November 12, 2002

VIA HAND DELIVERY

Luly Massaro, Commission Clerk
Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

Re: Docket No. 3459; Brief of New England Gas Company on the 2002-03 Annual Distribution Adjustment Charge

Dear Luly:

Enclosed is an original and nine copies of the above-referenced Motion. From what the Company understands, this represents the final record evidence introduced by the Company and the Division for the matters addressed. If the Division intends to introduce any new issues regarding the Distribution Adjustment Charge, the Company respectfully reserves its right to address any new issue. Thank you for your attention to this filing.

Sincerely,

CRAIG L. EATON (#5515)
Attorney for New England Gas Company

CLE/atn

cc: Service List

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STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE:	)	
NEW ENGLAND GAS COMPANY	)	DOCKET NO. 3459
DISTRIBUTION ADJUSTMENT	)	
CLAUSE	)	

BRIEF OF NEW ENGLAND GAS COMPANY
ON THE 2002-03 ANNUAL DISTRIBUTION ADJUSTMENT CHARGE

I. INTRODUCTION

On August 1, 2002, the New England Gas Company ("NEGC" or the "Company") filed its first annual Distribution Adjustment Charge for effect on November 1, 2002.[1] In its filing, the Company proposed to: (1) update two components of the DAC, which are the System Pressure factor and Environmental Response Cost ("ERC") factor; and (2) to account for various reconciliation elements to conclude the Energize Rhode Island Extension Settlement Agreement (the "ERI-2 Settlement"). Exh. NEG-1, at 2-4.

With respect to the DAC components, the Company proposed to update the System Pressure factor to reflect projected costs for the November 2002 through October 2003 time period and the ERC factor to incorporate fiscal year 2002 expenditures and revenues. Id. at 4-5. At an Open Meeting of the Commission held on October 24, 2002, the Commission delayed the implementation of the DAC adjustments until all adjustments can be made at one time. Tr. at 11.

[1] The DAC was established in New England Gas Company, Dkt. No. 3401 and initially became effective on July 1, 2002, pursuant to the terms of the Commission's approval in that docket. Consistent with the provisions of the Company's tariff, RIPUC NEGC No. 101, and the Company's testimony in Docket No. 3401, the Company's August 1, 2002 filing was designed to update those components of the DAC that differed from those in effect as of July 1, 2002. Exh. NEG-1, at 2.

Under the terms of the ERI-2 Settlement, the Company was required to establish a Deferred Revenue Account (the "DRA"), the balance of which would be credited or debited to customers upon the expiration of the ERI-2 Settlement (ERI-2 Settlement Agreement, Section II.(1). The balance of the DRA results from: (1) any earnings in excess of the allowed rate of return on equity (10.7 percent) (Section II.I, 2-4); (2) adjustments due to exogenous events (Section II.J); (3) non-firm margins (Section II.K); and (4) the weather-mitigation clause (Section II.L). The Company's calculation showed a debit balance (or balance due to the Company) totaling $4,278,411 for the DRA, which is the sum of the Winter 2001-02 weather mitigation adjustment of $4,516,200, less 75 percent of non-firm margins for the 2001-02 period or $237,789.

In this proceeding, no issues have been raised in relation to the Company's calculation of the adjustments to the DAC components, non-firm margins or the weather-mitigation adjustment. Rather, the debate centers on the determination of whether the earnings realized by the Company during the 21-month period of October 1, 2000 through June 30, 2002, resulted in a return on equity in excess of 10.7 percent. As discussed below, the Division has proposed a series of adjustments to the Company's calculations that contravene the intent of the ERI-2 Settlement Agreement, are inconsistent with Commission ratemaking practice or are based on erroneous assumptions. As a result, the Division's claim that the Company realized "excess" earnings of approximately $2.5 million during the term of ERI-2 is flawed and must be rejected by the Commission.

Specifically, the Division contests the following components of the Company's calculation of earnings: (1) the inclusion of actual cash expenditures for environmental remediation costs in the accumulated depreciation portion of the rate base calculation; (2) the inclusion of prepaid expenses in rate base; (3) the use of the actual tax rate paid by Southern Union Company on the earnings produced by its Rhode Island operations; and (4) the use of an overlapping period in accounting for the expenses incurred in relation to the Company's Integrated Resource Plan (the "IRP"). In addition, the Division contends that a "gross-up" of the earnings that it has calculated to be in excess of the allowed return on equity of 10.7 percent is required. Each of these issues requires a determination as to the terms of the ERI-2 Settlement Agreement based on the intent of the Settling Parties.[2] To the extent that the ERI-2 settlement agreement is silent or ambiguous, determination of the issues will require an examination of extrinsic documentation, Commission ratemaking precedent and prior practice of the parties. As discussed below, the Company's calculation of earnings for the 21-month term of the ERI-2 Settlement Agreement comports with the meaning and intent of the Settlement Agreement and is consistent with Commission ratemaking practice. Accordingly, the Commission should reject the adjustments to the calculation recommended by the Division in this proceeding.

[2] As discussed below, the Company has included herewith the Affidavit of Mr. Kenneth J. Hogan on the issue of treatment of environmental costs for the purposes of the earnings calculation to assist in the Commission's consideration of the "intent" of the Settling Parties. Mr. Hogan's affidavit is provided in response to the Commission's inquiry that "no one from the company who was present at [the]negotiations has come forward" on the issue of environmental costs (Tr. at 185, lns.19-21), and Mr. Effron's representation that no one from the company who participated in the negotiations would have a different view than his on this issue (id. at 186, lns 1-5). As a witness for the Division, Mr. Effron is not competent to speak on behalf of the Company on this issue or to provide testimony as to the Company's "intent" during settlement negotiations.

II. DETERMINATION OF THE TERMS OF THE ERI-2 SETTLEMENT AGREEMENT

The Commission approved the ERI-2 Settlement Agreement between the Providence Gas Company ("ProvGas") and the Division, the Energy Council of Rhode Island and the George Wiley Center (together, the "Settling Parties") on September 29, 2000. The ERI-2 Settlement Agreement represented a 21-month extension of the Energize Rhode Island Price Stabilization Plan (the "PSP" or "ERI-1"), which had been in effect since 1998. Providence Gas Company, Docket No. 2581, at 1 (2000) ("Dkt. No. 2581"). As acknowledged by the Commission, the ERI-2 Settlement Agreement was designed to extend and maintain the structure of the PSP, with certain modifications, in order to bridge the period between the expiration of the PSP and the implementation of new rates on July 1, 2002, that would result from the filing of a rate-consolidation plan on or before December 1, 2001. Id., fn.2. In evaluating and approving the proposed ERI-2 Settlement Agreement, the Commission investigated all of the substantive provisions contained in the Settlement Agreement, as well as a number of related cost-of-service, ratemaking, and gas-purchasing issues.

The Commission is now being called upon to make certain determinations regarding the calculation of earnings over the 21-month period of the PSP extension in this proceeding. Because the ERI-2 Settlement Agreement is silent or ambiguous on a number of critical components that enter into the calculation of earnings, the Commission must look beyond the plain terms of the agreement to aid in its interpretation. To the extent that the ERI-2 Settlement Agreement may be considered by the Commission to be a form of a "contract" between the

Settling Parties, the Commission may take note of the well-established rules on the interpretation of contracts formulated by the Rhode Island courts.

Under Rhode Island law, a court being asked to interpret contractual terms will first determine whether the terms of an agreement are clear and unambiguous. W.P. Associates v. Forcier, Inc., 637 A.2d 353, 356 (R.I. 1994). To determine whether an agreement is clear and unambiguous, the court will view the document in its entirety and its language will be given its plain, ordinary and usual meaning. Id. (citing Antone v. Vickers, 610 A.2d 120, 123 (R.I. 1992)). Where the terms of an agreement are clear and unambiguous, the task of judicial construction is at an end and the terms of the agreement must be applied as written. Forcier, 637 A.2d at 356, citing Aetna Casualty & Surety Co. v. Graziano 587 A.2d 916, 917 (R.I. 1991). Even where no ambiguity is found, however, the main objective of the court is to construe contract terms consistent with the intent of the parties. Capital Properties v. State of Rhode Island, 749 A.2d 1069, 1081 (R.I. 1999) (citing Johnson v. Western Nat. Life Ins., Co., 641 A.2d 47, 48 (R.I.1994)). The courts will enforce the intentions of the parties, as manifested in the terms of the contract, if the intent can be clearly inferred from the writing and can be fairly carried out in a manner consistent with settled rules of law. Forcier, 637 A.2d at 356; Westinghouse Broadcasting Co. v. Dial Media, Inc., 122 R.I. 571, 581 (1980). Thus, Rhode Island courts will "consider the situation of the parties and the accompanying circumstances at the time the contract was entered into, not for the purpose of modifying, enlarging or curtailing its terms, but to aid in the interpretive process and to assist in determining its meaning." Hill v. M.S. Alper & Son, Inc., 106 R.I. 38, 47 (1969).

The courts have consistently found that an agreement is ambiguous only when it is reasonably and clearly susceptible to more than one interpretation. Forcier, 637 A.2d at 356 (citing Gustafson v. Max Fish Plumbing & Heating Co., 622 A.2d 450, 453 (R.I. 1993)); Nelson v. Ptasczek, 505 A.2d 1141, 1143 (R.I. 1986)). If so, extrinsic evidence is admissible to aid in the interpretation of the contract. Forcier, 637 A.2d at 356; Nelson, 505 A.2d at 1143. Accordingly, the courts will allow extrinsic evidence to complete or clarify a document that appears on its face to be incomplete or ambiguous. Supreme Woodworking,Co., Inc. v. Zuckerberg, 82 R.I. 247 (1954).

To apply these principles to the issues raised in this proceeding, the Commission will need to first determine whether the terms of the Settlement Agreement relating to each of those issues is clear and unambiguous. To the extent that the terms are unambiguous but under dispute, the Commission should view the document in its entirety and its language should be given its plain, ordinary and usual meaning. In that regard, consideration of the intent of the Settling Parties may aid the interpretive process and assist in determining the meaning of the terms embodied in the Settlement Agreement. Where the Settlement Agreement is silent, or its terms are reasonably susceptible to more than one interpretation, then the Commission should establish the intent of the Settling Parties with reference to: (1) record evidence in Dkt No. 2581, in which the Commission investigated the operation and effect of the proposed ERI-2 Settlement Agreement; (2) the terms and operation of the pre-existing PSP; and (3) Commission ratemaking precedent. Accordingly, the Company has applied these principles of contract construction to each of the Division's issues in order to demonstrate that its recommended adjustments are unfounded and inconsistent with the meaning and intent of the ERI-2 Settlement Agreement.

From an overall perspective, the design and intent of the ERI-2 Settlement Agreement is clear. As stated in the ERI-2 Settlement Agreement, the intent of the Settling Parties in reaching consensus on the ratemaking and policy issues embodied therein was to "bridge the time period until a rate plan for the consolidated companies could be implemented" (ERI-2 Settlement Agreement, Section I.A, at p. 3). To that end, the Settlement Agreement was designed: (1) to maintain the basic structure of the PSP through a 21-month extension period; (2) to continue specified consumer benefits enjoyed by ProvGas customers under the PSP; and (3) to incorporate certain modifications to the PSP to reflect changes in the procurement and cost of natural gas, as well as the Company's cost of service. See Order of the Commission in Dkt. No. 2581, at 1; Settlement Agreement at Section I.A, at pages 2-5. Therefore, these objectives should be taken into consideration in construing the Settlement Agreement to reach a determination on the issues raised by the Division.

III. ANALYSIS AND DISCUSSION

A. Environmental Remediation Costs

On October 21, 2002, the Company filed Data Request DIV 1-06 (Corrected) because it had mistakenly omitted an adjustment to the earnings-sharing calculation that should have been included under the terms of the Commission's approval of the ERI-2 Settlement Agreement. Specifically, the Company inadvertently excluded actual cash expenditures for environmental remediation costs from the accumulated depreciation portion of the rate-base calculation, although the Commission's approval of the ERI-2 Settlement Agreement made clear that actual expenditures for environmental remediation would be included in the accumulated depreciation portion of rate base for the purpose of calculating the Company's earnings over the 21-month term of ERI-2. Although the Company has provided ample documentation that the record in Docket 2581 shows that such costs were intended to be included, the Division is contesting the inclusion of this amount.

In that regard, the Division makes four claims: (1) that the inclusion of environmental remediation costs in the Accumulated Depreciation balance is not consistent with the intent of the ERI-2 Settlement (Tr. at 146, lns. 12-15); (2) that Section G of the Settlement Agreement was intended to be the entire treatment of the environmental response costs (Tr. at 147, lns.19-21); (3) that continuing to account for these costs as part of the cost of removal in the depreciation reserve, puts the Company "out of compliance" with the requirement to maintain a "separate account" of fund for these costs, pending the Commission's ratemaking approval in Docket 3401 (Tr. at 146-47); and (4) that the questions posed by Mr. Massaro and answered by Mr. Hogan during the evidentiary hearing in Docket 2581, were making reference to the treatment accorded to these costs in ERI-1 and not ERI-2 (Tr. at 192-193). The record shows that there is no basis for any of these claims, and therefore, the Commission must reject the Division's recommendations on this issue.

First, contrary to Mr. Effron's unsubstantiated conclusions regarding the intent of the ERI-2 Settlement, the record demonstrates the following: (1) both accrued and actual cash expenditures were included in the rate-base component of the earnings calculations under ERI-1, as acknowledged by the Division (Tr. at 192-193; Affidavit of Mr. Hogan at 3; DIV 8-02 (Docket 2581)); (2) data requests issued by the Division in Docket No. 2581, and responded to by the Company state that, for purposes of the ERI-2 earnings calculation, the Company would exclude <u>accrued</u> environmental expenses from the balance of Accumulated Depreciation, leaving in actual cash expenditures (Docket No. 3459, DIV 1-06 (corrected); Docket No. 2581, DIV 8-02; RIPUC 1-09; (3) at the hearing held during the Commission's investigation of the proposed settlement agreement, the Company responded to specific questions from the bench regarding the sample calculation (provided in response to DIV 1-09, in that proceeding) and the "inclusion or exclusion" of such costs from rate base, stating that actual cash expenditures were included in that calculation and would be included in rate base "going forward" (Docket No. 2581, Tr. at 82 (ln.13-17)); (4) at the hearing in Docket No. 2581, the Division raised no objection and offered no corrections to the Company's representations to the Commission regarding the ratebase treatment for actual cash expenditures; and (5) Mr. Hogan, who participated in the settlement discussions and testified on behalf of the Company has submitted an affidavit confirming that the intent was to include these costs in the Accumulated Depreciation portion of rate base. The intent to include such costs in the ratebase calculation is most directly evidenced by the Commission's order in Docket No. 2581 stating that "Mr. Hogan outlined the treatment of environmental remediation costs, stating that the Company would include actual cash expenditures for environmental remediation costs in the rate base . . . but not any accruals for costs that have not yet been paid.[3] <u>See</u>, Docket No. 2581, at 10-11.

Second, the Division's claim that Section G of the Settlement Agreement was intended to be the entire treatment of the environmental response costs is not supported by the record, nor is it consistent with the Commission's order approving the ERI-2 Settlement Agreement (Tr. at 147, lns.19-21). Section G of the Settlement Agreement, as well as other sections contained

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[3] Reference to the Company's representations on this issue is specifically noted in the Commission's order in Docket No. 2581, approving the ERI-2 Settlement Agreement. The Division may argue that this reference does not represent approval by the Commission of this treatment, but the Commission's approval was contingent upon a number of modifications to the Settlement Agreement, none of which were directed at any changes in relation to the inclusion of actual cash expenditures (Docket 2581, at 18). To the contrary, the Commission explicitly noted that the rights of the parties were reserved for "a future proceeding," wherein the Commission would "revisit the costs and appropriate accounting" for environmental remediation (<u>id.</u>).

therein, show the intent to put in place a new framework to separate costs (i.e., the creation of a "separate account") so that the costs would be transparent to the Commission when it approved a new, permanent accounting and ratemaking treatment of these costs in a future base-rate proceeding. In that regard, Section G states that "[a]n Environmental Response Fund shall be established to create a mechanism to fund the recovery" of environmental costs" (Section G.1) (emphasis added). Nowhere does it state that the accounting treatment relating to the fund would apply to the calculation of earnings under ERI-2, or that Section G was intended to govern cost recovery during ERI-2. By comparison, Section L of the Settlement Agreement reached in Docket No. 3401 ("Accounting Treatment for Environmental Cost") states, "[t]he Settling Parties agree that the Company shall be entitled to recover Environmental Response Costs, as defined below" (emphasis added). The differences in the language used to outline the provisions of the ERI-2 Settlement Agreement and Docket No. 3401 Settlement Agreement confirm that the intent of Section G in the ERI-2 Settlement Agreement was to allow for the separate tracking of these costs and to establish a framework that would be consistent with Commission precedent when the issue would be taken up by the Commission in the next rate proceeding.

Moreover, Section 1.B of the ERI-2 Settlement Agreement states that the settlement is based on "extensive discovery and negotiations" among the Settling Parties. The record in this proceeding clearly reflects that the discovery between the Company and the Division anticipated the inclusion of these costs in the rate base calculation and not, as the Division claims, that Section G was intended to represent the "entire treatment" of such costs, including the treatment of such costs in the earnings sharing calculation. In addition, other sections of the Settlement Agreement indicate that the intent was to establish the fund as the basis for a new treatment of environmental costs on a going forward basis, but not for purposes of the earnings calculation. For example, the overview of the major aspects of the ERI-2 Settlement Agreement are stated in the introduction, and nowhere does it state that the Settling Parties have resolved the accounting and ratemaking treatment of these costs, nor does it state that the Settling Parties have made a wholesale change in the way that these costs would be factored into the earnings calculations (ERI-2 Settlement Agreement at 1-2). Since there is no statement in the Settlement Agreement indicating that that the establishment of the Environmental Response Fund was in any way related to the calculation of earnings under ERI-2, the agreement is ambiguous as to the effect of the establishment of this fund on the calculation of earnings.[4]

Third, the Division claims that continuing to account for these costs as part of the cost of removal in the depreciation reserve, puts the Company "out of compliance" with the requirement to maintain a "separate account" of fund for these costs, pending the Commission's ratemaking approval in Docket 3401 (Tr. at 146-47). However, at the hearing, the Company testified that it is tracking the environmental costs in a separate "cost of removal" account within the Accumulated Depreciation section of the balance sheet (Tr. at 201), so that the debits and credits to the account were transparent for purposes of the base-rate proceeding in Docket No. 3401, wherein the Commission approved a new ratemaking treatment for environmental costs as anticipated by the ERI-2 Settlement Agreement. Therefore, the Company is in full compliance with the provisions of the Settlement Agreement.

Lastly, the Division claims that the questions posed by Mr. Massaro and answered by Mr. Hogan during the evidentiary hearing in Docket 2581, were making reference to the treatment accorded to these costs in ERI-1 and not ERI-2 (Tr. at 192-193). However, as noted at

4 At the hearing, the Division referenced the cover letter that accompanied the filing of the ERI-2 Settlement Agreement with the Commission noting that the accounting treatment for the fund was "designed to be consistent with the Commission's treatment of similar expenditures in the electric industry" (Tr. at 149-150). The Company agrees that, as stated in the filing cover letter, the intent of establishing the fund was to put in place a "mechanism to fund the recovery" of environmental costs that would be viewed favorably by the Commission in the next base-rate proceeding because of its consistency with the framework established by the Commission for the electric industry. This statement makes no reference to an agreement by the Company to incorporate the accounting treatment for the fund into the calculation of earnings under ERI-2.

the hearing by Ms. Partridge, it is clear from the context of the transcript that Mr. Massaro was questioning the Company as to the changes in treatment between ERI-1 and ERI-2 of unamortized Y2K and environmental costs on a "going forward basis" (Tr. at 199-200). Moreover, Mr. Effron's suggestion that, in referring to "the calculation that the Company made," Mr. Hogan was referring to calculations under ERI-1 is inaccurate, because the transcript in Docket No. 2581, states that Mr. Hogan was, in fact, referring to the calculations made in preparing the ERI-2 Sample Earnings report provided in response to DIV 8-02 in Docket No. 2581 (see Tr. at 131, Docket No. 2581). In any event, it is clear from the Commission's order that the discourse reflected on the transcript between Mr. Massaro and Mr. Hogan was indeed referring to the treatment that would be afforded to these costs under ERI-2 (Order at 10-11, Docket 2581).

Based on the foregoing, the Division's claims in relation to inclusion of environmental costs in the Accumulated Depreciation portion of rate base for the purpose of calculating the Company's earnings under ERI-2 are not supported by the record in this case. The record shows that the intent of the Settlement Agreement was: (1) to create a separate fund to facilitate the Commission's review and determination of the accounting and ratemaking treatment of these costs in a future base-rate proceeding that would be consistent with Commission precedent; and (2) to continue to include these costs as accumulated depreciation in calculating the return-on-equity for the term of ERI-2. The record also shows that the Company created a separate account for these costs consistent with the terms of the Settlement Agreement. Lastly, the record shows that the Commission explicitly investigated, evaluated and accepted the treatment of these costs as part of rate base in the earnings calculation in approving the ERI-2 Settlement Agreement. Accordingly, the Division's claims must be dismissed by the Commission.

B. Prepaid Expenses

The Division claims that the inclusion of prepaid expenses in rate base is "not consistent with the established Commission ratemaking principles for Providence Gas" and recommends that these expenses should be excluded from the calculation of rate base in this proceeding. Exh. DIV-1, at 9. However, the record in this proceeding shows that the inclusion of prepaid expenses in rate base is, in fact, consistent with Commission ratemaking principles, as most recently demonstrated in the Commission's approval of the Settlement Agreement in Docket No. 3401, which includes such expenses in rate base for the purposes of the earnings sharing calculation. Therefore, the Division's recommendation should be rejected by the Commission.

In Docket No. 3401, the Company included prepaid expenses relating to insurance, taxes and other expenses in rate base. See, e.g., Exh. SP-2 and SP-3, Schedule 4. In his rebuttal testimony, Mr. Effron did not make any claim that these expenses are not rate-base items. See Rebuttal Testimony of David J. Effron, at 20. Rather, Mr. Effron asserted that these costs should be excluded from the calculation only because they would no longer be incurred by ProvGas. Id. at 21. Mr. Effron further proposed to exclude prepayments related to taxes from rate base stating that the "pattern of the payment of income taxes should be taken into account in the lead-lag study." Id. In the Settlement Agreement in Docket No. 3401, only prepaid taxes are excluded from the earnings-sharing calculation. See Docket 3401, Settlement Agreement at Section F.1, at page 11. Moreover, the record in this proceeding shows that the Commission has included prepayments in rate base in other proceedings (Tr. at 158, lns. 21-24; Tr. 44-45).

In this case, there is nothing in the ERI-2 Settlement Agreement that states that prepayments will be excluded from rate base, nor does the agreement state that something other than the actual prepayments incurred by the Company during the term of ERI-2 will be used in the earnings calculation. The fact that ProvGas may not have included prepayments in rate-base calculations has no bearing on whether Southern Union, during the term of ERI-2, would have incurred those prepayments, and to the extent that those prepayments exist, it is consistent with Commission ratemaking precedent to include those payments in rate base. Accordingly, there is no basis for the exclusion of these items from rate base in the earnings calculation.

C. Tax Rate Applied to Earnings

The record in this proceeding shows that on September 28, 2000, the ProvGas operations were merged with Southern Union Company (COMM 1-09, at 1). The record also shows that Southern Union's Rhode Island gas distribution operations are organized and operated as a division of the corporation, and not as an independent subsidiary (Tr. at 206). As a result, the financial results of the ProvGas operations have been consolidated with those Southern Union since the date of the merger for both financial reporting and income-tax purposes (COMM 1-09, at 1; Tr. at 206). This means that taxable income is not calculated at the operating division (ProvGas) level, nor are individual financial reports generated for the Rhode Island operations (Tr. at 199, 206). Instead, income taxes are calculated and paid by Southern Union based on its consolidated net taxable income (COMM 1-09, at 20; Exh. NEG-2, Attachment SP-1). Accordingly, to calculate the actual income-tax expense associated with the earnings generated by the ProvGas operations during the term of ERI-2, the Company applied Southern Union's actual or "effective" tax rate of 38 percent. As discussed below, this calculation is consistent with the intent of the ERI-2 Settlement Agreement and Commission ratemaking principles, and therefore, should be accepted by the Commission.

First, the ERI-2 Settlement Agreement is entirely silent on the income tax rate that would be used to calculate income-tax expense. The Division urges the Commission to apply the "statutory" tax rate of 35 percent because "the statutory federal income tax rate was intended to be the appropriate federal income tax rate for ratemaking purposes subsequent to Southern Union's acquisition of ProvGas" (Exh. DIV-2, at 5). The Division claims that this "intent" is clear. The Division further contends that the Commission has "never used a so-called effective income tax rate" to calculate the income taxes to be included in operating expenses and that using this rate would be inconsistent with Commission ratemaking principles and would "violate" the ERI-2 Settlement Agreement (id. at 6). However, the record in this proceeding does not support these claims of the Division.

First, the record reflects that, in Docket No. 2286, which is the most recent cost-of-service rate case for ProvGas prior to the case filed in Docket 3401, as well as in Docket 3401, the Commission included in rates income-tax expenses that were computed to represent an "effective tax rate," as the Company has done in this case Exh. NEG-4. This computation is also used in Schedule 3, Page 4 of the exhibit accompanying the testimony of James DeMetro in Dkt. No. 2581, which the Division asserts represents the "intent" of the Settling Parties (attached). The record shows that, in all three of these cases, income-tax expenses were calculated by (1) multiplying pre-adjusted taxable income by the statutory tax rate to derive a "base" income-tax expense; and (2) adding (or subtracting) various adjustments applicable to taxable income, such as "Schedule M" timing differences or other required accounting treatments affecting the level of taxable income.[5] As the Division acknowledges, the recognition and incorporation of such adjustments to taxable income has the effect of either increasing or decreasing the total income-tax expense depending on the nature of the adjustment (Tr. at 143, lns 11-23). Therefore, all of the "evidence" cited by the Division instead shows that the Company's calculation is consistent with its demonstrations in Docket No. 2581.

The use of the term "effective tax rate" means only that taxable income has been adjusted to reflect certain accounting or timing differences, and that the resulting level of income-tax

[5] The actual or effective tax rate may vary from the statutory rate because of adjustments to the company's taxable income that are required by the law and regulation of the Internal Revenue Service (i.e., Schedule M).

expense is different from the total that would be derived by simply multiplying the statutory rate by the pre-adjusted taxable income. As a result of these adjustments to taxable income, the proportion of income-tax expense to pre-adjusted taxable earnings may be greater than or less than the statutory rate (depending on the nature of the adjustment), thereby producing an "effective tax rate." The record shows that, in Dockets No. 2286 and 3401, the Commission incorporated such adjustments to taxable income, which produced a total income-tax expense representing an "effective tax rate," after the statutory tax rate was applied to the taxable income base (or non-adjusted taxable income). Accordingly, Mr. Effron's contention that the use of the effective tax rate would be inconsistent with Commission ratemaking principles and would violate the terms of the ERI-2 Settlement Agreement is erroneous.

Notably, Mr. Effron states the following:

> [I]t's possible that during the period of ERI-2, that there were some items that would have caused the income tax expense to be different from the amount [that is] calculated by applying the statutory tax rate to the taxable income. . . . If differences were identified, not to take a so-called effective income tax rate applicable to Southern Union and apply it to the operations of Providence Gas. As far as I know, the Commission has never done anything like that in my experience.

(Docket No. 3489, Tr. at 144-145). Mr. Effron's statements imply that there is a difference between the calculation of income-tax expense and the calculation of the "effective tax rate," and that the former calculation is acceptable, while the latter calculation is not. However, as noted above, the term "effective tax rate," refers to nothing more than the total income-tax expense (after required adjustments to taxable income) expressed as a percentage of pre-adjusted taxable income.

In fact, Mr. Effron concedes that "if differences were identified, the proper way to account for those differences is to take them into account and calculate an income tax expense."

This is exactly what the Company has done. In Exh. NEG-2, Schedule SP-1, the Company has identified the "differences" or adjustments to taxable income that are required of Southern Union as a result of accounting and IRS principles, and has incorporated those differences into the calculation of income taxes. In fact, the calculation set forth in Exh. NEG-2, Schedule SP-1 is no different than the Commission's calculation from Docket No. 2286, which was submitted as Exh. NEG-4 in this proceeding, Mr. DeMetro's calculation provided in Docket No. 2581, or the Company's calculation in Docket No. 3401 (Tr. at Exh. NEG-2, SP-1 and SP-2, Schedule 1). All of these calculations accomplish the same thing, which is to identify the actual income-tax expense incurred by the utility in relation to the earnings realized in the same period. The only difference here is that the adjustments to taxable income are those of Southern Union, which is, in fact, the entity that is paying taxes on the earnings realized during the term of ERI-2.

Mr. Effron suggests that if Southern Union's tax rate was affected by a write-off and amortization of goodwill, or presumably any and all other adjustments not directly attributable to the Providence operations, those adjustments to taxable income should not be included in calculating net income for ProvGas for the ERI-2 period. However, the adjustments to Southern Union's taxable income are required by accounting and IRS principles and are unavoidably applicable to the income generated by the Rhode Island companies. Moreover, federal income taxes on the earnings of the Rhode Island operations are calculated on the basis of Southern Union's financial records and are paid by Southern Union (and not ProvGas), in accordance with that calculation.[6] Therefore, consistent with Commission ratemaking practice, the income-tax

[6] The record shows that the 38 percent tax rate computed by the Company is based on utility operations only. See Tr. at 14-15).

expense applicable to those earnings is derived by applying the statutory tax rate to the adjusted taxable income of Southern Union (as discussed above), resulting in the effective tax rate of 38 percent as calculated by the Company in this proceeding.

The intent of the return on equity calculation of the ERI-2 Settlement Agreement is to determine what the Company's earnings were in the 21-month period following the completion of the merger. For example, the Settlement Agreement states that the purpose of the overlapping 12-month measurement periods was to "enable the Company to accurately report earnings" without distortion from the seasonal nature of the Company's earnings (Settlement Agreement, Section I.2 at page 13). Neither the ERI-2 Settlement Agreement, nor any other record evidence provided in this proceeding contradicts the stated intent to accurately report earnings, nor is there any record evidence indicating that the design or underlying intent of the return-on-equity calculation was to replicate ProvGas expenses in the absence of the merger. Accordingly, the Commission should reject the Division's recommendation to simply apply the statutory tax rate in the return-on-equity calculation because it is not consistent with Commission precedent on the calculation of income-tax expenses, nor does it reflect the income-tax expense incurred by Southern Union on the income generated by the ProvGas operations during the term of ERI-2.

D. IRP Expenses

Under the terms of the ERI-2 Settlement Agreement, the Company committed to fund the following programs: (1) the Low-Income Assistance Program at an annual level of $1.3 million; (2) the Demand-Side Management rebate program at an annual level of $0.3 million; (3) the Low-Income Weatherization Program at an annual level of $0.3 million for the first year and $0.2 million for the second year (collectively, the "IRP Programs") (Settlement Agreement, Section II.F). As noted by the Division, the Company's average annual funding commitments totaled $1,850,000 (Exh. DIV-2, at 3). The Division claims that the earnings report prepared by the Company shows charges against revenue of $2,212,000 for funding of the IRP Programs in each of the reporting periods, which exceeds the $1,850,000 required by the Settlement Agreement. The Division attributes this difference to the $250,000 "incremental commitment" related to the Gas Purchasing Plan Settlement, and to the "double counting" of the Low-Income Assistance Program costs for the three months of the two, 12-months periods that overlap (id. at 3-4). The Division therefore contends that the Company's revenues in each of the reporting periods should be increased by $362,000 (id.). Both of these claims are in error and should be rejected by the Commission.

First, with respect to the $250,000 "incremental commitment" related to the Gas Purchasing Plan Settlement, the Division contends that the "increased commitment was intended to be a contribution from shareholders," and therefore it should be eliminated from the cost of the IRP Programs (Exh. DIV-2, at 3). However, the inclusion of this amount in IRP Program expenses does not grant recovery to the Company. In fact, the inclusion of this item in this calculation is necessary for the very reason that the commitment of these funds reduced the Company's earnings during the term of ERI-2, and therefore, exclusion of these expenses from the calculation would have the effect of artificially inflating earnings beyond what the Company was able to realize.

Second, with respect to the claim of "double counting" of Low-Income Assistance Program costs, the Company provided the detail on monthly IRP Program expenses by month for the 21 months comprising the term of ERI-2 in response to data request COMM 1-10. As explained at the hearing, the Company divided the annual funding commitment by 12 months for the period October 2000 through September 2001, and by nine months for the period October 2001 through June 2002 (Tr. at 82-83). In each of those months, the Company recorded 1/12th or 1/9th of the annual funding commitment, respectively, matched the expense with the associated revenues recovered through the fixed cost component of the Company's rates on a uniform basis over the 21-month period (Data Request DIV 4-01).[7] In each of these periods, the Company recorded no more and no less than the funding committed under the ERI-2 Settlement Agreement.

For the purposes of calculating the return on equity, the Company testified that both the expenses and offsetting revenues for the two, 12-month periods of October 2000 through September 2001 and July 2001 through June 2002 are represented in the calculation. Because the periods overlap, the months of July, August and September 2001 are included in the calculation of return on equity in both measurement periods (id.). The Division's suggestion that revenues for this period should be increased by $362,000 per year to offset these alleged excess expenditures is misguided because revenues equal to the "double counted" expenses are already included in the calculation.[8] Accordingly, no adjustment is needed or warranted in relation to IRP Program funding commitments.

[7] Once recorded on the Company's books, these amounts represent a charge to the Company's earnings, even if the funds are not actually disbursed until a future period. See Data Request DIV 1-04.

[8] This claim of the Division is especially perplexing because then all expenses would be "double-counted" given the use of the overlapping periods to determine earnings. There would be no reason why only these expenses would be affected by the overlapping periods.

[9] Reference to the Company's representations on this issue is specifically noted in the Commission's order in Docket No. 2581, approving the ERI-2 Settlement Agreement. Although the Commission's approval was contigent upon a number of modifications to the Settlement Agreement, the Commission did not direct that the Settling Parties institute any changes in relation to the inclusion of actual cash expenditures (Dkt. 2581, at 18).

E. GROSS-UP OF EARNINGS

The Division claims that to the extent that the calculation of the return on earnings results in a return in excess of 10.7 percent, the revenues associated with that return should be "grossed-up" by a factor of 1.75. This calculation directly contradicts the plain language of the ERI-2 Settlement Agreement, which is very precise in terms of the calculation. This additional calculation is not established in either the ERI-2 Settlement Agreement or the Commission's order approving the ERI-2 Settlement Agreement. The ERI-2 Settlement Agreement specifically states that the earnings report will calculate the return on equity "using an average of the return on equity for the 2 twelve-month reporting periods: October 1, 2000 - September 30, 2001; and July 1, 2001 – June 30,2002" (Settlement Agreement at Paragraph I.2). The ERI-2 Settlement Agreement further states that any earnings in excess of 10.7% (as modified), excluding the Company's incentive portion of non-firm margins will be credit to the Deferred Revenue Account (id.). Thus, the provisions of the ERI-2 Settlement Agreement establish a two-step process, whereby (1) the return on equity is calculated for each of the two reporting periods and is averaged together; (2) earnings associated with a return on equity above 10.7% are subject to the sharing mechanism.

The Division claims that the "gross-up" is implied as a matter of "simple arithmetics." Exh. DIV-2, at 9. However, the test for the Commission in interpreting the terms of the Settlement Agreement is not whether "simple arithmetics" would require such a calculation, but rather, what the intent of the parties in relation to the claimed "gross-up." In that regard, the Division has offered not one piece of corroboration that the intent of the parties was to gross-up

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[10] At the hearing, the Division referenced the cover letter that accompanied the filing of the ERI-2 Settlement Agreement with the Commission noting that the accounting treatment for the fund was "designed to be consistent with the Commission's treatment of similar expenditures in the electric industry" (Tr. at 149-150). The Company agrees that, as stated in the filing cover letter, the intent of establishing the fund was to put in place a "mechanism to fund the recovery" of environmental costs that would be viewed favorably by the Commission in the next base-rate proceeding because of its consistency with the Commission's policy

the earnings using a multiplier, nor has the Division offered extrinsic evidence to that effect. In fact, the Company has offered testimony directly contradicting this claim. As a result, there is not substantial evidence upon which the Commission could conclude that the intent of the Settlement Agreement was to include such a calculation. Accordingly, the plain and precise language of the agreement should not be contravened to as to read in an intent to include an additional calculation.

IV. Conclusion

The design and intent of the return on equity calculation of the ERI-2 Settlement Agreement is to determine what the Company's earnings were in the 21-month period following the completion of the merger. Neither the ERI-2 Settlement Agreement, nor any other record evidence provided in this proceeding contradicts the stated intent to accurately report the earnings realized during the term of ERI-2, which followed the merger with Southern Union. Nor is there any record evidence indicating that the design or underlying intent of the return-on-equity calculation was to replicate ProvGas expenses in the absence of the merger. Based on these factors, as well as the evidence presented by the Company as discussed above, the Commission should: (1) allow the inclusion of actual cash expenditures for environmental remediation costs in the accumulated depreciation portion of the rate base calculation; (2) allow the inclusion of prepaid expenses in rate base; (3) apply the actual tax rate paid by Southern Union Company on the earnings produced by its Rhode Island operations; and (4) reject the Division's claims that revenues should be adjusted because IRP expenses have somehow been overstated in a manner different from all other expenses underlying the calculation. In addition, the Commission should dismiss the Division's claim that a "gross-up" of the earnings that it has

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decisions for the electric industry. This statement makes no reference to an agreement by the Company to incorporate the accounting treatment for the fund into the calculation of earnings under ERI-2.

calculated to be in excess of the allowed return on equity of 10.7 percent is intended by the terms of the Settlement Agreement.

Respectfully submitted,

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Dated: November 12, 2002

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