STATE OF NEW YORK DEPARTMENT OF PUBLIC SERVICE
THREE EMPIRE STATE PLAZA, ALBANY, NY 12223-1350

Senate Standing Committee on Energy and Telecommunications

National Grid's Accounting and Expense Account Practices and its Effects on Ratepayers

Testimony of the New York State Department of Public Service
Garry A. Brown, Chairman, Public Service Commission
October 19, 2010

Introduction

Good Morning, Chairman Maziarz and Members of the Committee. My name is Garry Brown. I am the Chairman of the Public Service Commission and Chief Executive Officer of the Department of Public Service. With me today are Wayne Brindley, Deputy Director of the Office of Accounting and Finance, and Joseph Lochner, a Chief in the Office of Accounting and Finance. Wayne has responsibility for the Management Audit function at the Department and Joe has responsibility for the rate case and audit processes for Niagara Mohawk. We thank you for the opportunity to discuss our oversight of Niagara Mohawk and National Grid in general and its service charge allocations in particular.

My presentation today touches on three topics: first, some background information on National Grid and Niagara Mohawk and its cost allocation process; second, the investigatory processes undertaken by the Department and others relative to these matters; and third, the implications of this situation on the bills of New York State ratepayers. In providing this testimony today please understand that because the rate case and investigation proceedings are currently pending, I must be circumspect in what I state as I do not want to create any impression that I have pre-judged any issues that I must decide.

The bottom line of my testimony is that there are numerous investigations underway related to this matter both in New York State and elsewhere. In New York, a December 2009 Commission ordered management audit identified potential weaknesses in service company allocations[1], and the Commission is taking steps to strengthen those processes to assure that Niagara Mohawk controls these expenses. The Commission has also commenced a proceeding to further investigate National Grid's cost allocations.[2] Finally, Department Staff reviewing the current Niagara Mohawk rate case raised specific concerns regarding cost allocations; remedies are being considered in that case, which is being briefed to the Administrative Law Judge at this time.[3]

Grid Background

Although we are focused today on Niagara Mohawk, I'd like to put this into a broader context. Niagara Mohawk is one of six major electric utilities and twelve major gas utilities. The Commission also has oversight responsibility for eight large water companies and 40 telephone companies with a combined total annual operating revenue of about $30.4 billion and gross investment in plant of about $70 billion. The Commission also oversees Con Ed's New York City steam service, 330 small water companies, 39 municipal electricity cooperatives, 29 cable companies, and hundreds of competitive telecommunications companies, power generation companies, and energy service companies. So the Commission has a lot on its plate.

National Grid, plc is a large international corporation, headquartered in London and operating principally in the United Kingdom and the United States. Aside from its ownership of Niagara Mohawk, which is the gas and electric utility company in upstate New York, National Grid also owns KeySpan, the gas utility in Brooklyn and Long Island, utilities in Massachusetts, Rhode Island and

---

[1] See Case 08-E-0827, Comprehensive Management Audit of Niagara Mohawk Power Corporation d/b/a National Grid's Electric Business.

[2] Case 10-M-0451, Proceeding on Motion of the Commission to Investigate National Grid Affiliate Cost Allocations, Policies and Procedures.

[3] See Case 10-E-0050, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Niagara Mohawk Power Corporation for Electric Service.

New Hampshire, and performs various utility functions under contract for the Long Island Power Authority. In terms of total customers, National Grid is the second largest electricity and gas utility in the US.

National Grid acquired Niagara Mohawk in 2002 and KeySpan in 2007. When the Commission approves such acquisitions, we typically require the transaction to provide tangible benefits to customers. These benefits often take the form of rate freezes for a period of time, adoption of industry best practices leading to efficiency gains, and synergy savings resulting from consolidation of common functions. For example, the Commission reduced Niagara Mohawk's electric delivery rates by $160M and then froze them at that level for up to 10 years when the Commission approved the merger with National Grid in 2002. At that time, the Commission also extended an existing gas rate freeze by 16 months which ultimately produced no changes in gas delivery rates until May 2009.

The Commission also considered the level of synergy savings from the National Grid merger with Niagara Mohawk and determined that there were about $130 million per year of such savings, with 62% allocated to New York.[4] Synergy savings are produced when functions which had previously been performed at a utility subsidiary level are consolidated at higher levels within the holding company, most often through a service company or holding company. This is accomplished by consolidating common functions that are required by many subsidiaries into one corporate wide service company function. This includes such activities as accounting, purchasing, human resources, taxes, treasury, auditing, engineering, information systems, insurance, and executive costs. When functions are consolidated within holding companies, it is necessary to establish a cost allocation process to assign to each subsidiary its fair share of the underlying costs for functions that the subsidiary had previously performed. Ideally, this produces savings because the overall cost of performing the function at a higher level within the holding company is less than the cost of each

---

[4] Case 01-M-0075, Joint Petition of Niagara Mohawk Holdings, Inc., Niagara Mohawk Power Corporation, National Grid Group plc and National Grid USA for Approval of Merger and Stock Acquisition, Opinion 01-6, Opinion and Order Authorizing Merger and Adopting Rate Plan, issued December 3, 2001 at page 7.

subsidiary individually performing the function. For National Grid, the total amount of costs that are allocated by this process across all of its affiliates was $1.8 billion in 2009.

The cost allocation process which effectuates synergy savings to the benefit of customers can also result in undesirable or inappropriate costs being allocated to subsidiaries to the detriment of customers. This can occur in a number of ways: when non-regulated costs are allocated to a regulated company (for example, when a cost that is incurred by National Grid solely to administer its LIPA contract is allocated to Niagara Mohawk); when utility costs are inappropriately allocated between companies (for example, when a cost that is entirely incurred on behalf of a specific company is allocated to all companies and vice versa); and when inappropriate costs are allocated to ratepayers that should be covered by shareholders (for example, political and charitable contributions).

There is also a built in tendency for a holding company to allocate costs to its subsidiaries that are rate regulated and are better able to pass the costs on to consumers. Businesses with regulated and non-regulated operations always have an economic incentive to allocate the costs to the regulated side of the business, where customers are captive and costs can ultimately be recovered in rates, rather than to allocate the costs to a competitive side of the business where such costs would only reduce profits to shareholders. Similarly, within a utility holding company, there are also incentives to allocate costs away from utilities operating within extended rate plans to utilities with rate cases underway or utilities in states with more liberal cost recovery policies. Our Staff is aware of this bias and reviews these costs during rate cases to ensure costs allocated to the New York utilities are reasonable. This is what occurred in the case of Niagara Mohawk.

These potential detriments of cost allocations, some of which Department staff has documented in Niagara Mohawk's pending rate case, are the genesis as to why I'm testifying before you today. Specifically, there were costs in the rate filing that the Company has admitted should not have been allocated to New York operations.

Investigatory Steps

I would next like to review the investigatory steps already undertaken relative to this matter. The Commission used two tools to uncover and begin to address this issue. First, our Management Audit of Niagara Mohawk electric operations identified cost allocations as a potential problem and made recommendations to remedy the problem going forward. By contrast the subsequent review by the Department's staff of Niagara Mohawk's electric rate case, made with knowledge of the Management Audit's finding, found that the potential future problem was in fact an actual current problem. In short, the analogy I like to use is that the forward-looking management audit process said there's smoke, and the rate case team found the fire. These are separate but complementary processes----and an evolving process.

Management Audit Process

Let me briefly relate the ongoing management audit of Niagara Mohawk's electric operations and where it now stands. In early 2008, the Commission reinvigorated its management audit process. In July 2008, the Commission issued a request for proposals to select an independent management auditor to examine Niagara Mohawk's electric operations. NorthStar Consulting Group was selected.

The primary goal of the audit was to identify opportunities to improve Niagara Mohawk's construction program planning processes and operational efficiency for its electric operations. The approach of the audit was to examine existing functions, processes, systems, organizations, and staffing, as well as past performance, for the purpose of defining changes that will improve prospective performance.

The 192-page audit report, submitted to the Commission by NorthStar in December 2009 is available on the Department's web site,[5] and contains 179 separate findings and 44 specific recommendations on ways the company can improve the management and operation of its electric

[5] http://documents.dps.state.ny.us/public/Common/ViewDoc.aspx?DocRefId={95B9AEEF-5A54-40C1-AC03-00D802088CE8}

services. The report focused on Niagara Mohawk's corporate mission, objectives, goals and planning; load forecasting; supply procurement; system planning; capital and operating and maintenance budgeting; program and project planning and management; work management; and performance and results measurements.

The report included significant findings related to costs that were allocated to Niagara Mohawk by National Grid's service companies. More specifically, NorthStar's analysis found that Niagara Mohawk had no effective means of managing and controlling the level and cost of services provided by the National Grid service companies.

The management audit recommended that Niagara Mohawk enter into Service Level Agreements with the National Grid service companies which would be regularly updated. Service Level Agreements are formal contracts between a supplier and consumer of services. Similar to a contract between an outside vendor and the company, Service Level Agreements provide a mechanism for controlling the services provided by the National Grid service companies. NorthStar stated that such information would better enable Niagara Mohawk to identify, understand, and analyze the services it receives while adding much more transparency to the cost allocation processes. The Commission was very interested in this matter from the start and we requested NorthStar to perform additional work on the matter of Service Level Agreements, before finalizing the Management Audit report issued in December 2009.[6]

Rate Case

At the outset, because the rate case is an open docket before the Commission, I want to again underscore that I am studying the entire record and have reached no conclusions on any specific disputed issues. So while I cannot, at this juncture, comment on the merit or lack thereof of any parties' position on this matter in the rate case, I can give you a thumbnail summary of what is happening in the case. Concerns regarding Niagara Mohawk's control of its service company costs

---

[6] Ibid, at IX-23.

have been raised in the ongoing rate case. The Department Staff found weaknesses in internal controls and an inability by Niagara Mohawk to explain what it is charged for, and raised concerns regarding the nature of costs allocated, the relative allocation percentages and the amount of costs allocated to Niagara Mohawk.

One factor that alerted the rate case team to a potential problem was the increase in overall Service Company costs and increases in Service Company cost allocations to Niagara Mohawk. After adjusting for certain one-time costs, the increase in total Service Company costs was 20%, compared to 1.50% inflation as measured by the GDP deflator. Furthermore, while the overall average increase in service company charges among all Grid companies was 20%, Niagara Mohawk's increase was 33%. The rate case Staff addressed this matter by making a $26 million dollar "macro" adjustment and recommending that an additional investigation be conducted. The management audit process and rate case reviews are presently the best tools we have available to investigate matters such as this. While the Department was able to conduct regular "books and records" audits of major utilities in the past which may have uncovered potential problems earlier, we have not had sufficient resources to pursue this approach for some time.

<u>Other Processes</u>

The management audit and the investigations that are part of the rate case are not the only processes that are ongoing regarding these affiliate transactions. In early 2009, the Federal Energy Regulatory Commission (FERC) began an audit of National Grid's allocation process as part of its normal review process. The FERC audit is evaluating National Grid's compliance with service company allocation methodologies. Also, several New England States have commenced, or are contemplating commencing, proceedings on this matter. Department Staff is in communication with both FERC and the New England states and we will share information and coordinate our efforts in New York with the work of the other States, as appropriate.

In addition, National Grid itself has hired a consultant, Liberty Consulting Group, to review affiliate transactions. Liberty is the same consultant the Commission hired to review New York Telephone's affiliate charges in the early 1990s. National Grid has committed to provide us with access to responses to Liberty data requests, interview notes and the consultants themselves as this audit is conducted.

Next Steps

On September 16, 2010, the Public Service Commission initiated a specific investigation into National Grid's affiliate costs, policies and procedures. We directed Department staff to provide a detailed scoping memorandum for the investigation and a recommendation at the Commission's November 18th meeting to engage an independent auditor.

Our investigation will focus on costs charged to Niagara Mohawk and KeySpan, for service performed by affiliated companies, and on the procedures used to allocate common expenses among the various National Grid companies. Specifically, the objectives of the Commission's investigation are three-fold: first, to ensure that no past, present or future customers of National Grid pay for inappropriate costs; second, to ascertain whether past costs were capitalized or included in deferrals and inappropriately allocated to Niagara Mohawk, thus setting the stage for future rate recovery from customers; and third, to ascertain whether changes that National Grid has already made, and will put in place as a result of the investigation, are adequate to mitigate future problems relative to affiliate issues.

Customer Impact

The bottom line question that I am sure many of you are thinking about is the extent to which these potential problems have resulted in higher than necessary customer bills. It is a legitimate question that the investigation will examine for both the electric and gas operations, both retrospectively and prospectively.

As you'd expect, the Commission is keenly interested in safeguarding and protecting consumers in this regard. During the pendency of our investigation, the Commission has at its disposal a variety of remedies all of which would assure that ratepayers are protected until such time as the cost allocation matters now before us are resolved. Those remedies are under consideration in the on-going electric rate case and interested parties may comment on proposals to protect ratepayers' interests. Again, because the precise mechanism used to protect ratepayers is an issue in the rate case, I prefer not to go into the details of any particular approach, but rather simply make sure you know that there will be protections going forward as long as necessary.

Conclusion

In summary, cost allocations are necessary for utility holding companies like National Grid or Iberdrola. They are in fact a means by which customers can benefit from the consolidation of corporate functions. However, utilities and regulators must be vigilant to assure that inappropriate charges are not passed through to customers in rate cases. There are numerous investigations underway related to this matter both in New York State and elsewhere. In New York, the management audit identified potential weaknesses in service company allocations, and we are taking steps to strengthen those processes to assure that Niagara Mohawk controls these expenses. The Commission has also commenced a proceeding to further drill down into the specifics of National Grid's cost allocations. Finally, remedies are being considered in the current rate case which is being briefed to the Administrative Law Judge at this time.

This concludes my prepared remarks. We are happy to answer any questions you may have.