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

February 2007

Prepared Testimony of Merger Policy Panel:

State of New York
Department of Public Service
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REDACTED

Q. Please state your name and business address.
A. Our names are John D. Stewart, Warren E. Myers and Thomas Coonan. Our business address is Three Empire State Plaza, Albany, New York 12223.
Q. Mr. Coonan, by whom are you employed and in what capacity?
A. I am employed by the New York State Department of Public Service as a Utility Supervisor in the Gas Rates Section of the Office of Gas & Water.
Q. Mr. Coonan, are you presenting other testimony in this proceeding?
A. Yes, my educational and professional background is provided as part of that testimony.
Q. Dr. Myers, by whom are you employed and in what capacity?
A. I am employed by the New York State Department of Public Service as a Chief of Regulatory Economics in the Office of Regulatory Economics.
Q. Please outline your educational background and professional background.
A. I have a Ph.D. in Agricultural Economics from Cornell University (1989), with minors in Production Economics and Economic Theory; a M.S. in Agricultural Economics from the Pennsylvania

State University (1983); and a B.S. in Environmental Resource Management (1980), with an emphasis in Environmental Economics and Policy, also from the Pennsylvania State University. In March 1989, I began working for the Department as an Associate Economist in the Office of Regulatory Economics. I was promoted to Principal Economist in November 1991 and to Supervisor of Regulatory Economics in September 1995. In June 2002, I became the Chief of Utility Programs in our Office and, in March 2006, was promoted to my current position, Chief of Regulatory Economics.

Q. Have you previously testified before the New York Public Service Commission?

A. Yes, I have testified in numerous proceedings, including Niagara Mohawk Power Corporation's last few rate cases, as well as the 2001 National Grid and Niagara Mohawk merger case.

Q. Mr. Stewart, by whom are you employed and in what capacity?

A. I am employed by the New York State Department of Public Service (Department) as a Section Chief, in the Office of Accounting and Finance.

Q. Please outline your educational background and professional background.

A. I graduated from the State University of New York at Albany in 1980 with a Masters Degree in Business Administration and a course concentration in finance. Prior to that, I received a Bachelor of Science Degree in Business from St. John Fisher College. In June 1980, I joined the Department Staff.

Q. What are the responsibilities of your Section of the Office of Accounting & Finance?

A. My Section's responsibilities include financing petitions, rate proceedings, financial forecasting, economic analysis, audits, and other investigations and studies. Regarding financings, recommendations are made to the Commission concerning utility petitions requesting authority to issue debt and equity securities. The focus is on the appropriateness of the mode of financing selected and the cost of securities issued. In rate proceedings, recommendations are made to the Commission regarding the fair rate of return, cash flow considerations, ratemaking policy issues, and cost of service adjustments. Additionally, financial forecasts and economic analyses are made in response to various types of utility proposals, such as mergers and acquisitions.

Q. Please describe your professional experience.

A. During my 26 years with the Department, I have presented expert testimony in various Commission proceedings on more than 60 occasions and I have had supervisory responsibility for the financial testimony provided by Staff witnesses in many other proceedings. This testimony has addressed a wide variety of ratemaking, financial, and regulatory issues. I have also prepared and supervised the preparation of many analyses that have been presented to the Commission at its Sessions.

Q. Panel, did you prepare exhibits supporting this testimony?

A. Yes, we prepared 28 Exhibits, referenced throughout this testimony as Exh__(MPP-1) through Exh__(MPP-28).

<u>OVERVIEW</u>

Q. What is the purpose of this testimony?

A. This testimony explains why the proposed acquisition of KeySpan Corporation (KeySpan) by National Grid PLC (Grid) is not in the public interest, and as such, should not be approved by the Commission as it is currently configured.

Q. How did you reach this conclusion?

A. We have studied and analyzed the information contained in the merger petition, the testimony filed in support of the petition, various interrogatory responses, and other relevant information. Our recommendation is the product of this analysis.

Q. Grid and KeySpan (collectively, Petitioners) have also, as part of the overall transaction, proposed separate 10 year rate plans for both KeySpan Energy Delivery New York (KEDNY) and KeySpan Energy Delivery Long Island (KEDLI). KEDNY and KEDLI have also filed for single year rate increases which would become effective in early September 2007. Explain Staff's overall approach to the various utility rate issues in this proceeding.

A. Staff's rate case analysis has focused on the one-year rate filings by KEDNY and KEDLI. This is because reasonable cost based rates for KEDNY and KEDLI are necessary whether or not the proposed transaction occurs.

Q. To what extent does Staff address the proposed multi-year rate proposals for KEDNY and KEDLI in this testimony?

A. This testimony addresses certain elements of the proposed ten-year rate plans and explains why these elements support our position that the proposed transaction is not in the public interest.

Q. Could Staff support the acquisition of KeySpan by National Grid under an alternative set of terms and conditions?

A. We outline, near the end of this testimony, general terms and conditions under which we might be able to support a merger.

EXECUTIVE SUMMARY

Q. What standard did you employ when determining that the proposed transaction was not in the public interest?

A. We considered how the proposed transaction would likely affect the Petitioners' ability to meet their most basic public service responsibility: the provision of safe and adequate service at a reasonable price. Consistent with that standard of review, we weighed the testimony of Witnesses Reilly and Zelkowitz which explained why the Petitioners believed that the proposed transaction was in the public interest. These witnesses stated (19-20) that the merger would not only provide "long-term tangible and intangible benefits for the state" but also "significant immediate and lasting economic benefits to customers through operational synergy savings, gas synergy savings, and avoidance of other costs that would have to be incurred by KeySpan absent the merger." Witnesses Reilly and Zelkowitz also testified that Petitioners were making commitments to "increase investment in infrastructure, maintain service quality, and expand and improve KEDNY and KEDLI's retail access, low income, and demand-side management programs." Given the large cost saving benefits alluded to by the Petitioners and the fact that KeySpan has indicated publicly that it entertained a purchase offer from another entity, we also compared the effects on New York State ratepayers of the potential benefits of the proposed transaction and the alternative transaction to assure that KeySpan's management and Board of Directors did indeed reasonably balance the interests of shareholders and ratepayers when evaluating various purchase offers.

Q. Explain generally why you have concluded that the proposed transaction is not in the public interest.

A. Grid's ownership of KeySpan, as envisioned by the proposed transaction, creates an unreasonably high number of future risks and uncertainties for New York ratepayers and utility investors. The proposed transaction is totally reliant on debt financing and has already had a negative credit impact on both Grid and KeySpan. The significant amount of debt financing used by National Grid to finance the cash purchase price for KeySpan creates significant financial risks for investors. At best the debt ratios for Grid and KeySpan after the transaction are consistent with low investment grade bond ratings, assuming that the rating agencies do not perceive a change in Grid's risk as a result of the transaction. At worst, Grid's debt ratios could be viewed as indicative of non-investment grade (high yield or "junk") credit quality if the bond rating agencies see increased risk in a post-merger Grid by virtue of the generation assets it will own after the transaction.

The only consideration keeping the rating agencies from downgrading Grid to the full extent suggested by the projected debt ratio levels after the transaction occurs is the cash flow produced by the ten year rate plan on which the merger is premised. This rate plan, however, is flawed. As proposed, it will produce unreasonably high rates for New Yorkers while at the same time enabling Grid to earn excessive profits. Moreover, the proposed rate plan is based on a framework that has not worked well at Niagara Mohawk, provides minimal synergy savings for KEDNY and KEDLI ratepayers, and creates great potential for future rate increases through the use of extensive deferrals in combination with an automatic annual rate increase mechanism (LDAC).

The transaction is also inconsistent with the Commission's guidelines regarding vertical market power (VMP). If approved in its current form, Grid will have a financial incentive to make operating and investment decisions regarding its transmission assets which would not be in the public interest.

The transaction may also adversely impact the quality of service for KEDNY and KEDLI customers. Staff witness Reulet testifies that the quality of Niagara Mohawk's electric service has deteriorated since it merged with Grid. Grid's record at Niagara Mohawk raises concerns about the effect of Grid's management practices on the quality of KEDNY and KEDLI service. The Commission should not consider allowing Grid to expand its operations in New York until the problems noted in Mr. Reulet's testimony are affirmatively addressed, improvements realized and financial assurances made that similar experiences will not occur elsewhere within the state.

Currently KEDNY and KEDLI ratepayers are subjected to the management of a holding company, KeySpan, over which the Commission can indirectly exert considerable influence. By contrast the proposed transaction would subject KEDNY and KEDLI ratepayers to the management of a much larger multi-national holding company over which the Commission has a much reduced ability to influence behavior. This becomes a significant issue if the holding company (by virtue of events such as a change in executives or an acquisition by another entity) adopts policies and practices that are not in the best interests of New York ratepayers.

Finally, we considered the process that KeySpan used to analyze the various purchase offers it received. Based on this review, we are unable to conclude that the transaction as proposed best meets the needs of ratepayers or shareholders.

CAPITAL STRUCTURE: Credit Quality

Q. What price will Grid pay to purchase KeySpan?

A. Grid proposes to pay $42 per share to acquire all 174.4 million outstanding shares of KeySpan stock. On an aggregate basis, this results in

Grid paying approximately $7.3 billion of cash to KeySpan shareholders.

Q. How will Grid finance the $7.3 billion payment?

A. Virtually all of the payment will be financed with cash from the proceeds of new debt issued by Grid to finance the KeySpan acquisition.

Q. Discuss the impact of debt from the transaction on Grid's balance sheet, capital structure, earnings asset base, credit standing and ability to withstand risks and uncertainties in the future.

A. Grid will assume between $4.5 and $5.0 billion of KeySpan's debt and reflect it in its balance sheet capital structure. Grid's mix of debt and equity will change substantially as a result of the transaction. Grid provided a pro forma calculation of its capital structure based on actual US Generally Accepted Accounting Principle (GAAP) results as of March 31, 2006. This information, provided in response to a request by the City of New York, is attached as Exh__(MPP-1). We note at the outset that this calculation does not reflect recent debt issues by KEDNY and KEDLI totaling $500 million. Thus, the debt ratios reflected in the pro forma projection may be slightly understated.

Q. What does Grid's projection show?

A. Grid shows that its debt will increase by about $11.4 billion as a result of the transaction. Since Grid's common equity balance is unaffected by the proposed transaction, its ratio of equity to total capital (equity ratio) will fall. As a result, Grid's ratio of debt (excluding short term debt) to total capital (debt ratio) increases from 52% to 63% while its equity ratio declines from 48% to 37%. While there is no increase in the value of common equity at the consolidated Grid level, about $4.5 billion of the debt is used to finance goodwill, an asset which the New York Commission does not provide recovery of in utility rates. (This is noteworthy because it appears that the Petitioners seek to record goodwill as an asset on the books of KEDNY and KEDLI and increase the common equity of KEDNY and KEDLI by a corresponding amount.) Since corporate creditworthiness is substantially impacted by a company's debt burden and the quality of its assets, Grid's creditworthiness will decline not only as the result of the increase in its outstanding debt but also because about 40% of this new debt supports the non-earning goodwill created by this transaction.

Q. Do you think that the change in Grid's capital structure caused by it reliance on debt to pay for the acquisition of KeySpan is in the best interests of New York ratepayers?

A. No. Grid's reliance on debt to finance the transaction puts downward pressure on its credit quality and produces capital structure ratios that are not fully consistent with investment grade bond ratings. Grid, however, would offset the financial effects of this dramatic change in its capital structure through its proposal to preserve the ratemaking capital structure for KEDNY and KEDLI at the levels currently requested in their stand alone rate case filings. This results in KEDNY and KEDLI, ratepayers paying unreasonably high rates which not only produce excessive Grid profits but also effectively result in New York ratepayers paying rates that support a level of credit quality which will not be realized. That is, ratepayers would be asked to support an equity ratio consistent with a credit rating of at least "A" while being served by a company with a debt ratio supporting a "BBB" or "BB" rating. Finally, the use of debt to finance the goodwill associated with the acquisition creates added risks for the future.

Q. What is the basis for your statement that Grid's capital structure ratios are unlikely to support an investment grade bond rating after the transaction?

A. This statement is based on our knowledge of utility finance issues and on reports by both Standard & Poor's (S&P) and Moody's.

Q. What S&P reports did you use to make this determination?

A. Two S&P reports were used. One report focuses on United States utilities while the other report considers power companies on a global scale.

Q. Why is S&P's ratings approach for US utilities appropriate for an international holding company such as Grid?

A. S&P views the risks of Grid's United States and foreign operations as very similar. For example, in a recent review of Grid, S&P characterized Grid's U.S. and U.K. operations as "low-risk" businesses. This report is presented in Exh__(MPP-2). As a result, the same credit metrics that S&P applies to Transmission and Distribution (T&D) utilities in the United States should also be appropriate to apply to Grid's overall operations.

Q. Explain how you applied S&P's domestic credit metrics to analyze Grid's capital structure after the merger occurs.

A. S&P published revised bond rating guidelines for United States utilities in June 2004. The report, attached as Exh__(MPP-3) indicates that one of the three key credit quality ratios considered by S&P is the ratio of debt to total capital (debt ratio). This report presented an approach under which S&P recognizes business risk profiles from 1 to 10 for utilities and then establishes debt ratio guidelines for various bond ratings across that spectrum of business risk profiles.

Q. What is the meaning of the business risk profiles?

A. Utilities with lower business risks have lower business profile numbers assigned them by S&P. Utilities with higher business risk have higher profile numbers assigned to them. S&P notes that most T&D utilities would have business profiles of 1-3. Vertically integrated utilities with transmission, distribution and generation/production activities would have profiles of 4-6. Generators, power marketers and other competitive players in utility markets will have profiles of 7 and higher. Lower risk companies, having lower business profile scores can use higher amounts of debt to maintain a given bond rating than do higher risk companies with higher profile scores.

Q. What is Grid's current business profile score?

A. S&P currently assign's National Grid USA a business profile of 2. Because National Grid USA's business risks are, according to S&P, similar to Grid's overall business risks, it is reasonable to assume that the same business profile is appropriate for all of Grid's regulated operations.

Q. What capital structure requirements does S&P have for utilities with a business profile of 2?

A. S&P requires respective debt ratios of 45-52%, 52-58%, and 58-68% for AA, A and BBB bond ratings.

Q. What bond rating is suggested by Grid's current pre-merger 52% debt ratio as shown in Exh__(MPP-1)?

A. Based on S&P's debt ratio requirements, Grid's current debt ratio of 52% is consistent with a strong A bond rating or a weak AA bond rating.

Q. What is Grid's current overall bond rating?

A. Grid's current overall bond rating is A.

Q. What bond rating is suggested by the 63% debt ratio which Exh__(MPP-1) shows would occur after the proposed transaction?

A. This debt ratio increase would imply a reduction in Grid's bond rating from its current A rating to the BBB category for utilities with business profiles of 2.

Q. Is Grid likely to maintain a business risk profile of 2 as a result of the transaction?

A. It is not likely. The transaction results in

Grid owning about 6600 MW of generation in New York State, thereby transforming the company from a T&D utility to a more risky vertically integrated utility. Moreover, Ravenswood, which represents over one third of this MW total is subject to competitive market prices and as such is riskier than utility generation typically subject to cost based rates.

Q. What is the normal business risk profile for a vertically integrated utility?

A. The midpoint of the 4-6 range of profiles which S&P typically assigns to vertically integrated utilities is 5.

Q. What are the debt ratio and bond rating metrics for utilities with a business risk profile of 5?

A. S&P requires respective debt ratios of 35-42%, 42-50%, 50-60 and 60-65 for AA, A, BBB and BB bond ratings.

Q. What bond rating is suggested by Grid's pro forma 63% debt ratio and these credit metrics?

A. Grid's pro forma 63% debt ratio implies a BB rating, if it were viewed as a vertically integrated utility.

Q. What is the significance of such a bond rating?

A. This bond rating is not of investment grade quality. This is significant because the terms and conditions associated with debt obtained by companies' of below investment grade credit quality (junk credit quality) are not only more costly but also more restrictive than the terms associated with investment grade debt.

Q. How did you factor S&P statements about global utilities into your analysis?

A. Petitioners provided a segment of an S&P report titled "Power Companies" as part of their response to DPS-198. This report, attached as Exh__(MPP-4) contains a table (page 33) which shows median financial ratios for T&D utilities, generators, and vertically integrated utilities sorted by A and BBB bond ratings. This table indicates that the median debt ratio for A and BBB rated T&D companies are 55% and 65% respectively. By contrast the median debt ratios for A and BBB rated vertically integrated utilities are 45% and 56%.

Q. What are the implications of these ratios for this proceeding?

A. Grid's current debt ratio of 52% implies a strong A or weak AA bond rating. This statement is based on the fact that median debt ratio for an A rated T&D utility is 55%, an amount 3% higher than Grid's debt ratio. By contrast Grid's debt ratio after the transaction of 63% is 7% higher than the 56% median debt ratio for BBB rated vertically integrated utilities, thereby implying a junk credit quality for Grid after the transaction.

Q. How did you employ information from Moody's to assess Grid's relative credit quality before and after the transaction?

A. We considered a March 2005 report from Moody's titled "Rating Methodology: Global Regulated Electric Utilities". This report, attached as Exh__(MPP-5) was provided by petitioners as part of their response to DPS-198. It contains a table (page 8) presenting financial ratios for various Moody's bond ratings for low and medium business risk utilities.

Q. Does Moody's consider Grid a low or medium business risk utility?

A. Moody's never states its opinion directly; however, Moody's strongly implies that Grid is closer to a low risk utility than it is to a medium risk utility. For example, an October 2006 Moody's analysis of Grid, attached as Exh__(MPP-6), states that the ratings of Grid are "underpinned by its relatively low-risk businesses, the vast majority of which operate within stable and transparent regulatory frameworks" and that "(w)ith more than 80% of its operating profits stemming from NGET, NGG and National Grid USA (intermediate holding company for the group's US subsidiaries), the group's business risk profile remains driven by the stability and predictability of its UK and US regulated businesses. These businesses operate within established and transparent regulatory frameworks associated with little regulatory uncertainty…"

Q. What does the information in the table on page 8 in the March Moody's 2005 report indicate about Grid's current bond rating?

A. Assuming that Grid is a low risk utility, its 52% pre-transaction debt ratio implies a strong A bond rating. This is because 52% is near the lower end of the debt ratio range for an A rating listed by Moody's.

Q. What does this information indicate about Grid's bond rating after the proposed transaction?

A. Assuming Grid remains a low risk utility, the post transaction debt ratio of 63% implies either an A or a Baa bond rating.

Q. What are the bond rating implications of Moody's reclassifying Grid as a medium business risk utility as the result of Grid owning 6600MW of generation after the transaction?

A. Grid's bond rating under such circumstances would likely fall into either the lower end of the Baa category or the Ba category. Given the fact that Moody's current Baa1 bond rating for Grid unsecured debt falls below the level of credit quality implied by its current equity ratio, there is the distinct possibility that the proposed transaction could result in a decline in Grid's bond rating to the junk category.

Q. Why is it important to consider declines in the credit quality of the holding company parent of Niagara Mohawk, KEDNY and KEDLI as a result of the transaction?

A. Utilities are responsible for providing safe and adequate service at a reasonable rate. Declines in the credit quality of Grid not only affect Grid's ability to raise capital in the financial markets at reasonable terms but also the ability of its subsidiaries to do so as well. While the cost associated with a credit quality decline within the investment grade category may not be significant, a decline in credit quality to a level below investment grade credit quality could put upward pressure on utility rates. Thus, the proposed transaction will undermine the ability of Niagara Mohawk, KEDNY and KEDLI to raise capital at reasonable terms.

Q. What is the basis for your statement that declines in Grid's credit quality also drive down the credit quality of its utility subsidiaries?

A. This statement is based on the bond rating approach taken by both S&P and Moody's for holding companies with utility subsidiaries. More specifically, absent specific provisions to isolate the risks of the holding company from utility subsidiaries, S&P is unlikely to assign a utility subsidiary a bond rating that differs from that of the parent. While Moody's may assign a higher bond rating to utility subsidiaries, the difference is likely to be no more than a notch. Thus, downgrades by Moody's or S&P of Grid's overall bond rating will likely lead to a downgrade in the bond rating of Niagara Mohawk, KEDNY and KEDLI.

Q. Have either Moody's or S&P indicated that bond rating downgrades are likely if the transaction is approved?

A. Yes, Exh__(MPP-6) contains a report from Moody's and Exh__(MPP-7) contains a report from S&P. Together they express concern over the amount of debt leverage employed by Grid to complete the transaction as well as the idea that the transaction will transform Grid from a low risk transmission and distribution company to a higher risk vertically integrated utility. As a result of this concern both Moody's and S&P have put Grid and KeySpan and their subsidiaries on watch for a downgrade if the transaction is completed.

Q. How much of a downgrade is likely as a result of the transaction?

A. S&P and Moodys' have suggested a bond downgrade of a notch for most KeySpan and Grid affiliates. We are not confident, however, that the downgrade will only be one notch. We say this for two reasons. First, the debt ratios produced by the proposed transactions suggest a greater downgrade. Second, forecasts of the other cash flow based parameters provided by the Petitioners to the rating agencies are likely to reflect the ratemaking and structural outcome desired by petitioners rather than an outcome consistent with established Commission policies and approaches for issues such as VMP or capital structure. Thus, if the Commission determines that the transaction itself and the proposed rate plan are in need of modification to properly protect the public, the expected financial parameters from the transaction may differ from those provided by Petitioners to the financial community.

Q. What are the implications for the investment community of the Commission requiring that the proposed transaction conform to established regulatory policies, guidelines and procedures?

A. It is reasonable to expect that financial experts possess the experience, knowledge and expertise to evaluate and understand the extent to which utility proposals realistically conform to established Commission policies, guidelines and ratemaking practices, and to inform the investing public of potential uncertainties when utility requests conflict with these policies and practices. As a result, it should not come as a surprise to the investment community, investors, or the Petitioners for that matter, if the Commission takes predictable actions in this proceeding based on established principles related to issues such as VMP or capital structure.

Q. Is there anything else to add on the general subject of credit quality?

A. Yes, Moody's issued a report on January 12, 2007 in which it noted that it was adopting a new methodology for European regulated utility groups. This report, attached as Exh__(MPP-8) indicates that Moody's now will normally have a one notch bond rating difference between holding company parents and their utility subsidiaries. Grid's consolidated bond rating is Baa1 while the bond ratings of many of its regulated subsidiaries are A2. Moody's now indicates that if the proposed transaction goes through, the subsidiary bond ratings will fall to A3 and Grid's overall Baa1 rating will remain unchanged. By contrast, if the merger does not occur, then Grid's bond rating will increase to A3 and the subsidiary bond ratings will be unchanged. While we are still evaluating this report, we continue to be concerned that the credit parameters actually produced by the proposed transaction may reduce creditworthiness to a level lower than either Moody's or S&P now anticipate. We also note that this Moody's report indicates that the proposed transaction has already prevented Grid from obtaining a bond rating upgrade.

<u>CAPITAL STRUCTURE: Leveraged Subsidiary "Equity"</u>

Q. Does Grid's post acquisition capital structure and credit quality have any other implications for New York ratepayers?

A. Yes, Petitioners have proposed that the

Commission set rates and calculate earned returns for KEDNY and KEDLI over a 10 year period using a stand-alone equity ratio of 50% for both KEDNY and KEDLI. This request will result in ratepayers paying rates that not only far exceed underlying costs but also support a level of credit quality that is not achievable.

Q. You stated that the use of a 50% equity ratio results in ratepayers paying rates that far exceed underlying costs. Why is this true?

A. This is true because Grid's position would result in ratepayers paying an equity return and associated income taxes on a balance reflected on KEDNY's and KEDLI's books as common equity which is actually fully funded by the debt which Grid issued to purchase KeySpan's common stock. Debt is not only tax deductible but also carries a lower cost rate than common equity. Thus, Grid's ratemaking request effectively results in New York ratepayers paying a return on equity plus income taxes to support securities with a much lower cost. This results in excessive rates for New York ratepayers and excessive profits for Grid's shareholders.

Q. Explain, in more detail, why this occurs.

A. First, it is important to recognize that the acquisition of KeySpan by Grid produces no new Grid common equity on the consolidated balance sheet. This is because Grid will finance virtually all of the purchase of KeySpan's common equity with proceeds from debt issues. The net effect of the transaction on Grid's balance sheet, as shown in Exh__(MPP-1), is a significant increase in Grid's overall debt balance yet no change whatsoever in its common equity balance. Grid's leveraged financing of the purchase of KeySpan's common stock effectively exchanges KeySpan's common equity for debt on Grid's consolidated balance sheet. By contrast, if Grid had issued common equity to raise cash to pay for the acquisition, Grid's common equity balance would have increased.

Q. Why is this significant?

A. Grid's common equity balance does not change in any way as a result of the transaction. However, page 10 of Exhibit 8 to the initial petition shows that for KEDNY and KEDLI during the first year of the rate plan, Grid seeks an equity return on 50% of the projected rate base. This equates to a total implied equity balance of about $1.7 billion for both KEDNY and KEDLI. This equity, however, does not exist on Grid's consolidated balance sheet because Grid financed its purchase with debt.

Q. Is it possible to illustrate the effect on customers and shareholders of Grid's proposal to earn a return on this "equity"?

A. Yes, assume costs of equity and debt for Grid of 9% and 6%, respectively, and a tax rate of 40%. The pre-tax equity return is 15% (9%/(1-40%)). This return reflects the amount of revenues needed to provide the assumed 9% return after taxes are paid. Multiplying this return by the $1.7 billion of "equity" produced by a 50% equity ratio assumption, produces $255 million in revenue requirement. This revenue amount is needed to pay the 9% return on the "equity" and cover income taxes. By contrast, because Grid purchased KeySpan's real equity with debt proceeds, the amount it must pay investors to cover its actual financing cost associated with the KEDNY and KEDLI portion of the transaction is $102 million ($1.7 billion of debt times the 6% interest rate). Together these amounts show that ratepayers would pay $153 million over and above Grid's actual financing cost in their rates (255-102) if a 50% imputation is employed. The $153 million of excess revenue requirement translates into $91.8 million of excess profits after taxes (155*(1-40%)). Thus the rates proposed by Grid for KEDNY and KEDLI are unreasonable because they far overstate the actual cost of financing the acquisition.

CAPITAL STRUCTURE: Unobtainable Implied Credit Quality

Q. It was also stated that Grid's proposed capital structure would result in ratepayers supporting a level of credit quality that is not achievable. How does this occur?

A. Grid requests that rates be set on the basis of a 50% equity ratio. Based on S&P and Moody's guidelines already discussed, this level of equity ratio implies an AA bond rating for a low risk T&D utility. However, the rating agencies do not, absent ring-fencing provisions, isolate the credit quality of utility subsidiaries from the utility holding company's overall credit quality. Because Grid's credit quality is adversely impacted by the increase in debt leverage and change in business risk associated with the proposed transaction, KEDNY and KEDLI cannot obtain the AA rating implied by their requested 50% equity ratio. Thus, KEDNY and KEDLI would charge customers rates based on implied equity ratios and credit quality that are not obtainable.

<u>CAPITAL STRUCTURE: No Support for 50% Imputation</u>

Q. Do you have any other comments regarding the 50% equity ratio imputation sought by Petitioners?

A. Yes, while we believe that the information already presented in this testimony indicates that the Commission should not consider the use of a stand-alone equity ratio, an additional and equally compelling reason not to adopt the 50% imputed equity ratio is that Petitioners have provided no forecasts indicating that such a ratio is reasonably obtainable.

Q. Didn't the petitioners provide a capital structure forecast over the term of the 10 year rate plans as part of their initial filing?

A. Yes, Petitioners state in DPS-24 (Exh__(MPP-9)) that "Projections of KEDNY's and KEDLI's capital structures for ratemaking purposes over the term of the Rate Plan are shown in Lines 12, 13, and 14, Page 2 of Exhibit 8."

Q. Does the referenced information constitute a forecast?

A. No, the three referenced lines are the projected rate base times a 50% equity ratio amount with the product being a "projected" dollar amount of equity. Such an exercise, however, is deficient because it does not explain how the 50% equity ratio, the driver of the overall calculation, was developed for each year.

Q. Did Staff follow up on this response in order to obtain the details behind the 50% projection in each year of the rate plan?

A. Yes, DPS-103 (Exh__(MPP-10)) requested capital structure projections showing all forms of capital and providing the annual cash flow statements showing the transactions necessary to maintain the 50% equity ratio. The company's response was that it had not prepared any formal balance sheet or cash flow projections for either KEDNY or KEDLI over the life of the rate plans. Petitioners noted that they are proposing an "imputed" 50% equity ratio rather than an actual equity ratio.

Q. Why is it important to have a forecast of the actual capital structures over the life of the rate plan?

A. An actual capital structure forecast is needed to assure that the requested 50% equity is realistic given likely financial/operating results over the next 10 years and the likely presence of significant amounts of non-earning goodwill in KEDNY's and KEDLI's common equity. For example it would be unreasonable to set rates based on a 50% equity ratio if a specific forecast indicated that the company was more likely to maintain a 30% equity ratio. Alternatively, it would be unreasonable to set rates based on a 50% equity ratio if that ratio was actually obtained by including goodwill, an asset on which the Commission sets no return, in the common equity balance. Finally, the 50% imputation would not be reasonable if it resulted from equity infusions from Grid that were financed from the proceeds of debt issues by Grid. Thus, Staff concludes that, based on a review of the petitioner's presentation and interrogatory responses, their request for an imputed 50% equity ratio is totally unsupported.

Q. Is it true that the Petitioners claim that the use of an imputation will assure that rates are set reasonably for KEDNY and KEDLI?

A. Yes, Petitioners claim in DPS-103 that "The use of an imputed 50% equity ratio and a capital structure excluding goodwill is intended to ensure that rate regulation of KEDNY and KEDLI is unaffected by any goodwill, which may be pushed down to these subsidiaries." Such a claim is impossible to verify in the absence of a forecast.

GOODWILL: Overview

Q. Why is Staff concerned about goodwill in this proceeding?

A. We are concerned that a finding by KEDNY or KEDLI that their goodwill is impaired could lead to a common equity write-off which might impact their financial viability as well as their ability to provide safe and adequate service at a reasonable price. We are also concerned by the fact that Grid will likely have over $9.0 billion of goodwill on its books (US GAAP) after the proposed transaction, an amount that represents over half of its consolidated common equity book value balance.

Q. What is the book value of KeySpan's common equity?

A. KeySpan's 10-Q for the quarter ending September 30, 2006 indicates that the book value of common equity is about $4.6 billion.

Q. How much is Grid paying to purchase KeySpan's equity?

A. As previously noted, Grid is paying roughly $7.3 billion to acquire KeySpan's common stock.

Q. How do the Petitioners propose to treat the $2.7 billion difference between the purchase price and KeySpan's book value treated for accounting purposes?

A. The $2.7 billion difference between KeySpan's book value and the amount paid by Grid will be recorded as goodwill on the asset side of the balance sheet for the acquired companies including KEDNY and KEDLI.

Q. Do you know how much goodwill will be allocated to each of the acquired companies?

A. No, Petitioners' response to DPS-28 and DPS-106, attached as Exh__(MPP-11) indicates that this amount will not be determined until after the transaction closes and that no forecast has been made of the likely amounts for each company.

Q. How is goodwill treated for accounting purposes?

A. Formerly, goodwill was amortized to earnings over an extended time period, usually 40 years. However, as a result of recent accounting changes goodwill is no longer amortized, but rather remains on a utility's books until a determination is made that it is impaired, at which time all or a portion of the goodwill is written off to common equity.

Q. How is a determination made regarding whether assets are impaired?

A. The utility in conjunction with an independent auditor annually performs various analyses to determine the current market value of the utility. This value is then compared to the carrying value of the securities on the firm's books that are used to finance its operations and any goodwill. To the extent the market value exceeds the carrying value, there is no impairment. If market value is less than the carrying value, there is impairment and a write-off of all or a portion of the goodwill to common equity is necessary.

GOODWILL: Capital Structure Effects

Q. Would recording goodwill affect KEDNY's and KEDLI's capital structures?

A. Yes. While goodwill increases the asset side of the balance sheet, the petitioners also must recognize how the goodwill was financed as part of the capital structure. For example, KeySpan, upon acquiring Boston Gas recorded about $770 million of goodwill as an asset on Boston Gas' balance sheet. At the same time, KeySpan recorded a $600 million advance to Boston Gas (at an average 7.78% interest rate) and an increase in its common equity of about $170 million.

Q. How do petitioners propose to adjust the capital structures of KEDNY and KEDLI to reflect the proposed transaction?

A. As previously noted, the cash payment by Grid to

KeySpan will be financed with debt proceeds. Petitioners have indicated that none of the debt used to finance the cash payment associated with the transaction will be pushed down to either KEDNY or KEDLI. As a result, the common equity for KEDNY and KEDLI must, by default increase by an amount that matches the new goodwill balances reflected on their books. Grid's overall common equity balance is, by contrast, unaffected by the proposed transaction.

Q. How will the increase in common equity from the recognition of goodwill as a result of the transaction impact the actual equity ratios for KEDNY and KEDLI over the term of the proposed rate plan?

A. While the incremental effect of the transaction is a definite increase in their common equity balances, Staff is unable to state how the actual equity ratios of either KEDNY or KEDLI will be affected by the proposed transaction. This is because Petitioners have not prepared a specific capital structure forecast for KEDNY and KEDLI over the term of their proposed rate plans that reflects the ongoing cash needs of the company, its external financing plan, and its dividend payments.

Q. What is the significance of this omission?

A. A forecast of likely events over the term of the proposed rate plan is necessary to assure that the 50% equity ratio is consistent with how Grid plans to manage the cash flows and capital needs of KEDNY and KEDLI. It represents a necessary disclosure to the Commission and the public that the request to impute a 50% equity ratio is based on a plan that is reasonably achievable. The absence of the forecast makes it impossible to determine the extent to which Grid's proposal to impute 50% equity ratios to KEDNY and KEDLI for ratemaking purposes is realistic or reasonable.

Q. Why is it important to determine if Grid's proposal to impute 50% equity ratios is realistic and reasonable?

A. Absent a specific forecast, the Commission has no way of knowing whether Grid's plans for KEDNY and KEDLI are actually capable of maintaining an equity ratio at or near the requested 50% imputation. This is significant because the use of a 50% imputed equity ratio for ratemaking purposes would produce excessive earnings and excessive rates if the actual equity ratios of these entities, were, in fact, projected to be lower.

Q. Does Staff have additional concerns about the lack of a forecast for the 50% equity ratio imputation?

A. Yes, the lack of a forecast makes it impossible to determine if the debt issued by Grid to finance the acquisition is effectively treated as equity on the books of KEDNY and KEDLI for ratemaking purposes. It would be unreasonable to include any of the equity that is created by acquisition (to reflect the goodwill increase) within the equity used to justify the 50% ratemaking imputation. This is because the equity created by the transaction is actually Grid debt that is artificially transformed into equity at the subsidiary level.

<u>GOODWILL: General Policy</u>

Q. What is Staff's general position regarding the recording of goodwill on a regulated utility's books?

A. Generally, we oppose recording goodwill on the books of regulated utilities. Moreover, in those limited circumstances where it may be appropriate to recognize goodwill, we see it as an asset that would likely be written off over a relatively short time period.

Q. What is the basis for your opposition to the recognition of goodwill on a regulated utility's balance sheet?

A. Goodwill reflects the value in a utility in excess of the underlying book value of its common equity. However, the Commission is required to set utility prices at levels intended to recover all prudently incurred utility costs including a fair return on investor provided capital. This means that a utility's revenue requirement collects only moneys that are needed to cover a utility's underlying costs.

Q. How are the costs associated with utility investments in plant addressed by the ratemaking process?

A. Investments in plant are recovered on the basis of their original cost through a return of the investments (depreciation) and a return on the investment (rate of return). When the ownership of rate regulated assets changes as the result of a sale, the amount collected in rates for the assets remains at the original cost rather than the price paid at the time of the sale. Under this regime, no moneys or cash flows come to the utility that do not already match an expense that has been incurred or is expected to be incurred. Thus, there is no basis for reflecting goodwill from a utility sales transaction if rates are set properly to recover underlying costs. As a result, the recognition by regulated utilities of goodwill, unsupported by future cash flows, creates a real risk of financial problems when that asset is inevitably deemed impaired and, as a result, written off to common equity.

Q. Do you have an example to illustrate this effect?

A. Yes, Exh__(MPP-12) contains an example which shows that the after tax cash flows produced by the ratemaking process over the life of an asset equate, on a present value basis, to the original cost of the investment. This exhibit reflects a hypothetical utility with total book value at the beginning of the analysis of $1000 (book life is 10 years, tax life is 5 years, tax depreciation is straight line). Revenues and cash flows are then calculated for each year. This example shows that if rates are set on the basis of underlying costs, the future net cash flows produced for investors by the ratemaking process will, when discounted back at the appropriate after tax cost of capital, produce a present value amount of $1000 which exactly matches either the initial book value of the company or its initial common equity value. If investors price utility assets in a rational way, based on the fundamental cash flows produced by the assets when rates set to equal underlying utility costs, then utility stock prices should generally reflect book value. Thus, if rates are set correctly, there are no free cash flows to justify a stock valuation that exceeds the initial original cost book value.

Q. You implied earlier that there were

circumstances in which it might be reasonable to reflect goodwill on the books of a regulated subsidiary. What are those circumstances?

A. It would be reasonable to reflect goodwill on a regulated utility's books in the situation where an acquisition produced synergy savings and at least some portion of the savings were expected to flow to the utility's shareholders as an incentive. Under such circumstances, the goodwill balance would reflect the present value of the after tax future savings amounts.

Q. How would the recognition of goodwill in this type of situation be treated over time?

A. As the shareholders' portion of synergy savings is realized, the goodwill amount would be reduced to reflect the idea that cash flows which formed the basis for recognition of the goodwill have been realized and would, therefore, no longer support the existing goodwill balance.

Q. How does this factor into Grid's proposal to share savings between ratepayers and shareholders for a 10 year period?

A. The proposed transaction implies that the initial goodwill balance on the books of KEDNY and KEDLI should approximate the shareholders portion of expected future after tax synergy savings. Moreover, given the terms of the rate plan, this balance would be reduced to zero at the end of 10 years because it is at that point under Grid's proposal that the Commission would set fully cost based rates for KEDNY and KEDLI, thereby capturing for ratepayers the full value of all synergy savings. Thus, no excess after tax cash flows from KEDNY or KEDLI would be available to shareholders from that point forward.

Q. Is the impairment of goodwill inevitable for regulated utilities operating under a regulatory regime that generally sets cost bases rates using the concept of original costs?

A. Goodwill impairment is very likely for regulated utilities whose rates are set on an original cost basis. While the temporary sharing of synergy savings may make it possible for utilities to realize free cash flows, these cash flows are of limited duration. Thus, the eventual impairment of regulated utility goodwill is virtually assured.

Q. Is there another explanation why a regulated utility whose rates are set on the basis of underlying costs could realize free cash flows to support a goodwill balance over an extended time period?

A. Yes, the utility might assume that because its holding company parent frequently acquires other companies, that regulatory lag will assure that synergy savings not yet captured in rates flow to investors.

Q. Does this form a reasonable basis for continuing to recognize goodwill?

A. We think not. Considering the emphasis of the accounting industry on conservatism, it seems rather optimistic to assume that goodwill is justified by savings that <u>might</u> be generated in the future by uncertain, unspecified and/or unknown transactions.

Q. Should the expectations of investors be considered when making a determination about the impairment of utility goodwill?

A. No, some might suggest that it is reasonable to maintain goodwill on a utility's books because investors expect additional transactions in the future which could provide synergy savings, at least a portion of which would inure to shareholders. Thus, it would be reasonable for utility management to reflect that expectation when considering the goodwill on a utility's books. Such a perspective, however, raises the fundamental question of whether a utility's books and records should be driven by the expectations of investors or a fundamental analysis of expected cash flows produced by the ratemaking process. Absent the existence of specific transactions, the details of which are known, the maintenance of goodwill based solely on investor expectations about what might occur in the future may lead to overly optimistic financial statements.

Q. Is it true that a utility could realize free cash flows and justify a goodwill balance based on the assumption that the utility would consistently earn a return above the cost of equity?

A. Yes, the utility might assume that it will earn in excess of the cost of equity on an ongoing basis. Such an assumption rests on the proposition that either the Commission sets rates too high from the start or the utility will consistently be able to find efficiencies that contribute to higher earnings. While this latter explanation is quite optimistic over an extended time period, there is evidence presented in Mr. Barry's testimony suggesting that the Commission might in fact be setting rates of return on equity at levels that are too high.

Q. Has staff tried to determine the extent to which Grid considered the limits established by the ratemaking process and the cash flows produced by it when determining how much to pay for KeySpan?

A. Yes, staff asked Grid about its specific basis for a payment above book value for a regulated utility. Exh__(MPP-13) contains Grid's responses to DPS-28 and 35, as well as respective follow-up requests DPS-106 and 108. DPS-28 part 2a-2e, and all of DPS-35 directly addressed the basis for the recording of goodwill and the dynamic between goodwill and cost based rates mentioned earlier in this testimony. Grid did not address questions related to the components of the goodwill from the proposed transaction, the reason why cost plus utilities should be allowed to record goodwill, how the goodwill might be amortized over time, and the effect of the Commission capturing 100% of all synergy savings upfront on goodwill. Moreover, when given a second opportunity to answer similar questions, via the follow-up interrogatories, Grid's responses were once again inadequate.

Q. Do either Grid or KeySpan ever consider their expected future after tax cash flows when evaluating the level of goodwill on their books?

A. Yes, consistent with GAAP requirements both Niagara Mohawk and KeySpan do compare expected future cash flows to the level of goodwill currently on their books to determine whether the goodwill is impaired. However, these analyses, prepared by independent auditors and reviewed by management, make simplifying assumptions that limit the amount of detail present in the cash flow forecasts. We are concerned that these analyses may not accurately reflect the future cash flows of a regulated utility subject to cost based rates.

Q. What kind of simplifying assumptions are employed by Grid and KeySpan in their impairment analyses?

A. KeySpan's impairment analysis, submitted in response to DPS-17 uses two approaches to value its regulated gas utility subsidiaries, an income approach and a market approach. The income approach uses an actual forecast of cash flows for a four year period. Cash flows after that point are based on a normalized cash flow amount for the fourth year projections and an assumed annual growth rate for that cash flow. The market approach uses the ratio of the enterprise value of other utility holding companies to earnings before interest taxes depreciation and amortization (EBITDA multiple) to establish an initial market value upon which other adjustments are made. Grid's methodology is similar to KeySpan's income approach because Grid projects actual cash flows for a discrete time period and then applies a growth rate to the last year's cash flow balance. Thus, these approaches rely on long term cash flow growth rates or EBITDA multiple assumptions to capture the present value of the majority of future cash flows.

Q. Do these approaches reflect cash flows from utility operations that reflect rates set on the basis of underlying costs?

A. After the initial period of actual cash flow forecasts there is no evidence that the longer term projections do reflect cash flows produced by rates set in the future on the basis of underlying costs. For example, the use of an EBITDA multiple extends to regulated utilities the current market valuation of holding companies that not only own regulated utilities but also competitive businesses. This valuation, neither considers how future utility cash flows might change or the actual utility costs the cash flows must cover. Similarly the income analysis makes an assumption about cash flows which also may or may not be consistent with the actual cash flows expected if rates are set based on underlying costs.

Q. Do you have any other concerns about goodwill?

A. Yes, our review of KeySpan and Grid goodwill impairment analyses indicates an apparent inconsistency in application. Virtually all of KeySpan's goodwill is reflected on the books of its New England operations. KeySpan's impairment analysis, however, includes cash flows from KEDNY and KEDLI to support the New England goodwill. By contrast, Niagara Mohawk's analysis of its goodwill does not consider cash flows from other affiliates.

CAPITALIZATION AND GOODWILL: Policy and Practice

Q. Is there an element of inconsistency in Grid's capitalization/financing policies?

A. Yes, for decades New York utilities have tried to impress upon regulators the importance of regulatory support for credit quality and strong financial profiles. By having ratepayers pay rates supporting a reasonably strong financial profile, the utility is able to raise capital at favorable terms in all types of credit markets in order to assure that necessary investments can be made to maintain safe and adequate service.

The Petitioners' request that the Commission set rates for KEDNY and KEDLI on a 50% equity ratio is the latest example of this type of argument. It is inconsistent, however, for the Petitioners to emphasize the importance of credit quality, when their own actions undermine it. Grid will employ consolidated debt leverage levels which far exceed what they advocate the Commission recognize when setting rates for a financially viable utility. Thus, Grid's request for 50% equity ratios for KEDNY and KEDLI would improperly place the responsibility for undoing the negative effects of Grid's own financial practices on the Commission and, ultimately KEDNY and KEDLI ratepayers.

<u>MERGER RATE PLAN: Grid/NMPC Experience</u>

Q. What is the duration of the proposed Rate Plans for KEDNY and KEDLI?

A. The proposed Rate Plans for KEDNY and KEDLI would cover a ten year period from the date the acquisition was approved by the Commission.

Q. What is the typical duration of recent multi-year rate plans?

A. The duration of recent rate plans is typically either two or three years. While there have been some exceptions, most notably occurring to implement rate reductions and rate freezes when the electric utility industry was restructured, the Commission has approved a ten rate plan on only one occasion.

Q. What were the circumstances regarding that ten year rate plan?

A. The case (01-M-0075) involved Grid's proposed acquisition of Niagara Mohawk Power Corporation (NMPC). In its December 3, 2001 Opinion and Order Authorizing Merger and Adopting Rate Plan ("2001 Order"), the Commission approved a 10 year rate plan ending December 31, 2011.

Q. What reasons did Staff set forth for agreeing to the ten year duration of the Grid/NMPC rate plan?

A. As summarized on pages 26 - 27 of the 2001 Order, Staff contended the extended duration was needed to accomplish the significant rate reductions and stranded cost write-offs, and that the plan incorporated numerous safeguards that allayed concerns about the extended term.

Staff also pointed to the fact that the Joint Proposal contained stranded cost write-offs and merger and efficiency savings which greatly exceeded the petitioners' initial offer, which Staff regarded as inadequate.

Q. Are the circumstances which produced the Grid/NMPC rate plan similar to the circumstances which produced the 10 year rate plans now proposed for KEDNY and KEDLI?

A. There are not many similarities from the perspective of ratepayer benefits. The NMPC Joint Proposal contained over $850 million in stranded cost write-offs, an immediate delivery rate reduction of approximately 8% and the intent of fixed delivery rates for the entire ten year rate plan. By contrast, the proposed KEDNY and KEDLI rate plans contain no write-offs and no immediate rate reductions. In fact the rate plans not only build in four automatic delivery rate increases and an automatic gas adjustment clause increase, but also contain features that will likely lead to even greater rate increases during the next ten years. Finally, while rates for KEDNY and KEDLI rise, the use of a debt financed equity ratio assures that Grid's shareholders will realize excessive profits which in no way reflect the reallocation of risk from shareholders to ratepayers occurring under the proposed transaction.

Q. Describe Staff's experience with the National Grid/NMPC rate plan regarding the concerns expressed by the Attorney General?

A. The Grid/NMPC rate plan has been effective since February 1, 2002. Since then the Office of Accounting & Finance Staff assigned to NMPC has encountered a number of problems related directly to the terms of the rate plan. Staff's negative experience with Grid/NMPC's 10-year rate plan is one element of our position that the 10-year plan proposed here is not in the interests of New York State ratepayers.

Q. Describe these problems and issues.

A. The problems stem largely from the twenty different deferrals permitted by the Grid/NMPC rate plan. These provisions have not only undermined the ability of the rate plan to produce stable delivery rates, but also made it exceedingly complex and difficult for Staff to verify the reasonableness of the costs for which Grid/NMPC seek deferral.

Q. Has the Grid/NMPC rate plan produced stable delivery rates?

A. No, while delivery rates were projected to remain fixed for the entire ten year term of the Grid/NMPC rate plan, the plan's deferral provisions have produced rate increases that were not expected when the rate plan was initially developed. More specifically, a 3% delivery rate surcharge of about $100 million went into effect April 1, 2006 and an additional 3% increase went into effect January 1, 2007 (making the total 2007 surcharge approximately $200 million). Because these surcharges only partially recover deferrals allowed under the Joint Proposal, future surcharge increases are likely.

Q. What is the likely total additional cost to the public attributable to the extensive deferral provisions in the Grid/NMPC rate plan over a ten year period?

A. The company's September 2005 projection of deferrals when combined with more current information indicates that for the entire 10 year period, NMPC ratepayers could face delivery rate surcharges of \$1.4-\$1.7 billion as the result of deferrals created under the rate plan. We explain later in this testimony why we think similar rate adjustments are likely for KEDNY and KEDLI as a result of the proposed transaction.

Q. Describe the problems that Staff has had verifying the reasonableness of the deferred expenses.

A. Staff assigned to Grid/NMPC reports that the amount and complexity of issues relating to Grid/NMPC deferrals has rapidly expanded. Staff, in the current NMPC Case 01-M-0075 deferral proceeding, completed a <u>partial</u> audit of the deferrals the company recorded on its books for the first 3.5 years of the rate plan (through June 30, 2005). Based on that partial audit, Staff submitted approximately 400 pages of direct and responsive testimony, along with approximately 700 pages of exhibits, recommending the disallowance of over \$300 million of deferrals previously recorded on NMPC books. The Grid/NMPC response to Staff was of similar magnitude in terms of number of pages of testimony and exhibits.

Q. Did Staff perform a complete audit of Grid/NMPC deferred items in this deferral proceeding?

A. No, Staff's audit did not cover all of the deferrals booked through June 30, 2005. Staff's inability to complete the audit was due to both the complexity and number of deferrals in combination with the company's inability to consistently provide supporting documentation in a timely manner. Based on that experience, Staff is very concerned that this problem could worsen in the future, because as the unaudited deferrals age, it may become more difficult for Grid/NMPC to retain and/or produce the records supporting the unaudited deferrals.

Q. Does staff anticipate other problems with the Grid/NMPC extended rate plan?

A. Yes, a ten year rate plan is unrealistic given the likelihood that regulatory approaches and strategies may change over the term of an extended rate plan. For example, a Commission determination that revenues should be decoupled from sales in order to support demand side management initiatives would be at odds with the Grid/NMPC rate plan which included a cost of equity reflecting the fact that the company was at risk for all public sales variances for all ten years of the rate plan. Thus, the issue for the Commission in this situation would be whether to postpone adopting such an approach for NMPC until after 2011 or to effectively reconsider the entire Grid/NMPC rate plan. By contrast the Commission would not face a choice with such long term consequences under rate plans of shorter duration.

Q. Has staff encountered other problems with the Grid/NMPC rate plan?

A. Yes, there is great ambiguity concerning exactly the costs that rates cover in the latter years of the plan. While utilities may have detailed cost forecasts for the first few years of an extended rate plan, the capability of any business to provide accurate forecasts beyond a shorter term time horizon is limited. In the Grid/NMPC rate plan the annual cost forecasts for years four and beyond usually consist of year three's detailed forecast plus inflation. Because no specific expenses are typically identified beyond the third year, it becomes inevitable that arguments arise regarding whether costs that the company incurs in the latter years were covered by the inflation adjusted expense level. This issue is exacerbated in situations when certain programs are scaled back or eliminated and new ones introduced. The net effect of this problem is a major increase in the amount of work required by staff to understand these changes and the potential creation of unnecessary deferrals. By contrast, shorter term rate plans based on discrete cost forecasts for all years avoid this type of problem.

GRID KEYSPAN MERGER RATE PLAN: Rate Impacts

Q. What utility prices are established under the ten year KEDNY and KEDLI rate plans?

A. The plans freeze rates until March 31, 2009 at which point four bi-annual rate increases would become effective starting on April 1, 2009. The respective percentage revenue increase in total bills for KEDNY and KEDLI are approximately 3.0%

and 3.2% for 2009, 2.9% and 3.1% for 2011, 2.8% and 2.9% for 2013, and 2.3% and 2.2% for 2015.

Q. Does the company forecast other increases in charges to customers over the term of these rate plans?

A. Yes, KEDNY and KEDLI initially defer certain costs primarily related to uncollectible gas costs and the return requirements on gas storage and gas working capital. These costs are recovered in the gas adjustment clause commencing on October 1, 2008. This results in additional total bill increases for both KEDNY and KEDLI of about 2% in 2008 and 2009.

Q. These rate increases are expressed in terms of total bill increases. How does the proposed rate plan affect KEDNY and KEDLI delivery rates?

A. Exh__(MPP-14) presents our calculation of the approximate effect of the proposed rate plans on the delivery rates of both KEDNY and KEDLI based upon information contained in the Petitioners' presentation. These calculations compute the percentage increase in delivery by considering the base delivery revenues, revenues from sales growth and revenues from base rate increases shown in Schedule MDL/JMM-4, page 1, for both KEDNY and KEDLI. The annual compounded increase in delivery rate revenues after sales growth and rate increases is compared to the annual compounded increase in delivery rate revenues just from sales growth over the term of the rate plan. The difference between the two rates approximates the change in the average annual delivery rates that would be necessary to produce the forecasted delivery revenues over the rate plan. Based on these results we estimate that delivery rates will increase by average annual compound rates of 3.1% and 4.5%, respectively for KEDNY and KEDLI over the life of the rate plan.

Q. Have the Petitioners provided a forecast of changes in future commodity costs for KEDNY and KEDLI gas customers?

A. No, the aggregate dollar amount of commodity costs are frozen at estimated 2008 levels over the life of the rate plan.

Q. Is this an important omission in the Petitioners presentation?

A. It could be. The lack of a commodity cost forecast means that the proposed rate plans do not reflect changes in an expense category which represents more than half of the total utility bill. Moreover, if one assumes that retail penetration remains constant and sales to full service customers increase over time, the forecast of commodity costs in the rate plan is actually declining. As a result, any statements by the Petitioners about the total bill impact of their rate plan proposal must be viewed with caution based on the knowledge that actual changes in total bills are dependent on future commodity cost levels not included in the forecast used to justify the proposed rate plan.

MERGER RATE PLAN: Rate Impacts

Q. Do the proposed rate plans allow for delivery rate increases beyond those reflected in the petition?

A. Yes, balancing accounts are established in each rate plan to track differences between forecast costs and actual costs. To the extent that the balancing account exceeds $50 million for KEDNY and $25 million for KEDLI, the variance is recovered via an adjustment (LDAC) in delivery rates. Such increases, however, may not commence until April 2009. An upward annual limit of 2.5% is established for such rate changes.

Q. Why do the petitioners believe that these provisions are in the public interest?

A. Petitioners state (Joint Petition, 31) that "These provisions, together with the forecasted escalation of Balancing Account items reflected in the Rate Plans over the next ten years, are designed to assure that the implementation of the LDAC will not lead to unreasonable fluctuations in delivery rates to customers."

Q. Do you agree with this assessment?

A. We think that the balancing accounts will likely far exceed the levels currently projected by petitioners in the KEDNY and KEDLI rate plans. This would, in turn, lead to a much greater need for LDAC rate increases than is currently projected.

Q. Why are the current balancing account forecasts for KEDNY and KEDLI too low?

A. The balancing account amounts are based on forecasts in the KEDNY and KEDLI rate plans of property taxes, Site Investigation and Remediation (SIR) costs, Demand Side Management (DSM) costs, Low Income programs costs, and capital additions that are inconsistent with past experience and/or inconsistent with Petitioners' own positions in this proceeding.

Q. Have you estimated by how much the balancing account may exceed the level forecast by Petitioners in the KEDNY and KEDLI rate plans?

A. We believe that the Petitioners have not adequately considered a number of items that may put upward pressure on rates. Before considering the implications of LDAC recovery, we estimate that actual deferrals and interest could be more than $1.7 billion over the levels current forecast for KEDNY and KEDLI. This amount is composed of about $230 million related to SIR costs, $520 million related to DSM and Low Income programs, $620 million related to real estate and special franchise taxes, and $340 million related to KEDNY capital additions.

Q. What are the implications of this information?

A. Given the balancing account limits established in the KEDNY and KEDLI rate plans, the vast majority of this $1.7 billion amount would have to be collected from ratepayers over the last 7 years of the rate plan. This represents a significant future rate impact. If one makes the simplifying assumption that the $1.7 billion of deferrals are proportioned equally to KEDNY and KEDLI, it can be estimated that the combined LDAC revenues for KEDNY and KEDLI would have to be increased by about $41 million in September 2009 and every year thereafter by a similar $41 million amount, to offset the increase in the balancing account caused by these deferrals (Exh__(MPP-15)). This exhibit also shows that these LDAC increases equate to an average delivery bill increase of about 3.1% in every year from 2009 until 2017 over and above the 3-4.5% annual base rate increases already contained in the company's rate plan. Thus, the forecasts provided by petitioners in support of the proposed transaction are unrealistically optimistic, thereby understating the rate effects of the proposed rate plan. Our conclusion mirrors the actual experience under a similar plan for Grid/NMPC.

Q. How does this information help shape Staff's position in this proceeding?

A. This information indicates that the proposed rate plans for KEDNY and KEDLI are not in the public interest. Not only are the merger benefits which purportedly manifest themselves in a 10 year rate plan largely illusory, they are based on a rate plan with a 10 year term that is simply too long a time period on which to set rates. A more frequent, routine review of a company's finances is better for ratepayers. The establishment of deferrals, true-ups and balancing accounts over such an extended period, based on an approach that is not working well for Grid/NMPC, masks future rate increases, reduces shareholder risk while enabling Grid to earn excessive profits and severely lacks the cost control measures associated with a series of shorter term rate plans which include regular rate case quality reviews of underlying costs.

<u>MERGER RATE PLAN: Special Franchise and Real Estate Tax True-Ups</u>

Q. Is the company's forecast of special franchise and real estate taxes in the KEDNY and KEDLI rates plans reasonable?

A. No, KEDNY and KEDLI forecast these taxes to increase at an annual rate of about 2.2% over the term of the rate plan. Actual taxes over these amounts are deferred and added to the balancing account. By contrast, the petition notes (21) that KEDNY's franchise and real estate taxes have increased by 223% over the last 10 years, or annual rate of about 9%. Moreover KEDLI's property taxes increased by about 4% per year between the $73.2 million of property taxes it paid in 1999, its first year of business and the $99.5 million it projects for the 12 months ending March 2008.

Q. What is the significance of this information?

A. Petitioners have not justified the basis for their 2.2% projection of the property tax true-up target. This is significant because Exh__(MPP-16) shows that if the actual escalation rate were 9% per year for KEDNY, and 4% per year for KEDLI, then the total amount of property taxes that would be deferred over the life of the rate plans would be about $530 million combined for KEDNY and KEDLI. Assuming 5% interest, the total deferral would be about $620 million. This amount would be collected through the LDAC, subject to its limitations, with any amounts remaining in the balancing account accruing interest.

MERGER RATE PLAN: SIR True-Ups

Q. What forecast of SIR costs are reflected in the KEDNY and KEDLI rate plans?

A. KEDNY reflects $16.5 million per year and KEDLI reflects $10.1 million per year for each year of the rate plan.

Q. How are differences between these estimates and actual SIR costs treated in the rate plan?

A. The revenue requirement effect of incurring SIR costs at levels above these amounts are deferred and accumulated in the balancing account. The revenue requirement effect includes a return on capital and a ten year amortization of capital, based on Staff testimony in this proceeding.

Q. Do these forecasted amounts in the rate plan match KEDNY and KEDLI's stand-alone forecast of SIR costs?

A. No, Petitioners' response to DPS-37 indicates that KEDNY, as part of its stand-alone rate case, forecasted approximately $165 million of SIR expenditures through 2013, with almost $60 million incurred in the 2007/2008 rate year. DPS-37 also shows that KEDLI forecast about $100 million of SIR expenses through 2013 with $35 million projected for 2008.

Q. Do you think that there are additional SIR costs not reflected in the KEDNY and KEDLI stand-alone forecasts which might be incurred over the term of the 10 year rate plan?

A. Yes, KeySpan's most recent 10-K indicates that the company forecasts $333 million of SIR expenditures for both KEDNY and KEDLI. This implies that $67 million (333-165-101) of SIR costs are not reflected in the stand-alone KEDNY and KEDLI forecasts.

Q. What are the implications of this information on the proposed 10 year rates for KEDNY and KEDLI?

A. The SIR forecast in the 10 year rate plans is inconsistent with KEDNY and KEDLI's actual plans and public statements. More specifically, the rate plan estimates not only ignore the front-end loaded KEDNY and KEDLI stand-alone projections but also do not reflect the likelihood that additional SIR costs would have been expended by KEDNY and KEDLI after 2013. Exh__(MPP-17) shows that about $175 million of revenue deferrals could accumulate if the rate plan forecast were consistent with KEDNY and KEDLI's own plans and statements. Assuming 5% interest and no rate recovery, this figure increases to about $234 million. This amount would be collected through the LDAC in the maximum amount permissible with the remaining balance accumulating interest.

Q. Have Petitioners explained the basis for the difference between the two forecasts of SIR costs?

A. No. If the Petitioners choose to explain the difference and it is their position that, contrary to their rate case position, the levelized amounts rather than the stand-alone amounts are appropriate, then KEDNY and KEDLI should adjust the SIR expense levels reflected in their proposed stand-alone rate cases.

<u>MERGER RATE PLAN: DSM and Low Income True-Ups</u>

Q. What level of expenditures for DSM and low income programs are reflected in the KEDNY and KEDLI rate plans?

A. The KEDNY and KEDLI rate plans project no expenses for either of these programs.

Q. What expenditure levels are KEDNY and KEDLI likely to incur for DSM and low income programs?

A. The approximate combined cost of the low income programs for both KEDNY and KEDLI, as adjusted by Staff, is about $7 million per year. The approximate cost of the KEDNY and KEDLI DSM programs, based on company testimony is about $30 million per year.

Q. What are the implications of these amounts on the balancing account?

A. Exh__(MPP-18) shows that deferrals associated with these amounts could exceed $400 million without interest and $520 million with interest. Deferrals for these programs would be collected through the LDAC in the maximum amount permissible with the remaining balance accumulating interest.

<u>MERGER RATE PLAN: Capital Additions True-Ups</u>

Q. What are the provisions of the balancing account relating to capital additions?

A. The rate plan establishes capital targets for KEDNY city/state construction, KEDLI investment in bare steel pipe replacement, KEDNY and KEDLI capital expenditures for system improvements excluding growth-related local distribution mains, services and meters, and KEDNY and KEDLI incremental capital expenditures associated with new programs mandated by federal, state or local authorities. The revenue requirement effects (depreciation, income taxes and return on capital) associated with variances from these targets are accumulated in the balancing account and collected, when necessary via the LDAC.

Q. Where are KEDNY's capital targets for each of these items reflected in the filing?

A. Petitioners indicated that the original combined city/state and non-growth tracker amounts presented in KEDNY Exhibit 6, Attachment 2, page 3 of 5 were erroneous. The correct totals provided by the company in Exhibit 8-KEDNY - Updated, page 10 of 12, are contained in Exh__(MPP-19).

Q. How were the corrected KEDNY city/state non-growth targets calculated?

A. They were based upon the average of actual expenditures by KEDNY for 2003, 2004 and 2005. This unadjusted average was then assumed to remain constant for the rate years ending in 2008, 2009 and 2010. The targets were then increased by a 2.3% escalation rate through the 2017 rate year.

Q. Where are KEDLI's capital targets reflected in the filing?

A. Exhibit 6, Attachment 2, KEDLI, page 3 of 5 provided the non-growth targets as well as the bare steel replacement program targets. Once again we assume that the company has reflected no capital additions in its forecast for new programs mandated by federal, state, or other local authorities.

Q. How was the bare steel target calculated for KEDLI?

A. The KEDLI bare steel target reflects the replacement of 40 miles of pipe per year.

Q. How was KEDLI's non-growth capital addition target calculated?

A. It was calculated in the same manner as KEDNY's. Thus, the first three years of the rate plan reflect a three year average based upon 2003-2005, while the remaining years increase by a 2.3% escalation rate.

Q. Does Staff have concerns about the city/state and non-growth target calculations?

A. Yes. While the basic calculation of the targets is questionable, a comparison of the targets to KeySpan's stand-alone 10 year capital forecast assuming no merger raises even more questions.

Q. What is the basis for this conclusion?

A. The target employed for 2008-2010 is based on the average of actual expenditures for 2003-2005. Petitioners have provided little justification for this approach other than the fact that it is based on actual results. Considering that the levels used for 2008-2010 are not adjusted for inflation, this approach means that KEDNY and KEDLI will spend lower amount of real dollars in this area over the 2008-2010 time period than they did in 2003-2005.

Q. What do these stand-alone forecasts show?

A. Exh__(MPP-19) presents the KEDNY and KEDLI capital forecasts for the next 10 years assuming no merger occurs. These forecasts are taken directly from both companies' stand-alone rate filings and show that over the next ten years KEDNY and KEDLI expected to spend about $1.995 billion and $1.392 billion, respectively, on capital additions.

Q. How much does Grid plan to spend on capital additions for KEDNY based on its 10 year rate plan?

A. The 10 year rate plan updated figures reflect capital expenditures of $1.426 billion for KEDNY, a reduction of about $570 million from KEDNY's stand-alone budget.

Q. Is this difference important?

A. Yes, it suggests a major difference of opinion between Grid and KeySpan regarding the amount of capital expenditures necessary for KEDNY. A decline in projected spending for the future raises questions about the ability and, perhaps, willingness of Grid to provide reasonable service to KEDNY customers in the future.

Q. Are there other reasons why this difference is important?

A. Yes, the substantial difference between the two forecasts has immediate implications for KEDNY's one year rate case which is based on KEDNY's stand-alone capital additions projections. KEDNY must fully explain why it believes its stand-alone forecast is reasonable and necessary to assure that it is in a position to provide safe and adequate to the public, or it should make an adjustment to its filing to reflect Grid's lower forecast. Petitioners cannot have it both ways. KEDNY's stand-alone forecast is either overstated or Grid's rate plan forecast is understated.

Q. Are there other ratemaking considerations related to the different capital additions forecasts?

A. Yes, Exh__(MPP-19) shows that $481.8 million of the $570 million total difference is attributable to items (city/state and non-growth construction) that are trued up under the proposed 10 year rate plan. Given the KEDNY stand-alone capital forecast, the questionable historic average used by Grid to establish a deferral target, and the ever present incentive of the merger proponents to make the transaction appear favorable, Staff is concerned that Grid's capital forecast masks great potential for rate increases caused by actual capital additions tracking KeySpan's stand-alone forecast. Exh__(MPP-19), shows that if this stand-alone forecast is accurate, about $290 million of revenue requirement deferrals would be added to the balancing account. The deferral would increase to about $345 million with interest. This amount would be collected through the LDAC in the maximum amount permissible with the remaining balance accumulating interest.

Q. How much does Grid plan to spend on capital additions for KEDLI based upon its ten year rate plan?

A. The rate plan projects total spending of $1.46 billion, an increase of about $70 million over KEDLI's stand-alone forecast.

Q. What are the primary causes of this difference?

A. Grid projects KEDLI spending about $200 million more on steel pipe replacement than the amounts KEDLI reflected in the stand-alone forecast. We estimate that this increase is partly offset by two items. Grid projects KEDLI spending about

$58 million less on non-growth projections than what KEDLI reflected in its stand-alone forecast and Grid eliminates the $47 million Islander East project.

Q. What is the significance of these differences?

A. There is a difference of opinion between the management of Grid and KeySpan regarding the reasonable amount of future capital additions for KEDLI.

Q. What is Staff's opinion regarding Grid's elimination of the Islander East project?

A. We recognize that the status of the Islander East project is uncertain. However, we think that this project or one like it is in the public interest, and we do not think it reasonable to rule out the possibility the Islander East project or an alternative might be completed during the term of the rate plan. Because, we highly doubt that KEDLI or Grid would start such a project without some assurance regarding cost recovery, Grid's elimination of the Islander East project from the rate plan for its entire term may not be reasonable. As such, there may be deferred revenues for KEDLI which are not reflected in the rate plan. We think that Grid should address the treatment of the Islander East project or an alternative in the proposed KEDLI rate plan.

Q. Do you have anything else to add on this general topic?

A. We received Petitioners' response to DPS 317 on January 22, 2006. This response, attached as Exh__(MPP-20), supports our concerns about deferrals related to capital additions. The response to question 1 indicates that KeySpan does not agree with Grid's methodology of estimating construction expenditures and that KeySpan's approach is superior because it is based on specific plans and projects.

Q. Does this IR response provide any other important evidence?

A. Yes, question 2 refers to the idea that Grid's rate plan assumes O&M reductions for KEDNY and KEDLI of $24.9 million and $11.3 million below the levels reflected in the stand alone rate case. KeySpan does not support these adjustments to the one year rate cases.

Moreover, KeySpan notes that to the extent these expenses are required and the merger takes place, then they will be deferred for recovery through the LDAC. We do not think that this type of deferral was originally contemplated as part of the proposed rate plan and we note that the deferral of recurring expenses of $35 million per year over an extended time period would put even greater upward pressure on rates.

<u>SYNERGY SAVINGS: Background</u>

Q. What is the purpose of this section of the Panel's testimony?

A We address the non-gas cost synergy savings and the costs to achieve the merger which were estimated by Petitioners.

Q. What is the total amount of net synergy savings produced by the proposed transaction?

A. The company estimates that total net synergy savings of $1.637 billion are achievable over a ten year time period after the merger is consummated. This amount is net of the cost to achieve and it excludes savings related to gas costs and uncollectibles.

Q. How do the Petitioners propose to allocate synergy savings between the affiliates of Grid and KeySpan?

A. The synergy savings are allocated on the basis of the T&D revenues of each affiliate and an estimate of these revenues for LIPA.

Q. How do the Petitioners propose to allocate the synergy savings between the ratepayers and shareholders of KEDNY and KEDLI, and what is the basis for the sharing percentage?

A. Savings for KEDNY and KEDLI are shared 50/50 between ratepayers and shareholders. Petitioners state that this percentage was the sharing methodology agreed to in the National Grid merger with Niagara Mohawk.

Q. How much of the $1.637 billion total net synergy savings amount does Grid propose to flow to KEDNY and KEDLI ratepayers?

A. Grid proposes to allocate $217.2 million (13.27%) and $129.0 million (7.88%) of the net synergies to KEDNY and KEDLI, respectively. Under the 50/50 sharing proposed by Grid ratepayers of KEDNY and KEDLI would receive net synergy savings of $108.6 million (6.63%) and $64.5 million (3.94%), respectively, over the 10 year rate plan.

Q. Is this a benefit of the proposed transaction?

A. In isolation yes, however, these benefits are more than offset by the excessive rates produced by Grid's request to set the return on equity on a debt-leveraged common equity ratio. This topic was addressed earlier in this testimony.

Q. What companies are the beneficiaries of the remaining synergy savings?

A. Synergy savings are also allocated to Niagara Mohawk, LIPA, and the out-of-state affiliates of both KeySpan and Grid.

Q. Describe the effects of the net synergy savings allocation on Niagara Mohawk customers and investors.

A. Niagara Mohawk's electric and gas operations will realize net synergy savings of about $406 million. Under the terms of Niagara Mohawk's rate plan, 50% of these net synergy savings will flow to ratepayers during the first 5 years, while 100% of the savings will flow to ratepayers during the last 5 years of the proposed 10 year rate plan for KEDNY and KEDLI. We believe that the estimates, provided by witnesses Laflamme and Molloy, of about $342 million of benefits to ratepayers and $64 million of benefits to shareholders is consistent with the information provided in the petition.

Q. Describe the effects of the net synergy savings allocation on LIPA customers and investors.

A. LIPA is allocated $344 million of net synergy savings. The rate treatment of this amount is unknown and beyond the Commission's jurisdiction.

Q. Describe the effects of the net synergy savings allocation on the customers and investors of Grid's and KeySpan's out-of-state subsidiaries.

A. The remaining $541 million of net synergy savings will flow to affiliates of Grid and KeySpan which operate outside of New York State. Because many of these companies operate under rate plans which will not capture synergy savings for ratepayers, a large portion of these savings will flow to Grid's shareholders. On the basis of information provided by Grid regarding the sharing provisions of its various rate plans and the calculations presented in

Exh__(MPP-21), we estimate that about 70% of the $541 million amount, or about $372 million will flow to Grid shareholders.

SYNERGY SAVINGS: Grid Estimate

Q. Why is it important to develop a reasonable estimate of net synergy savings for the transaction?

A. Inaccurate estimates can negatively affect the public interest. If the synergy savings estimate is too high, then the utility may attempt to offset this error by cutting expenditures for necessary services. By contrast, if the estimate is too low, then the utility will realize excess profits and ratepayers will pay excessive rates.

Q. Does staff have concerns regarding the basic calculation of the total net synergy savings?

A. Yes, at the present time, Grid estimates that, when fully realized, gross synergy savings (before deducting the costs to achieve) will be between $153 million and $208 million per year. It also estimated the total cost to achieve to be $400 million or roughly two times more than the annual synergy savings. While the

Petitioners provided calculations as part of their initial filing and hundreds of pages of work papers to support these levels, they never provided a clear and succinct description of how the specific synergy savings items were identified and quantified. The company updated its savings analysis on December 6, 2006 but noted that these calculations were not final and that senior management would approve final numbers during the first quarter of 2007. While the December updated dollar range of net synergy savings was generally consistent with the initial range, it is not the product of the same analysis because it now includes an explicit weighting of potential benefits by probability assessments based on the likely success of various synergy savings actions, whereas the earlier analysis did not. Once again the company provided no clear and succinct description of how it identified and quantified the synergy savings. Therefore, the validity and accuracy of the synergy savings calculations presented by the companies is dubious. We further note that the usefulness of such a review is questionable because the estimate is by Grid's own admission incomplete and not final.

SYNERGY SAVINGS ALLOCATIONS:

Q. What are staff's conclusions regarding Grid's proposed treatment of synergy savings?

A. We think that Grid's proposals produce results that are unfair to the ratepayers of KEDNY and KEDLI. The approach not only allocates too many benefits away from KeySpan to Grid's pre-merger affiliates, it also allocates too many benefits to shareholders rather than ratepayers over too long a period of time.

Q. Why do you believe that Grid's proposal allocates too many benefits away from KeySpan to Grid's affiliates?

A. Based on Schedule MDL/JMM-3, the allocation methodology assigns $501.4 million of net synergy savings, before sharing, to KeySpan's operations (listed as BUG, LILCO-Gas, Boston Gas, Colonial Gas, Essex Gas and EnergyNorth Gas). This represents about 30% of the $1.64 billion total net synergy savings.

Q. How do the 30% of net synergy savings that flow to KeySpan's former subsidiaries as a result of Grid's proposed allocation methodology compare to the percentage of net synergy savings that flowed to Niagara Mohawk as part of its merger with Grid?

A. By way of comparison, about 60% of the net synergy savings calculated in the Grid - Niagara Mohawk merger were allocated to Niagara Mohawk.

Q. How was the proposed allocation of synergy savings between the KeySpan and Grid affiliates developed?

A. The proposed allocation was based on the Transmission & Distribution revenues of each subsidiary of Grid and KeySpan as well as an estimate of these revenues for LIPA.

Q. Does staff believe this is a reasonable way of allocating savings from the proposed transaction?

A. No, the use of T&D revenues to allocate savings discriminates against KeySpan's natural gas distribution subsidiaries.

Q. Why do you believe that Grid's approach is unfair for KeySpan's natural gas affiliates and their ratepayers?

A. Electric utility T&D revenues recover not only the costs of distributing electricity to end-users but also the costs of transmitting electricity across longer distances. By contrast, KeySpan's T&D revenues reflect primarily the costs of distributing gas to end-users. Thus, Grid T&D revenues reflect a function which is not a significant part of the business of KeySpan's regulated gas distribution subsidiaries. As such it is unreasonable to premise the allocation of savings from the proposed transaction on an approach which gives weight to a function that is a significant part of Grid's business but not a significant part of the business of KeySpan's regulated subsidiaries. The result of using this approach is the allocation of an excessive amount of synergy savings to Grid.

Q. Do you have any factual basis for your conclusion that Grid is far more involved in activities related to the transmission of a commodity than KEDNY or KEDLI?

A. Yes, NMPC's five-year financial results which are available on the Commission's website show that for the period 2001-2005, the total Niagara Mohawk electric operation and maintenance expense related to T&D was $1.03 billion. Of that amount about $273 million was related to transmission of electricity. This represents about a quarter of the total. By contrast Niagara Mohawk's gas transmission expense represents less than 1% of its gas distribution expense. This indicates a substantial difference between the functions within Niagara Mohawk. Moreover, the same data source also indicates that KEDNY's and KEDLI's combined gas transmission expense represented less than 5% of their combined T&D expense for the same time period. This provides further support that KEDNY's and KEDLI's involvement in the transmission business is not comparable to Grid's involvement. Thus, the proposed allocation factors transfer too many benefits away from KeySpan's affiliates.

Q. Does staff have other concerns about the allocation factors?

A. Yes, we question the fairness of allocation factors that flow less than one third of the benefits of the transaction to the entity, KeySpan, which is the root cause of the savings. Put another way, any synergy savings realized by any Grid affiliate occur as the result of the opportunities created by the integration of KeySpan into the overall corporation. Thus KeySpan, by definition, is a primary cause of any incremental net savings associated with the transaction. It seems unreasonable, therefore, for over two-thirds of the net savings to flow to entities other than KeySpan.

Q. What other problems did Staff identify with the company's proposed allocation of net synergy savings?

A. The company's proposal to allocate a portion of the net synergy savings to LIPA is problematic. KeySpan provides service to LIPA, under contract, through an unregulated affiliate. KeySpan is under no obligation to pass along net synergy savings being created due to merger activity to LIPA.

Q. Did Staff identify other problems with the LIPA allocation factor?

A. Yes, we do not think that Grid has justified the

21.01% allocation factor which is based on LIPA "transmission and distribution" revenues of $1.159 billion.

Q. Why do you disagree with this allocation factor?

A. The inclusion of transmission revenues in this calculation is inappropriate for the reasons already noted. However, while the allocation factor is supposedly based on T&D revenues, the LIPA revenues include $322 million related to payments that LIPA makes to KeySpan for certain services related to its Power Supply Agreement, such as generation capacity, variable operating and maintenance expenses, ancillary services and performance incentives. These services are generation related services. As such, they are not classifiable as T&D revenues, rather, they appear to relate to discrete services provided by KeySpan to LIPA that are in no way related to any of Grid's existing businesses. Such expenses should not be in the allocation factor.

Q. Do you have any other concerns about the LIPA allocation?

A. Yes, based upon information provided in DPS-99, we are unable to verify that the remaining $836 million of LIPA "transmission and distribution" revenues properly exclude costs related to LIPA's 18% ownership of the Nine Mile Point Unit 2 nuclear power plant and/or payments in lieu of taxes that may not be related to the T&D business.

Q. What is your overall conclusion about how the net synergy savings are allocated between Grid and KeySpan affiliates?

A. We think the proposed T&D revenue allocation factor results in too low of an allocation for gas utilities. We think it unreasonable that less than a third of the total savings from the transaction flow to KeySpan. Finally, we think that there are problems in the calculation of the allocation factor for LIPA.

Q. What is your opinion about the 50/50 ratepayer/shareholder sharing relationship advocated by petitioner in this proceeding?

A. We disagree with this proposal. Despite claims by Petitioners that the Grid/Niagara Mohawk transaction provides precedent for this sharing arrangement, it is important to recognize at the outset, that there is little precedent for this approach and that within Grid, the 50/50 sharing relationship only really applies to KEDNY and KEDLI. The sharing arrangements for other affiliates, including Niagara Mohawk, are either significantly different or unknown.

Q. How do the sharing arrangements for the other affiliates differ?

A. Niagara Mohawk would share the savings from the proposed transaction at the 50/50 rate for the first 5 years but would then provide 100% of the savings to ratepayers for the following 5 years. By contrast, and as noted previously, about 70% of savings for out of state affiliates are likely to flow to shareholders. Finally, the exact breakdown of savings between LIPA ratepayers and its investors is unknown.

Q. Why is this information important?

A. Petitioners support the proposed 50/50 sharing by referencing the provisions of the Grid/Niagara Mohawk merger. The validity of such a reference is called into question when one recognizes that those merger provisions were the product of a negotiated settlement, those very merger provisions support a higher sharing percentage under certain circumstances such as the proposed transaction, and the sharing provisions of other Grid utilities do not match Niagara Mohawk's. Thus, any suggestion that the Grid/Niagara Mohawk merger provides a strong precedent for using the proposed 50/50 sharing is misplaced.

Q. Is this 50/50 sharing percentage consistent with the sharing arrangement that occurred when the Long Island Lighting Company (LILCO) merged with The Brooklyn Union Gas Company?

A. No. In Case 97-M-0567, the BUG/LILCO Merger proceeding, the synergy savings sharing arrangement was 90% to customers, 10% to shareholders. In that case, the Staff Panel testified as follows: "Q. What does the Settlement provide regarding sharing between customers and shareholders of the post-merger savings? A. In Staff's view, implicit in the imputed base rate reductions in the Settlement (for LILCO electric, implicit in its savings allocation) is sharing between customers and shareholders of the post-merger savings. Of the imputed savings, 90% go to the benefit of customers and the remaining 10% go to the benefit of shareholders. This 90%/10% sharing provision allows LILCO and BU to appropriately share in the benefits of the merger." [Prepared Testimony of Staff Panel, dated December 12, 1997, Mimeo pp. 20-21]. Staff further explained in its brief, the following: "In fact, approximately 78% of Staff's total savings estimate of $1,273,360,000 is captured in up-front imputed rate reductions by the Settlement. As ten of the remaining 22% of Staff's total savings estimate is intended by Staff to be retained by the Companies as an incentive, there remains only 12% of Staff's total savings estimate that is not imputed and must be captured through the sharing of over-earnings." Case 97-M-0567, Staff's Brief, dated January 14, 1998, at p. 19. We note that the 90/10 sharing provisions were also the result of a negotiated settlement and must be viewed in that light.

Q. What then is the Panel's overall assessment of a 50/50 sharing percentage between shareholders and ratepayers?

A. Petitioners have not provided any affirmative policy testimony explicitly stating why it is in the public interest for ratepayers to share any savings with shareholders. Moreover, while petitioners state that the merger will result in lower costs, they have not explained why ratepayers should pay rates above underlying costs for an extended time period (as a result of the proposed sharing mechanism) while KEDNY and KEDLI rates increase. Finally, the Petitioners have not explained why the rate plan's significant transfer of risks from shareholders to ratepayers justifies shareholders retaining anything beyond a minimal percentage sharing amount. As a result, we think that KEDNY and KEDLI ratepayers should retain a much higher percentage than the 50% sharing level proposed by Petitioners. We make a recommendation for 90/10 ratepayer/shareholder savings later in this testimony.

Q. You stated that the sharing occurs over too long a period of time. What is the basis for this conclusion?

A.

Q. Is there other relevant information concerning the level of net synergy savings realized by New York State ratepayers in this proceeding?

A. Yes, as noted elsewhere in this testimony, KeySpan received an offer to merge with another entity. The level of estimated synergy savings that would have been available to KeySpan ratepayers from the alternative transaction is an important consideration when reviewing the reasonableness of the Petitioner's overall net synergy savings proposal. Based on this information as well as the concerns previously addressed, we recommend that 90% of all synergy savings flow to ratepayers.

Q. What should the Commission do about the lack of a clear level of synergy savings from the merger?

A. Petitioners' have yet to provide their final estimate of synergy savings supported by clear and concise evidence. Given the lack of a final estimate, we recommend that the uncertainty concerning the level of synergy savings be considered as another reason why the Petitioners have not demonstrated that the merger is in the public interest.

Q. Do you have any other comments related to the topic of synergy savings?

A. Yes, it is our assumption that the synergy results presented by petitioners in this proceeding reflect no efficiency gains that could otherwise be achieved without the proposed transaction. If our assumption is inaccurate, then petitioners' synergy savings estimate is likely overstated. We expect more information on this subject to become available after the net synergy savings estimates are finalized in the first quarter of 2007.

Q. Does staff have any comments regarding the treatment of the cost to achieve merger savings?

A. Yes. The company has not yet specifically quantified all items that go into the cost to achieve. The purpose of such a quantification is to assure that elements of the cost to achieve are not charged to ratepayers as part of the revenue requirement or as reductions in the earned return on equity during the time period in which net synergy savings are being shared between ratepayers and shareholders. The Commission should not set rates based on the proposed transaction until a final detailed estimate of the cost to achieve synergy savings is available.

VERTICAL MARKET POWER (VMP)

Q. Please summarize your position with respect to the proposed transaction, VMP and the public interest.

A. VMP concerns are one of the reasons we believe that the proposed transaction is not in the public interest. More specifically, we think that (1) Grid's proposed purchase of a New York utility owning competitive (i.e. market-priced) generation assets contradicts the structural path that parties negotiated for, that ratepayers have paid for, and that the Commission and Niagara Mohawk have supported for many years; (2) Grid has not met the burden to rebut the presumption of VMP laid out in the Commission's 1998 Vertical Market Power Policy Statement; (3) the purchase, by Grid, of KeySpan's generators will provide Grid with the incentives and the ability to exercise VMP to the detriment of New York State electric ratepayers; and (4) any financial disincentive that National Grid currently may have for promoting electric energy efficiency measures would be exacerbated if it were to own, or be affiliated with entities that own, New York generators facing market prices. It is critical to note that Grid is not proposing, with this transaction, to return to owning fully rate-regulated generation. Rather, Grid proposes to purchase a gas utility that owns competitive (market-priced) generation, a much more serious concern with respect to VMP.

Further, for reasons discussed below, even if Grid were to commit to divesting KeySpan's competitive generation (in addition to curing all of the other problems staff sees in this proposal) we have serious concerns about the Commission's ability to rely solely on such a commitment. We do not recommend that the Commission rely on such a commitment unless it is accompanied by the other safeguards and conditions noted in this testimony.

Q. Do you have any other recommendations and conclusions?

A. Yes, Petitioners apparently desire that the parties enter into settlement negotiations at some point in the future. We would condition staff's participation in such negotiations on Petitioners' agreement that competitive generation will be divested prior to closing and that direct and indirect affiliates of National Grid will not own competitive generation in New York State in the future. We emphasize this as a threshold requirement because the proposed transaction is so at odds with established Commission policy as well as with prior commitments made by Niagara Mohawk and Grid.

<u>Generator Divestment by T&D Companies</u>

Q. Describe the structural policy path that has been pursued by this Commission since the mid 1990s.

A. The separation of generation from T&D companies was developed under Case 94-E-0952 and implemented in individual utility restructuring orders which were issued in the late 1990s. The initial work in this subject area began in the early 1990s when the Commission issued a list of "Principles to Guide the Transition to Competition," for comment on December 22, 1994. The seventh principle was:

"7. The current industry structure, in which most power plants are vertically integrated with natural monopoly transmission and distribution, is incompatible with effective wholesale or retail competition." (OPINION NO.94-27, p.11)

The following June, this principle was modified and adopted by the Commission in Opinion No. 95-

7 as:

"7. The current industry structure, in which most power plants are vertically integrated with natural monopoly transmission and distribution, must be thoroughly examined to ensure that it does not impede or obstruct development of effective wholesale or retail competition." (OPINION NO.95-7, p.8)

In making this change, the Commission noted that parties were collaborating on restructuring models "…with complete awareness of our strong concern about the existing vertically integrated structure." (OPINION NO.95-7, pp. 8-9) In May, 1996, in Opinion 96-12, the Commission stated, "In a wholesale or retail competitive model, generation and energy service functions should be separated from Transmission and Distribution systems in order to prevent the onset of vertical market power. Total divestiture of generation would accomplish this most effectively and is encouraged." (Opinion 96-12, p.99)

Q. Did the individual utility restructuring plans lead to the divestiture of generation by the electric T&D companies?

A. Yes. The electric T&D utilities agreed to divest almost all of the electric generators that they owned. The only exceptions were Con Edison plants needed to support its steam system, certain small hydro plants and several RG&E plants which were expected to be closed. The few plants that remained with the utilities remained under cost-of-service rate regulation, as well. While nuclear power plants were excluded from the initial sales, they were subsequently divested.

Q. Did Niagara Mohawk divest its generation?

A. Yes, in the October 1997 PowerChoice Settlement, the Company agreed to divest its non-nuclear generators and to not purchase any generation in the State of New York (excerpt contained in Exh__(MPP-22)). The Commission adopted the terms of the Settlement (with modifications) in Opinion 98-8 in March 1998. In April, 1998, the Commission approved the Company's auction process, stating:

"Perhaps the most important factor ameliorating vertical market power is the divestiture of generating facilities. If the owners of the Transmission and Distribution utilities possess little or no generation, vertical market power issues are reduced or eliminated. Niagara Mohawk has agreed to divest itself of virtually all of its non-nuclear generating facilities, retaining only a few renewable-fueled facilities. Other upstate utilities that have presented auction plans also will not participate in their auctions." (CASE 94-E-0098, ORDER AUTHORIZING PROCESS FOR THE AUCTIONING OF GENERATING FACILITIES, April 8, 1998, p.23)

Q. Was divestiture a simple or costless undertaking?

A. No. Divestiture was a public benefit negotiated as part of the restructuring plans. After those negotiations, auction plans were developed and filed; environmental impact statements were evaluated; financial consultants were hired to run the auctions; bidders committed significant time and expense in conducting due diligence and crafting bids; final transactions were negotiated and executed; and transactions costs were paid. In Niagara Mohawk's case, it incurred a total of $31.2million in transactions costs for generator divestment (DPS-273), and ratepayers paid an additional $18.6 million in incentive payments to shareholders for these sales (DPS-75, part 9).

Q. When National Grid merged with Niagara Mohawk, did they assure Department staff, and the Commission, that they were "in the final stages of exiting the generation business" and that the Company would be an independent T&D company?

A. Yes. For example, in their October 2001 Statement in Support of the Joint Proposal, National Grid and Niagara Mohawk stated:

"The merger between Niagara Mohawk and National Grid brings together two major utilities that are focused on the transmission and distribution of electricity and natural gas subject to comprehensive regulation of their prices and terms of service. This merger is thus somewhat different from many of the mergers that are taking place in the utility industry today. Niagara Mohawk and National Grid are not seeking to combine to increase their market share in the commodity markets. National Grid has exited the commodity market: it has divested its marketing affiliate, and nearly all generation. Niagara Mohawk Holdings, Inc. recently announced an agreement to sell its marketing subsidiary, Niagara Mohawk Energy Marketing, Inc. Niagara Mohawk is in the final stages of exiting the generation business. Pending before the Commission is a petition to sell its interests in the Nine Mile Point Nuclear Units."

"Rather, the strategy supporting this merger is refreshingly simple. Niagara Mohawk and National Grid are combining to rebuild the economies of scale that have been substantially diminished through divestiture of generation. The administrative and general functions that were supported by both the generation and delivery business in the past are now supported by only the delivery business. Horizontal combinations can rebuild the scale economies lost by the sale of generation through elimination of duplicative functions and improved efficiencies. The larger organization can provide more and better services at a lower cost per unit of energy delivered than two smaller, independent corporations. The larger organization also has the scope and size to develop the infrastructure that is now required to facilitate the larger and more vigorous wholesale and retail markets in electricity and gas." (Case No. 01-M-0075, PETITIONERS' STATEMENT IN SUPPORT OF JOINT PROPOSAL, October 15, 2001, pp.3-4, emphasis added, excerpt attached as Exh__(MPP-23))

Q. Would it make sense to expend all the effort and incur all the cost of generation divestment and then simply allow the utilities to re-invest in generators?

A. No. Hence, the Commission, in July 1998, issued its Vertical Market Power Policy Statement (sometimes referred to as its Vertical Market Power Guidelines).

The 1998 Vertical Market Power Policy Statement

Q. Please describe the fundamental tenet underlying the Commission's VMP Policy Statement (CASE 96-E-0090, et al., Statement of Policy Regarding Vertical Market Power, July 17, 1998). (VMP

Statement)

A. In the first two sentences of the statement, the Commission expressed its preference for structural over behavioral solutions: "In creating a competitive electric market, the Commission has viewed divestiture as a key means of achieving an environment where the incentives to abuse market power are minimized. Recognizing that vigilant regulatory oversight cannot timely identify and remedy all abuses, it is preferable to properly align incentives in the first instance." (VMP Statement, App. I, p.1)

Q. How did the Commission define VMP in its statement?

A. The Commission defined VMP as "…when an entity that has market power in one stage of the production process leverages that power to gain advantage in a different stage of the production process." (VMP Statement, App. I, p.1) In particular, the Commission was concerned about an electric utility using its monopoly ownership of its T&D system to improperly influence the market prices received by its affiliated generators as well as the prices received, or costs incurred, by other competitive generators. The VMP Statement provided two examples in which a T&D company owning generation would have the ability and incentives to adversely affect market prices or, relatedly, competitive entry: (1) one in which the generation is located in the same market as the T&D company; and (2) one in which the generation is on the high cost side of a transmission constraint and the T&D company has the ability to influence the transmission constraint. (VMP Statement, App. I, p.1) As discussed below, each of these examples apply, at different times, to National Grid's ownership of KeySpan's generators.

Q. How does the VMP Policy Statement affect Section 70 Petitions, such as the National Grid and KeySpan merger petition?

A. In the Statement, the Commission said, "To guard against undesirable incentives, a rebuttal (sic) presumption will exist for purposes of the Commission's Section 70 review of the transfer of generation assets, that ownership by a T&D company affiliate would unacceptably exacerbate the potential for vertical market power." (VMP

Statement, App. I, p.2)

Q. Did the Commission consider FERC regulation and NYISO control of transmission operation to be sufficient to rebut the presumption?

A. No. In discussing the VMP Policy Statement (VMP Statement, pp. 2-4), the Commission noted that a number of utilities "…argue that the New York State Independent System Operator (ISO), Federal Energy Regulatory Commission (FERC), and this Commission would have sufficient control over the T&D utility to prevent the exercise of vertical market power." The Commission unambiguously rejected this argument:

"While the utilities are correct that regulatory controls and enforcement mechanisms exist, the degree to which these mechanisms can be effective is subject to debate. For example, the ISO can recommend, and FERC or this Commission can direct, that a utility reinforce its transmission system. That utility, however, must go through the siting process for authorization, and its role as a possibly reluctant sponsor could introduce complexities and delays in the process. It is also difficult for regulators to detect an inappropriate failure to act when critical information resides with the T&D utility."

"The ISO would provide information on market prices and transmission requirements, but it would not act as a shadow regulatory body. The task of uncovering vertical market power abuses would remain with the regulator. Such regulation is likely to be costly and create conflict. It is preferable to avoid the incentive for abuse unless there are demonstrable efficiency gains and adequate mitigation procedures. It is that demonstration which a purchasing utility could make in rebutting the presumption in a particular case." (VMP Statement, pp. 3-4, footnote omitted)

Q. Did the Policy Statement provide any further guidance on how a utility might rebut the presumption of VMP?

A. Yes. The Commission gave a number of alternatives. (VMP Statement, App. I, p.2) First a petitioner could demonstrate that "…circumstances do not give the T&D company an opportunity to exercise market power, or because reasonable means exist to mitigate market power." In the alternative, a T&D company would have to show that the proposed generation ownership will lead to "substantial ratepayer benefits," and those, along with mitigation measures, merit overcoming the presumption. Finally, the Commission noted three possible means of mitigating VMP:

-- Limitation on the degree of control over the constraining transmission interface held by the T&D utility.

-- A pledge by the T&D utility to pursue transmission projects recommended by the Commission or by the ISO, together with a proposal that would neutralize profit maximizing incentives on generation that is within the market power control area pending the completion of all reasonable efforts by the T&D company to complete recommended transmission projects.

-- An agreement by the T&D company to participate in a binding arbitration in the event of a dispute over a new generator's interconnection requirements in the T&D utility's territory. (VMP Statement, App. I, p.2)

The Petitioners' Filings

Q. Please describe the filings the petitioners have made to address the electric VMP concern.

A. The Petitioners (in particular National Grid) have made two sets of filings addressing these types of VMP concerns:

(1) As part of the original July 2006 filing, the Petitioners included a 10 page appendix (Appendix 6) titled "Compliance with Commission's Market Power Guidelines for the Transfer of Generating Facilities." Pages 4 to 10 of that appendix address "Vertical Market Power."

(2) The Petitioners supplemented that Appendix with testimony filed on October 27, 2006 by Witnesses Reilly, Fox-Penner, Schiavone and Saidi.

While the October 27 filing intersperses new arguments, it repeats much of what was included in the July filing. While this posed a challenge for organizing our response, we will address these filings chronologically.

The Petitioners' July "Appendix 6" Filing

Q. Summarize the arguments presented by National Grid in pages 4-10 of Appendix 6 to its July 2006 filing.

A. The arguments are:

1. National Grid's T&D lines and KeySpan's generators are not in the same market;

2. Even if they were, FERC policies and ISO rules mitigate any concerns the Commission may have about any incentives Grid may have to "make entry into its own territory difficult"; (Appendix 6, p.4)

3. Even if some adverse impact is found, the merger provides "substantial benefits to utility customers" and any hypothetical VMP is sufficiently mitigated--mainly, again, by the existence of NYISO rules and policies and, further, by National Grid assurances that it will support projects to "economically alleviate transmission constraints." (Appendix 6, p.8)

4. Finally, National Grid notes that "generation margins that could be realized from transmission constraints are already limited by KeySpan's contracts with LIPA for most of its generation, and through market mitigation by the

NYISO for the output from the Ravenswood facility." (Appendix 6, p.9)

Response to July "Appendix 6" Arguments

Q. Do you agree with National Grid's first point that KeySpan's generators and National Grid's T&D operations are not in the same market.

A. No, this is simply wrong. Approximately 58% of the time, KeySpan's large NYC generator (Ravenswood) is in the same market as part, or all of National Grid's T&D system. This conclusion is based on an analysis of NYISO Geographic Markets that Dr. Anping Liu of the Department's Office of Regulatory Economics had previously developed. We asked Dr. Liu to update his analysis to include the most recent information available. His updated analysis is included as Exh__(MPP-24). Based on the major transmission interfaces which, during certain conditions, separate the state into different markets, Dr. Liu considers five submarkets in his analysis: Upstate West, Upstate East, Dunwoodie (otherwise known as Zone I, the portion of Westchester just north of NYC and just south of "Upstate East"), NYC and LI. Dr.

Liu then calculates the percentage of the hours in a year that these submarkets are separate from each other, or combine to be part of some larger market. Below we extract and summarize some of his most relevant 2006 information.

- 30.0% of the time NYC is a totally separate market (even separate from LI); 30.4% of the time NYC, or NYC and LI, are separate from the rest of the state;
- 44.8% of the time NYC, NYC and Dunwoodie, NYC and LI, or NYC and Dunwoodie and LI are separate from the two upstate submarkets;
- About 55.2% (100% minus 44.8%) of the time NYC is in the same market as one or both upstate markets (46.8% of the time with <u>both</u> upstate markets and the remainder with just Upstate East);
- 46.8% of the time NYC, Dunwoodie, Upstate East and Upstate West are all part of the same market (41.6% of the time this market is composed of the four regions and an additional 5.2% of the time LI joins them);
- 90% of the time LI is in a separate market from both upstate markets.

In summary, based on 2006 data, KeySpan's NYC generation is in the same market as some or all of Grid's New York T&D assets approximately 55% of the time. KeySpan LI generation is in the same market as these assets about 10% of the time. Finally, Dr. Liu's analysis also shows that these figures have varied over the years. For example, the percent of time that NYC is in the same market as one or both upstate markets ranged from a high of 76% in 2001 to a low of 45% in 2003. Meanwhile, LI's separation from the upstate markets has grown steadily, from about half of the time in 2000 and 2001 to 90% in 2006.

Q. How is this information relevant to National Grid's arguments about VMP?

A. First, National Grid's claim that KeySpan's generators and Grid's T&D are in separate markets is incorrect over 50% of the time. Second, Dr. Liu's analysis demonstrates that Grid's attempt to focus strictly on the Leeds-Pleasant Valley line (i.e. their line in southeast New York that directly interconnects with a Consolidated Edison substation) is a gross oversimplification. The concern is much greater than controlling the flows over one line or interface. Rather, for a significant portion of the year the concern we have for National Grid owning a generator in NYC is similar to the concern we would have for it owning a generator in Albany, or Syracuse. During those hours any lower cost generation added to New York State--whether from a new generator located in-state or from transmission improvements that increase inflows of power from out of state--will threaten the profits of that NYC generator. In this situation, National Grid would have the inappropriate incentive to inhibit these forms of competition. As the Commission recognized in its order on VMP, such inhibition could take a number of forms, some very difficult to detect and regulate. The most difficult to detect, of course, are the transmission projects that are never considered, designed, proposed, and developed by National Grid.

Q. What about the remaining 40-50% of the year when NYC is a separate market from all or part of Upstate NY?

A. This is the situation described in the Commission's second example, where the generator is on the high cost side of a constraint and National Grid has the ability to influence the extent of the constraint. Because of the proximity and size of Grid's upstate transmission system, it can have significant influence on the number of hours that NYC is in a separate market and, hence, the number of hours during which more expensive eastern or downstate generators are the marginal generators setting the market price received by NYC generators. Over the long-run, transmission projects developed, or not developed, by National Grid may have a major influence on just how much of the time this is. Here, we refer not only to constraints in Southeastern NY separating NYC from all of upstate, but also to upstate constraints (such as "Total East") which are squarely within National Grid's territory and which separate western and eastern NY, driving up prices received by all eastern generators--including those in NYC. Allowing National Grid to own generation in NYC could provide the incentive that results in NYC following the LI trend of becoming a more and more isolated market over time. It is this incentive, and the incentives discussed above, that the Commission's policy on VMP and generator divestment sought to avoid.

Q. Do the precise annual estimates made by Dr. Liu matter for the purposes of your testimony here?

A. Not really, they simply help to illustrate the complexity of New York's electric market and submarkets. These numbers will change from year to year. A single year's "snapshot" is not the most important consideration for the medium and long term incentive issues that concern us here. What is important is, in future years, the Ravenswood generation station may be in the same market as National Grid's T&D assets for a significant portion of the time. For the remaining portion of the time, also likely to be significant, transmission constraints will separate New York City generators from upstate markets, leading to increased prices received by those generators. In either situation, National Grid's management, through its planning and investment its T&D system (or lack thereof) will influence the prices received by Ravenswood. Similarly, National Grid's actions or inactions will play a role in determining the amount of time each of these situations occurs.

Q. Discuss National Grid's third point, that the merger would provide "substantial benefits to utility customers" and that the combination of NYISO rules and National Grid assurances are enough to mitigate the Commission's VMP concerns.

A. We have addressed the magnitude and allocation of synergy savings elsewhere. However, it should be noted here that National Grid has acknowledged that the synergy savings it has identified and proposed to share with customers are unrelated to generator ownership (IR DPS #75, (1-3)). Grid's position, therefore, unreasonably implies that it is necessary to undermine the Commission's VMP policy in order to obtain these unrelated synergy savings. (Further discussion of this is contained in the confidential portion of our testimony.)

Q. What is your opinion regarding Grid's suggestion that NYISO rules and Grid commitments will mitigate VMP?

A. As already noted, the Commission considered and rejected the argument that NYISO control of the operation of the transmission system was adequate to rebut the presumption of VMP. Further, National Grid assurances that it will ignore the incentives to benefit its proposed generation business should be treated as temporary, unreliable statements—-just as National Grid's 2001 assurance, quoted above, that it was in the "final stages of exiting the generation business" proved to be temporary and unreliable. Neither NYISO control, nor Grid's assurances, adequately mitigates the financial incentive that would remain. It is the existence of this incentive that concerned the Commission and which continues to concern us.

Q. Address National Grid's fourth point: "generation margins that could be realized from transmission constraints are already limited by KeySpan's contracts with LIPA for most of its generation, and through market mitigation by the NYISO for the output from the Ravenswood facility."

A. The portion of the statement regarding the LIPA contract is somewhat accurate. The ability for the owner of the LI generators to profit from market price increase is limited, at least in the short run, by the terms of the contract. As long as the contract does not tie the generation owner's compensation to market prices, then the incentive to limit transmission flows to raise prices is reduced. However, there would still be a longer run concern about the terms negotiated for future contracts and, ultimately, the sale value of those generation assets. Essentially, the more restricted transmission to LI remains or becomes, the more valuable are those generators. Conceivably, this could provide a disincentive to National Grid to participate in ways to promote improved power flows to LI. However, for at least the near term, it is our understanding that the generation contract is negotiated under the premise that the terms should reflect actual costs, rather than what the market will bear. This, in conjunction with FERC regulation, amounts to something analogous to cost of service regulation. This is fundamentally different from the market-based pricing faced by the Ravenswood plant in NYC. While this situation could change under a new contract, it is the Ravenswood plant that raises the most serious VMP concerns at this time. However, given that we currently have a market structure under which the LI generators are not owned by an electric T&D company, changing that to a situation in which National Grid essentially owns those generators should still be considered a negative development with respect to VMP incentives.

Q. The second part of National Grid's fourth point was that VMP was mitigated "…through market mitigation by the NYISO for the output from the Ravenswood facility." Is this true?

A. No. The relevant NYISO mitigation measures fall into two categories: (1) bid caps on energy bids by NYC generators under certain conditions; and (2) price caps on the capacity prices received by Ravenswood and the two other divested generation owners in NYC. Those mitigation measures address in-city horizontal market power concerns, not the VMP incentives that are the subject of this testimony. In particular, the bid caps placed on Ravenswood's (and other NYC generators') energy price bids under certain conditions do not remove the incentive a NY T&D company such as National Grid would have if it owned Ravenswood. Despite the bid caps, restrictions on transmission flows (including those that result from projects that are never proposed or developed) will lead to higher NYC prices, higher revenues for Ravenswood and, thus, an inappropriate incentive for National Grid if it owned the plant. In addition, the price caps on Ravenswood's capacity prices do not remove the incentive to avoid projects or actions that would reduce Ravenswood's capacity sales or lower market capacity prices below those capped levels.

The Petitioners' October 27 Filing

Q. Summarize the arguments presented by the Petitioners in their October 27, 2006 Supplemental filing.

A. These testimonies repeated and elaborated on many of the same fundamental points made in the July "Appendix 6" filing, summarized above. Because we have already addressed these topics, our testimony here focuses only on the new information and arguments from that filing.

Q. Summarize any additional points made in Dr. Fox-Penner's testimony.

A. Dr. Fox-Penner attaches his previously-provided FERC analysis as an exhibit. In addition, Dr. Fox-Penner states that the proposed transaction "will pose no vertical market power problems under FERC's requirements." Dr. Fox-Penner acknowledges that the FERC and the Commission have different standards for considering VMP problems, although he says he believes that the standards "overlap to a substantial extent." (Dr. Fox-Penner's Testimony, p.3)

Q. Summarize any additional points made in Mr. Reilly's testimony.

A. In addition to reiterating many of the points above, and summarizing the testimony of other witnesses, Mr. Reilly stated:

1. Based on Dr. Fox-Penner's analysis, the FERC concluded that it had little or no

Horizontal or VMP concerns.

2. Other jurisdictions, like the FERC, consider "…the adoption of Standards of Conduct, when coupled with the transfer of operational control of a utility's transmission assets to an ISO or RTO [to be] sufficient to resolve vertical market power concerns." (Reilly testimony, p.21)

3. The Federal Trade Commission granted early termination of the waiting period for the proposed transaction under the Hart-Scott-Rodino Antitrust Improvements Act.

4. FERC's market behavior rules which allow for market-based rates "…prohibit actions or transactions that manipulate electricity market prices."

5. The Energy Policy Act of 2005 granted the FERC new authority to punish entities that violate its rules and the FERC "has taken a more active role in enforcement and investigation of unduly discriminatory practices in recent years." (Reilly testimony, pp. 26-27)

6. "[A]ny attempt to exercise vertical market power is likely to be visible to the NYISO and

market participants," which, in turn, will lead to FERC penalties and "…damage to the reputation of the Companies…" (Reilly testimony, pp.28-29)

7. Mr. Reilly testifies "As National Grid's Chief Compliance Officer in the US, I want to assure the Commission that the Companies are fully committed to comply with the letter and the spirit of all applicable regulatory requirements which preclude the use of the transmission system to improperly affect market prices for electricity in wholesale and retail electric markets." (Reilly testimony, p.30)

8. Mr. Reilly considers "commitments" made by Mr. Schiavone to report outages to the Commission, and by Ms. Saidi to continue to support certain transmission-related policies and projects, to be sufficient mitigation of "…even the hypothetical opportunity for the Companies to benefit from vertical market power." (Reilly testimony, pp.30-33)

9. If National Grid were to own generation as a result of the proposed merger, it would be consistent with the current and past Niagara Mohawk rate plans.

10. Selling the generators would reduce the economic value of the transaction to National Grid (because of a tax liability) and require reallocating a significant portion of the $47.7 million of KeySpan overhead costs currently assigned to generation.

Q. Summarize any additional points made in Mr. Schiavone's testimony.

A. Mr. Schiavone testifies that, because of NYISO control and oversight of the transmission system, National Grid has no ability "…to exercise short-term vertical market power," even if ownership of KeySpan's generators were to give it an incentive to do so. In addition, Mr. Schiavone offers to notify the Commission of any emergency 230 kV and 345 kV outages as soon as National Grid notifies the NYISO of such outages. Following Mr. Reilly's lead, Mr. Schiavone refers to this notification as a market power "mitigation mechanism." (Mr. Schiavone's testimony, pp. 36-37)

Q. Summarize any additional points made in Ms. Saidi's testimony.

A. Ms. Saidi testifies that National Grid has proposed and advocated policies to "allow customers to benefit from the efficient operation and expansion of the transmission system"; that National Grid plans to continue such advocacy after the merger; and that National Grid will commit, "as a condition to approval of the merger, to assume certain new obligations to propose and build regulated transmission projects in New York with economic or reliability benefits without regard to the impact of such projects on the economics of KeySpan Ravenswood or any other generation interests of the merged company." (Saidi testimony, pp. 4-5)

Response to Dr. Fox-Penner's October 27 Testimony

Q. Dr. Fox-Penner acknowledges that the FERC and the Commission have different standards with respect to VMP. Is this difference significant?

A. Yes, it is the primary reason for our disagreement with the Petitioners on this issue.

Q. Please explain.

A. One of the main differences between the two standards is that FERC relies on regulation and oversight to prevent abuses while doing little to directly address the underlying financial incentives for exercising VMP. By contrast the Commission addresses this financial incentive in its VMP approach. More specifically, behavioral mitigation including ceding operational control to an ISO or RTO, along with FERC oversight, is sufficient, in FERC's eyes, to prevent a transmission owner from responding to inappropriate incentives to benefit generation it owns. The Commission standard goes further and requires the elimination of the inappropriate incentives themselves. As noted above, the Commission's preferred method for eliminating these incentives is a structural one: total divestment of generation by transmission owners, except in very limited circumstances.

Q. What is the significance of FERC's less stringent VMP standard?

A. This standard made it fairly simple for Dr. Fox-Penner to conclude that National Grid purchasing KeySpan's generation would pose no VMP problems "under FERC's requirements," as he testified.

This is because the existence of the NYISO satisfied the FERC's concern. However, it does not directly address, let alone eliminate, the financial incentives that are at the core of the Commission's standard (supra).

<u>Response to Mr. Reilly's October 27 testimony</u>

Q. What are your views on the ten different points contained in Mr. Reilly's October 27, 2006 testimony that were not specifically noted in the Petitioners' July "Appendix 6" filing?

A. Mr. Reilly's ten points provide no basis for concluding that VMP issues are properly addressed in the proposed transaction. His first point is that the FERC approved the merger, concluding that there were no VMP concerns. This fact is not dispositive as it derives directly from the two different standards applied by the FERC and the Commission. Similarly, his second point (that other jurisdictions follow a standard similar or identical to FERC's) and third point (that the Federal Trade Commission granted early termination of the waiting period under the Hart-Scott-Rodino Act) add no relevant information because they derive from standards or purposes distinct from those addressed by this Commission.

Q. Mr. Reilly's fourth, fifth and sixth points are, essentially, that any attempt to exercise VMP would be recognized by the NYISO and market participants, would violate FERC rules, and would elicit FERC penalties, which have been strengthened in recent years. Please respond to this.

A. This is simply a reiteration of the arguments that were raised by the utilities, and rejected by the Commission, at the time of the Commission's VMP Statement. The Commission did not say "if we had a better idea of how NYISO operations would work," or "if only FERC penalties were larger," then it would be satisfied with a behavioral rather than structural solution. Rightfully, the Commission said that it was concerned that "vigilant regulatory oversight cannot timely identify and remedy all abuses"; that, even when regulators order a utility to reinforce its transmission system, that "utility, however, must go through the siting process for authorization, and its role as a possibly reluctant sponsor could introduce complexities and delays in the process"; and that "it is also difficult for regulators to detect an inappropriate failure to act when critical information resides with the T&D utility."

Mr. Reilly's testimony also appears to be trying to direct our focus to overt, discrete, and inappropriate acts that would be highly visible and easily caught by regulators. Mr. Reilly conveniently ignores an issue of great concern to the Commission: the harm to the public caused by failures to act. The Commission expressed the concern that regulating utility behavior would not uncover all abuses, would have a particularly difficult time regulating failures to act, and would be costly and controversial. To address these very fundamental concerns, the Commission concluded that it was far better to eliminate the inappropriate incentives in the first place.

Q. Mr. Reilly's seventh and eighth points relate to "commitments" National Grid is willing to make.

Are these "commitments" meaningful, reliable or adequate mitigation of the inappropriate incentives the Commission sought to eliminate?

A. No.

Q. Please explain why you say that these "commitments" are not meaningful.

A. First, Mr. Reilly, as "National Grid's Chief Compliance Officer in the US," assures the Commission that his company is "committed to comply with the letter and the spirit of all applicable regulatory requirements…" It is hard to attach any added significance to this statement. Clearly there is already a divergence of opinion between the Petitioners and regulators about what constitutes compliance with applicable regulatory requirements

Second, Mr. Reilly considers the commitment by Mr. Schiavone to notify the Commission, by telephone, of unscheduled outages to be an additional mitigation measure. Mr. Schiavone proposes to begin providing this information "once the merger transaction is completed." We assume that the Commission can require the provision of this information whenever such is necessary to meet the Commission's statutory obligations, whether or not the Commission approves the Petitioners' proposed transaction.

Finally, Mr. Reilly also considers, as mitigation measures, the commitments Ms. Saidi makes: (1) to continue to support the projects the Company has already proposed to the NYISO; (2) to file a joint complaint with the Commission to the FERC to adopt a transmission planning process that National Grid, according to Ms. Saidi's testimony, is already on record supporting; and (3) to expand the conditions under which National Grid would commit to propose and construct regulated transmission projects. It is difficult to attach much significance to a "commitment" by National Grid to continue to support positions it is already on record supporting. If the Company were to become affiliated with KeySpan's generators, it would not be surprising to see National Grid's "support" for said policies in the future to evolve into ones more fully "fleshed out" with nuances, conditions and clarifications that, essentially, render the projects less viable or useful. It would also not be surprising for a company, like National Grid, to argue that such an evolution was not inconsistent with the "spirit" of the commitment it made in this proceeding. Our concerns here are similar to the Commission's concerns, expressed in the VMP Statement, of a utility as a possibly reluctant sponsor in a siting proceeding. In other words, specifying what constitutes "support" can be a subjective thing, totally under the control of the utility.

Q. Should these "commitments" by National Grid be relied upon by the Commission in protecting the public interest?

A. It would be inappropriate for the Commission to simply trust a utility's promise to ignore the financial incentive that would exist for the utility to act in a manner that would run counter to the public interest.

Q. Do these "commitments" represent adequate mitigation of the inappropriate incentives the Commission sought to eliminate?

A. No. These are simply promises to adopt certain attitudes or take certain selective actions, under certain conditions, despite the continued existence of the inappropriate incentives. Thus, these commitments do not address the difficult to detect and regulate actions--and failures to act--mentioned in the VMP Statement. Moreover, while the Petitioners promise to ignore the financial incentives that would exist to exercise VMP, such promises are temporary and cannot be viewed as a long term solution. Their promises do not dull the monetary consequences of either actively exercising VMP or passively allowing transmission flows to become more and more restricted. Because such active or passive practices can be so difficult, costly and controversial for regulators and market monitors to detect and prove, it would be much more effective to allow the incentives to remain properly aligned in the first place.

Q. Mr. Reilly's ninth point is that National Grid's ownership of KeySpan's generation would be consistent with Niagara Mohawk's current rate plan, and the prior "PowerChoice" rate plan. Do you agree?

A. No. We have already quoted National Grid's

Statement in Support of the Joint Proposal regarding the current rate plan in which they assured the Commission they were in the final stages of exiting the generation business. At the time of those negotiations, National Grid's representatives assured Department staff that they were well aware of the Commission's policy regarding separating the ownership of generation from the ownership of T&D assets and that Grid was a perfect partner for Niagara Mohawk. We were told that Grid's business interest was to focus on managing T&D systems, not generators. Further, we have already described the process of Niagara Mohawk agreeing to, and then effectuating, the divestment of its generators. Mr. Reilly chose to quote only the portion of the PowerChoice agreement that states that because the Commission will review merger applications, nothing in the agreement will limit their ability to merge. Mr. Reilly omitted virtually all of the other important language that addressed the future ownership of generation. A reading of the full section on divestiture gives a better sense of the parties' intent and the "spirit" of the agreement:

"After the auction and/or spinoff transactions described herein are complete, Niagara Mohawk and its subsidiaries agree not to own any generation assets in New York State, with the exception of any sale/leaseback transactions and reorganizations necessary to close the MRA and except as otherwise provided for in this agreement. In the case of a reorganization transaction pursuant to the MRA, NMPC will either lease any project facilities acquired in the reorganization to a third party operator, or enter into a management and services contract with such a third party approved by the PSC, or operate the facility itself but only for its own use and not for re-sale. In addition, neither HoldCo nor RegCo will own any generation assets inside or outside New York, except as otherwise provided for in this agreement. However, any other affiliate of HoldCo is not restricted in any way by this agreement from owning generation assets outside New York."

"Because the PSC will review merger

applications under the Public Service Law, nothing in this agreement will limit the Company's ability to merge with or be acquired by another entity owning generation. Moreover, nothing in this agreement will limit the Company's ability to form partnerships or affiliations with entities who own generation in New York State, provided that those partnerships or affiliations do not involve ownership of generation assets. An unregulated affiliate of HoldCo may enter into arms length contracts with an entity owning generation in New York State."

"The sale/leaseback transactions, reorganizations, partnerships and affiliations and arms-length contracts referred to above are all subject to the restriction that they must not create a conflict between the interests of RegCo ratepayers and Company stockholders by tying the profitability of the Company to the profitability of the entity's generation business."

"Any material violation of the above restrictions may result in, inter alia, an affiliate being prohibited from further transacting business with end users within the RegCo service territory or divestiture of the affiliate, provided, however, that the Company shall be given the opportunity to explain why a violation has not occurred and to remedy any such alleged violation in accordance with the procedures outlined in Section 9.3.9 regarding Corporate Structure and Affiliate Transactions." (Exh__(MPP-22), PowerChoice Settlement Document, Volume 1 - Agreement, pp. 17-18, emphasis added)

Q. Please summarize your point.

A. The proposed transaction is totally at odds with the spirit of the PowerChoice Settlement.

National Grid's purchase of KeySpan's generators is not only inconsistent with the agreements in PowerChoice regarding no continued ownership of generation in New York, it is also inconsistent with the assurances made by National Grid--assurances made when it was seeking the approval of its acquisition of a New York utility, Niagara Mohawk—-that it was in the final stages of exiting the generation business.

Q. What are your views on Mr. Reilly's last point, that divesting KeySpan's generation would reduce the economic value of the transaction to National Grid (because of a tax liability), and require reallocating the $47.7 M of KeySpan overhead costs that are presently allocated to the generation business?

A. At the outset, it is important to recognize that this last point seems to reflect Grid's concern that because it based its offer to KeySpan on the continued ownership of generation rather than divestiture, the price it has offered KeySpan may be too high if divestiture is required. Grid's management should have expected that the Commission's VMP policies at the time it agreed to purchase KeySpan would be a significant barrier to the proposed transaction. As a result, it is Grid's responsibility, not the Commission's, to resolve any difficulties created by this situation. Otherwise, the proposed transaction should be rejected by the Commission.

Q. Do you have other comments on Mr. Reilly's last points?

A. Yes, the Petitioners have acknowledged that the synergy savings they estimate are unrelated to generation (See above). Divesting the generators would not lower the synergy savings. Thus, while divesting the generation may impact the profitability of the transaction for National Grid, it would not reduce the alleged ratepayer benefits that National Grid proffers as evidence that the transaction is in the public interest. This is important enough to restate: the alleged public benefits—the synergy savings—do not require generation ownership. Further, we note that Mr. Reilly did not say that divesting the generators would result in a transaction that would cause National Grid to incur an economic loss, just that it would "reduce KeySpan's economic value."

Q. Hypothetically, what if the tax liability is so large that divestment would cause National Grid to withdraw its offer to purchase KeySpan?

A. If so, National Grid should not have been selected by KeySpan for this transaction in the first place.

Q. Finally, Mr. Reilly argues that divestment would "…make the realization of savings to customers from the Transaction…more difficult" (Reilly testimony, p.38) because it would require reallocating a significant portion of the $47.7M of generation overhead costs to other portions of the business. Please comment.

A. Petitioners acknowledge that they don't know how much of the $47.7 M could be avoided if the Company exited the generation business. Second, to the extent that this was a material issue, it was already encountered when New York's vertically integrated electric utilities divested their generation in the late 1990s. Clearly, the Commission felt that the benefits of separating generation ownership from T&D ownership were sufficient to accept the transition required to transform Companies with overheads that supported transmission, distribution and generation businesses to Companies with overheads to support just T&D businesses. Now that the transition has taken place, it is inappropriate for National Grid to try place the burden on the Commission or Staff to justify reallocating some of KeySpan's overheads simply because National Grid wants to purchase a Company that owns profitable generation. It is not the Commission's, or the Department's, burden to find a way to allow National Grid to profitably merge with KeySpan. As Mr. Reilly testified, "…generation ownership represents a significant portion of KeySpan's business and value." (Reilly testimony, p.38) Given that acknowledgement and the Commission's policies described earlier, National Grid should have realized that this transaction was not appropriate for an electric T&D company.

<u>Response to Mr. Schiavone's October 27 testimony</u>

Q. Please respond to Mr. Schiavone's testimony.

A. Mr. Schiavone's arguments are no different than those raised by certain utilities, and rejected by the Commission, at the time the NYPSC adopted its VMP Statement. The Constraints Panel provides a more detailed response to Mr. Schiavone's testimony.

<u>Response to Ms. Saidi's October 27 testimony</u>

Q. Does Ms. Saidi's description of the policies National Grid has supported, or projects National Grid has proposed, allay your VMP concerns?

A. No. Ms. Saidi would have the Commission focus on what National Grid has done during a period when it did not own market-priced generation. The real concern is what might National Grid do, or no longer do, <u>after</u> it owns KeySpan's generators?

Q. Do Ms. Saidi's commitments about National Grid's future actions allay your VMP concerns?

A. No. As we discussed in response to Mr. Reilly's testimony, a regulator should not rely on a regulated entity's promise to ignore financial incentives that run counter to the public interest. Not only are National Grid's assurances potentially temporary, compliance with them would be subject to interpretation and only partially observable. We already noted the Commission's concern with difficult-to-regulate and detect failures to act when critical information resides with National Grid. Another example mentioned by the Commission is the fact that the T&D company must go through the siting process to receive authorization for projects and "its role as a possibly reluctant sponsor could introduce complexities and delays in the process." (VMP Statement, p.3) We are confident that there are innumerable ways a utility could undermine any long run goals and processes to improve transmission flows without producing "smoking gun" type evidence that would allow us to find them financial liable. These could range from something as overt as a vote (or even an abstention) on a NYISO committee, to something as subtle as directing the best employees or resources away from these functions internally. As the Commission noted, it is preferable to properly align the incentives in the first instance.

Q. Does Ms. Saidi commit to certain "new obligations" as a condition of the NYPSC's approval of the merger?

A. Yes. Ms. Saidi describes the reliability-based projects that National Grid currently would be required to propose and build if designated by the NYISO as the "Responsible TO." Ms. Saidi proposes, if the NYPSC approves the transaction, to expand this to include projects justified for economic reasons, if National Grid is designated as the "Responsible TO." In addition--again conditioned on the NYPSC's approval of the transaction--Ms. Saidi proposes to expand the types of projects it would be responsible for to include certain projects, if feasible, even if National Grid is not designated as the "Responsible TO."

Q. Do Ms. Saidi's description and commitments undermine certain prior arguments raised by the Petitioners?

A. Yes. The fact that Ms. Saidi believes that current rules and regulations do not require National Grid to propose and build certain projects for economic reasons seems to confirm that it recognizes that it has the ability to avoid proposing and building certain projects that might depress the profits earned by KeySpan's generators.

Q. Does Ms. Saidi's commitment alleviate that concern?

A. No. For all of the reasons discussed above, it is much better to prevent the establishment of the inappropriate incentives in the first place rather than trust the promises made by the entity that would be facing those incentives.

Other Incentive Concerns

Q. Do any other potential incentive issues arise if electric T&D companies were to start acquiring generators?

A. Yes. The NYPSC has had a long-standing interest in energy efficiency measures, and the incentives electric T&D companies have to facilitate or discourage the same. Two recent examples of this are (a) the last Consolidated Edison electric rate case (Case 04-E-0572) included provisions for utility-implemented energy efficiency programs; and (b) Cases 03-E-0640 and 06-G-0746 investigate the potential that rate structures faced by T&D companies may provide a disincentive for the promotion of energy efficiency and other measures. The financial incentives that electric T&D companies have for considering, promoting and/or implementing energy efficiency measures will be negatively affected if these utilities were to own, or be affiliated with entities that own, generators facing market prices.

Q. Why is that?

A. All else equal, programs that reduce the demand for electricity will tend to reduce the near term market price of electricity received by these generators.

Recommended Mitigation Measure

Q. You have discussed why the "mitigation measures" proposed or described by National Grid do not address the incentive concerns at the heart of the Commission's VMP standard. What mitigation measure would work?

A. Divestiture of the generation assets, most importantly of Ravenswood, combined with certain other assurances related mainly to the ownership of generation by Grid affiliates would effectively address VMP issues. The merger, if allowed to go forward at all, should be approved only on these conditions.

Q. Is divestiture the only mitigation measure that would eliminate the profit incentive to plan and manage National Grid's T&D system to benefit KeySpan's generators?

A. Yes it is, however we are aware of two other approaches that would, if they prove to be feasible, reduce the financial incentives we have discussed in this testimony. One approach would permanently return Ravenswood to cost-of-service regulation. The other approach would use a purchased power contract to define the level of energy and capacity payments received by Ravenswood over an extended time period. While these approaches would reduce the incentives with which we are concerned, neither approach would necessarily eliminate them.

Q. Do you think it would be appropriate to recommend returning Ravenswood to cost of service regulation in this proceeding?

A. No. As discussed above, the Commission has had a long-standing policy of structurally separating the ownership of NY generators from regulated T&D companies and developing competitive, market-based wholesale commodity markets. Reversing that policy for Ravenswood could have significant consequences for the NYC market and the other competitive generators in the city. While we do not think that it would be appropriate to take such a step in a proceeding addressing utility rates and a merger transaction, the Commission could, if it wishes, revisit this policy, either generally or for NYC, by establishing a generic proceeding to consider all of the impacts such a change would have on the market, the market participants and the public interest, in general. We are not recommending such an approach at this time, but merely recognizing it as an option.

Q. What concerns do you have if a long run contract was proposed for Ravenswood's output as VMP mitigation?

A. Our long run concerns would be similar to those we expressed regarding the LIPA generation contract. However, this approach would have additional problems to overcome. First, a willing buyer would need to be found for such a large and long-term contract. Second, mutually acceptable terms and conditions would need to be negotiated. This includes prices and the term of the contract. The length of the contract is a key to determining the extent to which the inappropriate incentives are mitigated. The shorter the contract: the worse the incentives. Finally, our long run incentive concerns regarding the renewal of the contract (or the sale of the asset) are worse here, since Ravenswood currently sells its output at market rates.

Q. Would bid caps on Ravenswood's output mitigate the VMP incentives you have discussed?

A. No, as discussed above, bid caps address generator horizontal market power in certain circumstances. Bid caps would not prevent market-clearing prices from rising due to suboptimal transmission flows. It is these market-clearing prices that Ravenswood would receive for its output, even if it were forced to bid a zero price for that energy.

REGULATORY INFLUENCE

Q. Are holding companies that own utility subsidiaries operating in New York subject to the same level of Commission review as their New York utility subsidiaries?

A. No, the Commission does not have the same level of authority to review and approve the actions of the holding company. For example the Commission does not have the authority to directly consider and approve holding company security issuances, holding company expansions into unregulated operations and/or holding company acquisitions of entities not subject to

Commission regulation.

Q. Are these areas in which actions of the holding company might conflict with the Commission's responsibility of assuring safe and adequate service at a reasonable price?

A. Yes.

Q. To what extent can the Commission influence the actions and behaviors of a holding company if the Commission perceives that the holding company is not acting in the best interests of New York State ratepayers?

A. The Commission can attempt to indirectly influence the behavior of holding companies through the manner by which it regulates utility subsidiaries of the holding company that operate within New York State. Financial signals created by Commission actions in rate cases and other proceedings may influence holding company business and financial decisions.

Q. Under what circumstances are the actions of the Commission likely to have a greater impact on holding company behavior?

A. Commission actions are likely to have a greater impact in those situations where New York utility operations represent a substantial part of the holding company's consolidated operations.

Q. Under what circumstances are the actions of the Commission likely to have less of an impact on holding company behavior?

A. Commission actions are likely to have less of an impact in those situations where New York utility operations represent a small part of the holding company's consolidated operations.

Q. How big are KEDNY and KEDLI relative to KeySpan?

A. The stand-alone rate cases provide earnings base calculations for both KEDNY and KEDLI. Exhibit JFB-3, Schedule 2, page 2 of both filing provides a KEDNY capitalization of $2.1 and a KEDLI capitalization of about $1.7 billion. Based on data provided to the SEC for the 3rd Quarter of 2006, KeySpan's consolidated total of long and short term debt and common stock was approximately $8.8 billion. Thus, the combined KEDNY and KEDLI capitalization of $3.8 billion represents 43% of KeySpan's total capital. When one recognizes that KeySpan's capitalization also supports about $1.7 billion of goodwill, it becomes very clear that KEDNY and KEDLI together represent a significant portion of KeySpan's business.

Q. How does the combined size of KEDNY and KEDLI compare to Grid?

A. Exhibit__(MPP-5) presents Grid's consolidated capital structure on a United States GAAP basis adjusted to reflect the effects of the transaction. If one uses a 1.8 ratio of dollars to pounds, the total consolidated Grid capital structure becomes $47.5 billion. Thus, KEDNY and KEDLI would represent 8% of the total business. This represents a substantial diminishment in the size of KEDNY and KEDLI relative to their holding company parent.

Q. What is the significance of this information?

A. The proposed transaction will limit the Commission's ability to influence the actions of KEDNY and KEDLI's holding company parent in order to assure that the interests of New Yorkers are protected. As such this is one more reason the proposed transaction is not in the public interest.

KEYSPAN: REVIEW OF BIDS

Q. Did you consider the process that KeySpan used to analyze the various purchase offers it received?

A. Yes, we considered the description of the sales process noted in KeySpan's Definitive Proxy Statement as well as materials assessing various offers which were provided to KeySpan's management and Board of Directors by KeySpan's financial advisor. The materials we considered were obtained primarily through interrogatories DPS-58, DPS-179 and DPS-235.

Q. Why is it in the public interest for staff and the Commission to review these materials?

A. The Commission's main regulatory responsibility is to assure that utilities provide safe and adequate service at a reasonable price. KeySpan has indicated in its proxy statements that it entertained serious bids from at least one other entity. Given that fact, it is in the public interest for staff to consider whether an alternative ownership scenario might have better satisfied the Commission's interests. Such an inquiry is particularly important here given the financial, ratemaking, service quality, and vertical market power challenges posed by the proposed transaction. Moreover, the fact that various news services provided unconfirmed reports that the other KeySpan bidder was Con Edison, a company with an overlapping and contiguous service territory with KEDNY and KEDLI, raised questions about the potential of such a combination to deliver significant savings to downstate New York ratepayers. Given these facts and circumstances, we think it is extremely important for the Commission to consider how reasonably KeySpan balanced the interests of investors and ratepayers when considering the offers it received.

Q. Are there other more generic reasons why staff and the Commission ought to consider this process?

A. Yes. The Commission routinely reviews the process, terms, and conditions of utility asset sales to assure that the value of such sales are reasonable. It does this to help assure that utility rates remain as low as possible. While the sale of an entire utility company and its holding company parent is a more complicated situation, it nevertheless has definite implications for utility rates and the quality of service. If the Commission did not consider the rate implications of the alternative offer it would be ignoring valuable information in assessing the reasonableness of National Grid's offer.

Q. Why is that?

A. This is so for a several reasons. First, whether the price offered for a good or service is reasonable is always a relative question. In particular, it is relative to the market conditions at the time. The best indication of these market conditions is what other market participants demonstrate they are willing to pay for the same good or service. Thus, if a utility were to propose to the Commission to sell a parcel of land in ratebase for $100, the Commission surely would want to be informed if others had offered $150 for that same parcel before the Commission decides whether the $100 proposed transaction is reasonable.

Another reason for considering the alternative offer is that the Grid/KeySpan proposal is more complicated than a single asset sale. Alternatively structured proposals can lead to different benefit levels for certain interest groups, such as shareholders, while having markedly different impacts on the public at large. Reviewing the alternative bid provides valuable information on the weighing of private and public interest that did and did not take place.

Finally, we have argued that the proposed transaction is contrary to certain Commission policies in the areas of finance and vertical market power. The petitioners have suggested that divestiture of Ravenswood would reduce the value of the transaction. Reviewing the alternative bid provides the opportunity to see if KeySpan considered the alleged synergy savings achievable without compromising these well-known Commission policies.

Q. Is it Staff's opinion that KeySpan's management and Board of Directors reasonably weighed the interests of ratepayers and shareholders when deciding to accept Grid's bid?

RECOMMENDATIONS

Q. What is Staff's overall recommendation in this proceeding?

A. For the reasons noted in this testimony we recommend that the Commission find that the proposed merger of Grid and KeySpan is, as filed, not in the public interest and, therefore, reject the Petitioner's request to approve the transaction.

Q. Can Staff conceive of an alternative proposal under which a merger between Grid and KeySpan might proceed?

A. Staff might not oppose a merger of Grid and KeySpan based upon a number of conditions which protect the interests of New Yorkers by assuring that both KEDNY and KEDLI are in a position to provided safe and adequate service at a reasonable price to the public.

Q. Generally describe the conditions that Staff would extend to the proposed transaction.

A. We would establish conditions addressing the quality and reliability of service, VMP issues, and various accounting, financial and ratemaking aspects of the proposed filing.

Q. Why are you addressing quality of service issues for KEDNY, KEDLI and Grid?

A. Mr. Reulet's testimony shows that the quality of service at Niagara Mohawk has deteriorated since the Grid merger. In addition, we are concerned that Grid's operational practices might produce similar results for KEDNY and KEDLI.

Q. What specific conditions would you extend regarding the quality and reliability of service?

A. The service quality revenue adjustments now in effect for Niagara Mohawk do not appear to have produced the desired behavioral results. We would, therefore, support a significant increase in the size of service quality incentives for KEDNY and KEDLI as part of any merger with Grid. Moreover, considering our concern about the quality of service and the size of KEDNY, and KEDLI relative to Grid as a whole, we would also require that Grid extend to the Commission the ability to order, after appropriate hearings, the divestiture of KEDNY and KEDLI from Grid with Grid waiving its ability to challenge the legal basis for the Commission's authority to order divestiture.

Q. What specific conditions would you require to address VMP issues?

A. We would require the divestiture of the Ravenswood generating plant prior to the closing of the merger transaction. Because we will not negotiate against an established Commission policy, we would condition our participation in negotiations on this agreement to divest. We would also require the divestiture of all other Long Island generating plants should the prices charged for their output no longer be based upon underlying costs.

Q. What is the basis for this requirement?

A. The basis for this requirement is presented within this testimony as well as that of witnesses Paynter and Schrom.

Q. Could this requirement affect the value of KeySpan to Grid?

A. Yes, this requirement could affect the economics of the transaction. The Commission's guidelines in this area were well known. Grid and KeySpan, therefore, should have considered and affirmatively addressed market power prior to announcing the proposed transaction. Any diminution of value as a result of this requirement, therefore, stems from the failure of the management of both companies to appropriately consider the topic.

Q. Would Staff recommend requiring the divestiture of KeySpan's Long Island fleet of generation?

A. Not necessarily. It is our understanding that the revenues of these plants are set on the basis of underlying costs, subject to FERC regulation. As discussed above, this significantly reduces the inappropriate incentives for National Grid's T&D business. While we would still prefer that these assets not be owned by a New York electric T&D company, eliminating the inappropriate incentives entirely, it is more difficult for us to recommend against the transaction if the LI generators continue to receive cost-based, as opposed to market-based, rates. As a result, if all of our other concerns were to be addressed adequately, and we saw significant offsetting public benefits, we might not oppose the proposed transaction, subject to the requirement that the LI generators remain under cost-based rates. The Commission should require, as a condition of its approval, that the LI generators must be divested in the event that they become authorized to charge market-based, rather than cost-based, rates. To make such a condition effective, the Commission should establish appropriate daily revenue adjustments if the Petitioners do not comply with this condition.

Q. Would you establish any other conditions related to vertical market power?

A. Yes, Grid would have to agree that no affiliate would directly or indirectly own generation in New York. This condition is required because VMP concerns would exist under the proposed transaction so long as any Grid affiliate with generation in New York could realize profits as the result of Petitioners exercising VMP.

Q. What conditions would you establish regarding the accounting, financial and ratemaking aspects of the proposed transaction?

A. We would reject the use of a 10 year rate plan and instead enter negotiations for a much shorter plan, most likely of three years based upon the typical terms and conditions used in recent two and three year rate plans. We would set the rate of return using Grid's consolidated capital structure based on United States GAAP, consistent with Commission policy. We would significantly modify the proposed treatment of synergy savings to provide New York ratepayers a fair share of the savings. We would also align the accounting treatment of goodwill with the synergy savings approach.

Q. Why do you reject the use of a 10 year rate plan?

A. We explained in this testimony why such an approach has not worked well for Grid/NMPC and we demonstrated that the same approach applied to KEDNY and KEDLI would likely produce a similar outcome.

Q. You state that a three year rate plan should reflect terms and conditions typical for multi-year rate plans. What do you view as typical terms and conditions?

A. Based on plans recently considered and approved by the Commission, a typical plan would include cost based projections of sufficient detail to understand all of the major specific cost components of the revenue requirements. The plan would likely contain deferral provisions for various items but place limits on those deferrals once certain earnings thresholds are exceeded. Rate of return and earnings cap provisions would be consistent with levels recently considered and approved by the Commission, and would be justified on the basis of the technical analyses of the parties. A consolidated capital structure approach would be used to develop the overall rate of return unless extensive ring fencing provisions were put in place to effectively isolate the credit risks of KEDNY and KEDLI from Grid's other businesses. Incentives and program initiatives of various types might also be part of a typical rate plan. Finally, for KEDNY, to the extent that it desired to once again true-up and defer differences between rate allowances and actual expenses for pensions and OPEBs, any rate plan would have to consider the significant benefits derived by shareholders (and conversely, the lost benefits of ratepayers) realized by KEDNY when it was not covered by the true-up provisions of the Commission's Pension Policy Statement.

Q. How would Staff modify the treatment of synergy savings?

A. We would modify the treatment of savings in three ways. First based on evidence presented earlier in this testimony and our general belief that it is unreasonable to deprive the public of the full benefits of any utility merger for a period greater than five years, we would shorten the sharing period from ten to five years. Second, we would revise the allocation of net synergy savings between various KeySpan/Grid affiliates based upon an approach that gives more weight to KeySpan than the current approach which allocates only 33% of total net synergy savings to KeySpan. This approach needs to be developed and it should also reflect our belief that account based allocation factors are unlikely to capture the idea that KeySpan Corporation (KEDNY, KEDLI and various New England affiliates) is a primary cause of incremental savings realized from the transaction. Finally, we would change ratepayer/shareholder sharing ratio to 90/10 to reflect a more reasonable allocation of benefits to shareholders given the evidence in this proceeding regarding net synergy savings.

Q. Are your proposals regarding net synergy savings consistent with the treatment of synergy savings in the Grid/NMPC merger?

A. No, our decision to use a different approach is based on three considerations. First, as we have already noted, synergy savings associated with the proposed transaction are derived directly from integration efforts related specifically to KeySpan and its affiliates. Given this concept, the results of the Petitioners' proposed treatment of synergy savings are totally unreasonable and unfair to KEDNY and KEDLI ratepayers. Based on the data presented earlier, Grid shareholders receive more than 5 times as much value as KEDNY and KEDLI ratepayers, and more of the overall benefits are allocated to National Grid companies or LIPA than are allocated to KeySpan. Finally, given the likely upward pressure on KEDNY and KEDLI rates which we have identified in this testimony, it is imperative that a greater portion of the net savings be made available to mitigate future price effects.

Q. You also stated that the accounting treatment of goodwill should be aligned with the synergy savings approach. How would this occur?

A. Goodwill would be recorded on the books of KEDNY and KEDLI in an amount matching the present value of the savings that would flow to shareholders of Grid from each subsidiary. The goodwill balance would be reduced as the savings are realized over the initial five years of the rate plan. Any other goodwill which Petitioners wish to report on the books of KEDNY and KEDLI should be justified on the basis of discrete forecasts of cash flow over an extended time period that do not rely on general assumptions about either EBITDA multiples, future growth or similar approaches.

Q. What synergy savings are appropriate for use in this proceeding?

A. We are not in a position to make a final recommendation on this subject. As noted earlier, the Petitioners' presentation has not lent itself to easy analysis, has changed over time and may very well change in the near future. While we would like to present additional testimony on this topic, the fact that Petitioners will not have their final synergy savings estimate available prior to the deadline for filing testimony impacts our ability to inform the record.

Q. Does this conclude your testimony?

A. Yes, at this time.

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National Fuel Gas Rate Case (07-G-0141)
Filed January 29, 2007

- Proposed Rate Increase
  - NFG proposes to increase gas delivery rates by $52 million resulting in a 6.4% bill increase (19% increase in delivery rates)
  - Filed rates would be suspended through December 28, 2007

- Last Rate Increase
  - NFG's last rate increase was in July 2005, and increase of $ 21 million, but tariffs increased only $ 15.8 million due to credits

- Drivers - - Staff's reconciliation vs. current rates ($ millions):

Conservation Program	12.7
ROE & Cap. Structure	9.2
Depreciation	8.5
Uncollectibles	8.2
Pension Reserve	4.6
Sales Forecast	3.2
Rate Base – Plant	2.7
Site Remediation	2.3
Cap. > Earnings Base	1.1
Miscellaneous	-1.6
Total	50.9

- Requested ROE = 11.65% vs. 10.39% in the last case (100 basis points = $5.8 million)

- Conservation Incentive Program with RDM
  - Company proposes a $12 million program consisting of three initiatives:
    - A Low Income Usage Reduction Program - - $2.6 million
    - Residential and Commercial Appliance Rebates - - $4.8 million total ($3.3 and $1.5 million, respectively)
    - Outreach and Education - - $4.6 million total ($1.1 million for Low Income and $3.5 million for general)
  - Proposed new Conservation Incentive Program Cost Recovery Mechanism (CIP)
    - annual charge/credit to keep the company whole for differences between forecast use per account for small volume customers (105/Mcf vs. 113/Mcf in the last case) and actual average weather normalized use per customer

- Proposed Rate Changes
  - Seasonal Recovery of Pipeline Demand Costs
    - Compress recovery of interstate pipeline demand charges (within the GAC) to the months of December – March, instead of over 12 months

- Rate Design
  - Increase residential minimum charge from $13.54 to $20 (with a seasonal adjustment)
  - Move the recovery of fixed costs from the volatile tail-block to the minimum charge and less volatile penultimate block
  - Increase monthly Billing charge from $2.00 to $2.26 and combine with minimum charge for billing purposes
  - Eliminate standard DG tariff (current DG customers use other services)

- Retail Competition
  - Continue the following:
    - POR; unbundled rates; customer awareness surveys (less frequently); customer education efforts (less intensive); ESCO ombudsman
  - Discontinue the following:
    - Market Referral program; Market Match program; Market Expo; Residential Energy Fair; Pilot Program to promote ESCO fixed price or other hedged service offers; Mass Market Migration programs.

- Depreciation Expense
  - Use of Iowa curves vs. NY H-curves
  - Remaining life vs. whole life
  - Reduce average service life for plastic mains from 70 years to 55 years

- Low Income Services
  - Phase in of targeted Low Income Customer Affordability Program
    - Funding continued at $5 million (surcharge if participation > $5 million)
    - Phase out of Low Income Residential Assistance Service (limited success)

- Changes to Transportation Services
  - Mandatory capacity assignment to marketers after critical level of marketer provided capacity achieved
  - Elimination of "No Harm, No Foul" cash out provisions for daily balanced customers
  - Tighter imbalance trading rules – post trade position must be closer to zero vs. current lower absolute value position
  - Eliminate existing 2% tolerance before recalculating revised capacity requirements for changes in marketer load

- Other Proposals
  - Local Production meter maintenance fee differential rotary vs. orifice meters
  - True up of PSC Assessment through a separate surcharge
  - No extension of Safety Performance Standards beyond existing rate plan
  - Continue existing mechanisms including weather normalization clause and 90/10 sharing
  - Make permanent funding of the existing cost mitigation reserve from the first $1.0 million of capacity release credits

- Tariff Loss Factor percentage to continue at the existing 1.90%