's attempts to divest its holdings will compete with offerings by AWW, which may slow improvements in leverage.

Notwithstanding the medium-term weakness in AWW's financial profile, these risks are partially offset against AWW's excellent business risk profile. A favorable competitive position, diverse and supportive regulatory environment, and stable, above-average service territory characterize AWW's business risk profile. AWW's regulatory framework includes reasonably allowed ROEs and various cost-recovery mechanisms, including incentives for infrastructure improvements. The company's geographic diversity provides it with some market, cash flow, and regulatory diversification. In addition, we view AWW's operating risks associated with its regulated and nonregulated operations as fairly low. AWW's aggressive financial profile, uncertainties associated with planned equity offerings, elevated capital-spending requirements for infrastructure replacement, increased compliance costs with water-quality standards, and the company's reliance on acquisitions to provide growth partly offset these strengths.

AWW provides regulated water and wastewater services to more than 3.3 million customers in 20 states. AWW's regulated utility subsidiaries represent almost 90% of total revenues, but have provided almost 100% of adjusted EBIT for the past three years. The company's nonregulated subsidiaries consist of water and wastewater facility management and maintenance, as well as design and construction consulting services related to water and wastewater plants. We view these nonregulated segments as having modest incremental risk to AWW due to their lack of cash flow contribution and modest expected capital requirements.

AWW's financial metrics are acceptable for the 'BBB+' rating. RWE's agreements to not file rate cases for up to three years following its AWW acquisition in 2003, as well as significant goodwill impairments, resulted in a deterioration of the financial profile. AWW has since filed a number of rate cases, which total about $300 million to cover rising operating costs, capital expenditures, and pension and other postretirement obligations.

Adjusted FFO was $514 million for the 12 months ended March 31, 2008. FFO to total debt was 9%, which are somewhat weak, but acceptable, for the rating. The uncertainties associated with the timing of the company's rate cases and the substantially higher capital plans are significant risks that may prevent adequate improvements to the company's financial profile. Adjusted debt to capital was 60% at March 31, 2008, from 49% as of the previous year. A portion of the increased leverage metric is attributed to the $750 million goodwill impairment related to a post-IPO valuation test and the issuance of unsecured notes to redeem the company's outstanding preferred stock, which we consider to have intermediate equity characteristics.

Short-term credit factors

The 'A-2' short-term ratings on AWW and AWCC reflect sizable borrowing capacity under the company's revolving credit facility and stable cash flows from regulated subsidiaries. However, AWW's cash uses include high levels of capital spending, substantial upcoming debt maturities, and expectations that the company will institute a common stock dividend. Capital expenditures are projected at $4 billion to $4.5 billion during the next five years for infrastructure replacements, new facility construction, maintenance of water-quality and environmental standards, and system reliability.

With cash from operations for the past 12 months of only $550 million, AWW's cash flow generation is insufficient to meet its ongoing operating and capital needs, and will require additional access to the capital markets over the intermediate term. Scheduled debt maturities of $196 million in 2008, $55 million in 2009, and $54 million in 2010 are also fairly sizable. Contingent on board approval, AWW is expected to declare dividends equal to about $128 million per year, starting in the third quarter. This equals a 3.8% dividend yield at recent market prices, which is materially higher than the average dividend yield of other companies in its peer group of about 2%.

As of March 31, 2008, AWW had $9 million in unrestricted cash, about $420 million available under its $800 million revolving credit facility, which matures on Sept. 15, 2011, and a $10 million short-term working-capital line of credit. Financial covenants include a maximum debt to capital (with adjustments) of 70% and restrictions on liens, distributions, debt incurred at AWW, and asset sales.

Outlook

The stable outlook reflects our expectation that AWW will be granted supportive rate increases over the intermediate term to address rising costs and increased capital spending plans. The current rating can accommodate some acquisitions, assuming management funds the acquisitions in a balanced manner. The outlook could be revised to negative if financial performance stalls or deteriorates, which could result from substantial debt-financing of capital expenditures or acquisitions or if rate increases or allowed returns are set at levels substantially below the requested figures and significantly slower to be resolved than currently expected. Although less likely in the near term, the outlook could be revised to positive if higher-than-expected rate increases or favorable cost recovery mechanisms allow for adjusted FFO to total debt of closer to 12% and adjusted leverage between 50% to 55%.

Ratings List

Ratings Lowered, Off CreditWatch

American Water Works Co. Inc.

	To	From
Corp. credit rating	BBB+/Stable/A-2	A-/Watch Neg/A-2

American Water Capital Corp.

Corp. credit rating	BBB+/Stable/A-2	A-/Watch Neg/A-2
Senior unsecured debt	BBB+/Stable/A-2	A-/Watch Neg/A-2
Preferred stock	BBB-	BBB/Watch Neg

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Merger	Source	Term	Nominal/NPV	Benefits ($ Millions)	Delivery Revenues ($ Billions)	Ratio
NG/KS	SBOE Att. 2	10 years	Nominal	$ 692.9	$ 11.7	5.9%
EE/RGS	SBOE Att. 2	10 years	Nominal	$ 657.2	$ 13.0	5.1%
CMP/IBE (1)	SBOE p. 40	5 years	Nominal	$ 62.5	$ 1.1	5.6%
ALJ-RD/Staff	SBOE Att. 2	10 years	Nominal	$ 732.9	$ 13.0	5.6%

[1] The term of the Alternative Rate Plan 2008 (ARP2008) for Central Maine Power in Docket 2007-215 is five years. The annual benefit in the CMP rate plan is $12.5 million for five years or $62.5 million