STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
BEFORE THE PUBLIC UTILITIES COMMISSION

IN RE: NEW ENGLAND GAS COMPANY	**:**	
INVESTIGATION OF DISTRIBUTION	**:**	**DOCKET NO. 3459**
ADJUSTMENT CLAUSE (DAC)	**:**	
CHARGES	**:**	

POST-HEARING BRIEF OF THE DIVISION OF PUBLIC UTILITIES AND CARRIERS

The Division of Public Utilities and Carriers ("Division") submits the following arguments in support of its recommendations in five areas that were litigated before the Commission on October 22, 2002. The five areas are as follows:

I. Income Tax Rate

In calculating the federal income taxes to be included in operating expenses, NEG is proposing to apply an "effective tax rate" of 38% to the taxable income of Providence Gas Company. The so-called effective tax rate is derived from the financial statements of the parent company, Southern Union. (Tr. 10/22/2002, p. 18). It is the position of the Division that the appropriate tax rate to be employed in this calculation is the statutory federal income tax rate of 35%.

On cross-examination, Ms. Partridge explained that the purpose of using an effective rate of 38% is to capture the effect of certain items that go into the federal income tax expense that are not accounted for by applying the statutory rate to the taxable income of Providence Gas Company. (Tr. 10/22/2002, p. 198). However, Ms. Partridge admitted that she had no clue as to how the 38% effective rate itself was developed other than it came from the financial statements of Southern Union. (Tr. 10/22/2002, pp. 14-18).

Consider her testimony during cross-examination:

> MR. ROBERTI: Do you know any of the details [underlying the 38% tax rate]?
> MS. PARTRIDGE: I do not know any of the details of those accounts.
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> MR. ROBERTI: [I]t's fair to say that you cannot testify to the underlying detail that makes up the numbers on [Exhibit] SP-1?
> MS. PARTRIDGE: That's absolutely correct. (Tr. 10/22/02, at 17-18).

Although Ms. Partridge was at a complete loss to explain how the 38% effective rate was calculated, it is clear that the reason that Southern Union's effective rate is higher than the 35% statutory rate is that the Southern Union financial statements include expenses related to the amortization and write-off of goodwill, which are not deductible in the determination of taxable income. (Tr. 10/22/2002, p. 196-197, Division Ex. 2, p. 5). The amortization and write-off of goodwill on the books of Southern Union have nothing to do with the operations of Providence Gas and should not affect the income taxes included in the operating expenses of Providence Gas.

Ms. Partridge is correct that there can be certain items that go into the federal income tax expense that are not accounted for by applying the statutory rate to the taxable income of Providence Gas Company. The Commission has recognized the effect of such items in the past by <u>taking specific account of such items</u>, not by using an "effective income tax rate." (Tr. 10/22/2002, pp. 143-144). The Commission has never attempted to capture the effect of such items by using an effective income tax rate. (Division Ex. 2, pp. 5-6).

The Commission has always used the statutory federal income tax rate, not a so-called "effective tax rate", to calculate federal income tax expense. (Id.). Ms. Partridge made no attempt to identify or quantify any factors that would cause the Providence Gas federal income tax expense (as opposed to the Southern Union income tax expense) to differ from the income tax expense calculated by applying the statutory tax rate to taxable income. She offered no evidence that such factors even existed during the ERI-2 term (Tr. 10/22/2002, pp. 145-146). Rather, she relied on an "effective tax rate" derived from the financial statements of Southern Union. If the ERI-2 Agreement had specified that operating results will be adjusted to reflect Southern Union financial reporting principles, then perhaps the use of an effective tax rate would be appropriate. However, it does not. Rather, the ERI-2 Agreement states that operating results "will be adjusted to reflect established Commission ratemaking principles." Established Commission ratemaking principles do not include use of an "effective tax rate" to determine income tax expense. The use of an effective tax rate violates the ERI-2 Agreement and should be rejected. Application of "established Commission ratemaking principles" requires the use of the statutory federal income tax rate to calculate federal income tax expense.

II. Interest Rate

Interest expense is deducted from operating income in determining the net income available for common equity. The ERI-2 Agreement specifies that, "The applicable interest shall be calculated by multiplying average rate base by the percentage debt in the capital structure … times the applicable cost rate." (ERI-2 Settlement Agreement, Section

II-I-2). Mr. Effron stated that because the ERI-2 Agreement did not limit the debt in the capital structure to long-term debt, a reasonable interpretation is that the intent was that the debt in the capital structure should include a mixture of long-term debt and short-term debt, as the Company's capital structure has traditionally contained such a mixture. (Division Ex. 1, p. 8).

In her surrebuttal testimony, Ms. Partridge stated that it was appropriate to use the Company's proposed cost rate for long-term debt and recounted the testimony on the issue of the appropriate cost rate for long-term debt in Docket No. 3401. (New England Gas Ex. 2, pp. 5-6). This surrebuttal testimony did not address Mr. Effron's testimony that the calculation of the interest rate on debt should reflect a combination of long and short-term debt. Mr. Effron's testimony on this matter is uncontested, and the Commission should adopt Mr. Effron's calculation of the interest rate to be used in calculating the interest expense to be deducted from operating income.

III. Prepayments

The ERI-2 Settlement Agreement specifies that in determining the earned return on common equity:

> The rate base used in these calculations will be the average rate base for the relevant period, based on a five-quarter average at the end of each reporting period referred to in Section II.I and established Commission ratemaking principles.

Although Ms. Partridge testified that prepayments are an appropriate component of rate base (New England Gas Ex. 2, p. 6), as Mr. Effron stated, "neither the rate base calculations accompanying the quarterly reports filed pursuant to ERI-1 nor the rate base determination in Docket No. 2286 included prepaid expenses in rate base" (Division Ex.

1, p. 7). That omission is significant since it constitutes the foundation of ratemaking principles underlying the Commission's approval of the ERI-2 settlement agreement. Therefore, consistent with established Commission ratemaking principles, prepayments should not be included in the Providence Gas rate base for the purpose of calculating the earned return.

IV. IRP Accruals

As Mr. Effron explained in his supplemental testimony:

> The ERI-2 Agreement at Section II-F provides for funding of the following programs:
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> 1. The Low Income Assistance Program will be funded at an annual level of $1.3 million for each year of the Extended Term.
> 2. The Demand Side Management rebate program will be funded at an annual level of $0.3 million.
> 3. The Low Income Weatherization Program will be funded at an annual level of $0.3 million for the first year $0.2 million for the second year. (Division Exhibit 2)

Thus, the average annual level of funding for these programs is $1,850,000. Providence Gas accounted for the funding of these programs as charges against revenue. (Division Ex. 2, pp. 2-3).

The Company's earnings reports charged $2,212,000 against revenue for the IRP programs in each of the reporting periods (Id.). Based on the ERI-2 Agreement, the charges against revenue to fund these programs should be no more than $1,850,000 per year as required by Section II(F) of the Agreement. Therefore, the revenue for each of the reporting periods should be increased by $362,000 to reflect the funding of IRP programs authorized in the ERI-2 Agreement.

There are two reasons that the Company overstated the IRP accruals charged against revenue. First, the Company included the incremental commitment of $250,000 from the Gas Purchasing Plan Settlement. (Id.). This increased commitment was intended to be a contribution from shareholders, as noted repeatedly by the Commission in its order accepting the Gas Purchasing Plan Settlement. (See Report and Order, Docket Nos. 1673, 1736, and 3347, pp. 71-72, p. 82 ("shareholders contributed $333,000 to LIHEAP when the commission approved the Mitigation Strategy Plan" (Order at 58); the exact statement again appears at page 72 and then again at page 82)).[1] Therefore, this incremental $250,000 should be eliminated from the cost of the IRP programs charged against revenues. Second, the Company double counted the Low Income Assistance Program costs for the three months of the two ERI-2 twelve-month periods that overlap. (Division Ex. 2, pp. 3-4). 4). Correcting these two elements of the IRP costs charged against revenues by the Company results in an accrual of $1,850,000 per year.

V. Period of Excess Earnings

In his direct testimony Mr. Effron explained that he multiplied the average annual excess earnings by 1.75 to calculate the excess earnings over the twenty-one month term of ERI-2. (Division Ex. 1, pp. 11-12). Ms. Partridge opposed this method of calculating the excess earnings for the term of ERI-2 because "it is not established in either the ERI-2 Settlement Agreement or the Commission's order approving the ERI-2 Settlement Agreement." (New England Gas Ex. 2, p. 8).

On cross-examination, Ms. Partridge acknowledged that Mr. Effron's method of multiplying the average annual excess earnings by 1.75 to calculate the excess earnings

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[1] The $333,000 is comprised of $250,000 for Providence Gas Company and $83,000 for Valley Gas/Bristol & Warren Gas Companies.

over the twenty-one month term of ERI-2 is mathematically correct. (Tr. 10/22/2002, pp. 42-43). In addition, she admitted that limiting the over-earnings calculation to twelve months would allow the Company to retain a portion of the excess earnings (Tr. 10/22/2002, pp. 45-48). However, she continued to oppose Mr. Effron's method because it was not, in her view of the matter, explicitly set out in the ERI-2 Agreement.

Ms. Partridge's position leads to an absurd result that vitiates one of the most important components of the settlement – the earnings cap. By consciously attempting to ignore the plain and obvious reality that the term of the settlement agreement is 1.75 years – *and not one year* – Ms. Partridge's stance in effect will allow the company to achieve earnings that exceed the agreed-upon hard cap of 10.7% for the return on common equity. The Commission's Fiscal Analyst demonstrated that Ms. Partridge's interpretation would lead to a most untenable and inequitable result:

MR. MASSARO: Would that not mean that the company . . . would be retaining something over the cap of 10.7?
MS. PARTRIDGE: Mathematically, you're correct.

* * *

MR. MASSARO: [Y]ou would come out with an earnings level of over 10.7% [for] each period; would you not?
MS. PARTRIDGE: Yes. (Tr. 10/22/02, at 47-48).

The testimony demonstrates that Ms. Partridge's position would lead to an absurd and patently unreasonable interpretation of the ERI-2 Settlement Agreement. The omission of language specifying the use of mathematically correct procedures should not be construed as an implied agreement among the parties that improper, illogical and inequitable analytical techniques be employed. Suffice it to say that in the Division's view, the necessity of calculating excess earnings over the 1.75 year term of ERI-2 was so plainly obvious that it literally went without saying. By construing each provision of the settlement in a manner that renders the entire contractual instrument with a consistent, logical and equitable outcome, the average annual excess earnings must be multiplied by 1.75 to calculate the excess earnings over the twenty-one month term of the ERI-2 Agreement.

VI. Environmental Expenditures

On September 27, 2002, the Company filed what it characterized as "the final ERI-2 earnings reports." However, certain revisions to "the final ERI-2 earnings reports" were filed on October 21, 2002, one day before the scheduled hearing in this case. Apparently, at the last minute, the Company discovered certain ambiguous statements made in Docket No. 2581 that it now asserts can be interpreted to permit the inclusion of environmental response expenditures in rate base, thereby significantly increasing rate base and reducing the calculated return.

The ambiguous statements relied on by the Company were made by Providence Gas witness Kenneth Hogan in response to questions from the bench in Docket No. 2581. In the first instance, although the question directed to Mr. Hogan referred to the treatment of environmental response costs in ERI-2, Mr. Hogan appeared to preface his response with a description of the treatment of environmental response costs in ERI-1. Thus, Mr. Hogan stated, "The calculation that the Company **made** was to include actual cash expenditures that **were made** for environmental costs in the rate base …." (Docket No. 2581, at Tr. 9/22/2000, p. 82, (Emphasis added)). The use of the past tense implies a description of what the Company had been doing in its ERI-1 reports, not what the treatment would be in the ERI-2 reports.

In the second instance, Mr. Hogan was working from ERI-1 reports while explaining the difference between the depreciation reserve on the Providence Gas books of account and the depreciation reserve deducted from plant in service in the calculation of rate base. In fact, in his response at Tr. 9/22/2000, p. 130, Mr. Hogan referred back to his statements at Tr. 9/22/2000, p. 82, which appeared to be describing the treatment of environmental response costs in ERI-1. Again, it does not appear from his statements that Mr. Hogan was describing his understanding concerning the <u>prospective</u> treatment of environmental response costs during the term of ERI-2.

Ultimately, however all of that is irrelevant. The ERI-2 Settlement Agreement itself clearly sets out the treatment of environmental response costs in Section II-G. Paragraph (b) of that section states:

> <u>Funding</u>. Interest shall accrue, for the benefit of customers, on any credit balances in the fund at the customer deposit rate. <u>**No interest shall accrue on debit balances**</u>**.** (Emphasis added).

As, Mr. Effron explained, Section II-G was the complete, self-contained, prescription for treating environmental response costs in ERI-2. (Tr. 10/22/2002, p. 147). Unlike Mr. Hogan's testimony on cross-examination, the language in the Settlement Agreement itself is clear and unambiguous. Allowing a return on deferred environmental response costs by including such expenditures in rate base would circumvent the provision that "No interest shall accrue on debit balances" and would render it meaningless by providing the Company with a return on its deferred environmental costs. If the intent of the parties to the ERI-2 Settlement Agreement had been that interest would accrue on credit balances in the fund, but debit balances in the fund would be included in rate base, then the Agreement would have so stated. That is not what the Agreement provides. The Company should not be allowed to circumvent the provision that "No interest shall accrue on debit balances" by including such debit balances in rate base for the purpose of calculating the earned return during the term of ERI-2.

Besides the clarity of the settlement agreement, there is one more aspect of this case that independently should lead the Commission to reject the Company's assertions as meritless. As the evidence makes clear, the structural foundation of the settlement agreement on environmental remediation expenses came directly from the comprehensive settlement agreement reached in the unprecedented electric industry merger and consolidation rate proceeding in Docket No. 2930, which involved Narragansett Electric Company, Blackstone Valley Electric Company and Newport Electric Corporation (collectively, the "Narragansett Settlement"). Both Ms. Partridge and the former General Counsel and Vice President of the Company acknowledged that the ERI-2 Agreement, as far as the treatment of environmental remediation expenses, was "designed to be consistent with the Commission's treatment of similar expenditures in the electric industry." (Division Exhibit 5). This statement constitutes an affirmative representation to the Commission relative to the intent of the parties in reaching the ERI-2 Agreement.

The Commission can and should take administrative notice of the settlement provisions contained in the Docket 2930 Agreement with Narragansett Electric Company. It certainly will come as no surprise to the Division that the language regarding accounting treatment for environmental remediation expenses in the Narragansett Settlement is **identical** to the language in the ERI-2 Agreement. (See

Exhibit A, attached hereto). It should come as no surprise to Ms. Partridge as well, except that she failed to exercise diligence in ascertaining what constitutes "consistent treatment" with the Narragansett Settlement. Not only is the settlement language <u>identical</u>, but the record of Docket 2930 demonstrates that there was absolutely no uncertainty that <u>negative fund balances were to receive no interest</u>. The following exchange occurred during the presentation of the Narragansett Settlement to the full Commission:

> MR. JOHNSON: In the event that you build up a deficiency in the fund during the rate freeze period, how would that be treated?
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> MR. REILLY: During the rate freeze period, the fund does not accrue any interest . . . So if we spend more on cleaning up sites than there is in [the fund], we are suffering an economic loss associated with that.
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> MR JOHNSON: The interest rate is the rate on customer deposits?
> MR. GERWATOWSKI: Just on positive deposits. There is no interest on negative balances. (Docket 2930 Tr. 2/11/00, at 161, 163).

The entire discussion on the electric industry treatment, which the Commission should take administrative notice in the instant proceeding, is attached hereto as Exhibit B. As a matter of regulatory policy, the Commission's interpretation of <u>identical provisions</u> in a settlement agreement that relate to <u>identical items</u> ought to be the same. Ms. Partridge's unfamiliarity with the mechanics and principles of the ERI-2 settlement agreement, and the fact that the Company's current management team was simply not privy to the negotiations which led to the execution of the ERI-2 Agreement, should lead the Commission to the inevitable conclusion that negative fund balances are to be treated just as the ERI-2 Settlement dictates: " No interest shall accrue on debit balances."

(Emphasis supplied).

VII. Summary

In all fairness, the positions taken by New England Gas Company in this proceeding amount to a transparent attempt to ignore the clear and unambiguous terms of the ERI-2 Settlement Agreement and to re-write those terms to serve its own purposes:

1. When the ERI-2 Settlement Agreement states that operating results "will be adjusted to reflect established Commission ratemaking principles", it does not mean that income tax expense will be calculated by using the effective tax rate of the parent company of the utility, a practice never authorized by the Commission for any utility company subject to its jurisdiction.

2. When the ERI-2 Settlement Agreement states that the allowance for IRP programs will be $1,800,000 in the first year of the ERI-2 term and $1,900,000 in the second year of the ERI-2 term, it does not mean that the allowance will be $2,212,000 for each of the years.

3. When the ERI-2 Settlement Agreement specifies that its term will be 21 months and that any excess earnings will be credited to the Deferred Revenue Account, it does not mean that the Company can pretend that the term of the Agreement is only 12 months for the purpose of determining excess earnings.

4. When the ERI-2 Settlement Agreement states that environmental response costs will be accounted for in a separate fund and "No interest shall accrue on debit balances" in the Environmental Response Fund, it does not mean that it was the intent of the parties to permit the Company to include any such debit balances in rate base, which would circumvent that provision and render it meaningless.

There is no ambiguity regarding any of these terms. The Commission should not countenance the Company's attempts to re-write the clear terms of the ERI-2 Settlement Agreement and should require the Company to calculate the credit to the Deferred Revenue Account for excess earnings according to those terms.

Respectfully submitted,

DIVISION OF PUBLIC UTILITIES AND CARRIERS

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CERTIFICATION

I hereby certify that on this 12th day of November, 2002, the within Brief of the Division of Public Utilities and Carriers was served, by first class mail, on those persons listed on the Service List compiled by the Clerk of the Commission in this docket.

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