

**Rochester Gas and Electric Corporation**  
**Financial Statements**  
**For the Years Ended December 31, 2010 and 2009**

# Rochester Gas and Electric Corporation

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## Report of Independent Auditors

To the Stockholder and Board of Directors  
of Rochester Gas and Electric Corporation:

In our opinion, the accompanying balance sheets and the related statements of income, of cash flows, and of changes in common stock equity present fairly, in all material respects, the financial position of Rochester Gas and Electric Corporation (the "Company") at December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

March 28, 2011

**Rochester Gas and Electric Corporation  
Statements of Income**

Year Ended December 31, (Thousands)	2010	2009
<b>Operating Revenues</b>		
Electric	\$663,230	\$648,892
Natural gas	319,296	360,970
<b>Total Operating Revenues</b>	<b>982,526</b>	<b>1,009,862</b>
<b>Operating Expenses</b>		
Electricity purchased and fuel used in generation	272,909	297,125
Natural gas purchased	165,823	211,046
Other operating expenses	184,810	222,294
Maintenance	57,415	35,348
Depreciation and amortization	70,095	67,008
Other taxes	90,200	74,370
<b>Total Operating Expenses</b>	<b>841,252</b>	<b>907,191</b>
<b>Operating Income</b>	<b>141,274</b>	<b>102,671</b>
<b>Other (Income)</b>	<b>(8,865)</b>	<b>(4,208)</b>
<b>Other Deductions</b>	<b>792</b>	<b>863</b>
<b>Interest Charges, Net</b>	<b>65,724</b>	<b>75,391</b>
<b>Income Before Taxes</b>	<b>83,623</b>	<b>30,625</b>
<b>Income Taxes</b>	<b>29,286</b>	<b>6,016</b>
<b>Net Income</b>	<b>\$54,337</b>	<b>\$24,609</b>

The accompanying notes are an integral part of our financial statements.

**Rochester Gas and Electric Corporation  
Statements of Comprehensive Income**

Year Ended December 31, (Thousands)	2010	2009
<b>Net Income</b>	<b>\$54,337</b>	<b>\$24,609</b>
<b>Other Comprehensive Income, Net of Tax</b>	<b>3,775</b>	<b>27,769</b>
<b>Comprehensive Income</b>	<b>\$58,112</b>	<b>\$52,378</b>

The accompanying notes are an integral part of our financial statements.

**Rochester Gas and Electric Corporation  
Balance Sheets**

<b>December 31,</b> (Thousands)	<b>2010</b>	<b>2009</b>
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$38,457	\$6,136
Accounts receivable and unbilled revenues, net	186,085	184,550
Affiliated accounts receivable	13,716	13,616
Natural gas in storage, at average cost	27,420	27,934
Materials and supplies, at average cost	9,349	9,586
Deferred income taxes	14,834	11,857
Broker margin accounts	8,728	8,217
Prepayments and other current assets	35,292	37,757
<b>Total Current Assets</b>	<b>333,881</b>	<b>299,653</b>
<b>Utility Plant, at Original Cost</b>		
Electric	1,458,408	1,453,104
Natural gas	638,630	620,339
Common	206,046	208,872
	<b>2,303,084</b>	<b>2,282,315</b>
Less accumulated depreciation	683,351	632,284
<b>Net Utility Plant in Service</b>	<b>1,619,733</b>	<b>1,650,031</b>
Construction work in progress	121,477	55,845
<b>Total Utility Plant</b>	<b>1,741,210</b>	<b>1,705,876</b>
<b>Other Property and Investments</b>	<b>11,469</b>	<b>17,483</b>
<b>Regulatory and Other Assets</b>		
Regulatory assets		
Nuclear plant obligations	48,010	74,315
Pension and other postretirement benefits	114,616	118,526
Environmental remediation costs	78,836	79,008
Unfunded future income taxes	133,444	130,722
Unamortized loss on debt reacquisitions	10,051	9,920
Nonutility generator termination agreements	35,287	45,355
Natural gas hedges	7,445	5,474
Other	109,146	123,229
Total regulatory assets	536,835	586,549
Other assets		
Other	17,642	20,185
Total other assets	17,642	20,185
<b>Total Regulatory and Other Assets</b>	<b>554,477</b>	<b>606,734</b>
<b>Total Assets</b>	<b>\$2,641,037</b>	<b>\$2,629,746</b>

The accompanying notes are an integral part of our financial statements.

**Rochester Gas and Electric Corporation  
Balance Sheets**

<b>December 31,</b> (Thousands)	<b>2010</b>	<b>2009</b>
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Current portion of long-term debt	<b>\$61,000</b>	-
Notes payable	-	\$16,000
Accounts payable and accrued liabilities	<b>68,685</b>	24,488
Accounts payable to affiliates	<b>9,863</b>	18,158
Accounts payable, natural gas purchased	<b>18,271</b>	18,015
Accounts payable, electricity purchased	<b>22,163</b>	22,025
Interest accrued	<b>11,956</b>	14,985
Taxes accrued	<b>20,245</b>	1,682
Derivative liabilities	<b>7,439</b>	5,295
Environmental remediation costs	<b>14,649</b>	10,850
Other	<b>45,645</b>	45,611
<b>Total Current Liabilities</b>	<b>279,916</b>	177,109
<b>Regulatory and Other Liabilities</b>		
Regulatory liabilities		
Accrued removal obligations	<b>201,462</b>	203,493
Deferred income taxes	<b>37,312</b>	42,109
Positive benefit adjustments	<b>89,321</b>	120,018
Gain on sale of generation assets	<b>8,203</b>	5,390
Other	<b>85,395</b>	80,305
Total regulatory liabilities	<b>421,693</b>	451,315
Other liabilities		
Deferred income taxes	<b>273,972</b>	259,694
Nuclear plant obligations	<b>121,974</b>	121,808
Pension and other postretirement benefits	<b>102,527</b>	90,921
Asset retirement obligations	<b>16,466</b>	16,075
Environmental remediation costs	<b>62,359</b>	65,706
Other	<b>23,690</b>	25,841
Total other liabilities	<b>600,988</b>	580,045
<b>Total Regulatory and Other Liabilities</b>	<b>1,022,681</b>	1,031,360
Long-term debt	<b>657,451</b>	818,400
<b>Total Liabilities</b>	<b>1,960,048</b>	2,026,869
<b>Commitments and Contingencies</b>		
<b>Common Stock Equity</b>		
Common stock (\$5 par value, 50,000 shares authorized, 38,886 shares outstanding at December 31, 2010 and 2009)	<b>194,429</b>	194,429
Capital in excess of par value	<b>529,943</b>	509,943
Retained earnings	<b>138,076</b>	83,739
Accumulated other comprehensive (loss)	<b>(64,221)</b>	(67,996)
Treasury stock, at cost (4,379 shares at December 31, 2010 and 2009)	<b>(117,238)</b>	(117,238)
<b>Total Common Stock Equity</b>	<b>680,989</b>	602,877
<b>Total Liabilities and Equity</b>	<b>\$2,641,037</b>	\$2,629,746

The accompanying notes are an integral part of our financial statements.

**Rochester Gas and Electric Corporation  
Statements of Cash Flows**

Year Ended December 31, (Thousands)	2010	2009
<b>Operating Activities</b>		
Net income	\$54,337	\$24,609
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	72,570	69,723
Amortization of regulatory and other assets and liabilities, net	77,356	57,866
Deferred income taxes and investment tax credits, net	2,134	39,620
Storm cost related to joint proposal	18,911	-
Positive benefit adjustments (income) including carrying costs	(30,697)	7,647
Pension expense	8,074	1,341
Changes in current operating assets and liabilities		
Accounts receivable and unbilled revenues, net	(1,635)	34,877
Inventory	751	30,235
Broker margin accounts	(511)	34,000
Prepayments and other current assets	914	(10,057)
Accounts payable and accrued liabilities	11,501	(31,250)
Interest accrued	(3,029)	2,174
Taxes accrued	20,197	(19,755)
Other current liabilities	2,042	12,165
Changes in other assets		
Nonbypassable wires charges	13,090	(4,515)
Other	(37,653)	(32,941)
Changes in other liabilities		
Asset sale gain account charges	2,035	(84,549)
Reserve on regulatory assets	(11,442)	11,442
Other	2,346	4,094
<b>Net Cash Provided by Operating Activities</b>	<b>201,291</b>	<b>146,726</b>
<b>Investing Activities</b>		
Utility plant additions	(85,181)	(63,863)
Other property sold	7,276	-
Investments, net	4,935	(384)
<b>Net Cash Used in Investing Activities</b>	<b>(72,970)</b>	<b>(64,247)</b>
<b>Financing Activities</b>		
Equity contribution from parent	20,000	25,000
Derivative activity	-	(20,900)
Long-term note issuances	-	184,950
Long-term note repayments	(100,000)	(100,000)
Notes payable three months or less, net	(16,000)	(172,540)
<b>Net Cash Used in Financing Activities</b>	<b>(96,000)</b>	<b>(83,490)</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>32,321</b>	<b>(1,011)</b>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>6,136</b>	<b>7,147</b>
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$38,457</b>	<b>\$6,136</b>

The accompanying notes are an integral part of our financial statements.

**Rochester Gas and Electric Corporation**  
**Statements of Changes in Common Stock Equity**

(Thousands)	Common Stock Outstanding \$5 Par Value		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
	Shares	Amount					
<b>Balance, January 1, 2009</b>	38,886	\$194,429	\$484,943	\$59,130	\$(95,765)	\$(117,238)	\$525,499
Net income				24,609			24,609
Other comprehensive income, net of tax					27,769		27,769
Comprehensive income							52,378
Equity contribution from parent			25,000				25,000
<b>Balance, December 31, 2009</b>	38,886	194,429	509,943	83,739	(67,996)	(117,238)	602,877
Net income				54,337			54,337
Other comprehensive income, net of tax					3,775		3,775
Comprehensive income							58,112
Equity contribution from parent			20,000				20,000
<b>Balance, December 31, 2010</b>	38,886	\$194,429	\$529,943	\$138,076	\$(64,221)	\$(117,238)	\$680,989

The accompanying notes are an integral part of our financial statements.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Note 1. Significant Accounting Policies

**Background:** Rochester Gas and Electric Corporation's (RG&E, the company, we, our, us), principal business consists of its regulated electricity transmission, distribution and generation operations and regulated natural gas transportation and distribution operations in western New York. RG&E generates electricity from three natural gas turbine plants and several smaller hydroelectric stations. RG&E serves approximately 367,000 electricity and 303,000 natural gas customers in its service territory of approximately 2,700 square miles. The service territory contains a substantial suburban area and a large agricultural area in parts of nine counties including and surrounding the city of Rochester, New York with a population of approximately one million people. We operate under the authority of the New York State Public Service Commission (NYPSC) and are also subject to regulation by the Federal Energy Regulatory Commission (FERC).

We have evaluated events or transactions that occurred after December 31, 2010, for inclusion in these financial statements through March 28, 2011, which is the date these financial statements were available to be issued.

RG&E is a subsidiary of Iberdrola USA, Inc. (Iberdrola USA), which is a wholly-owned subsidiary of Iberdrola, S.A. (Iberdrola), a corporation organized under the laws of the Kingdom of Spain. On December 1, 2009, Iberdrola USA changed its legal and operating name to Iberdrola USA, Inc., from Energy East Corporation.

As part of an effort to reduce costs and increase efficiency, we undertook various measures to reduce workforce levels in 2010. We reduced workforce levels by 40 employees through an involuntary separation at a cost of approximately \$0.8 million, which we paid in cash and charged to other operating expenses. We also offered voluntary early retirement programs (VERPs) to qualifying nonunion employees. The 56 employees who accepted the VERPs will receive forms of enhanced pension benefits. In 2010 we recorded costs totaling approximately \$6.4 million of which \$0.3 million relates to intercompany charges with IUMC for the VERPs, which will be paid from pension plans. As part of the New York rate order (see Note 11), we were allowed to defer and recover these costs in rates.

RG&E received equity contributions from Iberdrola USA in December 2010 and November 2009.

**Accounts receivable:** Accounts receivable at December 31 include unbilled revenues of \$53 million for 2010 and \$47 million for 2009, and are shown net of an allowance for doubtful accounts at December 31 of \$19 million for 2010 and \$20 million for 2009. Accounts receivable do not bear interest, although late fees may be assessed. Bad debt expense was \$14 million in 2010 and \$20 million in 2009.

Unbilled revenues represent estimates of receivables for energy provided but not yet billed. The estimates are determined based on various assumptions, such as current month energy load requirements, billing rates by customer classification and delivery loss factors. Changes in those assumptions could significantly affect the estimates of unbilled revenues.

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable, determined based on experience for each service region and operating segment. Each month we review our allowance for doubtful accounts and past due accounts over 90 days and/or above a specified amount, and review all other balances on a

## **Notes to Financial Statements**

### **Rochester Gas and Electric Corporation**

pooled basis by age and type of receivable. When we believe that a receivable will not be recovered, we charge off the account balance against the allowance. Changes in assumptions about input factors and customer receivables, which are inherently uncertain and susceptible to change from period to period, could significantly affect the allowance for doubtful accounts estimates. During 2010 we recorded an increase in the allowance for doubtful accounts of \$2 million because we no longer consider customer security deposits when we determine the amount of our allowance for doubtful accounts.

***Asset retirement obligations:*** We record the fair value of the liability for an asset retirement obligation (ARO) and/or a conditional ARO in the period in which it is incurred and capitalize the cost by increasing the carrying amount of the related long-lived asset. We adjust the liability to its present value periodically over time, and depreciate the capitalized cost over the useful life of the related asset. Upon settlement we will either settle the obligation at its recorded amount or incur a gain or a loss. We defer any timing differences between rate recovery and depreciation expense as either a regulatory asset or a regulatory liability.

The term conditional ARO refers to an entity's legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. If an entity has sufficient information to reasonably estimate the fair value of the liability for a conditional ARO, it must recognize that liability at the time the liability is incurred.

Our ARO at December 31, including our conditional ARO, was \$16 million for 2010 and 2009. The ARO primarily consists of obligations related to removal or retirement of: asbestos, PCB-contaminated equipment, gas pipeline and cast iron gas mains. The long-lived assets associated with our AROs are generation property, distribution property and other property.

We have AROs for which we have not recognized a liability because the fair value cannot be reasonably estimated due to indeterminate settlement dates, including: the removal of hydroelectric dams due to structural inadequacy or for decommissioning; the removal of property upon termination of an easement, right-of-way or franchise; and costs for abandonment of certain types of gas mains.

***Accrued removal obligations:*** We meet the requirements concerning accounting for regulated operations, and recognize a regulatory liability, for financial reporting purposes only, for the difference between removal costs collected in rates and actual costs incurred. We classify those amounts as accrued removal obligations.

***Broker margin accounts:*** We maintain accounts with clearing firms that require initial margin deposits upon the establishment of new positions, primarily related to natural gas and electricity derivatives, as well as maintenance margin deposits in the event of unfavorable movements in market valuation for those positions. The amount reflecting those activities is shown as broker margin accounts on our balance sheets.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**Statements of cash flows:** We consider all highly liquid investments with a maturity date of three months or less when acquired to be cash equivalents and those investments are included in cash and cash equivalents.

<b>Supplemental Disclosure of Cash Flows Information</b>	<b>2010</b>	<b>2009</b>
(Thousands)		
Cash paid (received) during the year ended December 31:		
Interest, net of amounts capitalized	<b>\$53,572</b>	\$50,657
Income taxes, net	<b>\$8,256</b>	\$(15,224)

Interest capitalized was \$1.3 million in 2010 and less than \$0.5 million 2009. We have decreased utility plant additions by \$25 million for amounts payable as of December 31, 2010.

**Depreciation and amortization:** We determine depreciation expense using the straight-line method, based on the average service lives of groups of depreciable property, which include estimated cost of removal. The weighted-average service lives of certain classifications of property are: transmission property – 62 years, distribution property – 59 years, generation property – 54 years and other property – 34 years. We determine depreciation expense for the majority of our generation property using remaining service life rates, which include estimated cost of removal, based on operating license expiration or anticipated closing dates. Our depreciation accruals were equivalent to 2.6% of average depreciable property for 2010 and 2.9% for 2009.

We charge repairs and minor replacements to operating expense, and capitalize renewals and betterments, including certain indirect costs. We charge the original cost of utility plant retired or otherwise disposed of to accumulated depreciation.

**Government grants:** Authoritative accounting principles generally accepted in the United States of America do not address accounting for government grants. For that reason, we account for government grants related to depreciable assets in accordance with the prescribed FERC accounting for contributions in aid of construction, that is, the grant amount is credited to the cost of the related property, plant and equipment. In accounting for government grants related to operating and maintenance costs, we recognize amounts receivable as compensation for expenses already incurred in profit or loss in the period in which it becomes receivable.

**Limited voting junior preferred stock:** We have established a class of preferred stock having one share and a par value of \$1, which is issued and outstanding and has voting authority only with respect to whether RG&E may file a voluntary bankruptcy petition.

**New accounting standards adopted:** We have adopted new accounting standards issued by the Financial Accounting Standards Board (FASB) as explained below.

**Fair value measurements:** The FASB has issued a number of new standards related to fair value measurements. In April 2009 the FASB issued two new standards related to fair value measurements, which we began applying effective April 1, 2009:

- One of the new standards provides guidance for determining fair value when the volume and level of activity for an asset or liability have significantly decreased and for identifying transactions that are not orderly. It provides additional guidance to entities for estimating fair value in accordance with existing requirements when the volume and level of activity for an asset or a liability has significantly decreased. Even in those circumstances, and without considering the valuation technique(s) used, the intention of fair value measurement does

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### **Rochester Gas and Electric Corporation**

not change. The new standard also provides guidance for identifying circumstances that indicate a transaction is not orderly. In addition, it amends the disclosures in connection with fair value measurements to require disclosure in interim and annual periods about the inputs and valuation techniques used to measure fair value as well as a discussion of any changes in them during the period; and to require disclosures concerning debt and equity securities according to major security types.

- The other new standard provides amended guidance concerning the recognition and presentation of other-than-temporary impairments. It amends the guidance in U.S. generally accepted accounting principles for other-than-temporary impairment of debt securities (but not equity securities) to make it more operational and to improve the financial statement presentation and disclosure of other-than-temporary impairments on debt and equity securities.

In August 2009 the FASB issued an accounting standards update to provide amended guidance concerning the fair value measurement of liabilities. The key provisions of the amendments include clarification about valuation techniques that are to be used in circumstances in which a quoted price in an active market for the identical liability is not available and that a reporting entity is not to include a separate input or adjustments to other inputs to reflect the existence of a restriction that prevents the transfer of a liability. The amended guidance is effective for an entity's first reporting period (including interim periods) beginning after issuance of the update. We initially began applying the guidance effective October 1, 2009.

In January 2010 the FASB issued amendments to improve disclosures about fair value measurements. New disclosures that are or will be required include: 1) details of transfers in and out of Level 1 and Level 2 of the fair value measurement hierarchy, and 2) gross presentation of roll forward activity within Level 3 – separate presentation of information about purchases, sales, issuances and settlements. Entities will also have to provide fair value measurement disclosures for each class of assets and liabilities, as well as disclosures about inputs and valuation techniques for both recurring and nonrecurring Level 2 and Level 3 fair value measurements. The amendments are effective for interim and annual reporting periods beginning after December 15, 2009, except that the disclosures about Level 3 roll forward activity are effective for fiscal years beginning after December 15, 2010, and interim periods within those fiscal years.

Our adoption of the new standards related to fair value measurements had no effect on our financial position, results of operation or cash flows. Our adoption of the amendments concerning Level 3 roll forward activity effective for fiscal years beginning on or after January 1, 2011, and interim periods within those fiscal years, will not affect our results of operation, financial position or cash flows.

Variable interest entities: In June 2009 the FASB issued amendments to its revised interpretation concerning consolidation of variable interest entities (VIEs). The amendments clarify, but do not significantly change, the criteria for determining whether an entity meets the definition of a VIE, and change existing consolidation guidance so that qualifying special purpose entities are no longer exempt from consolidation. The amendments require an enterprise to perform ongoing assessments as to whether an entity is a VIE and whether the enterprise is the primary beneficiary of a VIE. Previously such assessments were required only when specified events occurred. The amended standard will alter how an enterprise determines when an entity that is not sufficiently capitalized or not controlled through voting should be consolidated. An enterprise will also be required to perform a qualitative analysis to determine

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### Rochester Gas and Electric Corporation

whether it should provide consolidated reporting of an entity based upon the entity's purpose and design and the enterprise's ability to direct the entity's actions. The amended standard also requires enhanced disclosures to provide more transparent information about an enterprise's involvement in a VIE, and any significant changes in its risk exposure due to that involvement. The amendments are effective at the start of a company's first fiscal year beginning after November 15, 2009, including interim periods. Our adoption of the amendments effective January 1, 2010, did not affect our results of operation, financial position or cash flows.

#### ***Other (Income) and Other Deductions:***

<b>Year Ended December 31,</b>	<b>2010</b>	<b>2009</b>
<b>(Thousands)</b>		
Interest and dividend income	<b>\$(277)</b>	\$(255)
Allowance for funds used during construction	<b>(1,765)</b>	-
Carrying costs on regulatory assets	<b>(6,728)</b>	(3,953)
Miscellaneous	<b>(95)</b>	-
Total other (income)	<b>\$(8,865)</b>	\$(4,208)
Civic donations	<b>\$327</b>	\$321
Miscellaneous	<b>465</b>	542
Total other deductions	<b>\$792</b>	\$863

***Regulatory assets and regulatory liabilities:*** We currently meet the requirements concerning accounting for regulated operations for our electric and natural gas operations in New York; however, we cannot predict what effect the competitive market or future actions of regulatory entities would have on our ability to continue to do so. If we were to no longer meet the requirements concerning accounting for regulated operations for all or a separable part of our operations, we may have to record certain regulatory assets and regulatory liabilities as an expense or as revenue, or include them in accumulated other comprehensive income.

Pursuant to the requirements concerning accounting for regulated operations we capitalize, as regulatory assets, incurred and accrued costs that are probable of recovery in future electric and natural gas rates. Substantially all regulatory assets for which funds have been expended are either included in rate base or are accruing carrying costs. As a result of the New York rate decision (see Note 11), the majority of our regulatory assets and liabilities are now included in rate base. As a result, carrying costs will decline significantly from 2010 levels. We also record, as regulatory liabilities, obligations to refund previously collected revenue or to spend revenue collected from customers on future costs.

Unfunded future income taxes and deferred income taxes are amortized as the related temporary differences reverse. Unamortized loss on debt reacquisitions is amortized over the lives of the related debt issues. Nuclear plant obligations, gain on sale of generation assets, other regulatory assets and other regulatory liabilities are amortized over various periods in accordance with our current rate plans. Amortization of total regulatory assets net of amortization of total regulatory liabilities was \$68 million in 2010 and \$51 million in 2009.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

In 2009 we recorded reserves totaling \$11.4 million on existing regulatory assets to reflect management's assessment of risk and increased uncertainty about the ultimate recovery for ongoing disputes which includes \$10 million related to earnings sharing accruals (see Note 5) that have not been resolved with our regulator. The resulting charge increased other operating expenses for the period.

Other regulatory assets and other regulatory liabilities consisted of:

<b>December 31,</b>	<b>2010</b>	<b>2009</b>
<b>(Thousands)</b>		
Loss on sale of Oswego generating unit	<b>\$16,335</b>	\$22,467
Deferred storm costs	-	20,711
Asset retirement obligations	<b>12,963</b>	10,133
Nonbypassable wires charges	<b>1,475</b>	10,712
Property taxes	<b>41,762</b>	33,711
Outreach and education program	<b>6,270</b>	6,861
Deferred natural gas costs	<b>1,077</b>	5,683
Cost to achieve efficiency initiatives	<b>6,356</b>	-
Other	<b>22,908</b>	24,393
Reserve on regulatory assets	-	(11,442)
Total other regulatory assets	<b>\$109,146</b>	\$123,229
Pension	<b>\$11,600</b>	\$24,929
Nuclear fuel disposal	<b>5,518</b>	5,981
Decommissioning	<b>12,545</b>	11,339
Property tax	<b>8,758</b>	6,712
Economic development	<b>17,747</b>	13,378
Nonbypassable wires charges	<b>6,851</b>	-
Other	<b>22,376</b>	17,966
Total other regulatory liabilities	<b>\$85,395</b>	\$80,305

**Related party transactions:** Iberdrola USA Management Corporation provides various administrative and management services to Iberdrola USA's operating utilities, including RG&E, pursuant to service agreements. The cost of those services is allocated in accordance with methodologies set forth in the service agreements. The cost allocation methodologies vary depending on the type of service provided. Management believes such allocations are reasonable. The cost for services provided to RG&E by Iberdrola USA and its subsidiaries were approximately \$31 million for 2010 and \$39 million for 2009 and cost for services provided by RGE to Iberdrola USA and its subsidiaries were approximately \$10 million for 2010 and \$8 million for 2009.

**Revenue recognition:** We recognize revenues upon delivery of energy and energy-related products and services to our customers.

We enter into power purchase and sales transactions with the New York Independent System Operator (NYISO). When we sell electricity from owned generation to the NYISO, and subsequently repurchase electricity from the NYISO to serve our customers, we record the transactions on a net basis in our statement of income. We net our purchase and sale transactions with NYISO on an hourly basis.

In addition, we accrue revenue pursuant to the various regulatory provisions to record regulatory assets for revenues that will be collected in the future.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**Taxes:** We compute our income tax provision on a separate return method. The determination and allocation of our income tax provision and its components are outlined and agreed to in our tax sharing agreements with Iberdrola USA.

Deferred income taxes reflect the effect of temporary differences between the amount of assets and liabilities recognized for financial reporting purposes and the amount recognized for tax purposes. We amortize investment tax credits over the estimated lives of the related assets.

We account for sales tax collected from customers and remitted to taxing authorities on a net basis.

We classify all interest and penalties related to uncertain tax positions as income tax expense.

**Use of estimates and assumptions:** The preparation of our financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Significant estimates and assumptions are used for, but not limited to: (1) allowance for doubtful accounts and unbilled revenues; (2) asset impairments; (3) depreciable lives of assets; (4) income tax valuation allowances; (5) uncertain tax positions; (6) reserves for professional, workers' compensation, and comprehensive general insurance liability risks; (7) contingency and litigation reserves; and (8) earnings sharing mechanism (ESM), nonbypassable wires charges and environmental remediation liability. Future events and their effects cannot be predicted with certainty; accordingly, our accounting estimates require the exercise of judgment. The accounting estimates used in the preparation of our financial statements will change as new events occur, as more experience is acquired, as additional information is obtained, and as our operating environment changes. We evaluate and update our assumptions and estimates on an ongoing basis and may employ outside experts to assist in our evaluations, as considered necessary. Actual results could differ from those estimates.

#### Note 2. Income Taxes

Year Ended December 31, (Thousands)	2010	2009
Current		
Federal	\$23,778	\$(26,436)
State	3,374	(7,168)
Current taxes charged to expense	27,152	(33,604)
Deferred		
Federal	2,163	32,982
State	824	7,491
Deferred taxes charged to expense	2,987	40,473
Investment tax credit adjustments	(853)	(853)
<b>Total</b>	<b>\$29,286</b>	<b>\$6,016</b>

The significant increase in current income tax expense in 2010 as compared to 2009 is driven primarily by an increase in pretax income and the current effect of the tax deduction related to previously capitalized repair costs taken on the 2008 tax return filed in 2009, offset by the tax depreciation deduction for 2010. The significant decrease in deferred income tax expense in

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

2010 as compared to 2009 is driven by the corresponding effects of the tax deduction related to capitalized repair costs taken on the 2008 tax return filed in 2009, offset by the tax depreciation deduction for 2010.

Our tax expense differed from the expense at the statutory rate of 35% due to the following:

<b>Year Ended December 31,</b>	<b>2010</b>	<b>2009</b>
<b>(Thousands)</b>		
Tax expense at statutory rate	<b>\$29,268</b>	\$10,719
Depreciation and amortization not normalized	<b>3,612</b>	(145)
Investment tax credit amortization	<b>(853)</b>	(853)
State taxes, net of federal benefit	<b>2,728</b>	210
Cost of removal, not normalized	<b>(3,743)</b>	(1,976)
Medicare subsidy	<b>244</b>	(167)
Tax return and audit adjustments	<b>(1,302)</b>	(1,567)
Other, net	<b>(668)</b>	(205)
<b>Total</b>	<b>\$29,286</b>	\$6,016

Income taxes were essentially the same in 2010 as they would have been at the federal statutory rate of 35% and \$4.7 million less in 2009. The 2010 effective tax rate was more than the statutory rate primarily due to the flow-through treatment of book tax depreciation differences, state taxes offset by removal costs and the effects of the flow-through differences in the 2009 filed tax return compared to the 2009 booked expense. The 2009 effective tax rate was less than the statutory rate primarily due to the flow-through treatment of removal costs and the effects of the differences in the 2008 filed tax return compared to the 2008 booked expense. The variance in state taxes, net in 2010 as compared to 2009, is driven primarily by the increase in pretax income.

Our deferred tax assets and liabilities consisted of:

<b>December 31,</b>	<b>2010</b>	<b>2009</b>
<b>(Thousands)</b>		
<b>Total Current Deferred Income Tax Assets</b>	<b>\$14,834</b>	\$11,857
<b>Noncurrent Deferred Income Tax Liabilities (Assets)</b>		
Depreciation	<b>\$291,404</b>	\$281,980
Unfunded future income taxes	<b>52,864</b>	49,860
Accumulated deferred investment tax credits	<b>2,650</b>	3,502
Deferred gain on sale of generation assets	<b>26,008</b>	38,248
Derivative asset	<b>(37,792)</b>	(40,926)
Pension	<b>32,188</b>	33,165
Other postretirement benefits	<b>(31,805)</b>	(32,338)
Positive benefits adjustments merger order	<b>(35,385)</b>	(47,545)
Other	<b>11,152</b>	15,857
<b>Total Noncurrent Deferred Income Tax Liabilities</b>	<b>\$311,284</b>	\$301,803
Less amounts classified as regulatory liabilities		
Deferred income taxes	<b>37,312</b>	42,109
<b>Noncurrent Deferred Income Tax Liabilities</b>	<b>\$273,972</b>	\$259,694
Deferred tax assets	<b>\$119,816</b>	\$132,666
Deferred tax liabilities	<b>416,266</b>	422,612
<b>Net Accumulated Deferred Income Tax Liabilities</b>	<b>\$296,450</b>	\$289,946

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

We have no federal or state tax credit or loss carryforwards, and no valuation allowances.

<b>Reconciliation of Gross Income Tax Reserves</b>	<b>2010</b>	<b>2009</b>
(Thousands)		
Balance as of January 1	<b>\$4,154</b>	\$692
Increases for tax positions related to prior years	-	4,154
Reductions for tax positions related to prior years	-	(692)
Balance as of December 31	<b>\$4,154</b>	\$4,154

The total gross unrecognized tax benefits as of December 31, 2010, were \$4.3 million, including gross income tax reserves of \$4.2 million and interest of \$0.1 million. Including interest, \$0.1 million of the total gross unrecognized tax benefits would affect the effective tax rate, if recognized.

We have been audited through 2005 for federal income taxes. The statute of limitations in the state of New York has expired for all years through 2006. Our federal returns for 2006 through 2009 are currently under review. We anticipate that the reviews will be completed in 2011. We cannot predict the ultimate outcome of the reviews.

As a result of the passage of The Small Business Jobs Act in September 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 in December 2010, certain capital additions qualify for 50% bonus depreciation and 100% expensing, respectively, for tax purposes. Iberdrola USA and its affiliates have elected to apply the 50% bonus and 100% expensing to the additions it has determined qualify for this accelerated tax depreciation. There is no earnings effect related to this election as the accelerated tax depreciation creates a temporary difference that requires the establishment of a deferred tax liability.

**Elimination of tax deduction related to Medicare Part D Subsidy:** The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (H.R. 4872) were signed into U.S. law in late March 2010. We receive a federal subsidy because we sponsor retiree health benefit plans that provide a benefit that is at least actuarially equivalent to the benefits under Medicare Part D. The subsidy is known as the Retiree Drug Subsidy (RDS or the subsidy). The RDS payments we receive are not currently taxed. A provision in the PPACA changes the tax treatment of the RDS, requiring the amount of the subsidy received to be offset against the amount of retiree health care payments that would be eligible for a tax deduction. As a result, the subsidy received would reduce an employer's tax deduction for the costs of retiree health care. Our subsidy receipts will effectively become taxable in tax years that begin after December 31, 2012.

In accordance with U.S. GAAP concerning accounting for income taxes, a reporting entity is required to immediately recognize the effect of a change in tax law in continuing operations in the income statement in the period that includes the enactment date. We recorded the effect of the change related to the RDS in the quarter ended March 31, 2010, due to the fact that we accounted for the future tax benefit on an accrual basis. In accounting for the effect of the change for U.S. GAAP reporting, an employer that captured the tax benefit of future subsidies on an accrual basis would now be required to reduce the accumulated deferred tax asset on its balance sheet related to the accrued estimated deductible retiree health care payments to reflect the fact that the future deduction will now be reduced by the collection of the accrued subsidy.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

Companies that meet the requirements concerning accounting for regulated operations offset that decrease with the establishment of a regulatory asset. As a result, we have recorded a regulatory asset for unfunded future income taxes of approximately \$0.8 million and reduced our deferred income tax asset related to the costs of retiree health care by approximately \$0.5 million. In addition, because the recognition of the unfunded future income tax regulatory asset is considered a temporary difference, we have recognized an associated deferred income tax liability of approximately \$0.3 million. There is no immediate effect on the income statement under this accounting, only our balance sheet is affected. The amortization of the \$0.8 million regulatory asset and associated \$0.3 million deferred tax liability commenced on September 1, 2010, in accordance with the provisions of our rate settlement. The amortization period is 40 months.

#### Note 3. Long-term Debt

At December 31, 2010 and 2009, our long-term debt was:

	Interest Rates	Maturity	Amount (Thousands)	
			2010	2009
<b>First mortgage bonds<sup>(1)</sup></b>				
Series TT	6.95%	2011	<b>\$61,000</b>	\$161,000
Series WW	6.47%	2032	<b>100,000</b>	100,000
Series XX	8.00%	2033	<b>150,000</b>	150,000
Series VV	6.375%	2033	<b>75,000</b>	75,000
Series YY	5.90%	2019	<b>150,000</b>	150,000
PCN 2004 Series A	4.75%	2016	<b>10,500</b>	10,500
PCN 2004 Series B	5.375%	2032	<b>50,000</b>	50,000
PCN Series C	5.00%	2016	<b>29,350</b>	29,350
Total first mortgage bonds			<b>625,850</b>	725,850
<b>Unsecured pollution control notes (PCNs), fixed</b>				
1998 Series A	5.95%	2033	<b>25,500</b>	25,500
<b>Unsecured PCNs, variable</b>				
1997 Series A	0.60%	2032	<b>34,000</b>	34,000
1997 Series B	0.60%	2032	<b>34,000</b>	34,000
Total unsecured PCNs, variable			<b>68,000</b>	68,000
Unamortized discount on debt			<b>(899)</b>	(950)
Debt due within one year, included in current liabilities			<b>(61,000)</b>	-
<b>Total</b>			<b>\$657,451</b>	\$818,400

<sup>(1)</sup> The first mortgage bonds are secured by a first mortgage lien on substantially all of our properties. We have no other secured indebtedness. None of our other debt obligations are guaranteed or secured by any of our affiliates.

As of December 31, 2010 and 2009, we had outstanding \$183 million of tax-exempt pollution control notes, of which \$75 million have coupons fixed to maturity, \$40 million are notes with a mandatory redemption date in 2016 and \$68 million are 35-day auction rate notes. The notes with mandatory redemption dates in 2016 have maturity dates in 2032 and may be remarketed as tax-exempt bonds in a different interest rate mode after the mandatory requirements.

On December 30, 2010, we completed a make-whole redemption of \$100 million of 6.95% Series TT first mortgage bonds, due in April 2011, at a premium of \$1.6 million using available cash. On February 23, 2011, we redeemed the remaining \$61 million of outstanding Series TT notes at a premium of \$0.4 million using available cash.

In August 2008 we began to place orders for our own accounts in the auctions for \$44.4 million

## Notes to Financial Statements

### **Rochester Gas and Electric Corporation**

of auction rate notes. We bid at each auction for 100% of the outstanding securities at the greater of the one-month London Interbank Offer Rate (LIBOR) or the Securities Industry and Financial Markets index. In August 2009 we remarketed, as mandatory tender bonds, the securities we held pursuant to this program.

In August 2009 we converted PCN 1997 Series C and PCN 2004 Series A from auction rate to mandatory tender bonds, with 2016 tender dates. Those two series had been subject to the program described above wherein RG&E was bidding for the securities at auction. At the time of the conversion, we held \$33 million of PCN 1997 Series C bonds and \$11 million of PCN 2004 Series A bonds. Also at the time of conversion, we retired \$4.6 million of PCN 1997 Series C bonds in connection with the closing of Russell Station. After the conversion, there were \$29 million of PCN 1997 Series C bonds and \$11 million of PCN 2004 Series A bonds outstanding.

As of March 18, 2011, we were paying rates averaging .60% on the remaining \$68 million of auction rate notes on which we are not placing orders at auction, substantially all of which are being held on account and have been accounted for as a redemption of long-term debt.

In June 2009 we issued \$150 million Series YY first mortgage bonds bearing a coupon of 5.9% and with a maturity date of July 15, 2019. The proceeds of the issuance funded the redemption at maturity of \$100 million of Series B Medium Term Notes in October 2009. The remainder of the funds were used to reduce short-term debt and for general corporate purposes. We settled our October 2009 hedge in June 2009 at a loss of \$20.9 million in connection with the pricing of those Series YY Bonds. The hedge loss is included in other comprehensive income and is being amortized to interest expense over the term of the related new debt that was issued.

At December 31, 2010, long-term debt, including sinking fund obligations (in thousands), that will become due during the next five years is:

<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
\$61,000	-	-	-	-

**Cross-default provisions:** We have a provision in a participation agreement relating to certain series of pollution control bonds, which provides that default by us with respect to bonds issued under our first mortgage indenture will be considered a default under the participation agreement.

#### **Note 4. Bank Loans and Other Borrowings**

RG&E is a joint borrower with the other Iberdrola USA operating utilities in a revolving credit facility (the joint facility) providing maximum borrowings of up to \$475 million in aggregate. Sublimits that total to the aggregate limit apply to each borrower and can be altered within the constraints imposed by maximum limits that apply to each borrower. RG&E's maximum credit limit under the joint facility is \$100 million and was set at the maximum on December 31, 2010, and at \$75 million on March 18, 2011. The joint facility expires in 2012 and requires a fee of 10 basis points annually on the current sublimit amount.

We also have an intercompany credit facility under a demand note agreement with Iberdrola USA that provides financing of up to \$150 million. Under the terms of that agreement, which expires in 2018, we pay the same rate as under Iberdrola USA's credit facility. We had no debt outstanding under the agreement at December 31, 2010 and March 18, 2011. Iberdrola USA obtains funding for its own short-term needs and for the temporary needs of its subsidiaries

## **Notes to Financial Statements**

### **Rochester Gas and Electric Corporation**

through a separate credit facility providing maximum borrowings of up to \$300 million. That credit facility expires in 2012 and requires a fee on undrawn borrowings of 6 basis points. As of December 31, 2010, Iberdrola USA had utilized \$133 million of the \$300 million available under its facility.

We use drawings on our credit facility to finance working capital needs, fund letters of credit, temporarily finance certain refundings and for other corporate purposes. We had no short term-debt outstanding at December 31, 2010, and a \$16 million outstanding note payable under the joint facility at December 31, 2009. The weighted average interest rate on short-term debt was 0.58% at December 31, 2009. At March 18, 2011, we had no short-term debt outstanding.

In the joint facility we have a covenant not to permit, without the consent of the lender, our ratio of total indebtedness to total capitalization to exceed 0.65 to 1.00 at any time. For purposes of calculating the maximum ratio of indebtedness to total capitalization, the facility excludes from net worth the balance of Accumulated other comprehensive income (loss) as it appears on the balance sheet. The facility contains various other covenants, including a restriction on the amount of secured indebtedness RG&E may maintain. Continued unremedied failure to comply with those covenants for five business days after written notice of such failure from the lender constitutes an event of default and would result in acceleration of maturity. RG&E's ratio of indebtedness to total capitalization pursuant to the revolving credit facility was 0.49 to 1.00 at December 31, 2010. We were not in default as of December 31, 2010.

In its revolving credit facility Iberdrola USA covenants not to permit, without the consent of the lender, its ratio of consolidated indebtedness to consolidated total capitalization to exceed 0.65 to 1.00 at any time. For purposes of calculating the maximum ratio of indebtedness to total capitalization, the facility excludes from net worth the balance of Accumulated other comprehensive income (loss) as it appears on the balance sheet. The facility contains various other covenants, including a restriction on the amount of secured indebtedness Iberdrola USA may maintain. Continued unremedied failure to comply with those covenants for 15 days after written notice of such failure from the lender constitutes an event of default and would result in acceleration of maturity. Iberdrola USA's ratio of consolidated indebtedness to consolidated total capitalization pursuant to the revolving credit facility was 0.48 to 1.00 at December 31, 2010. Iberdrola USA was not in default as of December 31, 2010.

We believe we have sufficient liquidity available to meet our working capital and capital spending requirements. As of March 18, 2011, we have \$75 million available under the joint facility, \$150 million available under the intercompany credit facility and approximately \$17 million of cash on hand.

#### **Note 5. Commitments and Contingencies**

**Capital spending:** We have commitments in connection with our capital spending program. We plan to invest more than \$900 million in our energy delivery infrastructure during the next five years, including amounts dedicated to electric reliability. We expect that about three-fourths of our capital spending will be paid for with internally generated funds and the remainder through the issuance of debt securities. The program is subject to periodic review and revision. Our capital spending will be primarily for the extension of energy delivery service, increased transmission capacity, necessary improvements to existing facilities and compliance with environmental requirements and governmental mandates.

**Merger order:** The Iberdrola merger order contained a capital expenditure condition for NYSEG

## Notes to Financial Statements

### **Rochester Gas and Electric Corporation**

and RG&E of an aggregate \$540 million (NYSEG \$320 million, RG&E \$220 million) during 2009 and 2010. In September 2009 we requested a limited waiver of the capital expenditure merger condition to allow us to spend our capital investment by 2011. The NYPSC denied the request in its order issued in April 2010. If NYSEG and RG&E were to spend less than the amount targeted in the merger order, they were obligated to provide a calculation of the revenue requirement effect resulting from the actual level of capital spending compared to the targeted amount, which could be returned to customers if ordered by the NYPSC.

NYSEG and RG&E were also afforded the opportunity to provide an assessment of other considerations, including the effects on customers associated with a lower level of capital spending, and to provide reasons why the total revenue requirement effect, as calculated, should not be returned to customers. NYSEG and RG&E made their required filing on January 31, 2011. In that filing they informed the NYPSC that their capital expenditures for 2009 and 2010 totaled \$546.7 million, or \$6.7 million more than the \$540 million merger condition, in the aggregate. NYSEG's electric and natural gas businesses and RG&E's natural gas business invested more than their required expenditure levels, but RG&E's electric business invested less than its required expenditure level. In their filing, the companies also demonstrate that a deferral of any revenue requirement effect (in the form of a customer credit/regulatory liability) is unnecessary because: 1) in aggregate NYSEG and RG&E met the capital expenditure condition, 2) they continue to provide safe and reliable service and 3) RG&E's lower electric capital expenditures resulted in a customer benefit due to lower revenue requirements.

**Staff allegations concerning earnings sharing calculations:** The New York Department of Public Service Staff (Staff) in its testimony and briefs in the merger proceeding raised issues with regard to the ESM under our electric rate plan then in effect. In 2009 we reduced our regulatory assets by \$10 million with an offsetting charge to other operating expense due to the uncertainty related to those issues. The recent rate case settlement, which the NYPSC approved on September 16, 2010, includes a resolution of the issues as part of the overall settlement. The amount recognized in 2009 is approximately the same as the amount included in the settlement. (See Note 11.)

**Nuclear entitlement power purchase contracts:** In connection with our sales of nuclear generating assets in 2001 and 2004, we entered into four entitlement contracts under which we purchase electricity at a fixed contract price. We expensed approximately \$233 million for nuclear entitlement power in 2010 and \$227 million in 2009. We estimate that our nuclear entitlement power purchases will be \$221 million in 2011, \$182 million in 2012, \$195 million in 2013, and \$83 million in 2014.

#### **Note 6. Environmental Liability**

From time to time environmental laws, regulations and compliance programs may require changes in our operations and facilities and may increase the cost of electric and natural gas service.

## Notes to Financial Statements

### **Rochester Gas and Electric Corporation**

The United States Environmental Protection Agency and various state environmental agencies, as appropriate, have notified us that we are among the potentially responsible parties that may be liable for costs incurred to remediate certain hazardous substances at eight waste sites. The eight sites do not include sites where gas was manufactured in the past, which are discussed below. With respect to the eight sites, six sites are included in the New York State Registry of Inactive Hazardous Waste Disposal Sites and three of the sites are also included on the National Priorities List.

Any liability may be joint and several for certain of those sites. We have recorded an estimated liability of \$0.2 million related to the eight sites. We have recorded an estimated liability of \$1.8 million related to another six sites where we believe it is probable that we will incur remediation costs and/or monitoring costs, although we have not been notified that we are among the potentially responsible parties. The ultimate cost to remediate the sites may be significantly more than the accrued amount. Factors affecting the estimated remediation amount include the remedial action plan selected, the extent of site contamination and the portion attributed to us.

We have a program to investigate and perform necessary remediation at our 10 sites where gas was manufactured in the past. Eight sites are included in the New York Voluntary Clean-up Program.

Our estimate for all costs related to investigation and remediation of the 10 sites ranges from \$75 million to \$174 million at December 31, 2010. Our estimate could change materially based on facts and circumstances derived from site investigations, changes in required remedial action, changes in technology relating to remedial alternatives and changes to current laws and regulations.

The liability to investigate and perform remediation, as necessary, at the known inactive gas manufacturing sites was \$75 million at December 31, 2010 and 2009. We recorded a corresponding regulatory asset, net of insurance recoveries, because we expect to recover the net costs in rates.

Our environmental liabilities are recorded on an undiscounted basis. We have received insurance settlements during the last two years, which we accounted for as reductions to our related regulatory asset.

#### **Note 7. Accounting for Derivative Instruments and Hedging Activities**

We are exposed to certain risks relating to our ongoing business operations. The primary risk we manage by using derivative instruments is commodity price risk. In accordance with the accounting requirements concerning derivative instruments and hedging activities, we recognize all derivative instruments as either assets or liabilities at fair value on our balance sheet.

The financial instruments we hold or issue are not for trading or speculative purposes.

**Commodity price risk:** Commodity price risk, due to volatility experienced in the wholesale energy markets, is a significant issue for the electric and natural gas utility industries. We manage this risk through a combination of regulatory mechanisms, such as the pass-through of the market price of electricity and natural gas to customers, and through comprehensive risk management processes. Those measures mitigate our commodity price exposure, but do not completely eliminate it. Owned electric generation and long-term supply contracts reduce our exposure to market fluctuations.

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### **Rochester Gas and Electric Corporation**

We have electricity commodity purchases and sales contracts for both capacity and energy (physical contracts) that have been designated and qualify for the normal purchases and normal sales exception in the accounting requirements concerning derivative instruments and hedging activities.

Effective January 1, 2010, we no longer offered fixed price service to our electricity customers. We currently have a nonbypassable wires charge adjustment that allows us to pass through rates any changes in the market price of electricity. We use electricity contracts, both physical and financial, to manage fluctuations in electricity commodity prices in order to provide price stability to customers. We include the cost or benefit of those contracts in the amount expensed for electricity purchased when the related electricity is sold. We record changes in the fair value of electric hedge contracts to derivative assets and/or liabilities with an offset to regulatory assets and/or regulatory liabilities in accordance with the requirements concerning accounting for regulated operations.

We have a purchased gas adjustment clause that allows us to recover through rates any changes in the market price of purchased natural gas, substantially eliminating our exposure to natural gas price risk. We use natural gas futures and forwards to manage fluctuations in natural gas commodity prices in order to provide price stability to customers. We include the cost or benefit of natural gas futures and forwards in the commodity cost that is passed on to customers when the related sales commitments are fulfilled. We record changes in the fair value of natural gas hedge contracts to derivative assets and/or liabilities with an offset to regulatory assets and/or regulatory liabilities in accordance with the requirements concerning accounting for regulated operations. At December 31, 2010, the loss recognized in regulatory assets was \$7.4 million for natural gas hedges. For the year ended December 31, the loss reclassified from regulatory assets into income, which is included in natural gas purchased, was \$12.9 million for 2010 and \$32.9 million for 2009.

Our derivative volumes by commodity type that are expected to settle each year are:

<b>Year to settle</b>	<b>Natural Gas Contracts Financial Dths</b>	<b>Other Fuel Contracts Financial Gals</b>
<b>As of December 31, 2010</b>		
2011	7,140,000	287,500
2012	860,000	-
<b>As of December 31, 2009</b>		
2010	8,400,000	536,800
2011	920,000	-

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### Rochester Gas and Electric Corporation

The location and amounts of derivative fair values in the balance sheet are:

As of December 31, (Thousands)	Asset Derivatives		Liability Derivatives	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
<b>Derivatives designated as hedging instruments</b>				
<b>2010</b>				
Commodity contracts:				
Natural gas derivatives:				
Current	Current assets	-	Current liabilities	\$(7,439)
Long-term	Other assets	-	Other liabilities	(6)
Other contracts:	Current assets	\$20	Current Liabilities	-
<b>Total</b>		<b>\$20</b>		<b>\$(7,445)</b>
<b>2009</b>				
Commodity contracts:				
Natural gas derivatives:				
Current	Current assets	-	Current liabilities	\$(5,295)
Long-term	Other assets	-	Other liabilities	(179)
Other contracts:	Current assets	\$60	Current Liabilities	-
<b>Total</b>		<b>\$60</b>		<b>\$(5,474)</b>

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### Rochester Gas and Electric Corporation

The effect of hedging instruments on other comprehensive income (OCI) and income was:

Period Ended December 31,	Gain (Loss) Recognized in OCI on Derivatives	Location of Gain (Loss) Reclassified from Accumulated OCI into Income	Gain (Loss) Reclassified from Accumulated OCI into Income	Location of Gain (Loss) Recognized in Income on Derivatives	Gain (Loss) Recognized in Income on Derivatives
Derivatives in Cash Flow Hedging Relationships (Thousands)	Effective Portion <sup>(1)</sup>	Effective Portion <sup>(1)</sup>		Ineffective Portion and Amount Excluded from Effectiveness Testing <sup>(2)</sup>	
<b>2010</b>					
Interest rate contracts	-	Interest expense	\$(5,768)	Interest expense	-
Commodity contracts:					
Other	\$32	Other operating expenses	8		-
Total	\$32		\$(5,760)		-
<b>2009</b>					
Interest rate contracts	\$(55,471)	Interest expense	\$(4,981)	Interest expense	-
Commodity contracts:					
Electricity derivatives	15,915	Electricity purchased	(21,907)	Other (Income)/ Other Deductions	-
Other	(273)	Other operating expenses	(674)		-
Total	\$(39,829)		\$(27,562)		-

<sup>(1)</sup> Changes in OCI are reported in after-tax dollars.

<sup>(2)</sup> Ineffective portion of long-term power supply contracts that are designated as cash flow hedges.

The amount in OCI related to previously settled forward starting interest rate swaps, after tax and accumulated amortization, at December 31 is a net (loss) of \$(102.8) million for 2010 and \$(108.6) million for 2009.

As of December 31, 2010, we reported \$8 thousand in net derivative gains related to discontinued cash flow hedges. At December 31, 2010, \$22 thousand in gains are reported in OCI because the forecasted transaction is considered to be probable. We expect that \$20 thousand of gains in OCI will be reclassified into earnings within the next 12 months.

As of December 31, 2010, the maximum length of time over which we are hedging our exposure to the variability in future cash flows for forecasted energy transactions was 22 months – through October 2012.

We face risks related to counterparty performance on hedging contracts due to counterparty credit default. We have developed a matrix of unsecured credit thresholds that are dependent on a counterparty's or the counterparty guarantor's applicable credit rating (normally Moody's or S&P). When our exposure to risk for a counterparty exceeds the unsecured credit threshold, the counterparty is required to post additional collateral or we will no longer transact with the counterparty until the exposure drops below the unsecured credit threshold.

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### Rochester Gas and Electric Corporation

We have various master netting arrangements in the form of multiple contracts with various single counterparties that are subject to contractual agreements that provide for the net settlement of all contracts through a single payment. Those arrangements reduce our exposure to a counterparty in the event of default on or termination of any one contract. For financial statement presentation, we do not offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim or the obligation to return cash collateral arising from derivative instruments executed with the same counterparty under a master netting arrangement. Under the master netting arrangements our obligation to return cash collateral was \$32 thousand at December 31, 2010, and we had no right to reclaim or obligation to return cash collateral at December 31, 2009.

Certain of our derivative instruments contain provisions that require us to maintain on our debt an investment grade credit rating from each of the major credit rating agencies. If our debt were to fall below investment grade, it would be in violation of those provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position on December 31, 2010, is \$7.4 million for which we have posted collateral of \$8.7 million in the normal course of business. If the credit-risk-related contingent features underlying those agreements were triggered on December 31, 2010, we would receive a refund of \$1.3 million of collateral from our counterparties.

#### **Note 8. Fair Value of Financial Instruments and Fair Value Measurements**

The carrying amounts and estimated fair values of our financial instruments are shown in the following table.

December 31,	2010		2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
(Thousands)				
First mortgage bonds	\$625,850	\$679,777	\$725,850	\$772,270
Pollution control notes, fixed	\$25,500	\$24,577	\$25,500	\$25,147
Pollution control notes, variable	\$68,000	\$46,730	\$68,000	\$59,178

The carrying amounts for cash and cash equivalents, accounts receivable, notes payable and interest accrued approximate their estimated fair values.

We value all fixed rate long-term debt, whether unsecured or secured by a first mortgage lien, taxable or tax-exempt, by assigning a market-based yield for each security and then deriving the price from the yield. Market-based yields are determined by observing secondary market trading levels for debt of similar maturity, rating, tax and structural characteristics. We value all variable rate debt at par as it approximates fair value, except for our auction rate securities, which do not have an active market.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### *Assets and liabilities measured at fair value on a recurring basis*

Description (Thousands)	Fair Value Measurements at December 31, Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2010</b>				
<b>Assets</b>				
Noncurrent investments available for sale, primarily money market funds	\$9,827	\$9,827	-	-
Derivatives, other	20	-	-	\$20
Total	\$9,847	\$9,827	-	\$20
<b>Liabilities</b>				
Derivatives, natural gas	\$7,445	\$7,445	-	-
Total	\$7,445	\$7,445	-	-
<b>2009</b>				
<b>Assets</b>				
Noncurrent investments available for sale, other	\$15,811	\$15,811	-	-
Derivatives, other	60	-	-	\$60
Total	\$15,871	\$15,811	-	\$60
<b>Liabilities</b>				
Derivatives, natural gas	\$5,474	\$5,474	-	-
Total	\$5,474	\$5,474	-	-

We had no significant transfers to or from Level 1 and 2 during the year ended December 31, 2010. Our policy is to recognize transfers in and transfers out as of the actual date of the event or change in circumstances that causes a transfer, if any.

Valuation techniques: We measure the fair value of our noncurrent investments available for sale, using quoted market prices in active markets for identical assets and include the measurements in Level 1. The investments primarily consist of money market funds.

We determine the fair value of our various derivative assets and liabilities utilizing market approach valuation techniques:

- We enter into natural gas derivative contracts to hedge the forecasted purchases required to serve our natural gas load obligations. The forward market prices used to value our open natural gas derivative contracts are exchange-based prices for the identical derivative contracts traded actively on the New York Mercantile Exchange. Because we use prices quoted in an active market, we include those fair value measurements in Level 1.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### *Instruments measured at fair value on a recurring basis using significant unobservable inputs*

Year ended December 31, (Thousands)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	2010	2009
Beginning balance	\$60	\$(62,350)
Total gains (losses) (realized/unrealized)		
Included in earnings	(8)	27,562
Included in other comprehensive income	(32)	(7,851)
Included in regulatory assets and liabilities	-	21,799
Purchases, issuances and settlements	-	20,900
Ending balance	\$20	\$60

The gains and losses included in earnings for the periods (above), which are reported in the various categories indicated are:

	Electricity purchased	Other operating expense	Interest expense
(Thousands)			
Total gains (losses) included in earnings for year ended December 31,			
2010	-	\$(8)	-
2009	\$21,907	\$674	\$4,981

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Note 9. Accumulated Other Comprehensive (Loss) Income

	Balance January 1, 2009	2009 Change	Balance December 31, 2009	2010 Change	Balance December 31, 2010
<b>(Thousands)</b>					
Net unrealized holding gains on investments, net of income tax (expense) of \$(13) for 2009 and \$(46) for 2010	\$17	\$19	\$36	\$69	\$105
Amortization of pension cost for nonqualified plans, net of income tax benefit (expense) of \$110 for 2009 and \$(162) for 2010	(2,320)	(168)	(2,488)	246	(2,242)
Unrealized gains (losses) on derivatives qualified as hedges:					
Unrealized gains during period on derivatives qualified as hedges, net of income tax (expense) of \$(15,778) for 2009 and \$(9,100) for 2010					
Reclassification adjustment for losses (gains) included in net income, net of income tax (benefit) expense of \$(8,945) for 2009 and \$9,116 for 2010		24,051		13,871	
Net unrecognized (losses) gains on settled cash flow treasury hedges, net of income tax benefit (expense) of \$6,409 for 2009 and \$(2,285) for 2010		13,636		(13,894)	
		(9,769)		3,483	
Net unrealized (losses) gains on derivatives qualified as hedges	(93,462)	27,918	(65,544)	3,460	(62,084)
<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>\$(95,765)</b>	<b>\$27,769</b>	<b>\$(67,996)</b>	<b>\$3,775</b>	<b>\$(64,221)</b>

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Note 10. Retirement Benefits

We have funded noncontributory defined benefit pension plans that cover substantially all of our employees. The plans provide defined benefits based on years of service and final average salary. We also have other postretirement health care benefit plans covering substantially all of our employees. The health care plans are contributory with participants' contributions adjusted annually.

#### **Obligations and funded status:**

	Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009
<b>(Thousands)</b>				
<b>Change in benefit obligation</b>				
Benefit obligation at January 1	\$438,858	\$437,818	\$79,078	\$79,203
Service cost	4,576	4,334	564	581
Interest cost	24,541	25,708	4,613	4,692
Plan participants' contributions	-	-	2,954	3,035
Special termination benefits	6,379	-	-	-
Actuarial loss (gain)	21,879	8,470	7,399	(576)
Benefits paid	(41,677)	(37,472)	(7,625)	(8,093)
Federal subsidy on benefits paid	-	-	219	236
Benefit obligation at December 31	\$454,556	\$438,858	\$87,202	\$79,078
<b>Change in plan assets</b>				
Fair value of plan assets at January 1	\$421,197	\$382,663	-	-
Actual return on plan assets	53,211	76,006	-	-
Employer contributions	-	-	\$4,671	\$5,058
Plan participants' contributions	-	-	2,954	3,035
Benefits paid	(41,677)	(37,472)	(7,625)	(8,093)
Fair value of plan assets at December 31	\$432,731	\$421,197	-	-
Funded status at December 31	\$(21,825)	\$(17,661)	\$(87,202)	\$(79,078)
<b>Amounts recognized in the balance sheet</b>				
<b>December 31,</b>	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>(Thousands)</b>				
Current liability	-	-	\$(6,501)	\$(6,391)
Noncurrent liability	\$(21,825)	\$(17,661)	(80,701)	(72,687)
	\$(21,825)	\$(17,661)	\$(87,202)	\$(79,078)

We offered a VERP in our electric company plans during 2010, resulting in one-time charges for special termination benefits.

We have determined that we are allowed to defer as regulatory assets or regulatory liabilities items that would otherwise be recorded in accumulated other comprehensive income pursuant to the accounting requirements concerning defined benefit pension and other postretirement plans. Amounts recognized as regulatory assets or regulatory liabilities consist of:

	Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009
<b>(Thousands)</b>				
Net loss (gain)	\$107,442	\$110,054	\$(3,146)	\$(12,111)
Prior service cost	\$7,174	\$8,472	\$685	\$1,024
Transition obligation	-	-	\$1,817	\$3,655

Our accumulated benefit obligation for all defined benefit pension plans was \$426 million at

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

December 31, 2010, and \$412 million at December 31, 2009.

The projected benefit obligation exceeded the fair value of pension plan assets as of December 31, 2010 and 2009. The following table shows the aggregate projected and accumulated benefit obligations and the fair value of plan assets as of those dates.

December 31 (Thousands)	2010	2009
Projected benefit obligation	\$454,556	\$438,858
Accumulated benefit obligation	\$425,923	\$411,736
Fair value of plan assets	\$432,731	\$421,197

#### ***Components of net periodic benefit cost and other amounts recognized in regulatory assets and regulatory liabilities:***

Years ended December 31, (Thousands)	Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009
<b>Net periodic benefit cost</b>				
Service cost	\$4,576	\$4,334	\$564	\$581
Interest cost	24,541	25,708	4,613	4,692
Expected return on plan assets	(36,183)	(36,506)	-	-
Amortization of prior service cost	1,298	1,502	339	441
Amortization of net loss (gain)	7,463	6,303	(1,565)	(1,818)
Special termination benefits	6,379	-	-	-
Amortization of transition obligation	-	-	1,827	1,827
Net periodic benefit cost	\$8,074	\$1,341	\$5,778	\$5,723
<b>Other changes in plan assets and benefit obligations recognized in regulatory assets and regulatory liabilities</b>				
Net loss (gain)	\$4,851	\$(31,029)	\$7,399	\$(576)
Amortization of net (loss) gain	(7,463)	(6,303)	1,565	1,818
Amortization of prior service (cost)	(1,298)	(1,502)	(339)	(441)
Amortization of transition obligation	-	-	(1,827)	(1,827)
Total recognized in regulatory assets and regulatory liabilities	\$(3,910)	\$(38,834)	\$6,798	\$(1,026)
Total recognized in net periodic benefit cost and regulatory assets and regulatory liabilities	\$4,164	\$(37,493)	\$12,576	\$4,697

We include the net periodic benefit cost in other operating expenses. The net periodic benefit cost for postretirement benefits represents the amount expensed for providing health care benefits to retirees and their eligible dependents. We expect to recover any deferred postretirement costs by 2012. We are amortizing over 20 years the transition obligation for postretirement benefits that resulted from our adoption in 1992 of the accounting requirements concerning employers' accounting for postretirement benefits other than pensions.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Amounts expected to be amortized from regulatory assets or regulatory liabilities into net periodic benefit cost for the fiscal year ending

December 31, 2011 (Thousands)	Pension Benefits	Postretirement Benefits
Estimated net loss (gain)	\$9,561	\$(1,135)
Estimated prior service cost	\$1,140	\$325
Estimated transition obligation	-	\$1,827

We expect that no pension benefit or postretirement benefit plan assets will be returned to us during the fiscal year ended December 31, 2011.

Weighted-average assumptions used to determine benefit obligations at December 31,	Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009
Discount rate	5.00%	5.80%	5.00%	5.80%
Rate of compensation increase	4.00%	4.00%	N/A	N/A

As of December 31, 2010, we decreased our discount rate from 5.80% to 5.00%. The discount rate is the rate at which the benefit obligations could presently be effectively settled. We determined the discount rate by developing a yield curve derived from a portfolio of high grade noncallable bonds that closely matches the duration of the expected cash flows of our benefit obligations.

Weighted-average assumptions used to determine net periodic benefit cost for year ended December 31,	Pension Benefits		Postretirement Benefits	
	2010	2009	2010	2009
Discount rate	5.80%	6.10%	5.80%	6.10%
Expected long-term return on plan assets	8.75%	8.75%	N/A	N/A
Rate of compensation increase	4.00%	4.00%	N/A	N/A

We developed our expected long-term rate of return on plan assets assumption based on a review of long-term historical returns for the major asset classes, the target asset allocations and the effect of rebalancing of plan assets discussed below. That analysis considered current capital market conditions and projected conditions. We amortize unrecognized actuarial gains and losses over 10 years from the time they are incurred.

Assumed health care cost trend rates to determine benefit obligations at December 31,	2010	2009
Health care cost trend rate assumed for next year	7.8%	8.0%
Rate to which cost trend rate is assumed to decline (the ultimate trend rate)	4.5%	4.5%
Year that the rate reaches the ultimate trend rate	2028	2028

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

(Thousands)	1% Increase	1% Decrease
Effect on total of service and interest cost	\$(15)	\$11
Effect on postretirement benefit obligation	\$(255)	\$193

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**Plan assets:** Iberdrola USA's pension benefits plan assets are held in a master trust providing for a single trustee/custodian, a uniform investment manager lineup, and an efficient, cost-effective means of allocating expenses and investment performance to each plan under the master trust. Iberdrola USA's primary investment objective is to ensure that current and future benefits obligations are adequately funded and with volatility commensurate with its tolerance for risk. Preservation of capital and achievement of sufficient total return to fund accrued and future benefits obligations are of highest concern. Iberdrola USA's primary means for achieving capital preservation is through diversification of the trust's investments while avoiding significant concentrations of risk in any one area of the securities markets. Within each asset group, further diversification is achieved through utilizing multiple asset managers and systematic allocation to various asset classes, providing broad exposure to different segments of the equity, fixed-income and alternative investment markets.

Iberdrola USA's asset allocation policy is the most important consideration in achieving its objective of superior investment returns while minimizing risk. Iberdrola USA has established a target asset allocation policy within allowable ranges for the pension benefits plan assets of 56% equity securities, 30% fixed income and 14% for all other types of investments. The target allocations within allowable ranges are further diversified into 28% large cap domestic equities, 7% medium and small cap domestic equities, 5% emerging markets, and 16% international equity securities. Fixed income investment targets and ranges are segregated into long dated corporate securities 17%, annuity contracts 5%, and 25 year zero coupon bonds 8%. All fixed income investments are in domestic securities. Other, alternative investment targets are 4% for real estate, and 10% for absolute return and strategic markets. Systematic rebalancing within the target ranges, should any asset categories drift outside their specified ranges, increases the probability that the annualized return on the investments will be enhanced, while realizing lower overall risk.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

The fair values of Iberdrola USA consolidated pension benefits plan assets at December 31, 2010 and 2009, by asset category are shown in the following table. RG&E's share of the total consolidated assets is approximately 20% for 2010 and 19% for 2009.

Asset Category	Total	Fair Value Measurements at December 31, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2010</b>				
Cash and cash equivalents	\$49,214	\$734	\$48,480	-
U.S. government securities	52,122	52,122	-	-
Common stocks	1,036,468	749,565	286,903	-
Registered investment companies	85,923	85,923	-	-
Corporate bonds	183,186	-	183,186	-
Preferred stocks	7,039	7,039	-	-
Common/collective trusts	351,408	-	76,476	\$274,932
Partnership/joint venture interests	96,624	-	-	96,624
Real estate investments	45,374	-	-	45,374
Other investments, principally annuity and fixed income	243,841	21,817	31,712	190,312
Total	\$2,151,199	\$917,200	\$626,757	\$607,242
<b>2009</b>				
Cash and cash equivalents	\$38,248	\$927	\$37,321	-
U.S. government securities	49,619	49,619	-	-
Common stocks	1,000,311	997,495	2,816	-
Registered investment companies	119,155	119,155	-	-
Corporate bonds	364,243	-	364,243	-
Preferred stocks	6,916	6,916	-	-
Common/collective trusts	358,201	-	62,557	\$295,644
Partnership/joint venture interests	93,269	-	-	93,269
Real estate investments	40,618	-	-	40,618
Other investments, principally annuity and fixed income	183,173	20,784	31,265	131,124
Total	\$2,253,753	\$1,194,896	\$498,202	\$560,655

Valuation techniques: Iberdrola USA values the pension benefits plan assets as follows:

- Cash and cash equivalents – Level 1: at cost, plus accrued interest, which approximates fair value. Level 2: proprietary cash associated with other investments, based on yields currently available on comparable securities of issuers with similar credit ratings.
- U.S. government securities, Common stocks and Registered investment companies - at the closing price reported in the active market in which the security is traded.
- Corporate bonds – based on yields currently available on comparable securities of issuers with similar credit ratings.
- Preferred stocks – at the closing price reported in the active market in which the individual investment is traded.
- Common/collective trusts and Partnership/joint ventures – using the Net Asset Value (NAV) provided by the administrator of the fund. The NAV is based on the value of the underlying assets owned by the fund, minus its liabilities, and then divided by the number of shares outstanding. The NAV is classified as Level 2 if the plan has the ability to redeem the investment with the investee at NAV per share at the measurement date. Redemption

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

restrictions or adjustments to NAV based on unobservable inputs result in the fair value measurement being classified as Level 3 if those inputs are significant to the overall fair value measurement.

- Real estate investments – based on a discounted cash flow approach that includes the projected future rental receipts, expenses and residual values because the highest and best use of the real estate from a market participant view is as rental property.
- Other investments, principally annuity and fixed income - Level 1: at the closing price reported in the active market in which the individual investment is traded. Level 2: based on yields currently available on comparable securities of issuers with similar credit ratings. Level 3: when quoted prices are not available for identical or similar instruments, under a discounted cash flows approach that maximizes observable inputs such as current yields of similar instruments but includes adjustments for certain risks that may not be observable such as credit and liquidity risks.

(Thousands)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)					Total
	Corporate Bonds	Common/Collective Trusts	Partnership/Joint Venture Interests	Real Estate Investments	Other Investments	
<b>Balance, December 31, 2008</b>	\$112	\$432,918	\$106,819	\$58,687	\$156,149	\$754,685
Actual return on plan assets:						
Relating to assets still held at the reporting date	-	2,557	2,565	-	-	5,122
Relating to assets sold during the year	-	112,364	3,869	(19,345)	-	96,888
Purchases, sales and settlements	(112)	(252,195)	(19,984)	1,276	(25,025)	(296,040)
Transfers into and/or out of Level 3	-	-	-	-	-	-
<b>Balance, December 31, 2009</b>	-	295,644	93,269	40,618	131,124	560,655
Actual return on plan assets:						
Relating to assets still held at the reporting date	-	4,678	-	-	110	4,788
Relating to assets sold during the year	-	41,218	3,207	4,163	510	49,098
Purchases, sales and settlements	-	(66,608)	148	593	58,568	(7,299)
Transfers into and/or out of Level 3	-	-	-	-	-	-
<b>Balance, December 31, 2010</b>	-	\$274,932	\$96,624	\$45,374	\$190,312	\$607,242

Diversified equity securities did not include any Iberdrola common stock at December 31, 2010.

### Cash Flows

**Contributions:** In accordance with our funding policy we make annual contributions of not less than the minimum required by applicable regulations. We do not expect to contribute to our pension benefit plans in 2011 and we expect to contribute \$7 million to our other postretirement benefit plans in 2011.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**Estimated future benefit payments:** Our expected benefit payments and expected Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) subsidy receipts, which reflect expected future service, as appropriate, are:

	Pension Benefits	Postretirement Benefits	Medicare Act Subsidy Receipts
(Thousands)			
2011	\$41,646	\$6,117	\$217
2012	\$41,371	\$6,719	\$215
2013	\$42,761	\$6,717	\$210
2014	\$43,202	\$6,669	\$205
2015	\$43,284	\$6,569	\$202
2016 - 2020	\$200,173	\$31,729	\$1,045

#### Note 11. Regulatory Proceedings

In September 2009 we filed rate cases with the NYPSC requesting approval to increase the rates we charge to deliver electricity and natural gas by a total of \$150 million. The rate filings requested an allowed rate of return on equity (ROE) of 11.43% applied to an equity ratio of 48%.

On September 16, 2010, the NYPSC approved a new rate plan for our electric and natural gas service effective August 26, 2010, through December 31, 2013. Major provisions of the plan include:

- Approximate delivery rate increases as follows (in millions of dollars):

Rate year ending August 31,	Electric	Natural Gas
2011	\$15.6 (4.1%)	\$10.9 (8.0%)
2012	\$10.2 (2.6%)	\$10.9 (7.3%)
2013	\$13.2 (3.2%)	\$11.0 (6.9%)

- The delivery rate increases were moderated and levelized through the use of \$125 million in positive benefits adjustments (PBAs), including \$15 million of carrying costs, that were required and set aside for the benefit of ratepayers when Iberdrola, S.A. acquired RG&E in 2008. The PBAs will be utilized as follows: in September 2010 a one-time write-off of \$25.0 million, which is offset by write-offs of deferred storm costs of \$18.9 million, \$6.1 million in property tax; amortizations during the rate years ended August 31 of: \$28.7 million in 2011, \$15.4 million in 2012, \$13.9 million in 2013; and \$4.6 million in the four months ended December 31, 2013. The balance of \$37.9 million will be utilized at a later time.
- Rates were set to allow for the recovery, over the 40 months of the rate plan, of regulatory assets of \$102.5 million net of regulatory liabilities.
- The recovery in rates includes \$6.8 million for the cost to achieve efficiency initiatives through workforce initiatives (see Note 1). The rate increases were moderated with \$2.5 million in annual net savings from workforce reduction and related labor cost-cutting initiatives, and were further moderated by a one percent annual productivity adjustment.
- To resolve a number of disputed items related to the annual compliance filings, including the calculation of earnings sharing accruals, RG&E will absorb \$20 million of prior losses from interest rate hedges, we will add \$6.5 million to the ASGA, and we wrote off \$9.0 million of investment in Integrated Back Office and Work Management System software. In December 2009 we established a reserve of \$10 million for that contingency, which was reversed as a result of the rate decision.

## **Notes to Financial Statements**

### **Rochester Gas and Electric Corporation**

- The revenue requirements are based on a 10% allowed ROE applied to an equity ratio of 48 percent. Beginning in 2011, if earnings exceed the allowed return, a tiered earnings sharing mechanism (ESM) will capture a portion of the excess for the benefit of ratepayers. The ESM is subject to specified downward adjustments if we fail to meet certain reliability and customer service measures.
- Key components of the rate plan include electric reliability performance mechanisms, natural gas safety performance measures, customer service quality metrics and targets, and electric distribution vegetation management programs that establish threshold performance targets. There will be downward revenue adjustments if we fail to meet the targets.
- Low-income program budgets have been increased to approximately \$6.9 million. All home energy assistance program recipients will be eligible for the program.
- New revenue decoupling mechanisms (RDMs), intended to remove company disincentives to promote increased energy efficiency were established. Under the RDMs, electric revenues are based on revenue per customer class rather than billed revenue, while natural gas revenues are based on revenue per customer. Any shortfalls (excesses) between billed revenues and allowed revenues will be accrued for future recovery (refund).

Under the merger order prescribed by the NYPSC, our customers were to receive \$110 million in PBAs. Those benefits were to be used, over time, to either reduce rates or moderate requested rate increases. Conditions were also established to ensure that ratepayers receive a portion of any added benefits associated with synergy savings and efficiency gains produced by the transaction. We recorded the PBAs in September 2008, in accordance with the merger order, as a regulatory liability with an offsetting charge to income, and accrued a carrying cost at the pretax rate allowed by the NYPSC until used for the benefit of customers. Carrying costs, which are included in interest expense, were \$6 million in 2010 and \$8 million in 2009.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

As part of the new rate plan, we offset the PBAs and other regulatory liabilities against certain regulatory assets. In addition, we established a regulatory asset to allow recovery of the special termination benefits and severance and other costs associated with workforce initiatives (see Note 1), and wrote off some undepreciated fixed assets and reversed a reserve established in December 2009. The effects on net income of the various adjustments to regulatory assets and regulatory liabilities are:

Description	Income Statement Line Item	Increase (Decrease) in Net Income
(Millions)		
Elimination of annual compliance filing reserve regulatory liability	Electric operating revenue	\$10.0
ASGA	Electric operating revenue	(6.5)
Interim period adjustment	Electric operating revenue	1.9
	Total Electric Operating Revenue	5.4
Elimination of PBA regulatory liability	Other operating expenses	25.0
Elimination of storm costs regulatory assets	Maintenance	(19.2)
Establishment of cost to achieve efficiency regulatory asset*	Other operating expenses	7.9
Elimination of property taxes	Other taxes	(6.1)
Property, plant and equipment	Depreciation and amortization	(9.0)
	Total Operating Expenses	(1.4)
	Income Before Income Taxes	4.0
Income tax effect	Income Taxes	(1.6)
	Net Income	\$2.4

\*Relates to the recovery of special termination benefit costs (see Note 1).

Beginning on September 1, 2012, RG&E will amortize \$5.25 million per year of a theoretical excess depreciation reserve of \$105 million. The amortization amount reflects a 20-year amortization period. Theoretical excess depreciation is the difference between actual accumulated depreciation taken to date and a theoretical reserve. The actual accumulated depreciation is the result of depreciation rates allowed in prior rate orders based on estimates of useful lives and net salvage values as determined in those cases. The theoretical reserve is the amount that would have accumulated if the depreciation rates in the new rate plan had been in place for the entire useful lives of the affected assets. Differences between the actual reserve and the theoretical reserve are normal aspects of utility ratemaking. The usual treatment is to flow any excess or deficiency back as an adjustment to depreciation expense over the remaining life of the property. However, in accordance with the new rate plan, we will moderate electric rates by recording the theoretical reserve amortization as a debit to accumulated depreciation and a credit to other revenues, and normalize the amortization from a tax perspective.

#### **Note 12. Sale of Fossil Fuel Generation Assets**

Iberdrola, in connection with receiving authorization from the NYPSC in September 2008 to acquire Energy East, agreed to sell certain fossil fuel generation assets owned by RG&E. In its order authorizing the acquisition, the NYPSC directed Iberdrola and the other petitioners in the acquisition proceeding to develop, in collaboration with interested parties, a divestiture plan for the fossil fuel generation assets. Iberdrola and Energy East filed the divestiture plan with the NYPSC in November 2008. The NYPSC issued an order approving the divestiture plan as filed, effective November 17, 2009.

## **Notes to Financial Statements**

### **Rochester Gas and Electric Corporation**

The divestiture plan required the generation assets to be sold at auction in a two-stage process, and included extensive consultation with the NYPSC Staff concerning the auction process. The auction process would be suspended, but not terminated, if bids obtained were priced at less than the current net book value of the assets (approximately \$6 million at December 31, 2009). Iberdrola/RG&E would then petition the NYPSC for guidance on the next steps to be taken. The resulting auction process did not yield any conforming bids which met the minimum threshold. On December 29, 2010, we filed a petition with the NYPSC requesting permission to terminate the auction process.

As a result of the unsuccessful auction process we performed an impairment test of all long-lived assets not included in regulated rates. We determined that no impairment of long-lived assets had occurred.

We have determined that the criteria are not met in order to classify the assets as held for sale. In addition, the net book value of the assets is immaterial to our balance sheet.