BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

--x

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.

Case 07-M-0906

--x

REBUTTAL TESTIMONY OF
JEFF D. MAKHOLM

January 31, 2008

Case 07-M-0906

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

I. Introduction

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

A. My name is Jeff D. Makholm. I am a Senior Vice President at National Economic Research Associates, Inc. ("NERA"). NERA is a firm of consulting economists with its principal offices in a number of major U.S. and European cities. My business address is 200 Clarendon Street, Boston, Massachusetts, 02116.

Q. Please describe NERA.

A. NERA was founded in 1961 by consulting economists working in conjunction with Professor Alfred E. Kahn of Cornell University (a future Chair of the New York Public Service Commission and still an active Special Consultant at NERA), making it the oldest firm of independent consulting economists. Consistent with NERA's tradition of providing independent economic advice, the firm has no interest, as such, in the Iberdrola/Energy East merger and no stake in its outcome.

Q. Please describe your academic background.

A. I have M.A. and Ph.D. degrees in economics from the University of Wisconsin, Madison, with a major field of Industrial Organization and a minor field of Econometrics/Public Economics. My 1986 Ph.D. dissertation is entitled "Sources of Total Factor Productivity in the Electric Utility Industry." I also have B.A. and M.A. degrees in economics from the University of Wisconsin, Milwaukee. Prior to my latest full-time consulting activities, I was an Adjunct Professor in the Graduate School of Business at Northeastern University in Boston, Massachusetts, teaching courses in microeconomic theory and managerial economics.

Q. Please describe your work experience pertinent to this proceeding.

A. My work as a consulting economist principally involves the area of regulated industries—both those that operate networks (such as oil and gas pipelines, electricity transmission and gas distribution systems, telecommunications and water utility systems) and those operating infrastructure business at specific sites, such as airports, electricity generation plants, oil refineries and sewage treatment plants. In such industrial settings, I have researched and provided evidence regarding regulated pricing, the presence or absence of market power, competition, the fair rate of return, regulatory rulemaking, incentive ratemaking, load forecasting, least-cost planning, cost measurement, contract obligations and bankruptcy, among other issues. I have prepared expert testimony and affidavits, and I have appeared as an expert witness, in many state, federal and United States District Court proceedings, as well as in regulatory and court proceedings abroad.

I have also directed studies on behalf of utility companies, governments and the World Bank in many countries. In these countries, I have drafted regulations, established tariffs, recommended financing options for major capital projects and advised on industry restructurings. I have also assisted in the privatization of state-owned utilities. As part of my international work I have conducted formal training sessions for government, industry and regulatory personnel on the subjects of privatization, pricing, finance and regulation of the gas industry. My current curriculum vitae, which more fully details my educational and consulting experience and my publications, is provided as Exhibit ___ (JDM-1).

Q. Are you familiar with the way in which New York and other states, as well as the federal government, regulate the rates of utilities and other network industries such as interstate pipelines and electricity transmission systems?

A. Yes. I have submitted hundreds of testimonies in dozens of state and federal jurisdictions in the United States. These include a number of pieces of evidence for NYSEG, RG&E and other Energy East companies in NY, CT and ME, both before and after their mergers with Energy East. I have provided many testimonies on capital structure and cost of capital in NY for a number of gas and electric utilities, and I am familiar with the regulation of utilities by the Public Service Commission in New York State ("Commission").

Q. Please describe your appearances before the Commission.

A. Over the past 20 years, I have appeared as a sworn expert witness, or presented a sworn affidavit or testimony, 21 times before the Commission on a diverse range of subjects for electricity, gas and water utilities. The cases in which I have appeared are as follows:

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

- Prepared Rebuttal Testimony on behalf of National Fuel Gas Distribution Corp., Cases 28947 and 28954, September 14, 1987. Subject: Pass-through mechanisms for gas acquisition costs.

- Supplemental Prepared Direct Testimony on behalf of Empire State Pipeline, Case 88-T-132, October 17, 1988, in conjunction with testimony of Professor Alfred E. Kahn: Subject: Measured benefits of pipeline entry to gas transportation markets in New York State.

- Prepared Rebuttal Testimony on behalf of Empire State Pipeline, Case 88-T-132, September 6, 1989. Subject: Benefits of pipeline entry in New York State.

- Prepared Rebuttal Testimony on behalf of National Fuel Gas Distribution Corporation, Case 88-G062, October 27, 1989. Subject: Pass through of contract reformation costs of interstate gas pipelines pursuant to federal gas industry restructuring.

- Prepared Direct Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-1050, November 22, 1989. Subject: Cost of capital and capital structure.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-1050, April 27, 1990. Subject: Cost of capital and capital structure.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 89-G-126, May 18, 1990. Subject: Cost of capital and capital structure.

- Prepared Direct Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, November 15, 1990. Subject: Cost of capital, cost effect of weather adjustment clauses.

- Prepared Rebuttal Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, April 10, 1991. Subject: Cost of capital and capital structure.

- Prepared Supplemental Testimony on behalf of The Brooklyn Union Gas Company, Case 90-G-0981, July 29, 1991. Subject: Cost of capital.

- Prepared Direct Testimony on behalf of the New York State Electric and Gas Corporation, Case 91-E-0863, et al., August 28, 1991. Subject: Cost of capital.

- Prepared Rebuttal Testimony on behalf of New York State Electric and Gas Corporation, Case 91-E-0863, et al., February 3, 1992. Subject: Cost of capital.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

- § Testimony in Support of Multi-Year Agreement on behalf of New York State Electric and Gas Corporation, Case 92-E-1084, et al., April 15, 1993. Subject: Cost of capital.

- § Rebuttal Testimony in Support of Multi-Year Agreement on behalf of New York State Electric and Gas Corporation, Case 92-E-1084, et al., May 3, 1993. Subject: Cost of capital.

- § Rebuttal Testimony on behalf of Jamaica Water Supply Company, Case 92-W-0583, May 28, 1993. Subject: Cost of capital.

- § Prepared Direct Testimony on behalf of the Brooklyn Union Gas Company, Case 93-G-0941, November 1, 1993. Subject: Cost of capital.

- § Prepared Direct Testimony on behalf of New York State Electric & Gas Corporation. Case 01-E-0359. August 3, 2001. Subject: Electric price protection plan.

- § Prepared Rebuttal Testimony on behalf of New York State Electric & Gas Corporation. Case 01-E-0359. September 12, 2001. Subject: Electric price protection plan.

- § Direct Testimony on behalf of Rochester Gas and Electric Corporation. Case 02-E-0198, Case 02-G-0199. February 15, 2002. Subject: Cost of capital.

- § Rebuttal Testimony on behalf of Rochester Gas and Electric Corporation. Case 02-E-0198, Case No. 02-G-0199. September 30, 2002. Subject: Cost of capital.

- § Affidavit in support of Rochester Gas and Electric Corporation's Response to Staff's November 8, 2002 filing. Case 02-E-0198, 02-G-0199. November 14, 2002. Subject: Respond to staff's filing with respect to the rate-of-return and risk impacts of various regulatory mechanisms.

In addition, I participated in the Generic Finance Proceeding in New York in the early 1990s, as a consultant to the group comprising all of the regulated electricity and gas companies in the state. That work involved an investigation into the possibility of adopting a formula that would automatically update the cost of capital for regulated utilities in the state without necessitating formal case-by-case evidentiary hearings. While that lengthy proceeding took over a year and produced many written reports and recommendations, and is still referred to by Staff from time-to-time in its various rate case testimonies, it was never adopted formally by the Commission.

Q. So would you say that you are familiar with the way in which the Commission regulates the companies in its jurisdiction?

A. Yes. More specifically, in the case of independently owned and traded utilities, operating companies of larger holding companies and new regulated entrants, I am familiar with both the way in which this Commission administers its responsibilities to look out for the interests of consumers of utility services in New York and the way in which the Commission sets the fair rate of return, oversees utility capital structures and generally regulates tariff levels to that end.

Q. Have you worked in the past with Energy East or the utility operating companies that it now holds?

A. Yes. In addition to providing evidence for NYSEG on the cost of capital in New York, I worked for Central Maine Power, prior to its merger with Energy East, with respect to the productivity factor, based on my own empirical Total Factor Productivity (TFP) measurements, in its multi-year price cap plan in Maine. I also represented the Connecticut gas distribution utilities that are now a part of Energy East—Southern Connecticut Gas Company and Connecticut Natural Gas. I represented both companies as part of the Algonquin Customer Group in a number of

FERC cases involving interstate pipeline rates and charges. I also represented Southern Connecticut Gas, both before the courts in Connecticut and the Department of Public Utility Control regarding the recovery of its system enhancement costs.

Q. Does your experience with regulated utilities extend outside the U.S.?

A. Yes. I have directed projects involving the privatization and tariff regulation, including assessments of the opportunity cost of capital, for major regulated utilities and other network infrastructure businesses in many countries, including Poland, the United Kingdom, the Netherlands, Ireland, Spain, Argentina, Chile, Bolivia, Mexico, Canada, China, New Zealand, South Africa, Russia, and Australia, among others.

Q. Do you have any experience in bankruptcy proceedings, either for utilities or for firms related to utilities (like utility holding companies, power plants or energy marketing firms)?

A. Yes. I was a consultant to Public Service Company of New Hampshire in 1988 on various ratemaking questions when that firm became the first U.S. utility since the Great Depression to file for bankruptcy. I have since filed testimony in federal court in three bankruptcy proceedings involving utilities, interstate pipeline contracts or power sales contracts:

- Before the United States Bankruptcy Court for the District of Maine, Testimony on behalf of the Massachusetts Municipal Wholesale Electric Company in Eastern Maine Electric Cooperative, Inc., Adversary Proceeding No. 89-1006, December 14, 1989.

– Before the United States Bankruptcy Court, Northern District of Texas, Fort Worth Division, Report on behalf of Mirant Corporation, et al, Debtors. Case No. 03-46590 (Jointly Administered). March 22, 2005. Subject: Pipeline capacity valuation for a rejected pipeline capacity contract.

– Before the United States Bankruptcy Court, Northern District of Texas, Fort Worth Division, Reply Report on behalf of Mirant Corporation, et al, Debtors. Case No. 03-46590 (Jointly Administered). April 12, 2005. Subject: Pipeline capacity valuation for a rejected pipeline capacity contract.

– Before the United States Bankruptcy Court, Southern District of New York, Report on behalf of Solutia, Inc., Debtors. Case No. 03-17949 (PCB). March 23, 2007. Subject: Discount rate for damage projections for a rejected power sales contract.

– Before the United States Bankruptcy Court, Southern District of New York, Supplemental Report on behalf of Solutia, Inc., Debtors. Case No. 03-17949 (PCB). April 20, 2007. Subject: Discount rate for damage projections for a rejected power sales contract.

In addition, I have consulted and/or provided testimony in state proceedings for the solvent operating utilities of bankrupt holding companies or bankrupt sister subsidiaries under holding company structures. In particular, these cases included Portland General Electric Company (a subsidiary of the bankrupt Enron Corp) and Public Service Company of Colorado, a sister subsidiary of the bankrupt power trading company NRG under the holding company Xcel.

Q. Have you published papers relating to regulating the rates of public utilities?

A. Yes. My C.V. lists 17 published papers and one book pertaining to various elements of state and federal regulation, both in the U.S. and abroad.

Q. What is the purpose of your testimony?

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

A. My evidence in this proceeding serves to rebut evidence given by the New York Department of Public Service Staff Policy Panel ("Staff Policy Panel" or "Staff"). I conclude that the panel wrongly characterizes the transaction, misstates the nature of the proposed merger as it relates to the public interest in New York, misinterprets the significance of the opinions of the independent ratings agencies, wrongly criticizes the suitability of Iberdrola as a holding company vis-à-vis Energy East, and presents subjective and inappropriate financial calculations and conditions. The Staff Policy Panel's criticisms are inconsistent with the way New York, as well as other state commissions, regulates its investor-owned utilities.

Staff's strongly negative view of the proposed merger has no foundation in the "regulatory compact" that has evolved in the United States over many decades to serve the <u>twin goals</u> of protecting the public interest while allowing investor-owned utility companies to pursue their own legitimate business interests. Based on my experience, I believe the Staff's approach is inconsistent with the position of its peers in other state jurisdictions as well as that of Congress, the Federal Energy Regulatory Commission (the FERC) and the Securities and Exchange Commission (the SEC). Those other agencies realize that utility holding companies—whether based in the United States or abroad—cannot erode the rights of utility ratepayers and can neither evade nor lessen the effectiveness of the longstanding methods that federal and state legislatures and the courts have given regulators to protect the public interest when ratepayers are served by investor-owned utilities.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Q. Does your testimony address Staff's responses to information requests related to the Staff Policy Panel's direct testimony addressing the issues discussed in your testimony?

A. Yes. I have received and reviewed several responses by Staff to information requests related to the Staff Policy Panel's direct testimony and have specifically addressed some of the responses in my rebuttal testimony. However, additional analysis will be required to review and possibly specifically address many of Staff's responses as there was insufficient time to complete my review in the time provided to submit my testimony. I further note that in certain responses, Staff has indicated that it intends to revise certain exhibits and I reserve my right to revise my rebuttal testimony at hearing if those Staff revisions bear on my testimony.

Q. Are you sponsoring any exhibits in addition to your C.V?

A. Yes. Exhibit __ (JDM-2) contains a copy of one interrogatory response referenced in this testimony.

Q. How do you organize your testimony?

A. The Staff Policy Panel testimony runs to 317 pages with the various issues that I rebut spread throughout. To narrow my rebuttal to those elements that I consider most objectionable, I organize my response into the following seven topics, the contents of which I briefly describe below:

1. <u>Incentives Attached to "Goodwill"</u>. Staff wrongly claims that the merger will create incentives for Iberdrola, as the new owner, to "cut corners" and seek unreasonably high earnings from the regulated New York operating utilities in order to make a return on the accounting "Goodwill" that it will book for this

transaction. In fact, the presence of Goodwill in connection with a utility acquisition is routine in such transactions, and no new incentives will accompany this transaction or its outcome.

2. <u>Credit Quality/Ratings</u>. Staff misstates the issues surrounding credit quality. The rating agency concerns relating to New York pertain, according to them, largely to the State's harsh treatment of its regulated companies, not to this proposed transaction. Further, to the extent that the ratings agencies refer to this transaction, their concerns pertain largely to the problems that would occur if the Commission attempted to extract excessive concessions from the regulated operating companies.

3. <u>Vague Statements of "Risk"</u>. Staff's various uses of the term "risk" (e.g., generalized statements of concern regarding Iberdrola's unregulated subsidiaries and foreign utility operations) have nothing to do with ratepayers or with this transaction. The "risks" that can affect ratepayers (i.e., business risk, financial risk, etc.) are well defined terms of art in the financial and regulatory literature. Staff provides no basis—conceptual or empirical—for concluding that such risks will increase with this transaction.

4. <u>Transparency/Cross Subsidies/Affiliate Issues</u>. Staff implies that there are uncertainties regarding the internal workings of Iberdrola and its affiliates that create a potential problem for *ratepayers*. Such an implication is incorrect. The Commission will give up none of its reliable methods for dealing with affiliated interest issues in this transaction. If there are specific and substantive concerns from the Commission, merger conditions can make explicit the commitments that Iberdrola makes with respect to regulation in New York.

5. <u>Upstream Tax/Benefit Issues</u>. Staff's attempts to value this acquisition from Iberdrola's perspective are subjective and unrealistic, in addition to being irrelevant regarding the cost-based rates for New York consumers that the Commission oversees. The valuation of this merger in Iberdrola's eyes is a question that lies outside the appropriate frame of reference of the Commission.

6. <u>Improper Calculations/Wrong Proceeding</u>. All of Staff's calculations pertaining to "backed out" capital structure ratios are subjective and improper. Furthermore, Staff examines the subject of the cost of equity for the operating companies in a context inappropriate for the merger issues before it.

7. <u>Basic Statutory Control</u>. Staff ignores two fundamental points in its objection to this merger: (1) The Commission in New York will lose none of its ability to use its broad, legislatively-granted powers to protect the public interest in

New York through direct regulation of NYSEG and RG&E as a result of this transaction; and (2) the view of holding companies in the United States has evolved over time—from the 1935 Public Utility Holding Company Act to the 2005 Energy Policy Act. Holding companies subject to books and record requirements and protections against improper affiliate transactions are accepted by the Congress, the FERC and the SEC as a normal part of modern energy markets. Staff's proposal to go beyond these requirements and protections and essentially seek to regulate Iberdrola is out of step with these other regulators and Congress that recognize that it is neither wise nor necessary to promote both modern energy markets and the wider interests of the public.

8. <u>The Golden Share</u>. Staff recommends that a "golden share" condition be placed on approval of the transaction in order to prevent the possibility of a parent bankruptcy triggering the bankruptcy of its subsidiary. The voting rights of this golden share would be held by a party appointed by the Commission. This condition is not needed, as the Commission retains effective control over the regulation of the companies in its jurisdiction, including over affiliate transactions that could be associated with a parent bankruptcy. But in any case, it is contrary to the custom and practice of U.S. regulation for the Commission to appoint a party in the governance structure of an investor-owned utility.

Q. Please proceed.

A. I will address each of these points in order.

II. Incentives/Goodwill

Q. Please describe the purpose of this section of your testimony.

A. The Staff Policy Panel expresses significant concern with the price that Iberdrola proposes to pay Energy East above the regulated book value (i.e., the "rate base") in the regulated entities (see, for example, Staff Policy Panel testimony at pp. 179-193 which is entitled "Risky Nature of Goodwill"). Staff asserts that the resulting Goodwill that Iberdrola will book in its own accounts for this transaction will create new incentives for it to raise rates above reasonable levels or degrade the level of service to New York ratepayers in order to make a return on that Goodwill. In this section of my testimony I discuss why Staff's concern with Goodwill at the Iberdrola level is misplaced. Not only Iberdrola, but every private investor in U.S. utilities, pays above the book value for shares of utility equity. The incentives to earn profits by running utilities are no different for Iberdrola than they currently are for Energy East or for any other traditional equity investor for any utility in the country.

In other words, having Iberdrola replace Energy East as the holding company will have no effect whatsoever on the profit incentives inherent in the investor-ownership of NYSEG or RG&E, however Iberdrola treats the premium paid over book value. Staff's assertion that Iberdrola faces any new incentive to profit at ratepayers' expense, or that its avenues for profitability are different than those that have traditionally driven utilities in the U.S., is illogical and contrary to economics.

Q. Where does the Staff Policy Panel speak about how the Iberdrola Goodwill from this transaction will supposedly create new incentives to profit at ratepayers' expense?

A. The Staff Policy Panel brings up the issue several times in its testimony. For example:

On page 30, the Staff Policy Panel states:

> [w]e believe that the long term excess capital arising out of the M&A transaction (i.e., the premium paid), will create long term pressure on the management of the combined entity to cut corners and seek to extract a

> return from the utility assets which exceeds the realistic and reasonable earnings potential of those properties. The result can be financial stress and service problems over the long run.

On page 31, the Staff Policy Panel states:

> Post transaction, Iberdrola would have Goodwill and intangible assets on its books in an amount that is equal to 46% of its equity balance. This is a significant hazard to ratepayers.

On page 86, the Staff Policy Panel states:

> …the amount of non-earning assets created by this merger places a great deal of stress on utility operations to produce an adequate return to meet the needs of all of Energy East's operations. Goodwill already on the books of Energy East and Goodwill related to this transaction will make up approximately 63% of the equity of Iberdrola's investment in Energy East.

On page 192, the Staff Policy Panel states:

> When Iberdrola acquired Energy East, second generation Goodwill was created. Second generation Goodwill is Goodwill generated by the acquisition of an entity that already has Goodwill on its books. If Iberdrola is acquired at a premium, third generation Goodwill will be created. … This process is unsustainable in the long run.

Q. How do you respond to these kinds of Staff Policy Panel assertions that the merger will create incentives for Iberdrola to "cut corners" and "seek to extract" an excessive return as a result of its acquisition of Energy East?

A. The incentives facing Iberdrola are no different than those already facing all investor-owners of U.S. utilities, whether they are individual shareholders or holding company parents. Before specifically responding to Staff's claims as they relate to Goodwill, which I discuss further below, it is helpful to recall the long-established balance struck in U.S. utility regulation between ratepayer interests and the interests of private owners of utilities.

Q. Please proceed.

A. In the normal state of affairs, utility owners have long been recognized as having an interest in making the greatest return on the smallest investment in regulated public services. Since the early 20th century, when private utility ownership was accepted as the norm in the United States (as opposed to the practice of government ownership of utilities in many other countries), those incentives have been embraced as the way to harness private company initiative while maintaining high quality services to the public. The public is protected from the possibility of owners charging excessive prices or degrading the quality of service—whether the owners are individual shareholders or a corporate parent. That is to say, balancing public interest with investor ownership—*i.e.*, the "regulatory compact"—does not depend on whether the owners are individuals or a holding company.

Q. What is this "regulatory compact?"

A. The literature on regulation of investor-owned public utilities refers consistently to the concept of the "regulatory compact," defined by Professor Charles F. Phillips Jr., of Washington and Lee University—an authoritative writer in the field of public utility regulation—as follows:

> First, in return for a monopoly franchise, utilities [accept] an obligation to serve all comers. Second, in return for agreeing to commit capital to the business, utilities [are] assured a fair opportunity to earn a reasonable return on that capital.[1]

Others have called this mutuality of commitments the "regulatory bargain," reflecting the older terminology of early 20th century economists studying the economic and institutional foundation of American utility regulation. These economists saw a number of new relationships form in the development of complex "going concerns" during the industrial revolution. The economists called them "bargains" to signify what Professor Martin Glaeser at the University of Wisconsin—the author of the first authoritative regulatory economics text—described as "the economic framework by means of which business is carried on."[2] The ***cost bargain*** was how regulated enterprises acquired inputs in the market, and the ***investment bargain*** was how regulators would induce owners of capital to contribute it for

[1] *See* C.J. Phillips, Pub. Utils. Reports, Inc., *The Regulation of Public Utilities, Theory and Practice* at 21 (1993) (referencing I.M. Stelzer, *The Utilities of the 1990s*, Wall St. J., Jan. 7, 1987, at 20).

[2] M.G. Glaeser, *Outlines of Public Utility Economics* at 102, Macmillan (1927). Glaeser's influence on public utility economics in the United States, directly and through his many graduate students, has been profound. Indeed, Professor Phillips relies on Glaeser for, among other things, his basic definition for public utilities as distinct types of firms in the U.S. economy. *See* Phillips at 4. Glaeser himself, as an undergraduate at the University of Wisconsin in 1907, was one of 15 students in the world's first university class in regulatory economics, taught by the great institutional economist at Wisconsin, and drafter in 1907 of Wisconsin's regulatory statute, John R. Commons (later the President of the American Economic Association). Dr. Milo Maltbie, who almost simultaneously drafted New York's first regulatory commission statute, and an inaugural Commissioner of the New York Public Service Commission (appointed by Governor Charles Evans Hughes), credits Commons as having encouraged him to seek that appointment. According to Maltbie: "Professor Commons dropped into my office and asked if I were making any attempt to secure an appointment to the commission, … [and] that I was qualified for just such a place and that the Governor would appoint at least one man who knew what it was all about." *See* Howard J. Read, *Defending the Public: Milo Maltbie and Utility Regulation in New York* at 25, Dorrance Publishing Co. (1998); J. R. Commons, *Myself* at 128, Macmillan, (1934). Maltbie eventually served as Chairman of the New York PSC from 1930 to 1949. I bring up this history merely to help to show that the charges by the Staff Policy Panel that a new and harmful incentive will accompany this transaction are not only incorrect but uninformed. The protections of customers that utility regulation provides in New York, as elsewhere in the U.S., rests on a longstanding and substantial economic and institutional foundation crafted and administered by farsighted experts.

certain public purposes. The *income bargain* or *rate bargain* covered the transactions with utility customers.[3] These three relationships developed into the more modern term *regulatory bargain* that has defined U.S. regulation since the 1944 *Hope Natural Gas* decision.[4]

Q. What does the "regulatory compact," or alternatively "regulatory bargain," mean, in practical terms, for how customers are served by investor-owned regulated companies?

A. It means the compensation for the owners of utilities depends on the adequacy and quality of service to the public. If the public is not well served, the regulator can apply specific sanctions to the company or prevent it from earning a return commensurate with other firms in the market.

My point is this: The broad statutory powers given to regulators like the Commission in New York are fully capable of responding to poor services on the part of the investor-owned companies that they regulate. Whether the owners are individual shareholders or corporate parents has nothing to do with the Commission's key role of ensuring that the public is provided with safe, adequate and reliable service at the lowest reasonable cost.

---

3 Glaeser, *Outlines of Public Utility Economics* at 102-107; *see also* R.R. Breutigam, *A Regulatory Bargain for Diversified Enterprises*, International Journal of Industrial Organization, Vol. 11 at 1-20 (1993).

4 *Fed. Power Comm'n. v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Q. Getting back to the specific issues of risk associated with allegedly excessive Goodwill, do you believe Iberdrola can "cut corners" to the detriment of ratepayers as Staff alleges it might if it acquires Energy East?

A. Iberdrola will have no more ability to cut corners on NYSEG and RG&E customer service than these utilities had before and after they were acquired by Energy East. If the bills are wrong, if outages increase, if wait time for service calls increase, etc., the Commission can impose sanctions on the operating companies regardless of whom the corporate parent is. Staff's claim that Iberdrola's level of Goodwill will, in Staff's words, "create long term pressure on the management of the combined entity to cut corners," raises an unjustified concern given the Commission's ample regulatory authority over NYSEG and RG&E. The transaction will not "create" anything. The pressure on utility management to reduce costs has always existed—which is precisely why the Commission has the job of looking out for corner-cutting, listening to ratepayers' complaints, and sanctioning utility companies if for any reason they degrade what the Commission feels is adequate service. This transaction in no way increases this pressure. Moreover, it is my understanding that Iberdrola has committed to operate with local management.[5] Staff's allegations therefore seem speculative and unsupported.

[5] See Section VIII, below, where I discuss how the Commission previously cited the importance of local management, among other things, in its approval of the acquisition of United Water Resources by the French holding company, Suez Lyonnaise des Eaux.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Q. Changing the focus from service quality to rate levels, the Staff Policy Panel says that Iberdrola will "seek to extract a return from the utility assets which exceeds the realistic and reasonable earnings potential of those properties" (*see* Staff Policy Panel at p. 30). Can it?

A. No. Every owner of every investor-owned utility in the United States might be expected to want to earn profits "which exceed the realistic and reasonable earnings" of those utilities—but regulation prevents this from happening. These are monopolies, after all, and if we let them charge prices as they wished, they would raise prices and enjoy the fruits of their monopoly power. But it is incorrect to imply that just because the owners of a utility in the United States have the *incentive* to raise prices and extract extra profit, that they have the *ability* to do so. Ratepayers have no more risk of being overcharged by NYSEG and RG&E as subsidiaries of Iberdrola than they did when these companies were independently owned. Staff's suggestion to the contrary has no merit.

Moreover, there is nothing in the record to support Staff's speculation that Iberdrola will need to extract an extraordinary level of return to support its level of Goodwill. In fact, Staff's suggestion is contradicted elsewhere in its own testimony. In its discussion of "Benefits," the Staff Policy Panel (at p. 85) says that, based on its calculations, the proposed transaction "could be accretive to earnings." This would appear to alleviate Staff's concerns about whether Iberdrola can support the Goodwill that will be placed on its books in connection with the planned transaction.

Q. But what about the level of Goodwill on Iberdrola's books? Staff estimates that $1.4 billion will be recorded as Goodwill in connection with the transaction, and emphasizes (on page 181) that under recent changes in accounting standards that Goodwill is no longer amortized, but stays on the balance sheet unless it is impaired. Won't that be a hazard to ratepayers in New York?

A. The level of Goodwill estimated by Staff is not particularly unusual for a utility transaction of this size and I do not conclude that it will be a hazard. First, utility equities in the United States normally sell at a premium over book value—meaning that the Goodwill issue is the normal state of affairs for all utility equity investments. Second, the Goodwill at Iberdrola, and the accounting treatment of Goodwill on its balance sheet, is irrelevant from the perspective of how the Commission will set rates or ensure service quality for New York ratepayers.

Q. Please explain.

A. It is typical for utility equities to change hands—either for individual shares or for whole companies—at prices in excess of book value. Except for the unexpected inflationary periods of the 1970s and 1980s, or idiosyncratic examples of utility distress (such as those trying to finish nuclear power plants after Three Mile Island), utility equities in the United States have always sold at premiums above book value—sometimes substantial premiums. These premiums reflect investor expectations that companies will grow and that share prices will increase. Goodwill, whether booked as part of a parent company transaction or inherent in the purchase of an individual share of stock at a price above book value, is just the normal state of affairs in the United States, and it places no pressure on rates at all. Nor does it constitute a "significant hazard" to ratepayers, as the Staff Policy Panel states.

Q. You said that Goodwill places no pressure on rates. Why doesn't Goodwill enter the ratemaking process?

A. Because rates come from the rate base, and not the current market value of traded shares of utility equities. When the Commission sets the fair rate of return, it applies the result to the rate base, not to the price at which shares happen to be selling in the market. The Staff Policy Panel states, at page 189, that as the proportion of Goodwill to hard assets grows, the "hard assets must work harder and harder to generate a return…to keep Goodwill from being impaired."

Staff's assertion that assets are doing the "work" is illogical. It is the management and employees that "work" to enable a company to be successful and to earn its owners a return consistent with expectations in the market for capital. The Staff Policy Panel implies, without basis, that somehow the assets themselves will be stressed, or worn out, or broken, because of Iberdrola's level of Goodwill. But there is no basis whatsoever to imply that Goodwill will promote stress on capital equipment. When any purchaser of utility common stock equity (directly or indirectly through another company) pays more than its book value, the purchaser expects growth to allow it to earn a return greater than the product of the current fair return granted by the commission multiplied by the current rate base. Iberdrola should expect what any other buyer of utility equities would expect—to be able to manage and run these companies in a way that gives it an adequate return for committing its capital to the service of ratepayers in New York and the other states served by operating companies of Energy East. Whether it does so will be the result of its own skill, foresight and industry in managing these companies. But none of that has anything to do with the quality of services to ratepayers in those jurisdictions or the prices that the regulators will allow.

Q. Staff performs a calculation, on page 86, to show how Goodwill will cut by two thirds the return that Iberdrola can expect on its investment in Energy East. Are those proper calculations?

A. No, they are not proper, because they ignore the contribution of growth to the value of utility equity.

Q. Please explain.

A. In its calculations, the Staff Policy Panel assumes a current ROE of 12 percent and a level of Goodwill related to this transaction of approximately 63 percent. From these assumptions, it states (at pages 86-87) that

> …it would mean Iberdrola would see an ROE of just over 4% on its investment in Energy East [i.e., 12 x (1-0.63)]. Clearly other factors are in play other than utility earnings as to why Iberdrola decided to purchase Energy East.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

These are not proper calculations. When the cost of equity for utility investments, as measured by the market, is 12 percent, then simply because that result is applied to the rate base, and not the higher market value, it does not mean that investors expect something less than 12 percent. Investors expect company earnings to grow—to expand levels of service and to do so with operations that become more productive and efficient.

In other words, if a stock sells at 150 percent of book value in a market where the cost of equity (reflected by the Commission-awarded rate of return) is 12 percent, then the buyer of a share of stock in the market expects 12 percent—with part of the return coming from the return on the rate base and the other part coming from investors' expectations of earnings growth. The relationship between current yield and prospective growth is a part of every utility rate proceeding. I have been in numerous rate cases both inside and outside New York. No party to those cases would give credence to a witness who divided the fair rate of return by the current ratio of the market price to the book value to assert that the result is all that investors could see as part of their operation of the utility (as Staff Policy Panel has done in its calculations). This is precisely because those parties understand that growth is an integral part of the equity return equation for investors. By excluding growth from its calculations, Staff Policy Panel has drawn unsupportable conclusions on this issue.

Q. What do you conclude regarding the Goodwill issue?

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

A. Nothing about Goodwill will affect the regulatory compact or enter the service quality or ratemaking equation for New York ratepayers. Goodwill resulting from the proposed transaction will not be pushed down onto the books of NYSEG, RG&E or Energy East, and thus will have no effect on rate base or customer rates. The concern that the Staff Policy Panel displays with respect to Goodwill has no foundation in anything that will affect New York ratepayers. Iberdrola was readily capable of raising equity for this transaction—to acquire utilities with an exacting and highly evolved regulatory compact—Goodwill notwithstanding.

III. Credit Quality and Ratings

Q. Please describe the purpose of this section of your testimony.

A. I comment on the Staff Policy Panel's discussion of credit quality and independent credit ratings. Staff seems to believe that the proposed transaction will hurt the credit ratings of NYSEG and RG&E and thereby raise their own cost of debt, and it quotes various rating agency opinions in the process. There are two issues in particular that deserve rebuttal in this respect. The first is the fact that Iberdrola maintains a better credit rating, according to those ratings agencies, than the Energy East companies that it proposes to acquire. The second is Staff's unwillingness to acknowledge the significance of the criticism that the market seems to be leveling on the regulation of utilities in New York.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Q. Where does the Staff Policy Panel discuss the issue of credit ratings and the cost of borrowed funds to the operating utilities in New York?

A. The Staff Policy Panel makes numerous statements about ratings and credit quality. I give some examples below, along with some preliminary reactions to what I consider highly unsupportable or illogical assertions on the part of the Staff Policy Panel.

On page 150, the Staff Policy Panel states:

> The leverage reflected in Iberdrola's pro forma capital structure puts downward pressure on its credit quality. … Moreover, when the effects of the write down of Goodwill are considered, the capital structure ratios are not fully consistent with investment grade bond ratings.

Please notice here how Staff is substituting its own judgment on credit ratings for that of the independent ratings agencies. On page 158, the Staff Policy Panel states:

> The credit rating advantage that Iberdrola currently enjoys over Energy East apparently has no direct benefit to the utilities. S&P has NYSEG and RG&E on negative outlook due to issues arising from the M&A transaction. This casts doubt on Iberdrola's promise of greater financial strength for NYSEG and RG&E.

Mr. Fetter, for Iberdrola, will point out how this is a misstatement of the ratings agency opinions.

On page 168, the Staff Policy Panel states:

> Q. How much of a downgrade is likely as a result of the transaction?
> A. Since S&P has not stated otherwise, we believe the credit agency will limit any downgrade of for (sic) NYSEG and RG&E to one rating notch. We are not confident, however, that there will not be further downgrades to both the New York utilities and Iberdrola.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Notice again that S&P has said nothing about such downgrades, but only the Staff Policy Panel (because "S&P has not stated otherwise"). On page 170, the Staff Policy Panel states:

> The S&P credit reports for both NYSEG and RG&E highlight two reasons for a downgrade: the potential Iberdrola acquisition and the recent NYSEG rate case. That the NYSEG rate case appears in both credit reports is telling. <u>In theory</u>, NYSEG's rate case should have no bearing on the credit quality of RG&E. They are two separate entities whose rates, <u>in theory</u>, should have no effect on the other. The fact that S&P appears to consider the effects of the NYSEG ratemaking in an RG&E credit analysis indicates that regardless of whether the acquisition is approved or not, additional structural separations and other financial protections are needed to shield the two subsidiaries from all of their affiliates (my emphasis).

Please note here that the Staff Policy Panel uses the phrase "in theory" twice to attempt to separate the Commission's treatment of NYSEG and its effect on RG&E. It should be obvious that <u>in practice</u>, harsh treatment of one operating subsidiary of a holding company in a state like New York foretells a strong possibility of similarly harsh treatment to its sister subsidiary. Staff takes its "theory" to "indicate" a need for additional structural separations from all of Iberdrola's affiliates. The ratings agency reports do not indicate this at all. What they indicate is that those subsidiaries that can be affected by Commission action are in the same ratings boat—it has nothing to do with potential unregulated affiliates that lie beyond the reach of the Commission.

And on pages 171-4, the Staff Policy Panel first quotes Moody's, and then takes it upon itself to "rebut" the Moody's analysis:

> The Moody's reports state: "The negative outlooks for [Energy East] and its subsidiaries reflect, in part, the financial and operating challenges resulting from a surprisingly unfavorable decision NYSEG received in its general rate case decided in August 2006. … The negative outlooks also recognize that while the transaction with Iberdrola is subject to numerous state and some federal regulatory approvals, it is not uncommon for approvals of this nature to be conditioned upon additional rate concessions. …"

> We [the Staff Policy Panel] would be remiss; however, if we did not rebut certain misunderstandings contained in the Moody's report. … The adjective "harsh" used by Moody's [to refer to conditions imposed by the Commission] merely recognized the reality that rate concessions in excess of real merger savings will have a negative impact on credit quality.

Q. What is your reaction generally to these statements about ratings and credit quality?

A. In all of these statements the Staff appears to be trying to substitute its own judgment and opinion for that of the disinterested ratings agencies. What is clear to readers of those ratings agency reports of the past couple of years is that the Commission's "surprisingly unfavorable" treatment of NYSEG and RG&E has worried those agencies. The Staff Policy Panel does not acknowledge the ratings agencies' direct expression of concern about the impact of regulators' actions on the utility subsidiaries, and instead tries to turn that concern into a criticism of the potential effects of the merger.

Q. What do you see from an examination of the last two or three years of rating agency opinions about the credit ratings stemming from the treatment of the regulated utilities in New York?

A. A reading of all the recent ratings reports leads me to conclude that the ratings agencies are not so much concerned about Iberdrola's proposed acquisition of Energy East as they are about the Commission's regulation of NYSEG and RG&E.

Q. Did rating agencies downgrade Energy East and its subsidiaries upon the merger announcement?

A. No. The announcement of Iberdrola's acquisition of Energy East did not adversely affect the ratings of Energy East or its subsidiaries. Both S&P and Moody's reaffirmed their ratings of these companies:

> On June 26, 2007, Standard & Poor's Ratings Services affirmed its 'BBB+' corporate credit rating on Energy East Corp. and its affiliates on the announcement that Iberdrola S.A. will acquire the company for about $8.5 billion, including the assumption of about $4 billion of debt. The outlook remains negative.[6]

> Effective June 27, 2007, Moody's affirmed the ratings and negative outlook of EEC and its regulated utility subsidiaries […]. The ratings affirmation was in response to the announcement that Iberdrola of Spain agreed to acquire EEC[…]. The rating outlook remains negative for EEC and all of its subsidiaries.[7]

Q. How do rating agencies characterize the acquisition's effect on the credit quality of Energy East?

[6] Standard & Poors, *Research: Energy East Corp*. at 1 (Nov. 16, 2007).

[7] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

A. Moody's opinion is that Iberdrola's actions to raise funds for the acquisition have been consistent with its purpose of maintaining Energy East's credit quality unaffected:

> Although Iberdrola has announced it will acquire 100% of the outstanding equity stock of EEC and its subsidiaries for cash, Iberdrola has recently undertaken various capital raising initiatives, including issuance of common equity. Our current ratings of A3 for Iberdrola's senior unsecured debt and Prime-2 for its commercial paper take these capital raising initiatives into account. We view these initiatives to be consistent with our view that it has been Iberdrola's objective to complete the acquisition in a way that would not unduly compromise credit quality. We note that some of the required approvals in order to close the acquisition have been obtained, but others, including a key approval from the New York Public Service Commission, are still pending.[8]

Q. What do you see from an examination of recent rating agency opinions about the credit ratings stemming from the treatment of the regulated utilities in New York?

A. In view of the recent adverse decision in the NYSEG rate case, while assessing the outlook for Energy East, Moody's recognized the adverse regulatory environment as a reason to give these companies a negative outlook. The following excerpts from Moody's and S&P point out that the adverse regulatory environment recently has and will continue to have a negative impact on Energy East's ratings:

> <u>[P]otential regulatory outcomes that could hurt cash flow metrics would precipitate lower ratings</u>. Ratings stability at the current level is highly dependent on a balanced capital approach at Energy East, consistent cash flow metrics, and supportive regulatory outcomes.[9]

[8] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

[9] Standard & Poors, *Research: Energy East Corp*. at 2 (Nov. 16, 2007).

> The offsetting factors are a weaker regulatory environment for NYSEG and Energy East's consolidated financial profile that is likely to be pressured over the intermediate term. […] Energy East's financial performance is likely to deteriorate in the intermediate term due to the NYPSC's adverse rate decision. NYSEG contributed about 57% of Energy East's earnings in 2006, so the rate decrease materially affects the company's overall financial health. The authorized 9.55% ROE is considerably lower than its previously allowed 12.5% ROE and the 11% NYSEG had requested. Therefore, the $36.2 million annual reduction of delivery rates beginning in 2007 will result in weaker credit measures than expected for the rating.[10]

> The negative outlooks for EEC and its subsidiaries reflect, in part, the financial and operating challenges resulting from a surprisingly unfavorable decision NYSEG received in its general rate case decided in August 2006. The decision in this case introduced the risk that there could be residual negative financial effects on EEC's other utility subsidiaries in the event that the parent required an increase in dividends from those companies to compensate for any potential reduction in the levels previously paid by NYSEG.[11] (my emphasis)

Q. What do you conclude about the outlook on Energy East and its subsidiaries from the perspective of the rating agencies?

A. In evaluating the merger, rating agencies are not very concerned about Iberdrola intrinsically. They are more concerned about unreasonable concessions that the Commission may require to authorize the merger:

> [R]egulatory decisions in the pending acquisition by Iberdrola that do not impose harsh rate concessions could also lend stability to EEC's rating outlook.[12]

---

[10] *Id*.

[11] Moody's Investor Service, *Credit Opinion: Energy East Corp.* at 2 (Dec. 26, 2007).

[12] *Id.* at 7.

While the rating agencies mentioned that aggressive amounts of debt used in the financial strategy for the merger could play a role in downgrading Energy East, they also mentioned that this is unexpected since Iberdrola has shown a solid commitment to its plan to maintain Energy East's credit quality intact. S&P and Moody's are more concerned about the regulatory environment in the State of New York, particularly given the adverse decision in the 2006 NYSEG rate case:

> If EEC's receipt of dividends from its subsidiaries (especially NYSEG) is compromised in any material way because of less support from state regulators, or if Iberdrola ***unexpectedly*** uses aggressive amounts of debt in its acquisition financing strategy, then that could cause us to consider a downgrade of EEC's ratings. Also, if future regulatory decisions by the NYPSC are unsupportive, then the potential for a downgrade of the ratings of RG&E, EEC, and its other utility subsidiaries could increase (my emphasis).[13]

Q. Do you have some way of demonstrating further that "surprisingly unfavorable" treatment mentioned by Moody's?

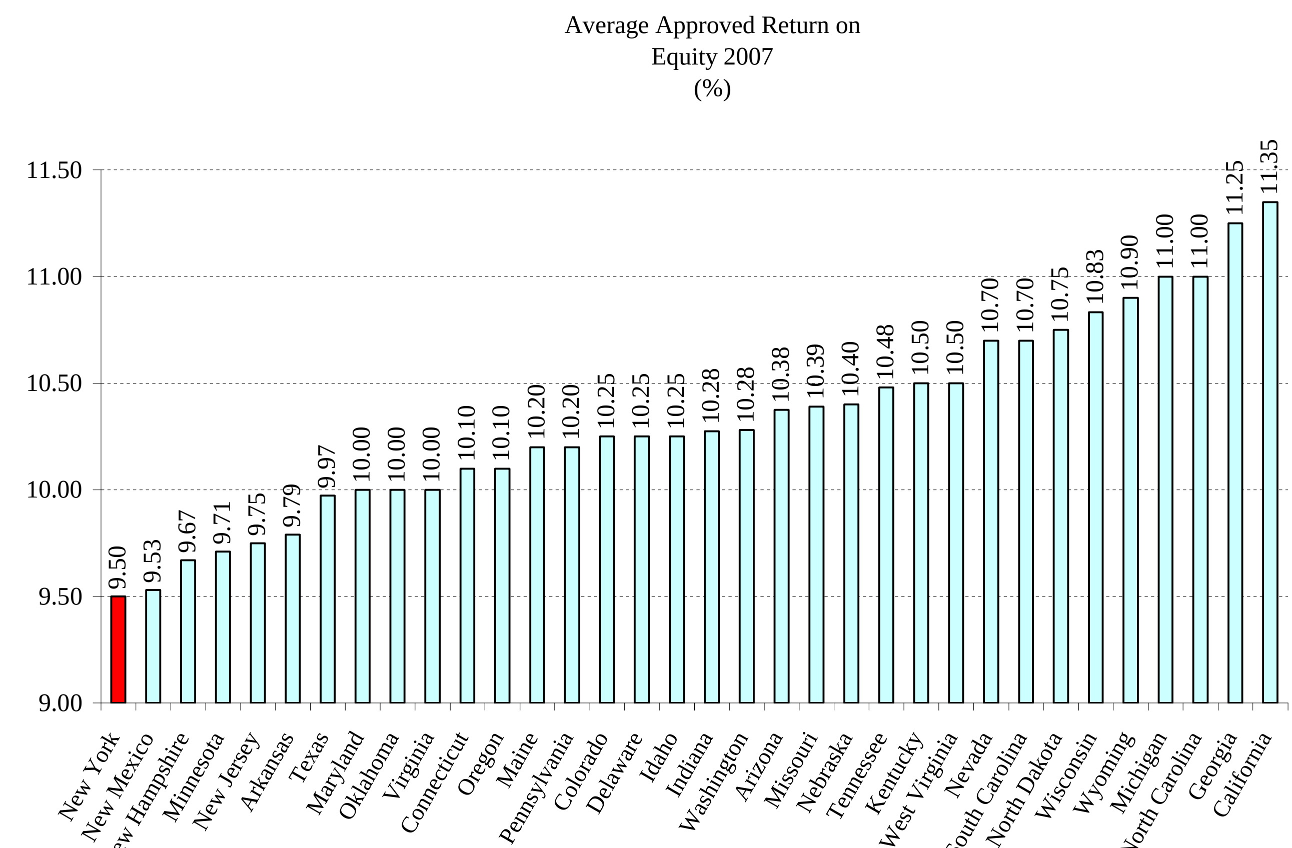
A. Yes. Figure 1, below, shows the return on equity, and overall rate of return, for every final state rate case decision in the past two years. The results at the bottom are from New York. It is obvious to the subscribers of regulatory newsletters (the source of those data) and to the credit markets generally that New York has awarded returns lower than those of any other state in the nation. Two recent decisions awarded 9.1

---

[13] Moody's Investor Service, *Credit Opinion: Energy East Corporation* at 7 (Dec. 26, 2007).

percent to both Orange and Rockland and National Fuel Gas Distribution Corporation.[14]

Figure 1



Source: Regulatory Research Associates

[14] *See* Case 06-E-1433 *Orange & Rockland Utilities Inc.* (Oct. 18, 2007); Case 07-G-0141, *National Fuel Gas Distribution Corp.* (Dec. 21, 2007).

Q. Does New York's position in this respect have an effect on ratings and the costs of borrowing for New York operating utilities?

A. I conclude that it does affect the cost of borrowing, based on my review of the ratings agency reports and in the recorded cost of borrowing for New York operating utilities. Indeed, the Staff Policy Panel shows at least part of that effect. On pages 176-78, the Staff Policy Panel states:

> On November 29th, 2007, NYSEG went to the capital markets and issued debt 225 basis points above 10-year treasures. This is significant [for in the same period] three companies deemed comparable to NYSEG by the company itself … issued debt that was on average 192 basis points above the 10-year treasury benchmark. Therefore, … [t]he debt issued by NYSEG was issued at 30 basis points above its self-described comparable peers. … This will cost ratepayers $600,000 … annually. … We believe that an imputation of 30 basis points should be made to NYSEG's rates to remove the effects of Iberdrola from the company's cost of debt.

Staff here simply <u>asserts</u> that the problem is Iberdrola, with no acknowledgment of the ratings agencies' discussion of the "surprisingly unfavorable" treatment of NYSEG at the hands of the Commission, or other factors that may have contributed to the higher pricing of the debt issued by NYSEG (an issue discussed further in Petitioners' Policy Panel testimony).

It is more likely than not, in my opinion, that the continued negative outlook for NYSEG's and RG&E's credit ratings originates in the Commission's "surprisingly unfavorable" treatment of NYSEG rather than their proposed affiliation with a better rated company. It appears that the rating agencies' concerns with respect to the merger derive not from the merger itself, but rather from the possibility that the Commission will impose unfavorable conditions as part of the merger approval process. Staff's own testimony in this proceeding further justifies the rating agencies' concerns.

Q. Does the Staff Policy Panel make other statements that seem to substitute its own opinions for those of the ratings agencies?

A. Yes. The Staff Policy Panel states, on pages 206-207:

> Because Iberdrola's credit quality is adversely affected by its increase in debt leverage and ongoing ambitious investment program, NYSEG and RG&E cannot obtain the strong A rating implied by their respective equity ratios.

There is nothing supporting Staff's opinion, and I see three problems with it. First, nothing from the rating agencies supports the charge that Iberdrola's "credit quality is adversely affected." Second, nothing from the ratings agencies makes such a tie between Iberdrola and the operating companies. Third, what rating the operating companies can attain is far more clearly tied by the ratings agencies to their treatment by the Commission in New York, which is where those operating companies' money comes from to cover their interest charges. In short, the Staff Policy Panel's assertion that Iberdrola is the cause of the operating companies' failure to achieve a strong "A" rating is without foundation and has nothing to do with the ratings agencies.

Q. What do you conclude about the Staff Policy Panel's statements regarding credit ratings and credit quality?

A. The Staff Policy Panel statements do not properly reflect the views of the rating agencies as stated in those agencies' reports. The principal message from the ratings agencies for NYSEG and RG&E is that the Commission has been, and is, unduly harsh in its treatment of operating utilities in the state. Evidence from allowed returns backs this up—New York is at the very bottom of U.S. state regulators in the returns it allows in regulated rates.

Based on my analysis of the credit reports and recent actions taken in the NYSEG rate case, I cannot agree with the Staff Policy Panel's discussion of the source or fair consequences of the operating companies' credit ratings. It remains the case that Iberdrola has better credit rating from the ratings agencies' perspective, than the Energy East's utility operating companies in New York. I do not see the credit risk issue with respect to this proposed transaction that Staff purports to exist.

IV. Vague Statements on "Risk"

Q. Please describe the purpose of this section of your testimony.

A. In a number of places in its testimony, the Staff Policy Panel warns how "risky" this merger will be for ratepayers. I have already dealt with those issues of risk for ratepayers that Staff alleges accompany Iberdrola's booked Goodwill from this transaction. In this section, I deal with other unfocussed and unsupported allegations of risk coming from the Staff Policy Panel.

Q. Please proceed.

A. The Staff Policy Panel catalogs a number of what it calls the “risks” of this transaction.

On pages 26-27, the Staff Policy Panel makes a preliminary statement about risk that epitomizes much of its subsequent use of the term:

> A significant risk to customers is how remote the corporate parent will be from the operating utilities and the language, foreign currency, and accounting differences between the parent company and its utility subsidiaries. … Another substantial risk is posed by the multitude and scope of the unregulated businesses in which Iberdrola is engaged and the complexity of its capital structure.

Q. Are these risks for ratepayers?

A. To the extent that the term “risk” applies to the possibility that customers will be overcharged (with respect to the legitimate cost of service) or will be underserved (with respect to standards for safe, adequate and reliable service), the answer is no. Staff says nothing about how the “risk” issues it discusses relate to ratepayers in any particular way. Just as in my discussion of the Goodwill issue, there is nothing about this transaction that prevents the Commission, or the Staff, from regulating NYSEG and RG&E as it has always done. Whether the ultimate parent’s headquarters is in New Gloucester, Maine, or in Spain does not constitute a material risk given the traditional care and methods that state regulatory agencies apply in regulating utility operating companies.

Q. Does the Staff Policy Panel make any other broad statements about risk?

A. Yes. On page 32, the Staff Policy Panel states:

> The transaction provides no benefits to the customers of NYSEG and RG&E, while saddling the customers with the enormous financial risks we described above.

On page 100-101, the Staff Policy Panel states:

> Besides the obvious financial and business risks that we address elsewhere, there are potential risks associated with this transaction because the combination of companies will greatly expand the size, scope, and geographic reach of the ultimate parent and affiliates of NYSEG and RG&E.

Staff has identified neither a rational basis for the "enormous financial risk" it asserts will be imposed on customers of NYSEG and RG&E as a result of this proposed merger, nor any source of additional business risk for NYSEG and RG&E. Iberdrola has a better credit rating than the operating companies and nothing on the horizon seems to point to that changing. Whatever financial risk is faced by NYSEG, RG&E and their respective customers is tied to the regulated capital structures of NYSEG and RG&E—the customer rates based on these capital structures is where the money to cover interest and principal payments will come from. The parent does not affect financial risk, as such; the regulated capital structure does. If there is no particular change in the capital structure accompanying this transaction, there will be no accompanying change in financial risk. Staff's use of the phrase "enormous financial risks" is misplaced and has nothing to do with this transaction in a practical sense.

Regarding business risk, Staff is also misusing the term. The business risk for investors in regulated enterprises stems from what the capital in question *does* and how it is regulated, not who *owns it*. Electric and gas utilities, as local public service monopolies, have always faced some degree of business risk—although those risks are largely ameliorated by the operation of cost-of-service regulation. One element of business risk not so ameliorated is *regulatory risk*. That risk, which is the risk that the process of regulation under the control of a regulatory commission will prevent a utility from recouping its legitimate costs, is necessarily a part of all regulated enterprises.

There is nothing inherent in the transaction that will serve to raise business risks for NYSEG and RG&E. The service territory, the weather, the national economy affecting customer purchases, etc., will all remain the same. The owner of the equity will change, but the source of equity is not a component of business risk. The regulatory risk will also remain the same.

In short, there is nothing to support Staff's charge of "obvious business risks" associated with this transaction, as that term is used and understood in the financial literature. There are no particular changes in business risk for NYSEG and RG&E associated with this transaction.

Q. Are there any other instances where the Staff Policy Panel engages in what you consider the misuse of the term "risk" as it applies rates or ratepayers?

A. Yes, there are many. But a good proportion of those have to do with the "risk" that something bad can happen to ratepayers because of the new corporate affiliations of Iberdrola versus Energy East. It is that issue that I turn to next.

V. Transparency and Affiliate Issues

Q. Please describe the purpose of this section of your testimony.

A. The Staff Policy Panel states that it is unable to understand the detailed internal workings of Iberdrola or its many affiliates, many of which are unregulated. Staff implies that Iberdrola's larger and assuredly more complicated corporate structure will create difficulties for Staff and also creates "risks" that ratepayers will subsidize Iberdrola's unregulated affiliates. Having presented this supposed problem, Staff states that the way to combat such potential affiliate abuse is to engage in a detailed operational accounting of Iberdrola—that is, to regulate Iberdrola's books to prevent New York ratepayers from cross-subsidizing unregulated Iberdrola operations. They claim that their difficulties in "regulating Iberdrola" as I would put it, are a reason to recommend the rejection of the merger.

None of this supposed problem asserted by the Staff—in essence, Staff's inability to regulate Iberdrola's own books as opposed to NYSEG's or RG&E's—is a genuine regulatory concern from the perspective of New York ratepayers. The defense against illicit utility transactions lies with the careful attention to the operating companies' books and records—not on the parent's. Proper separation of the operating subsidiaries' books, proper codes of conduct regarding the relationship between the parent and subsidiaries and, especially, the examination of affiliate interest transactions are the time-tested ways to deal with affiliate issues in regulation in the United States. There is nothing about the Iberdrola transaction that changes this.

Q. How does the Staff Policy Panel raise the issue?

A. Staff notes its concerns with the size and asserted complexity of Iberdrola many times in its testimony. I give only a few examples here.

On page 27, the Staff Policy Panel makes a statement about the supposedly new incentives to loot the utilities, so to speak, that the transaction would create:

> Another substantial risk is posed by the multitude and scope of the unregulated businesses in which Iberdrola is engaged and the complexity of its capital structure. The multitude of its unregulated operations <u>creates incentives</u> to misallocate costs and the complexity of its corporate structure would make it difficult to follow audit trails for its complex transactions (my emphasis).

The phrase "<u>creates incentives</u> to misallocate costs" is a Staff theme that I've already commented upon above in the section on Goodwill. The incentive of utility owners to profit by charging monopoly prices for the least commitment of capital has been around for more than a century. Nothing about the proposed transaction changes these incentives and nothing about Iberdrola diminishes the Commission's power to prevent owners of utility monopolies from acting successfully on these longstanding incentives.

On pages 49-50, the Staff Policy Panel states that it needs to look to the parent for the information it needs effectively to regulate the operating subsidiaries in New York:

> Operational detail [at the Iberdrola parent level] is very useful as a screen to help detect potential cross-subsidization of non-regulated entities by regulated utilities. This detail could be used to detect unusual patterns or results concerning a competitive operation's expenses. If unusual results or patterns are detected, it may signal potential cross-subsidization of competitive businesses by regulated businesses.

What the Staff Policy Panel is saying here is that they want to compare the operational detail of Iberdrola's various regulated and unregulated businesses to try to detect cross subsidies.

I cannot emphasize strongly enough how misguided it is to think that dissecting the "operational details" of Iberdrola's various businesses will lead to detecting cross subsidies between those businesses and its New York utilities. It is the ***affiliate transaction*** between operating utility and its affiliates that is the proper subject of careful scrutiny, not the parent's "operational details".[15] Indeed, this Commission's own recognition of this principle appears evident in the approval of another foreign holding company transaction in New York (as I discuss further in Section VIII), the

[15] In section VIII, I refer specifically to the testimony of Isaac C. Hunt Jr. before Congress in 2002 where he recommended the repeal of the Public Utility Holding Company Act of 1935. Mr. Hunt's testimony before Congress quite appropriately focuses on affiliate transactions, and not the operating details of the parent.

takeover of United Water Resources by the French company, Suez Lyonnaise des Eaux.[16]

In any event, how Iberdrola decides to devote resources, or allocate costs, profits, tax deductions, etc., to its various subsidiaries is not the point. The point for the Commission (as for any U.S. regulatory commission) is to prevent the business at the parent level from raising the legitimate cost of service for the regulated operating companies. Commissions have long dealt with such issues and have practical and realistic ways to do so. For example, inputs that come from markets (electricity and gas, capital, service trucks, etc.) reflect arms-length, competitive prices. For management or central office activities of holding companies (which are not terribly large in the greater picture), there are longstanding allocation formulae to reasonably, transparently and fairly perform the allocations. For any particular inputs that are purchased from affiliates, Staff and others can readily refer to market transactions to assess the adequacy of cost. My point is that these issues are nothing new, and that nothing about Iberdrola stepping in as the upstream owner of Energy East changes the way in which this Commission will continue to work to protect ratepayers. One doesn’t protect ratepayers by becoming deeply involved in the parent’s operations—one protects ratepayers by standing at the barrier between the parent and the regulated

[16] Case 99-W-1542, *United Water Resources Inc.*, *Order Approving Stock Acquisition* at 8 (July 27, 2000) (noting that United Water would “remain a fully regulated commodity and service provider, subject to our jurisdiction—and under local management, according to the proponents’ representations—in case there emerges some reason for concern about the company's ability or willingness to maintain safe and adequate service and conduct its affiliate transactions on an arms’ length basis.”).

operating subsidiaries (as always) to make sure that money does not cross that barrier—either way—without justification.

I note, however, that the Rebuttal Testimony of the Joint Petitioners' Policy Panel provides a detailed description of Iberdrola's affirmative commitments to ensure that there are no concerns related to transactions between NYSEG and RG&E and Iberdrola's unregulated affiliates, or a lack of access to books and records of Iberdrola or any Iberdrola affiliates that are related to NYSEG or RG&E.

Q. Does the Staff Policy Panel have anything else to say about the nature of Iberdrola's upstream transactions being a risk to ratepayers?

A. The Staff Policy Panel brings up the subject many other times. For example, on pages 107-8, it states:

> The utilities reports will concern transactions recorded by the utilities. These reports will not provide any information or details on the activities of the service or holding companies or the other business interests of Iberdrola. Without full knowledge of all of these entities, we cannot reliably confirm that the costs of the utilities are fairly stated.

"Full knowledge" of the Iberdrola entities is not a prerequisite for the Commission to have, as it has now, all of the tools at its disposal to protect the electric and gas ratepayers in New York from cross-subsidizing either ratepayers elsewhere or Iberdrola's unregulated operations.

The question of potential cross-subsidies between ratepayers of different utilities is raised by the Staff Policy Panel on page 221, where it states:

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

> Currently, the Energy East companies are located in the northeast United States and are primarily engaged in regulated utility distribution business. … <u>Cost shifting between these regulated businesses and service companies</u> generally should not result in any long-term advantage to Energy East as cost increases to one regulated business will result in cost reductions in another regulated business (my emphasis).

Staff seems to be saying that any internal subsidy from one operating company within Energy East to any other is less of a problem because Energy East is "primarily engaged" in utility distribution. This makes no sense at all. NYSEG ratepayers will be justifiably aggrieved if they thought that they were paying for RG&E's services. And the Commission in New York would be very upset if they thought that New York utilities were paying for services at Central Maine Power or vice versa (and the Maine Public Utilities Commission would be just as upset).

The idea, implied by the Staff Policy Panel, that there is less to worry about if costs shift around Energy East's various operating companies (to be sure, not all of which are regulated) does not accurately characterize how regulatory commissions in any state deal with multi-state holding companies. I do not know of any federal or state regulatory commission that has been relaxed about the nature of holding company operations just because they are "primarily" engaged in the same line of business. And if they were relaxed, they would not be doing their job of protecting the interests of those operating companies' ratepayers based on those companies' own legitimate costs.

Q. What do you conclude regarding the Staff Policy Panel's discussion of the affiliate issues regarding this transaction?

A. As with its discussion of Goodwill, the Staff Policy Panel fails to recognize the traditional types of safeguards that regulatory commissions in the U.S. use to protect the rights of ratepayers from marauding at the holding company level. It is clear that Iberdrola is a large and sophisticated international company engaged primarily in energy utility operations. It is not acquiring Energy East to diversify into a business about which it is unfamiliar.

That being said, there is nothing particularly unusual about this transaction from the perspective of how U.S. regulatory commissions will deal with the rates and service obligations of the various operating companies in their jurisdictions. Iberdrola is larger and more distant, geographically and linguistically, than such commissions are used to. But those things are not material in terms of the tools and methods that regulators have to police affiliate transactions and regulate the rates or service obligations of their local utilities. There are no new incentives that come into play in this transaction.

These are electric and gas distributors, after all. The regulation of these utility enterprises simply does not require that state regulators know everything that the parent company does and where. The Staff Policy Panel's complaints about the complexity and Spain-based nature of Iberdrola seems to me nothing more than a straw man, so to speak—to knock down by saying that the impossibility of regulating Iberdrola's internal operations leaves no choice but to object to the transaction.

VI. Upstream Tax and Other Benefits for Iberdrola

Q. Please describe the purpose of this section of your testimony.

A. The Staff Policy Panel devotes a substantial portion of its testimony to describing, valuing, and trying to appropriate for New York ratepayers the supposed benefits that this transaction will have for Iberdrola and its own shareholders. In this section of my testimony, I will describe how Staff's arguments are speculative and fall outside the scope of what the Commission must evaluate in its duty to protect the interests of New York ratepayers.

Q. Please proceed.

A. The Staff Policy Panel in its testimony shifts the spotlight from "synergies" that can lower rates to the consumers of the operating companies to "synergies" that can somehow work to benefit the shareholders of Iberdrola. On pages 78-79, 82-84, the Staff Policy Panel states:

> Q. What non-traditional synergistic tax benefits have you identified?
>
> A. Staff has obtained information indicating that Iberdrola will reap very significant tax benefits as a result of this M&A transaction. These tax benefits come in the form of United States Production Tax Credits (PTC) and Spanish tax credits. …
>
> PTCs are tax credits against U.S. federal income taxes. PTCs are not refundable, so their use is dependent on earning a level of U.S. income tax liability equal to or greater than the value of the credits. …
>
> If Iberdrola constructs all of the planned generation for 2007-2008 … and assuming such generation is eligible for PTCs, it could generate up to $150 million in PTCs per year by 2008. …

> While we concede some of the above analysis is based on assumptions, more certain information is not available because Iberdrola's (sic) has declined the opportunity to provide better information. … Staff [thus] found that there are hundreds of millions of dollars of benefits related to the merger that are tangible and significant, but that are not presented as customer benefits.

Q. How do you respond to Staff's claim that PTCs are an unidentified tangible benefit to customers?

A. Staff's claim is wrong in both critical respects—PTCs are not a source of benefit to ratepayers, nor are Staff's calculations "tangible." These PTCs have nothing to do with NYSEG's or RG&E's customers and the assumed value to Iberdrola's shareholders that Staff has placed on them as a result of this transaction is completely speculative.

Q. Please explain.

A. PTCs may be real enough for some of those who generate electricity from renewable resources. But such power production facilities that are owned by Iberdrola's affiliates sell into a competitive wholesale power market—they are not traditionally regulated facilities, as such. Whether and what "benefits" these unregulated facilities can provide to Iberdrola as their owner, is not as a threshold matter an issue pertaining to the customers of NYSEG and RG&E.

Furthermore, the extent to which Iberdrola can use such tax credits has nothing to do with Energy East. If Iberdrola needs tax liabilities to enjoy the credits, it has any number of ways of obtaining them (either through the purchase of tax paying entities or through some other method of assuming U.S. income tax liabilities). The Joint Petitioners' Policy Panel explains further why from a practical perspective there are no PTC-related "benefits" associated with this transaction.

It is important to remember the role of income taxes for NYSEG and RG&E—whether they are independent operating utilities or parts of any sort of larger holding company. The rates that the Commission approves contain a fair rate of return for those who devote their equity capital to the service of the public. This is simply a part of the *regulatory compact* that drives all investor-owned utility regulation in the U.S. Because the return for equity holders constitutes owners' income, it creates a federal income tax liability. Every regulator of every investor-owned utility in the U.S. thus grosses up the permissible revenue to include those federal income taxes into customer rates. It is precisely because of this that investor-owned public utilities are such reliable sources of federal income tax revenues—the taxes are there because the regulators set the income levels that generate the federal income tax proceeds. None of this is left to the market in the way that taxes are paid (or not) by unregulated corporations if they record profits (or don't).

The Staff Policy Panel, in its discussion of PTCs, confuses the question of federal income taxes owed by regulated operating utilities and those owed by unregulated affiliate corporations. None of what goes on at the level of the owners of the equity is relevant from the perspective of what customers pay for the capital that is devoted to serve them—as a matter of fact. That is not the way utility rates are set in this country, and for good reason. If regulators tried to appropriate the upstream tax benefits of utility owners, then it would have to try to regulate what kind of shareholders were capable of owning utility equity—and that is not the business of U.S. regulators. Anyone can own shares in utility common stock. While it is true that regulators have long been concerned with whether utility stock is held by individual investors or a holding company (as I describe in Section VIII, below), taxes at the holding company level have not been the issue of concern.

Q. What do you conclude about this tax issue related to PTCs?

A. In its discussion of PTCs, Staff appears to want to appropriate the tax credits of Iberdrola and its affiliates in order to lower the cost of service for ratepayers. This, however, is inconsistent with the way operating utilities are regulated in the U.S. Whether there is a holding company or not, the operating companies pay federal income taxes on the income that represents the payment to owners for the use of their capital to serve the public.

Staff seems to want to cloud the issue of whether this is a synergistic merger or not. By raising the issue of PTCs under the heading on page 78 of “Other Synergistic Benefits Exist,” the Staff Policy Panel has confused whose synergies we are talking about. By shifting the focus from “regulated operating synergies” to “parent tax benefits,” the Staff Policy Panel has shifted its spotlight to something that has nothing to do with regulated rates for NYSEG and RG&E.

VII. Improper Capital Structure and Cost of Capital Calculations

A. Please describe the purpose of this section of your testimony.

Q. The Staff Policy Panel engages in two sorts of capital structure and cost of capital calculations in its testimony. The first pertains to what I call a "re-engineering" of hypothetical regulated capital structures for NYSEG and RG&E under Iberdrola ownership. The second has to do with what looks like *pro forma* cost of capital for the post-transaction regulated operations at NYSEG and RG&E. This section of my testimony serves to show that both sets of calculations are improper. The first is improper because Iberdrola's consolidated capital structure reflects a firm that heretofore has had nothing to do with regulated U.S. utilities. The second is improper because this is not a rate case, which I believe is inappropriate for this merger transaction proceeding.

Q. Please explain.

A. The first issue deals with the Staff Policy Panel's hypothetical calculations pertaining to a post-Iberdrola transaction capital structure for the regulated operations of NYSEG and RG&E. In its testimony on pages 194-205 (headed: "Inadequacy of Pro Forma Capital Structure for NYSEG and RG&E"), the Staff Policy Panel comes to the conclusion that the post merger capital structure is untenable for the regulated operations of NYSEG and RG&E. The Staff Policy Panel states on page 205:

> Simply put, the pro forma consolidated capital structure of Iberdrola is too leveraged given the business profiles of its operations. The burden of supporting this aggressive capital structure would fall squarely onto the shoulders of the ratepayers of NYSEG, RG&E and the rest of the Energy East utilities. It is one of the many reasons why the Commission should reject this transaction.

Q. Do you see a problem with Staff's assertions?

A. Yes, there is a threshold problem that renders all of the Staff Policy Panel's calculations inappropriate and irrelevant. Under the pretense of using a "consolidated" capital structure as if it were <u>required</u> to do so, Staff has taken Iberdrola and backed into a regulated capital structure for NYSEG and RG&E using a number of completely subjective and unsupportable adjustments (e.g., removing Goodwill from the capital structure and removing $10 billion from Iberdrola's consolidated equity and $3.3 billion from its consolidated long-term debt—see page 203). The problem is that starting any regulated capital structure calculation for NYSEG and RG&E by working backward from an adjusted capital structure for Iberdrola is nonsensical, even if the calculations were not already completely subjective on the Staff Policy Panel's part.

Q. Doesn't the Staff Policy Panel say that it is customary policy for the Commission to use a consolidated capital structure?

A. Yes, but even if the Commission in New York has used such an approach on occasion, particularly when a regulated parent like National Fuel Gas Company, for example, that raises debt for its various regulated subsidiaries, it does not appear to be required in this case and most certainly is not advisable.

Q. Please explain why this policy is not inconsistent with Commission precedent.

A. The Staff Policy Panel makes this point on pages 194-195 when it cites the National Fuel Gas Distribution Corporation case:

> The Commission declared in Case 28947, Opinion No. 85-15 (issued September 26, 1985), p. 47, "When the utility itself is a subsidiary, as is National Gas Distribution Corporation, it is proper, at least in the first instance, to assume that the parent corporation's cost of capital is also the subsidiary's because it is the parent that raises capital."

When the Commission rules in Case 28947, National Fuel Gas was a holding company subject to broad regulation by the SEC under the PUHCA, because it owned regulated gas distribution operations in Ohio, Pennsylvania and New York as well as supply and transport operations subject to FERC regulation.[17] The holding company raised the long-term debt for all of the state-regulated gas distribution utility operations and federally-regulated gas supply and pipeline transport businesses. In that case, the broader company was almost totally a regulated entity (either at the FERC or in the three states), and the use of a consolidated capital structure has some appeal because of the lack of alternatives.

---

[17] *See Moody's Public Utility Manual*, Vol. II at 2873 (1983).

Here, however, NYSEG and RG&E will continue to raise their own debt capital, as always.[18] For that reason, and because they will remain independently regulated operating companies in New York (unlike in the National Fuel Gas case in both respects), it would appear neither necessary nor practical to look to the parent for information on a regulated capital structure, There is an ample number of independent operating utilities regulated by the commissions in the various states to judge the reasonableness of NYSEG's and RG&E's ratemaking capital structure without looking to the parent, with its various mix of businesses.

Q. Besides the question of the starting point—that is, Iberdrola's capital structure—are there any other problems with the Staff Policy Panel's calculations in that section of its testimony.

A. Yes. The Staff Policy Panel's calculations are subjective and reflect unsupported assumptions, which are to be expected when trying to arrive at a reasonable regulated capital structure for NYSEG and RG&E from the starting point of Iberdrola—which is to say, there is no objective or accepted roadmap for such calculations as the Staff Policy Panel attempts. For example, on page 199, Staff backs out $55.4 billion from Iberdrola's capital structure at a 50/50 capital structure ratio based on S&P U.S.

[18] Iberdrola, in the testimony of the Joint Petitioners' Policy Panel, has stated that Iberdrola shall not borrow from money pools in which NYSEG and RG&E are participants and that NYSEG and RG&E will not loan funds to Iberdrola or any unregulated affiliate, either through a money pool or otherwise, unless otherwise authorized by the Commission. In any event, the Commission retains effective control on where and in what markets these operating companies obtain their debt capital.

ratings criteria. Iberdrola is not a U.S. utility, so there is no logic in such a calculation.

On pages 202-4, the Staff Policy Panel further backs out Goodwill at a 75/25 equity/debt ratio with the only justification that it is "conservative." Again, there is no foundation for Staff's calculations, other than Staff's own assumptions.[19] The Staff Policy Panel reports the result of these two calculations, driven by Staff's own assumptions, as follows:

> The ratemaking capital structure after these two adjustments produces an untenable capital structure (it implies a negative equity ratio). These two adjustments show that, after the merger, Iberdrola's pro forma capitalization would be over-leveraged. There is not enough equity to adequately support an A3 rating for Iberdrola's current operating assets, its Goodwill and the operating assets of Energy East. … Simply put, the ratemaking capital structure for NYSEG and RG&E that would be developed through subsidiary adjustments to Iberdrola's capital structure is unacceptable. … The subsidiary adjustments expose the depth and breadth of the risks attending Iberdrola's overall capitalization.

Staff, however, simply made the two "adjustments" without any objective or accepted basis for doing so, and they therefore do not prove anything with regard to capital structure. Moreover, they have nothing to do with the credit ratings (like the A3 rating cited by Staff) issued by independent ratings agencies, which as Mr. Fetter discusses, have done a forward-looking analysis of Iberdrola, including the proposed transaction, and affirmed a "stable" outlook for Iberdrola.

---

[19] This is confirmed in Staff's response to IBER / EE IR No. DPS 84, attached hereto as Exhibit ___ (JDM-2).

Reverse engineering a regulated capital structure for NYSEG and RG&E, by starting with Iberdrola's consolidated capital structure, makes no sense. The National Fuel Gas case that the Staff Policy Panel cites argues against such a practice, precisely because its status in 1985 is totally different than that facing NYSEG and RG&E as a result of the merger. I cannot believe that the Commission would engage in such a string of subjective and unsupported assumptions as the Staff Policy Panel has suggested here to set regulated capital structures for the utilities in its jurisdiction. Even if this were a rate case in which the capital structures of NYSEG and RG&E were at issue—which it is not and should not be—there are other more reliable and objective methods for setting regulated capital structures. First among these more reliable methods is to use a proxy group of independent operating gas and electric utilities that are in the same business and subject to the same types of business risk, and hence ability to reasonably leverage their capital structures, as NYSEG and RG&E.

Q. Does the Staff Policy Panel use a set of proxy companies in its ROE calculations?

A. I believe it does. But while Staff does appear to reference a proxy group in support of what I conclude is a very low proposed ROE (particularly by the standards of other commissions as Figure 1 shows) what I'm speaking of here is another point. My point is that there is no basis in this proceeding for proposing a consolidated capital structure, nor any basis for making artificial adjustments to the capital structure, for the purpose of attempting to extract concessions associated with merger approval.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Q. What about the Staff Policy Panel's imputation of a cost of equity for these regulated operations going forward?

A. The Staff Policy Panel states on p. 267 that "the appropriate return on equity for NYSEG and RG&E given its risk factors is 9.0%."

Q. Do you think this is reasonable?

A. No. A glance back at Figure 1 will show that it is not reasonable—far below the range of returns granted in other jurisdictions.

There is no question that if the cost of equity were to be fully litigated (which, as I have discussed, would be inappropriate in this proceeding), evidence would be brought to bear to show that the Staff Policy Panel's 9.0 percent recommended return on equity is unreasonably low.

VIII. Basic Statutory Issues Regarding Utility Regulation and Holding Companies

Q. Please describe the purpose of this section of your testimony.

A. In this section I provide the background for my statement that the Staff Policy Panel has ignored two critical points: (1) that the Commission loses none of its broad power effectively to regulate the rates and services of NYSEG and RG&E, whoever the holding company is (indeed, Iberdrola is making transparency/reporting commitments in this case, and such similar commitments fully addressed concerns raised about these issues in Maine); and (2) the view of holding companies in the U.S. has changed in the past 70 years, led by Congress, the FERC and the SEC. Holding companies are no longer the troublesome sources of vague risks for ratepayers that they were before the modern era of utility regulation—as suggested in the Staff Policy Panel's negative comments regarding Iberdrola's purported incentives.

Q. You have stated that the Commission has all the tools it needs to effectively regulate holding companies. Has this always been the case in New York?

A. No. Early efforts at public utility regulation in New York, unlike today, were ill-equipped to deal with the regulation of holding companies. The States of New York and Wisconsin were the pioneers in creating regulatory agencies that dealt with the deficiency.[20] The Staff Policy Panel takes such a number of shots at the presumed problems of regulating a subsidiary of Iberdrola. Accordingly, I describe briefly below how New York's regulation developed and why, in conjunction with actions taken later by Congress, the Commission is already well suited to deal with and Iberdrola subsidiary.

Q. Please proceed.

A. A fundamental turning point in state utility regulation came in 1905, when Charles Evans Hughes (future Governor of New York and Chief Justice of the U.S. Supreme Court) was chosen to lead a public inquiry into the gas industry in New York State. At issue was the capital stock of the gas trust which, through a series of mergers, had

[20] *See* Phillips, *The Regulation of Public Utilities, Theory and Practice* Phillips 132-33.

inflated its valuation to several multiples of the original cost.[21] Hughes was able to expose this merger-induced overvaluation and draft new laws creating a new Commission of Gas and Electricity to regulate rates.[22] Hughes' report concluded:

> The gross abuse of legal privilege in overcapitalization and in the manipulation of securities … shows clearly that … for the protection of the public there should be created a commission with inquisitorial authority, competent to make summary investigations of complaints, to supervise issues of securities and investment in the stocks or bonds of other companies, to regulate rates and to secure adequate inspection, or otherwise to enforce the provisions of the law.[23]

Hughes' efforts led to the establishment of strong commissions with power to set "fair and reasonable" rates and that were expected to utilize "special knowledge, flexibility, disinterestedness, and sound judgment in applying broad legislative principles that are essential to the protection of the community, and of expanding enterprise."[24]

Q. Did utility holding companies come under the scrutiny of Congress later on?

A. Yes. In the late 1920s, the Federal Trade Commission (FTC) conducted an investigation of public utility holding companies and published a huge report (96 volumes) showing the considerable dominance of vertically-integrated holding

---

[21] *Id.* at 136.

[22] 1905 Laws of New York, Chapter 737.

[23] M.J. Pusey, *Charles Evans Hughes*, Columbia University Press at 205 (1951) (referencing C.E. Hughes (1905).

[24] Pusey at 202.

companies and their effectiveness at evading state regulation.[25] Congress in response passed the Public Utility Holding Company Act (PUHCA) of 1935. PUHCA gave the Securities and Exchange Commission (SEC) jurisdiction over public utility securities. As part of its new jurisdiction, the SEC was given the power to simplify the holding company structures of gas and electric utilities.

The SEC, under the "death sentence clause" that gave it authority to break up the holding companies, was largely successful and the Supreme Court upheld its constitutionality in several cases.[26] By 1950, utility reorganizations were virtually complete, and the regulation of holding companies was passed to the SEC.[27]

Q. What has happened in utility holding company regulation since PUHCA?

A. During the energy market reforms of the 1980s, efforts to repeal PUHCA began in earnest, supported by the SEC. The emerging importance of qualifying facilities (QFs) and independent power producers (IPPs) in the wake of the Public Utility Regulatory Policies Act of 1978 (PURPA) generated strong calls for the repeal of PUHCA to allow utilities to participate in this type of generation.

---

[25] Final Report of the Federal Trade Commission to the Senate of the U.S. pursuant to S. Res. 83, 70th Cong., 1 Sess. at 615 (1935).

[26] Charles Evans Hughes, the force behind New York's original 1907 statute, was Chief Justice of the Supreme Court during the period of most intense challenges to the constitutionality of PUHCA, and wrote several of the majority opinions upholding the statute. *See, e.g.*, ***Elec. Bond and Share Co. v. SEC***, 303 U.S. 419 (1938).

[27] Energy Information Administration (EIA), "Public Utility Holding Company Act of 1935: 1935-1992" at 12 (1993).

The Energy Policy Act of 1992 (EPAct 1992) included significant reforms to PUHCA—but did not repeal it. PUHCA became an issue again in 2002, when a D.C. Circuit Appeals Court decision prompted the SEC to reexamine its approval a merger of American Electric Power (AEP) and Central and South West Power (CSW). In the decision, Judge Tatel said that PUHCA may be "outdated in light of recent technological advances. In view of the statute's plain language, however, only Congress can make that decision."[28]

The SEC did reexamine its role in overseeing utility holding companies. One of its Commissioners, Isaac C. Hunt, Jr., testified before Congress in 2002 specifically to recommend that PUHCA be repealed and that the SEC end its holding company oversight role. Specifically with respect to affiliate transactions and the possibility for cross-subsidization, Mr. Hunt testified:

> As we have testified in the past … we continue to believe that, in order to provide needed protection to utility consumers, the FERC and state regulators should be given additional authority to monitor, police, and regulate affiliate transactions.[29]

His emphasis on *affiliate transactions* is notable, for it stands in sharp contrast to the Staff Policy Panel's preoccupation with the internal workings of Iberdrola. Chairman Hunt also discussed how the repeal of PUHCA would eliminate barriers in the flow of capital to the utility industry:

---

[28] *Nat'l Rural Elec. Coop. v. SEC*, 276 F.3d 609, 618 (D.C. Cir. 2002).

[29] *The Effect of the Bankruptcy of Enron on the Functioning of Energy Markets: Hearing Before the Subcomm. on Energy and Air Quality of the H. Comm. on Energy and Commerce*, 107th Cong. 52 (2002) (statement of Isaac C. Hunt, Jr., Comm'r, U.S. Securities and Exchange Commission).

> …repeal of [PUHCA] would eliminate regulatory restrictions that prohibit utility holding companies from owning utilities in different parts of the country and that prevent nonutility businesses from acquiring regulated utilities. In particular, repeal of the restrictions on geographic scope and other businesses would remove the impediments created by [PUHCA] to capital flowing into the industry form sources outside the existing utility industry.[30]

It is evident from this testimony that the historical problems in parent company ownership of utilities had long ceased to trouble the SEC—as long as regulators continued to have the ability effectively to monitor affiliate relationships. Congress apparently agreed in 2005, when it repealed PUHCA in conjunction with enactment of the Energy Policy Act of 2005 (EPAct 2005) and replaced it with the more limited Public Utility Holding Company Act of 2005 ("PUHCA 2005").

Q. Did the FERC, for its part, have any supportive words to say about the repeal of PUHCA?

A. Yes. FERC Chairman Pat Wood III said the following in 2003 in his testimony before Congress concerning PUHCA:

> PUHCA was enacted primarily to undo harms caused by certain holding company structures that no longer exist. In the almost 70 years since PUHCA was enacted, utility regulation has increased substantially under the Federal Power Act (including oversight of corporate restructurings such as electric utility mergers), federal securities laws and state laws, all of which ensure that customers are fully protected.[31]

Commissioner Brownell agreed, saying:

---

[30] *Id.* at 55.

[31] *Electricity Proposals and Electric Transmission and Reliability Enhancement Act of 2003: Hearing on S. 475 Before the S. Comm. on Energy and Natural Resources*, 108th Cong. 130 (2003) (statement of Pat Wood III, Chairman, Federal Energy Regulatory Commission).

> I support the repeal of PUHCA. PUHCA was necessary to address abuses that existed a half-century ago. However, that statute has not only outlived its usefulness, it is actually thwarting needed development of our electricity resources by subjecting registered utility holding companies to heavy-handed regulation of ordinary business activities and to outdated requirements that they operate "integrated" and contiguous systems… The FERC is aware of the concerns of the cooperatives and of the problems with market power in general, and we are engaged in an overhaul of our efforts at market monitoring and market power protection.[32]

I conclude that it is reasonable to say that both the SEC and the FERC understand and rely on the fact that the broad substance of the "regulatory compact" in the U.S. provides for the protection of ratepayers, holding companies notwithstanding. Both of these agencies appear to realize that opinions on the treatment of holding companies have evolved since the 1930s. The source of the fears that originally caused Congress to cause holding companies to be dissolved, as FERC Chairman Wood stated, "no longer exist."

Q. Are we to take from this that holding companies are no longer a concern?

A. No, and indeed PUHCA 2005 provides for certain reasonable oversight relating to the books and accounts of holding company systems. What we should take from this is that while holding companies may remain a concern, the powers of regulatory commissions in the U.S. since the 1930s are sufficiently advanced to deal with the affiliate and securities issues that holding companies pose. A great deal of the modern architecture of utility ratemaking and constitutionality occurred in the later

[32] *Comprehensive National Energy Policy: Hearings Before the Subcomm. On Energy and Air Quality of the H. Comm. On Energy and Commerce*, 108th Cong. 60 (2003) (statement of Nora Mead Brownell, Comm'r, Federal Energy Regulatory Commission).

1930s and 1940s. With those regulatory advancements, and the recent liberalization of upstream energy markets (in power and natural gas), Congress, in my opinion, saw that the 1935 PUHCA law was no longer necessary. This Commission's focus, however, can and should remain on the New York regulated subsidiaries of Energy East, and protecting local ratepayers through appropriate regulation of the utilities' rates and services, including proper scrutiny of affiliate transactions.

As long as a vigilant regulator stands on the boundary between regulated utilities and their holding company parents, as the Commission does now, there is no reason to believe that holding companies would pose a threat to ratepayers. The Commission said as much itself in its approval of the takeover of United Water Resources by the French holding company, Suez Lyonnaise des Eaux, responding to opponents' claims that a distant holding company would be detrimental to quality of service:

> The threat of management insensitivity to customers' needs appears chimerical because there is no basis for the opponents' assumption of indifference on the part of the parent company. And, even if the assumption were valid, United Water will remain a fully regulated commodity and service provider, subject to our jurisdiction—and under local management, according to the proponents' representations—in case there emerges some reason for concern about the company's ability or willingness to maintain safe and adequate service and conduct its affiliate transactions on an arms' length basis.[33]

Thus, the Commission already knows that it is perfectly capable of continuing to act as the guardian of ratepayers, whether the holding company is located in New

[33] Case No. 99-W-1542, *United Water Resources Inc.*, *Order Approving Stock Acquisition* at 8 (July 27, 2000).

York, France or Spain. As previously noted, Iberdrola is not seeking recovery of any transaction costs associated with the merger, and no harm will come to ratepayers so long as the Commission exercises its well-established regulatory tools in monitoring affiliate transactions and quality of service. In these respects, the merger, in my opinion, is in the public interest and should be approved.

IX. The Golden Share Issue

Q. Please describe the purpose of this section of your testimony?

A. Staff Policy Panel recommends the creation of a "golden share" as a condition of the merger. In this section of my testimony I describe why I conclude that this is a counterproductive proposal that will serve no beneficial purpose but can create costs and unanticipated problems for Iberdrola, and possibly for ratepayers, down the road.

Q. Please proceed.

A. The Staff Policy Panel proposes a "golden share" condition on the Iberdrola transaction that it defines on page 283 as:

> …a class of preferred stock having one share, subordinate to any existing preferred stock, and [which would be issued] to a party to be determined by the Commission who would protect the interests of New York and would be independent of the parent company and its subsidiaries. The "golden share" will have voting rights, which limit …[the] right to commence any voluntary bankruptcy, liquidation, receivership, or similar proceedings without the consent of the holder of that share of stock.

Further, the Staff Policy Panel holds the golden share to be a very important condition of this proposed transaction, saying on page 285:

> We believe it is an important tool, perhaps the most important tool that the Commission can use to isolate NYSEG and RG&E from the risks of Iberdrola. Given those risks, … a golden share that controls whether a utility may voluntarily be placed into bankruptcy is essential. The Commission might also consider an LPE [limited purpose entity holding the golden share] as an instrument for ensuring compliance with dividend and money pool restrictions. These vehicles could create greater structural separation between Iberdrola and its subsidiaries.

Q. Do you agree?

A. No, I do not agree. The golden share proposal is a redundant and unnecessary protection for the customers of NYSEG and RG&E. In Section VIII, above, I discussed at length why the SEC and the FERC (as well as Congress) concluded that the modern measures for dealing with affiliate transactions are sufficient to deal with the protection of ratepayers.

Q. What is the harm in the golden share?

A. The golden share has actual and potential costs and consequences that we cannot predict. As new layers of corporate governance, it will by necessity create direct costs. Furthermore, its novelty both in New York and in U.S. utility regulation generally creates uncertainties for Iberdrola (and possibly also for utility customers) that have no corresponding benefit. The idea, put forward by the Staff Policy Panel, that NYSEG or RG&E would voluntarily declare bankruptcy at the behest of Iberdrola, so that Iberdrola could "siphon assets out of its financially healthy subsidiary"[34] simply is nowhere near a realistic possibility. Such "siphoning" is impossible as a realistic regulatory matter, as I discussed in Section VIII. But further, my experience with utility bankruptcies (and other bankruptcies) leads me to conclude that there is no basis whatsoever in believing (either within Iberdrola or within the Commission) that declaring bankruptcy could erode the protections for ratepayers or work to benefit the equity owners of the utility operating companies.

In a nutshell, the golden share proposal serves no purpose but to inject a new class of preferred shareholder into the New York operating utilities' governance and financial picture, potentially tying their hands (or Iberdrola's) for no legitimate reason. Given that the Staff Policy Panel also suggests additional things—beyond the bankruptcy issues—that a golden shareholder would do ("The Commission might also consider an LPE as an instrument for ensuring compliance …"), I conclude that the LPE idea serves only to obstruct the merger to no useful end.

Q. Where did the idea come from in New York?

A. My understanding is that the golden share proposal, with an LPE to hold it, arose in the negotiations for the National Grid/Keyspan merger. The concept is new generally in regulating companies in the United States.

[34] This is a quote from a 1999 S&P document referred to by the Staff Policy Panel that I conclude is both dated and not aimed at this type of transaction in the U.S. under a strong regulatory environment like New York's. I will return to this S&P document further below.

Q. Is there other U.S. precedent for such a golden share controlled by a party appointed by a regulatory commission?

A. Not to my knowledge. The Staff Policy Panel brings up the case of MidAmerican / PacifiCorp, but that example is different than what Staff is proposing here. Specifically, while the Staff Policy Panel refers to MidAmerican / PacifiCorp, in that case, there was no involvement by the Public Utility Commission in Oregon in selecting a party that would become a part of the governance of the utility (PacifiCorp). Rather, the special purpose entity was set up to include standard provisions for separating corporate entities, including provisions for separate books and records, financial statements, and arm's lengths relationships with affiliates.[35] This was a far less intrusive measure than Staff's proposal of setting up a "golden share" to be controlled by a party appointed by the New York Commission.

Q. The Staff Policy Panel specifically brings up the question of a voluntary bankruptcy at NYSEG or RG&E being ordered by Iberdrola. Would the interjection of LPEs prevent Iberdrola from ordering such a thing?

A. I cannot conceive of any possible scenario that would cause Iberdrola to order its otherwise healthy, going-concern, utility subsidiaries in New York to declare bankruptcy. Not only is such a thing totally unprecedented as a historical/factual matter, there is no possibility for Iberdrola to gain from a process before a federal bankruptcy judge in a very expensive bankruptcy process.

[35] *See MidAmerican Energy Holdings Co.,* Order No. 06-082, 2006 Ore. PUC LEXIS 74 (2006).

The bankruptcy of substantial utilities in the United States like NYSEG or RG&E is exceedingly rare. And when those events happen, the companies are driven to bankruptcy by matters of great uniqueness and exigency. There have only been four investor-owned utility bankruptcies since the Great Depression. I provide that list in Table 1, below. The first two were caused by companies suffering with stranded, non-operating nuclear power plants post Three Mile Island. The third was a gas pipeline company operating subsidiary of a larger holding company hobbled by take-or-pay contract that arose with the one-time gas industry restructuring. The fourth arose in the context of the complicated California Energy Crisis of 2000-2001. We have none of those circumstances here.

REBUTTAL TESTIMONY OF JEFF D. MAKHOLM

Table 1

Company	Bankruptcy Filing Date	Reason	Context
Public Service Company of New Hampshire	January 28, 1988	Unable to service its debt, in large part due to its investment in the Seabrook nuclear facility.	Invested approximately $2.9 billion in Seabrook. Under NH law, plant was not allowed in rate base until the plant was actually online. Provided electric service to 400,000+ homes and businesses.
El Paso Electric Company	January 8, 1992	The PUCT authorized $47 million of a requested $131.3 million rate increase. El Paso was unable to meet its debt obligations.	Incurred substantial debt related to the construction of the Palo Verde nuclear facility. Integrated utility, served about 270,000 customers.
Columbia Gas Systems, Inc.	July 31, 1991	The settlement Columbia negotiated required it to make two $15 million deposits into an escrow account, one immediately after the settlement.	Columbia was involved in a class action suit regarding its underpayment of gas contracts. A settlement was reached in 1991. These were “take or pay” contracts.” These contracts, in conjunction with the deregulation of the wellhead price of gas, forced Columbia to incur gas commodity costs that it could not pass on in full.
Pacific Gas and Electric	April 6, 2001	Retail rates had been frozen. During the rise in wholesale cost of power, retail rates did not cover the cost of power purchases.	Victim of the 2000-2001 California Energy Crisis.

Source: Company Annual Reports and Commission Reports

In all of these cases, the question of ratemaking and the traditional public service issues of service adequacy stayed with the relevant Commission throughout.

Q. Have there been cases of bankrupt parents controlling solvent and going-concern operating utilities?

A. Yes. Portland General Electric (PGE) in Oregon remained a going utility concern while its parent (Enron) suffered bankruptcy. I am personally familiar with the operation of PGE through his period. Enron owned PGE from July 1, 1997 to April 3, 2006, and filed for Chapter 11 bankruptcy on December 2, 2001. I filed testimonies before the Oregon Commission for PGE in 2001, 2004 and 2005, both before and after that bankruptcy filing.

Q. You seem to be suggesting that there is a possibility that LPEs and golden shares could create unanticipated problems for Iberdrola, and possibly for ratepayers, down the road. What do you mean by that?

A. Golden shares are a novel and untested addition to the governance structure of U.S. utilities. Whether the LPE can deal with issues other than bankruptcy, or whether it would survive if Iberdrola decided to spin NYSEG or RG&E back into an independent operating utility are questions that Staff does not address. Staff seems to want the LPE to prevent a voluntary bankruptcy that has no practical payoff for Iberdrola (i.e., one which is ordered by Iberdrola for the purpose of “siphoning” funds from the operating companies). To the extent that NYSEG or RG&E truly require the protection from creditors that voluntary bankruptcy customarily provides, the LPE would either be redundant or could conceivably get in the way of what bankruptcy is designed to accomplish for companies seeking protection from their creditors.

Q. What do you conclude regarding this issue?

A. Neither LPEs nor golden shares are traditional parts of U.S. utility regulation. They seem only to have been adopted once (in New York) as part of a negotiated settlement. The other case brought up by the Staff Policy Panel (in Oregon) did not involve the Commission in the way proposed here. I know of no other instance of this form of corporate governance for any utility in the U.S. This added layer of governance is superfluous, since the "siphoning of subsidiary funds through voluntary bankruptcy" is not a realistic concern.

In the near term, the perceived problem associated with the golden share for National Grid (a lower credit rating of the prospective parent) does not accompany this transaction with Iberdrola (which has a credit rating solidly higher than NYSEG and RG&E). In the longer term, ongoing and effective regulation of affiliate transactions provides a sufficient protection for ratepayers without adding what I conclude is a superfluous layer of corporate governance.

Q. Do you have any final overall comments regarding the Staff Policy Panel's testimony?

A. Yes. I have structured my testimony to target those aspects of the Staff Policy Panel's testimony that I conclude are the most flagrantly subjective or unsupportable regarding this merger. As such, my comments are quite targeted, and they include some considerable detail about how regulation works to protect the public interest—holding companies notwithstanding.

From a wider perspective, I can see no harm to ratepayers in New York from this proposed transaction. The Staff Policy Panel's many allegations of risk and harm associated with Iberdrola as a holding company are, in my opinion, not based on any factual substance or valid theoretical concern. The Staff Policy Panel has substituted its own view for the opinions of independent ratings agencies, it has offered calculations that have no foundation, it has cast aspersions on Iberdrola's motives and has repeatedly sought concessions from Iberdrola that have no connection with the genuine cost of serving customers of NYSEG and RG&E. As a result, I do not believe there is a sound basis for Staff's statements about the need for the Commission to reject this merger. As has been the case in other jurisdiction (like Maine), I recommend that with suitable commitments, such as those provided here by Iberdrola, information provision and the scrutiny of affiliate transactions, that the Commission permit this transaction to go forward.

Q. Does this conclude your testimony?

A. Yes.