Energy East Corporation

Consolidated Financial Statements

For the Years Ended December 31, 2008 and 2007

Energy East Corporation

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Management’s Report on Internal Control Over Financial Reporting

Energy East Corporation’s (“the Company”) internal control over financial reporting is a process affected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. An entity’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity’s assets that could have a material effect on the financial statements.

Management is responsible for establishing and maintaining effective internal control over financial reporting. Management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2008, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated Framework*. Based on that assessment, management concluded that, as of December 31, 2008, the Company’s internal control over financial reporting is effective based on the criteria established in *Internal Control—Integrated Framework*.

Energy East Corporation
February 12, 2009

PRICEWATERHOUSECOOPERS

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Report of Independent Auditors

To the Shareholders and Board of Directors of Energy East Corporation and Subsidiaries:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of changes in common stock equity present fairly, in all material respects, the financial position of Energy East Corporation and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assertion of the effectiveness of internal control over financial reporting, included in *Management's Report on Internal Control Over Financial Reporting* dated February 12, 2009, listed in the accompanying Index to the Company's Consolidated Financial Statements for the Years Ended December 31, 2008 and 2007. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included 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. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and those charged with governance; and (iii) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
February 12, 2009

Energy East Corporation
Consolidated Statements of Income

Year ended December 31, (Thousands)	2008	2007
Operating Revenues		
Utility	**$4,535,051**	$4,652,783
Other	**533,995**	525,325
Total Operating Revenues	**5,069,046**	5,178,108
Operating Expenses		
Electricity purchased and fuel used in generation		
Utility	**1,260,776**	1,441,000
Other	**375,191**	363,793
Natural gas purchased		
Utility	**1,204,683**	1,116,092
Other	**86,560**	90,418
Other operating expenses	**847,692**	842,996
Merger costs	**30,227**	-
Positive benefit adjustments	**275,000**	-
Maintenance	**180,251**	175,618
Depreciation and amortization	**271,683**	277,490
Other taxes	**265,133**	255,680
Total Operating Expenses	**4,797,196**	4,563,087
Operating Income	**271,850**	615,021
Other (Income)	**(32,417)**	(38,884)
Other Deductions	**22,025**	11,483
Interest Charges, Net	**282,487**	275,938
Preferred Stock Dividends of Subsidiaries	**1,140**	1,128
(Loss) Income Before Income Taxes	**(1,385)**	365,356
Income Taxes	**(46,559)**	114,058
Net Income	**$45,174**	$251,298

The notes on pages 6 through 33 are an integral part of our consolidated financial statements.

Energy East Corporation
Consolidated Balance Sheets

December 31,	**2008**	**2007**
(Thousands)		
Assets		
Current Assets		
Cash and cash equivalents	**$71,892**	$97,066
Investments available for sale	**-**	177,045
Accounts receivable and unbilled revenues, net	**916,513**	990,255
Fuel and natural gas in storage, at average cost	**364,406**	258,172
Materials and supplies, at average cost	**34,286**	28,722
Deferred income taxes	**58,887**	38,383
Derivative assets	**366**	23,959
Prepaid income taxes	**118,105**	23,561
Prepayments and other current assets	**188,240**	109,430
Total Current Assets	**1,752,695**	1,746,593
Utility Plant, at Original Cost		
Electric	**5,994,022**	5,787,362
Natural gas	**2,792,134**	2,708,612
Common	**630,054**	583,657
	9,416,210	9,079,631
Less accumulated depreciation	**3,149,351**	3,086,765
Net Utility Plant in Service	**6,266,859**	5,992,866
Construction work in progress	**161,263**	165,628
Total Utility Plant	**6,428,122**	6,158,494
Other Property and Investments	**228,627**	172,993
Regulatory and Other Assets		
Regulatory assets		
Nuclear plant obligations	**149,846**	190,367
Unfunded future income taxes	**395,172**	338,749
Environmental remediation costs	**236,882**	185,773
Unamortized loss on debt reacquisitions	**55,196**	48,819
Nonutility generator termination agreements	**54,577**	64,744
Natural gas hedges	**66,741**	11,154
Pension and other postretirement benefits	**1,197,515**	259,554
Other	**386,654**	346,079
Total regulatory assets	**2,542,583**	1,445,239
Other assets		
Goodwill	**1,526,598**	1,526,048
Prepaid pension benefits	**27,062**	698,432
Derivative assets	**28,334**	17,450
Other	**131,989**	113,460
Total other assets	**1,713,983**	2,355,390
Total Regulatory and Other Assets	**4,256,566**	3,800,629
Total Assets	**$12,666,010**	$11,878,709

The notes on pages 6 through 33 are an integral part of our consolidated financial statements.

Energy East Corporation
Consolidated Balance Sheets

December 31,	**2008**	**2007**
(Thousands, except shares)		
Liabilities		
Current Liabilities		
Current portion of long-term debt	**$331,020**	$99,914
Notes payable	**623,988**	137,717
Accounts payable and accrued liabilities	**500,617**	484,963
Interest accrued	**56,396**	58,681
Taxes accrued	**75,034**	77,276
Derivative liabilities	**104,877**	11,491
Other	**243,412**	251,239
Total Current Liabilities	**1,935,344**	1,121,281
Regulatory and Other Liabilities		
Regulatory liabilities		
Accrued removal obligation	**914,671**	892,333
Deferred income taxes	**428,643**	5,088
Gain on sale of generation assets	**76,027**	99,514
Pension benefits	**72,474**	124,300
Natural gas hedges	**-**	1,544
Positive benefit adjustments	**280,010**	-
Other	**174,866**	165,869
Total regulatory liabilities	**1,946,691**	1,288,648
Other liabilities		
Deferred income taxes	**917,826**	1,322,738
Nuclear plant obligations	**158,672**	157,376
Pension and other postretirement benefits	**651,641**	451,642
Environmental remediation costs	**170,547**	158,629
Derivative liabilities	**117,264**	21,318
Other	**233,355**	248,368
Total other liabilities	**2,249,305**	2,360,071
Total Regulatory and Other Liabilities	**4,195,996**	3,648,719
Long-term debt	**3,576,937**	3,877,029
Total Liabilities	**9,708,277**	8,647,029
Commitments and Contingencies		
Preferred Stock of Subsidiaries		
Redeemable solely at the option of subsidiaries	**24,549**	24,587
Common Stock Equity		
Common stock ($.01 par value, 100 shares authorized and outstanding at December 31, 2008; 300,000,000 shares authorized and 158,278,536 shares outstanding at December 31, 2007)	**-**	1,583
Capital in excess of par value	**1,759,101**	1,752,465
Retained earnings	**1,314,433**	1,447,889
Accumulated other comprehensive income (loss)	**(140,350)**	7,609
Treasury stock, at cost (no shares at December 31, 2008; 86,372 shares at December 31, 2007)	**-**	(2,453)
Total Common Stock Equity	**2,933,184**	3,207,093
Total Liabilities and Stockholder Equity	**$12,666,010**	$11,878,709

The notes on pages 6 through 33 are an integral part of our consolidated financial statements.

Energy East Corporation
Consolidated Statements of Cash Flows

Year Ended December 31,	**2008**	**2007**
(Thousands)		
Operating Activities		
Net income	**$45,174**	$251,298
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	**287,302**	291,686
Amortization of regulatory and other assets and liabilities	**70,509**	95,164
Deferred income taxes and investment tax credits, net	**23,218**	107,443
Pension income	**(59,000)**	(47,355)
Positive benefit adjustments	**280,010**	-
Changes in current operating assets and liabilities		
Accounts receivable and unbilled revenues, net	**70,340**	(164,649)
Inventory	**(111,799)**	24,507
Prepayments and other current assets	**(89,376)**	61,553
Accounts payable and accrued liabilities	**15,869**	25,029
Interest accrued	**(2,286)**	1,438
Taxes accrued	**(85,778)**	15,002
Customer refund	**-**	(10,056)
Other current liabilities	**6,939**	(14,540)
Pension and other postretirement benefits contributions	**(53,500)**	(66,000)
Changes in other assets		
Preliminary survey	**(21,269)**	(10,093)
Other	**(84,379)**	(38,576)
Changes in other liabilities		
Asset sale gain account charges	**(36,820)**	(41,008)
Other	**(12,155)**	30,357
Net Cash Provided by Operating Activities	**242,999**	511,200
Investing Activities		
Utility plant additions	**(515,850)**	(444,009)
Other property additions	**(15,521)**	(2,570)
Other property sold	**-**	19
Maturities of current investments available for sale	**357,445**	1,007,850
Purchases of current investments available for sale	**(180,400)**	(1,164,895)
Investments available for sale	**(43,732)**	1,771
Net Cash Used in Investing Activities	**(398,058)**	(601,834)
Financing Activities		
Issuance of common stock	**-**	234,980
Repurchase of common stock	**(7,151)**	(8,339)
Issuance of first mortgage bonds	**-**	139,890
Repayment of first mortgage bonds and preferred stock of subsidiaries, including net premiums	**(35,038)**	(190,006)
Derivative activity	**(100,413)**	-
Long-term note issuances	**200,000**	259,758
Long-term note repayments	**(237,441)**	(192,221)
Notes payable three months or less, net	**486,272**	28,756
Notes payable issuances	**-**	2,654
Notes payable repayments	**-**	(3,055)
Dividends paid on common stock	**(176,344)**	(178,090)
Net Cash Provided by Financing Activities	**129,885**	94,327
Net (Decrease) Increase in Cash and Cash Equivalents	**(25,174)**	3,693
Cash and Cash Equivalents, Beginning of Year	**97,066**	93,373
Cash and Cash Equivalents, End of Year	**$71,892**	$97,066

The notes on pages 6 through 33 are an integral part of our consolidated financial statements.

Energy East Corporation
Consolidated Statements of Changes in Common Stock Equity

	Common Stock Outstanding $.01 Par Value		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
(Thousands, except per share amounts)	**Shares**	**Amount**					
Balance, January 1, 2007	147,907	$1,480	$1,505,795	$1,382,461	$(23,779)	$(1,610)	$2,864,347
Net income				251,298			251,298
Other comprehensive income, net of tax					31,388		31,388
Comprehensive income							282,686
Adjustment to initially apply FIN 48				1,291			1,291
Common stock dividends declared ($1.21 per share)				(187,161)			(187,161)
Common stock issued - public offering	10,000	100	242,400				242,500
Common stock issued - Investor Services Program	406	3	10,094				10,097
Common stock repurchased	(350)					(8,387)	(8,387)
Common stock issued - restricted stock plan	344		(8,273)			8,273	-
Amortization of restricted stock plan grants			9,943				9,943
Treasury stock transactions, net	(28)		27			(729)	(702)
Capital stock issue expense			(7,521)				(7,521)
Balance, December 31, 2007	158,279	1,583	1,752,465	1,447,889	7,609	(2,453)	3,207,093
Net income				45,174			45,174
Other comprehensive income, net of tax					(147,959)		(147,959)
Comprehensive income							(102,785)
Adjustment to initially apply EITF 06-10				(2,286)			(2,286)
Common stock dividends declared ($1.11 per share)				(176,344)			(176,344)
Common stock repurchased	(297)					(7,151)	(7,151)
Common stock issued - restricted stock plan	382		(9,817)			9,817	-
Amortization of restricted stock plan grants			15,320				15,320
Acquisition by Iberdrola	(158,364)	(1,583)	1,133			(213)	(663)
Balance, December 31, 2008	-	-	$1,759,101	$1,314,433	$(140,350)	-	$2,933,184

The notes on pages 6 through 33 are an integral part of our consolidated financial statements.

Notes to Consolidated Financial Statements

Note 1. Significant Accounting Policies

Background: Energy East Corporation (Energy East, the company, we, our, us) is a public utility holding company operating under the Public Utility Holding Company Act of 2005. We are a super-regional energy services and delivery company with operations in New York, Connecticut, Massachusetts, Maine and New Hampshire. Our wholly-owned subsidiaries, and their principal operating utilities, include: Berkshire Energy Resources – The Berkshire Gas Company (Berkshire Gas); CMP Group, Inc. – Central Maine Power Company (CMP); Connecticut Energy Corporation – The Southern Connecticut Gas Company (SCG); CTG Resources, Inc. – Connecticut Natural Gas Corporation (CNG); and RGS Energy Group, Inc. – New York State Electric and Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E). Effective September 16, 2008, 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 was completed through the acquisition by a subsidiary of Iberdrola, of all the outstanding common stock of Energy East. Subsequent to the consummation of the merger, Energy East cancelled all previously existing shares of common stock, including treasury stock, and issued 100 shares of common stock with a total par value of $1. As of December 31, 2008, Energy East has recorded merger costs of $30.2 million, which primarily consist of advisors' fees. We also incurred premiums totaling $12.7 million on the early retirement of debt due to special redemption on put options in the event of a change in control. The effects of the merger required for accounting purposes, including any allocation of goodwill, were not pushed down to Energy East. The accompanying consolidated financial statements have not been adjusted to reflect Iberdrola's basis in Energy East.

Under the merger order prescribed by the New York State Public Service Commission (NYPSC), NYSEG and RG&E customers will receive $275 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 until used for the customer's benefit at the pretax rate of return allowed by the regulator. Through December 31, 2008, we had accrued $5 million of carrying costs, which are included in interest expense.

***Accounts receivable*:** Accounts receivable at December 31 include unbilled revenues of $242 million for 2008 and $273 million for 2007, and are shown net of an allowance for doubtful accounts at December 31 of $51 million for 2008 and 2007. Accounts receivable do not bear interest, although late fees may be assessed. Bad debt expense was $91 million in 2008 and $68 million in 2007.

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 the operating companies review their 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 an operating company believes that a receivable will not be recovered, it charges 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. Our regulated utilities 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 $51 million for 2008 and $50 million for 2007. The ARO primarily consists of obligations related to removal or retirement of: asbestos, PCB-contaminated equipment, gas pipeline and cast iron gas mains. The long-lived assets associated with our AROs are generation property, gas storage property, distribution property and other property.

The following table reconciles the beginning and ending aggregate carrying amount of the ARO for the years ended December 31, 2008 and 2007. The increase in 2008 primarily relates to normal accretion. The decrease in 2007 primarily relates to a reevaluation of abatement costs for the Beebee generating station.

Year ended December 31,	**2008**	**2007**
(Thousands)		
ARO, beginning of year	**$49,670**	$57,253
Liabilities incurred during the year	**62**	574
Liabilities settled during the year	**(2,407)**	(1,723)
Accretion expense	**2,504**	1,949
Revisions in estimated cash flows	**959**	(8,383)
ARO, end of year	**$50,788**	$49,670

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.

Our regulated utilities meet the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (Statement 71), 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.

Consolidated 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.

Supplemental Disclosure of Cash Flows Information (Thousands)	2008	2007
Cash paid during the year ended December 31:		
Interest, net of amounts capitalized	**$251,726**	$245,167
Income taxes, net of benefits received	**$25,128**	$(12,377)

Interest capitalized was $4 million in 2008 and 2007.

Depreciation and amortization**:** We determine depreciation expense substantially using the straight-line method, based on the average service lives of groups of depreciable property, which include estimated cost of removal, in service at each operating company. The weighted-average service lives of certain classifications of property are: transmission property - 55 years, distribution property - 51 years, generation property - 48 years, gas production property - 31 years, gas storage property - 26 years, and other property - 28 years. RG&E determines depreciation expense for the majority of its generation property using remaining service life rates, which include estimated cost of removal, based on operating license expiration. The remaining service lives of RG&E's generating stations is approximately 31 years. Our depreciation accruals were equivalent to 2.8% of average depreciable property for 2008 and 3.0% for 2007.

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.

EITF 06-10**:** Effective January 1, 2008, we began applying the consensus in Emerging Issues Task Force (EITF) Issue No. 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements" (EITF 06-10), which the FASB ratified in late March 2007. EITF 06-10 requires an employer to recognize a liability for a postretirement benefit related to a collateral assignment split-dollar life insurance arrangement. In a collateral assignment split-dollar life insurance arrangement, the employee, versus the employer, owns and controls the insurance policy. EITF 06-10 also requires an employer to recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. Entities should recognize the effects of applying the consensus through either (1) a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or (2) a change in accounting principle through retrospective application to all prior periods. CNG is the only Energy East subsidiary with collateral assignment split-dollar life insurance arrangements. We elected to recognize the effects of applying the consensus as a change in accounting principle through a cumulative-effect adjustment that resulted in a decrease in retained earnings of $2.3 million. Our application of EITF 06-10 did not affect results of operation or cash flows.

FSP FAS 132(R)-1**:** In December 2008 the FASB issued FASB Staff Position (FSP) FAS 132(R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets," which amends FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits* (Statement 132(R)), to improve disclosures about postretirement benefit plan assets. FSP FAS 132(R)-1 applies to employers that are subject to the disclosure requirements of Statement 132(R). The FSP requires the disclosures about plan assets to be provided for fiscal years ending after December 15, 2009. We expect that our initial application of FSP FAS 132(R)-1 for the fiscal year ending December 31, 2009, will have no effect on our financial position, results of operation and cash flows.

Notes to Consolidated Financial Statements

Goodwill: We record the excess of the cost over the fair value of net assets of purchased businesses as goodwill. We evaluate the carrying value of goodwill for impairment at least annually and on an interim basis if there are indications that goodwill might be impaired. We may recognize an impairment if the fair value of goodwill is less than its carrying value. (See Background, earlier in this note, and Note 2.)

Investments available for sale - current: We held current investments of $177 million at December 31, 2007, which consisted of auction rate securities classified as available for sale. We recorded our investments in those securities at cost, which approximates fair market value, due to their variable interest rates, which typically reset every 7 to 35 days. Despite the long-term nature of their stated contractual maturities, we were generally able to liquidate such securities during the scheduled auctions, including all investments held at December 31, 2007. As a result, we had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from our investments. All income generated from our investments is recorded as interest income.

As a result of uncertainties in the auction rate securities markets, which began in early 2008, we have reduced our exposure to those investments. As of December 31, 2008, our investments in auction rate securities had declined to $3.9 million. In 2008 we began classifying our auction rate securities as noncurrent investments available for sale. Those investments are included in other property and investments.

Other (Income) and Other Deductions:

Year Ended December 31,	**2008**	**2007**
(Thousands)		
Interest and dividend income	**$(16,585)**	$(19,623)
Allowance for funds used during construction	**(5,267)**	(5,057)
Gains on energy risk contracts	**-**	(2,731)
Earnings from equity investments	**(3,740)**	(3,499)
Miscellaneous	**(6,825)**	(7,974)
Total other (income)	**$(32,417)**	$(38,884)
Early retirement of debt	**$12,704**	-
Losses from disposition of nonutility property	**-**	$122
Losses on energy risk contracts	**620**	4,495
Civic donations	**3,231**	2,766
Miscellaneous	**5,470**	4,100
Total other deductions	**$22,025**	$11,483

Early retirement of debt: In October 2008 SCG paid premiums of $11.1 million in connection with the early retirement of $25 million of long-term debt that was subject to special redemption or put options in the event of a change in control. Energy East's merger with Iberdrola qualified for such a change in control. SCG is not allowed rate recovery for such losses on reacquired debt. In addition, in October 2008 TEN Companies (TEN Cos.), a subsidiary of CTG Resources, paid premiums of $1.6 million in connection with the early retirement of a total of $22.5 million of long-term debt that was subject to similar put options in the event of a change in control. All of the put options were accounted for as embedded derivatives prior to the debt retirement. We did not assign any value to the put options prior to the merger as we believed that any fair value attributable to the put options would have been negligible because of significant uncertainty as to whether the merger would take place.

Principles of consolidation: These financial statements consolidate our majority-owned subsidiaries after eliminating intercompany transactions, except variable interest entities for which we are not the primary beneficiary.

Reclassifications: Certain amounts have been reclassified in our consolidated financial statements to conform to the 2008 presentation.

***Regulatory assets and liabilities*:** Our public utility subsidiaries currently meet the criteria of Statement 71 for their regulated electric and natural gas operations in New York, Maine, Connecticut and Massachusetts; however, we cannot predict what effect the competitive market or future actions of regulatory entities would have on their ability to continue to do so. If our public utility subsidiaries were to no longer meet the criteria of Statement 71 for all or a separable part of their regulated operations, they 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 Statement 71 our operating utilities 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. Our operating utilities 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, demand side management program costs, gain on sale of generation assets, other regulatory assets and other regulatory liabilities are amortized over various periods in accordance with each operating utility’s current rate plans. Amortization of total regulatory assets net of amortization of total regulatory liabilities was $54 million in 2008 and $74 million in 2007.

Other regulatory assets and liabilities consisted of:

December 31, **(Thousands)**	**2008**	**2007**
Statement 106 postretirement benefits	**$37,973**	$44,898
Customer Hardship Arrearage Forgiveness and related programs	**39,953**	44,960
Loss on sale of RG&E Oswego generating unit	**28,943**	35,419
Asset retirement obligation	**26,578**	24,842
Deferred storm costs	**79,168**	42,307
Deferred pension costs	**38,161**	31,760
Stranded cost reconciliation	**13,725**	8,126
Deferred natural gas costs	**23,175**	41,129
Nonbypassable wires charge	**20,131**	-
Other	**78,847**	72,638
Total other regulatory assets	**$386,654**	$346,079
Deferred natural gas costs	**$13,378**	$14,187
Asset retirement obligation	**11,023**	9,248
Nonfirm margin sharing	**27,332**	18,983
Economic development	**4,936**	3,855
Pension	**34,006**	16,709
Nuclear decommissioning	**15,509**	14,439
Accrued earnings sharing	**14,245**	16,957
Nonbypassable wires charge	**-**	4,084
Other	**54,437**	67,407
Total other regulatory liabilities	**$174,866**	$165,869

Preliminary survey costs represent expenditures incurred for the purpose of determining the feasibility of utility projects under contemplation. We include such costs in Other assets on our balance sheets. Preliminary survey costs at December 31 totaled approximately $31 million for 2008 and $10 million for 2007. Those amounts primarily consist of costs incurred in preparation of new transmission projects, primarily in Maine. When construction begins on these projects, the amounts are moved to construction work in progress, and then eventually to utility plant when construction is completed and the asset is placed in service. If a project is abandoned, the costs incurred for that project are charged to an appropriate transmission expense account, and included in future transmission rates.

Regulatory proceedings:

CNG overearnings and rate filing: In June 2008 CNG filed its monthly financial report with the DPUC showing that it exceeded its allowed return on equity by more than 100 basis points for the sixth consecutive monthly period. As a result, the DPUC initiated an overearnings investigation. On August 6, 2008, the DPUC issued a decision ordering CNG to implement a rate decrease of $15 million effective August 6, 2008, and the filing of a rate case by January 1, 2009.

On January 16, 2009, CNG filed an application for a delivery rate increase of $16.2 million or approximately 4.4% over the revenues produced from its existing rate schedules.

SCG overearnings and rate filing: In July 2008 SCG filed its monthly financial report with the DPUC showing that it exceeded its allowed return on equity by more than 100 basis points for the sixth consecutive monthly period. As a result, the DPUC initiated an overearnings investigation. On October 24, 2008, the DPUC issued a decision ordering SCG to implement a rate decrease of $15 million effective October 24, 2008, and to file pro forma adjustments for the purpose of a surcharge for the period beginning October 24, 2008, through June 30, 2009.

On January 20, 2009, SCG filed an application for a delivery rate increase of $50.1 million or approximately 15.2% over the revenues produced from its existing rate schedules.

NYSEG and RG&E rate filings: On January 27, 2009, NYSEG and RG&E filed rate requests asking the NYPSC for an increase in rates for electric and natural gas delivery service. The total delivery rate increase requested is $278 million and consists of increases of: for NYSEG - $135 million or approximately 10% for electric delivery, and $43 million or approximately 9% for natural gas delivery; and for RG&E - $66 million or approximately 12% for electric delivery, and $34 million or approximately 7% for natural gas delivery. The increases are necessary for the companies to have sufficient cash flow for planned infrastructure investment and the continued provision of safe and reliable service. Absent timely rate increases NYSEG and RG&E would rely more heavily on other funding sources. NYSEG's and RG&E's electric delivery rates have not increased since 1996, but have been reduced twice since then. Natural gas delivery rates have been essentially flat since 1994. The companies have asked the NYPSC to consider and approve the requests by July 1, 2009. A procedural conference was held on February 11, 2009 during which the NYPSC staff indicated that they were planning to file a motion to dismiss the request.

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

Pursuant to a Maine state law, CMP is prohibited from selling power to its retail customers. CMP does not enter into purchase or sales arrangements for power with ISO New England Inc. (ISO-NE), the New England Power Pool, or any other independent system operator or similar entity.

CMP sells all of its power entitlements under its nonutility generator (NUG) and other purchase power contracts to unrelated third parties under bilateral contracts.

NYSEG and RG&E enter into power purchase and sales transactions with the New York Independent System Operator (NYISO). When NYSEG and RG&E sell electricity from owned generation to the NYISO, and subsequently repurchase electricity from the NYISO to serve their customers, they record the transactions on a net basis in their statements of income. NYSEG and RG&E net their purchase and sale transactions with the NYISO on an hourly basis.

***Risk management*:** The financial instruments we hold or issue are not for trading or speculative purposes.

We use interest rate swap agreements to manage the risk of increases in variable interest rates and to maintain desired fixed-to-floating rate ratios. We record amounts paid and received under those agreements as adjustments to the interest expense of the specific debt issues. We also use derivative instruments to mitigate risk resulting from interest rate changes on anticipated future financings and we amortize amounts paid or received under those instruments to interest expense over the life of the corresponding financing. As of December 31, 2008, we had a derivative liability of $86.6 million on hedges related to future financings. The effects of those hedges will be included in the financing section of the cash flows statement when settled.

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

We have various master netting arrangements in the form of multiple contracts with various single counterparties that are subject to contractual agreements that provide for the net settlement of all contracts through a single payment. Those arrangements reduce our exposure to a counterparty in the event of default on or termination of any one contract. For financial statement presentation, we do not offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim or the obligation to return cash collateral arising from derivative instruments executed with the same counterparty under a master netting arrangement. Under the master netting arrangements our right to reclaim cash collateral was $18 million at December 31, 2008, and our obligation to return cash collateral was $7 million at December 31, 2007.

NYSEG and RG&E use electricity contracts, both physical and financial, to manage fluctuations in the cost of electricity required to serve customers. We include the cost or benefit of those contracts in the amount expensed for electricity purchased when the related electricity is sold.

All of our natural gas utilities have purchased gas adjustment clauses that allow them to recover through rates any changes in the market price of purchased natural gas, substantially eliminating their exposure to natural gas price risk. NYSEG and RG&E 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 recognize the fair value of our financial electricity contracts, natural gas hedge contracts and interest rate swap agreements as current and noncurrent derivative assets or current and noncurrent derivative liabilities. Our financial electricity contracts and interest rate swap agreements are designated as cash flow hedging instruments, except for our fixed-to-floating interest rate swap agreements with notional amounts totaling $320 million as of December 31, 2008, which are designated as fair value hedges. We record changes in the fair value of the cash flow hedging instruments in other comprehensive income, to the extent they are considered effective, until the underlying transaction occurs. We record the ineffective portion of any change in fair value of cash flow hedges to the income statement as either Other (Income) or Other Deductions, as appropriate. We report changes in the fair value of the interest rate swap agreement on our consolidated statements of income in the same period as the offsetting change in the fair value of the underlying debt instrument. We record changes in the fair value of natural gas hedge contracts as regulatory assets or regulatory liabilities.

As of December 31, 2008, the maximum length of time over which we had hedged our exposure to the variability in future cash flows for forecasted energy transactions was 16 months. We estimate that losses of $11 million will be reclassified from accumulated other comprehensive income into earnings during 2009, as the underlying transactions occur.

We have commodity purchases and sales contracts for both capacity and energy that have been designated and qualify for the normal purchases and normal sales exception in Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended.

Share-based compensation: As of September 16, 2008, our two share-based compensation plans, the 2000 Stock Option Plan and the Restricted Stock Plan, ceased as a result of our merger with Iberdrola. All stock options immediately vested upon consummation of Energy East's merger with Iberdrola and the holders received an amount in cash equal to the excess of the merger consideration per share over the exercise price per share. In addition, all shares of restricted stock vested upon consummation of the merger and became entitled to receive the merger consideration. The total compensation cost recognized in income for the two plans for the years ended December 31 was: $16.9 million for 2008 and $15.2 million for 2007. The total income tax benefit recognized in income for the share-based compensation arrangements for the years ended December 31 was: $6.7 million for 2008 and $6.1 million for 2007. The cash paid by Iberdrola for restricted stock is included in capital in excess of par value in shareholder equity.

Statement 141(R) and Statement 160: In December 2007 the FASB issued Statement 141(R), *Business Combinations*, and Statement 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. Both statements are the result of a joint project between the FASB and the International Accounting Standards Board. The objective of Statement 141(R) is "to improve the relevance, representational faithfulness, and comparability of information that a reporting entity provides in its financial reports about a business combination and its effects." Some key changes that will result from the application of Statement 141(R) are: all transaction costs and most restructuring costs will be expensed, acquired in-process research and development costs will not be expensed at acquisition, and equity securities issued as part of the purchase price will be measured on the closing date instead of the announcement date. Statement 141(R) will apply to business combinations for which the acquisition date is on or after the beginning of an entity's first annual reporting beginning on or after December 15, 2008 (our annual reporting period beginning January 1, 2009). It may not be applied before that date and must be applied prospectively.

Statement 160 is intended "to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements" about noncontrolling (sometimes called minority) interests. Minority interest earnings will no longer be excluded from net income as a result of applying Statement 160. Statement 160 is effective for fiscal years (including interim periods) beginning on or after December 15, 2008 (our fiscal year beginning January 1, 2009), with earlier adoption prohibited and prospective application required, except that the presentation and disclosure requirements are to be applied retrospectively. Our application of the two Statements will not materially affect our financial position, results of operation or cash flows.

Statement 157**:** In September 2006 the FASB issued Statement 157, *Fair Value Measurements*, which we adopted effective January 1, 2008, for financial assets and financial liabilities. Changes that result from the application of Statement 157 relate to the definition of fair value, the methods used to measure fair value, and expanded disclosures about fair value measurements. Statement 157 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. Our adoption of Statement 157 and related FSPs had no effect on our financial position, results of operation or cash flows.

The FASB issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, in February 2008. FSP FAS 157-2 delays the effective date of Statement 157 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. Nonfinancial assets and nonfinancial liabilities include all assets and liabilities other than those that meet the definition of a financial asset or financial liability as defined in paragraph 6 of FASB Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115*. FSP FAS 157-2 also requires additional disclosures concerning application of the provisions of Statement 157. FSP FAS 157-2 was effective upon issuance.

Statement 161**:** In March 2008 the FASB issued Statement 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, which 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. It is intended to improve transparency about the location and amounts of derivative instruments in the 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. Statement 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged. Disclosures for earlier periods presented for comparative purposes are encouraged but not required at initial adoption. In years after initial adoption, comparative disclosures are required only for periods subsequent to initial adoption. Our adoption of Statement 161 effective January 1, 2009, did not affect our financial position, results of operation or cash flows.

Taxes**:** We file a consolidated federal income tax return and allocate income taxes among Energy East and its subsidiaries in proportion to their contribution to consolidated taxable income. The determination and allocation of our income tax provision and its components are outlined and agreed to in the tax sharing agreements among Energy East and its subsidiaries.

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

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

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

Use of Estimates and Assumptions: The preparation of our consolidated 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 consolidated 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; (2) asset impairments, including goodwill; (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 consolidated 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.

Variable interest entities: A variable interest entity is an entity that is not controllable through voting interests and/or in which the equity investor does not bear the residual economic risks and rewards. A business enterprise is required to consolidate a variable interest entity if the enterprise has a variable interest that will absorb a majority of the entity's expected losses.

We have power purchase contracts with NUGs. However, we were not involved in the formation of and do not have ownership interests in any NUGs. We have evaluated all of our power purchase contracts with NUGs and determined that most of the purchase contracts are not variable interests for one of the following reasons: the contract is based on a fixed price or a market price and there is no other involvement with the NUG, the contract is short-term in duration, the contract is for a minor portion of the NUG's capacity or the NUG is a governmental organization or an individual. We are not able to determine if we have variable interests for 2008 with respect to four remaining power purchase contracts with NUGs because we are unable to obtain the information necessary to: (1) determine if any of the four NUGs is a variable interest entity, (2) determine if an operating utility is a NUG's primary beneficiary or (3) perform the accounting required to consolidate any of those NUGs. We routinely request necessary information from the four NUGs, but no NUG has yet provided the requested information. Concerning the four remaining contracts, one contract expired on December 31, 2008, the other three will expire before September 2009 and none of the four contracts will be renewed. We did not consolidate any NUGs as of December 31, 2008 or 2007.

We purchase electricity from the NUGs at above-market prices. We are not exposed to any loss as a result of our involvement with the NUGs because we are allowed to recover through rates the cost of our purchases. Also, we are under no obligation to a NUG if it decides not to operate for any reason. The combined contractual capacity for the four NUGs is approximately 261 MWs. The combined purchases from the four NUGs totaled approximately $267 million in 2008 and $237 million in 2007.

Note 2. Goodwill

We do not amortize goodwill, but test it for impairment at least annually. Impairment testing includes various assumptions, primarily the discount rate, which is based on an estimate of our marginal, weighted-average cost of capital, and forecasted cash flows. We test the reasonableness of the conclusions of our impairment testing using a range of discount rates and a range of assumptions for long-term cash flows. We had no impairment of goodwill in 2008 and no impairment was indicated within any of the ranges of assumptions analyzed.

The carrying amount of goodwill, by operating segment, as of December 31, 2007 and 2008, is shown in the following table. The increase in goodwill during 2008 is the result of the resolution of income tax audits. Goodwill has not been adjusted to reflect the purchase of Energy East by Iberdrola.

	Electric Delivery	Natural Gas Delivery	Other	Total
(Thousands)				
Balance, December 31, 2007	$845,296	$677,080	$3,672	$1,526,048
Preacquisition income tax adjustments			550	550
Balance, December 31, 2008	$845,296	$677,080	$4,222	$1,526,598

Note 3. Income Taxes

Year Ended December 31,	**2008**	**2007**
(Thousands)		
Current		
Federal	**$(60,513)**	$8,766
State	**(9,076)**	(2,134)
Current taxes charged to expense	**(69,589)**	6,632
Deferred		
Federal	**41,214**	91,492
State	**(15,156)**	18,993
Deferred taxes charged to expense	**26,058**	110,485
Investment tax credit adjustments	**(3,028)**	(3,059)
Total	**$(46,559)**	$114,058

The significant decrease in current income tax expense in 2008 as compared to 2007 is driven primarily by the effect of the 50% bonus depreciation on federal taxable income in 2008. The significant decrease in deferred income tax expense in 2008 as compared to 2007 is primarily due to deferred tax benefits related to the PBAs that were recorded as a result of the merger approval in New York state.

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

Year Ended December 31,	**2008**	**2007**
(Thousands)		
Tax expense at statutory rate	**$(85)**	$128,270
Depreciation and amortization not normalized	**(8,586)**	1,062
Investment tax credit amortization	**(3,028)**	(3,059)
Removal costs	**(5,853)**	(5,193)
Medicare subsidy	**(4,848)**	(4,673)
Out of period adjustments	**(14,871)**	(6,094)
State taxes, net of federal benefit	**(15,751)**	10,959
Other, net	**6,463**	(7,214)
Total	**$(46,559)**	$114,058

Income taxes were $46.5 million less in 2008 than they would have been at the federal statutory rate of 35% and $14.2 million less in 2007. The effective tax rate is not a meaningful value in 2008 due to the level of pretax income (a loss of $245 thousand). The effective tax rate in 2007 was 31%. The 2008 effective tax rate was less than the statutory rate primarily due to the reversal of reserves resulting from the favorable resolution of federal and state tax audits, benefits related to the early retirement of assets and tax deductibility of repairs resulting from filing the 2007 return in 2008 and the flow-through effect of a book depreciation rate change for CMP effective July 1, 2008. The 2007 effective tax rate was less than the statutory rate primarily due to variances in recurring flow-through items, including the flow-through effect of a book depreciation rate change for NYSEG effective January 1, 2007, and differences in the 2006 filed tax return compared to the 2006 booked tax expense, primarily due to a change related to the timing of the deductibility of property tax expense for RG&E. The variance in State taxes, net in 2008 as compared to 2007 is driven primarily by the decrease in pretax income and favorable resolution of state audits. The variance in Other, net in 2008 as compared to 2007 is driven primarily by the decrease in tax-exempt interest in 2008, an increase in nondeductible merger costs in 2008 and the flow-through effect of increased bad debt reserves in 2008.

Our consolidated deferred tax assets and liabilities consisted of:

December 31,	**2008**	**2007**
(Thousands)		
Current Deferred Income Tax Assets (Liabilities)		
Derivative (liabilities) assets	**$23,489**	$(3,029)
Other	**35,398**	41,412
Total Current Deferred Income Tax Assets (Liabilities)	**$58,887**	$38,383
Noncurrent Deferred Income Tax Liabilities (Assets)		
Property related	**$1,148,952**	$1,101,266
Unfunded future income taxes	**157,159**	129,988
Accumulated deferred investment tax credits	**33,774**	32,082
Deferred (gain) on sale of generation assets	**20,555**	(10,340)
Pension	**211,211**	206,873
Statement 106 postretirement benefits	**(109,124)**	(123,799)
PBA merger order	**(110,926)**	-
Other	**(5,132)**	(8,536)
Total Noncurrent Deferred Income Tax Liabilities (Assets)	**1,346,469**	1,327,534
Valuation allowance	**-**	292
Less amounts classified as regulatory liabilities		
Deferred income taxes	**428,643**	5,088
Noncurrent Deferred Income Tax Liabilities	**$917,826**	$1,322,738
Deferred tax assets	**$284,069**	$184,086
Deferred tax liabilities	**1,571,651**	1,473,238
Net Accumulated Deferred Income Tax Liabilities	**$1,287,582**	$1,289,152

Energy East and its subsidiaries have New York state loss carryforwards of $233 million, which expire between 2020 and 2027. No valuation allowance has been recorded as the company believes it will be able to fully utilize the loss carryforwards.

Reconciliation of Gross Income Tax Reserves **(Thousands)**	**2008**	**2007**
Balance as of January 1	**$17,991**	$21,220
Increases for tax positions related to prior years	**748**	1,262
Reductions for tax positions related to prior years	**-**	(2,875)
Decreases for positions related to settlements with taxing authority	**(14,037)**	(1,616)
Balance as of December 31	**$4,702**	$17,991

The total gross unrecognized tax benefits as of December 31, 2008, were $6.1 million, including gross income tax reserves of $4.7 million, interest of $1.2 million and a penalty of $0.2 million. Including interest and penalty, $2.9 million of the total gross unrecognized tax benefits would affect the effective tax rate, if recognized. Gross income tax reserves decreased by $13.3 million in 2008 due to various federal and state audit settlements. Gross income tax reserves decreased by $3.2 million in 2007 primarily due to a redetermination of reserves related to 2006, based on our filing of various 2006 income tax returns.

We have been audited through 2004 for New York state income taxes, through 2005 for federal income taxes and through 2006 for Maine state income taxes. The statute of limitations in Connecticut and Massachusetts has expired for all years through 2004. Our federal returns for 2006 and 2007 are currently under review. We anticipate that the reviews will be completed in 2010. We cannot predict the ultimate outcome of the reviews.

Notes to Consolidated Financial Statements

Note 4. Long-term Debt

At December 31, 2008 and 2007, our consolidated long-term debt was:

				Amount (Thousands)	
Company		**Interest Rates**	**Maturity**	**2008**	**2007**
	First mortgage bonds [1]				
RG&E	Series B, TT, UU, VV & XX	5.84% - 8.00%	2009 - 2033	**$586,000**	$486,000
RG&E	PCN 2004 Series A (variable)	1.496%	2032	**2,750**	10,500
RG&E	PCN 2004 Series B	5.375%	2032	**50,000**	50,000
SCG	Medium Term Notes I, II, III & IV	5.772% - 7.95%	2009 - 2037	**234,000**	194,000
SCG	Series W	8.93%	2008	-	25,000
Berkshire Gas	Series P	10.06%	2019	**10,000**	10,000
Total first mortgage bonds				**882,750**	775,500
	Unsecured pollution control notes (PCNs), fixed				
NYSEG	1985 Series A, B & D	4.00% - 4.10%	2015	**132,000**	132,000
NYSEG	2004 Series B & C	3.245% - 5.35%	2028 - 2034	**170,000**	100,000
RG&E	1998 Series A	5.95%	2033	**25,500**	25,500
CMP	Industrial Development Authority of the state of New Hampshire Notes	5.375%	2014	**19,500**	19,500
Total unsecured pollution control notes, fixed				**347,000**	277,000
	Unsecured PCNs, variable				
NYSEG	2006 Series A	1.775%	2024	**12,000**	12,000
NYSEG	2005 Series A	1.448%	2026	**6,975**	65,000
NYSEG	2004 Series A	1.496%	2027	**3,475**	104,000
NYSEG	1994 Series B, C, D1 & D2	1.625% - 1.775%	2029	**175,000**	175,000
RG&E	1997 Series A, B & C	2.165% - 2.765%	2032	**70,150**	101,900
TEN Cos	Industrial Revenue Variable Rate Demand Bonds	1.465%	2025 - 2030	**14,900**	14,900
Total unsecured pollution control notes, variable				**282,500**	472,800
	Various long-term debt				
Energy East	Unsecured Note	8.05%	2010	**200,000**	200,000
Energy East	Unsecured Note	6.75%	2012	**400,000**	400,000
Energy East	Unsecured Note	6.75%	2033	**200,000**	200,000
Energy East	Unsecured Notes	6.75%	2036	**500,000**	500,000
NYSEG	Unsecured Notes	5.50% - 6.15%	2012 - 2023	**600,000**	600,000
CMP	Series E & F Medium Term Notes	5.10% - 7.00%	2009 - 2037	**330,700**	335,700
CNG	Medium Term Notes Series A, B & C	5.63% - 9.10%	2012 - 2037	**130,000**	150,000
Berkshire Gas	Unsecured Notes	4.76% - 9.60%	2011 - 2021	**33,000**	36,000
Energetix	Promissory Note	8.50%	2008	**-**	3,509
TEN Cos	Senior Secured Term Notes	6.90% - 6.99%	2008	**-**	25,000
NORVARCO	Promissory and Senior Notes	7.05% - 10.48%	2020	**14,007**	15,190
Total various long-term debt				**2,407,707**	2,465,399
Obligations under capital leases				**21,297**	23,073
Unamortized premium and discount on debt, net				**(33,297)**	(36,829)
				3,907,957	3,976,943
Less debt due within one year, included in current liabilities				**331,020**	99,914
Total				**$3,576,937**	$3,877,029

[1] The first mortgage bonds are secured by liens on substantially all of the respective utility's properties.

There are federal and state regulatory restrictions on our ability to borrow funds from our utility subsidiaries. While we may be able to borrow funds from our utility subsidiaries by obtaining regulatory approvals and meeting certain conditions, we do not expect to seek such loans. Energy East has no secured indebtedness and none of its assets are mortgaged, pledged or otherwise subject to lien. None of Energy East's debt obligations are guaranteed or secured by its subsidiaries.

As of December 31, 2008, NYSEG and RG&E had outstanding $775.9 million of tax-exempt pollution control notes, of which $277.5 million have coupons fixed to maturity, $100 million are auction rate notes under a special rate period where the rate is fixed until January 2010, $187 million are weekly variable rate demand notes (VRDNs), $109.5 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, NYSEG and RG&E have restructured portions of their auction rate portfolios and taken other actions to mitigate the cost effect of the disruptions in the auction rate markets.

- In May 2008 NYSEG converted its $70 million New York State Energy Research and Development Authority (NYSERDA) Pollution Control Revenue Bonds, 2004 Series B maturing in December 2028 to a 5.35% fixed rate to maturity; the bonds become callable at par in May 2013. The coupon was subsequently swapped to a floating rate.
- In May 2008 RG&E converted its $50 million NYSERDA Pollution Control Revenue Bonds, 2004 Series B maturing in May 2032 to a 5.375% fixed rate to maturity; the bonds become callable at par in May 2013. The coupon was subsequently swapped to a floating rate.
- In July 2008 NYSEG converted three series of NYSERDA Pollution Control Refunding Revenue Bonds and one series of Indiana County Industrial Development Authority Pollution Control Revenue Refunding Bonds, totaling $187 million in principal amount, from 7-day auction rate mode to weekly VRDNs. In connection with those conversions, certain banks have issued letters of credit to provide credit and liquidity enhancement for the VRDNs. The letters of credit are issued pursuant to a $190 million revolving credit agreement that expires in August 2009 among NYSEG, certain lenders and JPMorgan Chase Bank, N.A., as administrative agent. Because the credit facility expires in less than one year, the $187 million of VRDNs have been classified as current maturities of long-term debt.
- Beginning in August of 2008 NYSEG and RG&E began placing orders for their own accounts in the auctions for $143.4 million of the remaining $211.4 outstanding auction rate notes. NYSEG and RG&E 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. As of December 31, 2008, NYSEG and RG&E held a total of $130.5 million of those securities, which have been accounted for as a redemption of long-term debt including: NYSEG PCN 2004 Series A, NYSEG PCN 2005 Series A, RG&E PCN 1997 Series C, and RG&E PCN 2004 Series A.

As of February 9, 2009, NYSEG and RG&E were:

- Paying rates averaging 1.5% on the remaining $68 million of auction rate notes for which they are not placing orders at auction.
- Paying rates averaging 0.60% on the $143.4 million of auction rates notes on which they are placing orders at auction. The $143.4 million includes $130.5 million of notes being held on account that have been accounted for as a redemption of long-term debt.
- Paying rates averaging 0.36% on the $187 million weekly VRDNs.

Beginning in May 2006, RG&E entered into a series of derivative transactions – forward starting swaps – intended to hedge $150 million of financing transactions in December 2008. These hedges were settled in December 2008 in connection with the pricing of RG&E's Series XX 8.00% Bonds due December 15, 2033, at a loss of $100.4 million. RG&E's 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.

At December 31, 2008, long-term debt, including sinking fund obligations and capital lease payments (in thousands) that will become due during the next five years is:

2009	2010	2011	2012	2013
$331,020	$246,477	$223,500	$562,002	$60,267

***Cross-default Provisions*:** Energy East has a provision in its senior unsecured indenture, which provides that its default with respect to any other debt in excess of $40 million will be considered a default under its senior unsecured indenture. Energy East also has a provision in its revolving credit facility, which provides that its default with respect to any other debt in excess of $50 million will be considered a default under its revolving credit facility.

Note 5. Bank Loans and Other Borrowings

Energy East is the sole borrower in a revolving credit facility providing maximum borrowings of up to $300 million. Our operating utilities are joint borrowers in a revolving credit facility providing maximum borrowings of up to $475 million in aggregate. Sublimits that total to the aggregate limit apply to each joint borrower and can be altered within the constraints imposed by maximum limits that apply to each joint borrower. Both facilities have expiration dates in 2012 and require fees on undrawn borrowing capacity. Two of our operating utilities have uncommitted bilateral credit agreements for a total of $10 million. The two revolving credit facilities and the two bilateral credit agreements provided for consolidated maximum borrowings of $785 million at December 31, 2008 and 2007. Energy East pays a facility fee of 10 basis points annually on its $300 million revolver and each joint borrower pays a facility fee on its revolver sublimit, ranging from 6 to 10 basis points annually depending on the rating of its unsecured debt.

We use commercial paper and drawings on our credit facilities to finance working capital needs, to finance temporarily certain refundings and for other corporate purposes. Drawings on Energy East's revolving credit facility are used to provide financing to its nonregulated subsidiaries and can be used to provide additional financing to its operating utilities. There was $624 million of such short-term debt outstanding at December 31, 2008, and $138 million outstanding at December 31, 2007. The weighted-average interest rate on short-term debt was 1.4% at December 31, 2008, and 5.1% at December 31, 2007. At February 9, 2009, there was $607 million of such debt outstanding.

In our revolving credit facility we covenant not to permit, without the consent of the lender, our ratio of consolidated indebtedness to consolidated total capitalization to exceed 0.65 to 1.00 at any time. For purposes of calculating the maximum ratio of consolidated indebtedness to consolidated total capitalization, the facility excludes from consolidated net worth the balance of Accumulated other comprehensive income (loss) as it appears on the consolidated balance sheet. The facility contains various other covenants, including a restriction on the amount of secured indebtedness Energy East 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. Our ratio of consolidated indebtedness to consolidated total capitalization pursuant to the revolving credit facility was 0.59 to 1.00 at December 31, 2008. We are not in default as of December 31, 2008.

In the revolving credit facility in which our operating utilities are joint borrowers, each joint borrower covenants not to permit, without the consent of the lender, its ratio of total indebtedness to total capitalization to exceed 0.65 to 1.00 at any time. For purposes of calculating the maximum ratio of consolidated indebtedness to total capitalization, the facility excludes from consolidated net worth the balance of Accumulated other comprehensive income (loss) as it appears on the consolidated balance sheet. The facility contains various other covenants, including a restriction on the amount of secured indebtedness each borrower may maintain. Continued unremedied failure to comply with those covenants for five business days after written notice of such failure from the lender constitutes an event of default and would result in acceleration of maturity for the party in default. We are not in default as of December 31, 2008.

Note 6. Preferred Stock Redeemable Solely at the Option of Subsidiaries

At December 31, 2008 and 2007, our consolidated preferred stock was:

Subsidiary and Series	Par Value per Share	Redemption Price per Share	Shares Authorized and Outstanding[1]	Amount (Thousands) 2008	Amount (Thousands) 2007
CMP, 6% Noncallable	$100	-	5,180	**$518**	$518
CMP, 4.60%	100	101.00	30,000	**3,000**	3,000
CMP, 4.75%	100	101.00	50,000	**5,000**	5,000
CMP, 5.25%	100	102.00	50,000	**5,000**	5,000
NYSEG, 3.75%	100	104.00	78,379	**7,838**	7,838
NYSEG, 4.50% (1949)	100	103.75	11,800	**1,180**	1,180
NYSEG, 4.40%	100	102.00	7,093	**709**	709
NYSEG, 4.15% (1954)	100	102.00	4,317	**432**	432
Berkshire Gas, 4.80%	100	100.00	1,218	**122**	160
CNG, 6.00%	100	110.00	4,104	**410**	410
CNG, 8.00% Noncallable	3.125	-	108,706	**340**	340
Total				**$24,549**	$24,587

[1] At December 31, 2008, Energy East and its subsidiaries had 16,732,182 shares of $100 par value preferred stock, 16,800,000 shares of $25 par value preferred stock, 775,609 shares of $3.125 par value preferred stock, 600,000 shares of $1 par value preferred stock, 1,000,000 shares of $100 par value preference stock and 6,000,000 shares of $1 par value preference stock authorized but unissued.

Note 7. Commitments and Contingencies

Alleged Overcharges by TEN Companies: The state of Connecticut (State) filed suit in February 2007 against Energy East and its subsidiaries TEN Companies, Inc., CNG and CTG Resources, Inc. for an alleged $14 million overcharge for heating and cooling services supplied to state buildings since 1992. Subsequently, the State provided an expert's report that claims the overcharges amounted to $30 million. The Connecticut Legislature passed temporary legislation preventing TEN Cos. from discontinuing service and was considering permanent legislation that would make TEN Cos. a utility subject to regulation by the DPUC when the legislative session ended.

On May 7, 2008, TEN Cos. and the State signed a memorandum of understanding (MOU) agreeing to stay the action through September 30, 2008, to allow the parties to finalize an agreement for the State's purchase of certain heating and cooling equipment that serves certain state buildings at a specified purchase price of $10.6 million, along with other terms specified in the MOU. TEN Cos. entered into an Asset Purchase Agreement (Agreement) contemplated in the MOU with the State of Connecticut on November 14, 2008. All lawsuits have been withdrawn with prejudice and mutual releases have been exchanged. The Agreement remains subject to authorizing legislation and we expect the sale to close in 2009.

Capital spending**:** We have commitments in connection with our capital spending program. We plan to invest approximately $4 billion in our energy delivery infrastructure during the next five years, including amounts dedicated to electric reliability. We expect that about one-half of our capital spending will be paid for with internally generated funds and the remainder through the issuance of a combination of debt and equity securities. The program is subject to periodic review and revision. Our capital spending will be primarily for the extension of energy delivery service, increased transmission capacity, necessary improvements to existing facilities and compliance with environmental requirements and governmental mandates.

Homer City: On June 23, 2008, NYSEG received a letter from subsidiaries of Edison Mission Energy regarding a notice of violation (NOV) from the United States Environmental Protection Agency (EPA) claiming that certain modifications to the Homer City Electric Generation Station (Homer City) during the time it was owned by NYSEG and Pennsylvania Electric Company (Penelec) were done in violation of EPA's new source review (NSR) regulations. Homer City was sold in 1999 to Edison Mission Energy by NYSEG and Penelec. Edison Mission Energy asserts that it is entitled to indemnification for fines, penalties and certain costs arising out of the violations alleged in the NOV under the terms of the asset purchase agreement for Homer City. Edison Mission Energy initially made the same claim to NYSEG in October 2000. NYSEG continues to believe that the costs sought by Edison Mission Energy are not liabilities of NYSEG and therefore did not retain liability for these material claims.

In mid-September 2008, NYSEG, Penelec and Edison Mission Energy met with EPA for a required NOV conference. EPA indicated at the meeting that it seeks a system-wide NSR settlement covering Edison Mission Energy's entire generation fleet, including a number of plants in Illinois, and would require installation of scrubbers on Homer City Units 1 and 2 as part of the settlement. While this change substantially increases the potential value of the claim, NYSEG believes that it has sound contractual defenses under the Asset Purchase Agreement. NYSEG estimates that its most likely cost exposure over the next several years will be primarily for legal defense costs and a proportionate share of fines EPA may assess against Edison Mission Energy. NYSEG cannot predict the nature or amounts of any potential fines or penalties.

DPS Staff Allegations Concerning Earnings Sharing Calculations: The New York Department of Public Service (DPS) Staff in its testimony and briefs in the merger proceeding has alleged that NYSEG did not properly compute the amount due to customers under the electric ESM in NYSEG's electric rate plan that was in effect from 2002 through 2006. The Staff claims that its preliminary analysis shows an additional $67 million, including interest, should have been allocated to customers. NYSEG vigorously disputes the Staff's claim. For each year 2002 through 2006 NYSEG made annual compliance filings, as required by the NYPSC. The DPS Staff has never formally presented its findings to NYSEG indicating its disagreements with NYSEG's 2002 through 2006 electric annual compliance filings. NYSEG is unable to predict when or how the issue will be resolved. The Staff also raised issues with regard to the ESM under the RG&E electric rate plan currently in effect, but has not completed its analysis. RG&E believes 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.

Nonutility generator power purchase contracts**:** We expensed approximately $403 million for NUG power in 2008 and $529 million in 2007. We estimate that our NUG power purchases will total $221 million in 2009, $78 million in 2010, $79 million in 2011, $73 million in 2012 and $68 million in 2013.

Nuclear entitlement power purchase contracts**:** In connection with our sales of nuclear generating assets in 2001 and 2004, we entered into four entitlement contracts under which we purchase electricity at a fixed contract price. We expensed approximately $274 million for nuclear entitlement power in 2008 and $270 million in 2007. We estimate that our nuclear entitlement power purchases will be $287 million in 2009, $296 million in 2010, $279 million in 2011, $182 million in 2012 and $195 million in 2013.

South Glens Falls Energy, LLC (SGF) Bankruptcy Proceeding**:** In January 2008 the trustee in the SGF Chapter 7 bankruptcy proceeding brought adversarial proceedings seeking repayment of alleged preferential payments made in the one-year period preceding the bankruptcy filing to SGF affiliates in amounts totaling $14 million. We evaluated the claims and filed responsive pleadings on April 1, 2008. The Energy East defendants filed a motion for summary judgment on the claims. Oral argument on the summary judgment motion was held October 28, 2008, and we are awaiting a decision. We do not believe there is merit to the claims, but cannot predict the outcome of this matter.

Note 8. Environmental Liability

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 EPA and various state environmental agencies, as appropriate, have notified us that we are among the potentially responsible parties who may be liable for costs incurred to remediate certain hazardous substances at 23 waste sites. The 23 sites do not include sites where gas was manufactured in the past, which are discussed below. With respect to the 23 sites, 14 sites are included in the New York State Registry of Inactive Hazardous Waste Disposal Sites, three are included in Maine's Uncontrolled Sites Program, one is included on the Massachusetts Non-Priority Confirmed Disposal Site list and nine 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 $2 million related to 11 of the 23 sites. We have paid remediation costs related to the remaining 12 sites, and do not expect to incur any additional liability. We have recorded an estimated liability of $7.4 million related to another 13 sites where we believe it is probable that we will incur remediation costs and/or monitoring costs, although we have not been notified that we are among the potentially responsible parties. The ultimate cost to remediate the sites may be significantly more than the accrued amount. Factors affecting the estimated remediation amount include the remedial action plan selected, the extent of site contamination and the portion attributed to us.

We have a program to investigate and perform necessary remediation at our 60 sites where gas was manufactured in the past. Eight sites are included in the New York State Registry, eight sites are included in the New York Voluntary Cleanup Program, three sites are part of Maine's Voluntary Response Action Program and two of those three sites are part of Maine's Uncontrolled Sites Program, three sites are included in the Connecticut Inventory of Hazardous Waste Sites, and three sites are on the Massachusetts Department of Environmental Protection's list of confirmed disposal sites. We have entered into consent orders with various environmental agencies to investigate and, where necessary, remediate 46 of the 60 sites.

Our estimate for all costs related to investigation and remediation of the 60 sites ranges from $204 million to $439 million at December 31, 2008. Our estimate could change materially based on facts and circumstances derived from site investigations, changes in required remedial action, changes in technology relating to remedial alternatives and changes to current laws and regulations.

The liability to investigate and perform remediation, as necessary, at the known inactive gas manufacturing sites was $204 million at December 31, 2008, and $187 million at December 31, 2007. We recorded a corresponding regulatory asset, net of insurance recoveries, because we expect to recover the net costs in rates.

Our environmental liabilities are recorded on an undiscounted basis unless payments are fixed and determinable. Nearly all of our environmental liability accruals, which are expected to be paid through the year 2030, have been established on an undiscounted basis. Some of our operating utility subsidiaries have received insurance settlements during the last two years, which they generally accounted for as reductions to their related regulatory assets.

Note 9. Fair Value of Financial Instruments and Fair Value Measurements

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

December 31,	2008		2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
(Thousands)				
First mortgage bonds	**$881,920**	**$899,492**	$774,591	$809,495
Pollution control notes, fixed	**$347,000**	**$319,671**	$277,000	$279,980
Pollution control notes, variable	**$282,500**	**$282,500**	$472,800	$472,800
Various long-term debt	**$2,375,240**	**$2,156,465**	$2,429,479	$2,472,389

The carrying amounts for cash and cash equivalents, investments available for sale, accounts receivable, notes payable, derivative assets, derivative liabilities 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.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

		Fair Value Measurements at December 31, 2008, Using		
Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(Thousands)				
Assets				
Noncurrent investments available for sale, auction rate securities	$3,850	-	-	$3,850
Noncurrent investments available for sale, other	119,214	$119,214	-	-
Derivatives	28,700	-	-	28,700
Total	$151,764	$119,214	-	$32,550
Liabilities				
Derivatives	$222,141	$62,699	-	$159,442
Total	$222,141	$62,699	-	$159,442

Valuation techniques: We value our noncurrent investments available for sale, auction rate securities at par due to the variable rate earned on the investments, which are currently earning pretax equivalent rates of 3.85%. At January 1, 2008, we included the fair value of those investments in Level 1.

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:

- NYSEG, RG&E and our energy marketing subsidiaries enter into electric energy derivative contracts to hedge the forecasted purchases required to serve their electric load obligations. Those companies hedge their 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.
- NYSEG, RG&E and our energy marketing subsidiaries enter into natural gas derivative contracts to hedge the forecasted purchases required to serve their 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.
- 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.

Instruments Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
Year ended December 31, 2008	Auction Rate Securities	Derivatives, Net	Total
(Thousands)			
Beginning balance	-	$19,885	$19,885
Total (losses) (realized/unrealized)			
Included in earnings	-	(34,283)	(34,283)
Included in other comprehensive income	-	(50,498)	(50,498)
Included in regulatory liabilities	-	(54,044)	(54,044)
Purchases, issuances and settlements	$(16,075)	(24,506)	(40,581)
Transfers into Level 3	19,925	12,704	32,629
Ending balance	$3,850	$(130,742)	$(126,892)
Total gains for the period included in earnings attributable to the change in unrealized gains relating to assets still held at December 31, 2008	-	$19,925	$19,925

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	Other Income	Other Deductions	Interest expense
(Thousands)					
Total gains (losses) included in earnings for year ended December 31, 2008	$(18,277)	$(3,017)	$288	$(13,324)	$47
Change in unrealized gains (losses) relating to assets still held at December 31, 2008	$(18,916)	$(1,297)	$288	$(620)	-

Note 10. Accumulated Other Comprehensive Income (Loss)

(Thousands)	Balance January 1, 2007	2007 Change	Balance December 31, 2007	2008 Change	Balance December 31, 2008
Net unrealized holding gains (losses) on investments, net of income tax (expense) benefit of $(71) for 2007 and $1,741 for 2008	$1,382	$116	$1,498	$(2,622)	$(1,124)
Amortization of pension cost for nonqualified plans, net of income tax (expense) of $(3,263) for 2007 and $(1,702) for 2008	(16,817)	4,916	(11,901)	2,473	(9,428)
Unrealized (losses) gains on derivatives qualified as hedges:					
Unrealized (losses) during period on derivatives qualified as hedges, net of income tax benefit of $12,093 for 2007 and $55,990 for 2008		(18,240)		(84,566)	
Reclassification adjustment for losses (gains) included in net income, net of income tax (benefit) expense of $(24,684) for 2007 and $1,557 for 2008		37,245		(2,374)	
Net unrecognized gains (losses) on settled cash flow treasury hedges, net of income tax (expense) benefit of $(4,719) for 2007 and $39,582 for 2008		7,351		(60,870)	
Net unrealized (losses) gains on derivatives qualified as hedges [1]	(8,344)	26,356	18,012	(147,810)	(129,798)
Accumulated Other Comprehensive (Loss) Income	$(23,779)	$31,388	$7,609	$(147,959)	$(140,350)

[1] See Risk management in Note 1.

Note 11. 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	
	2008	**2007**	**2008**	**2007**
(Thousands)				
Change in benefit obligation				
Benefit obligation at January 1	**$2,247,808**	$2,301,993	**$519,858**	$530,443
Service cost	**32,520**	35,113	**5,305**	5,754
Interest cost	**134,080**	129,850	**30,467**	29,690
Plan participants' contributions	**-**	-	**9,457**	7,809
Plan amendments	**232**	521	**(977)**	-
Actuarial (gain)	**(23,887)**	(74,399)	**(24,787)**	(16,135)
Benefits paid	**(150,012)**	(145,270)	**(44,041)**	(40,308)
Federal subsidy on benefits paid	**-**	-	**2,713**	2,605
Benefit obligation at December 31	**$2,240,741**	$2,247,808	**$497,995**	$519,858
Change in plan assets				
Fair value of plan assets at January 1	**$2,905,948**	$2,815,425	**$102,618**	$37,301
Actual return on plan assets	**(761,531)**	232,793	**(37,709)**	1,635
Employer contributions	**1,500**	3,000	**56,883**	72,334
Plan participants' contributions	**-**	-	**4,213**	3,781
Benefits paid	**(150,012)**	(145,270)	**(13,572)**	(12,433)
Fair value of plan assets at December 31	**$1,995,905**	$2,905,948	**$112,433**	$102,618
Funded status at December 31	**$(244,836)**	$658,140	**$(385,562)**	$(417,240)

Amounts recognized in the balance sheet	**Pension Benefits**		**Postretirement Benefits**	
December 31,	**2008**	**2007**	**2008**	**2007**
(Thousands)				
Noncurrent assets	**$27,062**	$698,432	**-**	-
Current liabilities	**-**	-	**$(5,819)**	$(5,890)
Noncurrent liabilities	**(271,898)**	(40,292)	**(379,743)**	(411,350)
	$(244,836)	$658,140	**$(385,562)**	$(417,240)

We have determined that all of our operating companies are allowed to defer as regulatory assets or regulatory liabilities items that would otherwise be recorded in accumulated other comprehensive income pursuant to FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. Amounts recognized as regulatory assets or regulatory liabilities consist of:

	Pension Benefits		**Postretirement Benefits**	
December 31,	**2008**	**2007**	**2008**	**2007**
(Thousands)				
Net loss	**$1,098,091**	$130,547	**$48,357**	$32,024
Prior service cost (credit)	**$29,920**	$33,988	**$(14,842)**	$(21,290)
Transition obligation	**-**	-	**$27,200**	$34,000

Our accumulated benefit obligation for all defined benefit pension plans was $2.1 billion at December 31, 2008 and 2007.

CMP's, CNG's and SCG's postretirement benefits were partially funded at December 31, 2008 and 2007. NYSEG began funding its postretirement benefits with a $60 million contribution to a VEBA in October 2007, followed by a second contribution of $52 million in January 2008.

The projected benefit obligation exceeded the fair value of pension plan assets for CMP's, CNG's, SCG's, RG&E's and Berkshire Gas' plans as of December 31, 2008, and for CMP's, CNG's and SCG's plans as of December 31, 2007. The accumulated benefit obligation exceeded the fair value of pension plan assets for CMP's, CNG's, SCG's, RG&E's and Berkshire Gas' plans as of December 31, 2008, and for CMP's plan as of December 31, 2007. The following table shows the aggregate projected and accumulated benefit obligations and the fair value of plan assets for those companies' plans for the relevant periods.

	Projected Benefit Obligation Exceeds Fair Value of Plan Assets		**Accumulated Benefit Obligation Exceeds Fair Value of Plan Assets**	
December 31	**2008**	**2007**	**2008**	**2007**
(Thousands)				
Projected benefit obligation	**$1,013,034**	$514,816	**$1,013,034**	$264,114
Accumulated benefit obligation	**$935,335**	$466,720	**$935,335**	$239,621
Fair value of plan assets	**$741,136**	$474,524	**$741,136**	$232,064

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

	Pension Benefits		**Postretirement Benefits**	
Years ended December 31,	**2008**	**2007**	**2008**	**2007**
(Thousands)				
Net periodic benefit cost				
Service cost	**$32,520**	$35,113	**$5,305**	$5,754
Interest cost	**134,080**	129,850	**30,467**	29,690
Expected return on plan assets	**(241,615)**	(232,860)	**(7,993)**	(3,528)
Amortization of prior service cost (benefit)	**4,300**	4,615	**(7,425)**	(7,433)
Amortization of net loss	**11,715**	15,927	**4,582**	5,531
Amortization of transition obligation	**-**	-	**6,800**	6,800
Net periodic benefit cost	**$(59,000)**	$(47,355)	**$31,736**	$36,814
Other changes in plan assets and benefit obligations recognized in regulatory assets and regulatory liabilities				
Net loss (gain)	**$979,259**	$(74,332)	**$20,915**	$(14,242)
Prior service cost	**232**	521	**(977)**	-
Amortization of net (loss)	**(11,715)**	(15,927)	**(4,582)**	(5,531)
Amortization of prior service (cost) credit	**(4,300)**	(4,615)	**7,425**	7,433
Amortization of transition obligation	**-**	-	**(6,800)**	(6,800)
Total recognized in regulatory assets and regulatory liabilities	**963,476**	(94,353)	**15,981**	(19,140)
Total recognized in net periodic benefit cost and regulatory assets and regulatory liabilities	**$904,476**	$(141,708)	**$47,717**	$17,674

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. The amount of postretirement benefit cost deferred at December 31 was $38 million for 2008 and $45 million for 2007. 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 the adoption of Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

Amounts expected to be amortized from regulatory assets or regulatory liabilities into net periodic benefit cost for the fiscal year ending December 31, 2009	**Pension Benefits**	**Postretirement Benefits**
(Thousands)		
Estimated net loss	$47,708	$5,924
Estimated prior service cost (credit)	$4,055	$(7,152)
Estimated transition obligation	-	$6,800

We expect that no pension benefit or postretirement benefit plan assets will be returned to us during the fiscal year ended December 31, 2009.

Weighted-average assumptions used to	**Pension Benefits**		**Postretirement Benefits**	
determine benefit obligations at December 31,	**2008**	**2007**	**2008**	**2007**
Discount rate	**6.10%**	6.00%	**6.10%**	6.00%
Rate of compensation increase	**4.00%**	4.00%	**4.00%**	4.00%

As of December 31, 2008, we increased our discount rate from 6.00% to 6.10%. The discount rate is the rate at which the benefit obligations could presently be effectively settled. We determined the discount rate by developing a yield curve derived from a portfolio of high grade noncallable bonds that closely matches the duration of the expected cash flows of our benefit obligations.

Weighted-average assumptions used to determine net periodic benefit cost for	**Pension Benefits**		**Postretirement Benefits**	
years ended December 31,	**2008**	**2007**	**2008**	**2007**
Discount rate	**6.00%**	5.75%	**6.00%**	5.75%
Expected long-term return on plan assets	**8.75%**	8.75%	**-**	-
Expected long-term return on plan assets - nontaxable trust	**-**	-	**8.00%**	8.00%
Expected long-term return on plan assets - taxable trust	**-**	-	**4.80%**	4.80%
Rate of compensation increase	**4.00%**	4.00%	**4.00%**	4.00%

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. That analysis considered current capital market conditions and projected conditions. The operating companies 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.

Assumed health care cost trend rates to determine benefit obligations at December 31,	**2008**	**2007**
Health care cost trend rate assumed for next year	**8.0%**	8.0%
Rate to which cost trend rate is assumed to decline (the ultimate trend rate)	**5.0%**	5.0%
Year that the rate reaches the ultimate trend rate	**2014**	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:

	1% Increase	1% Decrease
(Thousands)		
Effect on total of service and interest cost	$1,588	$(1,338)
Effect on postretirement benefit obligation	$19,559	$(16,882)

***Plan assets*:** Our weighted-average asset allocations at December 31, 2008 and 2007, by asset category, are:

	Pension Benefits			Postretirement Benefits		
Asset Category	**Target Allocation**	**2008**	**2007**	**Target Allocation**	**2008**	**2007**
Equity securities	56%	**49%**	60%	56%	**52%**	58%
Debt securities	30%	**34%**	26%	37%	**40%**	37%
Real estate	4%	**6%**	5%	4%	**4%**	-
Other	10%	**11%**	9%	3%	**4%**	5%
Total	100%	**100%**	100%	100%	**100%**	100%

Our pension benefits plan assets are held in a master trust with a trustee and our postretirement benefits plan assets are held with two trustees in multiple VEBA and 401(h) arrangements. Those assets are invested among and within various asset classes in order to achieve sufficient diversification in accordance with our risk tolerance. This is achieved for our pension benefits plan assets through the utilization of multiple asset managers and systematic allocation to investment management styles, providing broad exposure to different segments of the fixed income and equity markets; and for our postretirement benefits plan assets through the utilization of multiple institutional mutual and money market funds, providing exposure to different segments of the fixed income, equity and short-term cash markets. Approximately 20% of the postretirement benefits plan assets are invested in VEBA and 401(h) arrangements that are not subject to income taxes. The remainder is invested in arrangements subject to income taxes. We believe that the resulting valuations are a reasonable estimate of fair value as of December 31, 2008. The fair values of an insignificant portion of the pension plan assets are subject to uncertainty, and therefore, may differ from the values that would have been used had a ready market for the investments existed. We do not expect that such differences would have a material effect on the funded status of the plan. Due to the level of risk associated with financial assets, and the level of uncertainty related to the changes in the values of those instruments, it is reasonably possible that changes in values in the near term could affect the fair value amounts reported as of December 31, 2008.

Equity securities did not include any Iberdrola common stock at December 31, 2008.

***Contributions*:** In accordance with our funding policy we make annual contributions of not less than the minimum required by applicable regulations. We expect to contribute between $25 million and $50 million to our pension benefit plans and less than $10 million to our other postretirement benefit plans in 2009.

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)			
2009	$144,871	$56,338	$(3,822)
2010	$150,945	$61,108	$(4,197)
2011	$159,156	$65,149	$(4,497)
2012	$162,651	$68,906	$(4,948)
2013	$168,922	$71,949	$(5,330)
2014 - 2018	$885,351	$393,777	$(30,934)

Note 12. Segment Information

Selected financial information for our operating segments is presented in the table below. Our electric delivery segment consists of our regulated transmission, distribution and generation operations in New York and Maine and our natural gas delivery segment consists of our regulated transportation, storage and distribution operations in New York, Connecticut, Maine and Massachusetts. We measure segment profitability based on net income. Other includes primarily our energy marketing companies, interest income, intersegment eliminations and our other nonutility businesses.

	Electric Delivery	Natural Gas Delivery	Other	Total
(Thousands)				
2008				
Operating Revenues	**$2,662,583**	**$1,872,468**	**$533,995**	**$5,069,046**
Depreciation and Amortization	**$174,129**	**$86,340**	**$11,214**	**$271,683**
Interest Charges, Net	**$186,973**	**$87,338**	**$8,176**	**$282,487**
Income Taxes (Benefits)	**$(55,195)**	**$15,013**	**$(6,377)**	**$(46,559)**
Net Income	**$16,589**	**$41,853**	**$(13,268)**	**$45,174**
Total Assets	**$8,220,519**	**$3,991,179**	**$454,312**	**$12,666,010**
Utility Capital Spending	**$383,574**	**$132,276**	**-**	**$515,850**
2007				
Operating Revenues	$2,880,994	$1,771,789	$525,325	$5,178,108
Depreciation and Amortization	$179,618	$86,919	$10,953	$277,490
Interest Charges, Net	$183,992	$86,596	$5,350	$275,938
Income Taxes (Benefits)	$71,002	$47,096	$(4,040)	$114,058
Net Income	$156,462	$92,829	$2,007	$251,298
Total Assets	$7,863,420	$3,580,748	$434,541	$11,878,709
Utility Capital Spending	$332,487	$111,522	-	$444,009