STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

In the Matter of

Case 07-M-0906

Joint Petition of Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A.

Brief on Exceptions

On behalf of

Strategic Power Management, LLC

Dated: June 26, 2008

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Introduction

On June 16, 2008 Secretary Brilling posted Administrative Law Judge (“ALJ” or “Judge”) Rafael Epstein’s Recommended Decision (“Rec Dec”) to the PSC’s Website. Within minutes the share price of Energy East plunged from the high $26 dollar range to below $24 dollars, finally settling at the close of the New York Stock Exchange at $22.75. This stunning double digit drop of over 14 percent is a testament to how quickly news travels. It also demonstrates how quickly New York's reputation as a good place to do business has been damaged.

The Rec Dec does not represent a fair or balanced view of the record in this case. Rather the Rec Dec is simply an embellishment of Staff's litigation position except for a number of minor disagreements.

This brief on exceptions will attempt to demonstrate that the Rec Dec, like Staff's position which it uncritically adopts, has been based on misguided assumptions about what the law requires for this Commission to approve a merger and what the facts present on the record reveal about this transaction. Strategic Power Management, LLC ("SPM") will also accept the various invitations contained in the Rec Dec to respond to sone of the late breaking proposals as this fascinating tale unfolds which reveals two views of this transaction's benefits and risks. It is as if the opponents of the transaction are in a parallel universe to the proponents of the deal. Where one side sees benefits, the other side warps those benefits into unacceptable risks.

The sad aspect of this case following on the Staff position and now the Rec Dec has already hurt New York State as an investment destination. One possible headline: "Subtle, Impossible to Detect, Potential Exercise of Vertical Market

Power from Planned Wind Generators Scuttles $2 Billion Investment in Upstate New York."

This Commission now has a responsibility to clean up the terribly negative impression that the Rec Dec has left of doing business (or not doing business) in New York State. The Rec Dec, starting with an illogical premise, comes to an equally unsound conclusion. It is a classic "tail wagging the dog story" coupled with an inflexible adherence to perceived, but inaccurately understood, precedent that has not been critically examined from a common sense perspective.

This brief on exceptions will start with the most troubling issue, the alleged vertical market power abuse associated with wind generation that has yet to be built, that is so compelling it requires extra ordinary conditions imposed on Iberdrola alone. Then it will turn to the PBAs which the Rec Dec has accepted in total, but defers implementation in the recommended rate cases. Finally, a few thoughts will be offered on the Rec Dec's structural and financial protections, further procedures and how this merger fits with state policy goals.

The Legal Standard

But first, the legal framework of Section 70 should be revisited since the Rec Dec has addressed this issue by incorrectly broadening the test to virtually include any consideration or speculation rather than those which are relevant and cognizable under the law as interpreted by the Third Department in International Railway Company v. PSC, 264 A.D. 506 (1942). If the Rec Dec's expansive view of Section 70 prevails it is unlikely that anyone will know what is expected in New York to consummate a utility merger. And this state flows directly from the situational view of the Public Service Law, where there is one standard for water utilities and another for electric and gas – even though the Public Service Law is identical for both.

So while the circumstance in each merger may and are likely different, the legal standard is the same. And while that standard from a legislative perspective does not require tangible ratepayer benefits, this Commission has added that requirement through case law for electric and gas companies while recently confirming that such is not the standard for water companies. Very recently the Commission addressed the public interest standard in the merger of Suez, SA with Gaz de France, SA:

> Public Interest
>
> Section 89-h of the PSL requires a demonstration that the proposed transaction be in the public interest for it to be approved. The petitioners claim that the regulated water companies and their customers will benefit from the

> proposed merger because they will be a part of a much larger international company with greater access to technology and research and development in utility operations management. In addition, the petitioners state that the regulated water companies will have better access to the capital markets after the proposed merger. Based upon our review of the petition and the responses to Staff Interrogatory Requests, it appears that there are no significant synergy savings or operational benefits to UW's New York ratepayers as a result of proposed transaction. Finally, we note that the merger, if successfully consummated, would assure that UW and UWNJ continue to have ready access to the financial markets at reasonable terms. This is an important public interest consideration given the capital intensive nature of the water utility business and our general desire to see a greater consolidation of ownership for the state's many water utilities.[1]

Section 89-h of the Public Service Law is identical to Section 70 insofar as the public interest language is concerned.

SPM will not waste time arguing over Commission policy as expressed in case law versus what is required by statute, especially in this case where the Joint Petitioners have conceded $202.6 million of PBAs which produce $54.8 million in immediate rate reductions. That 4.4% reduction provides the required tangible ratepayer benefits and so further discussion of the appropriate public interest standard is academic. But the Suez – Gaz de France standard provides the Commission with more flexibility and avoids forcing tangible ratepayer benefits

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1. Case 06-W-1367, Joint Petition for a Declaratory Ruling Disclaiming Jurisdiction or, in the Alternative, for approval of the Merger of Gaz de France SA and Suez SA, and the simultaneous Initial Public Offering of shares of Suez Environment, ORDER AUTHORIZING REORGANIZATION AND ASSOCIATED TRANSACTIONS (Issued and Effective June 25, 2008).

which might actually harm the operating utilities where none really exist.

Curiously the Rec Dec negates this $201.6 million concession and finds it is insufficient when compared to Staff's <u>litigation</u> position of $646 million in PBAs. The Rec Dec further notes that this is not a benefit of the transaction in that the Commission has the authority to reduce rates whether as part of the merger or in the absence of a merger. While that it true the Commission has to provide procedural and substantive due process to NYSEG and RGE. Does anyone think that such a significant rate concession would be offered up by Energy East in the absence of this merger? The rate relief will be immediate, a benefit not obtain outside of the merger.

The Rec Dec provides no discussion on how the Staff PBA position will affect the financials of the operating companies. This glaring omission, however, is consistent with the Rec Dec's position on rate cases. In effect, the Rec Dec is saying that it is unnecessary to consider such issues here since they will have to be considered in the comprehensive rate cases.

For the most part, except for Staff and now the Administrative Law Judge, all parties support the acquisition of Energy East by Iberdrola. Indeed, this case has caught the attention of elected official[2] who have weighed in supporting the merger and the many benefits it provides.

FERC Conclusion on Vertical Market Power

> 23. In mergers combining electric generation assets with inputs to generating power (such as natural gas, transmission, or fuel), competition can be harmed if a merger increases the merged firm's ability or incentive to exercise vertical market power in wholesale electricity markets. For example, by denying rival firms access to inputs or by raising their input costs, a merged firm could impede entry of new competitors or inhibit existing competitors' ability to undercut an attempted price increase in the downstream wholesale electricity market. Here, as discussed below, Applicants have shown that the proposed transaction does not raise any of these concerns.
>
> 24. Applicants have shown that the proposed combination of electric transmission and generation assets will not harm competition. We reject IPPNY's and AES's assertions that the merger would create vertical market power because Applicants will be able to use their transmission to favor their affiliated generation over other competitive generation. Turning over operational control of transmission facilities to an independent entity mitigates any concerns about transmission-related vertical market power because it eliminates a company's ability to use its transmission system to harm competition. In a number of cases, we have stated that both the ability and incentive to exercise vertical market power are necessary for a merger to harm competition. (footnote omitted). Here, Energy East has turned over control of its transmission facilities to two independent entities – NYISO and ISO-NE – so it has no ability to use its transmission to disadvantage its competitors. Moreover, Iberdrola has no transmission facilities other than those needed to connect to the transmission grid. Therefore, there is no need to impose vertical market power mitigation.

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2 Senator Charles Schumer, Governor David Patterson, State Senator Joe Bruno, and the Assembly Energy Committee, to name just a few.

> 25. We are not persuaded by IPPNY's assertion that, after the merger, Iberdrola's wind generators will have a competitive advantage in terms of interconnection in New York over competing wind generators. As noted by Applicants, the Commission requires the NYISO to adhere to the standardized interconnection terms and conditions in its OATT and requires all jurisdictional transmission owners in New York to comply with the Large Generator Interconnection Procedures. In addition, in Order No. 2003, the Commission concluded that such a "standard set of procedures as part of the OATT for all jurisdictional transmission facilities will minimize opportunities for undue discrimination and expedite the development of new generation." (footnote omitted). Therefore, we conclude that the merger will not result in undue preference in terms of interconnection for Iberdrola's wind generation capacity.
>
> 26. Similarly, Applicants have shown that the combination of natural gas transportation and electric generation assets will not harm competition. Applicants will not be able to favor their own generation, raise rivals' costs, or otherwise disadvantage rivals because: (1) the generation they own or control in the relevant markets is de minimis, (2) all the generators Iberdrola has in the relevant markets are wind generators and thus do not use natural gas, and (3) none of the Energy East affiliates own major interstate or intrastate gas transmission pipelines.27 Applicants have also shown that there are no other barriers to entry that would raise vertical market power concerns.

Energy East Corporation and Iberdrola, SA, Docket DL07-122-000, Order Authorizing Merger and Disposition of Jurisdictional Facilities (Issued December 6, 2007). FERC came to its conclusion on vertical market power <u>before</u> the Joint Petitioners agreed to divest all of their fossil generation. Thus, the hydro and wind generation that is left is truly de minimis. And as for the wind generation, it is not yet even operational.

New York’s View of Vertical Market Power

SPM submits that FERC’s conclusions on VMP are sound and should be followed by this Commission. This section will address the VMP issue as if the Commission has imposed a higher standard than FERC by virtue of its Policy Statement.

The Rec Dec impermissibly overrules the Commission’s Statement of Policy Regarding Vertical Market Power (Issued and Effective: July 17, 1998) (“Policy Statement”) by eliminating the “rebuttal presumption” for Iberdrola alone. Staff’s extreme position which would bar Iberdrola from pursuing any wind generation in New York has been rejected by the ALJ for good and sufficient reason. There is no logical explanation as to how that “remedy” cures potential VMP abuse in those parts of the state where Iberdrola affiliates do not own transmission and distribution facilities.

But just because the Rec Dec rejects the extreme does not make its acceptance of the less extreme any more acceptable. Accepting the IPPNY position requires this Commission to revisit that statement which expressly authorizes a company or its affiliate to appear before this Commission and make a showing rebutting the presumption against the ownership of generation and T&D facilities by the same or related entities.

To overcome the presumption the T&D company affiliate would have to demonstrate that vertical market power could not be exercised because the circumstances do not give the T&D company an opportunity to exercise market power, or because reasonable means exist to mitigate market power. Alternatively, the T&D company would need to demonstrate that substantial ratepayer benefits, together with mitigation measures, warrant overcoming the presumption. Possible means of mitigating market power include:

- Limitation on the degree of control over the constraining transmission interface held by the T&D utility.
- A pledge by the T&D utility to pursue transmission projects recommended by the Commission or by the ISO, together with a proposal that would neutralize profit maximizing incentives on generation that is within the market power control area pending the completion of all reasonable efforts by the T&D company to complete recommended transmission projects.
- An agreement by the T&D company to participate in a binding arbitration in the event of a dispute over a new generator's interconnection requirements in the T&D utility's territory.

Policy Statement at Appendix II, page 2.

Before looking at overcoming the presumption which can be done handily in the case of wind power, it is helpful to place into context Iberdrola Renewables' ("Renewables")interests at the present time. The size of the potential problem should govern the remedy or the mitigation considered.

Iberdrola Renewables New York Wind Generation
(In the Pipeline)[3]

Size (MW)	Name	Location	NYSEG/RGE Interconnection
80	Hardscrabble	Herkimer Co.	No
98	Jordanville	Herkimer Co.	No
126	Horse Creek	Jefferson Co.	No
80	Roaring Brook	Lewis Co.	No
250	Dutch Gap	Jefferson Co.	No
46	**Sangerfield**	**Oneida Co.**	**Yes**
60	**Sugar Creek**	**Livingston Co.**	**Yes**
60	**Houck Mountain**	**Delaware Co.**	**Yes**
124	Barre	Orleans Co.	No
74	Hamlin	Monroe Co.	No
998	Total Planned or In the Pipeline		
		(Operating)	
160	**Flat Rock I**	**Lewis Co.**	**No**
160	**Flat Rock II**	**Lewis Co.**	**No**
320	**Total Operating**		
1,318	Total Renewables' (operating and planned)		
166	**Interconnected with NYSEG/RGE (planned)**		

The New York Control Area has 38,966 MWs of required installed capacity as of December 31, 2007[4]. So Iberdrola's interconnected generation **potential** of 166 MWs is only .43% of New York's total, based on 2007 data. Moreover, Iberdrola is only entitled to 10% of the nameplate rating for summer U-Cap – to start out with[5]. Thus, Iberdrola potentially has only 16.6 MW of U-Cap in the critical summer market. As Dr. Hieronymus

3 Exhibit 57 (IBER-0008 S).
4 The figures here are taken from the NYISO's 2007 Annual Report.
5 See NYISO Installed Capacity Manual Version 6.5 dated May 15, 2008 at page 4-13.

argues, Iberdrola’s wind generation is *de minimis* and constitutes only 0.04% of the required capacity in New York.

It is hard to see how Iberdrola with this tiny amount of capacity is able to exercise vertical market power. Especially when one considers that wind generation has both very special factual and legal characteristics that should be kept in mind when analyzing VMP issues. On the factual side, these facilities are at the mercy of nature. If the wind does not blow, then there is no generation from the wind farm. Second, this form of electric generation is renewable and leaves no carbon footprint. This is a highly desirable benefit for the planet in general and for NYSEG and RG&E customers in particular. The fuel is “free”. Third, these facilities are price takers not price makers. Fourth, no one has to transport the fuel to the site thus eliminating further environmental impacts associated with the transportation of fuel. Finally, ratepayers will see downward pressure on wholesale rates as more wind generation comes on line. As price takers bidding in to the NYISI markets at zero[6], the wind generators will start to displace existing generation and the prices should fall, all else being equal. This latter fact may explain IPPNY’s position

6 See Direct Testimony of Mark Younger on behalf of IPPNY at SM 914 (“Most of the renewable generation will likely be bid into the NYISO's energy markets at very low or $0 levels consistent with its zero cost ‘fuel.’”)

since new wind entrants are likely to reduce LBMPs which may have an adverse impact on IPPNY's members.

Renewables' wind generation interconnected to affiliated transmission, considering the installed capacity market, renders its position inconsequential from a market power perspective.

Yet there is one aspect of market power that has been overlooked in the Rec Dec. Market power, whether horizontal or vertical, requires that non-competitive prices be maintained over a significant time period. How can an intermittent generating resource such as wind meet this important criterion of market power?

Does NYSEG and RG&E have an Opportunity to Exercise VMP?

SPM submits another major error with the Rec Dec in this area is its failure to critically analyze whether NYSEG and RG&E have a real opportunity and intend[7] to exercise vertical market power. Rather the Rec Dec assumes that the Commission's policy is to require complete divestiture no matter what the circumstances. Of course, such a position cannot be found in Commission orders or the Policy Statement. So it may be productive to look at the potential ways VMP can be exercised to the detriment of customers.[8]

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7 It is unnecessary to discuss intent if there is no opportunity.

8 Of course, it has been shown that VMP can also be exercised to benefit customers, but there has been no discussion of this

1. Price Manipulation Through Bidding or Withholding.

In view of the nature of wind generation, it is difficult to comprehend how VMP could be exercised. As shown above, with only 166 MWs in the pipeline that will be interconnected with NYSEG's T&D facilities, Iberdrola's wind generation is quite modest compared to the total generation in the applicable NYISO zones.

The average capacity factor of wind generation in New York ranges from 25% to an upper bound of 40%. Thus, the currently planned Iberdrola wind generation is expected to inject 363,540 to 581,664 MWHs on an annual basis. This should be compared to 167,341,000 MWHs of electric load managed by the NYISO in 2007. This means that Iberdrola wind power interconnected with NYSEG is expected to contribute anywhere from 0.22 to 0.35% at some point in the future if all of the planned projects are developed. These tiny injections are hardly market moving magnitudes. And to the extent these injections do move the market, as noted earlier, wind generation will exert a downward pressure on prices. If this is a consequence of the exercise of vertical market power, then let's have more of it!

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case by the Staff or Rec Dec. Only Dr. Hieronymus discussed how VMP would work to customers' benefit in connection with NYSEG and RG&E long term contracts.

So it takes quite an imagination to conjure the abuse of market power from a pricing perspective or withholding perspective[9]. There are three other areas of potential VMP abuse: manipulation of transmission outages, preventing competitors from interconnecting to NYSEG's transmission system and failing to maintain the transmission system.

2. Manipulation of transmission outages.

For Iberdrola to gain unlawful profits from the manipulation of its transmission outage schedule, it must also have the cooperation of the wind coincident with high demand. But the reality is that the NYISO controls the schedule of transmission outages, not NYSEG and RGE. See NYISO Outage Scheduling Manual, Revision 2.0 (November 2, 2004).

> The NYISO will have authority to defer, postpone, or cancel scheduled transmission outages of A-1 facilities (see Transmission Facilities under NYISO Operational Control as listed in Attachment A-1 of the ***NYISO Transmission and Dispatching Operations Manual***). This includes:
>
> a) Deferral to alternate dates of requested outages not yet approved by the NYISO

9 It may be theoretically possible to withhold generation of some wind generators to increase the LBMP for the others. But that would only work when the wind generators were the marginal resource, a status inconsistent with their zero based bid strategy as a price taker. Further, it requires that the remaining wind generators will be able to secure more revenue via higher prices than forgone by the withholding. That may work in a heavily constrained area when the demand/price function is approaching vertical, but Iberdrola's projects are all in the virtually unconstrained part of the NYCA where the price curve is not shaped like a hockey stick.

> b) Postponement and re-scheduling of previously NYISO approved outages for which the associated TO has not yet committed resources
> c) Cancellation and re-scheduling of previously NYISO approved outages for which the associated TO has committed resources. Based upon the terms as used in the context above, the NYISO will defer, postpone, or cancel requested transmission outages of A-1 facilities, if a contingency on a NYISO monitored facility will result in a reliability criteria violation.
>
> Otherwise, the NYISO will approve the requested outage, or reschedule the outage as agreed to by the requesting TO.
>
> The NYISO has final authority in postponing or canceling outages on transmission facilities under the NYISO operational control, which would violate established reliability criteria. When the NYISO postpones or cancels a transmission facility outage request, NYISO provides alternate periods for the TO to schedule the required outage.

This fact satisfies the Policy Statement's VMP mitigation remedy by removing, not just limiting, all control from NYSEG and RGE, in favor of the NYISO:

> Possible means of mitigating market power include:
> ---Limitation on the degree of control over the constraining transmission interface held by the T&D utility.

So the only chance Iberdrola has at manipulation is unscheduled outages. That also means lost transmission revenues. Any increased pattern of unscheduled transmission outages would be quickly recognized by the market monitors and remedied. Not to mention, such outages would accrue penalties under the Commission's SAIFI and CAIDI programs. In any event, the Commission could condition the merger on third party transmission outage scheduling for the non-A1 (non-NYISO) facilities.

3. Interconnection Refusal.

NYSEG and RG&E to advantage Renewables' generation could slow down or basically not work on competitors' interconnection requests. This too would become readily apparent and the NYISO has procedures to address this issue.

4. Diminished Investment in T&D by NYSEG and RG&E.

This would involve a long term strategy that will allow the NYSEG and RG&E systems to deteriorate in such a manner and place that the run down system would provide discriminatory benefits to the affiliated, interconnected wind generation. Of course, avoiding investment in the wires business for a wires company is not exactly a winning business strategy since the lost revenues would be orders of magnitude higher than the potential ill-gotten gains from somewhat higher LBMPs. This potential use of vertical market power is well beyond even the theoretical, rapidly approaching fantasy, since the upstate New York market is currently and for the relevant future unconstrained.

5. <u>Consequences of Attempting to Exercise VMP</u>

Human folly knows no bounds. But the Commission should consider whether any rational business would attempt to exercise VMP when the consequences are so severe. FERC now has the authority to impose $1 million per day in penalties plus disgorgement of any ill gotten gains. If that were not enough, FERC can pull the offenders market based rate authority which means that the wind generators would have no way to sell into the NYISO market. SPM submits that this is sufficient deterrence to eliminate any exercise of VMP if one could find a way to do so with wind generation.

There is no Literature that Suggests Wind Generation Can Exercise Vertical Market Power

A Google and Google Scholar search by SPM did not produce a single lead or record suggesting that anyone, anywhere, has found that wind generation is capable of exercising vertical market power, not even as a theoretical possibility. The literature did reveal that

> In an electricity market where intermittent generation, such as wind, comprises a small share of total output, the variability of intermittent output should not be expected to have much effect on the market price.[10]

However where substantial wind generation is present under perfect competition it received lower than average market price on a volume weighted average basis.

> In the presence of increasing marginal costs of conventional generators, during periods of high wind, the conventional generators, which provide the marginal

10 Twomey and Neuhoff, 2005, *Market Power and Technological Bias: The Case of Electricity Generation* (working paper presenting preliminary research findings), University of Cambridge, Faculty of Economics.

> generation, will be required to back down and move down the marginal cost curve, resulting in lower market price. Similarly, during periods of low wind, the conventional marginal generator will be required to increase output, moving up the marginal cost curve or activating higher cost generators, resulting in higher market price. As a result, the periods of high wind output receive a lower than average price and the periods of low wind output receive a higher than average price. The net effect is that the volume weighted average price by wind is lower than the average price.[11]

In essence, wind generation due to its intermittent nature receives something less than average price. This is hardly an expected outcome if wind generation could exercise VMP.

The Rec Dec's Treatment of Iberdrola's Interconnected Wind Generation is Not Consistent with the Public Service Law

Section 66-c of the Public Service Law states:

> 1. It is hereby declared to be the policy of this state that it is in the public interest to encourage, at rates just and reasonable to electric and steam corporation ratepayers, the development of alternate energy production facilities, co-generation facilities and small hydro facilities in order to conserve our finite and expensive energy resources and to provide for their most efficient utilization when such facilities are needed to fulfill the energy, capacity or other electric system needs of this state, as determined by the most recent state energy plan. <u>In furtherance of this declared policy, the commission shall encourage the participation of utilities in co-generation, small hydro and alternate energy production facilities either directly or through subsidiaries</u> formed pursuant to the provisions of subdivisions three and four of this section. (emphasis added.)

Section 2 of the Public Service Law defines alternate energy production facility:

[11] <u>Id.</u>

> 2-b. The term "alternate energy production facility", when used in this chapter, <u>includes</u> any solar, <u>wind turbine</u>, waste management resource recovery, refuse-derived fuel or wood burning facility, together with any related facilities located at the same project site, with an electric generating capacity of up to eighty megawatts, which produces electricity, gas or useful thermal energy. (emphasis added).

It should be noted that all three of the proposed Iberdrola Renewables wind farms to be interconnected with NYSEG transmission facilities are less than 80 MWs. Accordingly, as the Commission explained in *Lyonsdale Biomass*[12]

> The proposed acquisition transaction CHEC describes will not be reviewed under the PSL. Lyonsdale and its facility are exempt from PSL regulation, except for Article VII. Moreover, the transaction does not raise market power issues that might impel an inquiry into CHEC’s participation in the wholesale generation market.
> As CHEC points out, Lyonsdale’s facility is a QF under New York law. As a result, the facility is not electric plant under PSL §2(12), and its owner is not a person or an electric corporation under PSL §§2(4) and 2(13). CHEC’s ownership would not render the Lyonsdale facility subject to regulation, even though CHEC may be an electric corporation for other purposes. Nothing in the PSL prevents an electric corporation from owning a QF that is not subject to regulation, and it is public policy, under PSL §66-c, to promote the development of QFs. That policy accomplished in part through the exemption from PSL regulation extended to QFs. Therefore, PSL §70 does not pertain to the acquisition or transfer of ownership

[12] CASE 05-E-1423 – Central Hudson Enterprises Corporation – Petition for a Declaratory Ruling Regarding Approval of the Indirect Disposition of Majority Ownership Interests in Lyonsdale Biomass LLC., DECLARATORY RULING ON ACQUISITION OF OWNERSHIP INTERESTS IN A QUALIFYING FACILITY (Issued and Effective January 20, 2006)

interests in Lyonsdale, which can be consummated without seeking PSL review.

The foregoing case demonstrates the Public Service Law's special encouraging treatment of alternate power production facilities. There exists an obvious tension between Section 66-c of the PSL and the Policy Statement. While the law trumps policy, in this case, there is a co-habitation that is quite sensible. Based on the non-jurisdictional nature of alternate power production facilities, one could make the argument that they are exempt from the Commission's Policy Statement. The fact that Renewables' wind facilities are beyond Commission regulation, does not necessarily mean that the Commission should not apply its Policy Statement to those facilities in the context of this merger. But it does suggest that if direct and indirect ownership under the law is encouraged by utilities, then it seems the application of the Policy Statement should take that into account.

Accordingly, either the Commission should find that in this case, Renewables' ownership of interconnected wind generation at the levels currently in the pipeline are factually insufficient to trigger vertical market power, or the Commission can rule more broadly that alternate power production facilities are an exception to the Policy Statement such that the rebuttable presumption is met for such facilities.

Furthermore, Section 66-c stands as evidence of the legislature's determination to encourage the development of alternate power production facilities. The Rec Dec position is, therefore, completely at odds with the law in that it does not even give Renewables a chance to rebut the presumption against affiliated ownership of T&D and wind generation assuming the Policy Statement is applicable. However, it would be more sensible and encouraging to alternate power to just exempt such facilities from the Policy Statement altogether. Looking at it another way, if alternate power is subject to the Policy Statement then the Commission is regulating indirectly that which the legislature has purposely excluded from the Commission's jurisdiction.

Positive Benefit Adjustments and Rate Proceedings

The Rec Dec wisely calls for full blown rate cases for both NYSEG and RG&E to begin after the merger closes and to take the full statutory time of eleven months. While it is clear that the Rec Dec favors Staff's Positive Benefit Adjustments ("PBAs") in total, it also relegates their implementation to those rate cases.

In a classic "heads I win, tails you lose" scenario, the Rec Dec states

> Moreover, the acceptance of $201.6 million of PBAs in petitioners' Partial Acceptance is the practical equivalent of the acknowledgement that Staff has been demanding,

> except for the divergence between the PBA amounts proposed by petitioners and Staff respectively. That divergence in turn <u>highlights the main weakness of using PBAs as a proxy for synergies: even if some unquantifiable, future synergy savings are considered a certainty, one cannot justify any specific amount of PBAs and associated rate reductions as an appropriate proxy for those savings</u>. (emphasis added)

Rec Dec at 120. The Rec Dec nails down the weakness of PBAs, but attributes the $201.6 million concession as an acknowledgement that Staff is correct – there will be synergy savings. An equally plausible, and more likely, explanation is that the Joint Petitioners want this deal to close and made a pragmatic concession. In other words, the PBA concession was not a practical acknowledgement of synergy savings, rather the Joint Petitioners were simply being practical to provide tangible rate payer benefits to meet some of the parties concerns and the apparent Commission policy which requires tangible net benefits.

While the debate over the sufficiency of the tangible ratepayer benefits will continue probably beyond this case, at least the origin of those benefits has been determined to be indeterminate. Standing on this slender reed, the Rec Dec announces "The proxy theory therefore stands only for the proposition that some indeterminate amount of PBAs is appropriate." Id. The Rec Dec then completely abandons the "proxy theory" stating "that PBAs are needed not as a proxy for projected synergy savings but as a source of customer benefits mandated by a net benefits test under PSL §70”. What a bootstrap!

Finally, the real issue is that the Rec Dec, accepting Staff’s interpretation of the public interest standard, must find tangible customer benefits so it looks to Staff’s second theory which is a comparison of comparables. That comparison has three parts: (1) half of the benefits should go to customers, (2) this is just like a sale of an asset where customer rates supported that asset, and (3) from other mergers, imputed benefits expressed as a percentage of utilities’ delivery revenues.

SPM will concede the 50-50 sharing as fair between the shareholders and customers. So there is no quibble with the first part.

The purchase of the outstanding stock of Energy East is not equivalent to the sale of an asset. Customers have no claim on shareholder gains, just as they have no role in indemnifying shareholder losses. It is fair for customers to receive a rate imputation based on the majority of the cash received from an asset sale, since the customers have been paying a return on and of those assets, in some cases, such as Ginna, for many years. Looking at it another way, when a utility sells an asset, cash comes in to the utility. It does not go to the shareholder as it does when the stock is purchased. So the second part of the comparables argument fails in that the sale of an asset is quite different than the purchase of stock directly from the shareholder. As the Commission stated in the Con Ed acquisition of O&R:

> With respect to Rockland's claims that the CEI acquisition of O&R's common stock is the same as a transfer of the company's assets and its franchise rights, neither the facts here nor the applicable legal requirements provide any reason to recast the proposed merger. Both the May 10, 1998 merger agreement and the June 22, 1998 petition provide for O&R's common stock to be acquired by CEI and for O&R to survive the merger as a wholly-owned, CEI subsidiary. Since the petitioners have asked for Commission approval of this transaction, there is no reason
> to consider Rockland's proposal to treat the merger either as an asset transfer or as a transfer of O&R's franchise rights.1 And there would be no change to the merger if such a theory needed to be considered. (footnote omitted)[13].

More to the point is Staff's Reply Statement to Rockland in that case:

> Rockland's argument that ratepayers have a claim on a portion of the stock premium proposed to be paid by CEI shareholders to O&R shareholders is not borne out by the authorities cited. All of the authorities cited by Rockland refer to instances where utility assets were transferred out of ownership by the regulated utility. In the instant proceeding, no assets will be transferred out of ownership by either regulated utility. In fact, the Settlement specifically provides that the Companies have not identified the need for any transfer of assets to effectuate the merger, and that the settlement will not be construed as authorization for any transfer of assets. It is not true, despite Rockland's

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[13] Case 98-M-0961, Joint Petition of Consolidated Edison, Inc., and Orange and Rockland Utilities, Inc. for Approval of a Certificate of Merger and Stock Acquisition, ORDER AUTHORIZING MERGER (Issued and Effective April 2, 1999).

> profession, that utilities can circumvent ratepayer entitlement since virtually any sale of an operating asset can be structured as a sale of stock. If a portion of the assets of a regulated utility were to be transferred out of ownership of the regulated utility in the form of a stock sale, the transfer out of ownership of the regulated utility would trigger ratepayer entitlement regardless of the fact that it was a stock sale. The distinguishing factor is that the regulated utility would no longer retain title to the assets, either directly or as the holder of stock. That distinguishing factor is not present in this proceeding. What Rockland proposes is in essence a tax on the stock transfer even though the regulated entity has not given up a single asset. Staff knows of no precedent for such a proposal and sees no regulatory principle that would justify such a proposal as the ratepayer interest in the assets remains unaffected by the merger and stock transfer.

Exhibit 113, Staff Reply Statement at pages 9 to 10 (March 18, 1999.)[14]

Accordingly the approximate $930 million in shareholder gains cannot be considered a customer benefit and so should come off the benefit table. Leaving the rest, $749 million, for the sake of argument[15], the 50-50 sharing produces an approximately $375 million in customer benefit ($1.679 billion minus $930

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[14] CASE 98-M-0961 -Joint Petition of Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc. for Approval of a Certificate of Merger and Stock Acquisition.

[15] SPM does not concede that payments to investment bankers, lawyers, consultants and accountants are “benefits” that should be shared with customers since these are clearly costs incurred to close the deal. But in the spirit of creative compromise, they are accepted for the sake of this alternative manifestation of benefits.

million equals $749 million x 50%). This is higher than the unilateral concession and may be a deal breaker. It is offered as an alternative less injurious PBA position.

The ratepayer benefits as a percentage of utility revenues, or third part of the comparables test, is an extremely crude measure of potential ratepayer benefits. However, that part of the Rec Dec analysis demonstrates that the ratepayer benefits are outside the range of previously established reasonableness (6 to 10%). And these percentages derive from cases where all agreed there was going to be synergy savings and the discussion centered on how much and when would those savings be experienced.

In this case, the result of the Staff PBA measure of ratepayer benefits is 11% which is outside the center of gravity of the cited mergers that would produce an 8% average or median value which translates into total ratepayer benefits of $470.1 million (8/11 times $646.4 million). So if one were going to use the third part of the comparables analysis, one should use an average, 8%, not an outlier, particularly in this case where the putative synergy savings are indeterminate.

Nevertheless, there is no disagreement that eventually, if synergy savings occur, they will be reflected in rates albeit with a regulatory lag. That is not such an unfair outcome, because synergy savings typically have a cost to achieve and the lag in rate recognition can offset those costs. The Joint Petitions have not requested rate recovery of any cost to achieve.

In any event, the Rec Dec provides for a second round implementation of the ratepayer benefits in the rate cases. By then it may become clearer what potential synergies and costs to achieve are available. The first round or $201.6 million already conceded by the Joint Petitioners should go into effect quickly after the merger closes.

Then the parties who are interested in NYSEG and RG&E rate levels can consider appropriate adjustments in the post merger rate cases in a careful and deliberative fashion.

> And, contrary to petitioners' warning that a PBA requirement will tend to deter infrastructure investment, the Commission will continue to have a legal obligation to allow regulated returns sufficient to attract investment regardless of whether it approves this transaction. Meanwhile, a PBA requirement here would set a salutary precedent by raising the bar for other mergers that cannot satisfy §70 by means of synergistic benefits.

Rec Dec at 123. The first sentence is a clear affirmation of the Commission's responsibilities. However, the last sentence of this excerpt from the Rec Dec is quite troubling from a policy perspective for it may discourage a potentially beneficial transaction in the future. As discussed in connection with water utility mergers, this Commission did not insist on significant tangible ratepayer benefits. It was sufficient to justify a transaction if the acquirer had strong financial and technical hands. SPM urges the Commission to not "raise the bar", but rather to signal to the investment and business community that the Commission will take each merger on its own merits because each is different.

Reporting, Accounting and Financial Protections

For the most part SPM agrees with the Rec Dec's treatment of the various reporting, accounting and financial protection conditions.

This Merger is Consistent with and Supportive of

New York State Energy Policy

New York has been a consistent leader among the states in its energy policy goals and strategies. From the formation of the New York Power Pool in the 1960s, the restructuring of the electric and gas industries, the formation of the NYISO, the creation of the Renewable Portfolio Standard, Demand Side Management, Revenue Decoupling, and ongoing the proceeding on Energy Efficiency Portfolio Standard, New York is looked up to by many states for policy and technical guidance. Thus, it makes sense for Iberdrola, a world leader in renewable generation, to be interested in entering New York where it would be expected to be welcomed since its corporate goals are congruent with and will assist New York in meeting its own RPS and EEPS goals. That public-private partnership will serve the public interest. Iberdrola's recent commitment[16] to invest not just $100 million, but $2 billion in wind generation in upstate New York, is itself sufficiently in the public interest to justify this transaction.

Conclusion

Putting aside VMP and PBAs, there appears to be very little significant disagreement with most of the reporting, accounting and financial protection conditions. SPM assumes that there are few if any deal breakers in the group, with the possible exception of an expansive view of the Limited Purpose Entity or Golden Share. So it seems sensible under the circumstances for the parties to get back into settlement mode and make one more effort to try to settle this case. SPM assumes the Commission will not object if the parties try one more time to reach

16 SPM assumes that Iberdrola will execute a Joint Proposal or Acceptance of Merger Conditions to that effect.

agreement on reasonable conditions to this merger.

Respectfully submitted,

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