STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and Other Regulatory Authorizations	Case 06-M-0878

DIRECT TESTIMONY AND EXHIBIT OF

DR. DOUGLAS W. ELFNER

PUBLIC VERSION

Dated: February 20, 2007
Albany, New York

MINDY BOCKSTEIN, ACTING EXECUTIVE DIRECTOR/CHAIRPERSON
NYS CONSUMER PROTECTION BOARD
5 EMPIRE STATE PLAZA
SUITE 2101
ALBANY, NEW YORK 12223-1556
http://www.nysconsumer.gov

TABLE OF CONTENTS

INTRODUCTION 1
PART I: SUMMARY OF POSITION 2

PART II: RISKS OF THE PROPOSED TRANSACTION AND RATE PLANS ... 7

Treatment of Goodwill 8
Business Risk 12
Vertical Market Power 13
Ten-Year Rate Plan 15
Rate Adjustments, Deferrals and True-ups in Rate Plan 19
Responsiveness to KeySpan's Customers 23
Service Quality 25
Jobs and Other Economic Impacts 29

PART III: ALLEGED FINANCIAL BENEFITS OF THE PROPOSED TRANSACTION 33

Synergy Savings 36
Gross Synergy Savings 39
Costs to Achieve 44
Timing of Synergy Savings 48
Sharing of Net Synergy Savings 49
Allocation of Net Synergy Savings 51
Gas Supply Savings 55

PART IV: OTHER ALLEGED BENEFITS OF THE PROPOSED TRANSACTION 59

Avoidance of Rate Increases for KEDNY AND KEDLI 59
Other Public Benefits 60

1 **INTRODUCTION**
2
3 Q. Please state your name and title.
4 A. My name is Douglas W. Elfner. I am the Director of Utility Intervention for
5 the New York State Consumer Protection Board ("CPB").
6
7 Q. Have you testified previously in this proceeding?
8 A. Yes. I submitted testimony on January 29, 2007 regarding the stand-
9 alone rate filings of KeySpan Energy Delivery New York ("KEDNY") and
10 KeySpan Energy Delivery Long Island ("KEDLI"). That testimony contains
11 a summary of my education and employment experience.
12
13 Q. What is the purpose of this testimony?
14 A. I evaluate the proposed Transaction between National Grid plc ("National
15 Grid") and KeySpan Corporation ("KeySpan;" jointly, "the Petitioners") as
16 well as the associated rate plans and assess the impacts of those
17 proposals on consumers.
18 My testimony has four parts. In Part I, I summarize the CPB's
19 position and recommendation in this phase of the proceeding. In Part II, I
20 identify and explain the risks to consumers of the proposed Transaction
21 and associated rate plans, and identify measures the Commission should

1 consider to prevent or offset these impacts. The alleged financial benefits
2 of the Transaction to consumers are addressed in Part III. In Part IV, I
3 address the alleged non-financial benefits of the proposed Transaction
4 and rate plans.
5
6 Q. Are there any Exhibits associated with your testimony?
7 A. Yes. Exhibit___(DWE) contains a copy of all responses to information
8 requests that I reference in this testimony.
9

10 **PART I: SUMMARY OF POSITION**

11
12 Q. Please summarize briefly the proposed Transaction and associated rate
13 plans.
14 A. National Grid and KeySpan entered into an agreement on February 25,
15 2006 under which National Grid would acquire KeySpan for cash. Under
16 that agreement, KeySpan would become a wholly-owned subsidiary of
17 National Grid USA. The Companies filed a Joint Petition requesting Public
18 Service Commission ("PSC" or "Commission") approval of the proposed
19 Transaction and associated rate plans for KEDNY and KEDLI on July 20,
20 2006 and submitted testimony in support of those requests on October 3,
21 2006. Those rate plans would govern KEDNY and KEDLI for ten years,

1 and incorporate the Petitioners' view of ratepayers' share of the net
2 synergy savings from the Transaction. Under those rate plans, the non-
3 gas portion of delivery rates would be frozen for eighteen months,
4 customer bills would be increased to reflect certain gas-related costs
5 beginning in the nineteenth month, and biennial delivery rate increases of
6 2.5% for KEDNY and 2.8% for KEDLI would take place beginning in the
7 third year.
8
9 Q. Please summarize the CPB's position on the proposed Transaction and
10 rate plans.
11 A. The CPB recommends that the PSC reject the proposed Transaction and
12 rate plans as filed. If, however, the Commission decides to approve the
13 Transaction and rate plans, it should condition that approval in the manner
14 described herein in order to protect the interests of consumers.
15 The fundamental issue in this case is whether any benefits that
16 customers of the affected regulated utilities in New York can expect to
17 realize from the Transaction will be sufficient to justify the risks they would
18 be required to assume. If the answer is no, the Transaction as proposed
19 is not in the public interest and must be rejected or conditioned to redress
20 the benefit/risk imbalance.

1 As I demonstrate in this testimony, the risks of the Transaction and
2 associated rate plans to consumers are tangible and substantial, and have
3 been significantly understated by the Petitioners. In contrast, the benefits
4 are relatively small, in some cases are not substantiated or enforceable,
5 and have been significantly overstated by the Petitioners.
6 A summary of conditions that should accompany PSC approval of
7 the Transaction are as follows:

8 Merger Accounting and Ratemaking

9 KEDNY and KEDLI should be precluded from ever including goodwill
10 associated with this Transaction in rate base, earnings base for the
11 Earnings Base/Capitalization analysis or capital structure for ratemaking
12 purposes. (pp. 8-12)
13
14 The PSC should carefully review the likely impact of recording a large
15 amount of goodwill on the books of KEDNY and KEDLI and, if necessary,
16 take action now to ensure that such approval does not cause an increase
17 in costs to consumers, such as through higher financing costs, either in
18 this case or in the future. (pp. 8-12)
19
20 The Commission should establish the ratemaking principle now, that
21 future regulated rates of the merging entities should not reflect any
22 increase in cost of capital attributable to the merger. (pp. 12-13)
23
24
25 Vertical Market Power
26
27 Approval of the Transaction may create the opportunity for the merged
28 company to exercise vertical market power since electricity generation and
29 transmission would be owned by the same entity. To address this
30 possibility, the Commission should consider alternatives including a long-
31 term contract between the relevant generation assets and load serving
32 entities, or cost-based regulation of the relevant generation assets. (pp.
33 13-14)

1 Rate Plans
2
3 Petitioner's proposed ten-year rate plan should be rejected, and the
4 duration of any rate plan accompanying approval of the proposed
5 Transaction should be no longer than three years in duration. A portion of
6 merger synergies may be retained by Petitioners for up to five years. (pp.
7 15-19; 50-51)
8
9 The rate increase and deferral provisions of the proposed rate plans have
10 the effect of shifting costs and risks to consumers. They should be
11 rejected or substantially modified. (pp. 19-22)
12
13
14 Synergies and Financial Benefits
15
16 Petitioners' estimate of gross annual synergy savings associated with the
17 proposed Transaction is understated and should be adjusted as explained
18 herein. (pp. 39–44)
19
20 The Petitioners' estimate of the costs to achieve the merger should be
21 reduced from $400 million to no more than $276 million (before taxes).
22 (pp. 44-48)
23
24 For purposes of calculating the phase-in of net synergies for KEDNY and
25 KEDLI, the results achieved in the merger between National Grid and
26 Niagara Mohawk should be used as a basis in this proceeding. (pp. 48-
27 49)
28
29 The Petitioners' proposed allocation of net synergy savings to KEDNY and
30 KEDLI should be revised as explained herein. (pp. 51-55)
31
32 Evaluation of the benefits of the Transaction should not include the gas
33 supply savings identified by the Petitioners, since such savings are not
34 attributable to the merger. (pp. 55-59)
35
36
37 Service Quality and Reliability
38
39 The PSC should obtain explicit and enforceable assurances that National
40 Grid will spend no less on reliability-related programs, including its

Reliability Enhancement Program, for the next five years than is currently planned. (pp. 25-29)

The current rate plan for National Grid's electric operations should be modified to increase the financial consequences of that company's failure to meet SAIFI standards. (pp. 25-29)

The financial consequences of failure by KEDNY and/or KEDLI to achieve one or more service-related objectives in a given year, should be substantially increased for those measures in the subsequent year. (pp. 25-29)

The service quality programs for KEDNY and KEDLI identified in the January 29, 2007 testimony of CPB witness Ms. DeVito, should be adopted. (pp. 63-64)

Jobs and Economic Impacts

The PSC should obtain explicit and enforceable assurances regarding the geographic location of, and major functions assigned to, headquarter offices and other significant facilities in New York State, as well as the total number of management and non-management employees to be located in the State by the new company. (pp. 29-33)

Regulatory

The Commission should obtain an enforceable commitment that KeySpan will maintain all books and records in New York State or provide access in New York State to such books and records when Department of Public Service Staff deems necessary. (pp. 29-33)

The PSC should initiate an audit of KEDNY and KEDLI, pursuant to Public Service Law ("PSL") §66(19), in the third year following approval of the Transaction. (pp. 64-65)

Public Policy

KEDNY and KEDLI should not commence new programs for the promotion of retail markets, such as a Purchase of Receivables Program, ESCO Referral Program, Outreach and Education for retail choice and

Market Expo, if those programs are subsidized by ratepayers. (p. 61, citing Elfner January 29, 2007 Testimony, pp. 16 – 19)

KEDNY and KEDLI should implement demand side management programs of the type proposed in their stand-alone rate filings. The specific parameters of those programs should be determined in a collaborative proceeding as soon as possible. (p. 61, citing Elfner January 29, 2007 Testimony, pp. 19 – 22)

A revenue decoupling mechanism that addresses the CPB's concerns should be developed for KEDNY and KEDLI. The specific parameters of that mechanism should be determined in a collaborative proceeding as soon as is practicable. (p. 61, citing Elfner January 29, 2007 Testimony, pp. 23-24)

The low-income assistance programs identified in the January 29, 2007 testimony of CPB witness Ms. DeVito should be adopted. (p. 61-62)

PART II: RISKS OF THE PROPOSED TRANSACTION AND RATE PLANS

Q. What risks do the proposed Transaction and rate plans pose for consumers?

A. The proposed Transaction may negatively affect customers of the Petitioners' regulated utility operations both directly through the rates they pay and the quality of service they receive, and indirectly through its impact on the State's economy. The Petitioners' proposed accounting treatment for the Transaction, in particular, their proposal regarding the accounting for the excess of the acquisition price over the fair value of the net assets, known as goodwill, creates significant risks for ratepayers.

1 The proposed ten-year rate plan, guaranteed rate increases and deferrals
2 of future costs, significantly diminish utility accountability for cost
3 management and shift the risk of cost increases to consumers.
4 In addition, the process of integrating two large companies with an
5 emphasis on obtaining the cost savings necessary to make the
6 Transaction profitable, is very likely to result in a combined entity that is
7 less responsive to the needs of KeySpan's customers and less likely to
8 maintain the quality of service provided by those utilities.
9 Additionally, the Transaction creates the possibility of an increase
10 in business risk which would raise the cost of capital for the Petitioners'
11 regulated utility operations and lead to upward pressure on utility rates. It
12 will also likely lead to substantial job losses in New York State which could
13 negatively impact the State's economy.
14

15 Treatment of Goodwill
16
17 Q. Please explain why the proposed accounting for the acquisition of
18 KeySpan by National Grid creates risk for ratepayers.
19 A. The $42 per share price that National Grid proposes to pay for each
20 common share of KeySpan far exceeds the fair value of the assets of that
21 corporation. Overall, the approximate acquisition cost for the equity of

1 KeySpan is $7.3 billion, whereas its book value as of June 30, 2006 was
2 $4.6 billion, resulting in a premium over book value of approximately $2.7
3 billion. (NYC-37) The Petitioners are required to use the purchase
4 method of accounting to record the Transaction, under which the excess
5 purchase price over the fair value of the assets of the KeySpan companies
6 is recorded as goodwill. That goodwill will be pushed down and allocated
7 to each of the KeySpan affiliates, including KEDNY and KEDLI, based on
8 an analysis to be finalized after completion of the proposed Transaction.
9 (DPS-28; Testimony of Mr. John G. Cochrane, October 3, 2006, pp. 9 –
10 11)
11 The Petitioners assert that this treatment of goodwill will not affect
12 rates, since KEDNY and KEDLI would exclude goodwill from the
13 calculation of rate base, the earnings base used for the Earnings
14 Base/Capitalization analysis and in capital structure for ratemaking
15 purposes. They propose to use an imputed capital structure for
16 ratemaking purposes.
17
18 Q. Please explain your concerns with the Petitioners' proposed treatment of
19 goodwill.
20 A. The goodwill premium is an accounting mechanism that reconciles the
21 book value of assets and liabilities with the purchase price. It does not

1 represent any new facility or equipment to be devoted to public service. It
2 would be unreasonable to charge ratepayers for the goodwill premium
3 either directly or indirectly, just as it is unreasonable for ratepayers to fund
4 facilities or equipment that are not used and useful for the provision of
5 utility service.

6 A large goodwill premium on the books of a regulated utility could
7 be very harmful to customers. The utility has a powerful incentive to
8 include goodwill in rate base and in the capital structure used for
9 ratemaking, both of which would place upward pressure on rates paid by
10 customers. Although the Petitioners have committed not to include
11 goodwill in rate base or the capital structure used for ratemaking under the
12 rate plans proposed in their Petition (Testimony of Mr. Cochrane, October
13 3, 2006, p. 11), they have not extended these commitments to any rate
14 plan approved by the PSC in this proceeding or future proceedings.

15 Therefore, the CPB recommends that as a condition of approval of
16 the proposed Transaction, KEDNY and KEDLI be precluded from ever
17 including goodwill associated with this Transaction in rate base, earnings
18 base for the Earnings Base/Capitalization analysis or capital structure for
19 ratemaking purposes.

20

1 Q. Would approval of that condition fully satisfy your concern regarding the
2 risk to consumers of a large goodwill premium?
3 A. No. The CPB is concerned that even with the ratemaking condition cited
4 above, customers could be harmed because of the existence of a large
5 goodwill premium on the books of KEDNY and KEDLI. That is because
6 cash flows provided from utility ratemaking, which are based on the cost of
7 utility service and the book value of utility assets, are not sufficient to
8 support a large goodwill premium. The utilities will be under strong
9 pressure to increase cash flows from regulated operations to support this
10 goodwill premium. This factor helps explain why the Petitioners are
11 seeking approval of a long-term rate plan that would ensure an above-
12 market return on equity and guarantee true-up and recovery of numerous
13 costs. The presence of a large goodwill premium on the books of KEDNY
14 and KEDLI also increases the likelihood that they will seek to increase
15 regulated rates at the end of any rate plan, all else being equal.
16 Without sufficient cash flows to support goodwill, KEDNY and
17 KEDLI may in the future, have to write off the goodwill created under their
18 proposed accounting for the Transaction. That could reduce their equity
19 ratio, weaken their capital structure and raise financing costs, and place
20 upward pressure on regulated rates. There is also substantial risk to
21 ratepayers since the amount of goodwill to be recorded on the books of

1 KEDNY and KEDLI is currently not known with certainty, and will be
2 finalized “after completion of the merger” (DPS-28) or “by completion of
3 the merger.” (DPS-106)

4 As a condition of approving the proposed Transaction, the PSC
5 should carefully review the likely impact of recording a large amount of
6 goodwill on the books of KEDNY and KEDLI and, if necessary, take action
7 now to ensure that such approval does not cause an increase in costs to
8 consumers, such as through higher financing costs, either in this case or
9 in the future.

10

11 Business Risk

12 Q. Please elaborate on the concern that the proposed Transaction could
13 increase business risk and lead to upward pressure on regulated rates.

14 A. The Transaction is expected to lead to substantial management,
15 organizational, cultural and policy changes in National Grid’s and
16 KeySpan’s regulated utility operations in New York. At the same time,
17 utility executives will be under pressure to achieve, and perhaps exceed,
18 projected cost savings. Investors may view these factors as an increase
19 in business risk, which may in turn increase the cost of capital for these
20 regulated delivery companies and put upward pressure on regulated rates.

1 It is CPB's position that ratepayers should not be responsible,
2 either directly or indirectly, for any increase in the cost of capital for
3 regulated utility operations attributable to the Transaction. Instead, the
4 Petitioners should be accountable for the merger's success and ensuring
5 that the merger does not negatively affect regulated utility operations or
6 customers of regulated utilities.
7
8 Q. Do you have any recommendations to address this issue?
9 A. Yes. Any increase in KeySpan's cost of capital attributable to the
10 Transaction should not be reflected in regulated delivery rates. The
11 Commission should now establish the ratemaking principle, that future
12 regulated rates of the merging entities should not reflect any increase in
13 cost of capital attributable to the merger. Evidence regarding this issue
14 would be addressed in future rate proceedings.
15

16 Vertical Market Power
17
18 Q. Please explain your concern about vertical market power.
19 A. KeySpan owns electricity generation assets in downstate New York. It is
20 possible that with the approval of the Transaction, National Grid will not
21 maintain its existing transmission investment, pursue new transmission

1 projects or take other actions that could benefit downstate customers,
2 since such efforts may reduce the value of its generation assets. To the
3 extent that it refrained from such activities, market prices for electricity
4 would be higher than otherwise. Petitioners have submitted lengthy
5 testimony in which they attempt to demonstrate that the Commission need
6 not be concerned about this issue.
7
8 Q. What is the CPB's position on this matter?
9 A. The CPB is not fully convinced by the Petitioners' arguments. It appears
10 that approval of the Transaction would create the opportunity for the
11 merged company to take action that would place upward pressure on
12 market prices for electricity in New York. On the other hand, approval of
13 the Transaction would not affect the ability of other existing and new
14 transmission providers to take action that would have the effect of
15 mitigating this concern. The Commission should carefully review this
16 issue to determine its validity. If warranted, it should consider options to
17 eliminate or substantially mitigate this concern, through measures such as
18 a long-term contract between the relevant generator and load-serving
19 entities. The certainty provided by a long-term contract would
20 substantially reduce the incentive of the merged company to avoid or
21 delay transmission projects or other action that could provide benefits to

1 consumers. Alternatively, a return to cost-based regulation of the relevant
2 generation assets could be considered.
3

4 Ten-Year Rate Plan
5
6 Q. What is the duration of the rate plans that the Petitioners propose as part
7 of their filing?
8 A. The Petitioners propose ten-year rate plans for both KEDNY and KEDLI.
9
10 Q. Is such a duration common?
11 A. No, it is very unusual. I am aware of only one rate plan approved by the
12 Commission in recent history that had a length greater than five years,
13 and that was the result of a negotiated settlement supported by a broad
14 range of parties to address the unique circumstances of a utility under
15 severe financial stress. I know of no fully litigated case that has produced
16 a Commission order approving a plan of such long duration. In fact, I am
17 advised by counsel that such an order might be precluded by Section 72
18 of the Public Service Law which authorizes the Commission to fix rates
19 only for periods "not exceeding three years."
20
21 Q. Do Petitioners explain why they are seeking plans of such duration?

1 A. They do not explain in their testimony why ten-year rate plans for KEDLI
2 and KEDNY are necessary or desirable, but in their response to CPB-25
3 they do suggest several reasons why they would consider a one-year rate
4 case to be less advantageous. First, they point out that the costs to
5 achieve projected synergy savings are front-end loaded and will exceed
6 the benefits realized during the first few years after the merger. This, they
7 say, would require that rates be increased in year one and decreased in
8 later years, a less desirable situation than the gradual increases
9 embedded in their ten-year plans.
10 Second, they say that because some of the investments and
11 organizational changes necessary to achieve synergy savings will take
12 more than a year to complete, they would have less incentive to undertake
13 the changes without assurance that they will be permitted to recover the
14 cost plus a share of savings received. And finally, they say that costs
15 incurred to file multiple annual rate cases would eat into the merger
16 savings.
17
18 Q. Do these concerns justify fixing rates for a ten-year period?
19 A. No. The concerns are either unjustified or can readily be accommodated
20 within a traditional one-year rate case or three-year negotiated settlement.
21 The fact that costs to achieve synergy savings are front-loaded does not

1 require that rates fluctuate annually. For ratemaking purposes, the
2 Commission can authorize the deferral and amortization of such expenses
3 over a period that both provides a better matching of costs and savings
4 and keeps rates constant without affecting utility earnings. Indeed, this
5 would be the normal methodology in a one-year rate case for handling any
6 large expenditure that is required during the rate year but is not expected
7 to be repeated annually.

8 The Companies' concern that a long-term rate plan is necessary as
9 an incentive to make the investments necessary to achieve merger cost
10 savings, is also misplaced. As with costs to achieve, a regulatory
11 mechanism could be designed to help ensure that the Companies have an
12 appropriate incentive. For example, the dollar value of synergy savings
13 that KEDNY and KEDLI would be permitted to retain for up to five years,
14 could be specified in this proceeding and not be altered by subsequent
15 rate determinations.

16 Regarding the Companies' final point, the recent history of KEDLI
17 and KEDNY demonstrates that repeated annual rate filings are not
18 inevitable, or even likely, in the absence of a multi-year rate plan. By the
19 time tariffs approved in this proceeding take effect, those companies will
20 have operated more than eight years since rates were last set in Case 97-
21 M-0567.

1 Q. Are the ten-year plans necessary to permit the Petitioners to achieve the
2 projected merger-related synergy savings?
3 A. No, they are not. In CPB-25, we asked Petitioners whether net synergy
4 savings would be decreased if the Commission approved rates for one-
5 year only in lieu of the proposed long-term plans. Their response was that
6 "most savings could still be achieved" and that "costs to achieve would be
7 broadly similar." The lengthy rate plans are not necessary to generate
8 the projected financial benefits of the merger.
9
10 Q. What is the CPB's position on the proposed ten-year term for these plans?
11 A. It is far too long. As explained above, it appears that the PSC does not
12 have the legal authority to establish rates for a period of more than three
13 years. Further, a rate plan of longer than three years in duration is not
14 appropriate for public policy reasons. Forecasts of the cost and revenue
15 components of rates are subject to the effect of political, demographic,
16 economic and technological changes that are not perfectly predictable.
17 The farther into the future those forecasts are projected, the greater the
18 potential for error. Also, long-term rate plans make it difficult for the
19 Commission to implement policy changes.
20 In addition, the asymmetries in the information possessed by
21 utilities on the one hand, and consumers and regulators on the other,

1 further suggest that plans of longer than three years are not in the public
2 interest. Utilities possess information regarding their operations and the
3 likely impact of anticipated future events on those opeations, whereas in
4 general, regulators, ratepayers and organizations such as the CPB only
5 have access to information regarding utilities' financial condition that
6 utilities are required to report, in the absence of formal rate reviews.
7 Long-term rate plans exacerbate that informational asymmetry.

8 Overall, the CPB recommends that the Petitioner's proposed ten-
9 year rate plan be rejected and that the duration of any rate plan
10 accompanying approval of the proposed Transaction, be no longer than
11 three years in duration. Petitioners' concerns that a three-year rate plan
12 would not be of sufficient duration to permit them to recover a fair portion
13 of synergy savings, can be addressed through another regulatory
14 mechanism.

15

16 <u>Rate Adjustments, Deferrals and True-ups in Rate Plan</u>

17

18 Q. Please summarize those provisions of the proposed rate plans that would
19 affect charges paid by consumers.

20 A. Under the proposed rate plans, KEDNY and KEDLI's delivery rates would
21 be frozen for 18 months. Deferrals of certain costs would commence at

1 the start of the rate plan. In the 19th month, customer bills would increase
2 by $73.7 million for KEDNY (14.37% of delivery revenue of $512.9 million,
3 Exhibit 8 – KEDNY) and $30.9 million for KEDLI (8.52% of delivery
4 revenue of $362.8 million, Exhibit 8 – KEDLI), as a result of costs to be
5 collected through the gas adjustment clause ("GAC") or
6 GAC/Transportation Adjustment Clause ("TAC"). Base delivery rates
7 would increase at the beginning of years 3, 5, 7 and 9, by $57.6 million
8 (11.23% of the delivery revenue cited above) for KEDNY and $46.0 million
9 (12.68% of delivery revenue cited above for KEDLI. (Testimony of Mr.
10 Michael D. Laflamme and Mr. James M. Molloy, pp. 5-6)
11 The proposed rate plan also includes a number of provisions to
12 address items whose magnitude is not now known with certainty. For the
13 most part, these measures would shift risk to ratepayers through a series
14 of deferrals and true-ups. They would permit KEDLI and KEDNY to defer
15 the difference between actual expenses incurred and the amount allowed
16 for such expenses in rates, and then to recover the deferred amounts
17 through surcharges and credits incorporated in a Local Distribution
18 Adjustment Charge ("LDAC"). The Companies project increases in the
19 LDAC in years 3, 5, 7 and 9 of the rate plan of $4.9 million for KEDNY and
20 step decreases of $6.6 million for KEDLI. (Id., p. 6)

1 The proposed rate plans include an annual Settlement Levelization
2 regulatory asset that is designed to produce a levelized return on equity
3 for KEDNY and KEDLI of 11%. (Id., p. 7)
4
5 Q. What is the CPB's position on such provisions?
6 A. Overall, the proposed rate plans would guarantee multiple and significant
7 bill increases to KEDNY and KEDLI customers. Based on the CPB's
8 examination of the Company's stand-alone rate filings, the
9 recommendations of other parties regarding those filings, and KeySpan's
10 demonstrated ability to maintain delivery rates for many years, the
11 proposed rate increases are excessive.
12 Regarding the deferral and true-up provisions, the CPB
13 recommends that unexpected or extraordinary costs be addressed
14 pursuant to the Commission's standard policy regarding deferral and
15 recovery of such costs, which requires utilities to justify proposals in the
16 financial context in which the costs are incurred. This permits the PSC to
17 determine whether some division of responsibility between ratepayers and
18 shareholders is required. Automatic deferrals, by contrast, shift the
19 burden to ratepayers to show, after the fact – and often, long after the fact
20 – that the deferral of particular costs was inappropriate. Even under
21 reasonably well-defined rate plan provisions, decisions regarding deferral

1 and recovery of certain costs can require careful consideration of facts
2 and circumstances, and such decisions should be subject to review. This
3 has proven to be a significant concern in the context of National Grid's
4 ten-year rate plan associated with its previous acquisition of Niagara
5 Mohawk Power Corporation. In that case, a DPS audit of deferrals
6 proposed for recovery that began in the summer of 2005 remains
7 unresolved. It is much less difficult for the Commission to apply that
8 scrutiny before the fact, than to have to attempt to undo a *fait accompli*.
9 In addition, automatic deferral and recovery of costs inherently has
10 a negative impact on a company's incentive to manage costs
11 aggressively. Petitioners refer to the costs for which deferral provisions
12 are proposed as being "difficult to control" (Testimony of Mr. Laflamme
13 and Mr. Molloy, p. 6), not impossible. They note, for example, that
14 inflation has totaled 24% since the KeySpan companies' delivery rates
15 were last increased, but "efficiency gains and revenue growth" have
16 enabled them to avoid seeking rate relief. (Petition, p. 21) It is unlikely
17 that such efficiencies would have been pursued as diligently if recovery of
18 inflationary cost increases had been automatically assured.
19 For these reasons, the CPB recommends that the rate increase
20 and deferral provisions of the proposed rate plans be rejected.
21

1 Responsiveness to KeySpan's Customers

2

3 Q. Please elaborate on your concern that the proposed Transaction could
4 result in a firm that is less responsive to the needs of KeySpan's
5 customers.

6 A. The proposed Transaction would create an extremely large firm, which
7 would be the largest utility in Northeastern United States and the third
8 largest gas utility in the entire country. National Grid would continue to be
9 the largest delivery company of both electricity and natural gas in the
10 United Kingdom, the operator of both the electric and natural gas
11 transmission systems in the United Kingdom and the provider of retail
12 delivery services to more than half of the United Kingdom's natural gas
13 customers. KeySpan's regulated operations in New York would be only a
14 small component of that international firm.

15 This imposes several risks to customers of KEDNY and KEDLI. As
16 part of a larger firm, KEDNY and KEDLI would have a reduced ability to
17 establish a policy direction and determine the resources at their disposal
18 to address the needs of their customers and service territory. KEDNY and
19 KEDLI will increasingly have to fight for resources and attention from
20 senior management. Further, the UK-based firm may seek to have a
21 common set of policies, including regulatory policies, applicable to each of
22 its regulated utilities in the United States, potentially jeopardizing New

1 York-specific regulatory policies that address the needs of KEDNY and
2 KEDLI customers. All of these factors could negatively affect the interests
3 of KeySpan's customers in New York.

4 In addition, the Transaction may make it more difficult for the PSC
5 to regulate KEDNY and KEDLI. Experience with the merger of National
6 Grid and Niagara Mohawk has demonstrated the kinds of problems that
7 can arise. Efforts to audit deferral accounts established under the merger
8 settlement have consumed more than a year of intensive effort by staff of
9 the Department of Public Service due to its inability to obtain complete,
10 accurate and timely information. The root causes of the problem are
11 traceable to that merger and the pressure to achieve forecast synergy
12 savings. Records have been transferred to an out-of-state headquarters,
13 accounting software and systems have been changed, institutional
14 memory has been lost with the retirement and layoff of experienced
15 accounting personnel, and a general reduction in the number of
16 employees available to address information requests has significantly
17 lengthened response times.

18 In this case, similar problems are highly likely as nearly all of the
19 promised synergy savings must be generated through reducing O&M
20 expenses, which means staff reductions, facility consolidation and the

1 integration of systems. These concerns further demonstrate the need for
2 the safeguards we recommend herein.
3

4 Service Quality
5
6 Q. You mentioned that the Transaction may affect the quality of service
7 provided to the combined Companies' regulated customers in New York.
8 Please elaborate.
9 A. The Transaction would jeopardize high quality service for customers of the
10 merged Companies' regulated utility operations in New York. The
11 Transaction creates new opportunities for utility management to focus on
12 issues other than service quality, including pursuit of cost reductions;
13 integrating the personnel, operating systems and corporate culture of two
14 large corporations; as well as managing new businesses such as
15 KeySpan's generation and unregulated activities. In addition, the
16 Transaction may result in changes in existing service-affecting work
17 practices which may jeopardize service quality during a transition period.
18
19 Q. Do you have any concerns regarding the reliability of National Grid's
20 electric service in the service territories of Niagara Mohawk Power
21 Corporation?

1 A. Yes. As measured by the traditional indices for outage frequency
2 ("SAIFI") and outage duration ("CAIDI"), National Grid has not consistently
3 met electric reliability standards in upstate New York established in Case
4 01-M-0075. This casts doubt on the Petitioner's claims that "reliability and
5 service quality will either improve or maintain at current levels."
6 (Testimony of Mr. Feibelman and Mr. Levin, December 14, 2006, p. 10)
7 National Grid has not satisfied the SAIFI measure in 2003 – 2005
8 (DPS-281), and based on preliminary data provided by that company, it
9 did not meet that standard in 2006 (DPS-318). National Grid earned the
10 maximum $4.4 million penalty permissible by its regulatory plan for SAIFI
11 in each year 2003 – 2005. Based on available data, it appears that it will
12 do so again for 2006. Moreover, the company's poor performance on
13 SAIDI has apparently triggered a clause in its current rate plan under
14 which penalties are doubled for repeated failures. Under that provision,
15 the penalty for each service quality measure may be doubled only once
16 through 2011.
17 National Grid also did not meet the CAIDI measure in 2005, and
18 preliminary data for 2006 indicates that it just barely achieved that
19 standard (2.05 vs. 2.07). (Id.) In addition, National Grid's CAIDI results
20 for upstate New York have been below the state average for electric

1 utilities in each year 2001 - 2005. (The 2005 Interruption Report, DPS
2 Staff, Office of Electricity and Environment, June 2006)
3
4 Q. Is National Grid taking action to address these service quality concerns?
5 A. The Petitioners have stated that independent of the Transaction, they
6 have begun to implement programs designed to improve reliability and
7 satisfaction of National Grid's electric customers in upstate New York.
8 (Testimony of Mr. Feilbelman and Mr. Levin, p. 10) National Grid's
9 Reliability Enhancement Program ("REP") includes some expenditures
10 above levels reflected in that company's rate plan, including an increased
11 capital investment program. This program includes asset replacement,
12 enhanced inspection and maintenance and enhanced vegetation
13 management. (DPS-318) Over the next five years, National Grid states
14 that it will spend $620 million on distribution reliability, $360 million of
15 which is focused on the distribution system REP, and $576 million in
16 transmission system capital spending. (Id.)
17 Approval of the Transaction, however, may result in electric T&D
18 personnel reductions in Niagara Mohawk's service territory. It may also
19 result in significant changes to current and planned programs intended to
20 improve reliability and satisfaction. Either of those results would be

1 expected to lead to a decline in service reliability and customer
2 satisfaction, below levels for which improvement is already required.
3
4 Q. What is your recommendation?
5 A. The PSC should condition approval of the proposed Transaction upon
6 enhancements to ensure that the service quality of KEDNY, KEDLI and
7 Niagara Mohawk's regulated operations in New York is adequate,
8 particularly during the implementation phase of the Transaction.
9 Regarding National Grid, the PSC should condition approval of the
10 proposed Transaction on a definitive and enforceable requirement that
11 National Grid spend no less on reliability-related programs over the next
12 five years than currently planned, as described above. It should also
13 require National Grid to commit to a time table for such expenditures.
14 Moreover, the clause in the Company's current rate plan that prevents the
15 financial consequences for failure to meet SAIFI standards from being
16 doubled more than once, should be eliminated, since the results of the last
17 four years demonstrate that current incentives are not sufficient.
18 Regarding KEDNY and KEDLI, the recommendations identified in
19 the testimony of CPB witness Ms. Donna M. DeVito should be adopted,
20 irrespective of whether the proposed Transaction is approved. Moreover,
21 approval of the merger should be conditioned on a requirement that in the

1 event KEDNY and/or KEDLI do not achieve one or more service-related
2 objectives, the financial consequences associated with those service
3 measures in the subsequent year would double. This provision would be
4 applicable in the four-year transition to a single new company.
5

6 Jobs and Other Economic Impacts
7
8 Q. What effect will the proposed Transaction have on the employees of the
9 combined companies and the economy of New York State?
10 A. National Grid and KeySpan will have a very powerful incentive to enhance
11 merger-generated savings by reducing payroll expense, an area in which
12 they can exercise broad discretion. Based on the data available in this
13 case, the Companies are projecting a reduction in their combined
14 workforce of 874 to 1,332 full-time equivalent employees as a direct result
15 of the Transaction (December 14, 2006 Update, Exhibit No. ___(AVF/RJL-
16 1), p. 2), representing from 5.05% to 7.70% of the workforce analyzed.
17 (Calculated from CPB-213) The Petitioners have not yet provided any
18 information regarding how many of these job losses will be in New York
19 State. As explained in detail in Part III, the actual reductions will likely
20 prove to be larger as the pressure for greater savings mounts. National
21 Grid's only other merger with a New York State utility, for example,

1 resulted in an overall workforce reduction of 10% (DPS9(d)) and a
2 reduction in the number of full-time and part-time union employees in New
3 York of 1422, or 29.65%. (CPB-27)

4 Petitioners claim that they will continue to have a "significant
5 headquarter presence in New York and New England," that "no decisions
6 have been made about closing or reducing any of the current headquarter
7 locations" (Exhibit 1, p. 7 of 17), and that closing or moving National Grid's
8 offices in Syracuse and its electric line service barns in upstate New York
9 "are not options that we are actively exploring or anticipate exploring for
10 the foreseeable future." (DPS-224)

11

12 Q. What is the economic effect of job losses resulting from approval of the
13 proposed Transaction?

14 A. In addition to the immediate negative impact on the affected families,
15 workforce reductions also adversely affect general economic activity in the
16 State as economic multipliers propagate the effects of income losses
17 throughout the economy. Substantial job losses in any one region would
18 also have a significant effect on the local economy. It is noteworthy that
19 the Petitioners have not expressly precluded the elimination or transfer
20 from New York State, of headquarter offices, major functions assigned to
21 those offices, or significant facilities in the State.

1

2 Q. Are there other possible negative consequences of these workforce
3 reductions?
4 A. Yes. Such reductions have the potential to impair service quality and
5 reliability and to hamper the ability of the Commission to provide adequate
6 regulatory oversight of the combined companies. With respect to safety
7 and reliability, reductions in the number of union employees directly
8 engaged in maintenance and repair functions could be particularly
9 detrimental. Extensions to collective bargaining agreements recently
10 negotiated by KeySpan with its IBEW and TWU locals do impose some
11 restrictions on layoffs (DPS-131, Supplement), but according to the
12 Petitioners' summary of those agreements, they do not address the
13 replacement of workers lost through retirement or other causes, and they
14 do not mandate any increase in hires commensurate with the system wide
15 growth the company projects. Pressure to generate savings may very well
16 lead to a reduction in the union workforce through attrition and reduced
17 hiring. The merger between National Grid and Niagara Mohawk, which
18 has resulted in a 29.65% reduction in the union workforce in New York in
19 approximately five years, is instructive.
20 Management jobs, which are not subject to contractual restrictions,
21 will come under even heavier pressure. These employees are responsible

1 for planning, implementing and managing construction, maintenance,
2 inspection and repair programs. A significant reduction in their numbers
3 could also adversely affect safety and reliability.
4 In addition, the elimination or relocation of management positions
5 may significantly hinder the work of the PSC as institutional memory is lost
6 and books, records and systems become more difficult and costly to
7 access.
8
9 Q. What do you recommend?
10 A. The Transaction should not be approved without explicit and enforceable
11 assurances regarding the geographic location and major functions
12 assigned to headquarter offices and other significant facilities in New York
13 State, and the total number of management and non-management
14 employees to be located in the state. Definitive and enforceable
15 commitments in these areas are essential to a finding that the Transaction
16 is in the public interest. The Commission has imposed conditions of this
17 nature on approvals of other mergers involving large utilities, such as the
18 merger between NYNEX and Bell Atlantic Corporation in Case 96-C-0603.
19 Similar commitments to train and educate workers who are involuntarily
20 dismissed as a result of the Transaction, would be in the public interest.

1 In addition, the Transaction should be conditioned on an
2 enforceable commitment that KeySpan be required to maintain all books
3 and records in New York State or provide access in New York State to
4 such books and records when Department of Public Service Staff deems
5 necessary. The Commission has conditioned other mergers on a similar
6 commitment. (See, e.g., Case 99-C-0530, Joint Petition of Global
7 Crossing, Ltd. And Frontier Corporation for Approval of the Acquisition by
8 Global Crossing Ltd. Of all the Outstanding Shares of Frontier
9 Corporation's Common Stock, Order Approving Petition, December 1,
10 1999, p. 7)
11

12 **PART III: ALLEGED FINANCIAL BENEFITS OF THE PROPOSED**
13 **TRANSACTION**
14
15 Q. Who will benefit from the proposed Transaction?

16 A. As currently structured, the proposed Transaction will be very lucrative for
17 the shareholders of National Grid and KeySpan, and for many of
18 KeySpan's senior executives. For the ratepayers of National Grid and
19 KeySpan's regulated utility operations in New York, however, the benefits
20 will be very limited and insufficient to outweigh the risks consumers will be
21 assuming.
22

1 Q. How would shareholders benefit from the Transaction?

2 A. National Grid has offered to purchase KeySpan common stock at a price
3 of $42 per share, representing a premium of 16% over the market price of
4 $36.20 prevailing on February 16, 2006, the last day prior to KeySpan's
5 announcement that it was in discussions with various parties regarding a
6 potential combination. With approximately 175 million shares outstanding,
7 this represents a premium to KeySpan shareholders of over one billion
8 dollars.

9 National Grid projects that the Transaction will benefit its
10 shareholders as well, by enhancing earnings and cash flow through cost
11 reductions achieved in several ways. It says consolidation of two large
12 companies would permit redundant operations, systems and activities to
13 be eliminated, would facilitate identification and implementation of best
14 practices that would further reduce operating costs, and might also
15 generate cost reductions from the increased scale and scope of its
16 operations. For convenience, all of these cost reductions are referred to
17 as "synergy savings." Applicants estimate annual synergy savings of
18 approximately $200 million.

19

20 Q. How would Executives of the Petitioners benefit from the Transaction?

1 A. Executives with significant KeySpan stock holdings will benefit from the
2 premium paid by National Grid. According to a Preliminary Proxy
3 Statement filed by KeySpan in June 2006, Directors and senior executives
4 held nearly 1.2 million shares, for which the premium paid will be in
5 excess of $6.8 million. Much more significantly, however, Petitioners
6 estimate that Transaction-related stock options and "golden parachutes"
7 for such executives will cost the company $135 million. (Response to IR
8 DPS-11)
9
10 Q. How do Petitioners claim consumers will benefit from the proposed
11 Transaction?
12 A. Petitioners assert that the proposed Transaction will provide long-term
13 financial benefits to New York including: (1) a share of synergy savings
14 achieved and (2) a reduction in future gas supply costs. They also assert
15 that the Transaction will avoid rate increases for KEDLI and KEDNY that
16 would have been incurred absent the merger and result in various public
17 benefits such as the promotion of retail energy competition, new demand-
18 side management programs, reduction of disincentives for utilities to
19 encourage conservation, enhanced low-income discount programs and
20 maintenance of service quality standards. (Testimony of Mr. Reilly and Mr.
21 Zelkowitz, pp. 19 – 28)

1

2 Q. What is the CPB's position on these alleged benefits?

3 A. Overall, the benefits to consumers of the proposed Transaction are very
4 small, both relative to the size of the transaction and in comparison with
5 the risks that would be absorbed by consumers.

6 Synergy Savings
7

8 Q. What synergy savings do Petitioners project will result from the
9 Transaction?

10 A. According to the Petitioners, the Transaction would result in gross cost
11 savings, after a phase-in period, of approximately $200 million each year
12 on the combined systems of National Grid and KeySpan. Those savings
13 include a reduction in full-time equivalent employees of approximately 4%
14 (Exhibit 1, p. 5), subsequently revised to a range of 5.05% to 7.7% of the
15 workforce analyzed (calculated from December 14, 2006 Update, Exhibit
16 No. ___(AVF/RJL-1), p. 2 and CPB-213). After deducting the costs of the
17 Transaction and costs to achieve these savings, approximately two-thirds
18 of the net savings would be allocated to utility operations in New York.
19 Fifty percent of the net savings allocated to KEDNY, KEDLI, Niagara
20 Mohawk's electric operations and Niagara Mohawk's gas operations
21 would be used for the benefit of customers. (Testimony of Mr. Reilly and

1 Mr. Zelkowitz, pp. 20 -21) After a three-year phase-in period, customers
2 of those four entities would receive annual benefits from net synergies of
3 approximately $12.5 million, $7.4 million, $18.6 million and $4.8 million,
4 respectively. (Calculated from Petitioners' Exhibit 2, p. 1)
5
6 Q. What is the CPB's opinion of that proposal?
7 A. The savings for consumers are inadequate not only in absolute terms, but
8 also relative to other mergers and in relation to the risks consumers will
9 assume under the proposed Transaction. The annual benefits after the
10 phase-in period amount to only 0.63%, 0.65%, 0.60% and 1.67% of
11 delivery revenues of KEDNY, KEDLI, Niagara Mohawk's electric
12 operations and Niagara Mohawk's gas operations, respectively (based on
13 delivery revenues in the 12-months ending June 30, 2006, per CPB 212).
14 On a per-customer basis, the annual benefits after the phase-in period for
15 the average customer of KEDNY, KEDLI, Niagara Mohawk's electric
16 operations and Niagara Mohawk's gas operations would be only about
17 $10.66, $14.01, $11.56 and $8.47, respectively (based on customer
18 counts as of June 30, 2006). In the first three years after the merger is
19 completed, those benefits would average only $2.58, $3.39, $2.80 and
20 $2.06 each year for each entity, respectively.

1 The savings are also small in comparison with actual savings from
2 National Grid's previous acquisition of Niagara Mohawk. That merger
3 produced a workforce reduction of 10%.
4 Moreover, it is important to recognize that neither the CPB nor the
5 Commission can verify the Petitioners' synergy savings projections prior to
6 the closing of the merger. Petitioners state that their integration team,
7 which is charged with, among other things, identifying merger savings, will
8 not complete its work until "some time in the second quarter" (Testimony
9 of Mr. Feibelman and Mr. Levin, December 14, 2006, p. 5), which is after
10 the evidentiary hearings in this case have been completed. The
11 Companies have a strong incentive to underestimate net savings
12 attributable to regulated utility operations in New York since savings
13 estimates are unverifiable and the Companies are well aware that the New
14 York PSC has typically required a substantial portion of merger savings to
15 be shared with ratepayers.
16
17 Q. How did Petitioners derive the estimates of synergy savings included in
18 their proposal?
19 A. Petitioners' proposal was developed by estimating the overall savings that
20 would result from the merger, forecasting the costs to achieve those
21 savings, estimating the timing for achieving the savings, proposing an

1 allocation of savings among National Grid and KeySpan operations, and
2 proposing the fraction of savings to be retained by shareholders and the
3 time period over which that retention would be allowed.

4 Gross Synergy Savings
5
6 Q. What is the Petitioners' estimate of overall synergy savings that would
7 result from the merger?
8 A. The first estimate of overall synergy savings from combining with KeySpan
9 produced by or on behalf of National Grid of which CPB is aware, was
10 completed in March 2004. That study, conducted by Mercer Management
11 Consulting and based on data from 2002 and 2003, estimated personnel
12 reductions of 1,190 to 1,590 employees, representing from 15% to 20% of
13 positions analyzed, and annual savings in the range of $150 to $201
14 million. (CPB-214)
15 **CONFIDENTIAL INFORMATION**
16
17
18
19
20
21

1 **CONFIDENTIAL INFORMATION**

2

3

4

5

6

7

8 In March 2006, Mercer Management Consulting began the work
9 that led to the development of the estimates in the Joint Petition. Mercer
10 used a different scope and methodology than that which underlay
11 and concluded
12 that total annual savings from the Transaction would range from $165
13 million to $210 million. (Exhibit 1, p.1) That estimate included $125
14 million in annual savings resulting from a reduction of 624 positions, or 4%
15 of the workforce in entities analyzed, but did not address or include any
16 position reductions in generation and energy supply, electric T&D and
17 unregulated services. (Id., p. 9) Mercer increased its $125 million
18 projection to reflect a broad estimate of savings that would result from
19 operations it did not analyze, as well as to recognize that its workforce
20 savings estimates in prior National Grid USA mergers significantly
21 understated savings that were actually achieved.

1 On December 14, 2006, Petitioners filed additional testimony that
2 reflects the integration team's most recent findings. They now estimate
3 total O&M savings of $153 million to $208 million, including workforce
4 savings of 874 to 1,332 employees (Exhibit__AVF/RJL-1, p.2), based on
5 an analysis of all KeySpan entities except KeySpan Business Solutions.
6 The "high-end" workforce reduction of 1,332 FTEs is based on data as of
7 April 2006, and represents 7.7% of positions analyzed. (Calculated from
8 CPB-213) The Petitioners state that the integration teams continue to
9 work to develop more accurate estimates.
10 In summary, Petitioners estimated in confidential filings, savings of
11 up to **CONFIDENTIAL INFORMATION**.
12 In their public filings, Petitioners estimated savings of up to
13 $208 million annually and workforce reductions of up to 1,332 positions.
14
15 Q. Do you have any concerns about these estimates?
16 A. Yes. My principle concern is that Petitioners include a smaller estimate of
17 synergy savings in their filings in this case than were presented to
18 National Grid's Board of Directors to justify the Transaction, and that those
19 different estimates have not been reconciled. When asked to explain
20 differences in these estimates, Petitioners responded "a detailed
21 reconciliation of the two employee counts has not been made" (CPB 215-

1 amended). Similarly, when asked to explain apparent large differences in
2 the positions analyzed to develop synergy savings, Petitioners responded
3 "Mercer and the integration team have not undertaken a reconciliation of
4 the total staffing numbers [underlying two estimates of synergy savings.]"
5 (CPB 213(e))
6
7 Q. Is there any other information that would assist the Commission in
8 determining the gross synergy savings associated with the Transaction?
9 A. Yes. The Commission should consider that a bid to acquire KeySpan
10 featuring projections of synergy savings than those offered by
11 the Transaction under consideration in this case, was made by
12 **CONFIDENTIAL INFORMATION** contemporaneously with that of National
13 Grid. KeySpan's board determined that the interests of the Company's
14 shareholders were better served by the latter offer.
15 Utilities provide essential services to the public through a franchise
16 granted by the State. It is entirely appropriate, as a matter of policy, for
17 the Commission to consider the impacts on customers of offers that were
18 rejected by KeySpan, as part of its evaluation of the proposed
19 Transaction. Although utility boards of directors need not consider
20 benefits to customers in evaluating alternative offers, ratepayer interests
21 can, and should, be considered by the PSC.

1

2 Q. What synergy savings are projected from an acquisition by

3 **CONFIDENTIAL INFORMATION**?

4 A. Net savings were projected to be annually, compared with the

5 $200 million in this case. (DPS-235-1(c))

6

7 Q. How should that difference be considered in evaluating the appropriate

8 level of synergy savings to be retained by ratepayers in this case?

9 A.

10

11

12

13

14

15

16

17

18

19

20

1 Q. What is your recommendation regarding the level of gross synergy
2 savings from the proposed Transaction?
3 A. First, the Commission should not give any weight to the gross synergy
4 estimates provided by Mercer as part of the Petitioners' filings in this
5 proceeding in the absence of a full reconciliation and explanation of the
6 differences between those estimates and the forecasts presented to
7 National Grid's board of directors. Second, as explained above,
8 **CONFIDENTIAL INFORMATION**.
9
10 If this transaction
11 is approved, should be used as the estimate of gross annual
12 synergy savings associated with the proposed transaction.
13

14 Costs to Achieve
15
16 Q. What costs do Petitioners expect to incur to achieve those merger
17 savings?
18 A. **CONFIDENTIAL INFORMATION**
19
20 In this case, the
21 Companies have estimated that costs to achieve will total $400 million,

1 which according to the Petitioners is comprised of **CONFIDENTIAL**
2 **INFORMATION** and
3 $210 million of non-deductible costs that include fees to bankers and
4 lawyers and compensation to executives. (DPS 11b)
5 The Mercer study estimates simply assume that costs to achieve
6 will be 2.0 times projected annual synergy savings of $200 million, that is,
7 $400 million. Petitioners describe this as a "high-level" estimate, and state
8 that "over the following months, the integration team will address costs to
9 achieve and be able to produce a better estimate of the costs that will
10 ultimately be incurred." (Exhibit 1, p. 17) Petitioners' December 14, 2006
11 testimony updating estimates of merger impacts, does not specifically
12 address the costs to achieve, stating only that using twice the level of
13 savings "is appropriate for this transaction." (Testimony of Mr. Feibelman
14 and Mr. Levin, December 14, 2006, p. 10)
15
16 Q. Do you have any concerns about the Petitioners' estimate of costs to
17 achieve?
18 A. Yes. As stated above, $210 million of the estimated costs to achieve are
19 for fees to bankers and lawyers ($75 million), and for executive
20 compensation including "golden parachutes" ($60 million) and "options"
21 ($75 million). (DPS 11b) Costs for bankers and lawyers represent

1 transaction costs that are incurred to protect shareholder interests. These
2 shareholders have already received the benefit of a substantial increase in
3 the Company's stock price since just before the merger was announced,
4 and under the Petitioner's proposal **CONFIDENTIAL INFORMATION**
5
6 and a substantial
7 portion of savings allocated to regulated operations in New York.
8 Accordingly, consistent with Commission precedent, costs incurred to
9 secure approval of the merger should be borne entirely by shareholders.
10 (See, e.g., Case 99-C-0530, Joint Petition of Global Crossing, Ltd. And
11 Frontier Corporation for Approval of the Acquisition by Global Crossing
12 Ltd. Of all the Outstanding Shares of Frontier Corporation's Common
13 Stock, Order Approving Petition, December 1, 1999, p. 8**)** Nor should
14 ratepayers pay the $135 million in "golden parachutes" and additional
15 stock options for executives associated with the merger.
16 The CPB is also concerned that Mercer's high-level estimate of
17 costs to achieve of 2.0 times annual savings after the phase-in period, is
18 inconsistent with the actual results of the merger between National Grid
19 and Niagara Mohawk. In that case, actual costs to achieve were 1.48
20 times realized annual savings after the phase-in period. (Calculated from
21 CPB-17) Assuming annual merger savings of $200 million, use of the

1 1.48 factor from the National Grid/Niagara Mohawk merger would result in
2 costs to achieve of $295.5 million, or 26% less than Mercer's high-level
3 estimate.
4
5 Q. What is the CPB's recommendation regarding costs to achieve?
6 A. As with the estimate of synergy savings, the Petitioners have not provided
7 the type of reliable and verifiable projections of the costs to achieve
8 estimated merger savings that would serve as the basis for a decision on
9 rate levels in this proceeding. Based on available information, the CPB
10 recommends that rates be established by using as a starting point, an
11 estimate of total costs to achieve of no more than $276 million (before
12 taxes), rather than the $400 million proposed by the Petitioners. The $276
13 million estimate is based on the Petitioners' workpapers after excluding
14 transaction costs and executive compensation associated with the
15 Transaction.
16 In addition, costs to achieve should be recovered over a relatively
17 long time period because savings from the merger will continue
18 indefinitely. A longer amortization period provides a better matching of
19 cost responsibility with benefits received. Although the ten-year rate plan
20 proposed by the Petitioners is not in the public interest as explained in

1 Part II, amortizing costs to achieve over a relatively long period of time
2 such as 10 years would be appropriate.

3 Timing of Synergy Savings
4
5 Q. When will savings from the merger be achieved, according to Petitioners?
6 A. Petitioners' calculation of gross synergy savings reflects a four-year
7 phase-in during which 50%, 67% and 83% of total projected synergy
8 savings will be realized at the end of each of the first three years. (Joint
9 Petition Exhibit 2, page 4) These phase-in factors are not based on any
10 study or analysis of the proposed merger. They simply reflect
11 assumptions used in the settlement that resolved the merger between
12 National Grid and Niagara Mohawk. (CPB-17) According to the
13 Petitioners, those phase-in factors represent a "reasonable time line of
14 when the savings will be delivered," and will be updated by the integration
15 team. (Id.) Petitioners' December 14, 2006 testimony did not provide any
16 additional information regarding the timing of synergy savings.
17
18 Q. Do you have any concerns about these estimates?
19 A. Yes. The Petitioners have significantly underestimated the speed with
20 which synergy savings are likely to be achieved in this case, based on
21 actual results in the merger between National Grid and Niagara Mohawk.

1 By the end of the second year after consummation of that merger,
2 National Grid had actually achieved 78% of projected steady-state
3 savings, and the full amount of those savings were achieved by the end of
4 the third year. (Exhibit 1, workpapers, page labeled "Ramp Up") If
5 anything, it is reasonable to expect that the National Grid merger
6 integration team would be able to identify and implement savings for the
7 proposed Transaction more readily than in this case than it did in the
8 Niagara Mohawk transaction, given the experience it has gained.

9 If the actual results achieved in the merger between National Grid
10 and Niagara Mohawk are ignored, it is likely that the phase-in factors
11 proposed in this proceeding will permit the Petitioners to retain a
12 significant portion of savings that should be allocated to ratepayers. The
13 CPB recommends that the phase-in percentages for synergies achieved in
14 the merger between National Grid and Niagara Mohawk be used in this
15 proceeding to develop the savings to be allocated to KEDNY and KEDLI
16 customers.

17

18 Sharing of Net Synergy Savings

19

20 Q. What share of net synergy savings will be allocated to ratepayers?

1 A. For Niagara Mohawk, Petitioners propose to follow the terms of the
2 existing Rate Plan, under which shareholders would be permitted to retain
3 50% of net merger savings for the next five years. For KeySpan,
4 Petitioners assert that shareholders should be permitted to retain 50% of
5 merger savings for ten years. (Testimony of Mr. Laflamme and Mr.
6 Molloy, p. 15)
7
8 Q. What is the CPB's position on this matter?
9 A. The PSC's Order in Case 01-M-0075 dictates the sharing of savings from
10 "follow-on" mergers between shareholders and ratepayers of Niagara
11 Mohawk, and Petitioners agree to abide by that Order. Their proposal
12 concerning the savings allocation between KeySpan and its customers, on
13 the other hand, is substantially less beneficial to ratepayers, is
14 inconsistent with what would occur in a competitive market, and is,
15 therefore, unreasonable.
16 In a competitive market, firms undertake measures, such as
17 mergers, to reduce costs and enhance their ability to compete.
18 Competition ensures that firms adopt those measures, and that the price
19 of the firms' output reflects the resulting lower costs. Firms that do not
20 adopt industry-standard cost savings measures and do not reduce their
21 prices accordingly, lose market share and profitability. In a competitive

1 market, synergies and efficiencies from a merger would be retained by
2 shareholders only to the extent that they are not replicated by competitors.
3 Once cost savings adopted by one firm are replicated by others,
4 competitive forces place downward pressure on prices until prices reflect
5 the full amount of the cost reductions. Therefore, firms that are first to
6 adopt new cost savings will be able to retain them longer than firms that
7 are slow to adopt those savings.

8 To approximate what would occur in a competitive market, it is
9 reasonable for regulators to provide an incentive for utilities to adopt cost
10 savings measures by permitting them to retain a portion of the savings for
11 some period. In the context of my other recommendations regarding the
12 financial benefit of the proposed Transaction, the provisions of the
13 National Grid-Niagara Mohawk merger agreement allowing shareholders
14 to retain 50% of savings for up to five years, are reasonable.
15

16 Allocation of Net Synergy Savings
17
18 Q. How do Petitioners' propose to allocate net synergy savings among its
19 various entities?
20 A. Petitioners propose to allocate the net synergy savings among operating
21 Companies based on 2004 delivery revenues for the regulated entities

1 and LIPA, and on administrative and general expense for unregulated
2 operations such as non-LIPA generation. (Testimony of Mr. Lawrence J.
3 Reilly and Mr. Steven L. Zelkowitz, p. 20) Under that approach, KEDNY
4 and KEDLI would be allocated 13.27% and 7.88% of net synergies,
5 respectively, and Niagara Mohawk Power Corporation's electric and gas
6 operations would be allocated 19.72% and 5.09% of net synergies,
7 respectively. (Joint Petition, Exhibit 2, page 2) Overall, 45.95% of total
8 projected net synergies would be allocated to New York's regulated
9 operations.
10
11 Q. What is the CPB's position on that proposal?
12 A. Petitioners have a powerful incentive to understate the portion of net
13 synergies allocated to their regulated operations in New York because
14 **CONFIDENTIAL INFORMATION**
15
16
17
18
19
20 Those
21 operations account for 26.24% of 2004 delivery revenue for combined

1 National Grid and KeySpan Companies. **CONFIDENTIAL**
2 **INFORMATION**
3
4 The Rhode Island and LIPA
5 operations account for 27.81% of 2004 delivery revenues.
6 National Grid fully understands the advantage of understating the
7 portion of net synergy savings allocated to regulated operations in New
8 York.
9
10
11
12
13
14
15
16
17
18 In their regulatory filing in this proceeding, by contrast, Petitioners
19 used delivery revenues as their allocator for savings and, in a study that
20 included LIPA and unregulated operations, they concluded that only
21 45.95% of net synergies should be allocated to regulated operations in

1 New York. Using the Petitioners' assumptions regarding the magnitude of
2 net synergies, phase-in factors, and the percentage of savings shared with
3 customers, Petitioners' decision to change the allocator from
4 to delivery revenues would effectively shift $131.4 million (over
5 10 years) from New York ratepayers to shareholders.
6 The rate plan in Case 01-M-0075 (National Grid USA and Niagara
7 Mohawk Joint Proposal, Attachment 10) specifies the methodology to be
8 used to allocate synergy savings to the old Niagara Mohawk operations. It
9 does not specify the allocation of those savings to other operations such
10 as KEDNY or KEDLI. The CPB recommends that **CONFIDENTIAL**
11 **INFORMATION**
12
13
14 Q. Please summarize the CPB's position on the Petitioners' proposals
15 regarding the synergy savings to be used to benefit ratepayers.
16 A. As explained above, Petitioners' proposals are based on estimates and
17 assumptions that would have the effect of unreasonably shifting net
18 synergy savings from consumers to shareholders. The PSC should
19 modify those proposals to ensure that ratepayers achieve a fair portion of
20 these net savings.
21

1 Gas Supply Savings
2
3 Q. What merger synergy savings related to gas supply do the Petitioners
4 project?
5 A. Petitioners' witnesses Ms. Melissa Nairn and Mr. Lee Klosowski have
6 projected $146 million in gas supply cost savings over ten years, derived
7 from two sources: (1) reduction of KeySpan's peak day reserve margin
8 from 5% to 2.5%, and (2) utilization of 60,000 dekatherms per day (Dt/d)
9 of pipeline capacity held by National Grid to partially offset incremental
10 capacity requirements generated by future load growth. (Testimony of
11 Witnesses Nairn and Klosowski, pp. 4 – 5)
12
13 Q. Do you agree that these savings should be considered a benefit of the
14 proposed merger?
15 A. Absolutely not. These savings, and more, can and should be achieved by
16 KeySpan under any circumstances. They are completely irrelevant to any
17 determination of whether the proposed merger is in the public interest,
18 because no merger is required for their realization.
19
20 Q. What is the significance of KeySpan's proposed reduction in its peak day
21 reserve?

1 A. As I discussed in my testimony in the stand-alone rate case phase of this
2 proceeding, KeySpan calculates its peak gas supply requirements based
3 on a day with an average temperature of 0º F. and 13 mile-per-hour winds,
4 that follows a day with an average temperature of 5º F. (Elfner testimony,
5 January 29, 2007, pp. 5 – 9) It then increases the calculated requirement
6 by 5%. This 5% surplus is referred to as the peak day reserve. The
7 capacity and supply maintained by KeySpan to meet this reserve
8 requirement are funded by ratepayers through the Monthly Cost of Gas
9 Adjustment. Reducing the requirement by half will, at least approximately,
10 cut the cost to ratepayers of the peak day reserve in two.
11
12 Q. Why do you contend that these savings should not be attributed to the
13 proposed merger?
14 A. First, if KeySpan's peak day reserve were actually required for supply
15 security, there would be nothing that National Grid could do to provide it.
16 Unlike KeySpan, National Grid maintains only as much capacity and
17 supply as it needs to meet its requirements under design day weather
18 conditions. It does not add a peak day reserve. (CPB-20) Consequently,
19 on days when both utilities experience peak conditions, National Grid
20 cannot provide mutual assistance to KeySpan. Such days occurred in 8 of
21 the last 36 years, or about 22% of the time. (DPS-182) National Grid

1 cannot be treated as a reliable source of supply for KeySpan's peak
2 requirements, and the merger contributes nothing to the utility's peak day
3 supply security.
4 More importantly, as I discussed in my January 29, 2007 testimony,
5 neither a 5% reserve nor a 2.5% reserve is necessary under any
6 circumstances. By planning for a 0º peak day, KeySpan assures that it
7 will have a supply cushion of nearly 5% even if it experiences a repeat of
8 the coldest day its system has seen in the last 36 years. Adding a 5%
9 reserve on top of that cushion is completely unnecessary. Ratepayers
10 should not be required to pay for that reserve, with or without a merger.
11
12 Q. What National Grid capacity does KeySpan say it will be able to utilize
13 after the merger?
14 A. Witnesses Nairn and Klosowski say that KeySpan will gain access to
15 60,000 Dt of capacity that National Grid currently has under contract, but
16 only expects to need on the 20 coldest days of the year. On all other
17 days, this capacity can be released to KeySpan and will permit the
18 Company to deliver gas to Leidy, Pennsylvania, where it can be moved to
19 the New York City gate using capacity already owned by KeySpan.
20 (Testimony of Nairn and Klosowski, pp. 6 – 7)
21

1 Q. Why is this not a benefit of the merger?

2 A. Because it is a straightforward commercial transaction that could be
3 entered into at any time between the companies whether they were
4 affiliated or not. Witnesses Nairn and Klosowski acknowledge as much in
5 their response to CPB-19 in which they state that "Capacity release and
6 sale-for-resale transactions can theoretically be conducted between
7 [Keyspan] and National Grid without a merger." They go on to argue that
8 the proposed Leidy transaction would require National Grid to make a
9 long-term contractual commitment at increased cost and that, "Absent the
10 merger, National Grid would not enter into such an agreement with
11 [Dominion Transmission, Inc.] for a project whose benefit is primarily to
12 meet the load growth in KeySpan's territory." If anything, this contention
13 suggests that the merger, in the case of this transaction at least, will be
14 detrimental to National Grid ratepayers. That is because it implies that
15 KeySpan, as a separate utility, is unwilling or unable to pay enough to
16 persuade National Grid that its ratepayers will be adequately
17 compensated for the use of their capacity, but that if the merger is
18 consummated, that concern will no longer exist. The combination would
19 eliminate the arms-length bargaining between independent entities that
20 normally helps to assure that a transaction is structured to protect the
21 interests of both companies' ratepayers.

1

2 **PART IV: OTHER ALLEGED BENEFITS OF THE PROPOSED**
3 **TRANSACTION**

4 Avoidance of Rate Increases for KEDNY AND KEDLI
5
6 Q. Please summarize the Petitioners' assertions regarding the rate increases
7 for KEDNY and KEDLI that would be avoided if the proposed Transaction
8 is approved.
9 A. Petitioners contend that the rate plans associated with the proposed
10 Transaction would postpone and moderate the delivery rate increases
11 contained in the stand-alone rate filings. (Testimony of Mr. Reilly and Mr.
12 Zelkowitz, p. 24)
13
14 Q. Is that a valuable benefit?
15 A. No. CPB, DPS Staff and other parties filed testimony in the stand-alone
16 rate cases which demonstrates that KEDNY and KEDLI have substantially
17 overstated their revenue requirement and the need for delivery rate
18 increases. Taken together, the adjustments recommended by these
19 parties would eliminate the vast majority of the revenue requirement
20 increases requested by those Companies. Petitioners' claims that the rate
21 plans associated with the proposed Transaction benefit consumers

1 because they postpone and moderate the proposed stand-alone rate
2 increases, are overstated.

3 Other Public Benefits
4
5 Q. Please summarize the Petitioners' claims regarding the other public
6 interest benefits that would be obtained if the Transaction is approved.
7 A. The Petitioners assert that approval of the proposed Transaction would
8 provide additional public benefits including: (1) enhancements of programs
9 to promote competition in retail energy markets; (2) new demand-side
10 management programs; (3) a measure to reduce existing disincentives for
11 utilities to encourage conservation; (4) expanded low-income discount rate
12 programs and (5) maintained service quality. (Testimony of Mr. Reilly and
13 Mr. Zelkowitz, pp. 25-26)
14
15 Q. Do these asserted benefits provide support for a finding that the proposed
16 Transaction is in the public interest?
17 A. No. These proposals have no intrinsic relationship to the Transaction.
18 They do not depend upon, or result from, the proposed merger, but rather
19 from policy considerations that could be addressed in the pending rate
20 cases. If the proposals will, in fact, generate benefits for ratepayers, they

1 can, and should, be implemented by KeySpan whether or not the
2 Transaction is approved by the PSC.
3
4 Q. Do you have any other comments on the Petitioners' claims regarding
5 these five areas of public benefits?
6 A. Yes. The Petitioners' assertions that enhancing certain programs to
7 promote retail energy competition would provide additional public benefits,
8 was rebutted in my January 29, 2007 testimony. (Elfner Testimony, pp.
9 16-19) I also addressed in that testimony, the Applicants' proposals
10 regarding new demand-side management programs and a measure to
11 reduce existing disincentives for utilities to engage in conservation. (Id.,
12 pp. 19 – 25)
13
14 Q. Please summarize the Applicants' proposal regarding rates for low-income
15 customers.
16 A. As part of the Rate Plan associated with the proposed Transaction, the
17 Petitioners would increase the low-income discount for KEDNY customers
18 to $3.50 per month for non-heating customers and $7.50 per month for
19 heating customers, and would implement those same discounts for
20 KEDLI's low income customers. Discounts would be provided for up to
21 60,000 and 30,000 customers eligible for the Low Income Heating

1 Assistance Program in KEDNY's and KEDLI's service territories,
2 respectively. The increased costs of these programs would be recovered
3 from ratepayers through the Balancing Account. (Petition and Exhibits,
4 July 20, 2006, pp. 137, 190)
5
6 Q. What is the CPB's position on this matter?
7 A. The Petitioners have correctly recognized the need to provide additional
8 economic assistance to their low-income customers. However, those
9 additional consumer benefits are not contingent upon PSC approval of the
10 proposed Transaction. The Commission could order KEDNY and KEDLI
11 to adopt such programs as part of a stand-alone rate case, or at any time
12 on its own motion. In addition, as fully explained in the January 29, 2007
13 testimony of CPB witness Ms. Donna M. DeVito, the Petitioners' proposal
14 regarding assistance to low-income customers does not go far enough in
15 providing appropriate assistance to KEDNY's and KEDLI's most
16 economically disadvantaged customers.
17 The CPB recommends that the low-income assistance programs
18 identified in the January 29, 2007 testimony of CPB witness Ms. DeVito,
19 be adopted regardless of whether the proposed Transaction is approved.
20

1 Q. Please summarize the Petitioners' proposals regarding the service quality
2 benefits that would derive from approval of the proposed Transaction and
3 explain the CPB's position on that issue.
4 A. The Petitioners propose to maintain KEDNY's and KEDLI's existing
5 service quality performance mechanism throughout the ten-year rate plan.
6 That mechanism measures the level of customer complaints to the
7 Commission and the level of customer satisfaction as shown by a
8 contractor survey. Under those programs, KEDNY and KEDLI are each
9 subject to penalties of up to 40 basis points of pretax return on common
10 equity if service standards are not met. (Petition and Exhibits, July 20,
11 2006, pp. 136-137; 188-190)
12 As with other programs discussed above, the consumer benefits of
13 this service quality performance mechanism could be achieved in the
14 absence of the proposed Transaction. Indeed, since the Petitioners
15 propose to continue a mechanism that is part of the current rate plans for
16 KEDNY and KEDLI, the proposed Transaction offers nothing new at all,
17 other than removal of the threat that the program could be discontinued.
18 In addition, it is noteworthy that the Petitioners' proposal to maintain
19 existing service quality performance mechanisms does not ensure that
20 service quality will be maintained, contrary to their assertions. For the
21 reasons explained in the January 29, 2007 testimony of CPB witness Ms.

1 DeVito, enhancements to the existing service quality mechanisms are
2 required whether or not the Transaction is approved. Moreover, if the
3 proposed Transaction is approved, additional service quality protections
4 are required to protect consumers, as explained in Part II, infra.
5
6 Q. Do you have any other recommendations regarding the proposed
7 Transaction?
8 A. Yes. If the Transaction is approved, the PSC should initiate an audit of
9 KEDNY and KEDLI, pursuant to Public Service Law ("PSL") §66(19), in
10 the third year. The PSL requires the Department of Public Service to
11 conduct or oversee management and operations audits of gas
12 corporations such as KEDNY and KEDLI at least once every five years.
13 However, a formal audit of KEDNY or KEDLI has not been conducted in at
14 least 10 years. In addition, the CPB is not aware of any studies or
15 evaluations conducted by DPS Staff or on its behalf since the last audit,
16 which may have reasonably substituted for the formal audit required by
17 the PSL.
18 The audit should focus on construction program planning in relation
19 to the needs of KEDNY and KEDLI customers for reliable service and on
20 the appropriateness of the costs being charged and allocated to KEDNY
21 and KEDLI from various KeySpan Service Companies. Since the

1 Transaction, if approved, would involve significant changes to the
2 management and operations of the KeySpan companies, it is reasonable
3 to postpone commencement of the audit until the transition to a single
4 merged entity is virtually complete.
5
6 Q. Does this conclude your testimony?
7 A. Yes.