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February 20, 2007

**VIA ELECTRONIC FILING**

The Honorable Magalie Roman Salas  
Secretary  
Federal Energy Regulatory Commission  
888 First Street, N.E.  
Washington, DC 20426

**Re: ISO New England Inc., Docket No. ER07-116-000;  
Reply Comments of ISO New England Inc.**

Dear Secretary Salas:

Transmitted electronically for filing in the referenced docket are the Reply Comments of ISO New England Inc.

If there are any questions concerning this filing, please call me at (202) 661-2212.

Very truly yours,

*/s/ Daniel R. Simon*

Daniel R. Simon  
Counsel for  
ISO New England Inc.

Enclosures

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**ISO New England Inc.**

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**Docket No. ER07-116-000**

**REPLY COMMENTS OF ISO NEW ENGLAND INC.**

In accordance with the Order Accepting and Suspending Tariff Revisions, Subject to Refund, and Establishing Paper Hearing issued December 21, 2006 by the Federal Energy Regulatory Commission (“Commission”), *ISO New England Inc.*, 117 FERC ¶ 61,310 (2006) (the “Order”), ISO New England Inc. (the “ISO” or “ISO-NE”) provides these reply comments in the form of a brief with exhibits. As discussed below, the ISO asks the Commission to reject the arguments raised by the New England Advocates (“Advocates”) and leave the ISO’s average service lives and salvage values unaltered.<sup>1</sup>

**I. DOCUMENTS SUBMITTED WITH THIS BRIEF**

In support of these comments, the ISO submits the following exhibits:

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|---------------------|---|
| Exhibit No. ISO-7 - | Affidavit of Robert C. Ludlow, Vice President and Chief Financial Officer, ISO New England Inc. |
| Exhibit No. ISO-8 - | Simplified cash flow analysis of impact of Advocates’ depreciation recommendations              |
| Exhibit No. ISO-9 - | Documentation of bond counsel analysis of building provided to the ISO                          |

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<sup>1</sup> Capitalized terms not defined herein have the meanings ascribed thereto in the ISO New England Inc. Transmission, Markets and Services Tariff, FERC Electric Tariff No. 3 (the “Tariff”).

## II. DISCUSSION

The Commission should reject the Advocates' recommendations on service lives and salvages values, and continue to accept the ISO's existing depreciation rates as just and reasonable. As the following discussion explains:

- The ISO adequately explained in its initial brief how it has developed its average service lives and net salvage values, including its determination to premise its current capital budget and building funding mechanisms on the existing depreciation rates, on a just and reasonable basis. These rates fall well within the zone of reasonableness.
- It is just and reasonable for the ISO to maintain the current depreciation rates in light of the financial consequences the ISO and its customers would face by having to adjust established funding mechanisms. The Advocates' approach would artificially lower the ISO's rates in the short term. Although this approach might appear appealing at first, the ISO does not believe it is fiscally responsible.
- The Commission should reject Mr. Pous' assertions that the ISO was required or should have provided more detailed depreciation studies and that the ISO should have hired an outside depreciation expert, because the circumstances here do not warrant it, and much of Mr. Pous' testimony is either not based on expert analysis or fails to distinguish material facts unique to the ISO.
- The Advocates' failure to use the Commission-approved stakeholder process to raise their concerns is another factor favoring acceptance of the ISO's service life and salvage value principles.
- Nevertheless, if the Commission accepts the Advocates' arguments, its Order on Paper Hearing should recognize that projects will be deferred, additional borrowings will be required, or that Market Participants will need to supply capital funding directly under Section IV.B of the Tariff.

### A. **The ISO Has Adequately Explained How It Has Developed Its Average Service Lives and Net Salvage Values**

As a non-profit entity in which neither the organization as a whole nor any individual employees have any financial incentive to implement depreciation rates unfavorable to its

Customers,<sup>2</sup> the ISO has adopted and implemented just and reasonable service lives and salvage values that provide a fiscally responsible approach for consumers. As the following section demonstrates, the ISO's service lives and salvage values are consistent with the ISO's actual experience and independent analysis, and it was just and reasonable for the ISO to premise its current capital budget and building funding mechanisms on these depreciation rates.

**1. The Service Lives and Salvage Values Are Consistent With Actual Experience and Independent Analysis and, Therefore, Just and Reasonable**

The Advocates ask the Commission to force the ISO to change the depreciation rates the ISO utilizes for two categories: computer software and hardware and the new office building. The ISO believes it has adequately explained how it determined its depreciation rates, and why it is just and reasonable to *maintain these current rates*. Specifically, Mr. Robert C. Ludlow, ISO-NE Vice President and Chief Financial Officer, explained how the ISO determined the service lives based on actual experience (for, *inter alia*, software and hardware) and independent third-party analysis (for the building). The Advocates also ask the Commission to require the ISO to provide, in the future, additional information regarding its depreciation practices. The ISO believes it provides sufficient information through its annual administrative cost recovery filing, annual capital budget filing, quarterly capital budget reports, annual financial statements, and the stakeholder process.

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<sup>2</sup> The Advocates allege that the ISO's employees have a financial incentive to depreciate expenditures more quickly to make "the utility's balance sheet and management look better, leading to greater job security and higher pay for those employees." Advocates Reply Brief at 14. In response, Mr. Ludlow explains that the ISO does not tie any salaries or bonuses to the depreciation rates used by the ISO, or to the outcome of this proceeding. Exhibit No. ISO-7 at ¶ 10.

**Software and Hardware.** The ISO's use of a 3-year average service life for computer hardware and software is consistent with historical experience and additional replacements currently being developed to implement Commission-required or approved Tariff changes.<sup>3</sup> As Mr. Ludlow's affidavit explained, the vast majority of the expenditures included in this category involve the costs the ISO incurs for implementing Tariff changes, mainly market rule changes.<sup>4</sup> Such changes occur frequently. The ISO has needed to replace major software projects on a roughly three-year cycle.<sup>5</sup> Additional changes currently being developed by the ISO to be implemented in 2007 and 2008 are consistent with this approach.<sup>6</sup>

**Building.** The ISO developed a 25-year average service life for its building expenditures based on the opinion of independent bond counsel.<sup>7</sup> The analysis of bond counsel that was supplied to the ISO is included herein as Exhibit No. ISO-9. Relying on this independent third-party analysis was just and reasonable. In addition, the ISO bundled various types of building costs to arrive at the average service life of 25 years.<sup>8</sup>

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<sup>3</sup> See generally Exhibit No. ISO-1 at ¶¶ 27-32.

<sup>4</sup> *Id.* at ¶ 27; Exhibit No. ISO-2.

<sup>5</sup> *Id.* at ¶¶ 27-29.

<sup>6</sup> *Id.* at ¶¶ 31-32.

<sup>7</sup> *Id.* at ¶ 33.

<sup>8</sup> Specifically, the building costs are generally made up of three categories of tangible and real property with varying useful lives: (i) 40 years for the steel and concrete of the structure; (ii) 25 years for mechanical and electrical work; and (iii) 15 years for high wear and tear items, including paint, carpeting, millwork, roofing, and folding partitions. ISO Brief at 17; Exhibit No. ISO-1 at ¶ 34.

**Salvage Value.** It was just and reasonable for the ISO to not carry positive salvage value because, as Mr. Ludlow explained, doing so would require the ISO to incur additional debt costs to pass on to consumers.<sup>9</sup> Unlike investor-owned utilities, the ISO has no return on capital included in its rates and, consequently, no retained earnings from which to draw to cover positive salvage value.<sup>10</sup> Furthermore, as Mr. Ludlow attested, the ISO typically is unable to obtain salvage value for depreciated items when disposed of, including computer hardware and software.<sup>11</sup>

**Additional Information.** The Advocates also ask the Commission require the ISO to segregate its investment into “rational” sub-accounts for accounting and reporting purposes and to identify the dollar level of software investment subject to each enhancement. The ISO believes it already provides sufficient information through its quarterly capital budget reports filed with the Commission, which explains how each expenditure is being depreciated. The annual capital budget filing thoroughly explains each capital project forecast for the upcoming calendar year, and the quarterly reports explain how much the ISO actual spent for each project, along with changes to the different projects. The ISO also posts its annual financial statements, which include the depreciation rates and related information. Finally, the annual administrative

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<sup>9</sup> *Id.* at ¶¶ 20-23.

<sup>10</sup> *Id.* at ¶ 20.

<sup>11</sup> *Id.* at ¶ 38.

cost recovery filing identifies the different expenditures by year incurred and by category, with a breakdown of how each is being depreciated.<sup>12</sup>

**2. The ISO's Determination to Premise Its Current Capital Budget and Building Funding Mechanisms on the Existing Depreciation Rates Was Just and Reasonable**

Furthermore, the ISO explained why it was just and reasonable to use its depreciation rates to establish its capital budget funding mechanisms and, having now established these mechanisms, to continue with these depreciation rates. As Mr. Ludlow's affidavit explained, the ISO funds its annual capital budget through the September 2004 issue of \$39 million in 10-year private placement debt (the "Private Placement Note"), which was used to refinance \$39 million of existing term loan debt.<sup>13</sup> The ISO entered into the \$39 million Private Placement Note in 2004, with general support from stakeholders,<sup>14</sup> based on the ISO's analysis at the time that it would provide sufficient and cost-effective funding for its capital spending levels for the following ten years with an estimated annual capital spending program of \$20-23 million. Because the ISO has no equity, the Private Placement Note was designed *to reflect the current average service lives and no net salvage value for its depreciation expense, and conditioned on the ISO's ability to completely recover its costs each year.*<sup>15</sup>

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<sup>12</sup> The ISO included this exhibit as Exhibit No. ISO-2 in its initial brief. The ISO includes this exhibit every year in its annual filing to recover its administrative expenses.

<sup>13</sup> Exhibit No. ISO-1 at ¶ 15. The Commission authorized the ISO to issue up to \$39 million in senior unsecured notes in *ISO New England Inc.*, 108 FERC ¶ 62,049 (2004) (Letter Order). Previously, the ISO funded its capital expenditures through annual term loan borrowings.

<sup>14</sup> Exhibit No. ISO-1 at ¶ 19; Exhibit No. ISO-4.

<sup>15</sup> Exhibit No. ISO-1 at ¶ 17.

It is particularly important for the Commission to keep in mind the fact that the ISO merely recovers a return of, but not a return on, investment. Thus, the ISO's depreciation expense does not include a major component: profit. To the extent, *arguendo*, the Commission finds the ISO's depreciation rates slightly higher than might be expected for a similarly situated investor-owned utility, the resulting depreciation cost is more than offset by the absence of any return on investment.

**B. It Is Just and Reasonable for the ISO to Maintain the Current Depreciation Rates in Light of the Financial Consequences the ISO and Its Customers Would Face By Having to Adjust Its Established Funding Mechanisms**

Further supporting the justness and reasonableness of maintaining the current depreciation rates is a consideration of the adverse financial impact of adopting the changes recommended by the Advocates. As discussed below, following the Advocates' approach would increase the ISO's borrowing costs by about \$2 million a year for an indefinite extended period. Importantly, any inter-generational ramifications of current depreciation policies have a *de minimis* impact on consumers, yet following the Advocates' approach would result in a permanent rate *increase* beginning four years out. Although the Advocates' approach would artificially lower the ISO's rates in the short term, the ISO does not believe implementing such an approach is fiscally responsible.

First, the Advocates suggestion would, over time, cost consumers more. In order to implement the depreciation expense reductions as proposed by the Advocates without reducing capital spending levels, the ISO would need to borrow an additional \$36.5 million for the foreseeable future.<sup>16</sup> Mr. Ludlow has calculated the cost of these additional borrowings to

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<sup>16</sup> Exhibit No. ISO-7 at ¶ 4.

increase the ISO's annual revenue requirement by an average of approximately \$2 million a year.<sup>17</sup> Based on current capital budget spending levels as previously vetted with stakeholders, such costs would constitute a new and nearly permanent fixture in the ISO's Operating Expense Budget used to establish its rates. As explained below, this cost would offset much of the deferred depreciation (as urged by the Advocates) in the first few years, and would constitute a permanent rate increase in future years.

Second, the basic premise of the Advocates' comments – that the ISO's proposed accrual rates cause significant inter-generational cross-subsidization of future electricity customers by current customers – is not supported by the facts.<sup>18</sup> If the Advocates' approach were accepted, in the first three years, the ISO's rates would decrease by a *de minimis* amount. Specifically, implementing the Advocates' approach, including the additional debt costs the ISO would incur to support that approach, the average New England consumer would save approximately \$0.94 in year one, \$1.10 in year 2, and \$0.43 in year three. By year four, in part due to the additional \$2 million annual cost for increased debt, the average New England consumer would incur an annual cost increase of \$0.07 in year four, \$0.32 in year five, \$0.39 in year six, and \$0.22 in year seven.<sup>19</sup> The resulting inter-generational shift in costs at issue, therefore, amounts to a shift of

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<sup>17</sup> *Id.*

<sup>18</sup> Included in Exhibit No. ISO-8 are two simplified cash flow worksheets prepared at Mr. Ludlow's direction demonstrating the Advocates' approach. The first worksheet shows the impact of the ISO's depreciation rates as filed on cash. The second sheet shows the impact on cash of the position proposed by the Advocates.

<sup>19</sup> Exhibit No. ISO-7 at ¶ 6. The ISO derived these figures by taking the differences in depreciation on the simplified worksheets, subtracting the increased cost of debt of approximately \$2 million a year, and dividing by the annual amount of energy consumed in New England (projected to be 133,977,000 MWh) times the average monthly consumer usage of 750 kWh times 12.

approximately \$1.47 per consumer over a seven-year period, or an average of \$0.21 a year,<sup>20</sup> hardly a significant inter-generational cross-subsidization, yet resulting in rate increases four years out.

Meanwhile, the \$2 million a year cost to support the additional borrowings would constitute a near-permanent cost – of needless interest expense – to each New England consumer of about \$0.13 a year.<sup>21</sup> In the long run, the ISO’s current approach would cost less in total dollars and result in lower rates in four years, thereby rebutting the Advocates’ contention that “[f]inancing long-lived assets with reasonable cost long-term debt actually lowers the overall economic costs for customers.”<sup>22</sup>

The Advocates’ recommendation to carry a 20 percent residual value for the building would create a particularly ill-conceived consequence for consumers. Although a for-profit utility could earn a return on its assets in order to pay for such investments, the ISO does not have retained earnings to cover such costs. The ISO must rely solely on debt to finance its capital expenditures, including the building. Any positive salvage value carried by the ISO represents the portion of the underlying loans that the ISO can never recover from Customers and, therefore, cannot pay the lender until such items are disposed of.<sup>23</sup> Carrying 20 percent salvage value for the building, for instance, represents a portion of the financing the ISO cannot

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<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Advocates Reply Brief at 15.

<sup>23</sup> Exhibit No. ISO-7 at ¶ 7.

repay until the building is disposed of. Thus, the ISO must incur additional, near-permanent debt to support such positive salvage value.

In light of the financial consequences discussed above, the ISO strongly disagrees with the Advocates' position that "to the extent that the ISO's financial plans were based on the cash flow from these overstated accrual rates then it should simply change its plans."<sup>24</sup> Whether it is just and reasonable to maintain the current service lives and salvage values depends on all relevant factors, including the ISO's financial mechanisms, any additional costs consumers might incur in the long run to alter those financial mechanisms, and the limited benefit to consumers any inter-generational shift in costs might accomplish. As previously discussed, there is a limited amount of alleged "inter-generational cross-subsidization," yet making such changes would increase carrying costs for generations of consumers. Furthermore, the Advocates argue against reality by contending that "depreciation accrual rates of particular assets should not, by themselves, determine the terms of any debt issuance."<sup>25</sup> The fact of the matter is the ISO's depreciation rates dictate the amount of capital the ISO has available at any one time in order to finance stakeholder-vetted, Commission-approved capital projects, as well as dictate when the ISO will be able to recover such expenditures to repay its lenders.

The Commission also should reject the Advocates' contention that its recommended changes would lower the overall economic costs for consumers because "a customer's discount rate (12 to 18 percent) is typically significantly higher than ISO's borrowing rate (5 to 7 percent),

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<sup>24</sup> Advocates Reply Brief at 14.

<sup>25</sup> *Id.*

therefore borrowing at ISO's lower cost rate actually benefits customers in the long run."<sup>26</sup>

Consumers do not earn 12 to 18 percent. Although it is possible that commercial and industrial customers might use this range as a return on investment goal when evaluating the procurement of equipment, but the ISO finds it hard to believe that the *de minimis* cash flow impact of implementing the Advocates' recommended depreciation changes, as analyzed above, would affect any consumers' decisions.

### **C. The Commission Should Reject Mr. Pous' Testimony**

In support of their position, the Advocates include with their comments the testimony of Mr. Jacob Pous. As discussed below, his testimony does not provide sufficient evidence or analysis to negate the fact that the ISO has demonstrated its service lives and salvage values to be just and reasonable.

#### **1. The Commission's Regulations Do Not Require Additional Depreciation Studies, and the Nature of the ISO's Expenditures Do Not Warrant the ISO's Incurring the Expense of Hiring an "Expert"**

As an initial point, the Advocates attack the ISO for failing to include any depreciation studies or testimony from a depreciation expert. The ISO believes that neither is warranted here.

The Commission's regulation do not require a public utility to include depreciation studies in a rate filing that, as is the case here, does not seek to change its depreciation rates.<sup>27</sup> Furthermore, the ISO does not own the type of assets owned by a traditional public utility or

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<sup>26</sup> *Id.* at 15.

<sup>27</sup> Mr. Pous fails to cite the controlling provision. The controlling provision is 18 C.F.R. § 35.13(h)(10)(iv). It only requires a public utility to include any depreciation studies if the depreciation rates included in the filing "differ from those employed to support the utility's prior approved jurisdictional electric rate ...."

natural gas pipeline that typically would warrant detailed engineering or economic studies seeking to estimate, for example, the estimated useful life of a generating unit, transmission line, or pipeline. The ISO's depreciation expense primarily involves computer hardware and software, particularly software to operate New England's wholesale energy-related markets. The frequency with which the ISO needs to replace or substantially modify such software is dictated by market rule changes, and economic or engineering analyses would have little relevance. Similarly, the unique nature of the ISO's building (*i.e.*, a control room, offices, and equipment specifically designed for the New England independent system operator) does not lend itself to traditional depreciation study analysis. In any event, the testimony of Mr. Ludlow provides sufficient analysis of how the ISO derived its depreciation rates, and how such rates either track actual ISO experience or, for the building, was based on independent third-party analysis. In response to Mr. Pous' request, the ISO includes herein as Exhibit No. ISO-9 the analysis of the building bond counsel had provided.

The ISO also did not hire an outside depreciation rate expert because, under these circumstances, doing so would have constituted an unnecessary expense for its customers to incur.<sup>28</sup> As Chief Financial Officer, Mr. Ludlow was a key decision-maker in determining the current service lives and salvage values, along with establishing the current capital expenditure financial mechanisms based in part on the resulting depreciation rates. Mr. Pous provided no evidence disputing the facts presented by Mr. Ludlow in his affidavit. Furthermore, the ISO does not believe it needs to hire an expert to rebut Mr. Pous' testimony, because so much of his

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<sup>28</sup> In light of the discussion herein, it is also unreasonable to saddle the ISO's customers with the additional expense of revamping its accounting to propagate extensive new sub-accounts not required by the Commission's regulations.

empirical “techniques” are based simply on (questionable) “common sense,”<sup>29</sup> and assertions unrelated to any depreciation expertise.<sup>30</sup> Provided below is a brief list of points highlighting the limitations of Mr. Pous’ analysis:

- **Lack of Retained Earnings and Need for Increased Borrowing Costs.** Mr. Pous’ testimony fails to address the most significant reason for retaining the current depreciation rates: the fact that Mr. Pous’ recommendations would *increase* the overall cost for consumers.
- **Software Service Life.** Mr. Pous fails to distinguish the market-operating software primarily at issue from everyday software used by many companies, and fails to compare the type of software in the underlying data by different traditional public utilities to that utilized by the ISO. The ISO’s market rules are far from static, thereby requiring frequent software turnover and major modifications. At best, Mr. Pous merely rounds up the ISO’s typical service life experience to four years instead of down to three years, as the ISO has done.
- **Building.** Mr. Pous incorrectly assumes that the ISO’s building is part of a homogenous market with other buildings in Holyoke that contain some form of office space and fails to provide any analysis recognizing the unique nature of the ISO’s building.<sup>31</sup> Moreover, there is no reason to credit Mr. Pous with

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<sup>29</sup> See, e.g., Pous Testimony at p. 4 (relying on “common sense,” and not expertise in engineering or an ability to predict as to when the ISO might need to replace or substantially renovate the building); *id.* at 5 (relying on “common sense” to support a change in the building’s salvage value, instead of any expert knowledge as to the market rate for a building specifically designed to be used by the New England independent system operator); *id.* at 12 (relying on “common sense” to conclude that electrical wiring within walls should last much longer than 25 years, without relying on any expertise in electrical and informational system wiring and the likelihood that such wiring might become obsolete or need to be replaced sooner).

<sup>30</sup> See, e.g., *id.* at 23 (estimating the salvage value of the building based on his experience in buying approximately three dozen properties, but only one office building, without relying on a real estate expert); *id.* at 23 (pulling off the internet comparables on some “office” buildings currently for sale in the Holyoke area without providing any real estate market expertise).

<sup>31</sup> Mr. Pous suggestion that the ISO’s building has 100 percent salvage value is also inappropriate. Following his logic that every building sells for more than it cost to construct (which clearly is not always the case), the Commission would never let any public utility depreciate a building.

“expertise” when it is based on telephoning an owner (for whose expertise Mr. Pous provides no basis) of a random building in the neighborhood of the ISO’s control center “in an effort to determine if there is anything that would cause the life expectancy in that very specific area to be in the range of a 40-year life span.”<sup>32</sup> Looking at buildings with office space still for sale (and not yet sold)<sup>33</sup> similarly provides little insight into the service life or salvage value for the ISO’s unique building. Hiring an appraiser, as suggested by Mr. Pous,<sup>34</sup> also would not address the unique nature of the ISO’s building in comparison to whatever more traditional office buildings in Holyoke might be worth. In contrast with Mr. Pous’ “common sense” regarding the service life for the electrical wiring,<sup>35</sup> the ISO obtained its 25-year service life determination for the electrical wiring within the building walls from the project manager himself.<sup>36</sup> Furthermore, regardless of the weighted average of the average service lives of the entities listed in Mr. Pous’ Exhibit JP-2, several have lengths less than the 25 years used by the ISO, including the entity with the largest balance on the list (Virginia Electric Power Co. with an average service life of 24.7 years). On Exhibit JP-3, Southern California Edison, which also has substantial building expense, uses a 30-year service life for Account 390 with a 10 percent *negative* salvage value.

- **Reliance on EEI/AGA study.** Mr. Pous relies heavily on data from an outdated EEI/AGA study<sup>37</sup> to support his service life recommendations. The ISO is unaware of any order issued by the Commission relying on the EEI/AGA study,<sup>38</sup> which provides little indication as to the types of expenditures being depreciated

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<sup>32</sup> Pous Testimony at p. 12.

<sup>33</sup> *Id.* (performing “an internet search of office buildings for sale in the Holyoke, Massachusetts area”).

<sup>34</sup> *Id.* at p. 23.

<sup>35</sup> *Id.* at p. 12.

<sup>36</sup> Exhibit No. ISO-7 at ¶ 9.

<sup>37</sup> *See, e.g.*, Advocates Reply Brief, Exhibit JP-4 (showing study dates for items dating back to the 1990s, 1980s, 1970s, and earlier); *see also generally* Pous Testimony (relying on the EEI/AGA Survey of Depreciation Statistics).

<sup>38</sup> The ISO has been able to find only one Administrative Law Judge-issued initial decision using the EEI study for guidance. *See Southern California Edison Co.*, 34 FERC ¶ 63,016 (1986). The ISO’s actual experience with software replacement and modification, as explained in Mr. Ludlow’s testimony, provides the most appropriate guidance.

by each entity, to set the depreciation rates for a specific public utility where the nature of the assets are known and its prior practices have been explained.<sup>39</sup>

**D. The Advocates' Failure to Use the Commission-Approved Stakeholder Process to Raise Their Concerns is Another Factor Favoring Acceptance of the ISO's Service Life and Salvage Value Principles**

In the foregoing discussion, the ISO has demonstrated the just and reasonable nature of its service life and salvage policies through its explanation of: (i) how it developed its average service lives and net salvage values; (ii) the essential link between those policies and the capital financing mechanism approved by the stakeholders and the Commission, and the manner in which this mechanism avoids wasteful interest payments; and (iii) a number of shortcomings of the testimony of Mr. Pous. Another factor favoring the acceptance of the ISO's service life and salvage policies is the Advocates' failure to use the Commission-approved stakeholder process to raise their concerns about those policies.

The ISO established the current capital funding mechanism in 2004. Under that mechanism, depreciation expense reflecting the service lives and salvage value policies underpinning the operating budgets since that time has provided funding for the stakeholder-supported, Commission-approved annual capital budgets for that period. The mechanism is well-understood, and has been unopposed, by stakeholders. As noted, the instant proceeding involves the ISO's continuation of this reasonable mechanism through the longstanding depreciation and salvage value policies reflected in the 2007 operating budget.

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<sup>39</sup> It is also difficult to obtain an updated EEI depreciation study, which does not appear to be publicly available. The ISO is not an EEI member. The EEI library does not have a copy, and the EEI librarian stated that the survey is only available to members of the EEI Depreciation Accounting Committee.

Notwithstanding this context, the Advocates chose to ignore the opportunities they have been afforded by the Commission-approved stakeholder process. Had concerns been raised in the stakeholder process in 2004, the ISO could have considered other capital funding mechanisms (most of which would have incurred far more interest expense).

More recently, the Advocates again (and repeatedly) chose to ignore their opportunities to utilize the stakeholder process with respect to the 2007 operating budget, which would have provided a less costly forum for both the ISO and the Advocates to address this issue than this paper hearing. If they wished to object to the depreciation and salvage value policies of the ISO as they would shape the 2007 operating budget and corresponding updates to the ISO's rates, they had the opportunity to do so as long ago as May 12, 2006. Specifically, in the May 5, 2006 notice (posted on the ISO website at the time) that set forth the agenda for the May 12, 2006 NEPOOL Budget and Finance Subcommittee ("Subcommittee") meeting, the ISO specifically invited "[a]ny Participant concerns" regarding the "ISO Tariff Rate Design."<sup>40</sup> Furthermore, as noted by NEPOOL in its February 5, 2007 comments in this proceeding, the Advocates had "seven weeks between the time the 2007 Budget was initially presented to the Subcommittee [i.e., on August 28, 2006] and the time it was voted on by the Participants Committee [i.e., on October 13, 2006] to raise [the] issue [of services lives and salvage values.]"<sup>41</sup> As NEPOOL also

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<sup>40</sup> The May 6, 2006 notice of the May 12, 2006 Subcommittee, which includes the agenda for that meeting, is included herein as Exhibit No. ISO-10.

<sup>41</sup> See Comments of New England Power Pool Participants Committee, Docket Nos. ER07-116-000 and -001 (February 5, 2007) ("NEPOOL Comments"), at 5 n.10.

noted in its comments, the Advocates failed to raise this issue at the Participants Committee meeting on October 13, 2006 at which the vote to support the Operating Budget was taken.<sup>42</sup>

In the face of the Advocates' inappropriate non-participation in the stakeholder process, the Advocates' admonition – in its unauthorized answer to the ISO's rehearing request in this docket<sup>43</sup> – that the *ISO* should “*seek earlier approval of its rates*” is particularly objectionable. Indeed, this attitude strongly implies that the stakeholder process is not worth the Advocates' time and that the only thing that “counts” is costly litigation at the Commission. The Advocates should, instead, *undertake earlier and meaningful participation* in the stakeholder process, and the Commission should take the Advocates' conduct into account in its ruling on the paper hearing.

**E. If the Commission Accepts the Arguments of the Advocates, Its Order on Paper Hearing Should Recognize That Projects Will Be Deferred, Additional Borrowings Will Be Required, or That Market Participants Will Need to Supply Capital Funding Directly Under Section IV.B of the Tariff**

As explained in the ISO's Paper Hearing Brief and in the foregoing sections, the service life and salvage value policies of the ISO, as reflected in the ISO's 2007 rates, are just and reasonable. If, however, the Commission should accept the arguments of the Advocates to the contrary, difficult choices will be required, and the Commission's order on paper hearing should address the alternatives that are presented.

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<sup>42</sup> *Id.* at 3-5.

<sup>43</sup> *See* The New England Advocates' Motion For Leave To Answer And Answer To ISO New England's Request For Rehearing And Clarification, Docket No. ER07-116-001 (February 5, 2007) at 5.

Specifically, if the depreciation expense is not fully available to fund the capital projects for 2007, the ISO will face several unpalatable choices. The first alternative is to defer needed capital projects. Many of these projects, such as the systems supporting the Forward Capacity Auction and Long-Term Transmission Rights, are required by Commission order.<sup>44</sup> Another alternative is to seek approval under Section 204 for new borrowings to support these capital projects, thereby incurring needless interest expense. If the order were to cause a default under the Private Placement Notes, a third possibility would be that Market Participants would be assessed with an Early Amortization Charge under Section IV.B of the Tariff.

The ISO respectfully asks the Commission to address these dimensions in its order should it accept the Advocates' arguments and require adjustment of the ISO's longstanding service life and/or salvage value policies.<sup>45</sup> In particular, the ISO concurs with NEPOOL<sup>46</sup> that the stakeholder process should be utilized to consider the alternatives and that no change to rates be ordered until the process is completed and appropriate filings or actions have been made or implemented by the ISO.

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<sup>44</sup> See, e.g., *Devon Power LLC*, 115 FERC ¶ 61,340, *order on reh'g*, 117 FERC ¶ 61,133 (2006) (approving settlement in Docket No. ER03-563 to establish a Forward Capacity Market); Long-Term Firm Transmission Rights in Organized Electricity Markets, Order No. 681, 116 FERC ¶ 61,077 (2006).

<sup>45</sup> As indicated in its rehearing/clarification request in this proceeding, the ISO requests that any relief granted to the Advocates be prospective from the issuance of the paper hearing order.

<sup>46</sup> See NEPOOL Comments at 7-8.

### III. CONCLUSION

For the reasons stated herein, the Commission should accept the average service lives and net salvage values as used by the ISO in its October 31 Filing.

Respectfully submitted,

*/s/ Maria A. Gulluni*

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*/s/ Howard H. Shafferman*

---

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Counsel for  
ISO New England Inc.

February 20, 2007

**Exhibit No. ISO-7**



**I. CONSUMER IMPACT OF OBTAINING ADDITIONAL FINANCING**

4. In order to implement the depreciation rate changes requested by the Advocates without reducing the annual \$20-23 million capital spending previously established by the ISO, my staff and I have determined that the ISO would need to borrow an additional \$36.5 million for the foreseeable future. My staff and I have determined that the interest and other related expenses for obtaining such a loan would cost the ISO approximately \$2 million a year by obtaining a new \$10 million, 10-year borrowing, plus increasing the existing working capital lines by approximately \$26.5 million. Specifically, the annual interest expense on the new \$10 million, 10-year loan was estimated by KeyBank to cost approximately \$566,000 per year at an interest rate of 5.64 percent, while the increased interest expense on the ISO's new and existing working capital lines would cost approximately \$1.5 million per year using an interest rate of 6.16 percent. In order to obtain the funds to repay the lender this \$2 million annual cost, the ISO would have to pass this cost on to each Customers by including it in the ISO's annual Operating Expense Budget, which is part of the ISO's annual revenue requirement used establish its rates to recover its administrative costs.
5. Exhibit No. ISO-8 includes two simplified cash flow worksheets prepared at my direction that demonstrate the effect of the Advocates' approach on the ISO's cash flow. The first worksheet shows the impact of the ISO's depreciation rates as filed on cash. The second sheet shows the impact on cash of the position proposed by the Advocates.
6. Implementing the Advocates' approach, including the additional debt costs the ISO would incur to support that approach, the average New England consumer would save approximately \$0.94 in year one, \$1.10 in year 2, and \$0.43 in year three. By year four, in

part due to the additional \$2 million annual cost for increased debt, the average New England consumer would incur an annual cost increase of \$0.07 in year four, \$0.32 in year five, \$0.39 in year six, and \$0.22 in year seven. The resulting inter-generational shift in costs at issue, therefore, amounts to a shift of approximately \$1.47 per consumer over a seven year period, or an average of \$0.21 a year. My staff and I derived these figures by taking the differences in depreciation on the simplified worksheets, subtracting the increased cost of debt of approximately \$2 million a year, and dividing by the annual amount of energy consumed in New England (projected to be 133,977,000 MWh) times the average monthly consumer usage of 750 kWh times 12. Meanwhile, the \$2 million a year cost to support the additional borrowings would constitute a near-permanent cost to each New England consumer of about \$0.13 a year.

7. Carrying 20 percent salvage value for the building, as requested by the Advocates, represents a portion of the financing the ISO would be unable to repay until the building is disposed. Thus, the ISO must incur additional, near-permanent debt to support such positive salvage value.

## **II. BUILDING**

8. I also have included with my affidavit as Exhibit ISO-8 the analysis the ISO received from bond counsel determining the service life of the building to be 28.64 years. It is an excerpt from the closing documents on the tax exempt debt the ISO borrowed to finance the building. The ISO relied on this estimate in part to develop the 25-year service life it currently uses, as well as to determine the terms of the financing itself.
9. Mr. Pous relies on “common sense” to conclude that electrical wiring within the ISO building’s walls should last much longer than 25 years. The ISO obtained its 25-year

service life determination for the electrical wiring within the building walls from the project manager himself.

**III. CONCLUSION**

10. In response to concerns raised by the Advocates, I note that no salaries or bonuses at the ISO are in any way tied to the depreciation rates used by the ISO or the outcome of this or any other proceeding regarding the proper depreciation rates to use.
11. This concludes my Affidavit.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on February 20, 2007

/s/ Robert C. Ludlow  
Robert C. Ludlow

**Exhibit No. ISO-8**

**ISO New England  
2006 - 2017 Cash Flow  
(\$000's)  
ORIGINAL**

	2006 Actual	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	Total
Cash on Hand - Beginning of the Period (1)	\$ 5,786	\$ 3,691	\$ 3,586	\$ 9,372	\$ 14,718	\$ 16,027	\$ 16,663	\$ 17,294	\$ 17,787	\$ (21,464)	\$ (21,734)	\$ (22,007)	\$ 5,786
Add - Depreciation/Amortization (3)	22,787	25,464	27,708	24,769	20,734	20,061	20,057	20,042	20,019	20,001	20,000	20,000	261,642
Add - Depreciation for Building	1,077	2,420	2,420	2,420	2,420	2,420	2,420	2,298	1,578	1,578	1,578	1,578	24,207
Add - Term Loan Fees	53	20	-	-	-	-	-	-	-	-	-	-	73
Add - Collection of Deferred Asset	96	-	-	-	-	-	-	-	-	-	-	-	96
Add - Licap write off	3,530	-	-	-	-	-	-	-	-	-	-	-	3,530
Add - On-going Capital Funding (Bullet)	-	-	-	-	-	-	-	-	-	-	-	-	-
Add - LOC	6,500	-	-	-	-	-	-	-	-	-	-	-	6,500
Add - Borrowing for Building	20,561	-	-	-	-	-	-	-	-	-	-	-	20,561
	54,604	27,904	30,128	27,189	23,154	22,481	22,477	22,340	21,597	21,579	21,578	21,578	316,609
Less - Operating Cash Requirements (2)	(536)	(21)	(22)	(23)	(24)	(25)	(26)	(27)	(28)	(29)	(31)	(10)	(803)
Less - Capital Expenditures	(21,769)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(241,769)
Less - Debt Service	(13,833)	(2,623)	-	-	-	-	-	-	(39,000)	-	-	-	(55,456)
Less - Debt Service - Building	-	(1,365)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(19,565)
Less - Repayment of LOC	-	(4,000)	(2,500)	-	-	-	-	-	-	-	-	-	(6,500)
Less - Capital Expenditures for Building	(20,561)	-	-	-	-	-	-	-	-	-	-	-	(20,561)
Cash on Hand - End of the Period	\$ 3,691	\$ 3,586	\$ 9,372	\$ 14,718	\$ 16,027	\$ 16,663	\$ 17,294	\$ 17,787	\$ (21,464)	\$ (21,734)	\$ (22,007)	\$ (22,259)	\$ (22,259)

(1) Includes Operating Cash from the Dashboard Cashflow

(2) Ending accounts payable/accrued expenses remains constant year to year with 4% increase year to year for 2007 & beyond  
Operating Cost Recovery is reduced by the balance of the 2004 overcollection of \$2,214.4 unable to be amortized in 2005.  
In addition, the Operating Cost Recovery was reduced by the overcollection for 2005 up to the amount included in the 2006 tariff of \$2,261.4 for a total reduction of \$4,475.8. The total amount of overcollection for 2005 was \$5,857.0.  
The Operating Cost Recovery for 2007-2010 is projected to offset Operating Expenses for 2007-2010. The Operating Cost Recovery amount for 2007-2010 have not yet been established at this point.

(3) Depreciation is calculated using the assumption that we will only spend \$20,000 going forward with a 3 yr life at half year convention

**ISO New England  
2006 - 2017 Cash Flow  
(\$000's)  
SHOWING DEPRECIATION CHANGE AND COST FOR ADD'L DEBT**

	2006 Actual	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	Total	Orig Total	Variance
Cash on Hand - Beginning of the Period (1)	\$ 5,786	\$ 3,691	\$ 8,504	\$ 400	\$ 407	\$ 604	\$ 58	\$ 1,474	\$ 437	\$ (38,398)	\$ (38,616)	\$ (39,475)	\$ 5,786	\$ 5,786	\$ -
Add - Depreciation/Amortization (3)	22,787	10,425	10,573	17,450	20,783	24,020	24,896	21,476	20,169	20,776	20,776	20,776	234,907	261,642	26,735
Add - Depreciation for Building	1,077	1,401	1,401	1,401	1,401	1,401	1,401	1,401	1,021	641	641	641	13,828	24,207	10,379
Add - Term Loan Fees	53	-	-	-	-	-	-	-	-	-	-	-	53	73	20
Add - Collection of Deferred Asset	96	-	-	-	-	-	-	-	-	-	-	-	96	96	-
Add - Licap write off	3,530	-	-	-	-	-	-	-	-	-	-	-	3,530	3,530	-
Add - On-going Capital Funding (Bullet)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Add - LOC	6,500	8,500	-	-	-	-	-	-	-	-	-	-	15,000	6,500	(8,500)
Add - 2nd LOC	-	-	3,500	5,000	2,000	-	-	-	3,000	2,500	2,000	-	18,000	-	(18,000)
Add - Borrowing - \$10M 10 yr	-	10,000	-	-	-	-	-	-	-	-	-	-	10,000	-	(10,000)
Add - Borrowing for Building	20,561	-	-	-	-	-	-	-	-	-	-	-	20,561	20,561	-
	54,604	30,326	15,474	23,851	24,184	25,421	26,297	22,877	24,190	23,917	23,417	21,417	315,975	316,609	(634)
Less - Operating Cash Requirements (2)	(536)	(21)	(22)	(23)	(24)	(25)	(26)	(27)	(28)	(29)	(31)	(10)	(804)	(803)	0
Less - Additionally Interest Expense	-	(1,271)	(1,714)	(1,896)	(2,098)	(2,076)	(1,990)	(1,963)	(2,072)	(2,241)	(2,380)	(2,430)	(22,129)	-	22,129
Less - Additionally Annually Fee on new revolver	-	-	(23)	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(428)	-	428
Less - Additionally Closing Cost	-	(233)	-	(60)	-	-	-	(60)	(60)	-	-	-	(413)	-	413
Less - Capital Expenditures	(21,769)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)	(241,769)	(241,769)	-
Less - Debt Service	(13,833)	(2,623)	-	-	-	-	-	-	(39,000)	-	-	(10,000)	(65,456)	(55,456)	10,000
Less - Debt Service - Building	-	(1,365)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(1,820)	(19,565)	(19,565)	-
Less - Repayment of LOC	-	-	-	-	-	(2,000)	(1,000)	-	-	-	-	-	(3,000)	(6,500)	(3,500)
Less - Capital Expenditures for Building	(20,561)	-	-	-	-	-	-	-	-	-	-	-	(20,561)	(20,561)	-
Cash on Hand - End of the Period	\$ 3,691	\$ 8,504	\$ 400	\$ 407	\$ 604	\$ 58	\$ 1,474	\$ 437	\$ (38,398)	\$ (38,616)	\$ (39,475)	\$ (52,363)	\$ (52,363)	\$ (22,259)	\$ 28,836

(1) Includes Operating Cash from the Dashboard Cashflow

(2) Ending accounts payable/accrued expenses remains constant year to year with 4% increase year to year for 2007 & beyond

Operating Cost Recovery is reduced by the balance of the 2004 overcollection of \$2,214.4 unable to be amortized in 2005.

In addition, the Operating Cost Recovery was reduced by the overcollection for 2005 up to the amount

included in the 2006 tariff of \$2,261.4 for a total reduction of \$4,475.8. The total amount of overcollection for 2005 was \$5,857.0.

The Operating Cost Recovery for 2007-2010 is projected to offset Operating Expenses for 2007-2010. The Operating Cost Recovery

amount for 2007-2010 have not yet been established at this point.

(3) Depreciation is calculated using changing lives from 3 to 6 yrs and leaving a 20% salvage value

**Exhibit No. ISO-9**

37 **No \$150,000,000 Limit.** All of the proceeds of the Bonds will be used to finance Project costs that were or are to be incurred after August 5, 1997. Accordingly, pursuant to the provisions of Section 222 of the Taxpayer Relief Act of 1997 and Section 145(b)(5) of the Code, the Bonds are not subject to the limitation imposed by Section 145(b)(1) of the Code.

**3.8 No Residential Rental Property.** None of the assets comprising the Project includes facilities used for residential rental facilities for family units.

**3.9 Useful Life.** The weighted average maturity of the Bonds is no more than 26.94 years from the Closing Date. As reflected in Exhibit A hereto, 120% of the average reasonably expected remaining economic life of the assets comprising the Project is at least 28.64 years from the Closing Date. Accordingly, the weighted average maturity of the Bonds does not exceed 120% of the average reasonably expected economic life of the assets comprising the Project.

#### IV.

#### REPRESENTATIONS, CERTIFICATIONS, EXPECTATIONS AND WARRANTIES OF THE ISSUER AND THE BORROWER

**4.1 No Federal Guarantee.** The Issuer and the Borrower will not directly or indirectly use or permit the use of any proceeds of the Bonds or any other funds of the Issuer and the Borrower in such a manner as to, or take or omit to take any action that would, cause the Bonds to be obligations which are "federally guaranteed" within the meaning of Section 149(b) of the Code. In furtherance of this covenant, the Issuer and the Borrower will not allow the payment of the principal or interest with respect to the Bonds to be guaranteed (directly or indirectly) in whole or in part by the United States or any agency or instrumentality thereof. The Issuer and the Borrower also will not, except as provided in the next sentence, use 5% or more of the proceeds of the Bonds to make loans the payment of the principal or interest with respect to which are guaranteed in whole or in part by the United States or any agency or instrumentality thereof, nor will it invest 5% or more of the proceeds in federally insured deposits or accounts. The preceding sentence shall not apply (i) to investments of proceeds during the temporary periods described in this Tax Certificate with respect to the Project Fund and the Bona Fide Debt Service Fund or (ii) to investments in obligations issued by the United States Treasury.

**4.2 Prohibited Facilities.** None of the proceeds of the Bonds will be used to finance or refinance any airplane, skybox, or other private luxury box, facility primarily used for gambling, or a store the principal business of which is the sale of alcoholic beverages for consumption off premises.

**4.3 Replacement Proceeds; Earmarked Grants or Donations.** No portion of the Proceeds of the Bonds will be used directly or indirectly to replace funds of the Issuer or of the Borrower or any Related Party (i) if such funds are or will be used directly or indirectly to acquire Investment Property reasonably expected to produce a yield materially higher than the yield on the Bonds or (ii) which have been earmarked to pay for the Project. The Borrower acknowledges that the preceding sentence applies to any grant or donation received by the Borrower to the extent there is a clear nexus between such grant or donation and its expenditure

**EXHIBIT A**  
**USEFUL LIFE SCHEDULE**

<u>Item</u>	<u>Cost</u>	Placed in Service <u>(no earlier than)</u>	<u>Expected Econ. Life</u>
Land	\$2,500,000	NIA	NIA
Building Construction	<b>37,246,251</b>	05/01/2006	25 years
Equipment & Furnishing	5,156,629	05/01/2006	7 years
Costs of Issuance/Issuers Fee/Letter of Credit Fee	597,120	NIA	NIA

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Average Expected Economic Life of Facilities

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$$\begin{aligned}
 [2006.42 + (1.2)(25)] (37,246,251) &= 75,849,010,461 \\
 [2006.42 + (1.2)(7)] (5,156,629) &= \underline{10,389,679,242} \\
 &86,238,689,703
 \end{aligned}$$

$$\frac{86,238,689,703}{42,402,880} = 2033.79 \text{ years}$$

$$2033.79 - 2005.15 = 28.64 \text{ years}$$

**Exhibit No. ISO-10**



May 5, 2006

To: NEPOOL Budget & Finance Committee Members

The NEPOOL Budget & Finance Committee Meeting is scheduled for 10:00 a.m. on Friday, May 12, 2006. This meeting will take place via teleconference, the call in number is 888-455-9645, passcode: 36919.

The Agenda is as follows:

1. Review Draft Quarterly Unaudited Financial Statements and ISO Draft April 2006 budget vs actual results
2. Review NEPOOL April 2006 budget vs actual results
3. Review ISO Tariff Rate Design
  - a Cash Management Fee proposal
  - b ISO Tariff Schedule 4 proposed modification for prior year true-up
  - c Potential changes to Schedule 2
    - 1) Implement a charge for FTR Market Transactions – 2007
    - 2) Review potential changes as a result of ASM Phase II
  - d Any Participant concerns
4. Review ISO 1<sup>st</sup> Qtr CFT (Capital Funding Tariff) Filing
5. Report out on FAP Working Group progress on Tier 2 changes
6. Credit Insurance renewal process update
7. Miscellaneous Financial Assurance items - from Participants
8. Follow-Up from March 20th meeting:
  - a Pension question - Analysis results of freezing the ISO's Plan and introducing a Defined Cost Plan
  - b NEPOOL Legal Fees

NEPOOL Budget & Finance Committee Members attached



**CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 20<sup>th</sup> day of February, 2007.

/s/ Lyndsey Sites  
Lyndsey Sites  
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