

**Rochester Gas and Electric Corporation**  
**Financial Statements**  
**For the Years Ended December 31, 2009 and 2008**

# Rochester Gas and Electric Corporation

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**Report of Independent Auditors**

To the Shareholder 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 at December 31, 2009 and 2008, 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 30, 2010

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

Year Ended December 31, (Thousands)	2009	2008
<b>Operating Revenues</b>		
Electric	\$648,892	\$685,979
Natural gas	360,970	433,133
<b>Total Operating Revenues</b>	<b>1,009,862</b>	<b>1,119,112</b>
<b>Operating Expenses</b>		
Electricity purchased and fuel used in generation	297,125	308,182
Natural gas purchased	211,046	281,962
Other operating expenses	222,294	198,604
Positive benefit adjustments	-	110,239
Maintenance	35,348	35,683
Depreciation and amortization	67,008	66,569
Other taxes	74,370	75,841
<b>Total Operating Expenses</b>	<b>907,191</b>	<b>1,077,080</b>
<b>Operating Income</b>	<b>102,671</b>	<b>42,032</b>
<b>Other (Income)</b>	<b>(4,208)</b>	<b>(6,421)</b>
<b>Other Deductions</b>	<b>863</b>	<b>2,400</b>
<b>Interest Charges, Net</b>	<b>75,391</b>	<b>54,845</b>
<b>Income (Loss) Before Income Taxes</b>	<b>30,625</b>	<b>(8,792)</b>
<b>Income Taxes (Benefit)</b>	<b>6,016</b>	<b>(12,818)</b>
<b>Net Income</b>	<b>\$24,609</b>	<b>\$4,026</b>

The notes on pages 6 through 31 are an integral part of our financial statements.

**Rochester Gas and Electric Corporation**  
**Balance Sheets**

December 31, (Thousands)	2009	2008
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$6,136	\$7,147
Accounts receivable and unbilled revenues, net	184,550	220,064
Affiliated accounts receivable	13,616	12,979
Natural gas in storage, at average cost	27,934	55,843
Materials and supplies, at average cost	9,586	11,912
Deferred income taxes	11,857	22,777
Broker margin accounts	8,217	42,217
Prepayments and other current assets	37,757	32,876
<b>Total Current Assets</b>	<b>299,653</b>	<b>405,815</b>
<b>Utility Plant, at Original Cost</b>		
Electric	1,453,104	1,408,409
Natural gas	620,339	613,785
Common	208,872	212,256
	<b>2,282,315</b>	<b>2,234,450</b>
Less accumulated depreciation	632,284	599,298
<b>Net Utility Plant in Service</b>	<b>1,650,031</b>	<b>1,635,152</b>
Construction work in progress	55,845	68,071
<b>Total Utility Plant</b>	<b>1,705,876</b>	<b>1,703,223</b>
<b>Other Property and Investments</b>	<b>17,483</b>	<b>18,526</b>
<b>Regulatory and Other Assets</b>		
Regulatory assets		
Nuclear plant obligations	74,315	104,535
Pension and other postretirement benefits	118,526	157,361
Environmental remediation costs	79,008	78,250
Unfunded future income taxes	130,722	91,900
Unamortized loss on debt reacquisitions	9,920	11,209
Nonutility generator termination agreements	45,355	54,577
Natural gas hedges	5,474	27,272
Other	123,229	109,832
Total regulatory assets	586,549	634,936
Other assets		
Other	20,185	13,005
Total other assets	20,185	13,005
<b>Total Regulatory and Other Assets</b>	<b>606,734</b>	<b>647,941</b>
<b>Total Assets</b>	<b>\$2,629,746</b>	<b>\$2,775,505</b>

The notes on pages 6 through 31 are an integral part of our financial statements.

**Rochester Gas and Electric Corporation**  
**Balance Sheets**

<b>December 31,</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands, except shares)</b>		
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Current portion of long-term debt	-	\$100,000
Notes payable	<b>\$16,000</b>	97,040
Notes payable to affiliates	-	91,500
Accounts payable and accrued liabilities	<b>24,488</b>	52,551
Accounts payable to affiliates	<b>18,158</b>	15,340
Accounts payable, natural gas purchased	<b>18,015</b>	23,812
Accounts payable, electricity purchased	<b>22,025</b>	22,233
Interest accrued	<b>14,985</b>	12,811
Taxes accrued	<b>1,682</b>	20,432
Derivative liabilities	<b>5,295</b>	33,430
Environmental remediation costs	<b>10,850</b>	9,518
Other	<b>45,611</b>	33,446
<b>Total Current Liabilities</b>	<b>177,109</b>	512,113
<b>Regulatory and Other Liabilities</b>		
Regulatory liabilities		
Accrued removal obligations	<b>203,493</b>	196,351
Deferred income taxes	<b>42,109</b>	56,366
Positive benefit adjustments	<b>120,018</b>	112,371
Gain on sale of generation assets	<b>5,390</b>	56,553
Other	<b>80,305</b>	70,366
Total regulatory liabilities	<b>451,315</b>	492,007
Other liabilities		
Deferred income taxes	<b>259,694</b>	196,895
Nuclear plant obligations	<b>121,808</b>	121,636
Pension and other postretirement benefits	<b>90,921</b>	128,540
Asset retirement obligations	<b>16,075</b>	14,508
Environmental remediation costs	<b>65,706</b>	66,743
Derivative liabilities	<b>179</b>	56,191
Other	<b>25,662</b>	27,803
Total other liabilities	<b>580,045</b>	612,316
<b>Total Regulatory and Other Liabilities</b>	<b>1,031,360</b>	1,104,323
Long-term debt	<b>818,400</b>	633,570
<b>Total Liabilities</b>	<b>2,026,869</b>	2,250,006
<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, 2009 and 2008)	<b>194,429</b>	194,429
Capital in excess of par value	<b>509,943</b>	484,943
Retained earnings	<b>83,739</b>	59,130
Accumulated other comprehensive (loss)	<b>(67,996)</b>	(95,765)
Treasury stock, at cost (4,379 shares at December 31, 2009 and 2008)	<b>(117,238)</b>	(117,238)
<b>Total Common Stock Equity</b>	<b>602,877</b>	525,499
<b>Total Liabilities and Equity</b>	<b>\$2,629,746</b>	\$2,775,505

The notes on pages 6 through 31 are an integral part of our financial statements.

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

Year Ended December 31, (Thousands)	2009	2008
<b>Operating Activities</b>		
Net income	\$24,609	\$4,026
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	69,723	68,920
Amortization of regulatory and other assets and liabilities, net	57,866	49,075
Deferred income taxes and investment tax credits, net	39,620	(6,433)
Positive benefit adjustments including carrying costs	7,647	112,371
Pension expense (income)	1,341	(20,084)
Changes in current operating assets and liabilities		
Accounts receivable and unbilled revenues, net	34,877	6,667
Inventory	30,235	(9,426)
Broker margin accounts	34,000	(24,665)
Prepayments and other current assets	(10,057)	(14,673)
Accounts payable and accrued liabilities	(31,250)	(2,181)
Interest accrued	2,174	760
Taxes accrued	(19,755)	(445)
Other current liabilities	12,165	(313)
Changes in other assets		
Nonbypassable charges	(4,515)	(6,197)
Other	(32,941)	(26,173)
Changes in other liabilities		
Asset sale gain account charges	(84,549)	(51,172)
Reserve on regulatory assets	11,442	-
Other	4,094	5,796
<b>Net Cash Provided by Operating Activities</b>	<b>146,726</b>	<b>85,853</b>
<b>Investing Activities</b>		
Utility plant additions	(63,863)	(141,743)
Investments, net	(384)	(8,820)
<b>Net Cash Used in Investing Activities</b>	<b>(64,247)</b>	<b>(150,563)</b>
<b>Financing Activities</b>		
Equity contribution from parent	25,000	908
Derivative activity, net	(20,900)	(100,413)
Long-term note issuances	184,950	150,000
Long-term note repayments	(100,000)	(89,500)
Notes payable three months or less, net	(172,540)	131,240
Dividends paid on common stock	-	(25,000)
<b>Net Cash (Used in) Provided by Financing Activities</b>	<b>(83,490)</b>	<b>67,235</b>
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	<b>(1,011)</b>	<b>2,525</b>
<b>Cash and Cash Equivalents, Beginning of Year</b>	<b>7,147</b>	<b>4,622</b>
<b>Cash and Cash Equivalents, End of Year</b>	<b>\$6,136</b>	<b>\$7,147</b>

The notes on pages 6 through 31 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 Shares	Common Stock \$5 Par Value Amount	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
<b>Balance, January 1, 2008</b>	38,886	\$194,429	\$484,035	\$80,104	\$(8,696)	\$(117,238)	\$632,634
Net income				4,026			4,026
Other comprehensive (loss), net of tax					(87,069)		(87,069)
Comprehensive (loss)							(83,043)
Equity contribution from parent			908				908
Common stock dividends declared				(25,000)			(25,000)
<b>Balance, December 31, 2008</b>	<b>38,886</b>	<b>194,429</b>	<b>484,943</b>	<b>59,130</b>	<b>(95,765)</b>	<b>(117,238)</b>	<b>525,499</b>
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>	<b>38,886</b>	<b>\$194,429</b>	<b>\$509,943</b>	<b>\$83,739</b>	<b>\$(67,996)</b>	<b>\$(117,238)</b>	<b>\$602,877</b>

The notes on pages 6 through 31 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 gas turbine plants and several smaller hydroelectric stations. RG&E serves approximately 364,000 electricity and 301,000 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, 2009, for inclusion in these financial statements through March 30, 2010, which is the date these financial statements were available to be issued. (See "New accounting standards adopted," "Subsequent events," below.)

Effective September 16, 2008, Energy East Corporation (Energy East) became a wholly-owned subsidiary of Iberdrola, S.A. (Iberdrola), a corporation organized under the laws of the Kingdom of Spain. The merger provided for a business combination whereby Energy East and its subsidiaries, including RG&E, became wholly-owned subsidiaries of Iberdrola. The merger was completed through the acquisition by a subsidiary of Iberdrola, of all the outstanding common stock of Energy East. The effects of the merger required for accounting purposes, including any allocation of goodwill, were not pushed down to Energy East or RG&E. The accompanying financial statements have not been adjusted to reflect Iberdrola's basis in Energy East, or its subsidiaries including RG&E. On December 1, 2009, Energy East changed its legal and operating name to Iberdrola USA, Inc.

Under the merger order prescribed by the New York Public Service Commission (NYPSC), our customers will receive \$110 million in positive benefit adjustments (PBAs). Those benefits will, over time, be used 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. The PBAs were recorded in September 2008, in accordance with the merger order, as a regulatory liability with an offsetting charge to income, and will accrue a carrying cost at the pretax rate allowed by the NYPSC until used for the customers' benefit. Carrying costs, which are included in interest expense, were \$9.8 million in 2009 and \$2 million in 2008.

As part of an effort to reduce costs and increase efficiency, we have undertaken various measures to reduce workforce levels in 2010. On January 29, 2010, workforce levels were reduced through an involuntary separation. On February 12, 2010, we offered a voluntary early retirement program to our employees. Eligible employees who accept the offer will receive a pension that is enhanced by the annuity value of one week's pay for every full year of service and not reduced by the normal early retirement factors. Eligible employees have until April 2, 2010 to make their decision to accept the early retirement package. As of the date of these financial statements, an estimate of the impact to the Company can not be determined.

RG&E received an equity contribution from Iberdrola USA in November 2009.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**Accounts receivable:** Accounts receivable at December 31 include unbilled revenues of \$47 million for 2009 and \$53 million for 2008, and are shown net of an allowance for doubtful accounts at December 31 of \$20 million for 2009 and 2008. Accounts receivable do not bear interest, although late fees may be assessed. Bad debt expense was \$20 million in 2009 and \$25 million in 2008.

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 and other economic data. 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 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 such as economic conditions and customer receivables, which are inherently uncertain and susceptible to change from period to period, could significantly affect the allowance for doubtful accounts estimates.

**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 2009 and \$15 million for 2008. The ARO consists primarily of obligations related to removal or retirement of: asbestos, polychlorinated biphenyl (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.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

The following table reconciles the beginning and ending aggregate carrying amount of the ARO for the years ended December 31, 2009 and 2008. The increase in 2009 primarily relates to revisions in estimated cash flows and the increase in 2008 is due to normal accretion.

<b>Year ended December 31,</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
ARO, beginning of year	<b>\$14,508</b>	\$13,575
Liabilities settled during the year	<b>(493)</b>	(702)
Accretion expense	<b>412</b>	676
Revisions in estimated cash flows	<b>1,648</b>	959
ARO, end of year	<b>\$16,075</b>	\$14,508

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 gas and electric 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 sheet. That amount decreased \$34 million in 2009 due to decreased derivative liabilities.

***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>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Cash paid (received) during the year ended December 31:		
Interest, net of amounts capitalized	<b>\$50,657</b>	\$43,890
Income taxes received, net of taxes paid	<b>\$(15,224)</b>	\$(5,115)

The amount of interest capitalized was less than \$0.5 million in 2009 and \$1.9 million in 2008.

***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 – 58 years, distribution property – 53 years, generation property – 31 years and other property – 32 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 2.9% of average depreciable property for 2009 and 2.8% for 2008.

## Notes to Financial Statements

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

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.

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

***Disclosures about derivative instruments and hedging activities:*** In March 2008 the FASB issued a new standard that requires enhanced disclosures about an entity's derivative instruments and hedging activities to enable investors to better understand their effects on the entity's financial position, financial performance and cash flows. The enhanced disclosures are intended to improve transparency about the location and amounts of derivative instruments in an entity's financial statements and how the entity accounts for derivative instruments and related hedged items. Requirements include: disclosure of fair values of derivative instruments and their gains and losses in a tabular format, disclosure of derivative features that are credit risk-related, and cross-referencing within the notes to enable financial statement users to locate important information about derivative instruments. The new standard is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. In years after initial adoption, comparative disclosures are required only for periods subsequent to initial adoption. Our adoption of the new requirements effective for our financial statements issued for fiscal years and interim periods beginning on or after January 1, 2009, did not affect our financial position, results of operation or cash flows. (See Note 7.)

***Fair value measurements:*** The FASB has issued a number of new standards related to fair value measurements. The initial new standard was issued in September 2006, which we adopted effective January 1, 2008, for our fair value measurements of financial assets and financial liabilities. Changes as a result of the application of the new standard relate to the definition of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. The new standard applies under other accounting pronouncements that require or permit fair value measurements in which the FASB previously concluded that fair value is the relevant measurement attribute, but does not require any new fair value measurements.

The FASB issued a related new standard in February 2008 that was effective upon issuance. It delayed the effective date of the initial fair value measurement standard for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually), to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. It also requires additional disclosures concerning application of the provisions of the initial fair value measurement standard.

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.

Our adoption of the various new standards related to fair value measurements had no effect on our financial position, results of operation or cash flows.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

Postretirement benefit plan assets disclosures: In December 2008 the FASB issued a new standard that amends the disclosures an employer is required to provide about its pensions and other postretirement benefits, to improve disclosures about postretirement benefit plan assets. The improved disclosures include objectives and other information concerning fair value measurements of plan assets, and must be provided for fiscal years ending after December 15, 2009. Our application of the new standard beginning with the annual reporting period ending December 31, 2009, did not affect our financial position, results of operation or cash flows. (See Note 10.)

Subsequent events: In May 2009 the FASB issued a new standard to establish principles and requirements concerning accounting for and disclosure of subsequent events – events that occur after the balance sheet date but before the financial statements are issued or available to be issued. The new accounting standard is based on the same principles as in the existing auditing standard, with new terminology as to the evaluation of subsequent events either as of the date the financial statements are “issued” or “available to be issued”. We adopted the new standard as of June 30, 2009, and it had no effect on our financial position, results of operation or cash flows. (See “Background,” above, for the required disclosure.)

***New accounting standards issued but not yet adopted:*** New accounting standard issued by the FASB that we have not yet adopted in these financial statements are as explained below.

Disclosures about fair value measurements: In January 2010 the FASB issued amendments to improve disclosures about fair value measurements. New disclosures that 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 amendments as they become effective will not affect our results of operation, financial position or cash flows.

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

<b>Year Ended December 31,</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Interest and dividend income	<b>\$(255)</b>	\$(4,065)
Allowance for funds used during construction	-	(1,818)
Carrying costs on regulatory assets	<b>(3,953)</b>	(314)
Miscellaneous	-	(224)
<b>Total other (income)</b>	<b>\$(4,208)</b>	\$(6,421)
Civic donations	<b>\$321</b>	\$1,228
Miscellaneous	<b>542</b>	1,172
<b>Total other deductions</b>	<b>\$863</b>	\$2,400

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**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. 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 \$51 million in 2009 and \$44 million in 2008.

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>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Loss on sale of Oswego generating unit	<b>\$22,467</b>	\$28,943
Deferred storm costs	<b>20,711</b>	23,411
Asset retirement obligations	<b>10,133</b>	11,273
Nonbypassable wire charge	<b>10,712</b>	6,197
Property taxes	<b>33,711</b>	18,185
Outreach and education program	<b>6,861</b>	6,853
Deferred natural gas costs	<b>5,683</b>	-
Other	<b>24,393</b>	14,970
Reserve on regulatory assets	<b>(11,442)</b>	-
<b>Total other regulatory assets</b>	<b>\$123,229</b>	\$109,832
Pension	<b>\$24,929</b>	\$33,897
Nuclear fuel disposal	<b>5,981</b>	5,924
Decommissioning	<b>11,339</b>	9,585
Property tax	<b>6,712</b>	6,301
Economic development	<b>13,378</b>	4,936
Other	<b>17,966</b>	9,723
<b>Total other regulatory liabilities</b>	<b>\$80,305</b>	\$70,366

## Notes to Financial Statements

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

**Regulatory proceeding:** On September 17, 2009, we filed rate cases for our electric and natural gas businesses with the NYPSC. The rate cases request approval to increase the rates that we charge to deliver electricity and natural gas by a total of \$150 million. If approved, the proposed rates would ensure that we can meet our increasing cost of service and achieve an adequate return on investment. The increases would be the first for the company since the mid-1990s.

Under the proposed delivery rates, the typical RG&E total residential electricity bill would increase approximately 16.1% and the typical RG&E total residential natural gas heating bill would increase approximately 15.2%. The rate filings request an 11.43% ROE and a 48% equity ratio.

On January 22, 2010, the NYPSC Staff filed its testimony and exhibits related to the rate filings. Staff's testimony recommended a \$10 million or 7.9% delivery, net rate increase for our rate filings. Staff's proposal included ROEs of 9.8% and accepted our proposed 48% equity ratio. The NYPSC Staff also proposed one-time charges of \$29 million related to historical annual compliance filings and accounting for certain software costs. In addition, Staff has proposed that the Company absorb \$30 million of interest rate hedge losses. On February 12, 2010, we filed our rebuttal testimony and revised the requested rate increases to a total of \$105 million. Settlement discussions occurred during February and on February 26, 2010 the parties agreed to suspend hearings for 30 days to continue settlement discussions. If no settlement is reached, then hearings will begin on April 12, 2010. A decision by the NYPSC is expected in the summer of 2010.

**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 Management Corporation was approximately \$30 million for 2009 and \$25 million for 2008.

**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.

**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 the 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.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

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 charge 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 evaluation, as considered necessary. Actual results could differ from those estimates.

#### Note 2. Income Taxes

<b>Year Ended December 31,</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Current		
Federal	<b>\$(26,436)</b>	\$(1,283)
State	<b>(7,168)</b>	(5,102)
Current taxes charged to expense	<b>(33,604)</b>	(6,385)
Deferred		
Federal	<b>32,982</b>	(5,674)
State	<b>7,491</b>	495
Deferred taxes charged to expense	<b>40,473</b>	(5,179)
Investment tax credit adjustments	<b>(853)</b>	(1,254)
<b>Total</b>	<b>\$6,016</b>	\$(12,818)

The significant decrease in current income tax expense in 2009 as compared to 2008 is driven primarily by the effect of filing the 2008 federal and state income tax returns in September 2009. Those filings included a significant one-time tax deduction related to previously capitalized repair costs. The one-time deduction is a temporary difference between book and tax expense and requires normalization, resulting in an offsetting deferred tax expense, which is the primary driver of the significant increase in deferred income tax expense in 2009 as compared to 2008.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

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

Year Ended December 31, (Thousands)	2009	2008
Tax expense at statutory rate	\$10,719	\$(3,077)
Depreciation and amortization not normalized	(145)	(1,086)
Investment tax credit amortization	(853)	(1,254)
State taxes, net of federal benefit	210	(2,995)
Cost of removal, not normalized	(1,976)	(2,013)
Medicare subsidy	(167)	(145)
Tax return and audit adjustments	(1,567)	(1,028)
Other, net	(205)	(1,220)
<b>Total</b>	<b>\$6,016</b>	<b>\$(12,818)</b>

Income taxes were \$4.7 million less in 2009 than they would have been at the federal statutory rate of 35% and \$9.7 million less in 2008. 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 effective tax rate was less than the statutory rate in 2008 due primarily to the reversal of reserves resulting from the favorable resolution of federal and state tax audits, recurring flow-through items and the effects of the differences in the 2007 filed tax return compared to the 2007 booked tax expense. The variance in state taxes, net in 2009 as compared to 2008, is driven primarily by the increase in pretax income. The effective tax rate is not a meaningful value in 2008 due to the level of pretax income (a loss of \$8.8 million).

Our deferred tax assets and liabilities consisted of:

December 31, (Thousands)	2009	2008
<b>Current Deferred Income Tax Assets</b>		
Derivative assets	\$2,074	\$13,244
Other	9,783	9,533
<b>Total Current Deferred Income Tax Assets</b>	<b>\$11,857</b>	<b>\$22,777</b>
<b>Noncurrent Deferred Income Tax Liabilities (Assets)</b>		
Depreciation	\$281,980	\$260,293
Unfunded future income taxes	49,860	36,406
Accumulated deferred investment tax credits	3,502	4,355
Deferred loss on sale of generation assets	38,248	20,555
Derivative asset	(40,926)	(48,071)
Pension	33,165	28,228
Other postretirement benefits	(32,338)	(30,623)
PBA merger order	(47,545)	(44,516)
Other	15,857	26,634
<b>Total Noncurrent Deferred Income Tax Liabilities</b>	<b>\$301,803</b>	<b>\$253,261</b>
Less amounts classified as regulatory liabilities		
Deferred income taxes	42,109	56,366
<b>Noncurrent Deferred Income Tax Liabilities</b>	<b>\$259,694</b>	<b>\$196,895</b>
Deferred tax assets	\$135,655	\$145,987
Deferred tax liabilities	425,601	376,471
<b>Net Accumulated Deferred Income Tax Liabilities</b>	<b>\$289,946</b>	<b>\$230,484</b>

## 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>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Balance as of January 1	<b>\$692</b>	\$2,391
Increases for tax positions related to prior years	<b>4,154</b>	-
Reductions for tax positions related to prior years	<b>(692)</b>	-
Decreases for positions related to settlements with taxing authority	-	(1,699)
<b>Balance as of December 31</b>	<b>\$4,154</b>	<b>\$692</b>

The total gross unrecognized tax benefits as of December 31, 2009, were \$4.3 million, including income taxes of \$4.2 million and interest of \$0.1 million. Including interest, \$0.1 million of the gross unrecognized tax benefits would affect the effective tax rate, if recognized. Gross income tax reserves increased by \$4.2 million in 2009 primarily due to accelerated deductions taken on the 2008 federal and state tax returns. Gross income tax reserves decreased by \$0.7 million in 2009 primarily due to the expiration of state statutes.

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 2005. Our federal returns for 2006 through 2008 are currently under review. We anticipate that the reviews will be completed in 2011. We cannot predict the ultimate outcome of the reviews.

### Note 3. Long-term Debt

At December 31, 2009 and 2008, RG&E's long-term debt was:

	<b>Interest Rates</b>	<b>Maturity</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>				
<b>First mortgage bonds<sup>(1)</sup></b>				
Series B	7.60%	2009	-	100,000
Series TT	6.95%	2011	<b>\$161,000</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>	-
PCN 2009	4.75%	2032	<b>10,500</b>	2,750
PCN 2004 Series B	5.375%	2032	<b>50,000</b>	50,000
PCN Series C	5.00%	2032	<b>29,350</b>	-
<b>Total first mortgage bonds</b>			<b>725,850</b>	<b>638,750</b>
<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
1997 Series C	2.165%	2032	-	2,150
<b>Total unsecured PCNs, variable</b>			<b>68,000</b>	<b>70,150</b>
Unamortized discount on debt			<b>(950)</b>	(830)
Less debt due within one year, included in current liabilities			-	(100,000)
<b>Total</b>			<b>\$818,400</b>	<b>\$633,570</b>

<sup>(1)</sup> RG&E's first mortgage bonds are secured by a first mortgage lien on substantially all of its properties. RG&E has no other secured indebtedness. None of RG&E's other debt obligations are guaranteed or secured by any of its affiliates.

## Notes to Financial Statements

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

As of December 31, 2009, we had outstanding \$183.5 million of tax-exempt pollution control notes, of which \$75.5 million have coupons fixed to maturity, \$40.0 million are notes with a mandatory redemption date in 2016 and \$68 million are 35-day auction rate notes.

As of December 31, 2008, we had outstanding \$187.9 million of tax-exempt pollution control notes, of which \$75.5 million have coupons fixed to maturity, \$10.5 million are 7-day auction rate notes and \$101.9 million are 35-day auction rate notes.

In response to market disruptions triggered by downgrades of bond insurers that began in the first quarter of 2008, we began in August 2008 to place orders for our own accounts in the auctions for \$44.4 million 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. The securities we held pursuant to this program were remarketed as mandatory tender bonds in August 2009.

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, \$4.6 million of PCN 1997 Series C bonds were retired 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 19, 2010, we were paying rates averaging .60% on the remaining \$68 million of auction rate notes for which we are not placing orders at auction.

Beginning in May 2006 we entered into a series of derivative transactions – forward starting swaps – intended to hedge \$150 million of financing transactions in December 2008 and \$100 million in October 2009. The hedges that settled in December 2008, at a loss of \$100.4 million, were in connection with the pricing of our Series XX 8.00% Bonds due December 15, 2033. Our inability to issue the Series XX Bonds prior to receiving authorization from the NYPSC and the sharp decline in treasury yields and swap rates in November and December 2008 contributed to the magnitude of the loss on the hedges.

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, 2009, long-term debt, including sinking fund obligations (in thousands), that will become due during the next five years is:

<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
-	\$161,000	-	-	-

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

**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 party with the other Iberdrola USA operating utilities in a joint revolving credit facility. The joint facility provides up to \$475 million of credit in aggregate to the joint borrowers. Sublimits that total to the aggregate limit apply to each borrower and can be altered within constraints imposed by maximum limits that apply to each borrower. RG&E's credit limit under the joint facility is \$100 million at December 31, 2009, and \$100 million at March 19, 2010. The joint facility expires in 2012 and requires a fee on undrawn borrowing capacity. We pay a facility fee of 10 basis points annually on our current joint facility sublimit.

We use drawings on our credit facilities to finance working capital needs, to temporarily finance certain refundings and for other corporate purposes. We had a \$16 million note payable outstanding at December 31, 2009. We had \$189 million of short-term debt outstanding at December 31, 2008, including \$97 million borrowed under the joint facility and \$92 million borrowed from Iberdrola USA under a demand note. The weighted average interest rate on short-term debt was 0.58% at December 31, 2009, and 1.64% at December 31, 2008. At March 19, 2010, there was no debt outstanding under the joint credit facility.

In our revolving credit facility we covenant not to permit, without the consent of the lender, our ratio of indebtedness to total capitalization to exceed 0.65 to 1.00 at any time. 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 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 0.55 to 1.00 at December 31, 2009. We were not in default as of December 31, 2009.

We also have an intercompany borrowing 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, 2009 and March 12, 2010. Iberdrola USA obtains funding for its own short-term needs and for the temporary needs of its subsidiaries 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, 2009, Iberdrola USA had borrowed \$93 million of the \$300 million available under its facility.

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. 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 0.55 to 1.00 at December 31, 2009. Iberdrola USA was not in default as of December 31, 2009.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Note 5. Commitments and Contingencies

**Capital spending:** We have commitments in connection with our capital spending program. The NYPSC merger order contains a capital expenditure condition for RG&E of a total of \$220 million during 2009 and 2010. The company has requested a limited waiver of the capital expenditure merger condition to allow it to spend its capital investment by 2011. The request is pending before the PSC. We plan to invest approximately \$1.2 billion in our energy delivery infrastructure during the next five years, including amounts dedicated to electric reliability. Capital spending is expected to be paid for principally with funds generated from debt security and equity infusion. The program is subject to periodic review and revision. Our capital spending will be principally for necessary improvements to existing facilities, the extension of energy delivery service, compliance with environmental requirements and governmental mandates and an Infrastructure Replacement Program.

**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 currently in effect, but has not completed its analysis. We believe that it has been properly calculating the amount due to customers in its annual compliance filings since 2004, but cannot predict how the matter will be resolved. We reduced our regulatory assets by \$10 million as a result of the uncertainty related to this proceeding.

**Nuclear entitlement power purchase contracts:** In connection with our sales of nuclear generating assets in 2001 and 2004, we entered into two entitlement contracts under which we purchase electricity at a fixed contract price. We expensed approximately \$227 million for nuclear entitlement power in 2009, and \$217 million in 2008. We estimate that our nuclear entitlement power purchases will be \$237 million in 2010, \$219 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.

The United States Environmental Protection Agency and various state environmental agencies, as appropriate, notified us that we are among the potentially responsible parties who 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 \$1.3 million related to another six sites where we believe it is probable that we will incur remediation and/or monitoring costs, although we have not been notified that we are among the potentially

## Notes to Financial Statements

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

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 \$175 million at December 31, 2009. The 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, 2009, and \$71 million at December 31, 2008. We recorded a corresponding regulatory asset, net of insurance recoveries, because we expect to recover the net costs in rates.

Our environmental liability accruals are recorded on an undiscounted basis. We received insurance settlements during the last two years which we accounted for as reductions in 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 risks we manage by using derivative instruments are interest rate risk and commodity price risk. In accordance with the accounting requirements concerning derivatives 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.

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 will no longer offer fixed price service to our 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

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

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.

Owned electric generation and long-term supply contracts reduce our exposure to market fluctuations.

We have purchased gas adjustment clauses that allow 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.

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

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

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

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

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

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

Period Ended	Gain (Loss) Recognized in OCI on Derivatives	Location of Gain (Loss) Reclassified 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
December 31, 2009					
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>	
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 direct costs	(674)		-
<b>Total</b>	<b>\$(39,829)</b>		<b>\$(27,562)</b>		<b>-</b>

<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 amounts in OCI related to previously settled treasury lock contracts, after tax and accumulated amortization, at December 31 is a net (loss) of \$(108.6) million for 2009 and \$(92.4) million for 2008.

As of December 31, 2009, we reported \$(23.0) million in net derivative (losses) related to discontinued cash flow hedges. At December 31, 2009, \$60 thousand in gains are reported in OCI because the forecasted transaction is considered to be probable. We expect that \$60 thousand of gains in OCI will be reclassified into earnings within the next 12 months.

As of December 31, 2009, the maximum length of time over which we are hedging our exposure to the variability in future cash flows for forecasted energy transactions was 16 months – through April 2011. We estimate that no losses will be reclassified from accumulated other comprehensive income into earnings during 2010, as the underlying transactions occur.

We face risk 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.

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 we had no right to reclaim

## Notes to Financial Statements

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

or obligation to return cash collateral at December 31, 2009, and our right to reclaim cash collateral was \$14 million at December 31, 2008.

Certain of our derivative instruments contain provisions that require us to maintain an investment grade credit rating on our debt 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, 2009, is \$5.5 million for which we have posted collateral of \$2.8 million in the normal course of business. If the credit-risk-related contingent features underlying those agreements were triggered on December 31, 2009, we would be required to post an additional \$2.7 million of collateral to 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.

<b>December 31,</b>	<b>2009</b>		<b>2008</b>	
	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>	<b>Carrying Amount</b>	<b>Estimated Fair Value</b>
<b>(Thousands)</b>				
First mortgage bonds	<b>\$724,900</b>	<b>\$772,270</b>	\$637,920	\$653,969
Pollution control notes, fixed	<b>\$25,500</b>	<b>\$25,147</b>	\$25,500	\$20,136
Pollution control notes, variable	<b>\$68,000</b>	<b>\$59,178</b>	\$70,150	\$70,150

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 that 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)	Total	Fair Value Measurements at December 31, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>2009</b>				
<b>Assets</b>				
Noncurrent investments available for sale, other	\$15,811	\$15,811	-	-
Derivatives	60	-	-	\$60
Total	\$15,871	\$15,811	-	\$60
<b>Liabilities</b>				
Derivatives	\$5,474	\$5,474	-	-
Total	\$5,474	\$5,474	-	-
<b>2008</b>				
<b>Assets</b>				
Noncurrent investments available for sale, other	\$16,776	\$16,776	-	-
Total	\$16,776	\$16,776	-	-
<b>Liabilities</b>				
Derivatives	\$89,621	\$27,271	-	\$62,350
Total	\$89,621	\$27,271	-	\$62,350

*Valuation techniques:* We measure the fair value of our noncurrent investments available for sale, other 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, but also include some fixed income and equity investments.

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

- We enter into electric energy derivative contracts to hedge the forecasted purchases required to serve our electric load obligations. We hedge our electric load obligations using derivative contracts that are settled based upon Locational Based Marginal Pricing published by the NYISO. Forward market price quotes for some NYISO locations are not actively traded and not readily available outright from market dealers. We derive forward market prices for some locations based on the historical relationship of prices in those locations to prices in locations where an active market exists. The resulting value represents the derived forward market price for each location, which we use to value the open derivative contracts. Because we adjust quoted market prices for our own load characteristics, we include those fair value measurements in Level 3.
- 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

- We enter into treasury-related derivative contracts to hedge the forecasted issuance of debt, to manage the risk of changes in interest rates associated with existing debt, and to maintain desired fixed-to-floating rate ratios. We value those derivatives based on indicative values provided by transaction counterparties and calculated based upon proprietary models that use well-recognized financial principles and reasonable, market-based estimates of relevant future market conditions. We assess the reasonableness of the transaction counterparty valuations utilizing a model that constructs forward LIBOR rates from a spot LIBOR curve, applies the forward rates to construct pro forma cash flows and discounts the pro forma cash flows to the present using forward rates. Because the valuations provided by the counterparties are only indicative and do not represent prices at which the counterparties would be willing to transact, we include those fair value measurements in Level 3. We had no treasury-related derivative contracts at December 31, 2009.

#### ***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)	
	Derivatives, Net	
	2009	2008
Beginning balance	\$(62,350)	\$(18,243)
Total (losses) (realized/unrealized)		
Included in earnings	27,562	167
Included in other comprehensive income	(7,851)	(23,637)
Included in regulatory assets and liabilities	21,799	(20,637)
Purchases, issuances and settlements	20,900	-
Ending balance	\$60	\$(62,350)
Total gains for the period included in earnings attributable to the change in unrealized gains relating to assets still held at December 31, 2009	-	-

The amounts of realized and unrealized gains and losses included in earnings for the period (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,			
2009	\$21,907	\$674	\$4,981
2008	\$639	\$(472)	-
Changes in unrealized gains (losses) relating to assets still held at December 31,			
2009	-	-	-
2008	-	-	-

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### Note 9. Accumulated Other Comprehensive Loss

	Balance January 1, 2008	2008 Change	Balance December 31, 2008	2009 Change	Balance December 31, 2009
<b>(Thousands)</b>					
Net unrealized holding gains (losses) on investments, net of income tax benefit (expense) of \$244 for 2008 and \$(13) for 2009	\$389	\$(372)	\$17	\$19	\$36
Amortization of pension cost for nonqualified plans, net of income tax (expense) benefit of \$(478) for 2008 and \$110 for 2009	(3,048)	728	(2,320)	(168)	(2,488)
Unrealized (losses) gains on derivatives qualified as hedges:					
Unrealized (losses) gains during period on derivatives qualified as hedges, net of income tax benefit (expense) of \$17,592 for 2008 and \$(15,778) for 2009		(26,815)		24,051	
Reclassification adjustment for losses included in net income, net of income tax (benefit) of \$(119) for 2008 and \$(8,945) for 2009		181		13,636	
Net unrecognized (losses) on settled cash flow treasury hedges, net of income tax benefit of \$39,881 for 2008 and \$6,409 for 2009		(60,791)		(9,769)	
Net unrealized (losses) gains on derivatives qualified as hedges	(6,037)	(87,425)	(93,462)	27,918	(65,544)
<b>Accumulated Other Comprehensive (Loss) Income</b>	<b>\$(8,696)</b>	<b>\$(87,069)</b>	<b>\$(95,765)</b>	<b>\$27,769</b>	<b>\$(67,996)</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	
	2009	2008	2009	2008
<b>(Thousands)</b>				
<b>Change in benefit obligation</b>				
Benefit obligation at January 1	\$437,818	\$457,167	\$79,203	\$80,856
Service cost	4,334	4,489	581	611
Interest cost	25,708	26,586	4,692	4,774
Plan participants' contributions	-	-	3,035	3,232
Plan amendments	-	27	-	(1,010)
Actuarial loss (gain)	8,470	(2,259)	(576)	(1,291)
Benefits paid	(37,472)	(48,192)	(8,093)	(8,115)
Federal subsidy on benefits paid	-	-	236	146
<b>Benefit obligation at December 31</b>	<b>\$438,858</b>	<b>\$437,818</b>	<b>\$79,078</b>	<b>\$79,203</b>
<b>Change in plan assets</b>				
Fair value of plan assets at January 1	\$382,663	\$583,680	-	-
Actual return on plan assets	76,006	(152,825)	-	-
Employer contributions	-	-	\$5,058	\$4,883
Plan participants' contributions	-	-	3,035	3,232
Benefits paid	(37,472)	(48,192)	(8,093)	(8,115)
<b>Fair value of plan assets at December 31</b>	<b>\$421,197</b>	<b>\$382,663</b>	<b>-</b>	<b>-</b>
<b>Funded status at December 31</b>	<b>\$(17,661)</b>	<b>\$(55,155)</b>	<b>\$(79,078)</b>	<b>\$(79,203)</b>
<b>Amounts recognized in the balance sheet</b>				
<b>December 31,</b>	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>				
Current liability	-	-	\$(6,391)	\$(5,818)
Noncurrent liability	\$(17,661)	\$(55,155)	(72,687)	(73,385)
	<b>\$(17,661)</b>	<b>\$(55,155)</b>	<b>\$(79,078)</b>	<b>\$(79,203)</b>

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	
	2009	2008	2009	2008
<b>(Thousands)</b>				
<b>December 31,</b>				
Net loss (gain)	\$110,054	\$147,387	\$(12,111)	\$(13,352)
Prior service cost	\$8,472	\$9,974	\$1,024	\$1,465
Transition obligation	-	-	\$3,655	\$5,482

Our accumulated benefit obligation for all defined benefit pension plans was \$412 million at December 31, 2009, and \$409 million at December 31, 2008.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

The projected benefit obligation exceeded the fair value of pension plan assets as of December 31, 2009 and 2008. The accumulated benefit obligation exceeded the fair value of pension plan assets as of December 31, 2008. The following table shows the aggregate projected and accumulated benefit obligations and the fair value of plan assets as of those dates.

<b>December 31</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>		
Projected benefit obligation	<b>\$438,858</b>	\$437,818
Accumulated benefit obligation	<b>\$411,736</b>	\$408,758
Fair value of plan assets	<b>\$421,197</b>	\$382,663

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

<b>Years ended December 31,</b>	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
<b>(Thousands)</b>				
<b>Net periodic benefit cost</b>				
Service cost	<b>\$4,334</b>	\$4,489	<b>\$581</b>	\$611
Interest cost	<b>25,708</b>	26,585	<b>4,692</b>	4,774
Expected return on plan assets	<b>(36,506)</b>	(46,615)	-	-
Amortization of prior service cost	<b>1,502</b>	1,502	<b>441</b>	859
Amortization of net loss (gain)	<b>6,303</b>	(6,045)	<b>(1,818)</b>	(1,895)
Amortization of transition obligation	-	-	<b>1,827</b>	1,827
Net periodic benefit cost (income)	<b>\$1,341</b>	\$(20,084)	<b>\$5,723</b>	\$6,176
<b>Other changes in plan assets and benefit obligations recognized in regulatory assets and regulatory liabilities</b>				
Net (gain) loss	<b>\$(31,029)</b>	\$197,182	<b>\$(576)</b>	\$(1,291)
Prior service cost	-	27	-	(1,010)
Amortization of net (loss) gain	<b>(6,303)</b>	6,045	<b>1,818</b>	1,895
Amortization of prior service (cost)	<b>(1,502)</b>	(1,502)	<b>(441)</b>	(859)
Amortization of transition obligation	-	-	<b>(1,827)</b>	(1,827)
Total recognized in regulatory assets and regulatory liabilities	<b>\$(38,834)</b>	\$201,752	<b>(1,026)</b>	\$(3,092)
Total recognized in net periodic benefit cost and regulatory assets and regulatory liabilities	<b>\$(37,493)</b>	\$181,668	<b>\$4,697</b>	\$3,084

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

<b>December 31, 2010</b>	<b>Pension Benefits</b>	<b>Postretirement Benefits</b>
<b>(Thousands)</b>		
Estimated net loss (gain)	\$7,463	\$(1,875)
Estimated prior service cost	\$1,298	\$339
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, 2010.

<b>Weighted-average assumptions used to determine benefit obligations at December 31,</b>	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Discount rate	<b>5.80%</b>	6.10%	<b>5.80%</b>	6.10%
Rate of compensation increase	<b>4.00%</b>	4.00%	<b>N/A</b>	N/A

As of December 31, 2009, we decreased our discount rate from 6.10% to 5.80%. 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.

<b>Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31,</b>	<b>Pension Benefits</b>		<b>Postretirement Benefits</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Discount rate	<b>6.10%</b>	6.00%	<b>6.10%</b>	6.00%
Expected long-term return on plan assets	<b>8.75%</b>	8.75%	<b>N/A</b>	N/A
Rate of compensation increase	<b>4.00%</b>	4.00%	<b>N/A</b>	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 either over 10 years from the time they are incurred or using the standard amortization methodology, under which amounts in excess of 10% of the greater of the projected benefit obligation or market-related value are amortized over the plan participants' average remaining service to retirement.

<b>Assumed health care cost trend rates to determine benefit obligations at December 31,</b>	<b>2009</b>	<b>2008</b>
Health care cost trend rate assumed for next year	<b>8.00%</b>	8.00%
Rate to which cost trend rate is assumed to decline (the ultimate trend rate)	<b>4.50%</b>	5.00%
Year that the rate reaches the ultimate trend rate	<b>2028</b>	2014

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:

<b>(Thousands)</b>	<b>1% Increase</b>	<b>1% Decrease</b>
Effect on total of service and interest cost	\$(1)	\$(2)
Effect on postretirement benefit obligation	\$(252)	\$201

## 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 58% equity securities, 27% fixed income and 15% for all other types of investments. The target allocations within allowable ranges are further diversified into 30% large cap domestic equities, 10% medium and small cap domestic equities and 18% international equity securities. Fixed income investment targets and ranges are segregated into core fixed income at 5%, long dated corporate securities 6%, annuity contracts 13% and high yield fixed income 3%. All fixed income investments are in domestic securities. Other, alternative investment targets are 5% each for real estate, 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.

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

Asset Category	Total	Fair Value Measurements at December 31, 2009, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>(Thousands)</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
<b>Total</b>	<b>\$2,253,753</b>	<b>\$1,194,896</b>	<b>\$498,202</b>	<b>\$560,655</b>

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

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 restrictions or adjustments to NAV based on unobservable inputs result in the fair value measurement being classified as a Level 3 measurement 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

Diversified equity securities did not include any Iberdrola common stock at December 31, 2009.

## Notes to Financial Statements

### Rochester Gas and Electric Corporation

#### 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 and we expect to contribute \$6 million to our other postretirement benefit plans in 2010.

**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)			
2010	\$41,224	\$6,622	\$231
2011	\$43,765	\$6,630	\$229
2012	\$43,611	\$6,587	\$225
2013	\$45,563	\$6,534	\$217
2014	\$45,661	\$6,452	\$211
2015 - 2019	\$207,265	\$31,173	\$1,062

#### Note 11. 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.

The generation assets are to be sold at auction, in a two-stage process. Extensive consultation with the NYPSC Staff concerning the auction process is required and is currently ongoing. The auction process would be suspended, but not terminated, if bids obtained are 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. RG&E will be allowed to retain 10% of the net proceeds realized from the auction of its fossil fuel generation assets, up to a maximum pretax ceiling of \$5 million.

We have determined that all of the criteria are not yet 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.