BEFORE THE
STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

In the Matter of

Niagara Mohawk Power Corporation

Cases 12-E-0201 and 12-G-0202

August 2012

Prepared Testimony of:

Staff Accounting Panel - Corrected

Richard M. Davi
Allison A. Esposito
Denise A. Gerbsch
Gerry W. Wojcinski

State of New York
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Q. Staff Accounting Panel, would you please state your names and business addresses.

A. Richard M. Davi, Allison A. Esposito, Denise A. Gerbsch, Gerry W. Wojcinksi. Our business address is New York State Department of Public Service (DPS), 3 Empire State Plaza, Albany, NY 12223.

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

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

Q. Ms. Esposito, by whom are you employed and in what capacity?

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

Q. Ms. Gerbsch, by whom are you employed and in what capacity?

A. I am employed by the Department of Public Service as a Supervisor – Utility Accounting & Finance in the Office of Accounting and Finance.

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

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

Q. Mr. Davi, please summarize your education and work experience.

A. I received a Bachelor of Business Administration, with a concentration in Accounting, from Siena College in 1986. I am a certified public accountant in New York State. From 1986 to 1989 I was employed as a staff accountant for a local accounting firm. In May 1989, I joined the Department of Public Service in the Office of Accounting and Finance where I have been employed for the past 23 years. I have testified in numerous rate proceedings before the Commission regarding various revenue requirement and ratemaking issues, including rate of return. The list of cases includes Case 08-G-0609, the Company's most recent gas case.

Q. Ms. Esposito, please summarize your education and work experience.

A. I received a Master's degree in Accounting in 2004 from the State University of New York at Albany. I also received a Bachelor's degree in

Government from Cornell University in 2001. I am a certified public accountant in New York State. From July 2004 through May 2007, I worked as an auditor for PricewaterhouseCoopers in Albany, NY. In this position, I performed financial statement audits and Sarbanes-Oxley compliance audits for a number of companies in various industries. From May 2007 through May 2008, I supervised the expenses' department at the Golub Corporation in Schenectady, NY. I joined the Department of Public Service in May 2008. Since that time, I have testified in Case 08-G-1392, St. Lawrence Gas, and Case 10-E-0050, Niagara Mohawk Power Corporation.

Q. Ms. Gerbsch, would you please summarize your education and work experience.

A. I graduated from the State University of New York at Oswego in May 1988 with a Bachelor of Science degree in Accounting. Since June 1988, I have been employed by the Department of Public Service in the Office of Accounting and Finance. During this 24 year period, the vast majority of my time has been spent on accounting and ratemaking issues involving Niagara Mohawk, including rate cases, deferral petitions, fuel adjustment clause audits, commodity adjustment clause audits, transmission revenue adjustment clause audits, financings, refunds, and retail access issues. I also testified in Cases 08-G-0609 and 10-E-0050, the Company’s most recent gas and electric cases.

Q. Mr. Wojcinski, please summarize your education and work experience.

A. I graduated from Canisius College in 1972 with a Bachelors Degree in Business Administration, with a major in Accounting. From January 1973 to April 1974, I was employed as an Assistant to the Comptroller at the Wurlitzer Company. Thereafter, I joined the Staff of the Department of Public Service. Since that time I have participated in numerous utility accounting examinations including rate proceedings, finance cases and a merger. More recently, I have submitted testimony in the following rate proceedings: Case 07-G-0141, National Fuel Gas Distribution Corporation – Gas Rates, Case 08-G-0609, Niagara Mohawk Power Corporation – Gas Rates and in Case 08-G-1392 St Lawrence Gas

Company Inc.

Q. Panel, what is the scope of your testimony in this proceeding?

A. We are testifying on: (1) numerous expense cost components; (2) taxes other than income taxes; (3) the Company’s forecast of pre-rate year regulatory deferrals and the deferrals the Company has requested for the rate year ending March 31, 2014, and (4) service company issues associated with Niagara Mohawk. In terms of presentation and organization, we will address and discuss the issues in a manner which best follows the Company’s income statement in Exhibit ___(RRP-1CU), with any revenue issues addressed first, followed by expenses, etc. However, we note that there are some revenue, expense and rate base issues that overlap or are related to one another. In those instances, we will group the issues together rather than following the Company’s income statement. We will also include an additional “Miscellaneous” expense cost component to the Company’s income statement for those Staff adjustments which involve more than one cost component.

In addition, we are sponsoring Staff's overall revenue requirement exhibit.

Q. How many exhibits are you sponsoring?

A. We are sponsoring five exhibits.

Q. Would you briefly describe Exhibit ___(SAP-1 Corrected)?

A. Exhibit ___(SAP-1 Corrected) is Staff's rate year electric cost of service presentation, consisting of six schedules. Schedule 1 summarizes Staff's projection of electric operating income, rate base and rate of return for the rate year ending March 31, 2014. Schedule 1 is supported by Schedules 2 through 6.

Q. Please describe the format of Schedule 1.

A. Column 1 of Schedule 1 contains the rate year income statement, rate base and rate of return figures per Exhibit ___(RRP-1CU) of the Company's Corrections and Updates filing, before any required base rate increase. Column 2 contains Staff's proposed adjustments to the Company's rate year projections. Column 3 presents Staff's as adjusted rate year projections before any required base rate increase. Column 4 contains Staff’s proposed overall revenue requirement adjustment. Column 5 is Staff’s forecasted rate year income, expenses, rate base and rate of return after the revenue requirement decrease is reflected.

Q. What information is shown on Schedules 2, 3 and 4 of Exhibit ___(SAP-1 Corrected)?

A. Schedule 2 breaks down Staff’s forecast of rate year electric O&M expense by cost element, similar to the Company’s Exhibit ___(RRP-3CU). Schedule 3 shows Staff’s forecast of rate year electric federal income taxes, similar to the Company’s Exhibit ___(RRP-6CU). Schedule 4 presents Staff’s forecast of rate year rate base, by component, similar to the Company’s Exhibit ___(RRP-7CU).

Q. What information is shown on the remaining two schedules of Exhibit ___(SAP-1 Corrected)?

A. Schedule 5 provides the derivation of Staff’s recommended rate year weighted cost of capital, and Schedule 6 is a summary level description of each of Staff’s electric revenue, expense and rate base adjustments.

Q. Would you briefly describe Exhibit ___(SAP-2)?

A. Exhibit __(SAP)-2 is Staff’s rate year gas cost of service presentation, consisting of six schedules. Similar to Exhibit __(SAP-1 Corrected), Schedule 1 summarizes Staff’s projection of gas operating income, rate base and rate of return for the rate year ending March 31, 2014. Schedule 1 is supported by Schedules 2 through 6.

Q. Please describe Exhibits ___(SAP-3) and (SAP-3conf)?

A. Exhibit__ (SAP-3) contains the information requests, IR, responses referenced in the Staff Accounting Panel testimony as well as in the testimony of all other Staff witnesses and Staff panels. Exhibit __(SAP-3Conf),includes the confidential IR responses referenced in Staff’s testimony.

Q. How are IRs numbered in your testimony and in your exhibits?

A. In our testimony, as well as in the testimony and exhibits of all Staff witnesses and Staff panels, when reference is made to an IR, both the DPS and the Staff assigned IR number will be provided in the following manner, using Ms.

Gerbsch’s twenty-second IR for illustration purposes: DPS-149 (DAG-22). In our Exhibit ___(SAP-3), the Company’s IR responses are in DPS numerical order.

Q. Have you included the Company's entire responses to the various IRs in your exhibits?

A. Not in all cases. Due to the voluminous nature of some of the responses, we have only included those pages of the responses we deemed relevant. To the extent the Company or any other party believes we may have omitted anything of further relevance, they can supplement the record with the additional information. This also applies to the IR responses referenced in the testimony of all Staff witnesses and Staff panels.

Q. Please briefly describe Exhibit __(SAP-4).

A. Exhibit ___(SAP-4) is a compilation of Staff’s workpapers used to support our proposed adjustments.

Q. Would you briefly describe Staff’s audit of the Company’s filing in this rate case?

A. Staff conducted a rigorous audit within the timeframe allowed in this case. We reviewed the company’s voluminous filings, submitted over 500

IRs, many of which contained multiple parts, and we held numerous meetings with Company employees to gain greater clarity on a multitude of different issues.

Q. Would you please summarize Staff's recommendation regarding the Company's requested electric revenue requirement?

A. In its April 27, 2012 initial filing, the Company requested a $130.7 million base rate increase. In its July 16, 2012 Corrections and Updates filing, the Company increased its requested base rate increase to $145.4 million, as stated on page 3 of the Company's Revenue Requirements Panel's supplemental testimony. Staff is recommending an electric base rate increase of approximately $18 million, or approximately $128 million less in revenues than the amount requested by the Company. Exhibit ___(SAP-1 Corrected), Schedule 6 lists every adjustment Staff is proposing that makes up this $128 million revenue requirement differential, with the exception of Staff's return on equity and capital structure adjustments.

Q. Would you please summarize Staff's

recommendation regarding the Company's requested gas revenue requirement?

A. In its April 27, 2012 initial filing, the Company requested a $24.516 million base rate increase, offset by an amortization of net gas deferral credits of $14.104 million, for a net base gas delivery rate increase of $10.412 million. In its July 16, 2012 Corrections and Updates filing, the Company increased its requested gas base rate increase to $28.984 million, as stated on page 3 of the Company's Revenue Requirements Panel's supplemental testimony. This amount is again offset by the amortization of net gas deferral credits, an amount updated to $14.381 million, resulting in a net base delivery rate increase of $14.603 million. Staff is recommending a gas base rate decrease of approximately $13 million, or approximately $42 million less in revenues than the amount requested by the Company. At this time, Staff recommends no amortization of the projected deferred credit balance of $41 million as shown on Exhibit __ (RRP-7CU). If however, the Commission's ultimate decision results in a rate increase, we would recommend amortizing a portion of the deferred credit balance as an offset. Exhibit ___(SAP-2), Schedule 6 lists every adjustment Staff is proposing that makes up this $42 million revenue requirement differential, with the exception of Staff's return on equity and capital structure adjustments.

Q. Would you briefly summarize the major reasons for the $128 million difference in the electric rate year revenue requirement?

A. The largest difference, by far, is due to the Company's request for a 10.55% return on equity and an equity ratio of 51%, compared to Staff's recommended 8.9% return on equity and 48.0% equity ratio. We estimate these cost of money issues account for approximately $80 million of the $128 million difference. Other major differences include: (1) $12 million related to Staff's labor expense recommendations; (2) approximately $8 million for Staff's property tax recommendations; and (3) approximately $7 million related to the uncollectibles accounts expense allowance.

Q. Would you briefly summarize the major reasons for the $42 million difference in the gas rate year revenue requirement?

A. Again, the largest difference, by far, is due to the Company’s request for a 10.55% return on equity and an equity ratio of 51%, compared to Staff’s recommended 8.9% return on equity and 48.0% equity ratio. We estimate these cost of money issues account for approximately $20 million of the $40 million difference. Other major differences include: (1) $6 million for Staff’s depreciation expense adjustment; (2) $2 million related to Staff’s labor expense recommendations; (3) approximately $2 million for Staff’s property tax recommendations; and (4) approximately $5 million related to uncollectible accounts expense allowance.

Q. Do you have any general comment on the Company’s filing?

A. Yes. While overall the Company’s April 27, 2012 rate filing was adequate in presentation and support, there are some specifically identifiable areas the Company needs to improve on in future rate filings. Three such areas are, (1) review of historic test year costs, (2) Information Services (IS) historic year costs and projected future costs, and (3) federal and state income tax historic year and projected rate year expenses. In each of these areas, we had difficulties in auditing the Company's rate year request. With respect to historic year costs, there were some cost areas where, only after Staff began its auditing and review process, it became apparent the Company had not undertaken the necessary proper review to determine whether the historic test year actual costs needed to be normalized or not in formulating the rate year projections. Two very clear examples are the IS Transformation and expatriate costs, which are both addressed in detail in the testimony that follows.

Q. Please continue.

A. Another example relates to the federal and state income tax expense areas, where the Company failed to provide the detailed historic and link period information needed for us to determine if the rate year level is correct. This is basic information the Company should know is necessary in order for us to understand and verify its calculations. Instead, several IRs were needed to obtain this basic data. We remind the Company it should be including in its rate filing, historic test year balance sheets, income statements, and complete federal and state income tax calculations. This would include detailed information for all items such as Schedule M deductions and additions, tax rates applicable to derive taxable income and tax expense, deferred tax expense items that reconcile to Schedule M items, etc.

Q. Would you please begin explaining your proposed adjustments to the Company's rate case filing?

A. Yes. We will address the issues in the sequential order we previously described.

I. Expenses

A. Consultant Expense

Q. Are you making adjustments to cost element #100 Consultant expense?

A. Yes, we are recommending four normalizing adjustments be made to the rate year projection of Consultant O&M expense for charges incurred in the historic test year that, after review, appear to be one-time expenses and not of a recurring nature.

Q. What information did Staff rely upon to derive the normalization adjustments recommendation?

A. Staff used the information provided by the Company in its response to IRs DPS-88 (DAG-8), DPS-446 (DAG-59), and DPS-452 (DAG-62).

Q. What did the Company's responses to IR DPS-88 (DAG-8), DPS-446 (DAG-59), and DPS-452 (DAG-62) consist of?

A. As can be seen from the Company's Revenue Requirements Panel's Exhibit __ (RRP-3CU) Schedule 1, Page 5 of 5, in deriving the rate year forecast, the Company begins with the historic test year actual and removes charges considered non-recurring through the test year analysis review, and also normalizes out various buckets of costs that are included in other cost elements presented on the income statement, such as SBC costs, legal expense, accounting expenses, etc. The Company then applies an inflation factor of 4.2785% to the remaining normalized historic test year base to determine the rate year forecast. IR DPS-88 (DAG-8) asked the Company to provide detailed cost information, i.e. by activity number, by vendor, and by individual journal entries, for each of the cost buckets that were normalized out, as well as the remaining bucket of historic year consultant expenses that the inflation factor gets applied to. The historic test year charges that remain are shown in the Company's response to IR DPS-88 (DAG-8) Attachment 7. We then followed up with IRs DPS-446 (DAG-59) and DPS-452 (DAG-62) and requested the Company provide the detail for a list of sample charges derived from the Company's earlier response to IR DPS-88 (DAG-8).

Q. Please explain your first adjustment.

A. The Company's response to IR DPS-446 (DAG-59) identifies as being normalized and removed from the historic test year charges from Overland Consulting Inc. for work performed on the audit of National Grid's affiliate cost allocations, policies and procedures from Case 10-M-0451. Although the Company is correct that it removed some of the historic year Overland Consulting charges, based on the Company's response to IR DPS-88 (DAG-8), Attachment 7, there remains a portion of Overland charges in the historic test year base. Specifically, costs related to Overland invoices # 854-857, 861-862, and 865-866 need to be removed.

Q. Why should these costs be removed?

A. These are one-time costs incurred for a special audit, and are not expected to be of a recurring nature in the rate year. In addition, in IR DPS-446 (DAG-59) Attachment 1, the Company has stated these costs were supposed to be removed, but were inadvertently not captured for removal.

Q. What is Staff's adjustment?

A. Staff is removing historic year costs of $172,765 plus an inflation amount of $7,392, for a total adjustment of $180,157 ($153,866 for electric; $26,291 for gas).

Q. What is Staff's next adjustment?

A. The second adjustment, similar in nature to the Overland Consulting charges, relates to the Company response to IR DPS-446 (DAG-59) and its identification that historic year charges from Capgemini Technologies have been removed. The

Capgemini charges referred to here are in invoice #8104011012366 for work done on Project Marlborough, Phase 1 high level design. Project Marlborough is also known as the US Restructuring Program, which was a one-time special project, not expected to recur in the rate year. Here, too, the Company removed some of the historic year Capgemini charges but, based on the Company’s response to IR DPS-446 (DAG-59), Attachment 7, there are $123,521 of electric expense costs still in the historic test year base.

Q. What is Staff’s adjustment?

A. Staff is removing $123,521 plus an added inflation amount of $5,285, for a total of $128,806 removed from the forecasted consultant expense, electric only, for the rate year.

Q. Please explain Staff’s third adjustment.

A. The second adjustment discussed above, removed historic year Capgemini consulting costs that were charged through the National Grid Peoplesoft accounting system. There are additional Capgemini consulting costs charged through the legacy KeySpan Oracle system that need to be removed from the historic test year base as well, for the same reasons as discussed above. Specifically, the Capgemini charges coming through the Oracle system that should be removed are in invoice #8104011011509, and are for work done on the US Restructuring program initiative. Based on the Company’s response to IR DPS-452 (DAG-62), Attachment 1, there are $117,142 of total expense costs still in the historic test year base. Staff is removing $117,142 plus an added inflation amount of $5,012, for a total of $122,154 removed from the forecasted consultant expense ($101,388 for electric; $20,766 for gas).

Q. Please explain Staff’s next adjustment.

A. The Company incurred costs in the historic year for PA Consulting, a firm which performed the cost allocation review described in Exhibit __ (SCP-6) and whose results provide the recommended new allocators to be implemented by the Company as shown in Exhibit __ (SCP-7). These costs should be removed from the historic test year base the Company uses to project the rate year.

Q. Why should these costs be removed?

A. These costs are for a one-time special project; a project that, based on the nature of the project, should not be recurring in the rate year. No supporting information that would indicate otherwise has been provided by the Company.

Q. What is Staff's adjustment?

A. The Company incurred historic year costs of $93,755 electric expense and $16,017 gas expense for invoices #10017674, 10017784, 10017900, 10017961 and 1008117. These costs should be increased for the inflation factor of 4.2785%, resulting in a total reduction to rate year consultant expense of $114,468 ($97,766 for electric; $16,702 for gas).

Q. Do you have additional comments relating to consultants expense?

A. Yes, we have submitted a follow up IR, IR DPS-523 (DAG-91), on specific journal entry #99614-06EB that contains charges for consultant expense in the historic test year. We are awaiting a response to that IR to understand the reason for the charges and to determine if a normalizing adjustment is required to remove the charges from the historic test year base because the charges are shown to be of a non-recurring nature.

B. Other Expenses

1. Industry Association Dues

Q. Has the Company included any amounts in the rate year forecast for industry association dues?

A. Yes, the Company has included $168,385 in the rate year for annual American Gas Association (AGA) dues, $52,775 for annual Northeast Gas Association (NGA) dues, and $425,511 for Edison Electric Institute (EEI) dues in expense type 400 – Other Expense.

Q. Is there any Commission precedent or policy on allowing recovery of industry association dues in rates?

A. Yes. In previous Niagara Mohawk as well as other utilities’ rate proceedings, the Commission has allowed only half of industry association dues to be included in rates. Specifically, this issue was addressed in Niagara Mohawk Cases 28798, 28799 and 28800, Opinion No. 85-4, <u>Opinion and Order Determining</u>

Revenue Requirement and Rate Design, issued March 14, 1985; Cases 29069 and 29070, Opinion No. 86-6, Opinion and Order Determining Revenue Requirement and Rate Design, issued March 12, 1986; Cases 29327 and 29328, Opinion No. 87-3, Opinion and Order Determining Revenue Requirement and Rate Design, issued March 13, 1987; Cases 93-G-0162, 93-E-0376 and 93-E-0378 Opinion No. 94-13, Opinion and Order Approving Electric Settlement Agreements With a Change and Determining Gas Revenue Requirement and Rate Design, issued May 12, 1994. On page 40 of Opinion No. 94-13, the Commission ruled that an explicit adjustment disallowing the portion of AGA dues associated with lobbying must be made in order for rates to be consistent with "an agency policy concerning AGA dues expressed in a series of rate decisions and a state law [PSL S114-a] prohibiting the recovery in rates of lobbying expenses." Q. Has the Company set forth any evidence in this case as to what percentage of dues for AGA, NGA or EEI are related to lobbying?

A. The Company has not provided any testimony or exhibits supporting its full rate request for the AGA, NGA or EEI dues. In IR DPS-505 (DAG-87), the Company was asked to provide copies of all invoices with supporting documentation for the charges paid in the historic year for AGA, NGA and EEI charges. The Company's response included a copy of the "request for check" to pay each invoice, and the associated invoice for each membership's annual dues. As part of supplemental response to IR DPS-440 (DAG-56), the Company provided additional information; letters from the AGA and NGA that were part of the invoice initially received. While there is some description of the activities funded by the membership dues, it is not clear what percentage of dues is lobbying related.

Q. Is there any other information the Company has failed to provide for its membership in these industry associations?

A. Yes, in Opinion No. 85-4, the Commission stated "In future cases, we shall expect the company to make a better presentation on the benefits enuring to ratepayers from its membership in both EEI and the American Gas Association

(AGA)." The Company, in the current electric and gas rate case, provides no explanation or description of any resulting ratepayer benefits from its membership in these industry associations.

Q. What is your recommendation concerning the annual dues for the AGA, NGA, and EEI memberships?

A. Consistent with past Commission precedent and policy, we recommend disallowing 50% of the annual AGA, NGA, and EEI dues. A total adjustment, in the amount of $323,336 (-$212,756 for electric; -$110,580 for gas), reflects this recommendation.

2. Normalizing Adjustments

Q. Are you making any additional adjustments to cost element #400 "Other" expense?

A. Yes, we are recommending four normalizing adjustments be made to the rate year projection of Other O&M expense for charges incurred in the historic test year that, after review, appear to be one-time expenses and not of a recurring nature.

Q. What information did Staff rely upon to derive the normalization adjustments recommendation?

A. Staff used the information provided by the Company in its responses to IRs DPS-112 (DAG-14) and DPS-440 (DAG-56).

Q. What did the Company's responses to IR DPS-112 (DAG-14) and DPS-440 (DAG-56) consist of?

A. The Company defines the costs that get charged to cost element #400, Other expense, as expenses that do not get accounted for elsewhere. Similar to its projection of rate year consultant expense (cost type #100), the Company derives the rate year forecast beginning with the historic test year actual, then removes charges considered non-recurring through the test year analysis review, and also normalizes out many buckets of costs that are included in other cost elements presented on the income statement. The Company then applies an inflation factor of 4.2785% to determine the rate year forecast. IR DPS-112 (DAG-14) asked the Company to provide detailed cost information, i.e. by activity number, by vendor, and by individual journal entries, for each of the cost buckets that were normalized out, as well as the remaining bucket of historic year "Other" expenses that the inflation factor gets applied to. Staff followed up with IR DPS-440 (DAG-56) and requested the Company provide the detail for a list of sample charges derived from the Company's earlier response to IR DPS-112 (DAG-14).

Q. Please explain your first adjustment.

A. The Company incurred two charges for vendor Equisales of $391,500 (invoice # 24400, dated 10/6/2011) and $43,500 (invoice #24412, dated 10/26/2011). Equisales is a company that provides time-critical high voltage transformers and substation equipment. The two charges were associated with power transformers for the Company's Amsterdam, New York temporary substation that was under construction in the fall of 2011. Due to the damage caused by Hurricane Irene in August 2011 and Tropical Storm Lee in September 2011, the Company's Amsterdam substation was damaged beyond repair. As a result, the Company first constructed a temporary mobile substation, followed by a temporary substation to replace the use of a mobile substation. It was the Company plan to then build a new substation in the vicinity of the temporary station for long term use. Equisales' charges were associated with the temporary substation effort. The Company has provided no reason these specific historic year Equisales costs, would recur in the rate year. Therefore these costs should be removed from the rate year projection of "Other" expense. Staff's adjustment is $435,000 plus inflation of $18,611 for a total reduction to electric O&M expense of $453,611.

Q. Please explain your second adjustment.

A. Our second adjustment is for a journal entry cost identified as #PAFY11RES, with a historic year charge to electric Other expense of $1,074,393 and gas Other Expense of $348,663. In response to IR DPS-440 (DAG-56), the Company provided seven pages of a March 2011 journal entry that has a description of "PA reserve fiscal yr end 11 reserves," with a depreciation reserve adjustment calculation. The calculation shows the charges are for write-offs for (1) low dollar work orders less than $1,000 for legacy

National Grid companies and $2,500 for KeySpan companies, and (2) construction completed not closed less than $1,000 for legacy National Grid companies. The Company has provided no other information, explanation, description or any analysis that would indicate whether these types of write-offs are of such a recurring nature that they would again be incurred in the rate year, or that the write-offs even relate to the historic test year period, calendar year 2011. These costs should be normalized out of the historic test year base that is used to project rate year expense. Staff’s adjustment removes the actual historic test year amounts, increased for inflation of 4.2785%, and results in a total reduction of $1,483,942 ($1,120,361 for electric expense; $363,581 for gas expense).

Q. What is Staff’s third adjustment?

A. The Company includes a charge in the historic test year for a March 2011 journal entry, #99618DS21, with the amount charged to electric Other expense of $1,097,939 and gas Other expense of $224,879. The journal entry documentation provided by the Company describes the charges as service company tax adjustments related to fiscal year 2011. These historic year charges should be normalized out of the historic year base used to project the rate year expenses for two reasons. First, the Company has provided no analysis or additional information that would support the determination that these journal entry charges- both the type of adjustments they are and the amounts- are of such a recurring nature that they would again be incurred in the rate year, or, since the charge is for fiscal year 2011, that the charges even relate to the historic test year period.

Q. What is the second reason for disallowing this charge?

A. The Company has stated in response to IR DPS-366 (DAG-43) that all service company costs related to service company equity, tax and debt costs, should be normalized out to avoid a double count, as these type of costs are reflected elsewhere in the Company’s rate case presentation.

Q. Where are all the projected rate year service company equity, tax and debt costs reflected?

A. According to the Company’s response to IR DPS-366 (DAG-43), in the current rate case presentation, these particular service company costs are included as a return on service company plant assets net of deferred taxes in the calculation of forecast rent expense.

Q. Did the Company make any adjustments to its rate case filing to make sure there were no double-counts of service company equity, tax and debt costs?

A. Yes, the Company realized it had included some net credits for those items in cost elements #A20, Service Company Equity, and #A65, Service Company Operating Costs. Therefore, in its Corrections & Updates filing, the Company removes the net credits, increasing the rate year O&M expenses by $1,443,000 for electric expense and $270,000 for gas expense.

Q. What is the difference between cost elements #A20 and #A65?

A. The Company explains in IR DPS-89 (DAG-9) that historic year charges to cost element #A20 include costs for the fixed return on service company equity (service company income) and the tax expense the service company recorded during the historic test year (service company tax calculation). The charges to cost element #A65 are from the monthly journal entries that are posted to reflect the intercompany interest expense related to the service company's debt and income, the income and expense from investments related to employee deferred compensation, and a reversal done in March 2011 of some service company taxes that were incorrectly booked to this bill pool earlier in the fiscal year.

Q. If service company tax costs are reflected in forecasted rent expense, and the Company normalized out net credits cost elements #A20 and #A65, shouldn't the Company also normalize out the service company tax adjustment charge that is reflected as a historic year charge in cost element #400 – Other expense?

A. Yes, it should have. It is curious that the Company would book any service company tax adjustment to Other expense since cost elements #A20 for Service Company Equity, and #A65 for Service Company Operating Costs are supposed to be the cost elements that reflect historic year service company equity, tax and debt costs. Here is a prime example of the Company’s inadequate review of the historic test year charges and journal entries. Had it done so properly, this journal entry charge for a service company tax adjustment reflected in Other expense, similar to the adjustments made to eliminate the net credits from cost elements #A20 and #A65, would have been adjusted out.

Q. What is Staff’s adjustment for this item?

A. We are removing $1,379,414 from the Company’s rate year projection of Other expense ($1,144,914 for electric expense; $234,500 for gas expense). This reflects both the amounts included in the historic test year base that is used to project the rate year, plus an additional amount for the Company’s added inflation.

Q. Please explain Staff’s fourth adjustment to Other expense.

A. In projecting its rate year forecast, the Company is including a historic year journal entry charge, journal ID # 99614-17DS, as recurring in the rate year. The only documentation to support this $627,000 charge is a December 2010 journal entry, provided in response to IR DPS-440 (DAG-56), that is described as a December 2010 accrual for a Verizon credit that was coded to reverse in a subsequent month. The credit was reversed in January 2011. The Company provided nothing more. There is no other information, explanation, description or any analysis that would indicate this journal entry charge is of a recurring nature such that it would again be incurred in the rate year, or that the charge even relates to the historic test year period, calendar year 2011. In addition, due to the lack of supporting documentation, there is no assurance that the type of cost this charge is supposed to represent is not reflected in another cost element-such as consultant, contractor, hardware, or software. Staff has removed $653,826 (historic year charge of $627,000, increased for inflation of 4.2785%) from the projected rate year Other O&M expense.

C. Rents

1. Reservoir Woods

Q. Please explain the Company’s forecast for rent expense for the Reservoir Woods office building, and the allocation to Niagara Mohawk.

A. The leasing costs associated with the Reservoir Woods office building, located in Waltham, Massachusetts, is included within rent expense. In response to IR DPS-157 (CAS-8), the Company indicated the projected rate year rent expense allocation to Niagara Mohawk for Reservoir Woods was derived from bill pool #00603 information. The allocations for this bill pool are based on square footage data, the functional areas that occupy the space, and how employees in those areas allocate their time entry across the business. Using this bill pool produced allocation percentages of 32.016% to Niagara Mohawk electric and 3.993% to Niagara Mohawk gas.

Q. How long has the Company been using bill pool #00603 to allocate Reservoir Woods costs?

A. The Company in response to IR DPS-443 (CAS-18) states the bill pool #00603 was established in calendar year 2009 to allocate the Reservoir Woods costs, and that the allocation percentages have not changed since initially established. The analysis that was used to determine the bill pool allocations was prepared using the original square footage data from June 2009. Additionally, the Company maintains that the rate year forecast uses the most recent bill pool #00603 allocation percentages as of the time of the filing, and that the percentages did not change from the historic test year.

Q. Is it true the allocation percentages of bill pool #00603 have not changed since June 2009?

A. No. In response to IR DPS-52 (DAG-5), the Company provided a copy of its accounting manual as well as bill pool information for fiscal years 2010, 2011, 2012 and 2013. The Company is correct that for fiscal years 2010 through 2012, the bill pool #00603 allocations did not change. However, IR DPS-52 (DAG-5) Attachment 4 clearly shows the Reservoir Woods bill pool allocations were modified for fiscal year 2013, a period consisting of April 1, 2012 through March 31, 2013.

Q. What were the allocation changes taking place for fiscal year 2013?

A. The changes from fiscal year 2012 to fiscal year 2013 for the Reservoir Woods costs allocation to Niagara Mohawk were a reduction of 8.456% for electric (32.016% to 23.560%), and a reduction of 0.238% for gas (3.993% to 3.755%), or a total reduction of 8.694%.

Q. Did the Company provide a new analysis that would support the changes that became effective April 1, 2012, the start of fiscal year 2013?

A. No, the Company has not provided that analysis. In IR DPS-443 (CAS-18), the Company was asked if the bill pool allocations for Reservoir Woods had changed, and if not, that it explain why not, considering the significant reduction in employees due to the US Restructuring initiative. The Company was also asked to provide the analysis undertaken by the Company to determine the allocation of Reservoir Woods costs on a post-US Restructuring basis. In response to IR DPS-443 (CAS-18) the Company stated, “Prior to the announcement of restructuring, it was determined that there were no material changes to Reservoir Woods in terms of space and use and therefore the bill pool #00603 did not require a change. With regards to restructuring, it was determined that the re-organization needed to be complete before the bill pool analysis could be updated, if necessary. To date, the Company has not completed this analysis to determine the allocation on a post restructuring basis. As restructuring effected all departments, the Company does not believe that any change in the bill pool would be material.”

Q. If the Company’s accounting information supplied in response to IR DPS-52 (DAG-5) showed allocation percent changes being made to bill pool #00603 effective April 1, 2012, why did the Company indicate in response to IR DPS-443 (CAS-18) that the allocations did not change since being initially established?

A. The Company was asked that very question in IR DPS-490 (GRL-32). In its response, the Company states “The allocation percentages of 32.016% and 3.993% contained in the response to DPS-157 (CAS-8) were the most up to date information for

Reservoir Woods at the time and were used to develop the Rate Year forecast. As indicated in the response to DPS-443 (CAS-18), the Company did not update the allocation percentages because the reorganization had to be finalized before the analysis could be completed. In reviewing the calculation on Attachment 4, page 13 of 46, to DPS-52 (DAG-5), the Company discovered that the allocation percentages were incorrect and therefore did not update the Rate Year forecast using these percentages."

Q. Is the Company now proposing to reflect revised allocation percentages for the projected rate year Reservoir Woods costs allocated to Niagara Mohawk?

A. Yes, in its response to IR DPS-490 (GRL-32), the Company includes an updated bill pool #00603 calculation based on an updated analysis of the Reservoir Woods facility. The Company's updated analysis reflects allocation percentages of 25.912% and 5.815% for Niagara Mohawk electric and gas, respectively.

Q. Do you have any comments on the new Reservoir Woods cost allocation analysis provided by the

Company in its response to IR DPS-490 (GRL-32)?

A. Yes, we find it very curious that suddenly the Company now has a finalized updated analysis, when only 11 days prior, in its July 30, 2012 response to IR DPS-443 (CAS-18), the Company indicated that it had determined that the re-organization needed to be complete before the bill pool analysis could be updated, if necessary. Also the Company stated, “To date, the Company has not completed this analysis to determine the allocation on a post restructuring basis. As restructuring effected all departments, the Company does not believe that any change in the bill pool would be material.” Apparently the Company now believes the change in the bill is material enough to warrant a change in the projected rate year Reservoir Woods to Niagara Mohawk.

Q. What is the adjustment the Company has calculated?

A. The Company has applied the updated allocation amounts, 25.912% and 5.815% for Niagara Mohawk electric and gas, respectively, resulting from its updated analysis. The Company applies these allocation percentages to the total National Grid Reservoir Woods costs projected to be incurred in the rate year. This includes $17.756 million for rent expense and an additional $0.991 million for other expenses, as shown in the Company's response to IR DPS-490 (GRL-32), Attachment 2. The Company then applies the new updated allocation factors to the gross National Grid amounts to determine the newly revised Niagara Mohawk allocated amounts for the projected rate year. The Company's new calculation results in a reduction of $1.144 million to electric expense and an increase to gas expense of $0.342 million.

Q. Do you agree with the Company's calculation?

A. Absolutely not. The Company's newly provided "updated" analysis should be disregarded for two reasons. First, the Company's response and supporting analysis for IR DPS-490 (GRL-32)is suspect. It was only after Staff asked about the discrepancy between its responses to IRs DPS-443 (CAS-18) and DPS-52 (DAG-5), that the Company did anything about providing the updated analysis that it had allegedly been working on.

If it was going to incorporate the updated analysis into the rate case, and if it was so close to completing the analysis, it should have stated such 11 days earlier in the response to IR DPS-443 (CAS-18). If we had not followed up with IR DPS-490 (GRL-32), it is highly unlikely the Company would have come forth with any updated Reservoir Woods cost analysis.

Q. What is your second reason?

A. The Company states that in reviewing the fiscal year 2013 billing pool #00603 calculation supplied in the response to IR DPS-52 (DAG-5), it discovered the allocation percentages were incorrectly stated. This statement is highly suspect too, and should be given no weight. IR DPS-52 (DAG-5) asked for a copy of the Company's accounting manual, any instructions that accompanied it, billing pool information for the historic test year, and any updates subsequent to December 2011. The Company supplied the billing pool allocators that are being used in the fiscal year 2013 accounting process as part of its response to IR DPS-52 (DAG-5). To state now that at least one bill pool that is currently used and relied upon in charging costs to Niagara Mohawk is incorrect, calls not only all currently used bill pool allocations into question, but also begs the question to what extent past and future bill pool allocation calculations can be relied upon in projecting rate year expenses allocated to Niagara Mohawk.

Q. Has the Company provided a supplemental response to IR DPS-52 (DAG-5) that would indicate they have updated the fiscal year 2013 billing pools being used for accounting purposes?

A. No. No revised billing pool charts have been provided.

Q. What is your recommendation for determining the proper level of rate year Reservoir Woods costs that should be allocated to Niagara Mohawk?

A. The Company should be held to the bill pool #00603 allocations being used for fiscal year 2013 as presented on May 24, 2012 in its response to IR DPS-52 (DAG-5). As stated previously, the Company has identified the fiscal year 2013 allocations to Niagara Mohawk for the Reservoir Woods costs as 23.560% for electric and 3.755% for gas. These are the percentages Staff recommends be used in determining the rate year expenses for Reservoir Woods costs allocated to Niagara Mohawk.

Q. What is your adjustment?

A. We are using the Company's gross Reservoir Woods amount for the rate year of $18.747 million, as shown on IR DPS-490 (GRL-32) Attachment 2, page 1. This amount should then be allocated 23.560% to Niagara Mohawk electric, and 3.755% to Niagara Mohawk gas, for an allowed rate year amount of $4.417 million and $0.704 million, respectively. This produces a total reduction to the Company's rate year forecast of Reservoir Woods costs of $1.629 million ($1.585 million for electric; $0.045 million for gas). We have provided a calculation of our adjustments in Staff's workpapers, Exhibit __ (SAP-4).

2. Service Company Return on Assets

Q. Please explain what is meant by the term "service company return on assets."

A. At page 14 of the Service Company Panel testimony, the Company states "The service companies own or lease a number of shared assets that are used either by service company employees to provide services to affiliates or are used by the affiliates on a shared basis." Further, it stated "When the service companies finance and own the shared assets, the service companies charge the affiliates a rental fee based on pre-tax return on asset." The requested service company return on assets is 9.76%, with the calculation shown on Exhibit __ (SCP-8).

Q. Do you agree with the Company's calculated service company return on assets rate of 9.76%?

A. No, not entirely. We have substituted Staff's proposed capital structure and cost rates into the Company formula, producing a return on assets rate of 8.63%. In developing rate year cost projections, we recommend this revised rate be used in place of the Company's 9.76% rate.

Q. Which cost elements are affected by the service company capital charges?

A. In response to IR DPS-483 (DAG-75), the Company indicated the service company capital charges affect the Reservoir Woods leasehold improvements rent expense, and the capitalized software and other information systems rent expense. The service company base amount, against which the service company return on asset rate is applied, is provided in IR DPS-483 (DAG-75).

Q. Are you using the Company’s provided service company base amount in its return on asset calculation?

A. No. We have adjusted the service company base amount to take into account Staff’s proposed adjustment to billing pool #00603 allocation percentages.

Q. What is your proposed adjustment?

A. We have applied our calculated return on asset rate of 8.63% to the Staff adjusted service company base amount to calculate the rental fee amount Niagara Mohawk should be allowed to recover. Staff’s recommended adjustment is a reduction to rate year rent expense of $1,850,000 ($1,562,000 for electric; $288,000 for gas).

D. Materials – Outside Vendor

Q. Please explain Staff’s adjustment to the cost element #M10 for materials for outside vendors.

A. This adjustment corrects for an error made in the Company's Corrections & Updates filing for postage expense. The Company reflected an adjustment based on its response to IR DPS-327 (CAS-15), but the wrong adjustment amount was incorporated. Staff's proposed adjustment corrects for this error.

Q. Does the Company agree with this adjustment?

A. Yes. The Company's response to IR DPS-491 (DAG-81) confirms an additional adjustment is required. The materials outside vendor expense projection for the rate year should be reduced by an additional $338,640 ($281,071 for electric; $57,569 for gas).

E. Labor

1. Percentage of Labor Capitalized

Q. What percentage of labor costs did the Company forecast would be capitalized in the rate year?

A. The Company forecast 36.0% of total Niagara Mohawk labor costs would be capitalized in the rate year.

Q. What was the basis for this estimate?

A. 36.0% was the actual percentage of labor capitalized in the historic test year.

Q. Do you agree with this forecast?

A. No. In response to IR DPS–115 (RMD-12), the Company supplied monthly and rolling 12 month total updates of its actual labor costs split between expense, capital and other. As shown on that response, the percentage of Niagara Mohawk labor costs capitalized for the twelve-months ending July 31, 2012 is 38.1%, or 2.1 percentage points higher than the percentage capitalized in the historic test year.

Q. Generally speaking, what impact does understating the forecasted percentage of rate year labor capitalized have upon the revenue requirement?

A. Understating the forecasted percentage of rate year labor capitalized means that the forecasted percentage of rate year labor expensed is overstated. An overstated forecasted percentage of rate year labor expensed means that the labor expense forecast is overstated, which in turn means the revenue requirement is overstated.

Q. What labor capitalization rate do you recommend using to forecast rate year labor expense?

A. We recommend using the actual capitalization rate for the twelve-months ended July 31, 2012 as this more recent data provides a better estimate of rate year activity. As such, the capitalization rate applied to labor costs would be 38.1%, which would result in a decrease of $7,296,800 from the Company’s rate year labor expense forecast ($6,056,300 for electric expense; $1,240,500 for gas expense).

Q. Does your adjustment to the labor capitalization rate apply to all labor costs?

A. No. Our adjustment only affects labor costs charged directly from Niagara Mohawk. It does not include or affect labor costs charged from National Grid Service Company, KeySpan Corporate Services, KeySpan Utility Services, KeySpan Engineering and Survey (Service Companies), or any other affiliate.

Q. Did Staff propose a similar adjustment in Niagara Mohawk’s last electric rate case?

A. Yes. In Case 10-E-0050, the Staff Accounting Panel utilized an updated labor capitalization rate of 37.6% from March 2010 as opposed to the historic test year September 2009 rate of 35.77% used by the Company.

Q. Please summarize the Commission decision regarding this adjustment.

A. The Commission rejected it stating, “The rate year forecast of labor and benefits expense is the product of both the forecasted total cost of labor and the capitalization rate that allocates the cost to expense. The Staff proposal attempts to update this forecast only for the higher fiscal year capitalization rate, thereby reducing rate year expense, while ignoring that the fiscal year total labor costs used to derive the capitalization rate are higher than the historic test year. Updating for only one element of the forecast in this case results in an improper understatement of the rate year expense.” The Commission however, noted, “The Company agreed that Staff’s proposal would be acceptable if total labor did not increase between the historic test year and the fiscal year, and instead there was a shift of total labor expense to capital in the latter year. However, Niagara Mohawk asserts that this is not the case here. It notes that total labor costs increased by 10.8% between the end of the historic test period and the fiscal year.”

Q. Do you wish to clarify the Commission's reference to a 10.8% increase in total labor costs?

A. Yes. The 10.8% increase cited by the Company and referenced by the Commission does not represent the percent increase in total labor costs, but rather is the sum of the percent increases for each component of labor - expense, capital and other (i.e. 2.2% + 7.0% + 1.6%). Using the Company's numbers from that case, the actual percent increase in total labor costs during that time period was 3.3%.

Q. If the Commission rejected this type adjustment before, why do you propose it here?

A. The Commission's concern in the last case was that updating for only one element of the forecast resulted in an improper understatement of the rate year expense. The current circumstances differ from the last case in that Niagara Mohawk's total labor costs, rather than increasing, are trending downward. Data relied on in the last electric case provided that, between September 2009 and March 2010, Niagara Mohawk's total labor costs increased by 3.3%.

However, in the current case the facts and circumstances are the opposite. Specifically, between December 2011 and July 2012, Niagara Mohawk’s total labor costs have actually decreased by 1.7%, with the largest decrease occurring in labor expense (4.8%). We attribute the implementation of its US Restructuring as the main reason for the reduction in the Company’s labor costs. However, we note that the labor costs for the twelve months ending July 2012 do not include the full impact of the workforce reductions associated with US Restructuring. On a normalized basis, the labor costs would be even lower. To show how our adjustment is reasonable, we took the July 2012 level of labor expense, applied a growth rate to capture the 2012 and 2013 salary increases, and compared the result to the Company’s rate year forecast. The results clearly support our adjustment.

Q. Please explain your analysis.

A. According to the Company’s response to IR DPS-115 (RMD-12), $214.473 million is the amount of Niagara Mohawk labor charged to expense for the twelve months ending July 2012. We then applied a 5% growth rate which approximates the Company’s salary increases between July 2012 and the rate year. This is based on management pay increases of 3.37% in July 2012 and 3.00% in July 2013; and represented wage increases of 2.50% in April 2012 and 2013. Our calculation resulted in a rate year labor expense forecast of $225.196 million.

Q. How does this compare to the Company’s rate year labor expense?

A The $225.196 million we calculated was $8.621 million less than the Company’s rate year forecast of $233.818 million as shown on Exhibit __ (RRP-3CU), Schedule 31, Page 24.

Q. What do you conclude from this analysis?

A. The analysis clearly shows that Niagara Mohawk’s rate year labor expense forecast is overstated.

Q. How does the $8.621 million difference compare to your adjustment?

A. The $8.621 million difference is higher than our $7.297 million adjustment, which shows that our adjustment is conservative in nature.

Q. Does the Company’s CAPEX budget for the rate year support your adjustment to use a higher percentage of labor allocated to capital?

A. Yes. According to Exhibit ___ (RRP-7) Schedule 1, Page 7, CAPEX spending for the rate year is forecasted to be approximately 20% higher than the historic test year level.

Q. Does your adjustment require that the amount of capitalized labor be increased by $7,296,800?

A. No. According to the Company's response to IR DPS-155 (RMD-14) Part B, "The incremental capital costs associated with the increase in Rate Year 2014 capital spending are comprised of both labor and non-labor components and are fully reflected in the Company's Rate Year capital expenditure forecast in RRP-7, Schedule 1. The Company forecasts labor costs for purposes of determining rate year labor expense (included in RRP-3, Schedule 31) independent of the capital expenditure forecast, and based on staffing levels at the end of the HTY, December 31, 2011." Since, as the Company acknowledges the labor forecast and the capital expenditure forecast were developed independently, no rate base adjustment is necessary.

2. Percentage of Variable Pay Capitalized

Q. Please explain how the Company allocated variable pay between expense and capital for the rate year.

A. According to the response to IR DPS-320 (RMD-29), the Company allocated 100% of variable pay that was charged from Niagara Mohawk to expense. However, variable pay charged from the Service Companies was allocated between expense and capital in the same manner as productive payroll is charged.

Q. Did you ask the Company to explain why the disparity in allocation of variable pay?

A. Yes. According to the Company's response to IR DPS-320 (RMD-29), its proposal follows its current accounting practice. However, the Company also stated that allocation between expense and capital in the same percentage as productive payroll for Niagara Mohawk variable pay would be reasonable.

Q. What capitalization rate do you recommend using to forecast Niagara Mohawk's variable pay for the rate year?

A. We recommend using the same rate that was applied to productive pay, updated for the actual capitalization rate for the twelve-months ended July 31, 2012. As such, the labor capitalization rate would be 38.1%, which would result in a rate year variable pay expense forecast of $16,459,900, or a decrease of $4,137,600 from the Company's forecast ($3,434,200 for electric expense; $703,400 for gas expense). The Company provided quantification for this adjustment in response to IR DPS-438 (RMD-35) Attachment 2.

Q. In the past, the Commission has rejected variable pay allowances. Does this adjustment apply if the Commission disallows some or all of the variable pay?

A. No. If the Commission disallows a portion or all of the variable pay, Staff recommends that the Company's existing accounting practice be modified to expense 100% of Niagara Mohawk variable pay portion excluded from rates and a 38.1% labor capitalization rate be applied to the portion included in rates.

Q. Please clarify whether you are testifying to the reasonableness of the Company's rate year variable pay forecast and whether the costs should be reflected in rates.

A. No. Staff witness Schuler addresses both of these issues in his testimony. Our testimony only addresses how the Company's variable pay is allocated between expense and capital.

3. Management Compensation Adjustments

Q. Please summarize the management compensation adjustments to the rate year.

A. Staff witness Schuler is proposing two specific management compensation adjustments. His first adjustment limits management pay increases to 2.90% per year as opposed to 3.37% for 2012 and 3.0% thereafter, as requested by the Company. This adjustment results in a $565,900 reduction to management compensation which when applied to the Company's management pay expense factor of 76.6%, as shown on the Company's response to IR DPS-438 (RMD-35), results in a $433,700 reduction to rate year labor expense ($360,000 for electric expense; $73,700 for gas expense). His second adjustment reflects the pay differential by regions, resulting in a $2,712,400 reduction to management compensation which, when applied to the same 76.6% expense factor, results in a $2,078,600 reduction to rate year labor expense ($1,725,200 for electric expense; $353,400 for gas expense). In total, Staff witness Schuler is recommending a $3,278,300 reduction to the Company’s rate year management compensation which, when applied to the Company’s management pay expense factor of 76.6%, results in a $2,512,300 reduction to the Company’s rate year labor expense forecast ($2,085,200 for electric expense; $427,100 for gas expense). We will later address the specific management compensation costs identified by Staff witness Schuler and the operation of these costs within the concept and structure of the Service Level Agreements with its affiliates.

4. Other Labor Adjustments

Q. Are you proposing any other adjustments to labor?

A. Yes. As noted in the Company’s response to IR DPS-395 (DAG-50), the Company’s rate year labor should be reduced by $49,300 to reflect the removal of one additional full-time equivalent employee associated with US Restructuring ($41,300 for electric expense; $8,000 for gas expense).

Q. Please continue.

A. We also reflected a $411,700 reduction to electric labor expense as proposed by the Staff Electric Infrastructure Panel.

Q. Please summarize the total impact of Staff's labor adjustments.

A. Staff is proposing to reduce the Company's rate year labor forecast of $280,174,500 by $14,407,700, resulting in a rate year forecast of $265,766,800 ($223,483,200 for electric expense; $42,283,600 for gas expense).

F. Fringe Benefits

1. Percentage of Employee Benefits Capitalized

Q. What percentage of employee benefit costs did the Company forecast would be capitalized in the rate year?

A. The Company forecast 38.66% of total Niagara Mohawk employee benefit costs would be capitalized in the rate year.

Q. What was the basis for this estimate?

A. 38.66% was the actual percentage of employee benefit costs capitalized in the historic test year.

Q. Is the fringe benefit capitalization rate the same as the labor capitalization rate?

A. In theory it should be, as fringe benefits should follow the same allocation as labor costs. However, when computing the capitalization factor for fringe benefits, differences can arise because the Company includes only the labor cost components that contribute to net productive labor. For example, the Company does not include the labor components P21 – represented incremental overtime, P26 – management incremental overtime, and time not worked, in its determination of net productive labor. Conversely, when computing the capitalization rate for labor costs, all components of labor are included. For example, in the Company's response to IR DPS-115 (RMD-12) the labor capitalization rate for the historic test year is 36.0%. This compares to the Company's calculated fringe benefit capitalization rate of 38.66% for the same time period, as shown in the Company’s response to IR DPS-160 (AAE-5).

Q. Do you agree with using the Company’s 38.66% allocation rate for determining the rate year forecast of capitalized fringe benefits?

A. No, we recommend using a more current capitalization factor in place of the 38.66% rate.

Q. Please explain why.

A. In response to IR DPS-160 (AAE-5), the Company supplied monthly and rolling 12 month total updates of its actual employee benefit capitalization rate. As shown, the percentage of Niagara Mohawk employee benefit costs allocated to capital and other has increased subsequent to the historic test year ending December 2011 time period.

Q. What specific time period are you using to determine the forecasted rate year fringe benefit capitalization rate?

A. Similar to our recommendation for updating the labor capitalization rate, we recommend using the actual capitalization rate for the twelve-months ended July 31, 2012 as this more recent data provides a better estimate of rate year activity. As such, the employee capitalization rate should be 40.78%.

Q. In addition to following the increase in the labor capitalization rate, is there any other support for using a higher percentage of fringe benefits allocated to capital?

A. Yes. According to Exhibit ___ (RRP-7) Schedule 1, Page 7, CAPEX spending for the rate year is forecasted to be approximately 20% higher than the historic test year level.

Q. What specific accounts are impacted by this change?

A. A change to the employee capitalization rate impacts the following accounts: health care, workers compensation, thrift plan, FAS 112 post-employment, group life insurance, pensions and OPEBs.

Q. What is the rate year adjustment needed to reflect an employee benefit capitalization rate of 40.78% to each of the impacted accounts?

A. We are reflecting the following adjustments: (1) reduction to health care expense of $709,000 ($588,500 for electric expense; $120,500 for gas expense); (2) reduction to worker’s compensation expense of $128,700 ($106,800 for electric expense; $21,900 for gas expense); (3) increase to thrift plan expense of $96,300 ($79,900 for electric expense; $16,400 for gas expense); (4) reduction to FAS 112 long term disability expense of $154,400 ($128,200 for electric expense; $26,200 for gas expense); (5) reduction to group life insurance expense of $47,000 ($39,000 for electric expense; $8,000 for gas expense); (6) reduction to pension expense of $1,439,300 ($1,194,600 for electric expense; $244,700 for gas expense); and (7) reduction to OPEBs expense of $1,405,000 ($1,166,200 for electric expense; $238,900 for gas expense).

2. Other Fringe Benefits Adjustments

Q. Are you proposing any other adjustments to health care?

A. Yes. As noted in the Company’s response to IR DPS-395 (DAG-50), the Company’s rate year employee benefits forecast should be reduced by $7,200 to reflect the removal of one additional full-time equivalent employee associated with US Restructuring ($5,900 for electric expense;

$1,300 for gas expense).

G. Productivity

Q. Does the Company’s rate year forecast of productivity need to be adjusted for your proposed labor and payroll tax adjustments?

A. Yes. A concomitant adjustment needs to be made to follow our labor and payroll tax adjustments because productivity is calculated on the sum of labor and payroll taxes. As a result, a reduction to the Company’s forecasted rate year productivity of $345,400 is required ($288,400 for electric expense; $57,000 for gas expense). We have provided the calculation in our workpapers contained in Exhibit __ (SAP-4).

Q. Are you proposing any other adjustments to productivity?

A. Yes. As noted in the Company’s response to IR DPS-395 (DAG-50), the Company’s rate year productivity forecast should be reduced by an additional $1,200 to reflect the removal of one additional full-time equivalent employee associated with US Restructuring.

H. Uncollectible Accounts

Q. What is the Company’s forecast for

uncollectible, or UCBs, expense in this proceeding for the rate year?

A. The Company has included a forecast of $35.595 million for electric UCBs expense and $17.668 million for gas UCBs expense, a total of $53.263 million.

Q. Please explain the Company’s methodology for its calculation of $53.263 million in uncollectible expense.

A. The Company’s proposed uncollectible expense method is to divide historic twelve months of net write-offs by twelve months of revenues to arrive at an uncollectible percentage. The uncollectible percentage is then multiplied against rate year revenues to arrive at a rate year uncollectible expense. The assumption or theory behind this calculation is that, for ratemaking purposes, a percentage of the rate year revenues will not be collected and this expense attempts to measure this non-collection. In this case, the Company proposes to update to the latest 12 months of actual net write-offs and revenues information that is available, to calculate a percentage and apply it to the rate year revenues. The Company’s methodology and use of the latest available twelve months information has been adopted by the Commission in the previous electric rate case. In the last gas rate case, a settlement was reached that resulted in the use of historic and latest current information.

Q. Do you agree with the Company’s method and update proposal in this case?

A. We agree with the Company’s method of dividing twelve months of net write-offs by revenues to arrive at a percentage and multiply it against rate year revenues. However, we do not agree with the use of only the latest information for the calculation of the percentage.

Q. Please explain.

A. As provided in the Company’s responses to IR DPS-13(GRW-1) and IR DPS-472(GRW-26), the net write-off for the latest twelve months ended June 2012 is $67.5 million, $46.9 million for electric and $20.6 million for gas. This level is $7.3 million higher than the average net write-offs made for the similar periods 2008 through 2012. Furthermore, the amount of $67.5

million approaches levels not seen since 2009, a period of extreme economic distress. Lastly, the UCB rate for May and June 2012 is at a five year historic high. Exhibit__ (SAP-4) includes a workpaper that shows the historic information and calculations of the UCB rates. These high rates are at a time when current revenues are at a historic low. The Company offers two reasons for the high level of write-offs during the first half of 2012. The first reason, as cited in the response to IR DPS-370 (GRW-20), is due to the impacts of the relatively hot summer of 2010 followed by the colder winter of 2010 – 2011. With the 90-day lag between termination and write-off, the write-offs carried over into the write-off season of 2011.

Q. What is the second reason?

A. As stated in the direct testimony of Shared Services and Customer Panel (SSCP) at pages 26-27, the manual phase of the Transfer-to-Active Project, or TAP, caused uncollectible rates to be generally higher in 2011, especially when looking at the twelve month rolling rate.

Q. What is TAP?

A. As explained by the SSCP testimony at pages 22-24, during 2010 and through early 2011, the Company undertook a project to reinstate previously written-off accounts and transfer the unpaid balances to active. This project, the TAP, included an automated system change to the account initiation process that matches customers seeking new service with previously written-off amounts in the customer’s name. This is performed via a database search using a credit report service. The TAP also included a one-time manual effort to transfer previously written-off balances up to five years old to active accounts. The manual phase resulted in a one-time $9 million shift from the uncollectible reserve to active, which reduced uncollectible write-offs in the near term as previously written-off amounts were reinstated to active accounts, and, as a result, favorably affected uncollectible rates. Over time, any unrecovered balances associated with these reinstatements will move to write-off again, thereby increasing the write-offs in the future or during the period the Company will update the UCB rate.

Q. What was the impact to Niagara Mohawk of the reinstated accounts receivable during 2010 and through early 2011 during the TAP program?

A. According to the SCCP testimony at page 23, during the period of the TAP program, the Company reinstated accounts balances grew from $22 million to over $57 million. For the prior period, 2003 through 2010, the reinstated balances were in the $19 million range. These balances are now eligible to be written-off again for non-payment. Therefore, future write-offs will not only include current bills, but there is a potential for write-offs of an additional $35 million, the difference computed by deducting the $22 million from the $57 million.

Q. How does this potential $35 million impact the update for uncollectible expense?

A. It increases the net write-offs in the rolling twelve month time period used to calculate the uncollectible percentage factor in this case. The customer bills not only include current bill charges but bill charges that go back five years. The Company admits as much in its SSCP testimony at page 26; that write-offs will be higher where any unrecovered balances associated with these reinstatements will move to write-offs thereby increasing the uncollectible rates.

Q. How will the end of the transfer to active accounts under the TAP program impact UCBs?

A. The Company anticipated that the uncollectible rate would rise in the first six months of 2012, partially as a result of the increasing net write-offs from the TAP program. Since the benefits of TAP concluded in February 2011, the rolling net write-offs will increase for every month after February 2011 and will be completely eliminated from net write-offs for rolling 12 month periods after February 2012. During TAP, recoveries were higher than normal as result of the balance transfers from the uncollectible reserve to active accounts. The higher recoveries reduced gross write-offs so net write-offs were lower than they would be without TAP.

Q. Does the Company address the level of net write-offs through the end of 2012?

A. No, the Company does not address where net write-offs will be at the end of the year; the period they chose for the update of the UCB rate. The responses to DPS-370 (GRW-20) and DPS-386 (GRW-22) show gross write-offs at May 2012, for both electric and gas, at the highest level in years. In its response to IR DPS-370 (GRW-20), the Company, however, does indicate that there could be a more favorable level of write-offs largely driven by the significant lower bills from this past winter.

Q. Please explain why it is not proper to use the latest known information.

A. As explained, the purpose of any uncollectible expense is to provide recovery of rate year revenues that are not collected in the rate year. The use of the Company’s update based on the latest available 12 months data doesn’t appear to be reasonable, especially in light of the UCB rates for the May 2012 and June 2012 periods. The UCB rates are abnormally high when compared to historic three year and five year UCB rates as shown in our workpapers included in Exhibit__ (SAP-4). According to the Company, there is no reason to believe that UCB rates will fall to more normal levels. But the Company never addresses why these abnormal UCB rates are reasonable. The Company never addresses why write-offs will not fall for all of 2012, especially in light of lower customer bills due to lower commodity costs and normal weather. Nor does the Company address why lower customer bills will make it easier for customers to pay their bills and reduce the number of write-offs.

Q. How do you propose to calculate uncollectible expense?

A. Uncollectible expense should provide an allowance to offset the portion of rate year revenues that will not be collected. Our adjustment uses the Company method to calculate the uncollectible expense with one change. Rather than using the latest twelve months of write-offs, we propose to use the latest available 3 year Aggregated Uncollectible Rate as shown on the response to DPS-13(GRW-1), Attachments 1 (Electric) and 2 (Gas). The aggregated method is calculated by taking the sum of three years net write-offs and dividing it by the sum of three years of revenues for a similar period. It approximates the result from taking three uncollectible rates and dividing by three.

Q. Why is the use of the three year Aggregated Uncollectible Rate necessary?

A. The current 2012 UCBs are abnormal and need to be normalized to exclude the impacts of the relatively hot summer of 2010 followed by the colder winter of 2010 – 2011 and also to reflect the impacts of TAP. The three year Aggregated Uncollectible Rate period not only includes the TAP benefits for the reinstatement of customer balances and the lower net write-offs, but also includes the higher level of write-offs due to TAP. Lastly, this rate also includes the abnormal level of write-offs for the abnormal weather conditions.

Q. What adjustment are you proposing to uncollectible expense?

A. Based on using the three year Aggregated Uncollectible Rate, we are proposing to reduce the Company’s Corrections and Updates uncollectible expense request from $53.262 million to $40.922 million for a total reduction of $12.340 million; an electric expense reduction of $7.501 million and a gas expense reduction of $4.839 million.

Q. How are the electric and gas expense adjustments computed?

A. We have taken the latest three year Aggregated Uncollectible Rate rates, as shown for electric on DPS-13(GRW-1), Attachment 1 and for gas on Attachment 2, and multiplied them by the Company revenues that were provided in the Corrections & Updates filing for uncollectible expense. We have further adjusted the electric uncollectibles expense for Staff's recommended decrease in electric operating revenues.

I. US Restructuring Savings

Q. Please explain the Company's US Restructuring Program savings.

A. The US Restructuring Program is comprised of both labor and non-labor savings. Throughout the historic year, and up to the beginning of the rate year, National Grid will have eliminated over 1400 positions. The expected labor savings from the US Restructuring Program are reflected in the rate year forecast of the labor expense component.

Q. How are the US Restructuring Program non-labor savings reflected?

A. Based on its Corrections & Updates filing, National Grid estimates it will achieve approximately $68.996 million of annual non-labor savings by March 31, 2013. Niagara Mohawk's allocated share of the non-labor savings is $20.925 million ($17.618 million electric; $3.307 million gas). Of the $20.925 million allocable to Niagara Mohawk, it is estimated that $7.220 million ($6.186 million electric; $1.034 million gas) of non-labor savings have been achieved and reflected in the actual historic test year costs. Thus, these savings are inherent in the rate year forecast, as the historic test year is used as a base for developing the projected rate year. The remaining $13.704 million ($11.432 million electric; $2.273 million gas) of non-labor savings, increased for inflation of 4.2785%, is reflected as a credit on the income statement in the line item entitled, “US Restructuring Savings.”

Q. Do you agree with the Company’s projection?

A. No, not entirely. The Company has acknowledged, in its response to IR DPS-392 (DAG-49), that three adjustments need to be made for the initiatives labeled as LEG14-LEG20, R&P1 and NS25, as the savings achieved in both the historic year and expected to be achieved in the rate year were not correctly calculated. We are reflecting these adjustments in Staff’s revenue requirement. The Company has calculated the adjustments as an increase to expected rate year US Restructuring savings, of $518,291 ($422,184 electric; $96,107 gas).

Q. Do you agree with the Company’s calculations?

A. No, the Company needs to increase the adjustments for the inflation impact from the historic year to the rate year, as all US Restructuring program savings were calculated in 2011 dollars. Applying the Company’s inflation factor of 4.2785% to the base adjustment brings the total US Restructuring savings adjustment to $540,466 ($440,247 electric; $100,219 gas).

J. E&Y Analysis

Q. Please explain the Company's review of the historic test year service company costs.

A. As explained in pages 29 through 41 of the Service Company Panel testimony, the Company hired Ernst & Young, E&Y, to review the accounting for costs charged from the service companies to Niagara Mohawk during the historic test year. E&Y reviewed O&M charges from accounts payable, payroll expense, employee expenses and general ledger journal entries to determine (1) if the charges were incurred in the historic test year; (2) if the charges were made to the appropriate companies and segments; (3) if allocated, if the appropriate bill pool was used; and (4) if the charges should have been below the line for ratemaking purposes.

Q. Did the Company make an adjustment to the historic test year charges based on E&Y's analysis?

A. Yes. The Company adjusted its rate year O&M expenses by $2.420 million and ($.673) million for electric and gas, respectively.

Q. Do you agree with the Company's adjustment?

A. No. As discussed by Staff Witness Schuler, E&Y has not shown that the study is reasonably representative, unbiased or statistically valid.

Q. Why does E&Y feel their findings are valid?

A. It appears that E&Y believes that since they sampled a majority of the population of charges ($1.023 billion out of $1.621 billion or 63%), their findings are valid.

Q. Why is this incorrect?

A. Although E&Y states that they sampled $1.023 billion of transactions, in fact they only tested a fraction of that amount. There are a number of examples where E&Y only looked at a small portion of costs for a particular vendor, but included all of the charges as “sampled” charges. Thus, E&Y actually reviewed much less than $1.023 billion out of $1.621 billion.

Q. Can you provide examples of this?

A. Yes. Workbook C1.184, for A F Supply shows $3.357 million of charges. However, E&Y states “Gas conversions, so low risk, we test one, we double check a sample and conclude these are ok.” Thus, E&Y tested four items for $7,129 but mischaracterized that all $3.357 million were included in the “sampled” amount.

Q. Can you provide another example?

A. Workbook C1.013 for HSBC provides the testing procedures for the Company’s purchasing card or PCard transactions. E&Y looked at the allocation of $1.043 million of charges, but erroneously indicated that all $8.202 million were included in the “sample” that was tested.

Q. Please provide another example.

A. Workbook C1.182 for Blackman, Inc. shows $3.408 million of charges during the historic test year. However, E&Y states, “EY used a sample approach to test invoices from Blackman, testing one invoice from each allocation code this vendor charged.” Therefore, E&Y tested 16 items totaling $3,943 but incorrectly characterized all $3.408 million as being included in the “sampled” amount.

Q. Please provide another example.

A. Workbook C1.178 for FW Webb shows $4.635 million of charges during the historic test year. However, E&Y states, “E&Y will test 1 sample invoice for each of the six different direct charges being utilized (All non-NIMO).”

Therefore, E&Y tested 6 items totaling $20,085, but incorrectly stated that all $4.635 million were included in the “sample”.

Q. Please provide another example.

A. Workbook C1.047 for Stuart C Irby Company shows $1.306 million of charges. E&Y tested $499,546 of charges, but incorrectly indicated that all $1.306 million were included in the “sample”.

Q. Are there other examples?

A. Yes. Workbook C1.001 for DSM Energy Federation shows that E&Y reviewed the allocation for 56.8% of payables, Workbook C1.008 For Action Inc states that E&Y reviewed the allocation for 21% of payables and Workbook C1.010 for Conservation Services Group shows it tested 59 of the 301 invoices, which represented 21% of the 2011 payable amount. However, for each of these vendors, E&Y incorrectly indicated that the total payable amount was included in the “sample” that was tested. There are a number of other such examples.

Q. Was the examination E&Y performed on this small number of items sufficient?

A. No. In many instances, E&Y did not test in a way which would allow them to accurately determine if the costs were incurred in the historic test year, if they were allocated to the proper segment and/or company, or if they were appropriately included above the line.

Q. Please provide an example.

A. With the 25 PCard transactions from HSBC previously discussed, E&Y compared the employee’s payroll allocation with the PCard expense allocation for each line item. If the allocations matched, E&Y determined that the expenses were appropriately allocated. However, E&Y never looked at the receipts associated with these items, therefore, they have no way to determine what the costs were really for. As such, they have no way to determine if the costs were actually allocated correctly, much less if they were incurred in the historic test year or if they were appropriately included above the line. Furthermore, the summary tab of the HSBC workbook shows that for 3 of the 25 line items selected, E&Y was unable to tie the amount back to the individual vouchers. Instead of considering these errors or unsupported costs, E&Y simply picked 3 new items, stating that "As we tested 100% of the voucher totals in Test #1, we re-selected 3 new samples to perform payroll testing."

Q. Can you provide another example of E&Y using insufficient examination?

A. Yes. Workbook C1.004 shows $9,605,345 of charges from Pro Unlimited – a staffing company which includes former Company employees who do contract work for the Company. In the workbook, E&Y states that they were unable to obtain invoices or timesheets for these charges. As an alternate procedure, E&Y compared the bill pool used by the contractors with the bill pool used by their managers. If the bill pools matched, E&Y considered the costs to be appropriately allocated. Again, without looking at source documentation, in this case time sheets or invoices, E&Y has no way to determine if the costs were allocated correctly or if they were incurred in the historic test year. E&Y's alternate procedure does not provide for an adequate examination of these charges.

Q. Were there other problems with the Pro Unlimited testing procedures?

A. Yes. In IR DPS-448 (DAG-61), we asked the Company to provide supporting documentation for three line items we randomly selected. The documentation provided shows that for two of the three line items (#20 and #132), the work was performed in December 2010, prior to the historic test year and, as such, should have been normalized out. However, E&Y’s workbook states that these costs were incurred in the historic test year.

Q. Are you proposing an adjustment to normalize these costs out of the historic test year?

A. No. Due to the low amount of these invoices, $45 and $930 respectively, such an adjustment would be immaterial. However, the fact that we found errors in two out of the three items that we looked at raises serious concerns about the validity and accuracy of the limited work E&Y was supposed to have done.

Q. How much of the $515 million of accounts payable charges E&Y claims to have sampled did they actually examine?

A. We don’t know.

Q. Why not?

A. In IR DPS-509 (DAG-89), we asked the Company to provide the line items and charges that were actually subject to examination. This information would help us to determine how much of the historic test year charges E&Y actually sampled and tested. However, the Company did not provide this information in the response, but rather referred back to the workpapers in E&Y’s report.

Q. You have thus far discussed E&Y’s testing of accounts payable transactions. Do you have similar issues with their testing of payroll expenses?

A. Yes. For payroll testing, E&Y judgmentally selected a sample of departments, and from within that sample selected a sample of cost centers. From within that sample of cost centers, they judgmentally selected a sample of employees. However, despite only looking at this very small amount of individuals, E&Y included all charges within the departments in the “sample”. Furthermore, it does not appear that E&Y even looked at timesheets for the employees it did select. As a result, their assertion that any of these charges are accurately allocated or appropriately charged is not supportable.

Q. Do you have a similar issue with E&Y's testing of employee expenses?

A. Yes. E&Y used a variety of sampling techniques to test a small portion the $14 million population of employee expenses, however they characterized all $14 million as being included in the "sample". Again, it is simply untrue that E&Y examined all $14 million of charges.

Q. Are there other problems with E&Y's analysis?

A. Yes. E&Y's analysis only looked at O&M expenses; they made no examination of capital related charges. Per the Company's 2011 FERC Form 60 report, total Service Company billings to affiliates were $2.743 billion, however E&Y's population only covered $1.621 billion of charges. By excluding 40% of the total charges from the testing population, the validity and completeness of the analysis is further compromised.

Q. Are you proposing an adjustment related to this analysis of historic test year charges?

A. Yes. For the reasons stated, we have little confidence in E&Y’s study. As such, we are removing the O&M costs resulting from their analysis.

Q. What is your adjustment?

A. As previously stated, the Company increased its electric O&M expenses by $2.420 million and decreased its gas O&M expenses by $.673 million based on the results of this analysis. Our adjustment to remove these costs will therefore decrease rate year electric expense by $2.420 million and increase rate year gas expense by $.673 million.

K. Expatriate Proxy

Q. Please explain what expatriate costs are.

A. As explained by the Company in response to IR DPS-149 (DAG-22), an expatriate, or Expat, employee is an employee who undertakes a short-term (less than five years) international assignment to live and work in another country. In this case, an employee of National Grid plc, would be working on assignment in the US, and the costs associated with the assignment would include salaries and benefits, a cost of living allowance, relocation expenses, housing allowance and other items.

Q. What is the Company’s forecast for Expat costs in the rate year ending March 31, 2014?

A. The Company’s rate year forecast begins with actual historic test year costs of $2,124,399 ($1,870,372 electric; $254,027 gas), which is then adjusted by $90,892 ($80,024 electric; $10,869 gas) to reflect inflation of 4.2785% for the period between the historic test year and the rate year; with a final credit adjustment in the amount of $549,400 (-$457,700 electric; -$91,700 gas) for the Market Reference Point (MRP) calculation. The Company’s rate year forecast for Expat costs, as of the Corrections & Updates filing, is a total amount of $1,665,891 ($1,492,696 electric; $173,196 gas).

Q. Please explain what a Market Reference Point is.

A. In developing its rate year forecast, the Company analyzed each position held by an Expat during the historic test year and identified the market-based level of cash compensation for the position. The MRP adjustment reflects the lesser of each Expat employee's actual cash compensation, as adjusted for cost of benefits, or compensation equal to a market determined level for a US based employee in the Expat's position, as adjusted for cost of benefits.

Q. Has the Company provided any further information on Expat costs?

A. Yes, in IR DPS-382 (DAG-48), Staff requested additional information on Expat costs as a follow up to the Company's response to IR DPS-149 (DAG-22). In its response, the Company recognized that, in determining the proper level of historic year costs to compare with the MRP, it inadvertently failed to exclude three months of UK billing for salaries and benefits. As a result, the MRP calculation and adjustment that is reflected in the C&U filing is not correct; a further adjustment is warranted. The Company's calculation in IR DPS-382 (DAG-48), as well as the identification in its response to IR DPS-491 (DAG-81), shows that an additional adjustment reducing its projected rate year Expat costs by $430,288 ($398,865 for electric; $31,423 for gas) is needed.

Q. Do you agree with the Company’s calculation of this adjustment?

A. Yes.

Q. Are there any other adjustments that need to be made in projecting rate year Expat costs?

A. Yes, there are two additional adjustments that should be made. Through our analysis we found there was a significant decrease in the number of Expats who were charging costs to Niagara Mohawk from throughout the historic test year period to the first six months of 2012. The Company explains in response to IR DPS-382 (DAG-48) that twenty two Expats were on long term assignment in the US for all or part of the historic test year, with eleven of them ending their assignments sometime during 2011. From January 1, 2012 to June 30, 2012, an additional five Expats have ended their assignments, and another two are expected to leave their assignment by the end of calendar year 2012. Attachment 3 to the IR DPS-382 (DAG-48) response indicates the additional remaining four Expats currently on assignment have assignment end dates of 1/31/13, 4/30/13, 12/31/13 and 2/28/14.

Attachment 3 clearly lays out the Company's plans for the assignment end dates of current Expats working in the US. Projected rate year costs associated with Expats should be in sync with the chart provided.

Q. Does the Company agree that any adjustment should be made to reflect the decreasing number of Expats on assignment?

A. In its response to IR DPS-382 (DAG-48), the Company indicates it recognizes that to reflect the decrease in Expats it should remove rate year expense from the revenue requirement associated with the Expats whose assignment ended during the historic test year, as these costs are supplemented by internal labor costs already included in the revenue requirement. The Company cites an amount of $371,961 ($343,351 electric; $28,610 gas) as the associated expenses included in the revenue requirement for these Expats.

Q. Do you agree with this adjustment?

A. No. First, since the Company adjusted the historic test costs by the inflation factor to project rate year Expat expenses, 4.2785% for inflation needs to be added to these amounts in order to take out the appropriate level currently reflected in the rate year. The correct amount to reduce the rate year revenue requirement is $387,875 ($358,041 for electric; $29,834 for gas). Second, while we agree the adjustment cited by the Company should be made as we just modified it, there also needs to be a second adjustment.

Q. Please explain.

A. The Company's adjustment calculation only removes Expats whose US assignment ended throughout the historic test year. As already discussed, there are seven additional Expats whose assignments are ending by the end of calendar year 2012. Even though it indicates in its response to IR DPS-382 (DAG-48) that new international assignments in the US were suspended during this time frame due to the US Restructure, the Company does not appear to adjust the related costs for those Expats out of the rate year revenue requirement.

Q. Will the Company replace the Expats that are ending their assignments with any additional complement of the internal workforce?

A. From the documentation the Company has provided, it appears that is not the case. In its US Restructuring savings initiative, the Company has listed savings codes of HR111, FIN2, R&P3 and NS8, as being savings related to Expat reductions. When questioned about these particular savings in both IRs DPS-87 (DAG-7) and DPS-382 (DAG-48), the Company provided responses that indicated work responsibilities for these Expats were either shifted to other employees or the role was replaced with a US employee. The Company has provided no documentation or support showing they would hire additional people, beyond what they are already projecting and for which we are allowing, to replace the Expats that are leaving. We see no reason why the trend would be any different in the future.

Q. What is Staff’s recommended adjustment?

A. Based on the chart provided by the Company in its response to IR DPS-382 (DAG-48), Attachment 3, the only Expat costs that should be allowed in the rate year are for the Expats that are shown to be on assignment in the rate year period, and their projected rate year costs should be prorated for the number of months in the rate year they will be on assignment. There are three Expats that are expected to be on assignment during the rate year, assignee numbers 100056346 for 9 months of the rate year, 100062327 for 1 month of the rate year, and 100062738 for 11 months of the rate year. Staff's additional adjustment is to remove the remaining Expats who will be ending their assignments either before or during the rate year, and results in a reduction of $662,554 ($577,668 for electric; $84,886 for gas). This adjustment is in addition to the amount previously discussed, for a total adjustment to Expat expenses included in the revenue requirement of $1,480,717. We have included a workpaper with the calculations of Staff's adjustment in Exhibit __(SAP-4).

Q. Do you have any additional comments on the Expat costs?

A. Yes, we think it is important to highlight that this is another example of the Company not adequately reviewing the historic test year costs or projecting an accurate assessment of the expected rate year costs. If it had done a proper review initially, rather than performing the analysis only as a result of a Staff IR, it would have known what the actual historic test year Expat costs were, and that there were costs that needed to be removed before projecting the rate year expense. As it is, it took two Staff IRs - IRs DPS-149 (DAG-22) and DPS-382 (DAG-48) pointing the Company in the right direction for the Company to ascertain exactly the amount of actual historic test year costs incurred. In the future, the Company must do a better job of reviewing and scrubbing the historic test year in preparation of a major rate filing.

L. Allocation Reclass

Q. Please explain what is meant by allocation reclassification?

A. The Company includes an “Allocation Reclass” cost element on Exhibit __ (RRP-3CU) that shows an adjustment to the historic test year based on an analysis to derive the change in historic test year costs which are the result of the revisions to the general allocator and other cost allocators used by legacy National Grid USA and KeySpan Companies.

Q. Please explain why the revisions to the general allocator and other cost allocators are necessary.

A. In the Service Company Panel at page 47, the Company explains that, in anticipation of the consolidation of its two separate financial systems, National Grid USA’s use of Peoplesoft and KeySpan’s use of Oracle, onto SAP, it is revising its cost allocation methodologies to allow for a common cost assignment and allocation process. The Company employed a consultant, PA Consulting Group, to review its cost allocation practices and recommend a methodology consistent with industry best practices and capable of being implemented as part of the US Foundation Project initiative. National Grid plans to implement the recommended and revised methodologies when its financial systems are consolidated, a date targeted for October 2012.

Q. What was the result of the review done by PA

Consulting?

A. PA Consulting has helped National Grid develop new cost allocation policies and procedures that include (1) a revised general allocator to be used when there is no readily determinable cost causative basis available to allocate costs; (2) a cost causative process that will be consistently applied and stresses the importance of using direct assignment as a first preference, and, if no direct assignment can be made, provides a general allocator that bears the closest relationship to cost causation, as a second preference; and (3) a revised comprehensive cost allocation manual.

Q. Please describe the general allocator that PA Consulting has recommended.

A. PA Consulting has recommended that the Company use a three-factor formula as a general allocator. The consultant explains that this three-factor formula is common in the utility industry. Specifically, the consultant recommends that the Company adopt what is known as a Modified Massachusetts Formula, a three-factor general allocator that uses gross margin, net plant, and O&M expenses, equally weighted.

Q. Do you have any comments on any of the factors being used?

A. Yes. In its report, shown in Exhibit __ (SCP-6) page 18, PA Consulting indicates the O&M expense portion of the allocator will exclude costs allocated from the Service Company using the general allocator. However, the report also notes, “A Special Report will be required to determine the amount to be excluded for Service Company Charges based on the General Allocator. This is the single significant exception to the ‘transparency’ guiding principle.”

Q. Did the Company undertake an analysis to see how its historic test year costs would change if the revised allocation policies and procedures were implemented?

A. Yes. These results are included in Exhibit __ (SCP-7). The Company’s analysis shows that if the revised allocation policies and procedures had been put in place in calendar year 2011, Niagara Mohawk’s electric O&M costs would have decreased by $14.844 million and its gas O&M costs would have increased by $0.402 million.

Q. Are these amounts reflected in the Company’s rate year projection of O&M costs?

A. No. A normalizing adjustment was necessary to remove labor expense reductions and any costs to achieve the US restructuring efficiency savings from the total change in costs that was computed. The net change in costs from the use of the new allocators after normalizing adjustments is a decrease to electric O&M expense of $12.833 million and an increase to gas O&M expense of $0.359 million. Adjusting these revised 2011 historic year amounts, and adjusting for inflation of 4.2785%, results in a total decrease to projected rate year O&M expenses of $13.008 million- a decrease of $13.382 million to electric and an increase of $0.374 million to gas.

Q. Do you have any adjustments to the Company’s projection of the allocation reclassification?

A. No. From our review of PA Consulting’s cost allocation review project report in Exhibit __ (SCP-6) and the new allocators derivation and impact study in Exhibit __ (SCP-7), it appears that PA Consulting did a thorough analysis in deriving the proposed new general allocator and also the cost causative allocation factors. Having said this, however, it is important to note that the true impacts of the change in allocators will not be known until the US Foundations Program and the consolidated accounting system is implemented, when actual results, rather than projected impacts, can be analyzed. The specific allocators put in place, including the amounts used for each component in deriving the general allocator, will need to be reviewed. We, therefore, recommend that, after the consolidated accounting system has been in place long enough that twelve months of actual cost data are available, the Company undertake an analysis of the actual impacts, as well as a testing of transactions to assure they are properly documented and allocated, and provide the results of their analysis to the Commission.

M. IS Transformation Initiative

Q. What is the IS Transformation initiative?

A. National Grid has introduced a new operating model for its information systems (IS) organization, and termed it the IS

Transformation initiative. The IS Transformation initiative involves a redesign of the Company’s IS organization, as well as developing partnerships with various key vendors for the delivery of IS services. Traditionally, National Grid has delivered its IS services primarily using in-house employees, with external vendors providing support when needed. Recently, National Grid developed and has implemented a new service delivery model that now uses external vendors for many of its IS services, with some support from internal resources.

Q. What types of services are included in the IS Transformation initiative?

A. The IS Transformation initiative has seven sub-segments that include: 1) Service Management Integrator; (2) Enterprise Services; (3) Networks and Communications; (4) Internet, Collaboration, and email; (5) Managed Print Services; (6) Application Development and Maintenance (also known as Solutions Delivery); and (7) Contact Center Technology – At Home Agents.

Q. Please explain your review of the IS Transformation initiative projected costs for the rate year.

A. For each of the segments of the IS Transformation initiative, in IRs DPS-66 (CAS-2) and DPS-283 (DAG-35) we asked for a copy of the sanction paper or, in the event a sanction paper didn’t exist, copies of internal documents to senior management that would contain the same type and level of information, as well as confirmation of senior management approval of each project. Each major project undertaken by National Grid goes through a sanctioning process. An executive summary and other pertinent information, such as detailed projected costs and benefits, as well as an ultimate recommendation whether the project should go forward or not, is presented in one document for review and approval by National Grid’s executive management. Each segment of the IS Transformation initiative was supported by a sanction paper that had executive approval to move forward.

Q. Please continue.

A. In addition to the request for sanction papers, in IRs DPS-254 (DAG-33) and DPS-283 (DAG-35) we asked for the costs and benefits of each IS Transformation initiative segment as reflected in the Company’s rate year forecast, as well as a reconciliation of the costs and benefits back to the sanction papers. In its response to those IRs, the Company indicated it “inadvertently” failed to include certain IS Transformation costs and savings in its filing of the rate year forecast.

Q. What costs and savings were omitted from the Company’s filing?

A. There were numerous omissions, and apparently it was not until the Company was responding to Staff’s IRs on the specifics of the IS Transformation initiative, that it realized the rate year forecast it developed for the rate case filing was incomplete. The first omission was noted in its response to IR DPS-254 (DAG-33), a response that was dated June 29, 2012, a full two months after the submission of the rate case filing. In that response, it identified it did not remove the 88 employees from the labor forecast that were expected to be leaving the Company due to the outsourcing of the Enterprise Services segment. Not only did the Company forget to remove the reduction of employees, it also did not correctly reflect the increase in contractor costs embedded within the Enterprise Services contract.

Q.   Was that the entire omission?

A.   No. In its response to IR DPS-283 (DAG-35), the Company again noted it “inadvertently” did not normalize out an additional 14 employees, and also that certain costs of both the IS Transformation and the US Foundations Program were omitted from the rate case forecast. This particular IR response was dated July 2, 2012, again a full two months after the rate case was filed. A supplemental response to IR DPS-283 (DAG-35) was received on July 9, 2012. Until it prepared that response, the Company could not even determine what the overall projected IS Transformation initiative costs and savings would be for the rate year forecast, as the analysis simply had not been done.

Q.   Are the savings of the reduction of 102 employees that the Company neglected to take into account in its rate year labor forecast now reflected in the rate year revenue requirement?

A. Yes. In its Corrections and Updates filing, the Company determined that the appropriate number of additional employees needing to be removed from its rate year labor forecast was equivalent to 100 full time employees, with 98 employees impacting the Niagara Mohawk's labor expense forecast. The Company captured the savings totaling $2.085 million in labor expense and $0.645 million in benefits expense; these savings are reflected in the Corrections and Updates filing.

Q. What are the net costs for IS Transformation initiatives that are projected to be incurred for the rate year?

A. Based on the response to IR DPS-283 (DAG-35) and the Company's Corrections and Updates filing, on a total National Grid basis, the projected costs for the rate year are $61.021 million, with 23.38% allocated to Niagara Mohawk electric operations and 5.06% allocated to Niagara Mohawk gas operations. This equates to total projected

Niagara Mohawk costs of $14.267 million electric and $3.088 million gas

Q. The Company filed its rate case on April 27, 2012. Why was the rate year projection for IS Transformation costs and savings not available at that time?

A. We do not know why, but it is completely unacceptable for a company the size of National Grid to file such an incomplete and inadequate rate case, and then have to supplement its filing more than two months later with data that was available at the time it was preparing its filing. When it became apparent from Staff's audit and responses to IRs DPS-254 (DAG-33) and DPS-283 (DAG-35) that the Company had not accurately captured all components of the IS Transformation initiative, a follow up IR was submitted. IR DPS-367 (DAG-44) asked for a roadmap from the actual historic test year costs incurred to the projected rate year costs, for all of the IS Transformation initiative segments in their entirety, including any applied normalization adjustments and any incremental costs and savings that were reflected. The

Company was also asked how it “inadvertently” failed to include various cost and savings elements into its rate year forecast. In its response to IR DPS-367 (DAG-44), the Company attempts to offer some valid reason for its inadequate rate year expenses forecasting, but the reality is there is no acceptable excuse for the inadequate job the Company did in compiling its rate year forecast for the various IS Transformation initiative segments.

Q. Did the Company provide the roadmap that you requested in order to determine the proper rate year forecast for the costs and savings of IS Transformation initiatives?

A. Yes, between the responses to IR DPS-254 (DAG-33), DPS-283 (DAG-35), DPS-367 (DAG-44), the Company’s Corrections and Updates filing, and an IS review meeting held on July 25, 2012, the Company was able to show how it started with the actual historic year costs and came to the rate year projection as provided in IR DPS-283 (DAG-35).

Q. Did you perform more follow up audit work subsequent to the responses to the various IRs and the IS review meeting?

A. Yes. We submitted IR DPS-488 (DAG-80), in which we requested detailed backup to the IS Transformation initiative workpaper data presented in Exhibit __ (ISP-15CU).

Q. Did the Company provide the requested documentation in its response to IR DPS-488 (DAG-80)?

A. Yes. The backup documentation the Company supplied in its response was required to verify the adequacy of its rate year projection of costs associated with the IS Transformation initiative. In responding to IR DPS-488 (DAG-80), the Company found it had supplied an inaccurate rate year cost projection for the Solutions Delivery segment. To correct for this error, the Company notes its Corrections and Updates rate year cost projection for the IS Transformation initiative should be reduced by $886,000 ($757,000 for electric; $129,000 for gas).

Q. Do you agree with the adjustment the Company says is now needed?

A. Yes, we are in agreement and we have reflected this adjustment in both of our electric and gas revenue requirement exhibits.

Q. Do you have any additional comments?

A. Yes. We feel compelled to again note that there is no excuse for this error in the Company's filing. The Company needs to be more diligent in its analysis and preparation of its rate year cost projections. This error should have been caught much earlier, before it even filed its Corrections and Updates on July 16, 2012. Instead the error was discovered only in preparing its response to a Staff information request, a response that was dated August 9, 2012, a mere three weeks before Staff's direct testimony was due. The Company needs to be more conscientious in preparing its rate case filing so that errors similar to those that surfaced with respect to the IS Transformation initiative do not happen again.

N. Inflation Factor Update

Q. How did the Company calculate its general, or GDP inflation factor for inflation occurring between the historic test year and the rate year?

A. The Company calculated its GDP inflation factor using the values provided in the Blue Chip Economic Indicators index. The Company’s calculations for its GDP inflation factor are provided in its initial filing in Exhibit__(RRP-8).

Q. What GDP inflation factor did the Company use in its rate year forecast?

A. The Company’s GDP inflation factor is 4.2785%, calculated over a twenty seven month period between the historic test year ended December 31, 2011 to the rate year ending March 31, 2014.

Q. Did the Company make any updates to its rate year GDP inflation factor?

A. The Company did not update its rate year GDP inflation factor in its Corrections and Updates filing, but the Company did update the historic test year base used to calculate the rate year forecast with the rate year GDP inflation factor.

Q. Do you know the O&M expense items affected by the GDP inflation factor?

A. Yes. The O&M expense items affected by GDP inflation factor are provided in the response to

IRs DPS-100 (ACL-7) and DPS-482 (DAG-74).

Q. Are you proposing an adjustment to the Company's rate year GDP inflation factor?

A. Yes. We are proposing to update the Company's GDP inflation factor to 4.0918% using the latest known data from July 17, 2012.

Q. How did you calculate the updated GDP inflation rate?

A. We first obtained quarterly GDP price indices from the Blue Chip Economic Indicators on July 17, 2012. The quarterly GDP price indices are from the periods of calendar year ended December 31, 2011 (calendar year) and rate year ended March 31, 2014 (rate year). The average GDP price indices for each year are 113.373 and 118.012 for the calendar year and rate year, respectively.

Q. Please continue.

A. The difference between the calendar year and the rate year GDP price indices is 4.639. This difference is divided by the GDP price index from the calendar year to come up with 4.0918%. This is the percentage change between the calendar year and the rate year.

Q. Are you proposing an adjustment to reflect this more current estimate of inflation?

A. Yes. The inflation adjustment reduces O&M expense by $485,000 ($413,000 for electric; $72,000 for gas).

Q. How did you calculate this adjustment?

A. In the response to IR DPS-482 (DAG-74), the Company provided a list of the expenses to which it had applied inflation in projecting the rate year expense. We have used the Company’s compiled list and applied the updated inflation rate to calculate our adjustment. To avoid a double-count, we removed from this list any Staff adjustments we have made elsewhere that included an application of inflation. For example, when we normalized out the specific consultant expenses, as discussed in a prior section of our testimony, we removed the amount the Company had included in its rate year forecast, including the portion of the cost associated with the Company’s inflation factor of 4.2785%. We have removed the historic test year amount of the specific consultant adjustment, i.e. before inflation, from our expense base used in calculating our inflation adjustment.

Q. Please continue.

A. We then calculated the rate year inflation forecast. The difference between Staff's forecasted and the Company's forecasted inflation amount is our total adjustment of $485,000.

II. Taxes Other Than Income Taxes

A. Property Taxes

Q. Please explain how the Company derived its rate year property tax expense forecast.

A. As shown in Exhibit __ (RRP-5CU), Schedule 1, Pages 3-4, the Company began with actual property tax expense for the fiscal year ending March 31, 2012 of $182,147,655. The Company then increased this amount by 3.2% in fiscal year 2013 and fiscal year 2014 resulting in a rate year increase of $11,929,911. The Company further increased this expense by forecasting increases to property taxes associated with incremental additions to plant in service. These forecasted plant additions result in an additional $7,113,195 of rate year property taxes, for a total requested rate year allowance of $201,190,761. Overall this represents a 10.5% increase from the fiscal year 2012.

Q. Do you agree with the Company’s forecast?

A. No. We disagree with the Company’s forecast for the following two reasons. First, the Company’s growth factor of 3.2% is based on calendar year data, but should be based on fiscal year data. Second, the Company has incorrectly calculated incremental additions to plant in service.

Q. Please explain your first point that the 3.2% growth factor is based on calendar year data, but should be based on fiscal year data.

A. To forecast the annual growth factor, the Company used the increase in property taxes from calendar year 2010 to calendar year 2011, normalized to remove the effect of property tax refunds. However, the Company should have used the increase from fiscal year 2011 to fiscal year 2012. The term “fiscal year” refers to the twelve months ending March 31.

Q. Why should the Company use a fiscal year instead of a calendar year?

A. The Company should use a time period that coincides with the time period used in other areas of the analysis. The Company’s forecast is done with fiscal year data and the rate year is based on a fiscal year as well. As such, the Company should use a fiscal year when calculating the growth factor. Furthermore, using a calendar year creates a disconnect by leaving a three month gap between the calendar year end and the start of the forecast.

Q. Why did the Company use a calendar year growth rate?

A. On page 12 of the testimony of the Shared Services and Customer Panel, the Company states that this methodology is consistent with the methodology approved by the Commission in the 2010 Electric Rate Case. However, in that case, both the Company’s forecast and the rate year were based on a calendar year, therefore it made sense to calculate the growth factor on a calendar year as well. This is not the situation in this case.

Q. What is the growth rate for fiscal year 2012?

A. From the data provided in response to IR DPS-281

(RLC-14), we calculated a growth rate of 1.06%, as shown in the property tax workpapers in Exhibit__ (SAP-4). Using this 1.06% growth rate instead of a 3.2% growth rate decreases the electric and gas property tax expense forecasts by $6,289,802 and $1,743,151, respectively.

Q. Please explain your second point, that the Company has incorrectly calculated incremental additions to plant in service.

A. To calculate incremental additions, the Company compared forecast additions to the five year average of additions from 2005 through 2009. However, the Company should have compared forecast additions to additions during the same time period used to calculate the growth rate.

Q. Why did the Company use a five year average of additions?

A. On page 17 of the Shared Services and Customer Panel testimony, the Company states that the "3.2% growth factor implicitly incorporates capital spending that is approximately equal to its five-year historic average."

Q. Why is this incorrect?

A. A growth factor based on a certain historical period, for example in the Company's case calendar year 2011 over 2010, only incorporates the impact of additions occurring during the time period used in the calculation of that growth factor. The taxes related to additions from previous years would already be reflected in the base year taxes used to calculate the growth rate and so would not contribute to increased taxes from additions during the period of measurement. Therefore, additions from 2005 through 2009 would not impact the growth rate in 2011 at all.

Q. How should incremental additions to plant in service be calculated?

A. As the Company's forecast is based on a one year growth factor, plant in service additions from one year should be compared to the forecast additions to determine the incremental amount.

Q. What is your adjustment?

A. Using the most recent one year data to calculate the incremental plant in service additions decreases the electric and gas property tax expense forecast by $2,041,505 and $565,781, respectively.

Q. What is your rate year property tax expense forecast?

A. Our rate year property tax expense forecast for both electric and gas is $190,550,522, which represents a 4.61% increase over fiscal year 2012.

Q. Do you have any other comments on the property tax expense forecast?

A. Yes. On page 14 of the Shared Services and Customer Panel testimony, the Company states that the recent property tax cap law does not have any effect on their property tax expense forecast because the law caps the tax levy, whereas the Company's forecast of property tax expense is based on tax bills, not the tax levy. This logic is incorrect, however, as tax bills are based in part on the tax levy. Generally, the tax levy of the tax authority is determined by reducing the approved fiscal year expenditure budget by all other source of revenue. The taxing authority divides the total tax levy by the total amount of assessable property to establish a tax rate. This rate is then applied to a person or company's assessed property to determine their tax bill. Ergo, any cap on the tax levy will have an impact on tax bills and will likely result in moderating future tax increases.

Q. Are you proposing an adjustment to reflect the effect of the state’s 2% property tax cap on the Company’s rate year forecast?

A. No. As this legislation is fairly recent, we do not yet have enough data to accurately compute the impact on property tax expense. However, because our 1.06% growth rate is based on tax data prior to the tax cap being implemented, it does not reflect the impact and as such, is generous.

B. Payroll Taxes

Q. You have proposed an adjustment to the rate year labor forecast of $14,407,700, does the Company’s rate year forecast of payroll taxes need to be adjusted for those proposed labor adjustments?

A. Yes. A concomitant adjustment reducing rate year payroll taxes by 7.39% of our proposed labor adjustments is required. We have reduced rate year payroll taxes by $1.061 million

($0.886 million for electric; $0.175 million for gas).

Q. How did you derive your 7.39% payroll tax rate?

A. The Company's rate year forecast of payroll tax expense is $20.7156 million as set forth in Exhibit __ (RRP-5CU), Summary, Page 2. The Company's rate year forecast of labor expense is $280.1745 million as set forth in Exhibit __ (RRP–3CU), Summary, Page 2. Dividing these two dollar amounts results in payroll taxes being 7.39% of labor costs.

Q. Are you proposing any other adjustments to payroll taxes?

A. Yes. As noted in the Company's response to IR DPS-395 (DAG-50), the Company's rate year payroll tax forecast should be reduced by $3,800 to reflect the removal of one additional full-time equivalent employee associated with US Restructuring.

III. Rate Year Deferrals

A. Overview – Electric Deferrals

Q. Would you please list the electric revenue, expense, and capital categories for which the

Company is requesting deferral or true-up ratemaking treatment in this rate case?

A. As indicated in its response to IR DPS-380(DAG-46), the Company is seeking to continue currently in-place deferrals from the previous electric rate case, Case 10-E-0050, for the following revenues and expenses: pension expenses, other post employment benefits (OPEBs) expenses, low income discount program, economic development fund, auction debt true-up, service quality assurance program, and legislative or regulatory changes. In addition, as stated in the direct testimony of the Revenue Requirements Panel at pages 103-125, the Company proposes to maintain current ratemaking treatment of RPS program costs, SBC program costs, aggregation fee, voltage migration fee, temporary state assessment 18-A, electric supply reconciliation mechanism as well the new hedge adjustment and legacy transition charge (formerly known as the Commodity Adjustment Clause), Transmission Revenue Adjustment Clause, NYPA Residential Hydropower Benefit Reconciliation, NYISO Tariff Schedule costs – Schedules 1 and 2 for any NYISO rebills, and generation stranded cost adjustments.

Q. Is the Company requesting any new deferrals or true-ups in this rate case?

A. Yes. The Company is also requesting the following new or revised deferrals/true-ups: NERC Compliance rules, generating plant closures, NYPA discounts, variable pay, transmission tower painting, modifications to the extraordinary storm costs, site investigation and remediation (SIR), and economic development grant program.

Q. Are you in agreement with the continuation of the specific deferrals as proposed by the Company?

A. Yes, with one exception. Absent from the Company's discussion of deferrals is the deferral for tax and accounting changes that are externally imposed or internally adopted. We are not sure if this was an oversight or not, but Staff's recommendation is that the tax and accounting change deferral continue as currently designed, for both the sub-categories of externally imposed or internally adopted changes. This specific deferral is one of the deferrals contained in the Case 10-E-0050 Rate Plan Provisions (RPP) report, adopted by the Commission on July 17, 2012.

Q. What is the Company's proposal with respect to the RPP?

A. The Company proposes to continue the provisions and incorporate them into the electric and gas rate plans that have been established in this proceeding, except to the extent it has proposed any modifications throughout the filing.

Q. Has the Company proposed any modification to the tax and accounting change deferral as contained in Section 1.2.1 of the RPP?

A. Not that we are aware. Staff's recommendation is that the tax and accounting change deferral continue as is with no modifications.

Q. What is Staff's position on the proposed new deferrals?

A. Staff's Electric Infrastructure Panel discusses the new deferral requests associated with the NERC Compliance rules, generating plant closures, transmission tower painting, and the extraordinary storm costs and storm fund.

Staff's Site Investigation and Remediation Panel discuss SIR costs, the Staff Electric Rates Panel addresses the NYPA discount deferral, and the Consumer Issues Panel is responsible for the economic development grant program. We are in agreement with the Company's proposal for the variable pay deferral for any under spending of the amount allowed in rates.

B. Overview – Gas Deferrals

Q. Would you please list the gas revenue, expense, and capital categories for which the Company is requesting deferral or true-up ratemaking treatment in this rate case?

A. As indicated in its response to IR DPS-380(DAG-46), the Company is seeking to continue currently in-place deferrals from the previous gas case, Case 08-G-0609, for the following revenues and expenses: pension expenses, OPEBs expenses, low income discount program, SIR expenditures, deferred auction debt true-up, and service quality assurance program. In addition, as stated in the direct testimony of the Revenue Requirements Panel at pages 103-125, the Company proposes to maintain current ratemaking treatment of SBC program costs, temporary state assessment 18-A, GAC surcharge/refund adjustment, non-core revenue sharing, and the accrued unbilled revenue deferral.

Q. Is the Company requesting any new deferrals or true-ups in this rate case?

A. Yes. The Company is also requesting the following new or revised deferrals/true-ups: Pipeline Safety Act of 2011, economic development grant program, variable pay, temporary deferral balance refund, modifications to the regulatory, legislative and accounting changes, Empire Zone Rider (EZR) deferral, revenue decoupling mechanism (RDM), merchant function charge (MFC), and net revenue sharing mechanism.

Q. Are you in agreement with the continuation of the specific deferrals as proposed by the Company?

A. Yes.

Q. What is Staff’s position on the proposed new deferrals?

A. The Gas Rate Panel is addressing the proposed changes to the RDM, the MFC and the net revenue sharing mechanism. The Pipeline Act of 2011 deferral is addressed by Staff witness Maioriello, and the Consumer Issues Panel is responsible for the economic development grant program and EZR deferral. As for the modifications to the regulatory, legislative and accounting changes, the Company proposes to replace the term “accounting change” with “court change” to make the deferral for the gas business similar to the proposed deferral for the electric business as included in the RPP. We agree with the Company’s modification, as it makes sense to apply the same language to both electric and gas operations.

Q. What is the Company’s proposed language for gas accounting change deferrals?

A. The Company did not make a specific proposal for gas accounting changes. The Revenue Requirements Panel testimony only states that the Company will address any accounting changes outside of the operation of the proposed regulatory, legislative, and court change deferral provision. That is too ambiguous a response, especially in light of the significant history of dispute that occurred in the last electric rate case over accounting changes.

Q. What is your recommendation?

A. As we have just agreed that it makes sense for the electric and gas operations to have the same deferral for the regulatory, legislative and accounting changes, the same is true of the "accounting change" portion of the previous gas deferral. We propose that the same language that is contained in the RPP for accounting changes, be applicable for gas operations.

Q. What is your recommendation on the variable pay deferral as proposed by the Company?

A. We are in agreement with the Company's proposal for the variable pay deferral for any under spending of the amount allowed in rates.

Q. Please explain the Company's proposed new deferral for the temporary deferral balance refund.

A. This simply represents the Company's proposal to amortize the projected net gas deferral balance as of March 31, 2013 over three years. As discussed earlier, this would be accomplished outside of base rates, similar to the electric deferral surcharge that was implemented January 1, 2012.

Q. Are you in agreement with this proposal?

A. We agree with the concept, but due to Staff's proposed base rate decrease, we are recommending no amortization of the projected net gas deferral balances at this time. If however, the Commission's ultimate decision results in a rate increase, we would recommend amortizing a portion of the deferred credit balance as an offset.

C. Pre-Rate Year Deferrals

1. Federal Income Taxes – Repair Costs

Q. Would you please provide some background information on this issue?

A. Before its 2009 fiscal year, Niagara Mohawk capitalized routine repair maintenance costs for federal income tax purposes. Beginning in 2009, the Company changed its method of accounting, and instead began expensing the routine repair maintenance costs. In response to IR DPS-144 (DAG-21), the Company's calculation on Attachment 1 indicates that, for federal income tax purposes, this change resulted in a 2009 tax benefit for gas operations of approximately $53 million. In response to IR DPS-396 (DAG-51), the Company updates the calculated tax benefit received from 2009 to March 31, 2013 for gas operations to be a total $91.4 million.

Q. What is the required ratemaking for this accounting change?

A. Under the terms of the Joint Proposal in Case 08-G-0609, the gas portion of the cash flow enhancement resulting from this tax accounting change must be deferred for the future benefit of ratepayers. Section 4.2.1 of the Joint Proposal requires the Company to establish a deferred credit for the gas portion of the cash flow enhancement resulting from this accounting change, as long as the individual change has an impact that exceeds $2.283 million in any year.

Q. How much in required deferred ratepayer credits has been recorded for this Company acknowledged accounting change?

A. The Company has not recorded any gas deferred credits for the future benefit of ratepayers.

Q. Has this issue ever been presented to the Commission for determination?

A. Yes. In Case 10-E-0050, Niagara Mohawk’s most recently litigated electric case, this very issue, for both the electric and gas cash flow enhancements, was addressed by Staff and presented to the Commission for determination. For the very same reasons asserted here, Staff recommended the cash flow enhancement benefits of the tax accounting change should accrue to the benefit of ratepayers. In both the ALJs Recommended Decision and the Commission’s Order, Staff’s recommendation was adopted, but for the electric operations only. Both the ALJs and the Commission were silent as to the appropriate ratemaking treatment for the cash flow enhancements benefits of the gas operations. We have here the same exact issue as before, except that it relates to gas operations.

Q. How did the ALJs and the Commission address this issue on the electric side?

A. The ALJs agreed with Staff, stating that “… the change Niagara Mohawk made for tax accounting purposes was also a financial and regulatory accounting matter that affected the operations of the existing rate plan in the year in which the company made the change. The rate plan contemplated the possibility of accounting change and matters of this sort, and the regulators who adopted the multi-year plan insisted that the benefits of accounting changes inure to ratepayers and be captured for them. Ratepayers are exposed to the consequences of adverse tax changes and accounting requirements for which they are responsible. It is only fair that ratepayers receive the countervailing benefits of any tax and financial statement improvements, when available."

Q. Please continue.

A. The Commission stated in its Order, "Initially we must point out that the Merger Joint Proposal is not a contract and its provisions are not to be parsed in the manner the Company has attempted here to determine its proper operations during the term of the rate plan for ratepayers and shareholders alike. In ruling on the issue raised here, we look to the regulatory purposes and objectives that the Merger Joint Proposal is intended to serve and our actions are in keeping with the proper achievement of these goals. The Merger Joint Proposal was crafted to cover substantial changes in material items that alter the Company’s ongoing operations from those in place at the time the Merger Joint Proposal was adopted. It recognizes that such changes can go in both directions and they can be either advantageous or disadvantageous to the Company. The Merger Joint Proposal provides the Company protection from unknown, adverse changes and it captures for ratepayers advantages that were not and could not be known at the time it was adopted.” The Commission found “the change in federal income tax practice in 2009 was material and it achieved a significant cash flow reduction that is both captured by the Merger Joint Proposal and inures to the benefit of the ratepayers who have also been paying a large body of deferred costs that built up during the course of the Merger Joint Proposal.” The Commission agreed with the ALJs and required the cash flow enhancement be treated as a deferred credit.

Q. If the Commission previously ruled that the cash flow enhancement should be treated as a deferred credit, why has the Company not yet recorded any gas deferred credits for this tax accounting change?

A. In IR DPS-144 (DAG-21), the Company presents three reasons it believes the Commission would reach a different conclusion for the treatment of gas cash flow enhancement benefits. The first is because the Commission did not adopt Staff's recommendation to establish a gas deferred credit even though the issue was addressed in both testimony and briefs. The second reason is that the Company claims the wording of Section 4.2.1 of the Joint Proposal in the gas case, Case 08-G-0609, which deals with Regulatory, Legislative, and Accounting changes, does not explicitly address tax changes in any manner. Rather the section of the Joint Proposal that is in question here, the Company suggests, explicitly applies to "discrete regulatory, legislative and accounting changes," of which the change in tax strategy for the change to expensing the routine repair maintenance costs, is not a product. Therefore, it asserts that Section 4.2.1 does not apply.

Again the Company argues the word “accounting” in Section 4.2.1 refers to changes in financial accounting and not changes in tax strategy or tax accounting.

Q. What is the Company’s third reason?

A. The Company says that, in contrast to the situation described by the Commission for Case 01-E-0075 and the electric Merger Joint Proposal, the Company has not built up a substantial amount of gas deferred assets, but rather there is now a $42 million credit balance available to go back to customers. The Company also mentions that the fairness concerns presented by the Commission are not applicable to its gas rates.

Q. Do you agree with the Company’s reasons?

A. No. Similar to the circumstances presented in Case 10-E-0050, the position is simply an attempt to renege on the settlement terms it agreed to in the previous gas case. First, whether the Company terms it as a change in its tax strategy or a change in tax accounting, it is still an accounting change. This has already been recognized by the ALJs in the last electric rate case. Furthermore, as the Commission did not dispute the ALJs findings that the Company's actions were indeed considered to be an accounting change, and that the benefits should inure to ratepayers, it can be easily inferred that the Commission supported the ALJs conclusion. Since the situation in this case is exactly the same as it was in the electric case, it is logical to conclude that the Commission would find the gas related cash flow enhancement benefits rightly belong to the ratepayers, and not the Company.

Q. What about the Company's argument that this is not a discrete regulatory, legislative or accounting change and thus Section 4.2.1 of the gas Joint Proposal is not applicable?

A. The Company is quite simply wrong. The tax accounting change that was implemented is most certainly discrete and distinct. A very specific change in the accounting for routine repair maintenance costs for federal income taxes was implemented. This is exactly the type of event Section 4.2.1 was intended to cover. This is, without question, a change of accounting. Previously, Niagara Mohawk was capitalizing these repair costs for tax purposes; and now Niagara Mohawk is expensing these repair costs for tax purposes. Changing from capitalizing certain costs to expensing those same costs for income tax purposes is a change in accounting; it is that basic. Relatedly, on pages 57 and 89-90 of its pre-filed direct testimony, the Revenue Requirements Panel itself proposes an accounting change to begin expensing in the rate year gas general equipment items under $2,500 that are currently being capitalized. This is the identical situation to the tax accounting change for repair costs – expensing items that were previously being capitalized.

Q. Please address the Company's argument that because there are already $42 million in gas deferred credits available for ratepayer benefit, the Commission's fairness concerns from Case 10-E-0050 are not applicable.

A. The Company's argument is illogical. It makes no difference whether there are $42 million of gas deferred credits or $42 million of gas deferred debits sitting on the books, ready for disposition to ratepayers. That would be like saying no additional deferred storm, pension or OPEBs costs can be booked because you already have deferred debit balances for these items. It is appropriate to judge each deferrable item based on its own merits. In this case it is clear, similar to the circumstances on the electric side, that ratepayers are entitled to 100% of the tax cash flow benefit enhancements from the time the Company took the tax deduction to the beginning of the rate year.

Q. Do you have any further comments?

A. Just that, while we do not know what the Commission was thinking at the time, it only makes sense that "[t]he Commission did not address the gas issue in any manner," because the only case before it at that time was the electric case.

Q. What is Staff's recommendation?

A. Under Clause 4.2.1 of the gas Joint Proposal in Case 08-G-0609, a gas deferred credit of $30.113 million must be established for the cash flow enhancement related to this accounting change.

Q. How did you quantify this deferred credit amount?

A. In response to IR DPS-396 (DAG-51), Attachment 1, the Company provides the quantification of what would be the pre-rate year gas deferral related to the federal repair cost deduction if the Commission were to adopt Staff's recommendation.

Q. Are you recommending the pre-rate deferral for the federal income tax repair costs be treated in the same manner the Company proposes for all pre-rate year deferrals?

A. No. The Company proposes to amortize the total projected balance of pre-rate year deferrals over three years. Based on the Company Corrections & Updates filing, the projected pre-rate year deferral balance is a credit amount of $41.095 million, and the amount proposed to be amortized in the rate year is $13.698 million, before any gross up for bad debt or revenue taxes.. We do not feel it is appropriate at this time to amortize any of the federal income tax repair cost deferral as the Internal Revenue Service has not issued its official revenue procedure regarding the repair deduction guidance on natural gas property. The Company expects the guidance to be issued prior to the end of calendar year 2012.

Q. Why is this important?

A. Although the Company implemented this tax accounting change and has taken federal income tax expense deductions for the repair costs since 2009, the IRS has not signed off on the amount of the Company’s deduction. There is a possibility that, with the issuance of the repair deduction guidance, the Company’s claimed deducted amounts may need to be adjusted. We therefore recommend, due to the size of the current computed deferral, that the deferral be set up and accrue carrying charges at the pre-tax rate of return, but that it be held in reserve and not passed back to ratepayers until the IRS issues its guidance for natural gas property.

2. Carrying Charges on Pre-Rate Year Deferrals

Q. What is your proposal on accruing carrying charges on pre-rate year deferral balances?

A. In the last electric rate case, Case 10-E-0050, Niagara Mohawk was allowed to begin accruing carrying charges on future deferred balances. In the last gas rate case, Case 08-G-0609, Section 4.5.1 of the Joint Proposal, the Company could not accrue carrying charges on deferred debit or credit balances, with the exception of RDM or as otherwise specified in the Company's tariffs. We now recommend the allowed carrying charge treatment be the same for both electric and gas operations. Therefore, the Company should start accruing carrying charges on deferred balances, cash items only, effective April 1, 2013.

3. Audit of Pre-Rate Year Deferrals

Q. What is the status of Staff's audit of the pre-rate year deferrals?

A. In the Case 10-E-0050 deferral recovery filing, Attachment 2 of the Commission's December 16, 2011 Order contained a schedule showing the status of Staff's audit on the December 31, 2010 electric deferral accounts balances. As of this filing today, this status has not changed, the deferral account balances noted still remain open, as well as the deferrals that have accumulated in calendar year 2011 and year to date 2012. Staff committed to endeavor to complete its audit, but due to resource and workload constraints, the audit is not yet complete.

Q. What is the status of the gas pre-rate deferrals?

A. Staff has reviewed a limited number of the gas Joint Proposal deferrals, but at this time cannot sign off on an amount associated with each deferral balance.

Q. Is it Staff's intention to resume auditing the remaining open electric and gas deferral account balances?

A. Yes, Staff will endeavor to complete the deferral audit on open deferral account balances and report back to the Commission any areas of disagreements that cannot be resolved through the traditional deferral audit process.

IV. Service Company Costs

Q. Would you please provide some background on National Grid's service companies?

A. There are four service companies providing services to National Grid affiliates. This includes National Grid Service Company, KeySpan Corporate Services LLC, KeySpan Utility Services LLC, and KeySpan Engineering and Survey Inc. The service companies provide various centralized services to other National Grid operating entities. National Grid is planning to implement its US Foundation Program in October 2012 to consolidate its finance, human resources and supply chain systems on a single SAP platform. At the same time, the legacy KeySpan Corporate and Utility Service Companies will be consolidated into the National Grid Service Company.

Q. What are the centralized services the service companies provide?

A. Examples of the services provided are financial services, human resources services, information technology services, and legal services, to name a few. The services provided are identified in the service company agreements that Niagara Mohawk has entered into and filed with the Commission.

Q. Can you give an overview of the various service company related concerns and issues identified in the last electric case, Case 10-E-0050?

A. As shown by the Company in the direct testimony of its Service Company Panel at pages 18-19, some of the key service company issues were (1) whether National Grid’s business structure lacked internal procedures and safeguards necessary to ensure proper allocation of service company costs to operating companies; (2) whether National Grid’s cost allocation methodology properly credited Niagara Mohawk for the economies of scale it creates as the largest US based operating company in the National Grid system; (3) whether Niagara Mohawk properly normalized historic test year service company charges; (4) the difficulties in auditing service company costs assessed to Niagara Mohawk; (5) the service companies’ lack of operating budgets and variance reporting; (6) the lack of review of service company charges at the operating company level; and (7) the personnel from the service companies making the decision as to what services Niagara Mohawk should take rather than Niagara Mohawk personnel independently making those decisions.

Q. Were any additional independent audits initiated because of the issues raised in Case 10-E-0050?

A. Yes, two separate audits were initiated. National Grid retained Liberty Consulting to conduct an independent review and evaluation of the affiliate relationships and transactions addressing all costs affecting its US utility operations. A copy of the Liberty report, including the findings and recommendations, has been provided as a response to IR DPS-465 (DAG-66). In addition, in Case 10-M-0451, Overland Consulting was retained by the Commission to perform a historical review of National Grid’s allocation of service company costs to Niagara Mohawk and other New York utilities over the period of October 2008 through May 2010, as well as service company affiliate policies and procedures. Overland has not yet issued its report with its findings.

Q. Do you have service company related concerns in this case?

A. Yes, while some of the concerns expressed in the last case have been alleviated, others remain.

Q. Please explain.

A. In Case 10-E-0050, one concern, as stated by the ALJs in the Recommended Decision, and shared by Staff, found that the structure of National Grid’s business organization around lines of business and the service companies lacked the internal procedures and controls necessary to ensure the proper allocation of costs to the individual operating companies. This specific concern regarding corporate structure has been mitigated by the Company’s decision to change from a global line of business model to a regional and jurisdictional model. The transition to the new structure was completed in September 2011. The new structure is intended to focus more on the needs of each separate jurisdiction and the individual operating entities within those jurisdictions. The regulated entities of New York, Niagara Mohawk and the KeySpan companies, now fall under the leadership of a president in charge of the New York jurisdiction.

Q. Have any other prior concerns have been mitigated?

A. We performed a limited review of Niagara Mohawk’s historic test year charges, both incurred charges from Niagara Mohawk itself and from the services companies. From our review, our previous concerns related to the misallocation of service company charges to Niagara Mohawk appear to have been addressed by Company’s actions over the last year. We did not find any instances of cross-subsidization by Niagara Mohawk of the other National Grid affiliates. While we do have some normalization of historic year costs concerns that are discussed elsewhere in our testimony, they are not of a service company cost allocation nature. Also, the previous concern of the difficulties in auditing service company costs assessed to Niagara Mohawk did not reappear throughout our current rate case audit. Our limited review of the historic year service company costs was done without the difficulties and constraints that previously existed.

Q. Are there any concerns from the last electric case that continue?

A. Yes. While we have no specific numerical adjustment to make in this case resulting from our review of individual service company transactions and their accounting and allocation, we have several service company concerns that continue to exist today. Specifically we have concerns associated with the Company’s service level agreements, the review and approval of the monthly service company bill, and the monthly budgeting and review process. Each of these concerns is addressed below.

Q. What is a Service Level Agreement?

A. The Company, at page 18 of the Service Company Panel’s testimony, describes SLAs, the service level agreements, as agreements between National Grid’s functional areas and the president of National Grid’s Niagara Mohawk operations that set forth the levels and cost of services provided by the functional groups to the jurisdictional entities. In response to IR DPS-484 (DAG-76), the Company provided copies of the current versions of its US SLA Governance Handbook, SLA agreements between the various functional providers and Niagara Mohawk, and the service agreements as filed with the Commission on March 30, 2012.

Q. Please explain how the service agreements that are filed with the Commission differ from the SLAs.

A. Service agreements are legal contracts between the specific operating company and the service company that set out the terms for the provisions of services being performed. The SLAs, as designed, are non-legally binding performance management tools that define the relationship between the functional service provider and the recipient of the services.

Q. Do you have any comments on the SLAs provided by the Company?

A. Yes, we have concerns with the SLAs as currently designed. The Liberty Consulting report, provided in response to IR DPS-465 (DAG-66), was issued March 21, 2011, and contains discussion and recommendations on SLAs. In particular, at page 63 of Attachment 1 of the report, Liberty states, “The design and use of SLAs emerged as a significant issue in the NYPSC management audit of Grid in 2009. Grid’s response remained a work in progress during the Liberty audit. Liberty has provided Grid with recommendations for SLA design, content and use. We have also emphasized the need to see them in the broader and overriding context of service-cost management. A new perspective on SLAs and service-cost management has emerged as a result of the shift to a regional organizational model. Liberty believes the judicious design and application of SLAs will form a central element in making the regional model effective.” In Appendix 2 of the same report, Liberty provided a listing of a general set of criteria that it recommended in the Company’s design of the new SLAs, including areas such as Service Definition, Cost and Pricing, Planning and Budgeting, Choice, Accountabilities, and Performance Standards and Measures. In IR DPS-501 (DAG-85), we requested the Company show where and how the current design of the Company’s SLAs reconciles to and incorporates the suggested criteria for the SLA design provided by Liberty. In its response, the

Company indicates it has addressed all the criteria suggested by Liberty.

Q. Do you agree?

A. No, we do not think the SLAs, as currently designed, adequately address Liberty’s recommendations.

Q. Please explain.

A. The SLAs provided by the Company in response to IR DPS-484 (DAG-76) do not contain pricing information, such as price and quantities of services to be provided, and 11 of the 16 SLA’s do not contain key performance indicators. The SLAs contain no provisions for bench marking or market testing of the services that are provided to Niagara Mohawk. Such provisions are necessary to ensure the costs are competitive with the pricing of non-affiliated vendors or of Niagara Mohawk performing the service itself.

Q. Why is it necessary the SLAs contain this information?

A. For the types of centralized services being provided by the service companies, the costs incurred and paid for by Niagara Mohawk should be coming from the most cost effective provider, whether from an affiliate, a non-affiliated vendor or Niagara Mohawk itself. Niagara Mohawk needs to have the information so it can monitor the cost of the services provided by the SLAs and the corresponding service agreements. Without it, the Company cannot compare the costs of the services being provided and determine whether receiving the services from its affiliates is the most cost effective alternative.

Q. Are the centralized service costs charged to Niagara Mohawk considered to be a significant amount?

A. Yes, this is confirmed by reviewing just a few of the draft SLAs provided in response to IR DPS-484 (DAG-76). Attachment 4 of this response is the draft SLA between the Finance functional service provider and Niagara Mohawk for the period August 1 through March 31, 2012. The controllable operating expense budget for Niagara Mohawk for the Finance functional area is $31.300 million. It is important to note this total amount portrayed is not solely the estimate of allocated costs from the centralized service companies, but includes direct charges to Niagara Mohawk as well. Attachment 7 of the response is the draft SLA between the Information Services functional service provider and Niagara Mohawk, with the controllable operating expense budget for Niagara Mohawk of an amount of $37.700 million. Similarly, Attachment 14 is draft SLA between the Shared Services functional service provider and Niagara Mohawk, with the controllable operating expense budget for Niagara Mohawk of $75.548 million. While there are sixteen SLAs in total, the amounts for just these three SLAs are already substantial.

Q. Is there a problem with the Company not segregating out the budgeted direct versus centralized service company amounts in the various SLAs?

A. Yes, this exacerbates the problem we identified previously regarding the SLAs being devoid of pricing information of the services to be provided by the service company. With the expected service company costs not broken out from the total budgeted operating expenses for the functional area in the SLAs, Niagara Mohawk cannot affirmatively determine that the costs and services provided are reasonable.

Q. How does National Grid then assure the cost of competitiveness of its services being provided to Niagara Mohawk?

A. In Exhibit __ (SCP-2) page 7, item VI:R6, and the response to IR DPS-468 (DAG-69), National Grid indicates it uses a "deep dive" process, which is considered to be a comprehensive analysis of a function or service area that addresses the business model or sourcing opportunities. It could include benchmarking, market testing and consultant services and where appropriate, comparisons of obtaining the services from alternative sources.

Q. What is your concern with the deep dive process as explained by the Company?

A. The deep dive process addresses the benchmarking from a high level type of overview, with the specific details missing. The deep dive process doesn't provide a comparison to the cost of Niagara Mohawk obtaining the service from another vendor or performing the service itself.

It only provides the allocated cost of National Grid providing the service, which is only one half of the comparison. As a result, it is not a proper market test or benchmarking. These deep dive and benchmarking details need to be formulated and incorporated into the SLAs for the SLAs to be an effective performance tool.

Q.   What other SLA concerns do you have?

A.   The SLAs should be incorporated into and be a part of the legal service agreements Niagara Mohawk enters into with the service companies. The Company indicated in response to IR DPS-484 (DAG-76), that the description of services in the SLAs will be aligned with the description of services contained in the service agreement and the service agreement will be referenced in the SLAs. However, this does not go far enough. Right now the SLAs are only a management performance tool, but in order to assure that Niagara Mohawk is receiving the most cost effective service from its service company affiliates, the SLAs should be part of the legally binding document that governs the terms of the services being provided.

Q. Please explain your concern with the review and approval of the monthly service company bill.

A. In IR DPS-378 (DAG-45) we asked the Company for an explanation and a copy of the Company's written accounting policies and procedures in place for its review of the service company bill and its charges that are sent from the KeySpan and National Grid service companies, and also the process employed to review and determine that the monthly service company charges to Niagara Mohawk are appropriately incurred and correctly allocated. The Company responded that the bill is produced in Peoplesoft and Oracle and available for viewing, but the bills are not distributed or signed off on, and there is no designated employee responsible for receiving and reviewing the bill. Payments of the monthly bills from Niagara Mohawk to the affiliate are made monthly and not contingent on the review or acceptance of the charges.

Q. If Niagara Mohawk does not review and approve the bills before payment, what are the internal controls in place to make sure the amount being paid is correct?

A. The Company states there are multiple levels of review for the service company costs being charged. First, when an invoice is paid, or payroll is charged, employees are advised that a review of the accounting is required as part of the approval process. Second, costs are reviewed by various decision support teams to compare them against budgeted amounts. Third, fluctuation analyses are done by the accounting group on income statements and balance sheets to review changes year to year. Fourth, a detailed review is currently being performed by the NY Jurisdiction Finance team.

Q. What is the problem with the Company's review process, or lack thereof?

A. The problem is that there is no one from the Niagara Mohawk operating company who is objectively or independently reviewing and making sure the charges it is incurring from the services companies are correct. The service company personnel are verifying the accuracy and appropriateness of its own bill calculations for Niagara Mohawk. Furthermore, the intercompany bill is automatically paid in lieu of any review. The service company is to be considered a vendor, similar to any other non-affiliated third-party vendor, and is by far Niagara Mohawk’s largest vendor. One would expect the Company would not pay a vendor’s charges without reviewing the bill and verifying the amount being charged is correct, and certainly the process should be no different in paying the bill of its largest vendor.

Q. Was this issue discussed in any other forum?

A. Yes. This issue was discussed in the last electric rate case, Case 10-E-0050; as well as in the audit performed independently by Liberty Consulting. In the audit that was undertaken by Liberty, it applied certain criteria in examining the affiliate billing process: (1) that affiliate billing should be accurate, timely and in the form of standard business to business invoices; (2) that invoices must provide clear and detailed information for the services and goods provided that allow for the evaluation of value and quality provided under appropriate SLAs or intercompany agreements; (3) that regulated operating companies must individually review and evaluate each invoice for accuracy and value provided; (4) that invoice approvals be made by high level operating company officers specified in delegation of authority documents; (5)that the invoice review and approval must provide a clear audit trail and meet corporate and Sarbanes-Oxley control requirements; and (6) that settlement processes and recording of payments must be timely, regular and auditable.

Q. Did Liberty make any findings as to how well the Company operated within those criteria?

A. Yes. In its review, Liberty found that (1) there was no review, evaluation, or payment authorization regarding service company billing to operating companies, or regarding billing between operating companies; (2) service company personnel effectively perform both ends of the billing, review, and settlement processes; (3) the mingling of roles impaired the ability to address operating company interests; and (4) the fact that the operating companies neither regularly review nor use the company employees to authorize payment of service company and intercompany invoices indicates that the specific interests of the operating companies do not have sufficient focus in affiliate transactions.

Q.   Given these Liberty findings, did Liberty make any recommendations?

A.   Yes. Liberty recommended National Grid (1) promptly establish consistent processes, procedures and delegation of authority for the independent review and approval of all affiliated company bills by senior managers accountable to each of the new regional presidents for the operating companies; and (2) strengthen processes, procedures, and culture to emphasize the importance of properly questioning and vetting charges for service company and intercompany payment authorization with the protection of operating company interests as being top priority.

Q.   What is your recommendation to address the concern about the lack of independent review of the service company bill and charges?

A.   Ideally, the Company should designate personnel who are solely Niagara Mohawk employees to review and approve payment of the service company bills and charges. In the alternative, the Company could install an annual verification process from an independent party that would perform a service company bill review and analysis, as well as transactional testing, so assurance can be provided that service company charges to Niagara Mohawk are appropriately incurred and allocated. Also, payment to the service company for its monthly bill should not be automatic; a monthly review of the bill and its charges should be performed, before payment is made.

Q. Please describe the detailed review that has recently begun being performed by the NY Jurisdiction Finance team.

A. As described by the Company in its response to IR DPS—378 (DAG-45), an additional level of review is currently being performed by the NY Finance group for the service company charges coming to Niagara Mohawk. This review is conducted through the monthly financial report for Niagara Mohawk, a report that was first implemented in October 2011. The monthly report compares monthly and year to date functional operating expenses to the budget and the prior year, as well as provides a breakdown of directly charged versus allocated costs. Each functional group provides detailed analyses and variance explanations, which is then reviewed by the NY Finance group to ensure the incurred charges are in line with expectations and that the variance explanations address the deviations from budgeted and prior year expense levels.

Q. Do you have any concerns with this new monthly reporting and review process?

A. Yes. First, this review process is described as an additional measure put in place that serves as a review of service company charges to Niagara Mohawk. As shown in the Company's response to IR DPS-469 (DAG-70), the NY Finance team is made up of National Grid personnel who are service company employees. So, again, we have service company employees undertaking a process where they are reviewing and monitoring their own charges, rather than an independent review coming from Niagara Mohawk employees. Second, the review process as described is inadequate and ineffective in determining if the service charges coming into Niagara Mohawk are appropriately charged and allocated. While the monthly reporting of actual versus budget process may serve the process of highlighting service company charge variances, it does nothing to monitor, review and ensure that service company charges are appropriately allocated, especially in the event that actual costs do not exceed the budgeted amount. One cannot assume that just because there is no variance, all service company costs have been properly accounted for and allocated to Niagara Mohawk. Furthermore, as indicated in response to IR DPS-298 (DAG-39), budgets are developed for each operating department housed within each service company. So it is the National Grid Service Company employees acting as Niagara Mohawk management who establish the budgeted service company amounts. From the start to the end of the process, it is service company employees deciding how much the services will cost.

Q. What is the status of the concern identified in the last electric case as to whether National Grid’s cost allocation methodology properly credits Niagara Mohawk for the economies of scale it creates as the largest US based operating company in the National Grid system?

A. We do not have an opinion on that at this time. The Company states in its Service Company Panel testimony at page 54, “Both National Grid’s existing cost allocation procedures and the revisions to those procedures that National Grid is proposing in the context of the consolidation of the service companies and the US Foundations Program are designed to ensure that no entity is cross-subsidized. These procedures also ensure that cost reductions are allocated among the operating entities in proportion to the level of services that those entities receive from the service companies.” Similar to our discussion on the allocator changes recommended by PA Consulting, we cannot conclude that Niagara Mohawk is receiving and benefitting from the economies of scale to the extent it should be until the US Foundations Program and the consolidated accounting system is implemented, and actual results can be analyzed. We, therefore, recommend that, after the consolidated accounting system has been in place long enough that twelve months of actual cost data are available, the Company undertake an analysis that will show to what extent Niagara Mohawk is actually receiving and benefitting from the economies of scale, and that it is not cross subsidizing any other affiliate. The results of such analysis should be submitted to the Commission.

Q. Turning now to management compensation, how much of the labor compensation charges reflected in Niagara Mohawk's rate year ended March 31, 2014 Operating and Maintenance expense (O&M) are from the National Grid USA Service Company and KeySpan Corporate Service Company (National Grid Service Companies)?.

A. There is $72.2 million of labor compensation included in the National Grid service company charges reflected in Niagara Mohawk's rate year ended March 31, 2014 O&M expense forecast.

Q. Are you aware of the National Grid Service Companies labor compensation comparison study that was performed by Staff witness Schuler?

A. Yes. According to Staff witness Schuler, the study shows that the compensation provided to the employees of the National Grid Service Companies is greater than that required for similar employees with like experience in the upstate New York labor market. This has resulted in Niagara Mohawk incurring nearly $3 million more in labor costs in the rate year ending March 31, 2014 than if Niagara Mohawk performed the services itself or, perhaps, obtained the services from a more regionally located vendor.

Q. Has Niagara Mohawk provided any comparisons for the services provided by the National Grid Service Companies to show that the costs of obtaining the services from its affiliates is competitive with the costs of Niagara Mohawk performing the services with its own employees or obtaining such services from another vendor.

A. No. Niagara Mohawk has provided no such market testing or benchmarking of the National Grid Service Companies’ cost of services as just described.

Q. Have any parties in the past recommended that such market tests or benchmarking of the National Grid Service Companies’ allocated service costs be done in order for Niagara Mohawk to manage and control the costs of these services.

A. In the Commission approved management audit report submitted by NorthStar Consulting Group (NorthStar) in Case 08-E-0827, NorthStar recommended that Niagara Mohawk enter into Service Level Agreements (SLAs) for those shared services it would consider obtaining from the National Grid Service Companies (see recommendations IX-4, 5 and 6). As part of the process of entering into such agreements, NorthStar recommended that Niagara Mohawk make such cost comparisons to assure that receiving such services from its affiliates was beneficial to its ratepayer. This is specifically covered on page IX-20 of the management audit report, at item #14 where it states, “The lack of formal Service Level Agreements (SLA) severely limits the ability of US Transmission and ED&G to proactively determine and then control levels of service and costs, and to compare costs with alternative potential suppliers of those services”. It should be noted in this context that Niagara Mohawk’s electric operations at the time were included under the US Transmission and Electric Distribution and Generation lines of business used by National Grid plc to organize and manage its businesses during the time of the management audit.

Q. Have any other parties recommended that Niagara Mohawk perform such comparisons for those services it receives from the National Grid Service Companies?

A. Yes. As discussed previously, the Liberty Consulting Group was retained by National Grid plc to examine the accounting practices and procedures related to its affiliate transactions and specifically those between its service companies and the affiliates receiving such services. On page 54 of its report presented to National Grid, included as the response to IR DPS-465 (DAG-66), Liberty recommended that the SLAs be implemented so as to provide the utilities the ability to manage their service costs with the ultimate test of being able to assure their customers that they are getting the best deal. In conjunction with the service cost management process, Liberty also recommended a formal program be developed for addressing the competitiveness of internally provided services, which would include benchmarking and market testing. In Appendix 2 of the report, Liberty provides suggested criteria for SLA design. Under the cost and pricing section, Liberty recommended that the competitiveness of the services provided by the National Grid Service Companies be documented and, if the pricing of its services is judged not to be competitive, a suitable cap should be established above which utility customers are protected.

Q. How has Niagara Mohawk responded to such recommendations requiring it to demonstrate the competitiveness of obtaining services from its affiliates?

A. Rather than perform market testing, Niagara Mohawk has employed a “deep dive” process as described in the response to IR DPS-468 (DAG-69) and as mentioned earlier.

Q. Please explain why the “deep dive” process is ineffective in demonstrating the competitiveness of the services Niagara Mohawk obtains from the National Grid Service Companies.

A. The “deep dive” process is ineffective since it only considers the cost of the services as provided through the National Grid Service Companies. It does not compare the cost of obtaining these services from alternative sources. By not making such comparisons, the competitiveness of obtaining these services from its affiliates is not demonstrated. Niagara Mohawk cannot demonstrate that it is obtaining these services at the best price.

Q. Considering the results of Staff witness Schuler’s study showing the higher labor compensation costs of the National Grid Service Companies as compared with upstate NY labor, explain the significance of Niagara Mohawk’s failure to require a demonstration of the competitiveness of obtaining services from its affiliates.

A. Staff witness Schuler shows that, due to the organization and location of the National Grid

Service Companies’ workforce, its compensation costs are greater than having these service performed by employees in the upstate labor market region. Without performing market testing it can’t be assured that these higher costs aren’t mitigated by an appropriate recognition of economies of scale in the allocation of service costs to Niagara Mohawk, so that costs of such services from its affiliates are comparable with Niagara Mohawk self provisioning these services or obtaining such services from an alternate provider.

Q. Please provide your recommendation as to the rate treatment of the higher National Grid Service Companies’ labor compensation costs flowing to Niagara Mohawk.

A. It is recommended that these higher labor compensation costs be excluded from the rate year ending March 31, 2014 O&M labor expense allowance for Niagara Mohawk. Niagara Mohawk has not demonstrated that the cost of obtaining services from its affiliates, which includes such higher costs, is competitive with other alternatives. Based on this, the indicated higher cost should not be allowed to be reflected in Niagara Mohawk's revenue requirement.

V. Overland Audit

Q. Please describe the current status of the independent audit being conducted by Overland Consulting in Case 10-M-0451.

A. Overland Consulting was retained by the Commission in Case 10-M-0451 to perform a historical review of National Grid's allocation of service company costs to Niagara Mohawk and other New York utilities over the period of October 2008 through May 2010, as well as service company affiliate policies and procedures. Overland has not yet issued its report with its findings. While we recognize the audit is currently ongoing, we expect the Overland audit report to be issued and brought before the Commission during the pendency of the rate case but sometime after Staff direct testimony is filed.

Q. Do you expect there to be any effect on the rate case once the Overland audit report is issued and delivered to the Commission?

A. We would expect the Commission Order in Case 10-M-0451 to provide direction as to whether and how the results should be incorporated into this pending rate case.

VI. Sales Adjustment Impacts

Q. Please explain the impact on rate year projected electric operating revenues from the sales forecast Staff witness Stella is recommending in his testimony.

A. Staff witness Stella is proposing an electric sales forecast that is lower than the level of sales reflected in the Company's forecast. Based on the Staff Electric Rate Panel’s electric revenue forecast contained in Exhibit __ (SERP-6 Corrected), we have reflected an adjustment that decreases projected rate year operating revenues by $8.162 million.

Q. Are there other cost elements that are also impacted by the change in the sales forecast and the operating revenues forecast?

A. Yes. Specifically, purchased power costs, revenue taxes, 18a assessment expense, and uncollectibles expense need to be adjusted as well, due to the flow through relationship that exists with the operating revenues component. As identified on Exhibit __ (SAP-1 Corrected), and again based on Exhibit __ (SERP-6 Corrected), projected rate year electric (a) purchased power costs have been decreased by $1.889 million; (b) revenue taxes have been decreased by $.068 million; and (c) 18a assessment expense has been decreased by $.705 million. The flow through adjustment for the projected rate year uncollectibles expense is contained within Staff's overall uncollectibles expense adjustment and has been previously discussed in a separate section of our testimony. Q. Does this conclude your testimony at this time?

A. Yes.