BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

National Grid PLC and KeySpan Corporation - Proposed Merger

Case 06-M-0878

The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York - Gas Rates

Case 06-G-1185

KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island - Gas Rates

Case 06-G-1186

January 2007

Prepared Testimony of:
Accounting Panel Rates (KEDNY)

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Public Utilities Auditor I

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Q. Please state your name and business address.
A. My name is Ronald F. Calkins. My business address is Three Empire State Plaza, Albany, NY, 12223.
Q. By whom are you employed and in what capacity?
A. I am employed by the Department of Public Service as a Supervisor, in the Office of Accounting and Finance.
Q. What is your education and business experience?
A. I graduated from Siena College with a BBA in Accounting. In June of 1969, I joined the Department of Public Service.
Q. Have you previously testified before the Public Service Commission (Commission)?
A. Yes. I have testified before the Commission in various electric, gas and telephone rate proceedings.
Q. Please state your name and business address.
A. My name is Richard M. Brash. My business address is Three Empire State Plaza, Albany, NY, 12223
Q. By whom are you employed and in what capacity?

A. I am employed by the Department of Public Service as a Public Utilities Auditor III, in the Office of Accounting and Finance.

Q. What is your education and business experience?

A. I graduated from the State University of New York at Albany in 1976 with a Bachelor's Degree in Business Administration. Since joining the staff of the Department of Public on October 1980, I have worked on rate and finance proceedings of electric, gas, telephone and water companies.

Q. Have you previously testified before the Commission?

A. Yes, I have testified in rate proceedings before the Commission.

Q. Please state your name and business address.

A. My name is George Abraham. My business address is 90 Church Street, New York, NY, 10007.

Q. By whom are you employed and in what capacity?

A. I am employed by the New York State Department of Public Service as a Public Utilities Auditor II, in the Office of Accounting and Finance.

Q. Please state your educational and professional background experience.

A. I graduated from Sri Venkateswara University, India in 1978 with a Masters of Arts Degree in Commerce. I have been on the audit staff with the Department of Public Service since March 1982.

Q. Have you previously testified before the Commission?

A. Yes.

Q. Please state your name and business address.

A. My name is Christopher G. Simon. My business address is Three Empire State Plaza, Albany, NY, 12223.

Q. By whom are you employed and in what capacity?

A. I am employed by the Department of Public Service as a Public Utilities Auditor I, in the Office of Accounting and Finance.

Q. What is your educational and business experience?

A. I attended the State University of New York Institute of Technology at Utica/Rome where I graduated with a Bachelor in Accounting and a

Master in Business Administration with a Concentration in Accounting. I worked for 2½ years at Warren Koch, PC, Croton-On-Hudson, NY. At Warren Koch PC, I worked as an Accountant and as the Network Administrator. After Warren Koch, I went to LCS&Z, LLP in Latham, New York where I was employed as an Accountant. In February 2005, I joined the Office of Accounting and Finance in the Department of Public Service in my present position.

Q. Have you previously testified before the Commission?

A. Yes, I have filed testimony as a part of the Accounting Rates Panel for Corning Natural Gas Corporation in Cases 05-G-1359, 05-G-1268 and 04-G-1032.

Q. What is the purpose of the Accounting Rate Panel (Panel or Staff) testimony in this proceeding?

A. The Panel participated in the examination of the KeySpan Energy Delivery of New York (KEDNY or Company) rate case filing, the supporting work papers, books, records and accounts of the Company and its affiliates. The Panel will propose specific adjustments to the Historic Test Year, Amortization Expense, Sales Promotion Expense, Other Employee Related Expenses, Inflation Percentage Factor, Labor, Payroll Taxes and Operations and Maintenance Expenses. The Panel is also proposing that KEDNY reverse the deferral of the Special Franchise Taxes that were booked after 2002.

Q. Has the Panel prepared any exhibits to be presented in this case?

A. Yes. The Panel is sponsoring Exh___(APR-1) Schedule A, Pages 1 Through 13. Schedule A contains the following data:

- Statement of Operating Income, Rate Base, and Rate of Return - Page 1 of 13;
- Operations & Maintenance Expense - Page 2 of 13;
- Depreciation - Page 3 of 13;
- Amortizations - Page 4 of 13;
- Taxes Other Than Income Taxes - Page 5 of 13;
- State Income Taxes - Page 6 of 13;
- Federal Income taxes - Page 7 of 13;

- Calculation of Interest Expense - Page 8 of 13;
- Calculation of Average Rate Base - Page 9 of 13;
- Capitalization Earning Base Comparison - Page 10 of 13;
- Computation of Cash Working Capital Allowance - Page 11 of 13;
- Company Proposed Capital Structure, Staff Proposed Capital Structure - Page 12 of 13;
- Computation of Recommended Additional Revenue Requirement - Page 13 of 13;

Exh___(APR-1) Schedule B, Pages 1 through 2. Schedule B contains the descriptions of Staff's adjustments.

Exh___(APR-1) Schedule C, Pages 1 through 5. Schedule C contains the following data:

- DPS-120 - Page 1 of 5;
- DPS-264 - Page 2 of 5;
- 15 Month Inflation Estimate - Page 3 of 5;
- Blue Chip Economic Indicators Vol. 32, No. 1 January 10, 2007 - Pages 4 & 5 of 5;

Q. Please briefly describe the pages in Schedule A of Exh__(APR-1).

A. Schedule A is Staff's Income Statement and Rate of Return calculation for KEDNY before and after our revenue requirement recommendation for the rate year ended March 31, 2008. Schedule A - page 1 of 13, is Staff's Statement of Operating Income, Rate Base and Rate of Return. The First column in Schedule A corresponds to the KEDNY Rate Year figures as presented in the Company's Rate Filing. The second column reflects Staff's adjustments. Exh___(APR-1) Schedule B contains the descriptions of all adjustments made in the second column. The third column is the sum of columns one and two. The fourth column reflects Staff's proposed Revenue Requirement. Finally, column five represents the sum of columns three and four. Staff is proposing a gas base rate increase of $8.729 million, or a .037% increase in the total bill.

Q. What other data is shown in Exhibit ___(APR-1), Schedule A Pages 2 through 13?

A. Schedule A, Page 2 of 13, shows the Operation and Maintenance expenses as adjusted by Staff. Schedule A, Page 3 of 13, shows the Depreciation Expense as adjusted by Staff. Schedule A, Page 4 of 13, shows the Amortizations as adjusted by Staff. Schedule A, Page 5 of 13, shows the Taxes Other Than Income Taxes as adjusted by Staff. Schedule A, Page 6 of 13, shows the calculation of the New York State Income Taxes as adjusted by Staff. Schedule A, Page 7 of 13, shows the calculation of Federal Income Taxes as adjusted by Staff. Schedule A, Page 8 of 13, shows the Calculation of Interest Expense as adjusted by Staff. Schedule A, Page 9 of 13, shows the average Rate Base as adjusted by Staff. Schedule A, Page 10 of 13, shows the Historic Earnings Base Capitalization Comparison as adjusted by Staff. Schedule A, Page 11 of 13, shows the Cash Working Capital allowance as adjusted by Staff. Schedule A, Page 12 of 13, shows the proposed Capital Structure and Rate of Return as filed by the Company's as well as Staff's proposed Capital Structure and Rate of

Return. Schedule A, Page 13 of 13, shows Staff's computation of its recommended additional Revenue Requirement for the twelve months ending March 31, 2008.

Q. Please describe the pages in Schedule B of Exh___(APR-1).

A. On Pages 1 and 2 are brief descriptions of the Staff adjustments to Operating Revenues, Operations and Maintenance Expense, Depreciation, Amortizations, State and Federal Income Taxes, Interest Deduction, Rate Base, Earnings Base/Capitalization, Cash Working Capital and the Capital Structure.

Q. Please describe the pages in Schedule C of Exh___(APR-1).

A. Schedule C - Page 1 of 5, is Staff's updated inflation estimate used to calculate the new Rate Year Expense. Schedule C - Pages 2 & 3 of 5 contains the updated GDP Deflators for 2007 and 2008 as provided by Blue Chip Economic Indicators Vol. 32, No. 1 January 10, 2007. Schedule C - Page 4 of 5, was Staff's interrogatory requesting the cost component schedule for the year ended December 31, 2004 and 12 months ended September 30, 2006. Schedule C - Page 5 of 5, was Staff's interrogatory requesting the cost component schedule for the years ended December 31, 2003 & 2006.

AMORTIZATION EXPENSE

Q. One of your recommendations is to reverse the deferral of the Special Franchise Taxes that were booked after September 2002. What is the impact of this recommendation on KEDNY's rate case?

A. The amortization of property taxes in the Rate Year Income Statement would be reduced by $5.542 million (Adjustment 13), State and Federal Income Tax would be adjusted accordingly, and the Rate Year Rate Base would be reduced by $36.025 million (Adjustment 27) and the associated accumulated deferred Federal Income Taxes and State Income Taxes of $15.862 million (Adjustment 30) would be eliminated. Additionally, the deferral balance of $38.074 million at September 2002 plus interest from that time to the Rate Year would become available for Commission disposition.

Q. Why did KEDNY defer the special franchise taxes in the first place?

A. In Case 97-M-0567, Appendix A, Section V.A.5.m., KEDNY was authorized to defer 90% of the difference between actual special franchise taxes and the level allowed in rates <u>if</u> KEDNY was successful in protesting its special franchise property tax. The Company was successful and in January 2000, it began deferring 90% of the difference between the rate allowance and actual special franchise property tax.

Q. Describe Section V.A.5.m which allowed KEDNY to defer this amount.

A. If KEDNY settled its property tax protest by receiving a cash refund or a limited term prospective reduction in special franchise taxes, Section V.A.5.m allowed a limited true-up of special franchise property taxes for each remaining fiscal year of the rate plan. The Company would defer 90% of the amount by which the tax expense varied from the specified target amount for fiscal years ending September 1998 to September 2002.

Q. Does the Rate Plan approved in Case 97-M-0567 address the effectiveness of its provisions beyond the time period for which it established rates?

A. Yes. Appendix A, Section V.A.8. addresses the continuation of the rate plan beyond 2002. It provides that all provisions of the agreement will continue beyond the last year of the rate plan on a year-to-year basis until modified or discontinued by the Commission. Based on this provision KEDNY continued to defer property taxes after September 2002 and it used the 2002 target as the reference point in making deferral calculations for each year thereafter.

Q. Do you agree that Appendix A, Section V.A.8. allows for continuation of the deferral of special franchise taxes?

A. No, while the continuation section described above does apply to other sections of the rate plan agreement it does not apply to KEDNY's franchise property tax true-up. This is because Section V.A.5.m., which establishes this particular true-up was not designed to last indefinitely, but to provide a mechanism to capture the tax savings from a specific event, (a tax protest settlement) that might occur during the term of the rate plan. As such this is not a typical true-up, but rather a discrete incentive designed to provide the Company an incentive to accomplish a specific event during the term of the Rate Plan.

Q. What is the basis for this conclusion about the effectiveness of Section V.A.5.m. beyond the 2002 conclusion of the rate plan?

A. Unlike typical true-up provisions, this true-up mechanism doesn't start until an event occurs (a tax settlement is realized). For example Appendix A, Section VI.A.6.e. of the Settlement Agreement in Case No. 97-M-0567, presents a property tax true-up for KeySpan Energy Delivery Long Island and it starts on day one of the rate plan. If the KEDNY special franchise tax deferral was simply meant to be a tax true-up it would have also started at the start of the rate plan. The unique nature of the special franchise fee incentive is specifically recognized in the terms of Section V.A.5.m., which state that it is limited to each remaining fiscal year of the rate plan. No other deferral section in the Rate Plan contains such wording.

Q. Is it possible to argue that because the continuation language in section V.A.8. extends the fiscal years of the rate plan beyond its original end date, the deferral would automatically continue to apply to these fiscal years after September 2002?

A. While such an argument can be made, it fails to recognize that unlike other sections, Section V.A.5.m. cannot be continued because it does not provide a target to true-up or a methodology for determining that target beyond the 2002 fiscal year.

Q. How is the omission of such a methodology different from the other sections that have targets?

A. Yes. Section V.A.5.j. (Earnings Sharing), provides a specific target for fiscal years 1998 through 2002, and then provides a target for additional years unless modified by the Commission. Section VI.A.6.e. (Property Taxes) and Section VI.A.6.k. (Pensions & OPEBS) provides a target for fiscal years 1998 through 2000, and then provides a target for subsequent years unless modified or terminated by the Commission. In Section V.A.5.m. there is no language on determining the target for fiscal years after 2002. The only logical explanation for this is that it was the intent of the parties to suspend the special franchise tax deferral mechanism at the original conclusion of the rate plan.

Q. Has the Panel addressed the Company's amortization and recovery of Merger Costs from the Brooklyn Union Gas/LILCO merger?

A. Yes. The Company has reflected in operating expense a $9,569,000 Merger Cost amortization as shown on Company Exhibit PJM-3, Schedule 1, Page 1. As outlined within the merger case settlement agreement (Case 97-M-0567, Opinion 98-9, issued and effective April 14, 1998), the parties agreed to permit the Company to amortize the allowed combination costs over a ten year period beginning in 1998. The ten year amortization period will be completed during the Rate Year. Once the merger costs are fully recovered, the revenue requirement collections covering this amortization should then be thereafter used to offset the deferred SIR costs.

Q. Has Staff adjusted the Company's amortization of environmental costs?

A. Yes. The Company's rate case operating expenses increased by $9,367,000 to reflect a seven-year amortization of Deferred Site Investigation and Remediation costs (SIR) associated with the former gas manufactured sites located within KEDNY's service territory. This calculation is based on a seven-year amortization assuming total unrecovered deferred cumulative SIR costs net of insurance recoveries, of $65,566,000 as of March 31, 2007. This forecasted amount of cumulative deferred SIR costs is far greater than the actual deferred costs of $13,577,815 at December 31, 2005 and $27,874,287 at September 30, 2006. Due to the large disparity between the actual and forecasted balances, we recommend a ten year amortization period for deferred SIR costs. The ten year amortization period was selected because it has been approximately ten years since the last rate change (Case 97-M-0567, Opinion No. 98-9, issued and effective April 14, 1998). This adjustment lowers the Company's rate year amortization by $6,580,000(Adjustment 18). The SIR deferral balance and the associated amortization level should be updated during the course of this proceeding.

SALES PROMOTION EXPENSE

Q. How is Staff proposing to adjust the Sales Promotion Expense?

A. Based on Staff witness Sorrentino's testimony, the Sales Forecast Sales Promotion expense for KEDNY will be reduced by $4.851 million (Adjustment 5).

Q. Why is this done?

A. According to witness Sorrentino's sales forecast, the sales promotion enhancements to the equipment and the rebate and financing programs that KeySpan is proposing will not be needed to achieve Staff's sales forecast.

OPERATIONS AND MAINTENANCE EXPENSE

Q. What is the first change that Staff is proposing for the Company's initial filing?

A. Staff is proposing to update the inflation pool expense item from the Historic Test Year December 31, 2005 to the Historic Test Year December 31, 2006.

Q. What is the rationale for updating the Historic Test Year?

A. During the initial investigation into the books and records supporting KEDNY's Historical Test Year ended December 31, 2005, we compared Operations and Maintenance expense levels for the time period to those in 2003, 2004 and preliminary results in 2006. Results for the year ended December 31, 2004 and the 12 months ended September 30, 2006 were obtained from interrogatory DPS-120, Exh___(APR-1), Schedule C - Page 1 of 5. Results for December 31, 2003 as well as an updated year ended December 31, 2006 (received January 15, 2007) were obtained from DPS-264, Exh___(APR-1), Schedule C - Page 2 of 5. These requested schedules provided Staff with a historical trend of the Operations and Maintenance Expenses and indicated that total expenses decreased from 2003 to 2004 by ($5,166,141) or (-1.66%), increased from 2004 to 2005 by $29,084,664 or 9.51% and then decreased from 2005 to 2006 by ($34,269,203) or (-10.23%). Given this trend Staff decided to base the Rate Year expenses on more current data. The update to the Historic Test Year results in an overall decrease in the Operations and Maintenance Expense accounts by $(6,036,156).

Q. Has Staff made any specific adjustments to the updated Historic Test Year based on the Company's books and records?

A. Yes, Other Related Employee Expense included a one-time expense recorded in March 2006 of $776,598 related to a Stock Option bonus for Mr.

Robert Catell based on the Company's overall 2005 financial performance. This amount was to have been recognized over the course of 2 years, but due to recent FASB regulations, the Company's accountants recorded the expense in 2006. Staff has eliminated this amount from the Updated Historic Test Year for the purpose of forecasting the 2008 Rate Year Expenses. Examination of this account from 2003 through 2006 shows this as a one-time event and there is no basis for assuming that this will occur during the 2008 Rate Year. For the year 2005, KEDNY's earnings, were not in excess of the 13.5% sharing threshold that would have allowed the customers to benefit by receiving a portion of the excess earnings achieved by the Company. Staff believes that since the customers did not benefit from KEDNY's 2005 financial performance, it is unreasonable to have customers fund any part of an executive bonus. This adjustment reflects a ($.777) million reduction to Other Related Employee Expense for the 2006 Historic Test period.

Q. Did Staff have to make any other adjustments to the original filing after updating the Historic Test Year to the calendar year 2006?

A. Yes, Staff updated the inflation factor to reflect the more up-to-date Historic Test Year. The Company used a 27-month inflation factor to update the Historic Test Year December 31, 2005 filing to the Rate Year March 31, 2008. When Staff reflected the actual data for calendar year 2006, a 15-month inflation factor was necessary to forecast expenses to March 31, 2008. The new 15-month inflation factor is 2.61%, Exh___(APR-1) Schedule C - Page 3 of 5, versus the 27 month inflation factor of 5.57%. Lowering the inflation factor results in a reduction of Rate Year Operations and Maintenance Expense by ($4,782,525).

Q. What schedules were presented in the original filing that show the Company's inflation factor?

A. The two schedules were the Company's Cost Adjustment Factors Reflecting Changes in Inflation Estimates for a 27 Month Period Schedule (Exhibit 4, JFB-4, Schedule 3, Page 2 of 2) and the supporting Cost Adjustment Factors Reflecting Changes in Price Levels March 2009 Through March 2012 Rate Year Schedule (Exhibit 4, JFB-10, Schedule 1 - Page 2 of 4).

Q. How were these schedules used in the Rate filing?

A. JFB-4 calculated the escalation factor used to inflate the 2005 expenses to the March 31, 2008 Rate Year levels. JFB-4 provides information for the time period third quarter 2005 through the third quarter 2007. The third quarter 2005 was based on the actual reported GDP Deflator and the remaining quarters were all forecasted. JFB-10 has the GDP Deflator forecasts for the period fourth quarter 2007 through third quarter 2011. Forecasted GDP Deflators were supplied by Blue Chip Economic Indicators - Vol. 30, No. 10, October 10, 2005.

Q. Did Staff update the GDP Deflators reflected in JFB-10 to a more recent estimate then the percentages provided as of October 10, 2005?

A. Yes, Staff received an updated forecast of GDP Deflators for the four quarters 2007 and the four quarters 2008 as provided by Blue Chip Indicators - Vol. 32, No. 1, January 10, 2007. Exh__(APR-1) Schedule C Page 5 of 5.

Q. What change did Staff make to schedule JFB-4 in order to calculate the 2.61% inflation factor?

A. Staff first updated the time period between the Historical Test Year and the Rate Year. As stated earlier, Staff is proposing to update the Historic Test Year from the year ending December 31, 2005 to the year ending December 31, 2006. This decreased the period of time between Historical Test Year and the Rate Year from 27 months to 15 months. The Company originally used the time period of the third quarter 2005 through the third quarter 2007 as the basis for calculating the inflation rate. This calculation incorrectly accounts for the third and fourth quarters of 2005, which would have already been accounted for in the actual expense in 2005. Staff used the format as provided in JFB-4 and the updated forecasted GDP Deflators for the 15-month period spanning from the first quarter 2007 through first quarter 2008. This time period encompassed the actual period of time between the updated historic test year and the rate year.

Q. Is Staff including any expenses in the new inflation pool that were not originally adjusted for inflation in KEDNY's original filing?

A. Yes, we include Health and Hospitalization in the general inflation pool. For decades, the Commission has included Health Care costs in an expense group to which an overall inflation index is applied. On occasion, utility companies have sought to apply a separate and higher cost escalation factor to the Health Care costs. However, the Commission has consistently rejected any such change to this approach. KEDNY claims that a separate inflator is need for Health Care costs given very large medical increases in recent times. We reject this argument and support the Commission's established practice. We also point out that some items to which the general inflation index is applied will exceed the index and some will fall below the rate of inflation. We believe that the standard ratemaking practice, which applies a general inflation factor to Health Care costs, and other cost categories, remains valid in today's circumstance and prevailing conditions.

Q. Is Staff proposing any other adjustment to non-inflation pool expense items due to the Updated Historical Test Year?

A Yes Staff is proposing to decrease the Labor expense in the Updated Historic Year and lower the rate of change associated with increasing the Labor expense to the Rate Year. The Company originally showed a Labor expense of $108.645 million in the Historic Test Year and then applied a composite increase (based on various Union Agreed Labor increases and Management increases) of 8.43%, resulting in a Rate Year expense of $117.803 million. Staff proposes to use the Updated Historic Labor expense of $108.636 million and apply a lower percentage increase. Staff's proposed increase is 4.68%.

Staff started with the original composite increase of 8.54% and used 15/27th of the increase. The 15/27th is the remaining time period between the Updated Historic Test Year and the Rate Year (15 months) versus the Original Historic Test Year and Rate Year (27 months) and it results in a change in Labor expense in the Rate Year of ($4.082) million.

Q. With the proposed change in payroll expense, do you have an associated adjustment to payroll taxes?

A. Yes, Staff has updated the Payroll Taxes to reflect the new Updated Historic Test Year ending December 31, 2006. The Company originally forecasted an increase in Payroll Taxes from the Historic Test Year to the Rate Year of 8.14%. Applying the same 15/27th as proposed with Labor, Staff increased the Updated Historic Test Year expense by 4.52%, resulting in an increase of Payroll Tax expense in the Rate Year of $.147 million.

Q. How does a reduction in Labor result in an increase in Payroll Taxes?

A. In order to stay consistent with the updated Historic Test Year. Staff used the 2006 calendar year Payroll Taxes. Although Labor decreased by $9,000 the associated Payroll Taxes increase was $298,000. Applying the updated inflation rate resulted in increasing Payroll Taxes.

Q. Is Staff' updated inflation estimate lower than the Company's estimate for the period between the Historic Test Year and the Rate Year?

A. Yes, Staff's Inflation Estimate is lower. The combination of a lower Inflation Estimate, higher total Operations and Maintenance expense, the one time adjustment to Other Employee Related Expense Benefits, and changes in Labor and Payroll Taxes results is a decrease in Operations and Maintenance expense of ($15,530,007). (Adjustment 8)

Q. Does Staff have any other adjustments to operations and Maintenance Expense?

A. Yes, Staff is proposing a 1% productivity adjustment on all updated Operations and Maintenance expenses. The 1% productivity adjustment is composed of two separate adjustments. The first adjustment is based on the Commission's commonly reflected 1% labor savings adjustment for all forecasted Rate Years. This adjustment is applied to the following expenses: Labor, Health and Hospitalization, 401K match, OPEB's, Payroll Taxes and Pensions. The second adjustment applies the 1% factor to the remaining expenses.

Q. The Commission commonly reflects a labor productivity savings in the forecast Rate Year. Did KEDNY reflect productivity savings in the Rate Year?

A. No, there is no productivity adjustment reflected in the KEDNY filing.

Q. Why did KEDNY not reflect any labor productivity adjustments?

A. Mr. Bondaza states (Page 7) that "It is my understanding that in calculating recoverable labor expense for the ratemaking purpose, the Commission's practice is to apply a 1% productivity adjustment that reduces recoverable labor expense. Given KeySpan's cost control efforts in the past, there is no justification for applying this adjustment in this proceeding. KeySpan has already voluntarily achieved the savings that are imputed through the productivity adjustment."

Moreover Company witness McClellan states (Page 11) that, "As explained in Mr. Bodanza's testimony, KEDNY has does an extraordinary job in controlling O&M expenses since the Brooklyn Union/LILCO merger. As an example, in the Test Year for KEDNY's June 30, 1993 rate filing, the O&M labor expense was $155,263,000 (PSC Case No. 93-G-0094). The December 2005 Test Year Labor expense was $108,645,000. This represents a 30.0% decrease in expense despite thirteen years of wage increases. Given this performance, it would be unreasonable to impute additional labor productivity in the determination of Company's Rate."

Q. Does Staff agree with this position?

A. No. Productivity adjustments are designed to reflect the forecasted payroll levels that drive expenses during the Rate Year. KEDNY's past performance shows that they should be able to continue this trend of cost savings. The 1% productivity adjustment reduces labor by ($1.724) million. (Adjustment 9)

Q. What is the basis for Staff's proposal of applying a 1% productivity adjustment on the remaining expenses not already factored into the Labor Adjustment?

A. The Operation and Maintenance Expense information in Exhibit 4, JFB-14, Schedule 1, Page 1 of 2, indicates that KEDNY has seen increases in expenses from 2001 through 2005 at a rate that was less then inflation. While KEDNY requests a rate increase based on the use of inflation to escalate most non-commodity Operations and Maintenance expense they have contended that: "… the provision of service through a service Company structure, along with KeySpan's other rigorous cost control efforts, has enabled KeySpan to hold its operations and Maintenance ("O&M") expense below the rate of general inflation over the past several years," (Mr. Bodanza (Page 3)). Staff would capture the continuation of this cost savings through the 1% productivity adjustment, which is generally consistent with the Company's recent experience. The effect of this adjustment is a decrease of ($1.159) million in Operations and Maintenance Expense. (Adjustment 10)

Q. What is the total change in Operations and Maintenance Expense after all adjustments?

A. The total adjustment to Operations and Maintenance is a decrease of ($18,413,067).

ACCOUNTING AND RATEMAKING FOR PENSION AND OPEB'S

Q. Does the Commission have a policy with respect to the accounting and ratemaking for Pension OPEB Benefit Plans?

A. Yes. In 1993, the Commission issued a Statement of Policy and Order Concerning the Accounting and Ratemaking for Pension and Postretirement Benefits Other Than Pensions (SOP) (Case 91-M-0890, issued September 7, 1993) that remains in effect today.

Q. What are some of the provisions of the SOP?

A. A key provision of the SOP is that utilities must defer the difference between their actual

Pension/OPEB expense and the amount allowed in rates for Pension/OPEB expense for future Commission disposition. The SOP also provides that the amount of Pension/OPEB rate allowance not deposited into an external trust, or paid out in benefits, be accounted for using the internal reserve method. It also requires that companies provide notification should they settle, curtail or terminate an employee benefit plan, or any portion of an employee benefit plan. Finally, there is a provision against the commingling of Pension/OPEB monies provided by NYS ratepayers with funds from other affiliates in a consolidated group.

Q. Is KEDNY also subject to the provisions of the Commission's SOP?

A. No. In Case 95-G-0761, et al, the Commission granted the Company a wavier from the requirements of the SOP.

RATE YEAR PENSION AND OPEB EXPENSE RATE ALLOWANCE

Q. In its filing, how much did KEDNY request as a rate allowance for Pension and OPEB expense?

A. The Company requested rate allowances of $17,898,000 and $21,926,000 for Pension and OPEB expense, respectively.

Q. Did the Company propose to revise its forecast of Pension and OPEB expense during the Staff discovery period?

A. Yes. In its supplemental direct testimony filed on January 10, 2007, the Company proposed a reduction of $4,132,000 from $17,898,000 to $13,766,000, to its forecast of Rate Year Pension expense, and a reduction of $4,748,000, from $21,926,000 to $17,178,000, to its forecast of Rate Year OPEB expense.

Q. Are you proposing to reflect these reductions in your forecast of Rate Year Pension and OPEB expense?

A. Not at this time.

Q. Please explain why not.

A. The Company did not provide any support at all for these updates and as a result they cannot be properly evaluated. We promptly submitted an information request asking the Company to explain and support the revisions. We will update our Rate Year forecasts if warranted.

STATEMENT OF POLICY

Q. Mr. Bodanza requests that the Commission allow KEDNY to go back on the SOP. In particular, the Company seeks to permission to reinstate the deferral accounting procedures of the SOP. Do you support the Company's request?

A. No, we do not. The Company's request would, among other things, shift the forecasting risks from shareholders to customers, a risk that the Company enthusiastically accepted when it went off of the SOP. The Company has not explained or justified why the Commission should protect shareholders, and expose customers to, the forecasting risk related with the Company's Pension and OPEB costs.

Q. What does the use of deferral accounting procedures for Pension and OPEB costs mean?

A. In establishing rates, a forecast of Pension and OPEB expenses is made based upon actuarial information and assumptions. Differences between the forecasted Pension and OPEB expense and actual Pension and OPEB expense are deferred for future Commission disposition.

Q. What were the circumstances for KEDNY to request a wavier from the Commission's Pension and OPEB's statement of Policy and Order issued September 2, 1993 in Case 91-M-0890?

A. In Case 95-G-0761, et al. KEDNY sought a wavier from the provisions of the SOP including deferral accounting for Pension and OPEB expense. At the time, KEDNY said its financial success will be dependent not "on the niceties of regulatory accounting, but rather on its real performance in a competitive market" (Initial Brief page 47). The Commission's approval of the settlement concerning the Company's corporate structure and rate plan terminated the application of the SOP effective October 1, 1996.

Q. Does the SOP provide guidance on the Company's request to return to the SOP?

A. No. The SOP does not envision that companies would go off the policy, and it, therefore, does not provide guidance on how a Company might return to its provisions. It is critical to recognize, however, that the deferral accounting provisions of the SOP provide equal protection to the Company and its customers. Because continuity in its application is essential to ensure that those protections continue in such a manner that is fair to both shareholders and customers, any view of the SOP as a pick and choose menu of options runs against not only intent bust also general public interest.

Q. Does KEDNY's request to return to the SOP provisions maintain a proper balance between customer and shareholder interests?

A. No. Our recommendation rejecting KEDNY's request is based on our careful consideration of the consequences of allowing it to return to the SOP. The Company's request has not properly balanced customer and shareholder interests.

Q. What is the basis for your conclusion?

A. The Company's filing indicates that it is forecasting significant increases in Pension and OPEB expenses. The Company's request to completely reconcile amounts provided in rates to actual costs would fully insulate shareholders from the impact of unforeseen changes in net income. By contrast, shareholders have been the direct beneficiaries of substantial decreases in Pension and OPEB expense since the Company went off the SOP.

Q. How much did shareholders benefit from lower Pension and OPEB expense in the period KEDNY was off the SOP?

A. We calculate that for the period October 1, 1996, through December 31, 2003, KEDNY recorded an increase to pre-tax earnings of roughly $50 million.

Q. What would have been the effects if KEDNY had remained on the SOP?

A. KEDNY's earnings would have been lower and the Company would have deferred the difference between the actual lower expense and the rate allowances for future disposition. This customer credit would then have been available to offset the Company's future revenue needs.

Q. What information can you offer concerning the level of unrecognized gains or losses associated with KEDNY's Pension and OPEB plans?

A. Based on our analysis, we believe the current unrecognized losses related to the Company's Pension and OPEB plan assets to be approximately $150 million, a major negative change since the date KEDNY went off the SOP. These losses will be recognized as a component of the Company's periodic Pension and OPEB costs over the next 10 years. The effect of this recognition will increase the Company's annual Pension and OPEB expense.

Q. What is the significance of the unrecognized loss when considering the Company's request to return to the SOP?

A. If the Company remains off the OSP, it is at risk for the recovery of this amount between rate filings. In other words, if the rate allowance for any rate year is not sufficient to cover the actual future expense levels required to extinguish the unrecognized loss, the Company's earnings will suffer. If KEDNY is allowed to return to the protection of the SOP, however, it would completely transfer the risk associated with these unrecognized losses from the shareholders to the customers.

Q. What were the levels of KEDNY's unrecognized gains and losses on Pension and OPEB assets when it went off the SOP?

A. Based on our review, KEDNY had unrecognized Pension gains of $130.200 million and unrecognized OPEB losses of $2.200 million. The net of the two indicates that the Company had approximately $128 million in unrecognized gains when it went off the SOP.

Q. Why is the change in the levels of unrecognized gains and losses between when KEDNY went off the SOP and now, when it seek to return, important?

A. The Company went off the SOP when it had unrecognized gains of $128 million. Since then, it realized additional income of approximately $50 million due to its recording of net Pension and OPEB income based on a number of assumptions regarding the future performance of its Pension and OPEB assets and liabilities. Despite this significant positive effect on short run earnings, the $128 million unrecognized gain when the Company left the SOP is now an unrecognized loss of approximately $150 million largely due to the fact that the Pension and OPEB assets and liabilities did not perform as management had predicted. If the Company were allowed to return to the SOP, the Commission would effectively guarantee the recovery of the losses that built up at the very time the Company was reporting enhanced earnings.

Q. Are there any other examples of management discretion that impact annual Pension and OPEB expenses that you can offer?

A. Yes. The Medical Prescription Drug Improvement Act of 2003 (ACT) began producing a tax-free subsidy for KEDNY in 2006. However, for financial accounting purposes, KEDNY began reflecting the impact of ACT in 2004. Doing so reduced 2004 and 2005 OPEB expense by $1.7 and $1.8 million, respectively.

Q. Did customers benefit from the recognition of the savings that resulted from the Act.

A. Customers will benefit from these savings when new rates are established for KEDNY in this proceeding. However, since the Company is not on the SOP, deferral to actual costs did not occur and the savings from January 2004 through March 2007 will not be fully captured for the benefit of customers.

Q. Will any of the savings resulting from the Act be captured for the benefit of customers?

A. Yes, they should be captured based upon the existing Merger Settlement Agreement (Case 97-M-0567, Op. No. 98-9, Issued and Effective April 14, 1998). These savings would be covered under the category of exogenous costs. The Agreement requires deferral of any unanticipated cost increases or decreases for KEDNY gas operations resulting from any new mandatory, regulatory, legislative or accounting change or tax law change, each in excess of three percent (3%) of pre-tax utility income for the year in which the change first occurs. These costs would be eligible for deferral treatment or included in rates if recurring.

Q. Please summarize your recommendation.

A. In light of the substantial windfalls KEDNY realized while off the SOP, and the substantial increase in net unrecognized losses, KEDNY should not be allowed to return to the SOP. Based on latest known actuarial information, a reasonable forecast, of Pension and OEPB expense can be made on this proceeding for the Rate Year. Therefore, deferral to actual expense in the Rate Year is not necessary. Further, it is not appropriate for customers to assume all of the risk for future increases in Pension and OPEB expenses that are the result of large losses that were realized while KEDNY profited when it was off the SOP.

PREPAID PENSION EXPENSE

Q. Did KEDNY include prepaid Pension expense in its Historic Test Year Rate Base and Rate Year Rate Base?

A. Yes.

Q. What reason did the Company provide for carrying a prepaid Pension expense balance?

A. Company witness Bodanza claims that KEDNY has a prepaid Pension expense because it has made cash contributions to its Pension in excess of its Pension expense level.

Q. Do you agree with its inclusion in the Company's revenue requirement?

A. No.

Q. Please explain.

A. KEDNY has accumulated a significant prepaid Pension expense balance. The balance as of December 2003 is $88,974,000 which accumulated while the Company was off the SOP.

Q. Please continue.

A. Mr. Bodanza's description of prepaid Pension expense and what accumulates in it is inaccurate. It is not simply the cash prepaid expense described by Mr. Bodanza, but rather the balance sheet effect that also results from the accrual of negative Pension expense. Mr. Bodanza has not recognized that KEDNY's prepaid Pension position was also due to the fact that KEDNY had substantial negative Pension expenses during the period it was off the Policy

Statement. This topic is becoming a significant issue because KEDNY is effectively seeking to include the balance of its prepaid pension expenses generated within Rate Base.

Q. Why is the inclusion of this item in rates problematic?

A. The inclusion of the prepaid Pension expense will provide the Company a cash return on the prepaid expense balance. The payment by customers of a return on this balance is unfair and unreasonable. This balance was generated during a period of time in which the Company profited from a negative Pension expense while ratepayers continued to pay rates that reflected a Pension expense level that far exceeded the Company's actual cost. Put another way, KEDNY retained Pension credits in excess of the amount reflected in rates for Pension expense since it was not on the SOP. To require customers to pay carrying costs on the portion of a benefit they never received is inequitable.

Q. How do you propose to adjust the Company's rate filing?

A. We propose eliminating the $88,974,000 million for prepaid Pension expense included in both the Historic Test Year Rate Base (Adjustment 36) and the Rate Year Rate Base (Adjustment 32) and also reducing Historic Test Year capitalization by $30 million (net-of-tax) (Adjustment 34) to eliminate the earnings for the period October 1, 1996 through December 31, 2003 from the capital supporting this non-ratemaking asset.

MEDICARE PART D FEDERAL INCOME TAX DEDUCTION

Q. Please explain your adjustment including a deduction related to the estimated rate year Medicare Part D subsidy.

A. On December 8, 2003, the Medicare Prescription Drug, improvement and Modernization Act of 2003, (ACT) was signed into law, expanding Medicare by adding a voluntary prescription drug benefit under a new Medicare Part D. To encourage employers to continue current prescription drug coverage for retirees, the federal government began in 2006, paying employers that provide a qualified retiree prescription drug plan a tax-free subsidy equal to 28% of qualifying enrollees' allowable annual prescription drug costs between $250 and %5,000 (i.e., up to $1,330).

Q. Under the ACT, when will employers recognize the tax deduction?

A. Employers will receive a tax deduction when they pay or fund retiree prescription benefits. However, they will not be taxed on any subsidy received under the ACT. For example, an employer that pays $5,000 in prescription drug costs and receives a $1,000 subsidy related to those costs will have a $5,000 tax deduction and receive the $1,000 subsidy tax-free.

Q. Does KEDNY qualify for the employer subsidy?

A. Yes. The Company's actuary determined that the Company will qualify for the employer subsidy.

Q. Does the Company's rate year forecast of OPEB costs reflect the impact of the Medicare Part D subsidy?

A. Yes.

Q. Does the Company's revenue requirement calculation include the tax benefit associated with the subsidy payment?

A. No.

Q. Are you proposing to reflect the tax benefit associated with the subsidy in Staff's revenue requirement calculation?

A. Yes. The Company will receive a tax benefit associated with the subsidy payment under the new Medicare Part D in the rate year. Also, there is sufficient actuarial information from which to estimate the rate year subsidy payment.

Q. Please explain your adjustment.

A. We are proposing to reflect a tax benefit associated with the subsidy payment of $920,000 (Adjustment 14) in the rate year forecast of FIT expense.

Q. How did you arrive at that amount?

A. According to actuarial information, KeySpan Corporation expects to receive tax-free subsidy payments of $3.9 and $4.3 million in 2007 and 2008, respectively. Therefore, we applied an estimated consolidated rate year subsidy payment of $4 million to the percentage of fiscal year 2005 consolidated OPEB costs borne by KEDLI (23%). This is a straightforward and reasonable way to forecast the rate year subsidy payment related to the ACT.

TAXES

Q. Has the Panel reviewed the Company's State Income Tax Calculation?

A. Yes. Staff is proposing to increase taxable income by $100,383,000 due to various Staff operating revenue and operating expense adjustments. The interest expense has decreased by ($5,638,000) as shown in Exh____(APR-1), Schedule A - Page 8 of 13. The various Staff adjustments produce changes to normalized items timing differences reflect the Medicare Cash proceeds, and normalize items timing differences for Pension and OPEB, Book and Tax depreciation and SIR cost and the related Deferred State Income Tax expense. The current State Income Tax expense has been increased by $5,935,000 from a negative ($2,944,000) to a $2,989,000. The deferred State Income Tax has been increased by $3,556,000 from $3,782,000 to $7,338,000. The total State Income Tax expense has increased by $9,491,000 from $838,000 to $10,372,000.

Q. Has the Panel reviewed the Federal Income Tax calculation?

A. Yes. Staff is proposing to increase taxable income by $100,383,000 due to various staff operating revenue and operating expense adjustments. The interest expense has decreased by ($5,638,000) as shown in Exh____(APR-1), Schedule A - Page 8 of 13. The various Staff adjustments produce changes reflecting the Medicare cash proceeds, and normalized items timing differences for Pension and OPEB, Book and Tax depreciation and SIR costs, SIT costs, and the related Deferred Federal Income Tax expense. The Current federal Income Tax expense has been increased by $20,926,000 from a negative ($6,183,000) to $14,743,000. The Deferred Federal Income Tax expense has been increased by $12,538,000 from $11,337,000 to $23,875,000. The total Federal Income Tax expense has increased by $33,464,000 from $5,154,000 to $38,618,000.

Q. Has Staff adjusted the Rate Year Interest Expense?

A. Yes. As shown in Exh___(APR-1), Schedule A - Page 8 of 13 we have reflected Staff adjustments decreasing Rate Base by ($123,718,000) and reflected interest bearing Construction Work in Progress of $11,923,000 to reflect a revised Earnings Base of $1,862,211,000. Applying Staff's Weighted Cost of Debt overall debt of 3.04% as reflected in the overall Rate of return of 6.92% to the Earnings Base produces an interest expense of $56,622,000.

Q. Has the Company been filing annual New York State Tax expense reconciliations?

A. Yes. The Company has been filing an annual New York State Tax reconciliation since the year 2000 in compliance with the provisions of Case 00-M-1556, Issued and Effective on June 28, 2001. The annual reconciliation will have to be filed up to the date that the State Income Tax expenses are included in Base Rates within this Rate Case.

RATE BASE ADJUSTMENTS

Q. Have you adjusted the Deferred Merger cost included in Rate Base from the Brooklyn Union Gas/LILCO merger?

A. Yes. The Deferred Merger cost of $4,634,000, as shown on Company Exhibit PJM-9, Schedule 2, page 1 of 7, is reflected as an addition to the Rate Year Rate Base. Within Mr. McCellan's testimony, he states that this amount is the projected average balance of unrecovered deferred merger costs, which were incurred during the transfer of assets between the Brooklyn Union Gas and the Long Island Lighting Company. As outlined within the merger case settlement agreement (Case 97-M-0567, Opinion 98-9, issued and effective April 14, 1998), the parties agreed to permit the Company to recover the allowed combination costs, which included carrying costs, over a ten-year period beginning in 1998. Allowing the deferred merger costs as an addition to Rate Base will provide the Company an opportunity to earn a dual return: initially through a carrying charge on the deferred merger cost balance as provided within the merger settlement agreement and then as a Rate Base component. We are removing the Deferred Merger Cost of $4,634,000 (Adjustment 25) from the Rate Year Rate Base and the associated accumulated deferred Federal Income taxes and State Income tax of $2,040,000 (Adjustment 29).

Q. Have you adjusted the deferred SIR expenditures included in Rate Base?

A. Yes. The projected Deferred SIR expenditures of $90,669,000 as shown on Company Exhibit PJM-9, Schedule 2, Page 3 of 7, is reflected as an addition to the Rate Year Rate Base. This balance is the Company's projection of the deferred cumulative SIR expenditures net of insurance recoveries and reflects a proposed seven-year amortization of the projected balance of $65,566,000 at March 31, 2007. In addition, the Company is estimating a growth in the Deferred SIR balance of approximately $60,000,000 on an annual basis and is reflected within the $90,669,000 balance. Presently the Company's forecasted deferred SIR costs are far greater than the actual deferred costs of $13,577,815 at December 31, 2005 and $27,874,297 at September 30, 2006. The Company has proposed to update the deferred SIR expenditure balance during the course of the proceeding. Our proposal, therefore, is to remove from the Rate Base, the projected Deferred SIR expenditures of $90,669,000 (Adjustment 26) and the associated accumulated deferred federal income taxes of $31,734,000 and accumulated deferred state income taxes of $8,187,411 for a total of $39,922,000 (Adjustment 28). We recommend that the actual Deferred SIR expenditures be updated at the time rates go into effect and the balance net of the associated accumulated deferred federal and state income tax balance should accrue a monthly carrying charge utilizing the Company's AFUDC rate.

Q. Have you adjusted the Unamortized Property Tax Costs included in Rate Base?

A. The unamortized property tax costs represent the customers' share of the special franchise tax liability included over an above the rate allowance as reflected in the merger settlement agreement (Case 97-M-0567). Our proposal is to exclude the average balance of the Unamortized Property tax costs of $36,025,000 (Adjustment 27) and the associated accumulated deferred federal income taxes and the accumulated deferred state income taxes of $15,862,000 (Adjustment 30).

Q. Have you adjusted the accumulated deferred taxes related to Staff changes in book depreciation expense and revised plant additions?

A. Yes. The Panel has reflected the revised book depreciation expense and tax depreciation expense associated with Staff adjustments within the Federal Income Tax and State Income Tax calculations. The accumulated deferred Federal Income Tax and State Income Tax expense was increased by $6,013,000 (Adjustment 31) and reflected as a reduction to rate base.

Q. Have you adjusted the cash working capital allowance included in Rate Base?

A. Yes. The Company's calculation of the Rate Year cash working capital allowance utilizes the total operation and maintenance expenses less fuel costs and the uncollectible loss allowance. However, the Rate Year estimated operation and maintenance expense includes $17,898,000 of Pension and $21,926,000 of OPEB's expenses. Both the Pension and OPEB's expenses are considered to be non-cash items and should be excluded from operation and maintenance expenses before computing the cash working capital allowance. The exclusion of these non-cash expenses in addition to reflecting the Staff adjustments to these items reduces the total Rate Year cash working capital allowance by $(9,870,000) from $42,284,000 to $32,415,000.

Q. Have you adjusted the Company's Earnings Base/Capitalization adjustment included in Rate Base?

A. Yes. The Company has performed an Earnings Base/Capitalization measurement for the Historic Test Year in this rate case. Within the calculation, the Company failed to exclude the twelve-month average balance of inter-Company Accounts Payable balance associated with fuel costs. The Company, within this rate proceeding, is requesting a cash working capital allowance for gas costs as a carrying charge collected through the GAC/TAC/Surcharges. The Company's inclusion of average inter-Company Accounts Payable balance associated with fuel costs within its capitalization is in effect a double count. Our proposal is to remove the average inter-Company accounts payable balance from capitalization. This revision increases the Earnings Base/Capitalization adjustment by $10,131,000 (Adjustment 35) and decreases the Company's Rate Year Rate Base.

Q. Have you adjusted the Cash Working Capital allowance included in the Historic Test Year earnings base?

A. Yes. The Company's calculation of Historic Test Year cash working capital allowance includes the estimated pension expense of $9,759,000 and OPEB expense of $21,151,000 included within the estimated operation and maintenance expense. Both Pension and OPEB expenses are considered to be non-cash items and should be excluded from operation and maintenance expense before computing the cash working capital allowance. The exclusion of these non-cash items will reduce the total Historic Test Year cash working capital allowance by ($3,864,000) (Adjustment 37).

Q. Does this conclude your testimony in this case?

A. Yes, at this time.