

BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

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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.
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Case 07-M-0906

**REBUTTAL TESTIMONY OF
WILLIAM H. HIERONYMUS**

January 31, 2008

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1 Q. Please state your name and business address.

2 A. My name is William H. Hieronymus. My business address is CRA International
3 Inc., 200 Clarendon Street, T-33, Boston, MA 02116.

4 Q. Are you the same William H. Hieronymus who filed Direct Testimony earlier in
5 this proceeding?

6 A. Yes, I am.

7 **Summary of Rebuttal Testimony**

8 Q. What is the purpose of your rebuttal testimony?

9 A. I am responding to the testimony of Mr. Mark Younger, a witness for the
10 Independent Power Producers of New York (“IPPNY”), and the portions of the
11 Staff Policy Panel testimony submitted by the Staff of the New York Public
12 Service Commission (the “Commission”) dealing with market power issues.

13 Q. Can you give us an overview of the issues you would like to discuss?

14 A. Yes. The general areas that I will address are the recommendations made by
15 IPPNY and Staff concerning the conditions that the Commission, if it approves
16 the merger between a subsidiary of Iberdrola, S.A. (“Iberdrola”) and Energy East
17 Corporation (“Energy East”) that is the subject of this proceeding (the “Merger”),
18 should place on the merging parties to resolve supposed vertical market power
19 concerns. In part, I am responding to comments that these witnesses make
20 concerning my Direct Testimony, particularly as it relates to (1) the lack of
21 relevance of Energy East’s existing generation to the Merger, (2) the *de minimis*

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1 nature of Iberdrola’s affiliated generation in the New York Independent System
2 Operator (“NYISO”) region, and (3) the substantial increase in regulatory
3 oversight of the electric industry in New York since 1998 when the Commission
4 issued its Vertical Market Power Policy Statement (the “Policy Statement”). I
5 also re-emphasize the points I made in my Direct Testimony regarding the
6 unpredictable and intermittent nature of wind, which makes wind-powered
7 generating facilities ill-suited to be used in the exercise of vertical market power.
8 I also respond to certain arguments made by these witnesses that are not directly
9 responsive to my Direct Testimony.

10 Q. Please begin first with Mr. Younger’s testimony. What are his concerns and
11 recommendations?

12 A. Mr. Younger is concerned that Energy East’s New York utility subsidiaries, New
13 York State Electric & Gas Corporation (“NYSEG”) and Rochester Gas and
14 Electric Corporation (“RG&E”), own, and after the Merger would continue to
15 own, rate-based generation (at 3). Mr. Younger contends that this ownership
16 contravenes established Commission policy and shifts cost risks to ratepayers (at
17 3). He also is concerned that allowing NYSEG or RG&E to own or be affiliated
18 with generation in their service areas would create vertical market power issues,
19 in that these utilities would favor their affiliated generation and impede the
20 development of unaffiliated generation in the areas (at 18-20). He recommends
21 that approval of the Merger be conditioned on the prompt sale of NYSEG’s and
22 RG&E's cost-of-service regulated facilities, and a permanent bar on NYSEG and

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1 RG&E owning or being affiliated with any generation in their respective service
2 areas (*see, e.g.*, at 2).

3 Q. What are Staff's concerns and recommendations?

4 A. Staff also is concerned with the potential vertical market power of the post-
5 Merger company, though (as with Mr. Younger) not all of its concerns relate to
6 the Merger itself. Staff believes that the Policy Statement remains relevant in that
7 the Commission should insist on strict structural separation between generation
8 and transmission (*e.g.*, at 126). Staff insists that regulation simply cannot guard
9 against any conceivable exercise of vertical market power and disagrees with my
10 characterization of the Merger's effects as *de minimis* (at 133-35). Staff
11 recommends that the Commission condition its approval of the Merger on the sale
12 of all generation in New York owned by either Iberdrola or Energy East, no
13 matter where that generation is located (at 288).

14 **The Existing Generation Owned by NYSEG and RG&E Is Unrelated to the Merger**
15 **and Irrelevant to a Vertical Market Power Analysis of the Merger**

16 Q. You stated that Mr. Younger was particularly concerned about the post-Merger
17 company owning rate-based generating facilities. Is Energy East's continued
18 ownership of cost-of-service regulated generation related to the Merger?

19 A. Clearly, the ownership of such facilities is wholly unrelated to this transaction.
20 Iberdrola owns no cost-of-service regulated generating facilities, and has no
21 transmission in New York. Hence, this issue raised by Mr. Younger and Staff

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1 concerns existing conditions that relate solely to Energy East and have nothing to
2 do with the Merger. There is therefore no principled basis for conditioning
3 Merger approval on the disposal of Energy East's existing generating facilities.

4 Q. Much of Mr. Younger's testimony concerns various reasons why it is bad policy
5 to allow regulated utilities to own or construct rate-based generating facilities. Is
6 there a reason why the ownership of such facilities in the NYSEG or RG&E
7 service areas raises vertical market power issues that are more serious than if such
8 facilities were supported solely by market revenues?

9 A. No, and Mr. Younger does not assert such a connection between cost-of-service
10 regulation and vertical market power issues. If anything, the fact that these are
11 cost-of-service regulated facilities should lessen any theoretical vertical market
12 power concerns. In my Direct Testimony, I concluded that Energy East's profit
13 share of this rate-based generation is 10 percent, with the remaining 90 percent
14 flowing through to customers. It is therefore the ratepayers, and not Energy East,
15 that primarily benefit from any value enhancement to these facilities, whether
16 arising from the exercise of vertical market power or any other cause. Since there
17 is little if any profit incentive for Energy East to enhance the value of these
18 facilities, the concern about hypothetical vertical market power should be less for
19 these cost-of-service facilities. My reading of the Commission's order in the
20 KeySpan-National Grid merger proceeding suggests that this also is the
21 Commission's view. While the Commission required divestiture of KeySpan's
22 Ravenswood facility in that order, no such requirement was placed on the

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1 KeySpan facilities dedicated to serving Long Island Power Authority’s (“LIPA”)
2 load under what are essentially cost-of-service contractual terms.

3 Q. Mr. Younger notes that you did not analyze vertical market power concerns as
4 they relate to RG&E's Russell Station. He asserts that since the Russell Station is
5 due to be retired in 2008, any repowering “is essentially a new generation addition
6 and must be reviewed in that context” (at 18). Would treating a repowering of the
7 Russell Station as a new unit change your view that it is not Merger-related?

8 A. No. The key fact about the Russell Station is not whether it is old or new, but that
9 it exists independent of the Merger and is not becoming newly affiliated with a
10 transmission owner as a result of the Merger. It is my understanding that, prior to
11 the announcement of the Merger, RG&E had already planned to propose to
12 repower the Russell Station. If, as Mr. Younger is testifying, it has been RG&E's
13 intention to repower the unit as a rate-based unit, this fact is not changed by the
14 Merger and hence is irrelevant to a vertical market power analysis of the Merger.

15 Q. Setting aside the fact that repowering the Russell Station as a rate-base unit is not
16 related to the Merger, is there a valid concern that the repowering would occur in
17 contravention of Commission policy that, as Mr. Younger suggests, seems to
18 oppose the recovery of the cost of owned units through regulated rates?

19 A. No. While I am not an expert on all aspects of New York utility regulation, I am
20 aware that a utility regulated by the Commission is not allowed to recover the cost
21 of investments that are not prudently incurred. I also am aware that, as a general
22 manner, it is necessary to get Commission permission to build new facilities.

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1 Whether the latter applies to repowered facilities or not, it clearly is the case that
2 the costs of repowering the Russell Station would have to be found to be prudent
3 if they are to be recovered by RG&E. If, as Mr. Younger and Staff assert, this
4 investment would be contrary to Commission policy, RG&E would have to be
5 very cautious about moving forward with the repowering in the expectation that it
6 would be permitted to recover its costs in rates. To be clear, I am not in any way
7 providing any opinion as to whether any amounts already spent by RG&E with
8 respect to repowering the Russell Station, or any amounts that RG&E will spend
9 in the future, are in fact prudent. Rather, I am explaining why I do not believe
10 that Mr. Younger has raised a valid concern that a repowering of the Russell
11 Station would violate any Commission policy that may oppose the recovery of the
12 cost of owned units through regulated rates

13 Q. Mr. Younger concludes that the benefits of Energy East’s continued ownership of
14 generation do not overcome the rebuttable presumption in the 1998 Policy
15 Statement (at 22). He bases his conclusion on a discussion of the economics of
16 repowering the Russell Station (at 22-23). Is this part of his testimony relevant to
17 this proceeding?

18 A. No. Mr. Younger’s conclusion that there is no ratepayer benefit to RG&E
19 retaining and repowering the Russell Station is irrelevant to the Merger. If,
20 hypothetically, Mr. Younger is correct that Energy East’s own analysis
21 demonstrates that repowering the Russell Station would not be cost effective, this
22 would factor into a prudence analysis when RG&E attempts to include those costs

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1 in its rate-base. This would make it less likely that RG&E East would in fact
2 proceed to repower the unit unless circumstances change.

3 Q. Mr. Younger also recommends the divestiture of the remaining rate-based hydro
4 and gas-fired units owned by NYSEG and RG&E (at 25). Do you see a reason to
5 require this divestiture?

6 A. No. First, these are also pre-existing NYSEG and RG&E units that will not
7 become affiliated with a transmission owner as a result of the Merger, and are
8 therefore unrelated to the Merger and any vertical market power analysis of the
9 Merger. Second, the amount of this generation is truly *de minimis*, less than 300
10 MW,¹ and is primarily run of river hydro and old gas turbines that rarely run.
11 The total output of these units in 2006 was only about 750,000 MWh, equivalent
12 to only a 100 MW base-load unit running at an 85 percent capacity factor. It
13 strains credulity to contend that the continued ownership of this amount of
14 generation by NYSEG and RG&E creates a vertical market power concern, even
15 if such generation were related to the Merger (which it is not).

16 Q. The Staff Panel is asked, “Why should the exiting (sic) RG&E and NYSEG
17 generation be included in the analysis of the proposed transaction?” (at 131).

18 Does the Panel answer this question?

19 A. No. The answer that follows merely identifies the facilities that are owned by
20 NYSEG and RG&E and recounts evidence that RG&E has appeared intent on

¹ In fact, this amount is closer to 200 MW when the Carthage Energy unit owned by NYSEG Energy Solutions is excluded.

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1 repowering the Russell Station. None of this discussion is responsive to the
2 question. The only element of Staff’s response that potentially bears on the
3 Merger is the statement that applicants might withhold output from Energy East’s
4 105 MW of peakers, which Staff states, parenthetically, to be a horizontal market
5 power issue (at 132). Notably, Staff nowhere suggests that the Merger causes any
6 horizontal market power problem, nor could it. It would defy logic to assert that
7 combining Energy East’s very small share of generation with Iberdrola’s minute
8 share would cause a horizontal market power problem.

9 **IPPNY’s Proposed Limitation on the Post-Merger Company’s Development and**
10 **Acquisition of New Generation in the NYSEG and RG&E Service Areas Is**
11 **Unnecessary**

12 Q. Mr. Younger also suggests that the Commission should require a commitment
13 from the merging parties that they would not in the future develop or acquire
14 generation in the NYSEG and RG&E transmission service areas (at 25).

15 Assuming that the Commission indeed does want to limit the amount of vertical
16 integration of transmission owning utilities, why is this commitment necessary?

17 A. Mr. Younger does not say why he believes this commitment would be necessary
18 given that the Commission already has regulatory oversight of these activities. It
19 may be that, because the Commission might in the future be more favorably
20 inclined toward vertical integration, he seeks a commitment that would survive
21 beyond such a change in policy. For example, without this commitment, the
22 Commission might in the future approve a utility-owned unit as part of the

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1 regulated reliability backstop process. Mr. Younger is silent on how, having
2 made such a commitment, NYSEG and RG&E would be able to meet the
3 requirement in Attachment Y of the NYISO tariff that they be prepared to offer
4 new regulated facilities in the event that the market does not support sufficient
5 capacity to meet reliability requirements.

6 Q. What do you mean when you say that the Commission already has regulatory
7 oversight over the future development or acquisition by the post-Merger company
8 of generation in the NYSEG and RG&E service territories?

9 A. Presuming that the Commission continues to want to limit vertical integration, it
10 has sufficient tools at its disposal to do so without requiring a commitment from
11 the merging parties in this proceeding that they will not in the future develop or
12 acquire generation in the NYSEG and RG&E transmission service areas. For
13 example, as described above, the Commission could prevent inclusion of a utility-
14 built generating unit in rate base by NYSEG and RG&E if it so desires. The
15 Commission also could presumably reject a Certificate of Public Convenience and
16 Necessity (“CPCN”) application for any unit proposed by affiliates of NYSEG or
17 RG&E in the future, whether located in the NYSEG or RG&E areas or not.
18 While the CPCN process does not apply to qualifying cogeneration facilities and
19 solar, wind, resource recovery and small hydro facilities with a capacity up to 80
20 MW, it is unlikely that any project smaller than 80 MW would be economic to
21 develop, except for small peakers required to meet specific local needs and
22 perhaps dispersed generation. Wind projects are typically larger than 80 MW as

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1 demonstrated by the wind farms that have been built or proposed in New York
2 (including Iberdrola’s affiliated projects that are in operation or under
3 development). I note also that Section 70 of the New York Public Service Law,
4 governing transfers of assets of utility corporations, gives the Commission
5 authority over the acquisition of any generating asset of non-trivial value.

6 Thus, while the Commission may not currently have the authority to fully
7 prevent all new generation developed or acquired by these applicants or their
8 affiliates in the future, it already has the authority (pursuant to the CPCN and
9 Section 70 provisions of the New York Public Service Law) to limit such
10 ownership to trivial amounts. Moreover, it is my understanding that Iberdrola and
11 Energy East are committing in their Policy Panel Testimony that NYSEG and
12 RG&E will not develop any new generation unless the Commission authorizes
13 such development.

14 **The Commission Orders Cited By IPPNY and Staff Do Not Support their**
15 **Conclusion That the Merger Should Be Conditioned Upon Divestiture of**
16 **Generation To Address Vertical Market Power Concerns**

17 Q. Mr. Younger and Staff point to various Commission orders and policy
18 pronouncements in concluding that the Commission fully opposes vertical
19 integration by utilities (*see, e.g.*, Policy Panel at 116). Do you agree that the
20 Commission will automatically reject a utility’s proposed affiliation with
21 generation?

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1 A. No. If this were the case, I would not be testifying since it would be pointless to
2 argue that the affiliation of Iberdrola’s wind facilities with Energy East is benign.
3 Rather, as Mr. Younger and Staff concede, the Policy Statement merely creates a
4 rebuttable presumption that the affiliation between generation and transmission
5 needs to be scrutinized. The Policy Statement expressly provides for the ability to
6 override this presumption, essentially on the grounds that any vertical market
7 power issue is *de minimis*, as I have concluded is the case here. In the Policy
8 Statement, the example of *de minimis* status is a very small transmission utility.
9 However, since it is the combination of generation and transmission that matters,
10 it likely should be the case that the combination of a substantial transmission
11 owner with *de minimis* generation should be permissible. The Policy Statement
12 also provides for the mitigation of any potential vertical market power.

13 Q. A more recent order that Mr. Younger cites for the proposition that the
14 Commission remains opposed to vertical integration is the December 24, 2007
15 order establishing a long-range electric resource plan, which he identifies as the
16 “ERP Order” (at 11). Does that order reaffirm the Commission’s Policy
17 Statement?

18 A. No. If anything, the essence of the ERP Order justifies a softening of the
19 Commission’s policy with respect to vertical integration. I note that the first
20 passage quoted by Mr. Younger has nothing to do with vertical market power
21 issues, but rather merely reaffirms the Commission’s preference for using market
22 mechanisms in preference to regulated solutions. However, the primary

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1 discussion in the ERP Order is an explanation as to why purely market solutions
2 may not meet the State's needs in terms of reliable service, economic generation,
3 risk diversification, environmental and other externalities, and so forth. The
4 second cited passage does indeed mention the risk of vertical market power.
5 However, a fair reading of that passage, which deals primarily with the need for
6 and implications of long-term contracts, is that the principal point being discussed
7 is the allocation of risks as between generators and customers (and not vertical
8 market power concerns). Indeed, the Commission concludes that long-term
9 contracts may be needed and even desirable in order to obtain the level and mix of
10 generation needed to meet the State's policy goals.

11 Q. If this order signals a willingness on the part of the Commission to contemplate
12 long-term contracts that transfer some cost and performance risk from generators
13 to customers, what, if anything, does that have to do with vertical market power?

14 A. It has long been recognized that horizontal and vertical market power issues can
15 arise from certain types of contracts just as readily as from generation ownership.
16 In analyses of mergers and of market power in other contexts, the policy of the
17 Federal Energy Regulatory Commission ("FERC") has long been to treat certain
18 contracts as transferring generation from the actual owner to its contractual
19 counter-party. The threshold issue is the length of the contract term. According
20 to FERC policy, short-term (*i.e.*, less than one year) contracts never transfer
21 control. For long-term contracts, it is the terms of the contract that dictate
22 whether control has passed from the owner to the contractual buyer. The two

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1 dimensions of control are (1) who profits from higher prices, and (2) who has
2 dispatch control over the facility. Regarding the profit issue, any long-term fixed
3 price contract or other contract that is not tied directly to prices in the electricity
4 market (*e.g.*, a contract indexed wholly or partially to fuels costs) transfers the
5 benefit of the contract to the buyer. The other dimension of contracts relevant to
6 market power is the control over generation dispatch, since it is this ability to
7 withhold generation from the market that is the *sine qua non* of exercising market
8 power. However, as Staff rightly observed, it is the financial interest that
9 primarily matters to vertical market power analysis, not the control over
10 generation dispatch.

11 Q. Can you summarize your conclusions on this point and how they relate to the
12 Merger?

13 A. I am making two points with this discussion. First, NYSEG and RG&E have the
14 requisite degree of control over generation (*i.e.*, a profit interest) for considerably
15 more generation than they actually own. For example, the market power
16 incentives that NYSEG and RG&E have as a result of their long-term contracts
17 for power from Nine Mile Point and Ginna facilities are precisely the same as
18 they would be if the companies had retained ownership of those facilities. Indeed,
19 in my FERC market power analysis of the Merger, I attributed all of Energy
20 East's long-term contracts to the company as if it owned the assets lying behind
21 the contracts. Thus, any generation divestiture will not cure the vertical market
22 power concern that Mr. Younger and Staff have raised.

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1 Moreover, as I will explain in detail later in my testimony, the addition of
2 Iberdrola’s generation in New York (all of which is wind powered and therefore
3 unpredictable and intermittent in nature) to what already is controlled by Energy
4 East will have little impact on its market share. In my FERC analysis, I
5 concluded that Energy East’s share of the NYISO market, inclusive of all of its
6 long-term contracts, is 2.9 percent and Iberdrola’s is 0.2 percent. For the New
7 York West market, the shares are 5.7 and 0.4 percent, respectively. I concluded,
8 and FERC agreed, that the addition of Iberdrola’s miniscule share to Energy
9 East’s small share did not create any market power issue, either horizontal or
10 vertical. Later in my testimony, I will address other specific reasons why
11 Iberdrola’s affiliated generation in New York does not raise any vertical market
12 power issues, including the significance of that generation being all wind-
13 powered, and therefore unpredictable and intermittent in nature.

14 My second point is that the Commission recognizes that long-term
15 contracts may be desirable or necessary, notwithstanding that such contracts, like
16 ownership, create potential vertical market power issues. In the ERP Order, the
17 distinction made between ownership and contracts was not about vertical market
18 power. It was about the allocation of cost and performance risk. In this regard, it
19 is notable for purposes of evaluating Mr. Younger’s reliance on the ERP Order
20 that applicants are not seeking rate-base treatment for any Iberdrola-affiliated
21 generation. More generally, the ERP Order signals an acceptance that there are
22 tradeoffs between vertical market power concerns and other policy goals. It

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1 further suggests that current policy requirements may not be achieved without a
2 modification of historic policies that sought to allocate all cost and performance
3 risks to generators and fully eliminate vertical market power risks.

4 Finally, I note that one of the concerns expressed in the ERP Order is that,
5 without long-term contracts, it could be difficult to achieve the State's renewables
6 objectives. The existing and planned generation in New York owned by
7 Iberdrola's affiliates is wholly renewable. It would not be advantageous in terms
8 of meeting the State's renewables objectives to prohibit the post-Merger company
9 from owning or contracting for renewable power as a condition of Merger
10 approval, particularly in light of Iberdrola's proven track record in developing
11 renewable resources. Yet, since ownership and a long-term contract for
12 renewable power are fully equivalent in terms of vertical and horizontal market
13 power concerns, that is effectively what Staff is proposing.

14 Q. A third Commission order that Mr. Younger and Staff point to in arguing that the
15 Commission's policy is resolutely against vertical integration involving
16 transmission operators is the KeySpan-National Grid merger order (*see, e.g.*,
17 Policy Panel at 121). In that case, the Commission required that KeySpan's
18 Ravenswood station in New York City be divested. Is there anything that
19 distinguishes that case from the Merger that is the subject of this proceeding?

20 A. Yes. First of all, the Ravenswood station is a very large part of the New York
21 City market, a load pocket with wholly inflexible capacity requirements. Along
22 with the other two largest generation owners in the City, the Ravenswood station

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1 has always been subject to comprehensive mitigation measures. Conversely,
2 Iberdrola’s affiliated wind generation is a small part of the NYISO Western
3 market which has excess supply and, significantly, is connected to other RTOs
4 that provide additional supply elasticity in the energy and capacity markets.
5 Recently, the Ravenswood station has been successful in maintaining prices in the
6 New York City capacity market above those that are consistent with the demand
7 curve, leading to an ongoing investigation into capacity market rules at FERC.
8 Maintaining higher prices in New York City by bidding capacity out of the
9 market requires a very large amount of capacity to be profitable. It requires still
10 more capacity in the statewide market.² Iberdrola’s affiliated capacity is far too
11 limited to have any impact on the New York energy, capacity and ancillary
12 services markets and, as I describe later in my testimony, is in any event all wind-
13 powered, and therefore unpredictable and intermittent in nature (and,
14 correspondingly, accorded far less than its nameplate rating as a capacity
15 product). In addition, the Commission appears to have relied on Staff evidence
16 that the energy price that Ravenswood receives in New York City can be, and has
17 been, significantly affected by the operation of National Grid’s New York
18 transmission system. I am aware of no similar evidence, or even assertions, in
19 this proceeding.

² The requirement that 80% of in-City load must be met from in-City resources narrows that market to only in-City capacity. Further, unlike the statewide market in which imports can be used to meet requirements, the 80% in-market capacity requirement is absolutely fixed, except for operation of the demand curve. Further, the steeper slope of the in-City demand curve in comparison to the statewide demand curve means that withholding of capacity in-City can be profitable for smaller amounts of generation.

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1 In conclusion on this point, my reading of the KeySpan order is that the
2 requirement to divest the Ravenswood facility was, at least to some degree,
3 dependent on the specific facts concerning that facility and the in-City market.
4 This conclusion is reinforced by the fact that KeySpan was not required to divest
5 its Long Island (Zone K) generation, despite the fact that the Long Island
6 generation is both more megawatts than Ravenswood and a higher share of
7 generation in the market in which it is located.

8 **There Are Adequate Safeguards and Incentives In Place To Prevent the Exercise of**
9 **Vertical Market Power**

10 Q. Both Staff (at 117-19) and Mr. Younger (at 21-22) assert that the arguments you
11 made in your Direct Testimony concerning the sufficiency of NYISO, FERC and
12 Commission oversight are similar to those made by generation owners, and
13 rejected by the Commission when it issued the Policy Statement, in the mid-
14 1990s. How do you respond?

15 A. The purpose of my Direct Testimony on this subject was to demonstrate the
16 extent to which circumstances have changed since the Policy Statement was
17 issued nearly ten years ago. The general appeal to the sufficiency of regulation
18 that was made at that time, and that was addressed in the Policy Statement, is far
19 different than pointing to the track record of NYISO market oversight, the
20 developments in market rules, expansion in FERC oversight and increases in its
21 remedial authority, none of which was in evidence at that time. I agree with
22 Staff's and IPPNY's characterization of the Commission's viewpoint in 1998. It

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1 is precisely my point that the facts have changed significantly since 1998, such
2 that the Commission should be comfortable with respect to the affiliation of
3 Iberdrola's extremely small amount of wind generation with Energy East.

4 Q. The Staff Panel disputes the conclusion you made in your Direct Testimony that
5 changed facts should cause the Commission to be more comfortable with the
6 vertical market power issues concerning the Merger (*see, e.g.*, at 133-35). Does
7 Staff raise substantive concerns?

8 A. Most of Staff's testimony is merely a recitation and interpretation of Commission
9 orders. This has little value concerning issues properly addressed by expert or
10 fact witnesses in this proceeding. In any case, the situation in New York in the
11 mid-1990s (of which I was a very close observer) was one in which each utility
12 owned not a few megawatts of generation, but enough to meet the substantial
13 majority of its load. Some or all were not eager to face competition or market
14 testing. It also was the case that New York had suffered through very substantial
15 cost overruns and even dead investments (*e.g.*, Shoreham) that created a strong
16 reason to separate the risks of generation ownership from regulated activities.
17 Once the State decided to restructure its electricity industry, New York also faced
18 a very difficult stranded cost calculation issue that was made more manageable if
19 assets were sold at arm's-length prices. Hence, there were many reasons for the
20 Commission to adopt a very strong policy of separating generation from
21 transmission and, still more so, from load service. Much of this motivation is no
22 longer relevant. Even the purely vertical concerns are far less, since the success

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1 of retail access has eliminated or at least substantially reduced the monopsony
2 power that the utilities previously were potentially able to exercise in the
3 wholesale power market.

4 Q. What other comments does the Staff make in response to your conclusion that the
5 Merger does not raise any vertical market power issues?

6 A. Staff observes that a transmission operator has an incentive to favor any affiliated
7 generation located in the same market and to frustrate unaffiliated generation (*see*,
8 *e.g.*, at 140). Staff also provides some examples that demonstrate how the
9 planning and operation of transmission systems could affect market prices and the
10 economics of connected generators. However, several elements are missing from
11 Staff's discussion. First, NYSEG and RG&E already have affiliated generation in
12 New York, as well as long-term contracts that give them the same theoretical
13 incentive to exercise vertical market power. Despite the nearly ten years of
14 operation of the NYISO, Staff presents no instances where NYSEG or RG&E
15 have in fact behaved improperly in favoring their affiliated generation or
16 damaging competing or potentially competing generation for vertical market
17 power concerns. No intervenor in this proceeding has presented such evidence or
18 even raised any such allegation. Indeed, Staff concedes that there are substantial
19 amounts of new generation in the NYISO queue seeking to locate in the NYSEG
20 and RG&E transmission areas. If vertical market power arising from the
21 ownership of small amounts of generation were viewed by entrants as a real
22 problem, one would not expect to see this level of queue activity.

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1 Second, Staff does not demonstrate, or even seek to demonstrate, that
2 Energy East’s affiliation with Iberdrola will injure customers or competitors. The
3 primary section in the Staff Panel Testimony dealing with potential harms is the
4 section dealing with “deliverability” issues. The point Staff appears to be making
5 is that, under NYISO rules, deliverability matters to generation owners,
6 particularly with respect to qualifying for deliverable status in the capacity
7 market. Staff believes that, by being recalcitrant in making the transmission
8 investments necessary to make output deliverable, NYSEG and RG&E can keep
9 competing generators out of the market to the advantage of their own affiliated
10 generation. However, this is not likely. Ever since the collapse of the merchant
11 bubble in 2001-3, there have been strong incentives for a transmission owner to
12 increase rate base. The very large increase in transmission construction that is
13 occurring demonstrates that utilities find it profitable to build transmission since
14 such investments earn regulated rates of return that are regarded as profitable.
15 Owners of transmission and distribution assets also have another, less direct
16 incentive to increase (rather than decrease) the amount of new generation in the
17 energy and capacity markets serving their customers. In particular, regulators and
18 other policy makers respond to high and increasing rate levels in a number of
19 ways. One response to high costs for generation is to put downward pressure on
20 delivery tariffs by, for example, setting allowed rates of return lower. Given the
21 weakness of the incentive arising from affiliation of Iberdrola’s generation with
22 RG&E and NYSEG, it takes little countervailing incentive to overwhelm any

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1 incentive that such affiliation might have to increase power costs. Staff provides
2 no analysis of these competing incentives, no nexus between its concern about
3 affiliated generation and this transaction, and no evidence to support its claims.

4 Staff insists that regulation can never detect and prevent all possible
5 exercises of vertical market power (at 133-35). It is a tautology that undetectable
6 exercises of vertical market power cannot be detected, and hence cannot be
7 disciplined by market monitoring and regulation. Generally, it is both state and
8 federal policy in the U.S., and in most other market economies, that absent the
9 showing of particular harm, businesses will be allowed to pursue their perceived
10 self-interests, including decisions to combine and to engage in transactions in
11 upstream or downstream markets. If it is the policy of the Commission that no
12 vertical affiliation between transmission owners and generation is acceptable, so
13 be it. If that is not the case, then Staff has provided no basis for concluding that
14 the affiliation of Energy East with Iberdrola’s miniscule generation raises any
15 market power issues.

16 **Iberdrola’s Affiliated Wind Projects Will Not Have Any Adverse Impact on the**
17 **Development of Renewable Resources in the State**

18 Q Staff expresses a view that the affiliation of Iberdrola and Energy East would
19 actually reduce the amount of renewable generation in New York, because
20 potential suppliers of wind and other renewables would shy away from places
21 where there is a possible incentive for a transmission owner to exercise vertical
22 market power (at 142-44). Do you have a response?

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1 A. Yes. I strongly disagree with this theory for a variety of reasons. Staff’s concern
2 with respect to this generation is belied on so many bases that it is difficult to
3 recount them. First, Staff itself has pointed to a substantial queue of potential
4 renewable generation seeking to connect to the NYSEG and RG&E transmission
5 systems (at 124). If vertical affiliation between generation and transmission were
6 a significant concern for competing developers, this queue would not exist and/or
7 would quickly be dissipating (which is not occurring). Second, none of these
8 generators, nor any other potential provider of renewable energy in New York,
9 has raised any concerns with the issue that actually is involved in the Merger – the
10 new affiliation between Iberdrola’s generation and NYSEG’s and RG&E’s
11 transmission. Even IPPNY, which seeks to condition Merger approval on Energy
12 East’s divestiture of its existing, non-Merger related rate-based generation, does
13 not claim that Iberdrola’s affiliated wind projects will eliminate renewable
14 competitors in New York, and does not ask that Iberdrola’s affiliates be required
15 to divest those projects. Third, the size of the renewables generation queue is so
16 much larger than the likely ability of western New York to absorb wind
17 generation that even if, hypothetically, vertical concerns would discourage some
18 potential entrant generators, this would not diminish the actual feasible supply of
19 such generation. Fourth, there are excellent wind regimes in Western New York
20 in areas not served by NYSEG and RG&E – indeed, more than half of the wind
21 power in the NYISO queue is in areas not served by NYSEG and RG&E. Fifth,
22 many of the areas in which NYSEG and RG&E own transmission are also served

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1 by other transmission owners, including the New York Power Authority, so that
2 competing generators wishing to locate in these areas would not necessarily have
3 to connect to NYSEG or RG&E transmission.

4 Q. Is there any significance to the fact that all of the generation in New York owned
5 by Iberdrola's affiliates is wind-powered?

6 A. Yes. As I described in my Direct Testimony, the fact that all of Iberdrola-
7 affiliated operational and planned capacity in New York is wind-powered has
8 several implications when evaluating the potential for the exercise of vertical
9 market power resulting from the Merger. The first is that wind is energy limited,
10 so that its energy and capacity value (hence, its "size" relative to vertical and
11 horizontal market power issues) is much less than its nameplate capacity. Second,
12 wind resources have unpredictable and rapidly variable output levels. Given the
13 unpredictable and intermittent nature of wind, electric energy from these projects
14 cannot reasonably be sold in NYISO's day-ahead market, in which the substantial
15 majority of New York electricity is bought and sold. If an Iberdrola-affiliated
16 project were to sell into the day-ahead energy market, it would have to assume the
17 risk of paying the unpredictable real-time price to cover the financially firm
18 energy that it sold in the day-ahead market in the quite common event that it
19 cannot produce the committed energy (*i.e.*, if the wind is not sufficient to run its
20 turbines). Instead, wind projects generally will participate in NYISO's much
21 smaller real-time market, meaning that Iberdrola's affiliated generation can have
22 no impact on day-ahead prices. Therefore, a hypothetical strategy of creating,

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1 maintaining or enhancing transmission constraints tailored to the market in which
2 Iberdrola's generation is sold (*e.g.*, sudden forced outages occurring after the day-
3 ahead market closes) would have, at most, a minor impact on prices paid by New
4 York consumers.

5 In addition, these wind projects have zero fuel costs. For this reason, it
6 would be economically costly, and thus irrational and self-defeating, to withhold
7 wind-powered energy from the real-time market. Indeed, wind resources are
8 typically bid into energy markets as a price taker to ensure that they are
9 dispatched when capable of producing energy. Hence, Iberdrola's affiliated
10 generation would be ill-suited for the exercise of market power – either directly
11 through their affecting prices by their bidding strategy, or indirectly through
12 impacting transmission constraints. Significantly, the Policy Panel did not
13 address any of these points.

14 Q. The Policy Panel also asserts that Iberdrola's affiliation with Gamesa, a supplier
15 of wind turbines and other equipment could enable it to discourage competitors
16 from entering New York (at 142-43). Is this a reasonable concern?

17 A. No. Gamesa is only one of several suppliers to the wind industry. According to
18 information on its web site, its worldwide market share is about 16 percent. Since
19 it is a Spanish company, with half the Spanish market, it is unsurprising that it is
20 still less of a factor in the U.S. According to data compiled by the American
21 Wind Energy Association, it supplied only 484 MW of the 5,244 MW of wind
22 turbines installed in the U.S. in 2007.

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1 **The Vertical Market Power Impact of the Merger is *De Minimis***

2 Q. Staff also disagrees with your characterization of the vertical market impact of
3 this transaction as *de minimis*, with your statement that none of Iberdrola's
4 affiliated generation is located in NYSEG or RG&E service areas, and with your
5 calculation of the amount of Iberdrola's affiliated generation (at 137-39).

6 Beginning with the *de minimis* issue, what is the basis for Staff's disputing your
7 conclusion?

8 A. I do not know, since Staff does not explain why it disputes my conclusion that the
9 impact of this transaction is *de minimis*. I based my conclusion in substantial part
10 on the fact that Iberdrola's affiliates controlled only 259 MW of wind powered
11 energy that either exists or is firmly planned to be completed. This equates to 26
12 MW of summer capacity and 78 MW of winter capacity. Staff concludes that I
13 should have counted an additional 15 MW of capacity which would add 1.5 MW
14 to summer capacity and 5 MW to winter capacity. This adjustment should not be
15 sufficient to cause Staff to dispute my conclusion that the impact of the Merger is
16 *de minimis*. Staff also focuses on all of the generation planned by Iberdrola's
17 affiliates, no matter how indefinite such plans are. Effectively, Staff treats
18 inclusion in the NYISO queue as equivalent to constructed capacity. As I noted
19 in my Direct Testimony, it is quite unlikely that all of this capacity will be built,
20 and it is not common practice to include merely planned facilities in analyzing
21 mergers. However, even if all of the capacity identified by Staff is conservatively
22 included, it amounts to only about 92 MW of summer capacity and 276 MW of

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1 winter capacity and energy. Staff agrees with my conclusion that Western New
2 York is a single market and, indeed, seems to suggest that it should not be
3 considered in isolation from its links to PJM and Canada. My FERC testimony,
4 filed earlier in this docket, found that Iberdrola's affiliates' share of the Western
5 New York market was 0.4 percent. Including the additional 15 MW that Staff
6 would attribute to Iberdrola does not change this conclusion. Staff also focuses
7 on all of the planned generation interests of entities in which Iberdrola has an
8 interest, including non-controlling interests (at 137-39). As noted above, this
9 amounts to 276 MW of energy equivalent capacity and 92 MW of summer
10 capacity. In comparison, the Western New York capacity, including all planned
11 capacity as Staff has done for Iberdrola, is sufficiently large that Iberdrola's
12 existing and planned capacity is less than 1 percent of the market, and its summer
13 capacity less than half a percent of the market. These remain *de minimis* shares.

14 Q. What is the basis for Staff's conclusion that you have understated the amount of
15 Iberdrola-controlled generation (at 137-39)?

16 A. In my Direct Testimony, I included only capacity controlled by Iberdrola's
17 affiliates and excluded an equity interest equivalent to 15 MW accruing to it as a
18 result of Iberdrola's minimal investment in Electricidad de Portugal. I did so
19 because FERC focuses on control in determining the party to whom generation
20 should be attributed. Staff observes, that when considering whether affiliation
21 with Iberdrola gives Energy East an incentive to misuse its control of

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1 transmission, the equity share is what matters. Even if this additional 15 MW of
2 Maple Ridge is attributed to Iberdrola, the impact is *de minimis*.

3 Staff also concludes that Iberdrola has planned facilities in the NYSEG
4 and RG&E transmission service area by reason of its indirect and non-controlling
5 ownership shares in Gamesa Energy and Horizon Wind (at 137-38). While I have
6 no reason to split hairs on this issue, my statement as made was correct. The
7 possibility that firms in which Iberdrola has a non-controlling interest may build
8 facilities in the NYSEG and RG&E transmission areas does not change it. Also,
9 as I discussed in my Direct Testimony, it is wrong to treat merely planned
10 facilities as if they were real capacity. Indeed, Staff notes that one of the two
11 facilities that Horizon Wind had planned for the region as of 2006 has since
12 disappeared from the NYISO queue.

13 **The Merger Does Not Raise Any Gas-Related Vertical Market Power Issues**

14 Q. Staff also briefly discusses Energy East's ownership of gas distribution as a
15 potential source of vertical market power (at 144). What is your response?

16 A. First of all, this issue is of little even theoretical consequence. NYSEG and
17 RG&E serve only about 150 MW of gas-fired third party generation, an amount
18 far too trivial to raise any market power concerns. Staff states that there are 314
19 MW of gas-fired generation in the NYISO queue in the NYSEG service area (at
20 144). There is no indication, however, as to whether these units plan to connect to
21 NYSEG's and RG&E's gas distribution networks, and no assurance that they will
22 be built at all. Second, this issue does not relate to the Merger, and even Staff

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1 does not treat it as such. Indeed, in hypothesizing potential harm arising from gas
2 distribution ownership, Staff focuses on how Energy East could use its gas
3 distribution system to favor Carthage (at 144), a unit owned by Energy East, not
4 Iberdrola.

5 **Conclusion**

6 Q. Do you have any summary thoughts to add?

7 A. Nothing in Mr. Younger's nor the Policy Panel's testimony causes me to modify
8 the conclusions I reached in my Direct Testimony. Indeed, the only event of
9 significance that has occurred since I submitted my Direct Testimony is that
10 FERC has concluded that the Merger creates no cause for concern that it will
11 result in the exercise of either horizontal or vertical market power.

12 Q. Does this complete your rebuttal testimony?

13 A. Yes, it does.