STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on August 22, 2007

COMMISSIONERS PRESENT:

Patricia L. Acampora, Chairwoman
Maureen F. Harris
Robert E. Curry, Jr.
Cheryl A. Buley

CASE 06-M-0878 - Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and other Regulatory Authorizations.

ABBREVIATED ORDER AUTHORIZING ACQUISITION SUBJECT TO CONDITIONS AND MAKING SOME REVENUE REQUIREMENT DETERMINATIONS FOR KEYSPAN ENERGY DELIVERY NEW YORK AND KEYSPAN ENERGY DELIVERY LONG ISLAND

(Issued and Effective August 23, 2007)

BY THE COMMISSION:

INTRODUCTION

This case concerns whether we should approve the proposed acquisition of KeySpan Corporation and its affiliates by National Grid plc. In approving the proposed acquisition, it is also necessary as a practical matter to make some revenue requirement determinations for KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island. These determinations are necessary for the Petitioners to determine if the merger should close. We are not authorizing any changes in rates or adopting what we would refer to as rate plans at this time. We expect to take such actions later this year.

This abbreviated order states our conclusions in the case and sets forth conditions that are part of our decision to approve the proposed acquisition. A more comprehensive order

will be issued at a later date, stating the reasons for our conclusions and the conditions we adopt.[1]

ABBREVIATED PROCEDURAL HISTORY

On July 20, 2006, National Grid plc (National Grid) and KeySpan Corporation (KeySpan), filed a joint petition seeking approval, pursuant to Sections 70, 99 and 100 of the Public Service Law, of their Agreement and Plan of Merger announced February 25, 2006.[2] The joint petition proposed a merger of National Grid and KeySpan, with National Grid acquiring the stock of KeySpan, and adoption of 10-year rate plans for The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York (KEDNY) and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island (KEDLI).[3]

On October 3, 2006, KEDNY and KEDLI each filed information in support of one-year base rate increases. They proposed that these one-year rate filings would govern in the event that the merger and 10-year plans were not adopted. Thereafter, other interested parties filed information

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[1] The due date for any petitions for rehearing runs from the issuance date of the subsequent order.

[2] As part of the joint petition, an EAF short-form was submitted to assist in determining whether the proposed merger will have a significant impact on the environment. An Order Adopting Negative Declaration was issued on November 9, 2006. Suffolk County appealed and its challenge was dismissed by the Albany County Supreme Court on June 19, 2007.

[3] The Petitioners asserted that the proposed ten-year rate plans reflected merger savings by providing lower delivery rates as compared to the stand-alone rate filings that would be pursued by each delivery company absent the proposed merger. They also asserted that the ten-year merger rate plans included provisions that would increase investment in utility infrastructure, maintain service quality, and expand and improve KEDNY's and KEDLI's retail access, low-income and demand-side management programs. Many of these topics are not addressed in the Joint Proposal before us.

concerning issues raised by the merger petition and the one-year rate filings and the Petitioners responded.

The Petitioners filed an Amended Notice of Confidential Settlement Discussions on November 29, 2006.[4] Meetings were scheduled for December 7 and 8, 2006 in Brooklyn, New York to discuss programs that may be implemented in the KeySpan service territories. Public Statement hearings were held on January 9-11, 16-18, and February 1, 2007 in Riverhead, Smithtown, Mineola, Brooklyn, Queens and Staten Island. Chairwoman Patricia Acampora and Commissioner Robert Curry attended some of the sessions.

Settlement discussions resumed March 12-15, and continued during the weeks of March 26, April 2, 16, 30, and May 7, 2007.

On May 11, 2007, some of the parties advised the judges that they had (1) reached agreements in principle regarding interim gas energy efficiency programs and the terms of three-year gas rate plans for KEDNY and KEDLI if there is no merger; (2) agreed that the merger case should be decided based on a fully litigated record; and (3) concluded that certain issues, including (a) permanent gas energy efficiency programs, and (b) permanent revenue decoupling mechanisms, further rate design changes, and low-income programs, should be the subject of two separate collaboratives to be concluded later this year.

A "Joint Proposal for Interim Energy Efficiency Programs" (JP 1) was executed and filed on May 31, 2007. The primary goal was to ensure interim programs would be available to KEDNY and KEDLI customers prior to the winter of 2007-2008. Most of the proposed terms were adopted.[5]

On June 15, 2007, the Petitioners noticed additional settlement discussions that commenced June 20, 2007 concerning the proposed merger and some revenue requirement issues for

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[4] The original notice had been filed one day earlier, on November 28, 2006.

[5] Cases 06-G-1185 and 06-G-1186, KEDNY and KEDLI – Gas Rates, Order Authorizing Interim Gas Efficiency Programs and Related Deferrals (issued July 18, 2007).

KEDNY and KEDLI. Very late in the evening on June 21, 2007, Department of Public Service (DPS) Staff reported that some of the active parties reached an agreement in principle concerning the merger case and certain aspects of five-year "rate plans" for KEDNY and KEDLI. The agreement in principle was initially memorialized in a term sheet. The agreement in principle was reduced to writing and the "Merger and Gas Revenue Requirement Joint Proposal" (JP 2) was filed on July 6, 2007. Initial and reply statements were submitted by some active parties. Those who executed JP 2 are referred to as the Signatories. Evidentiary hearings were held on July 19 and July 23, 2007. The record contains 590 transcript pages and 468 voluminous exhibits.[6]

On July 25, 2007, the Petitioners wrote to the Secretary further extending the suspension date, without a make whole and without conditions, through December 31, 2007. This makes it possible to establish new gas rate plans for KEDNY and KEDLI later this year, to be effective on or about January 1, 2008. A further public statement hearing was held in Niskayuna on that same date.

Just prior to our consideration of the case, a notice was issued, providing for additional submittals concerning service quality, reliability, and safety. Information responsive to the notice was filed and is considered here.

Our initial consideration of the case took place on August 15, 2007. At that time, the Petitioners were offered an opportunity to allay various concerns about some terms of JP 2.

On August 17, 2007, the Petitioners accepted many of the conditions discussed on August 15, 2007, pertaining to increased financial protections and addressing Vertical Market Power. They also renewed a commitment to invest approximately $1.4 billion over the next five years in the upstate service territory of Niagara Mohawk Power Corporation.

[6] Numbers 1-480, excluding 319-324, 448, 451, 452, 461, 462, and 468. The latter were not moved into evidence or are blank.

On August 20, 2007, comments were submitted by five other active parties, including State Assemblymember Alessi, DPS Staff, New York City, the Independent Power Producers of the State of New York (IPPNY), and Multiple Intervenors. The Petitioners promptly objected to DPS Staff's submittal and the latter replied in opposition. We considered all of the comments and the referenced pleadings before deciding the issues before us.

PUBLIC COMMENTS

Public Statement hearings were held on January 9, 2007 (Riverhead), January 10, 2007 (Smithtown), January 11, 2007 (Mineola), January 16 and 17, 2007 (Brooklyn), January 18, 2007 (Queens), February 1, 2007 (Staten Island), and July 25, 2007 (Niskayuna). In addition, 139 letters and other public comments outside hearings were timely received from ratepayers, utility employees, and members of other concerned constituencies. Of the many issues raised by the public, most concerned three broad areas: (1) power plant repowering, environmental remediation, and renewable energy and energy efficiency; (2) ratepayer benefits; and (3) service quality, reliability, and the workforce. These comments have all been carefully considered and some are addressed in the discussion that follows. As discussed above, we already acted to increase energy efficiency in the KEDNY and KEDLI service territories and we expect to do so again later this year. To the extent members of the public contend we should require the repowering of lightly regulated generating facilities providing electric products under long-term contracts with the Long Island Power Authority (LIPA) subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC), we decline to take such action.

DISCUSSION

The Standard of Review and Burden of Proof

Our statutory responsibility in this case is to determine whether the merger terms of JP 2 are in the public interest within the borders of New York, both in the short- and

long-term, and to determine whether the proposed resolution of some of the revenue requirement and related issues for KEDNY and KEDLI, as a part of overall rate plans to be adopted later this year, would result in just and reasonable gas rates that are adequate to ensure reasonable quality gas service.

The burden of proof with respect to all the merger and revenue requirement issues rests squarely on the Petitioners. However, the Petitioners' efforts in this regard can be and are supported by the other Signatories in this instance.

Procedural Issues

There are four procedural issues raised in the parties' pleadings, of which two are raised by Nassau and Suffolk Counties jointly, one is raised by LIPA, and one is raised by IPPNY. There is a fifth procedural issue implicit in a response to one of the Administrative Law Judges' (ALJs' or judges') questions.

The two Counties claim that the process in this case was too rushed, starting around the time the Signatories executed a term sheet in late June 2007. We agree with the judges' decision to adopt a process and schedule that preserved for us the opportunity to secure quantifiable benefits for New Yorkers worth more than $686 million on a net present value (NPV) basis over the next 10 years (see more below). This procedural argument is rejected.

The Counties' other procedural complaint stems from their belief that it would be unreasonable for us to adopt some revenue requirement terms now while reserving others for consideration later this year. They contend that at least one of the reserved issues--a reasonable allowance for Site Investigation and Remediation (SIR) costs associated with former Manufactured Gas Plant (MGP) sites--will have a material impact on revenue requirement and reduce the benefits of the acquisition to the public. We agree with the judges that the Counties' contentions are unfounded. SIR costs that should ultimately be reflected in the KEDNY and KEDLI revenue requirements, starting January 1, 2008, have nothing to do with the level of benefits of the proposed acquisition to New York.

The incremental effects of our SIR cost determinations later this year are completely independent of the merger and are, therefore, required whether or not the proposed transaction occurs. Notwithstanding inaccurate arguments by some Signatories to the effect that our adoption of the terms of JP 2 would result in no revenue increase for KEDNY for five years and a one-time revenue increase of $60 million for KEDLI, we are making no final revenue requirement and no rate determinations at this time.

On a related topic, some persons assert that all SIR cost and related issues must be considered now so that our consideration of the pending petition could be used as leverage to require the Petitioners to set forth detailed plans and schedules for the cleanup of MGP sites. However, the responsibility for these functions clearly falls within the jurisdiction of the New York State Department of Environmental Conservation (DEC), which is assisted in its efforts by the New York State Department of Health.[7] This Commission has no such jurisdiction.

The third procedural issue arises from LIPA's contention that another issue--whether Long Island's electric customers should be responsible for some SIR cost--should not be reserved and instead should be resolved now in the negative. There is no need to decide this issue in connection with the proposed acquisition and partial revenue requirements determination. This interim procedural outcome cannot reasonably be construed by anyone as an indication of how this issue will be resolved later on the merits.

The fourth procedural issue has to do with the fact that there are terms in JP 2, Section VIII(A) (concerning the inclusion of the New York Power Authority (NYPA) in those who could bid for Ravenswood Station and the return and rate base components of the cost-of-service cap determination) that arguably are consistent with the prefiled testimony and exhibits

[7] Environmental Conservation Law (ECL) Article 3, Titles 1 and 3; Article 27, Title 13; Article 71, Title 27, and 6 NYCRR Part 375.

in only the broadest sense and as to which the details were set forth for the first time either in the term sheet or in JP 2. We agree with IPPNY that the Signatories generally, and the Petitioners specifically, had the initial burden of establishing the reasonableness of these terms and that burden was not met timely in this instance. We reject these terms as a procedural matter, with one exception pertaining to NYPA.

Another procedural issue of concern arises if a suitable contract for the energy output of Ravenswood Station during the interim or extended interim period cannot be put in place by January 1, 2008. The Petitioners are clear that they believe a suitable contract will be in place in time.[8] However, if the Petitioners turn out to be wrong, no process or schedule for calculating the cost of service is outlined in JP 2. As discussed below, this is one of many reasons why the cost-of-service revenue cap option is not adopted.

Partial Revenue Requirements and the Benefits of JP 2 to New Yorkers

Two of the key issues in this case are whether the partial revenue requirement terms of JP 2 for KEDNY and KEDLI are reasonable without taking into account any savings from the proposed acquisition and whether the savings to New Yorkers from the proposed acquisition are adequate to conclude that the transaction would be in the public interest.

The five-year partial revenue requirement was arrived at by extending by two years the comparable revenue requirement terms that were agreed upon for three years, as a matter of principle, on or about May 11, 2007. We have reviewed the partial revenue requirement terms carefully and find them generally reasonable to the extent they fall within the reasonable range of outcomes in a litigated case, are uncontested by any party on the merits, and would provide a level of revenues (excluding issues that are reserved) commensurate with KEDNY's and KEDLI's need to provide reasonable

[8] Petitioners' Response to ALJs' question 182.

quality service.[9] One exception is that the $30 million extra, for KEDNY to get back under the 1993 Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post Retirement Benefits Other than Pensions, would almost certainly have been required in a litigation context, whether or not there is an acquisition.

With respect to the level and types of savings that would be available, we accept the proposed terms but conclude that the record supports a finding that New Yorkers would enjoy savings over the next 10 years of $686.515 million on a net present value basis (NPV) if Ravenswood Station is sold. Assuming that the existing level of annual delivery revenues would continue unchanged for the next 10 years for KEDNY, KEDLI, Niagara Mohawk and LIPA, those savings comprise 1.89% of projected delivery service revenues of $36.318 billion NPV. These savings are exclusive of any that result from conditions we are adopting, including one that we estimate is worth up to approximately $90 million (nominal dollars) in additional savings. (The actual could be more or less than $90 million.)

The more than $686 million of benefits to New Yorkers can be seen as the positive side of the ledger in a simple cost-benefit analysis. They comprise a significant part of the context within which we evaluate whether the proposed terms in JP 2 are collectively in the public interest.

While we conclude that the proposed acquisition would provide benefits to New Yorkers, many of these benefits are one-time in nature or the result of ratemaking conventions that will place upward pressure on rates for KEDNY and KEDLI at the end of five years. Parties may want to consider in the balance of the process in the companion rate cases whether there should be a reallocation of the benefits (producing the same net present value for New York) so as to reduce the extent to which there would be upward pressure on revenue requirements for KEDNY and KEDLI at the end of five years.

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[9] A possible adjustment to the return on equity earnings and earnings sharing trigger is discussed separately below.

Financial Protections

No party raises any issues concerning the level of financial protections that would be afforded to KEDNY and KEDLI if the terms of JP 2, Section VII are adopted. Multiple Intervenors, however, argues that the financial protections adopted for KEDNY and KEDLI should apply as well to Niagara Mohawk Power Corporation d/b/a National Grid.

We carefully reviewed the proposed protections, however, and find them wanting in several material respects. Accordingly, we are adopting the following conditions:

- The language in JP 2, Appendix 5, numbered paragraph 1 is adopted subject to the condition that National Grid provides documentation demonstrating that no elements of the cost to achieve merger savings as shown in JP 2, Appendix 6, page 6 which are recoverable from ratepayers, are also included in its determination of the goodwill balance associated with this transaction. Such documentation shall be filed with this Commission contemporaneously with National Grid's final determination of the goodwill balance.
- The language in JP 2, Appendix 5, numbered paragraph 3 is adopted subject to the conditions that:
  - The proposed use of the senior unsecured bond rating as the bond rating reference for KEDNY, KEDLI and National Grid plc is replaced by the use of the bond rating on the least secure forms of debt issued by KEDNY, KEDLI and National Grid plc.
  - The proposal that the actions of two U.S. nationally recognized rating agencies are necessary to trigger a dividend restriction for KEDNY and KEDLI is replaced by the requirement that the action of one or more U.S. nationally recognized rating agencies is necessary to trigger such a restriction.
  - The bond rating trigger proposals for KEDNY and KEDLI are augmented such that an immediate decline in bond rating to the non-investment grade category would also trigger the dividend restrictions.
  - The proposal that the bond rating of National Grid plc fall below investment grade to trigger a dividend restriction is augmented by the requirement that such restriction also occurs if the bond rating of National Grid plc is at the

lowest investment grade level and there is a negative watch/review downgrade notice by one or more U.S. nationally recognized rating agencies.

- A provision is added that in the event an action by a U.S. nationally recognized rating agency triggers a dividend restriction, KEDNY and KEDLI also may not transfer, lease, or lend any moneys, assets, rights or other items of value to any affiliate without first obtaining this Commission's permission. Such provision excludes payments for goods, services and assets related to reasonable commitments made 180 days prior to the trigger event, routine transactions required in the regular course of business pursuant to contracts and other arrangements existing 180 days prior to the triggering event, various corporate taxes, and payments of principal or interest on loans provided such payments are not accelerated.

- The language in JP 2, Appendix 5, numbered paragraph 5 is adopted subject to the condition that the fifteen month cure period is reduced to nine months.

- The language in JP 2, Appendix 5, numbered paragraph 6 is adopted subject to the condition that no debt associated with the merger is reflected on either the regulatory or US GAAP books and records of KEDNY and KEDLI.

- The language in JP 2, Appendix 5, numbered paragraph 7 is adopted subject to the condition that the Regulated Money Pool (the money pool) expressly prohibits its participants from directly or indirectly loaning or transferring funds borrowed from the money pool to National Grid USA, National Grid plc and all other non-participants in the money pool.

- The language in JP 2, Appendix 5 is adopted subject to the additional condition that there are no cross default provisions for any affiliate of National Grid plc which affect KEDNY and KEDNY and that National Grid plc and its affiliates will not enter into such arrangements in the future. Alternatively, to the extent that cross default provisions will exist immediately after closing, National Grid plc will use its best efforts to eliminate those provisions within 6 months of closing. If the cross default provisions are not removed within that time frame, National Grid is then required to obtain indemnification for KEDNY and KEDLI, at a cost not to be borne by ratepayers, from an investment grade entity which fully protects KEDNY and KEDLI from the effects of any cross default provisions.

- The language in JP 2, Appendix 5 is adopted subject to the additional condition that KEDNY and KEDLI will file, as part of the annual requirements described in JP 2, Appendix 4, paragraph 9, additional financial information, including consolidating balance sheets, income statements, and cash flow statements for National Grid plc as well as financial information about each of National Grid's regulated and unregulated energy companies operating in the United States. Such filings should reflect audited US GAAP financial statements in US dollars. The consolidating statements will illustrate how each of National Grid's major regulated and non-regulated subsidiaries contribute to the overall consolidated financial statements. This information should be in the same format as the consolidating financial statements contained in the SEC Form U-5S which registered utilities had been required to file under the Public Utility Holding Company Act of 1935 (PUHCA). The energy utility information should be fully consistent with the SEC Form U-9C-3 which registered holding companies had been required to file under PUHCA.
- The language in JP 2, Appendix 5 is adopted subject to the additional condition that KEDNY and KEDLI commit to modify corporation by-laws as necessary and establish a golden share in order to prevent a bankruptcy of National Grid plc, National Grid USA, or any other affiliate from triggering a bankruptcy of KEDNY or KEDLI. Within six weeks of closing, KEDNY and KEDLI will each file a petition seeking authority to establish a class of preferred stock having one share, subordinate to any existing preferred stock, and to issue such share of stock to a party to be determined by the Commission who would protect the interests of New York and would be independent of the parent company and its subsidiaries. Such stock shall have voting rights, which limit KEDNY's and KEDLI's right to commence any voluntary bankruptcy, liquidation, receivership, or similar proceedings without the consent of the holder of that share of stock. In the event that KEDNY and KEDLI are unable to meet this condition despite good faith efforts to do so, KEDNY and KEDLI are required to petition for relief from this condition, explaining why it is impossible to meet and how they propose to meet our underlying requirement that a bankruptcy involving National Grid plc, National Grid USA, or any other affiliate does not result in the inclusion of KEDNY and KEDLI in such a bankruptcy.

Having determined the level of financial protections required for KEDNY and KEDLI, the next question is whether a

similar level of protection should be adopted here for Niagara Mohawk Power Corporation d/b/a National Grid. Petitioners' argue that it would be unwise to require new financial protections if they would conflict with those already in effect. They also raise procedural concerns as this is not a Niagara Mohawk proceeding.

However, the proposed acquisition creates significant new financial risks that were not contemplated at the time Niagara Mohawk was acquired by National Grid. Moreover, the Petitioners clearly have no objection to our considering projected benefits to Niagara Mohawk as a basis to conclude that the proposed acquisition is in the public interest. In that context, we have no reservations about requiring, as a condition of our approval, that financial protections comparable to those adopted for KEDNY and KEDLI today are put in place for Niagara Mohawk. A process will commence to develop expeditiously new financial protections for Niagara Mohawk in light of changed circumstances. Our goal is to act on the results of that process not later than the first quarter of 2008, after all interested parties have an opportunity to be heard.

Vertical Market Power

The Evidence and Its Implications

Prior to the negotiations culminating in JP 2, initial, responsive and rebuttal testimony and exhibits were prefiled concerning Vertical Market Power (VMP) issues. Based on our review of this information, several initial conclusions are in order.

The first is that to the extent the Petitioners argue we should simply rely on FERC's evaluation of the market power issue, they are essentially arguing there is no need for the 1998 Statement of Policy on VMP, that regulatory solutions will always be adequate to address VMP, and that structural solutions that eliminate the incentives to exercise VMP are not needed. The key weakness in these contentions, however, and many other arguments presented in the prefiled testimony and exhibits of the Petitioners' witnesses, is that none of them limit or

eliminate opportunities for VMP that could be exercised in ways that would be hard or impossible to detect.

We agree with IPPNY and others that a decision by us to rely solely on regulatory solutions would signal and in fact would amount to a weakening of our resolve to ensure a competitive generation market and its attendant benefits.

Another initial conclusion is that DPS Staff clearly has the more persuasive evidence when it comes to the question of whether National Grid's transmission lines and KeySpan Corporation's generation facilities are frequently in the same market. Similarly, DPS Staff has the stronger case about the potential dollar consequences of an exercise of VMP and how National Grid's ownership of generation could interfere with the implementation of electric energy efficiency programs.[10] There is no response to these contentions in evidence, and indeed, the concerns about energy efficiency programs are not even mentioned much less addressed in JP 2 or in any of the Signatories' statements.

Our initial conclusion is that our review of all of the terms that are intended to mitigate the incentives to exercise VMP is properly conducted taking into account that the probable outcome of a litigated proceeding would almost certainly be heavily in DPS Staff's favor.[11]

The Principles in JP 2, Section VIII(A)

We are adopting all of the four principles ((a) through (d)) set forth in JP 2, Section VIII(A), but subject to conditions.

There is testimony by several witnesses that an incentive for National Grid to exercise VMP will exist during the interim period of up to three years or the extended interim period of up to four years. There is also testimony to the

[10] Ex. 24, pp. 156-157.

[11] One exception is that to the extent DPS Staff argues that ratepayer benefits must flow from ownership of generation, this contention is not supported by the language of the 1998 Statement of Policy on VMP.

effect that an incentive to exercise VMP would exist any time the cost-of-service revenue cap would be in effect. An incentive would also exist during the term of any long-term contract.

While the Petitioners deny categorically that they would act improperly with respect to transmission assets because of these incentives, no one denies the existence of such incentives.

In light of the testimony that the incentive to exercise VMP would continue during the interim and any extended interim period, we accept principle (b)'s suggestion that entering into an energy contract for the interim or extended interim period assures that National Grid is "indifferent" with respect to the price of energy in ISO Zone J. But we do so only in part.

The next question is whether the mitigation proposed in JP 2 is adequate and whether the more than $686 million NPV to New Yorkers is "substantial." Our conclusion on the latter point, as noted earlier, is that partial revenue requirement and merger-related savings to New Yorkers should total up to approximately 1.89% of the total gross delivery revenues for KEDNY, KEDLI, NIMO, and LIPA over the next 10 years.

Putting aside the benefits to New Yorkers, however, the goal of operating the transmission system without regard to the impacts on generation revenues (JP 2, Section VIII(A)(c)) does not comprise adequate mitigation. This amounts to a promise to ignore financial incentives in perpetuity, something that is very difficult to accept from an entity that is in business to make money in the long run.[12]

The commitment to propose and build regulated transmission lines for economic or reliability purposes is similar in part to one of the approaches to mitigation discussed explicitly in the 1998 Statement of Policy on VMP. Such a

[12] That this is hard to accept flows from the fact what a company will do in the future depends on many factors, many of which may be beyond the control of those making the promises now.

commitment has the potential to be very beneficial. To comprise adequate mitigation, however, this offer is supposed to be accompanied by a proposal to "neutralize" profit-maximizing incentives. For the reasons already discussed, this latter requirement is not met by the terms of JP 2, Section VIII(A). The principle reflected in JP 2, Section VIII(A)(d), accordingly, does not provide adequate mitigation either.

In light of our conclusions that the incentives to exercise VMP would continue if the terms of JP 2 were adopted, the inadequate mitigation proposed in JP 2 to address such incentives, and our conclusions above with respect to the real benefits of the acquisition to New Yorkers, the "goal" of divestiture is rejected and we will require instead, as a condition of today's approval, a closing on a sale and the transfer of ownership prior to the end of the interim or extended interim period. The mitigation principles in JP 2, Section VIII(A)(c) and (d) are accepted subject to this additional mitigation term.

In the event this condition is not met timely, the Petitioners agree that we have the right to consider all options available for addressing that failure, including the possible requirement that the merged entity pay $15 million per month into a fund for the benefit of electric customers in NYISO Zone J.

The Interim Period

We adopt the proposed terms concerning the length of the initial and extended interim periods. However, further action is required to ensure the interim or extended interim period ends as soon as reasonably possible. Accordingly, the capacity of Ravenswood Station, during that period, must initially be bid at zero as a condition of this order, commencing with the spot auction the NYISO holds for March 2008 capacity. That bid level could be replaced reasonably promptly by one that we agree is based solely on the marginal cost of continuing to maintain the plant in service and ready to provide energy to the market net of energy and ancillary services revenues (sometimes referred to as "avoidable" costs). These

conditions are adopted specifically for the purpose of encouraging a sale or long-term contract as soon as reasonably possible during the interim or extended interim period, but without requiring National Grid to enter into a "fire" sale, as some have used the term.[13]

No superior alternative has been suggested that would adequately mitigate the incentive to exercise VMP in the interim or extended interim period. IPPNY's proposal to shorten the interim period to one year, for example, is inadequate for several reasons.

Given the importance of the energy contract that would be in place for the duration of the interim or extended interim period, we are also requiring that such contract be presented to us for our review before it becomes effective.

In the event the energy contract is not in place effective January 1, 2008, zero or avoidable cost bidding in the capacity market would commence on January 1, 2008.

JP 2, Section VIII(A)(3)(a) and the Sale of Ravenswood Station

A sale of Ravenswood Station would best mitigate the incentives for National Grid to exercise VMP. We find and hold that a sale will be required.

As discussed above, IPPNY raised procedural objections to the proposal to allow NYPA to bid for Ravenswood Station. However, there is a possibility that an auction to sell Ravenswood Station will not bear fruit and we conclude it is more important in this context to increase the chances of a successful auction in order to mitigate for the long-term National Grid's incentive to exercise VMP. The absence of timely support for the NYPA carve out is mitigated because NYPA is a not-for-profit state agency and it is axiomatic that NYPA's

[13] While we agree with DPS Staff's testimony to the effect that such bid caps do not directly address VMP, they do address it indirectly where, as here, they are used to shorten the interim or extended interim period to get more quickly to a permanent solution. This condition is not intended to signal any desire to reregulate the market.

incentive to exercise VMP is necessarily lower than would be National Grid's. NYPA will be permitted to bid.

We also make no commitments now as to whether or not we would want to address Horizontal Market Power (HMP) concerns at the time we review any petition to divest Ravenswood Station. The Petitioners have not provided any reason as to why such an approach would make sense, especially given that circumstances at the time are not known to us now.

JP 2, Section VIII(A)(3)(b) and the Long-Term Contract Option

We are not adopting JP 2, Section VIII(A)(3)(b) at this time as a sale of Ravenswood Station is adopted as a condition of our order to mitigate the incentive to exercise VMP.

JP 2, Section VIII(A)(3)(c), (A)(6), and (A)(7) and the Cost of Service Cap Option

In light of our decision to require a sale of Ravenswood Station, our rejection of the long-term contract option at this time, and for a variety of other reasons, we are not adopting the cost-of-service revenue cap option. Given this conclusion, the terms of JP 2, Section VIII(A)(6) and (7) are also not adopted.

JP 2, Section VIII(A)(5)

As discussed above, National Grid is required, as a condition of our approval of the proposed acquisition, to sell Ravenswood Station, with the transfer of ownership completed before the end of the interim or extended interim period. That is the only option and the terms of JP 2, Section VIII(A)(5), accordingly, are unnecessary and are not adopted.

JP 2, Section VIII(A)(8) - Consultation and Record Keeping Requirements

These terms are reasonable and are adopted subject to one condition. National Grid must retain all offers and other communications from all bidders and other potential counter

parties for a minimum of one year after the end of the interim and, if there is one, after the extended interim period.

JP 2, Section VIII(B) - The Other Commitments

- We accept the terms of JP 2, Section VIII(B)(1)(a) subject to the understanding that pursuant to the principles of JP 2, Section VIII(A)(c) and (d), that we are accepting subject to a condition, that this term continues after the interim or extended interim period.
- The provision requiring National Grid to vote as a transmission owner (JP 2, Section (b)(1)(b)) is not adopted as we could not enforce it as a practical matter.
- The provision requiring National Grid to enter into good faith negotiations with Consolidated Edison Company of New York, Inc. (JP 2, Section VIII(B)(1)(d)) is adopted subject to the condition that our action does not diminish Consolidated Edison's statutory obligation to provide steam service reliably and at the lowest reasonable cost. This includes its obligation to ensure that it does not procure steam externally under an arrangement where the provider could exercise market power.
- The term that would authorize National Grid to increase its generation capacity (JP 2, Section VIII(B)(2)(a)) is adopted subject to the condition that we are making no determination now with respect to its ability to expand generation at the request of NYPA or LIPA. Should such circumstances arise, a separate petition would have to be filed for our consideration. We have no objection to a repowering of Ravenswood Station, though it seems unlikely the merged entity will go beyond studying the issue given the previously stated requirement that this facility must be sold as a condition of this order.
- The portion of the term reflecting that National Grid will continue to be subject to the 1998 Statement of Policy on VMP (the first sentence of JP 2, Section VIII (B)(2)(c)) is not adopted because it would duplicate existing requirements. The balance of this provision is accepted subject to the conditions that the analysis to be filed with us would be due one year prior to the expiration of any of the existing long-term contracts.

Customer Service Quality, Reliability and Safety Protections

KeySpan Companies

Parties in the pending KeySpan rate cases reported that they had reached an agreement in principle on certain safety, reliability, and customer service issues. On August 14, 2007, we stated that we may want to consider those issues in connection with our review of JP 2.[14] Parties were allowed to file comments by August 20, 2007 and a Joint Proposal for Gas Safety, Reliability and Customer Service Performance Requirements (JP 3) was filed by several parties.

We will explain the various metrics contained in the JP 3 in our forthcoming order, but we note now that given National Grid's history in New York and the consequences of declining service metrics for KEDLI and KEDNY, the amounts proposed to be put at risk are too small. For reasons we will explain later, we are increasing the amounts at risk for each measure so that the revenue adjustments contemplated in JP 3 are doubled, and tripled if the failure occurs when dividend restrictions are in effect. The JP 3 amounts will also be quadrupled for any year in which a measure is not met and had not been met in any two of the prior four years.

Finally, we had only a few days to review JP 3 and we reserve the right to consider it further. Accordingly, we adopt the metrics and amounts placed at risk here as a baseline for now, subject to the possibility that more stringent conditions may be adopted at the time we consider the balance of the reserved issues.

National Grid Electric Reliability Enhancement Plan

As a result of our preliminary discussions at the August 15, 2007 session, the Petitioners proposed this condition in response to our concerns about the reliability of the Niagara Mohawk electric system:

[14] Case 06-M-0878, Notice Regarding Reserved Issues (issued August 14, 2007).

> During the course of the proceeding, the Petitioners had proposed a merger condition associated with National Grid's investment in its transmission and distribution system . . .. The condition provided that National Grid would implement the Reliability Enhancement Plan set forth in the rebuttal testimony of the Company's reliability panel . . . which together with other T&D investment contemplates a total capital investment of approximately $1.4 billion over the five years. This condition was deferred to National Grid's own proceeding, but given the concerns expressed in the special session, Petitioners propose to include the condition as part of the merger approval in this proceeding. In addition, National Grid commits to file its Plan with the Commission for its review in a separate proceeding.[15]

The T&D investment plan may be a reasonable approach to enhancing reliability, and we order it, with these modifications:

1. National Grid will file its Reliability Enhancement Plan with this Commission for review and a decision in a separate proceeding. The filing must be made within 60 days of this order and must set forth the projected investments in transmission and distribution projects. Further, the Plan must address the continued reasonableness of the expenditures in light of the continued inflation in construction and equipment costs. We may order that updates to the Plan be filed in subsequent years.

2. Within 30 days following the end of each calendar year (2008–2011), National Grid must file a report with this Commission on actual T&D investment. To the extent the actual amount spent is less than the targeted levels in 2008, or total expenditures for 2008-09, 2008-10, or 2008-11 are less than the total of the annual targets for any of the corresponding

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[15] National Grid and KeySpan August 17 letter to Secretary Brilling, p. 3.

periods, carrying charges at the allowed overall cost of capital on the under spent amounts will accrue as a deferred credit for the future benefit of ratepayers.

3. This Commission previously adopted clause 1.2.4.16 of the National Grid (Niagara Mohawk) Merger Joint Proposal. This term affords an opportunity for National Grid to petition for special ratemaking treatment for incremental major programs and expenditures that may occur in years seven through ten of the Rate Plan Period. Any efficiency gains resulting from the incremental major programs and expenditures were to be used, either in whole or in part, as a method to recover the incremental costs to the extent a petition to defer the rate impacts related to the incremental costs is approved.

Should a petition contemplated by clause 1.2.4.16 be filed in connection with the Reliability Enhancement Plan investments, the carrying costs related to the incremental investment during the Niagara Mohawk Rate Plan Period will be limited to not more than 50% of the total, as ultimately determined by us. That 50% or more of the carrying costs for that period would be borne by stockholders increases the public interest benefits associated with the proposed acquisition and recognizes that investment over the last several years has been inadequate for Niagara Mohawk to meet certain reliability measures in three of the last five years. The carrying costs to be borne by shareholders for this period, as noted, are subject to further upward adjustment based on arguments that might be raised by the parties pursuant to the terms of our prior order concerning National Grid’s acquisition of Niagara Mohawk Power Corporation.

4. Within 60 days of this order, National Grid must report to this Commission on the condition of all the physical elements of its Niagara Mohawk system and prepare a plan and schedule identifying needed remedial actions, monitoring programs, and repairs.

Gas Service Quality for Niagara Mohawk d/b/a National Grid

Neither JP 2 nor JP 3 contains gas safety and customer performance mechanisms for Niagara Mohawk customers. Because those customers will be exposed to the same risks as customers of KEDNY and KEDLI, we are requiring similar mechanisms for National Grid as follows:[16]

1. Pipeline Replacement - During calendar years 2008 through 2012, Niagara Mohawk will use a risk-based method to identify and prioritize leak-prone mains and replace a cumulative total of at least 150 miles in its service territory and not less than 25 miles in any one year. This metric shall not apply if leak-prone pipe is being replaced due to interference projects and/or City/State construction requirements. Failure to meet the cumulative or any of the annual minimum targets will result in a revenue adjustment of $840,000.

National Grid has historically replaced 20 miles of leak-prone pipe annually. The actual incremental costs to achieve the 10 miles per year, on average, beyond the historical 20 miles may be deferred until Niagara Mohawk's next rate filing.

2. Emergency Response - If National Grid fails to respond to leak and odor calls within the time periods established in the table set forth below, for calendar years 2007 through 2012, it will be subject to the corresponding revenue adjustments for those calendar years and all subsequent years until changed by the Commission.

75% in 30 minutes	-	$1,050,000
90% in 45 minutes	-	$630,000
95% in 60 minutes	-	$420,000

3. Leak Management - If National Grid's leak backlog as of December 31 exceeds the targets set forth below for calendar

[16] The rate adjustment amounts discussed will increase by 50% each if the failure occurs when dividend restrictions are in effect.

years 2007 and beyond, it will be subject to the corresponding revenue adjustments for those years:

2007:	Number of Leaks	Revenue Adjustment
	60 or less	$0
	61-70	$10,000 per leak
	71-80	$100,000 + $20,000 per leak
	> 80	$1,260,000

2008:	Number of Leaks	Revenue Adjustment
	55 or less	$0
	56-65	$10,000 per leak
	66-75	$100,000 + $20,000 per leak
	> 75	$1,260,000

2009:	Number of Leaks	Revenue Adjustment
	50 or less	$0
	51-60	$10,000 per leak
	61-70	$100,000 + $20,000 per leak
	> 70	$1,260,000

2010:	Number of Leaks	Revenue Adjustment
	45 or less	$0
	46-55	$10,000 per leak
	56-65	$100,000 + $20,000 per leak
	> 65	$1,260,000

2011 and subsequent years until changed by the Commission:

Number of Leaks	Revenue Adjustment
40 or less	$0
41-50	$10,000 per leak
51-60	$100,000 + $20,000 per leak
> 60	$1,260,000

4. Damage Prevention - If National Grid, for any of the calendar years 2007 through 2011, either (i) fails to meet an Overall Damages target equal to or less than the level of excavation damages per 1,000 “One-Call Tickets” as set forth below, (ii) fails to meet an annual Damages Due to Mismarks per 1,000 One-Call Tickets targets as set forth below, or (iii) fails to meet an annual Damages Due to Company/Company Contractor per 1,000 One-Call Tickets target as set forth below, National Grid will be subject to the corresponding revenue adjustments for those calendar years:

(a) Overall Damages

	Target	Revenue Adjustment
2007:	5.9	$0
	5.9-6.1	$210,000
	> 6.1	$420,000
2008:	5.5	$0
	5.5-5.7	$210,000
	> 5.7	$420,000
2009:	5.1	$0
	5.1-5.3	$210,000
	> 5.3	$420,000
2010:	4.8	$0
	4.8-5.0	$210,000
	> 5.0	$420,000
2011	4.5	$0
	4.5-4.7	$210,000
	> 4.7	$420,000
2012 and subsequent years until changed by the Commission:		
	4.2	$0
	4.2-4.4	$210,000
	> 4.4	$420,000

(b) Mismarks

2007:	1.60	$0
	1.60-1.80	$525,000
	> 1.80	$1,050,000
2008:	1.50	$0
	1.50-1.60	$525,000
	> 1.60	$1,050,000
2009:	1.35	$0
	1.35-1.45	$525,000
	> 1.45	$1,050,000
2010:	1.20	$0
	1.20-1.30	$525,000
	> 1.30	$1,050,000

2011:	1.05	$0
	1.05-1.15	$525,000
	> 1.15	$1,050,000

2012 and subsequent years until changed by the Commission:

0.90	$0
0.91-1.00	$525,000
> 1.00	$1,050,000

(c) Company/Company Contractor Damages

Year 2007-2012 and subsequent years until changed by the Commission:

Target	Revenue Adjustment
0.25	$420,000

Any revenue adjustments arising from a failure to meet safety and reliability targets as set forth above will be credited to the National Grid (Niagara Mohawk) Balancing Account. The revenue adjustments set forth above for Niagara Mohawk Gas Reliability measures will be doubled for any year in which a metric is not achieved for the current year and any two years of the prior four years. If National Grid believes in any year that its inability to meet any of the established targets is attributable to force majeure circumstances, it may petition for relief from such revenue adjustments.

National Grid Electric Service Quality

The joint proposals filed in this case also did not address the question of whether additional service quality incentives are warranted for National Grid's electric customers. Because National Grid's performance did not meet established reliability standards for three of the past five years, and because there is a risk that resources might be diverted post merger, we are requiring enhancements to the existing Service Quality Assurance Mechanism.

In the event a service quality reliability measure is doubled pursuant to the doubling provision in the existing Niagara Mohawk rate plan, the incentive payment will be further increased by the amount of the original exposure (that is, prior

to doubling) in any period subsequent to the doubling where the performance target for a doubled measure is not satisfied by the company. This incremental exposure will repeat whenever a measure is missed in a subsequent year. Any incentive increment subsequent to the doubling will be eliminated upon achieving the target in a subsequent year. For example, if we decide that the SAIFI measure should be doubled (from $4.4 million to $8.8 million) for calendar year 2007, and the company fails to meet the measure in 2007, an additional $4.4 million (total of $13.2 million) of incentive would be added for the year 2008. If the company again fails to meet the measure an additional $4.4 million (total of $17.6 million) would be added for year 2009. If the company failed in year 2007 and then met the measure for 2008, the incentive would be reduced to $8.8 million for 2009.

Other Issues

JP 2, Section IV - General Provisions

There are no disputes about any of these terms but several of them require further discussion. First, most of the terms are clearly routine and generally require no action on our part. With respect to the parties' "reservation of rights" in numbered paragraph 1, the merger will close or not within a day of our order. Accordingly, the reservation of rights is not meaningful. With respect to paragraph 5, we are not adopting or establishing rate plans for KEDNY or KEDLI at this time; therefore provision for the filing of tariffs and statements are premature and are not adopted for this reason as well.

Numbered paragraph 6 is an exception, as it expressly recognizes that our statutory powers remain unchanged in light of the actions we take today. This term is adopted as part of our order. The dispute resolution terms in numbered paragraph 9 are also adopted. We also take this opportunity to make clear that our decision today can properly be cited and treated as precedent (see numbered paragraph 11).

JP 2, Sections IX(C)(3) and X(C)(3) – Other SIR Issues

In its supplemental comments dated July 30, 2007, DEC expresses concern that provisions calling for KEDNY and KEDLI to consult with DPS Staff and other interested parties "in order to establish a reasonable targeted cost level for each separate phase of SIR activity on any particular site"[17] could be misconstrued.

As DEC itself notes, the parties expressly acknowledged its primary jurisdiction in JP 2. Moreover, we expressly acknowledge above DEC's primary jurisdiction over SIR issues, in response to the Counties' concerns regarding SIR costs. Thus, it should be evident that terms we are adopting will not limit or predetermine the level or timing of expenditures for SIR activities as required by DEC. We retain jurisdiction to ensure that rates reflect only reasonable costs to perform the necessary investigation and remediation work.

We are accepting the terms of JP 2, Sections IX(C)(3) and X(C)(3) subject to other conditions. We accept the reconciliation or "true-up" of 100% of KEDNY's actual SIR costs prospectively, based on the understanding that this does not change the 90% reconciliation or "true-up" previously adopted and in effect for costs incurred during a period prior to 2008.

KEDNY and KEDLI will be permitted to retain 10% of any recovery of SIR costs from insurance carriers and/or other potentially responsible parties only to the extent they share 10% of the costs to recover that are incremental to amounts provided for in rates, such as for attorney fees and expert consultant fees.

In the event that KEDNY and KEDLI dispose any property upon which investigation and remediation activities have occurred, it also must credit pre-tax gains resulting from such disposition to the total SIR cost for the specific site.

DEC also proposes that, as a condition of today's order, we should require the merged entity to meet certain obligations to DEC. Such obligations exist as a matter of law and we decline to establish, as a requirement of our order, that

[17] JP 2 Sections IX(C)(3) and X(C)(3).

the merged entity must meet requirements that DEC would more properly enforce.

JP 2, Sections IX(D)(1) and X(D)(1) – Temperature Controlled Class

We find unpersuasive the Counties' objections to modifying the terms of the Temperature Controlled Class.

JP 2, Sections IX(E) and X (E)

JP 2 proposes upward adjustments of 10 basis points each for KEDNY's and KEDLI's earnings sharing thresholds in the event targets are met for demand side management programs to be adopted later this year. No mention is made in JP 2 or in any of the statements, however, of whether adjustments to the earnings sharing thresholds or to the allowed return on equity is warranted in the event a revenue decoupling mechanism is adopted later this year for KEDNY and KEDLI. Meanwhile, we previously held that the issue of adjustments to the allowed return for a revenue decoupling mechanism should be addressed in connection with the development of rate plans.[18]

In this context, we adopt the terms of the sections identified above subject to the condition that at the time we consider proposals for a revenue decoupling mechanism, there must be a record adequate for us to determine whether any adjustment to the allowed return on equity or the earnings sharing triggers would be warranted and, if so, the proper adjustment(s).

JP 2, Section XI(A) Niagara Mohawk Provisions – Merger Synergy Savings and Costs to Achieve

Multiple Intervenors expresses concern that National Grid's future rate filing may understate synergy savings allocable to Niagara Mohawk customers and/or overstate and over-allocate costs to achieve allocable to Niagara Mohawk customers.

[18] Cases 03-E-0640 and 06-G-0746, The RDM Proceedings, Order Requiring Proposals for Revenue Decoupling Mechanisms (issued April 20, 2007), p. 15.

The level of net synergy savings to Niagara Mohawk customers will be addressed by us finally when we consider the future separate filing that will be made by National Grid pursuant to the terms we are adopting here and those previously adopted in the 2001 Niagara Mohawk rate plan.

The Counties' Local Economy/Job Loss Arguments

The Counties assert that quantifiable benefits of the proposed acquisition may not outweigh the economic loss to the local economy which they estimate could be worth up to $100 million per year. Our assessment of the record is that the Counties significantly overstate the impact on the local economy of job reductions resulting from the proposed acquisition. The projected direct economic loss to the economy assumes that the entire salary of each lost worker is lost to the local economy. This overstates the loss because many of the affected employees will likely receive compensation packages and/or pensions upon their departure. This money will partially offset the lost salaries. Second, a subset of the employees that lose their jobs will find other productive uses of their time and skills in ways that will contribute to the welfare of the local economy. One can't analyze the re-employment with exactness, but it will occur to a large extent. Finally, given the size and health of the Long Island economy, the loss of jobs can be absorbed without any significant impact on the local economy.

Miscellaneous Corrections and Understandings of Other Terms of JP 2.

Our conditional adoption of the terms of JP 2 is subject to the following corrections:

1. The words "to cases" on p. 3, second full paragraph, line 4 is dropped.
2. The word "March" on p. 3, line 8 is "May."
3. The filing to be made under JP 2, Section VI, p. 8 will also be served on all active parties.
4. The second sentence of JP 2, Section XI (c) (1) is revised to delete the words "or electrician."

Our conditional adoption of the terms of JP 2 is subject to the following understandings:

1. We understand that the interim or extended interim period ends three or four years from the date of this order, at the latest, and prior to that time, ends when ownership of Ravenswood Station is transferred to a new owner.
2. We understand "net gain" as the term is used in JP 2, Appendix 4, p. 11, Section 8.2, second full paragraph, to refer to gains net of all applicable costs and taxes that are reasonably and incrementally incurred and are not related to internal company costs such as labor and fringe benefits.
3. We understand the words "gains or losses on the sale of real property not included in rate base," as used in JP 2, Appendix 5, Section 2, first paragraph, Subsection (iii), to refer to property never in rate base, earnings base, or held for future use.
4. We understand the terms "paid-in-capital," "unappropriated returned earnings," "unappropriated undistributed earnings," and "accumulated other comprehensive income," as those terms are used in JP 2, Appendix 5, Section 2, first paragraph, item iii, in the manner best described in the Petitioners' response to the ALJs' question 46.

CONCLUSION

For reasons to be discussed in detail in a subsequent order, we conclude that adoption of the terms of JP 2 and JP 3, subject to the conditions and discussion above, are in the public interest as they pertain to the proposed merger. For reasons to be discussed in a subsequent order, we also conclude that the terms of JP 2, subject to the conditions and discussion above, will, as part of an overall rate plan to be adopted later this year, help to ensure the rates for KEDNY and KEDLI will be just and reasonable and adequate to ensure reasonable quality service.

The Commission orders:

1. The terms of the Merger and Gas Revenue Requirement Joint Proposal filed July 6, 2007, and the terms of the Joint Proposal for Gas Safety, Reliability and Customer

Service Performance Requirements filed August 17, 2007, subject to the conditions and discussion above, and subject to the Petitioners' complete and unconditional acceptance of this order, are adopted in their entirety and are incorporated into and made a part of this order.

2. National Grid plc and KeySpan Corporation must submit a written statement of complete and unconditional acceptance of this order, signed and acknowledged by duly authorized officers, on behalf of themselves and their New York subsidiaries, at the earlier of the close of business on Friday, August 24, 2007 or before any closing of the proposed acquisition. These statements must be filed with the Secretary of the Commission and served contemporaneously on all active parties in this and the companion rate proceedings. In the absence of such acceptance, our decisions with respect to the proposed acquisition and partial revenue requirements are rescinded.

3. This case is continued.

(SIGNED) By the Commission,

JACLYN A. BRILLING
Secretary