NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3548

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

SUPPLEMENTAL TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

OCTOBER 20, 2003

Q. Please state your name.

A. My name is David J. Effron. A statement of my experience and qualifications is included with my direct testimony filed on October 7, 2003.

Q. What is the purpose of your supplemental testimony?

A. As I stated in my initial direct testimony, there were still requests for information outstanding at the time of the preparation of that testimony. Therefore, the calculations of earned return on equity and over-earnings that I presented at that time were not final. The purpose of this supplemental testimony is to update the calculation of over-earnings based on responses to information requests received since the preparation of my initial direct testimony.

Q. Have you also prepared an exhibit to support your update to the calculation of over-earnings?

A. Yes. I have prepared an exhibit consisting of Schedules DJE-1S and DJE-2S. My proposed adjustments to operating income are summarized on Schedule DJE-2S, Page 2, and my adjustments to rate base are shown on Schedule DJE-2S, Page 3.

Q. Referring to Schedule DJE-2S, Page 2, what is the first adjustment, related to carrying costs on stored gas inventory?

A. The Company recovers carrying costs on its stored gas inventory through the GCR. In calculating its earned rate of return, the Company included the carrying costs on stored gas inventory in revenue and the stored gas inventory in rate base.

It is my understanding that the purpose of allowing recovery of carrying costs on stored gas inventory through the GCR carrying costs is to match the carrying costs to the actual balance of the investment in stored gas, as that balance can, and does, fluctuate from month to month. Including the carrying costs on stored gas inventory in revenue and the stored gas inventory in rate base for the purpose of calculating the earned return upsets this matching. To the extent that the quarterly average of stored gas inventory differs from the actual balances on which the carrying charges are calculated, there will be an excess or deficiency in the carrying costs, which affects the earned return. As the Company recovers the actual carrying charges on the stored gas inventory through the GCR, the determination of earned return should not be affected by the inclusion of stored gas inventory in rate base.

Accordingly, I have eliminated the carrying costs on stored gas inventory from revenue, and I have eliminated the stored gas inventory from rate base. The effect is to reduce revenue by $1,588,000 (Schedule DJE-2S, Page 2) and to reduce rate base by $15,296,000 (Schedule DJE-2S, Page 3). I would further note that this treatment is consistent with the determination of rate base in Docket No. 3401, which excluded stored gas inventory from rate base.

Q. What is the adjustment related to advertising and public relations?

A. The response to Division Information Request shows that the company paid $106,337 to RDW Group in Fiscal Year 2003 for “advertising and public relations.” It is my understanding that, except for certain narrow exceptions, the Company cannot include expenditures for advertising in its cost of service. The Company has not established that the payments to RDW Group are of the kind that would qualify for inclusion in the cost of service. Based on the description of these expenditures as “advertising and public relations”, they do not qualify. Therefore, until the Company can demonstrate that the payments to RDW group should be treated as utility operating expenses for the purpose of calculating the earned return, I have eliminate those expenses and reduced operation and maintenance expense by $106,000.

Q. What is your next adjustment on Schedule DJE-2S, Page 2, related to the accrual for incentive bonuses?

A. In Fiscal Year 2003, the Company accrued $372,000 for incentive compensation. Based on the Company’s description, the incentive compensation is based on a combination of shareholder goals, such as earnings, and customer goals, such as service quality. In this regard, the incentive compensation accrued in Fiscal Year 2003 appears to be similar to the executive incentive compensation addressed by the Commission in Docket No. 2286, although it is my understanding that Fiscal Year 2003 incentive compensation program was not for executive employees. In Docket No. 2286, the Commission disallowed some, but not all, of the executive compensation from the cost of service. Based on the Company’s description, I have eliminated 50%, or $186,000, of the accrual for incentive compensation from the operating expenses included in the calculation of the earned rate of return.

Q. What is the next adjustment, for the Southern Union officer and director incentive plan?

A. The Company includes a corporate allocation of expenses from its parent company, Southern Union, in operating expenses. One of the items included in the payroll related costs allocated from Southern Union to New England Gas is $244,000 for the "officer and director incentive plan." The Company has not described this plan. However, incentive compensation programs at the corporate parent company level are more likely to entail shareholder goals such as income or earned return than ratepayer goals such as customer service. Therefore, unless the Company can establish that the Southern Union officer and director incentive plan reflects ratepayer goals, the cost of the plan should be eliminated from operating expenses for the purpose of calculating the earned return. Accordingly, I have reduced operation and maintenance expenses by $244,000, to eliminate the cost of the Southern Union officer and director incentive plan.

Q. What are the miscellaneous interest expenses on Schedule DJE-2S, Page 2 that you are proposing to eliminate?

A. The Company has included certain "Other" interest expenses in the total of interest deducted from operating income in the calculation of net income. Some of this interest, such as interest on customer deposits, is an appropriate deduction. However, other items are not. For example, interest on late payments of Rhode Island Sales Tax and property taxes are not appropriate deductions. As far as I can determine, none of the three items of "Other" interest listed on Schedule DJE-2S, Page 2 have been included in the cost of service used to calculate the Company's base rates. Therefore, I have eliminated these three items, totaling $69,000, from the determination of net income.

Q. In response to Division Information Request 4-08, the Company presented a revised calculation to correct certain errors in the balance of accumulated deferred income taxes ("ADIT") deducted from rate base in its initial calculation of over-earnings. Have you incorporated the Company's revisions to the balance of ADIT into your calculation of the earned return?

A. No. The Company correctly notes that the balance of ADIT of $32,316,489 on Attachment RJR-1, Page 5 erroneously includes ADIT booked pursuant to SFAS 109 that were never reflected in rates. As the balance ADIT booked pursuant to SFAS 109 is offset by a regulatory asset, this balance should not be included in the ADIT deducted from rate base. Offsetting this error is the Company's failure to record any changes to the balance of ADIT since September 30, 2000. The Company corrected these errors by first eliminating the ADIT booked pursuant to SFAS 109 and by then increasing the balance of ADIT from September 30, 2000 to Fiscal Year 2003 based on the annual rate of increase used in Docket No. 3401. The net effect is to decrease the ADIT deducted from rate base by $2,975,000 and to increase rate base accordingly.

The increase to the ADIT based on the annual rate of increase used in Docket No. 3401 is inadequate. Bonus depreciation, enacted in 2002 for qualifying property acquired after September 10, 2001, was not available to the Company in the test year in Docket No. 3401. The first year tax deduction for such qualifying property is 30% of the cost of the property, well in excess of the tax depreciation previously available to the Company under the Modified Accelerated Cost Recovery System used for depreciable property. As the Company normalizes the difference between tax depreciation and book depreciation, the increase in available tax depreciation would lead to a significant increase in the balance of ADIT, well above what the annual increase would be in the absence of the bonus depreciation. I believe that the effect of the bonus depreciation could be to increase the balance of ADIT to approximately the level that is reflected on Attachment RJR-1, Page 5. Therefore, I have not incorporated the Company's revision to the balance of ADIT in the response to Division Information Request 4-08.

Q. Do you have anything to add on the topic of ADIT?

A. Yes. The Company has explained that the balance of ADIT has not changed since September 30, 2000 because the Southern Union accounting system does not track tax timing differences at the divisional level. This is improper. Deferred taxes on the difference between tax accelerated depreciation and book depreciation represent customer supplied funds that must be deducted from rate base. Southern Union should make whatever modifications to its accounting system are necessary to properly credit ratepayers for funds that they provide to the Company through the normalization of tax depreciation.

Q. Have you reviewed the Company's treatment of the ERI-2 refund in the calculation of its Fiscal Year 2003 earnings?

A. Yes. The Company booked the ERI-2 refund liability in Fiscal Year 2003. This had the effect of reducing the reported revenue on the Company's books of account. For the purpose of calculating the earned rate of return, the refund liability was reversed, so that the earnings were calculated exclusive of the effect of the ERI-2 refund liability. The Company has treated this item properly in the calculation of its earnings for Fiscal Year 2003.

Q. With the above changes to the net income available for common equity and the balance of common equity, what return on equity have you calculated for FY2003?

A. With the modifications described above, I have calculated that New England Gas Company earned a 15.93% return on common equity on its Rhode Island operations in FY 2003 (Schedule DJE-1S), as compared to the 15.08% return on common equity calculated by the Company.

Q. Have you also calculated the excess revenue based on this earned ROE?

A. Yes, I have calculated excess revenue of $5,212,000 on Schedule DJE-1S. As in my initial direct testimony, this calculation is in the same format as Appendix C to the Settlement. The excess revenue of $5,212,000 is $730,000 greater than the excess revenue of $4,482,000 calculated by the Company.

Q. Have you also calculated what the ESM Factor to be included in the DAC would be based on this level of excess earnings?

A. Yes. Based on sales of 348,924,990 therms, the ESM Factor included in the DAC would be $0.0149 per therm (Schedule DJE-1S), rather than the ESM Factor of $0.0128 per therm calculated by the Company.

Q. Does this conclude your supplemental testimony?

A. Yes.

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Schedule DJE-2S
Page 1

NEW ENGLAND GAS COMPANY
RESULTS OF OPERATIONS
YEAR ENDED JUNE 30, 2003
($000)

	(1) Company Position	Adjustments		Division Position
Revenue	$ 343,434	$ (1,588)	(2)	$ 341,846
Operation and Maintenance Expense	266,272	(536)	(2)	265,736
Depreciation and Amortization	20,165			20,165
Other Taxes	20,475			20,475
Income Taxes	9,288	(126)	(2)	9,162
Operating Expenses	316,200	(662)		315,538
Operating Income	27,234	(926)		26,308
Interest on Short-Term Debt	550	(36)		514
Interest on Long-Term Debt	9,105	(590)		8,515
Other Interest	504	(69)	(2)	435
AFUDC	(172)	-		(172)
Total Interest Expense	9,986	(695)		9,292
Net Income	17,248	(232)		17,016
Preferred Dividends	481	(31)		450
Net Income for Common Equity	$ 16,767	$ (201)		$ 16,566

Sources:

(1)	Attachment RJR-2, Page 2			
(2)	Schedule DJE-2S, Page 2			
(3)	Rate Base		$238,566	DJE-2S, Page 3
	Interest on Short-Term Debt	0.22%	514	DJE-2S, Page 4
	Interest on Long-Term Debt	3.57%	8,515	DJE-2S, Page 4
	Preferred Dividends	0.19%	450	DJE-2S, Page 4

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NEW ENGLAND GAS COMPANY
DIVISION ADJUSTMENTS TO INCOME
YEAR ENDED JUNE 30, 2003
($000)

Elimination of Carrying Costs on Gas Inventory from Margin		(1)	(1,588)
Advertising and Public Relations		(2)	106
Accrual for Incentive Bonus		(2)	186
SU Officer and Director Incentive Plan		(3)	244
Adjustment to Operation and Maintenance Expense			536
Miscellaneous Interest Expense			
RI Sales Tax Audit		(4)	20
Property Tax		(4)	18
Conservation Fund/Other		(4)	31
Total Miscellaneous Interest Expense			69
Income Taxes:			
Revenue		(5)	341,846
Operating Expenses other than Income Taxes		(5)	306,376
Interest		(5)	9,292
Taxable Income			26,178
Income Tax Expense	35%		9,162

Sources:
- (1) Response to DIV 1-07
- (2) Response to DIV 3-04
- (3) Response to DIV 3-06, Follow-up
- (4) Response to DIV 3-08
- (5) Schedule DJE-2S, Page 1

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Schedule DJE-2S
Page 3

NEW ENGLAND GAS COMPANY
RATE BASE
YEAR ENDED JUNE 30, 2003
($000)

	(1) Company Position	Adjustments		Division Position
Utility Plant in Service	$465,354			$465,354
Less- Reserve for Depreciation	(203,388)			(203,388)
Net Plant	$261,966			$261,966
Add:				
Materials & Supplies	1,498			1,498
Prepaid Expenses	3,191	(1,227)	(2)	1,964
Deferred Debits	2,940			2,940
Gas Inventories	15,296	(15,296)		-
Cash Working Capital	7,760			7,760
Deduct:				
Accumulated Deferred FIT	(32,316)			(32,316)
Accumulated Deferred ITC	(1,980)			(1,980)
Customer Deposits	(2,742)			(2,742)
Injury and Damages Reserve	(524)	-		(524)
Rate Base	$255,089	($16,523)		$238,566

Source:
(1) Attachment RJR-2, Page 5
(2) Response to DIV 1-14

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Schedule DJE-2S
Page 4

NEW ENGLAND GAS COMPANY
RATE OF RETURN

	Ratio	Cost Rate	Wtd. Cost
Short Term Debt	8.80%	2.45%	0.22%
Long Term Debt	45.70%	7.81%	3.57%
Preferred Stock	1.90%	9.93%	0.19%
Common Equity	43.60%	11.25%	4.91%
Total	100.00%		8.88%

Source: Settlement, Section II.F
Attachment RJR-2 for Short Term Debt Rate