

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

Joint Petition of National Grid PLC and KeySpan Corporation for Approval of Stock Acquisition and Other Regulatory Authorizations

Case 06-M-0878

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of the Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York for Gas Service

Case 06-G-1185

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island for Gas Service

Case 06-G-1186

AFFIDAVIT OF  
DOUGLAS W. ELFNER  
and  
TARIQ N. NIAZI

Dated: July 18, 2007  
Albany, New York

MINDY BOCKSTEIN  
CHAIRPERSON AND EXECUTIVE DIRECTOR  
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AFFIDAVIT OF DOUGLAS W. ELFNER AND TARIQ N. NIAZI

Douglas W. Elfner and Tariq N. Niazi, having been duly sworn, depose and state as follows:

1. My name is Douglas W. Elfner. I am the Director of Utility Intervention for the New York State Consumer Protection Board ("CPB"). My business address is Five Empire State Plaza, Suite 2102, Albany, New York, 12223. I submitted testimony on January 29, 2007 regarding the stand-alone rate filings of KeySpan Energy Delivery New York ("KEDNY") and KeySpan Energy Delivery Long Island ("KEDLI"). That testimony contains a summary of my education and employment experience. I also filed testimony regarding the proposed transaction between National Grid plc ("National Grid") and KeySpan Corporation ("KeySpan"), dated February 20, 2007.
2. My name is Tariq N. Niazi, Chief Economist of the CPB. I have the same business address. I submitted testimony on January 29, 2007 regarding the stand-alone rate filings of KEDNY and KEDLI. That testimony contains a summary of my education and employment experience. In addition to my experience identified therein, I have served as the CPB's representative at the NYISO since that organization's inception. I am an active participant in the NYISO's Management Committee, Business

Issues Committee, and Operations Committee as well as working groups including the Installed Capacity Working Group. In addition, I am the Chairperson of the NYISO's Electric System Planning Working Group.

3. We provide this affidavit in response to the affidavit of Mr. Mark D. Younger, filed on behalf of the Independent Power Producers of New York, Inc. ("IPPNY"), on July 11, 2007. Mr. Younger asserts that provisions of the July 6, 2007 Merger and Revenue Requirement Joint Proposal ("Proposal") concerning the disposition of the Ravenswood Station, should not be accepted by the Commission.
4. Contrary to Mr. Younger's assertions, the provisions concerning Ravenswood are a reasonable compromise of contested issues. As Mr. Younger testified, DPS Staff's litigation position was that the plant must be sold immediately. The Petitioners contended that an immediate sale would jeopardize the financial viability of the transaction. The CPB suggested that both extremes might be avoided through the use of long-term contracts or cost-based regulation. The Proposal reasonably balances these positions by expressing a goal of divestiture, and providing appropriate protections for ratepayers until the plant is sold.
5. Mr. Younger's assertion<sup>1</sup> that the Proposal is inconsistent with the PSC's policy regarding the ownership of generation by a transmission and

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<sup>1</sup> Younger Affidavit, at 12.

distribution company, is not correct. The Commission did not unconditionally demand the immediate divestiture of all plants. Indeed, for various reasons, several utility-owned generation stations have never been sold, such as RG&E's Russell Station and hydro plants owned by NYSEG. Instead, the Commission has established a rebuttable presumption that "ownership of generation by a T&D company affiliate would unacceptably exacerbate the potential for vertical market power."<sup>2</sup>

That presumption is overcome by a showing that:

the vertical market power could not be exercised because the circumstances do not give the T&D company an opportunity to exercise market power, or because reasonable means exist to mitigate market power. Alternatively, the T&D company would need to demonstrate that substantial ratepayer benefits, together with mitigation measures, warrant overcoming the presumption.<sup>3</sup>

6. The Joint Proposal fully meets the burden set by the Commission. It mandates an attempt at divestiture of the Ravenswood Station, but also provides for mitigation of vertical market power if a sale is not completed. By requiring the financial sale of the future energy output from the plant for up to three years and a long-term bilateral contract for all of the products of the plant for a minimum of 15 years, it substantially eliminates any

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<sup>2</sup> Case 96-E-0900, et al., In the Matter of Orange & Rockland Utilities, Inc.'s Plans for Electric Rate Restructuring Pursuant to Opinion 96-12, Statement of Policy Regarding Vertical Market Power, July 17, 1998, pp. 1 – 2.

<sup>3</sup> Id., p. 2, emphasis added.

potential profit from the exercise of such power. If neither divestiture nor the long-term contract is accepted by National Grid and the Commission, it requires that revenues exceeding Ravenswood's cost-of-service be returned to customers. These mitigation measures, combined with substantial ratepayer benefits in the form of more than \$600 million in avoided rate increases for KeySpan's customers in New York City and Long Island, meet the Commission's test for overcoming its presumption favoring physical divestiture.

7. Mr. Younger's assertion that the Commission should condition approval of the merger on the requirement that the Ravenswood Station be divested no later than one year from the consummation of the merger<sup>4</sup>, is inherently flawed. That proposal would diminish the value of the merger transaction to National Grid, reducing the resources available to fund benefits to consumers. A quick, forced sale virtually assures a bad outcome for everyone except the purchaser.
8. There is currently substantial uncertainty regarding the market rules that will govern the capacity markets in which Ravenswood operates. An on-going FERC examination will eventually clarify these rules for the NYC

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<sup>4</sup> Younger Affidavit, at 14.

installed capacity market, both short and long-term,<sup>5</sup> but FERC is unlikely to reach a decision before the Spring of 2008. Until that decision is rendered and all issues requiring interpretation have been resolved, the value of the Ravenswood plant will inevitably be discounted to reflect the continuing uncertainty.

9. The Commission itself has recognized that regulatory uncertainty can be a problem for the seller of an electric power plant. In considering Con Edison's auction plans, it noted that "uncertainty regarding mitigation measures may impair the auction process and reduce sale prices, depriving electric customers from receiving the maximum benefit from divestiture."<sup>6</sup>
10. The Commission has also recognized that divestiture should not be rushed. The process involves many steps, including design of a bidding process, solicitation of offers, evaluation of offers and regulatory review. If done improperly, the seller may not obtain fair value for the plant. In the case of Con Edison, for example, the Commission provided five years for

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<sup>5</sup> 120 FERC ¶61,024, New York Independent System Operator, Inc., Docket No. EL07-39-000.

<sup>6</sup> Cases 96-E-0897 and 96-E-0916, In the Matter of Consolidated Edison Company of New York, Inc.'s Plans for (1) Electric Rate/Restructuring Pursuant to Opinion No. 96-12; and (2) the Formation of a Holding Company Pursuant to PSL, §70, §108 and §110, and Certain Related Transactions, "Order Authorizing the Process for Auctioning of Generation Plant," issued July 21, 1998, pp. 2-3.

the Company to divest its generating plants.<sup>7</sup> In another case, a petition for approval of a plant sale was withdrawn under pressure from claims that the divestiture was conducted too hastily to protect the interests of ratepayers.<sup>8</sup>

11. In recognition of the consumer benefits that would result from approval of the Proposal, the parties agreed to provide National Grid reasonable time to conduct an auction of Ravenswood Station and to obtain regulatory approval for the sale. The Proposal contemplates a period of up to 14 months for those tasks.<sup>9</sup> Additional time would be required for National Grid to design the bidding process and obtain an accurate assessment of the fair market value of the plant. This schedule gives National Grid an opportunity to complete the divestiture in a commercially reasonable manner that will permit it to realize the full market value of the Ravenswood asset. This arrangement is ultimately important not only to National Grid shareholders, but also to consumers who will obtain financial benefits under the Proposal that would not have been available if National Grid did not have an expectation that it could sell the plant at fair market

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<sup>7</sup> Id., p. 2.

<sup>8</sup> Case 99-E-0933, Joint Petition to Transfer Nuclear Generation Assets, "Order Allowing Petitions to be Withdrawn," issued April 25, 2000.

<sup>9</sup> Section VIII.A.3.

value. Forcing a distress sale in this case, as proposed by Mr. Younger, would benefit no one other than potential bidders for the plant.

12. Mr. Younger's contention that the provision in Section VIII.A.3(a) of the Proposal regarding the New York Power Authority ("NYPA") should be eliminated,<sup>10</sup> should be rejected. The Proposal requires that a purchaser of Ravenswood Station not own any electric transmission facilities in New York State or any generation capacity in Zone J previously divested by Con Edison. The provision cited by Mr. Younger exempts NYPA. He contends that an exception should not be made for NYPA since its ownership of Ravenswood Station would cause the same, or greater, vertical and horizontal market power problems as the ownership by National Grid.
13. Mr. Younger's contention overlooks several important and distinguishing facts. NYPA already owns both transmission and generation assets in New York State, as permitted by both the NYISO and the PSC. Further, it is a non-profit, public-benefit energy corporation that is not required as a matter of law, to maximize its profits, unlike IPPNY's members. These facts obviate the need for the changes sought by Mr. Younger.
14. With respect to paragraph VIII.A.3(b) of the Proposal regarding a long-term contract for the output of Ravenswood Station, Mr. Younger agrees

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<sup>10</sup> Younger Affidavit, at 17.



that “it is possible that the use of a contract could theoretically make National Grid insensitive to Ravenswood Station’s market revenue during the term of the contract.”<sup>11</sup> He expresses concern, however, that the Proposal does not dictate what terms would have to be included in such a contract to adequately mitigate market power.

15. That concern is not justified. The Proposal states explicitly that Commission approval of the long-term contract is required, and that the contract must comply with the intent of the Proposal and not create any new or unanticipated market power concerns.<sup>12</sup> The Proposal also memorializes in detail National Grid’s agreement to plan and operate its transmission system without regard to the impact on the profitability of Ravenswood Station, in recognition of the potential market power concern.
16. Mr. Younger also asserts that a long-term contract would interfere with the operation of a competitive market.<sup>13</sup> That claim ignores the fact that the long-term contract would be established between a willing buyer and seller, and therefore reflects the operation of the marketplace. His main concern appears to be that a long-term contract would reduce the volume

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<sup>11</sup> Younger Affidavit, at 23.

<sup>12</sup> Section VIII.A.3(b).

<sup>13</sup> Younger Affidavit, at 24.

of transactions on the spot market, and may place downward pressure on market prices, to the detriment of IPPNY's members.

17. The Proposal requires National Grid to abide by several bidding protocols in the event that it is required to return revenues exceeding its cost-of-service, to ratepayers. These rules are intended to ensure that the Ravenswood Station would act as a price taker, rather than a price setter, while operating under cost-of-service rules. This would tend to make the cost-of-service option less desirable, thereby providing an incentive for National Grid to divest the unit or enter into a long-term contract for Ravenswood's output.
18. In that circumstance, the company would be required to bid energy at the lower of marginal cost or the NYISO-established reference price, and to bid ancillary services at the lower of marginal cost or the otherwise applicable bid or price cap. Mr. Younger maintains that these requirements would force Ravenswood Station to offer its output to the market at less than cost when its marginal cost exceeds its reference price.<sup>14</sup> This, he says, will inappropriately depress clearing prices for energy and ancillary services to the detriment of other generators operating in the market. The basis of Mr. Younger's argument is his belief in the inability of the NYISO to revise reference prices to respond to actual

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<sup>14</sup> Younger Affidavit, at 31.

changes in a unit's cost. We believe that Mr. Younger's argument has no merit.

19. Reference prices were developed in conjunction with market price mitigation measures intended to protect consumers from excessively high prices. Their purpose is to capture all plant costs actually incurred so that suppliers are not penalized unfairly by the mitigation rules. The NYISO, at the insistence of the suppliers and with their input, has continually improved the ability of reference prices to track changes in the costs incurred by suppliers. Over the years, numerous changes have been made to improve the ability of suppliers to communicate changes in their cost structure to the NYISO. Similarly, procedures have been adopted to ensure that the NYISO makes these revisions as soon as practical. Under these circumstances, it is hard to conceive of a situation where a supplier will find its marginal cost to be below its reference price. Moreover, if such an anomalous situation were to occur, it would be corrected quickly enough not to cause the dire consequences portrayed by Mr. Younger's far-fetched scenario.
20. Mr. Younger also asserts that the Proposal contains improper bidding rules for capacity.<sup>15</sup> The Proposal requires National Grid to bid capacity at zero cost under the scenario in which it is required to return revenues

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<sup>15</sup> Younger Affidavit, at 36-39.

exceeding its cost-of-service to ratepayers. Mr. Younger contends that requiring Ravenswood Station to bid into the capacity market at zero will understate its costs, interfere with economically efficient markets and cause economic generators to shut down and retire.

21. Once again, Mr. Younger is looking at only one aspect of the situation and drawing a drastic and highly unlikely picture. The New York City capacity market is not competitive. The current wholesale electricity market in New York City permits suppliers to maintain market prices far above competitive levels. The NYISO's Independent Market Advisor concluded that the "Installed Capacity Spot Market Auctions during the 2006 Summer Capability Period have been characterized by economic withholding of Capacity to exercise market power to the maximum extent allowed."<sup>16</sup> This has caused electricity prices to be artificially high throughout New York State, causing customers to pay more than \$100 million in inflated electricity prices in 2006 alone.<sup>17</sup> These market design flaws continue in 2007, to the detriment of consumers.

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<sup>16</sup> Federal Energy Regulatory Commission ("FERC") Docket No. ER07-360-000, New York Independent System Operator, Inc., NYSIO Filing, December 22, 2006, Attachment II, Affidavit of David B. Patton, Ph.D., at 13-15.

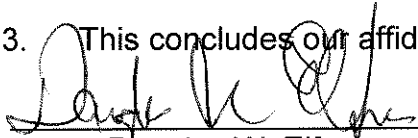
<sup>17</sup> FERC Docket No. ER07-360-000, Answer of Multiple Intervenors, The New York State Consumer Protection Board and Consumer Power Advocates In Opposition To The Motion By The Independent Power Producers of New York, Inc., May 15, 2007.

22. The Staff of the Department of Public Service reached the same conclusion. In its Initial Comments in Phase II of Case 06-M-1017, it said the following:

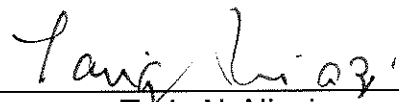
It is clear that suppliers in that arrangement can exercise market power – the existing ceiling on bids into that market has, in effect, become the market price. As a result, New York City ratepayers are not receiving the full benefit of competitive markets<sup>18</sup>

Based on their findings on the state of competitive markets in New York City, the Staff of the Department of Public Service offered a second-best solution; cost-based rates instead of market rates. Contrary to the assertions of Mr. Younger, we believe that long-term contracts or similar arrangements as offered in the Proposal are a better solution to the problems facing the New York City markets at this time than the arguments offered by the suppliers that seem only to work in theory.


23. This concludes our affidavit.


  
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Douglas W. Elfner

Subscribed and sworn to before me  
this 18<sup>th</sup> day of July, 2007.

  
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Tariq N. Niazi

Subscribed and sworn to before me  
this 18<sup>th</sup> day of July, 2007.

  
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DENISE DEVIVO Notary Public  
Notary Public, State of New York  
No. 4951771  
Qualified in Schenectady County  
Commission Expires May 30, 2011

  
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